



# **Effectiveness of the Measures for Introduction of Public Internal Financial Controls**



**The State Audit Office of Georgia**

**Performance Audit Report**

**2013**

# Contents

Executive Summary .....	4
1. Introduction .....	9
1.1 Background information and audit motivation.....	9
1.2 Audit objective and criteria.....	12
1.3 Audit scope and methodology.....	13
Audit findings .....	14
2. Quality of work carried out by the Internal Audit Units .....	14
2.1 The old approach has not changed .....	14
2.2 Internal audit reports fall short of International Audit Standards.....	15
2.3 Lack of adequate human resources affect Internal Audit Units .....	16
2.4 Trainings organized by the Harmonization Center are not sufficient.....	16
2.5 Ministries could not hire the competent staff in their Internal Audit Units .....	18
2.6. Conclusion:.....	18
3. Structure of Public Internal Financial Control in Georgia .....	19
3.1 Unclear distribution of responsibilities .....	20
3.2 The Ministry of Finance not in charge of the PIFC implementation:.....	20
3.3. Public Internal Financial Control structure contradicts with the accepted model:.....	21
3.4 Status of the CHU head not provided in the legislation: .....	23
3.5 Independence Issues: .....	24
3.6 Conclusions: .....	24
4. Support of the Public Internal Financial Control by Harmonization Center.....	25
4.1 The Harmonization Center can't manage the reform effectively .....	26
4.2 Overall planning of the PIFC. ....	28
4.3 International Cooperation.....	30
4.4 Conclusions: .....	31
OVERALL CONCLUSIONS .....	32

Recommendations:.....	34
Glossary .....	35

## Executive Summary

The State Audit Office carried out the performance audit on the effectiveness of the government measures aimed at introduction of the Public Internal Financial Controls for 2010-2012.

*Audit motive:* Development of Public Internal Financial Control system significantly improves public sector activities and management of its funds, which in turn, provides the Georgian citizens with the possibility to receive better public services for the taxpayers' money.

In addition, introduction of the Public Internal Financial Control is an obligation assumed by Georgia towards the European Commission in the framework of the European Neighborhood Policy and is one of the main conditions to harmonize Georgian public administration with the European Union standards.

The Parliament of Georgia underlined the importance of the Public Internal Financial Control by passing the law on the “State Internal Audit and Inspection<sup>1</sup>” in 2010, that laid the foundation for the introduction of the Internal Control. With this law, the ministries were required to create internal audit units within their organizations.

The State Audit Office, as a main watchdog for the rational spending of public funds, takes a special interest in the successful implementation of the reform.

Work carried out by the State Audit Office in recent years and information gathered from other sources indicates problems in the process of implementation of the reform.

*Audit objective:* To assess the progress of the Public Internal Financial Control reform and identify the problems hindering timely and full implementation: In this regard, the State Audit Office examined the measures taken by the government of Georgia, Ministry of Finance, Harmonization Center and other ministries in the implementation process.

The State Audit Office concluded that the implementation of the Public Internal financial Control reform is carried out with significant deficiencies. The Audit resulted in the following findings and recommendations:

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<sup>1</sup> By the amendment on December 9, 2011 the law on “State Internal Audit and Inspection” was formulated as the law on “Public Internal Financial Control”

## **Audit Findings**

### ***Internal audit reports are not in compliance with the International Standards of Auditing:***

Inspection approach is still widely used in the internal audit reports-the emphasis is put on the identification of the irregularities and delivering sanctions. This is largely due to the fact that the auditors do not possess necessary competence for the modern internal auditor.

### ***Insufficient training and inadequate recruitment practices:***

The Harmonization Center could not ensure the provision of sufficient and continuous trainings to develop professional skills of the internal auditors. Consequently, due to the lack of professional competence the Internal Audit Units are not capable of conducting the audits that would create an added value for the organizations and be compliant with the International Standards of Auditing.

In addition, the ministries have demonstrated insufficient initiative and failed to address their staffing problems – to recruit the experienced auditors by taking flexible approach and organize trainings by themselves.

Existing training and recruitment practice can't ensure the decent preparation for the traditional types of audit. In addition, preparation for IT, System and Performance Audit, that are expected to commence from 2013 according to the law on "Public Internal financial Control", in the audit period didn't take place.

***Public Internal Financial Control structure does not correspond to the model recommended by the European Commission:*** Existing legislation does not provide the organizational structure that will enable the Ministry of Finance to practically carry out the coordination function for the introduction of the Public Internal Financial Control assigned to it by the law.

This kind of organizational structure, where the Harmonization Center is created by the Government of Georgia and is accountable to it, does not correspond to the model of Public Financial Internal Control recommended by the European Commission. Such organizational structure is not conducive to the optimal distribution of duties and responsibilities, because the Ministry of Finance, as the main responsible body for the implementation of the reform, is not in charge of the process.

Harmonization Center is not a functional unit, as almost all of the duties and responsibilities assigned to it are carried out by the Secretariat created within the Harmonization Center. Also, the Harmonization Center has a conflict of interest, as the

Harmonization Center members (Council members) at the same time are the heads of the Internal Audit Units. Accordingly, these people are managing the process of introduction of the internal audit and monitoring, and also within their competence carry out the audits itself.

Functional independence of the Harmonization Center is restricted by staffing the Secretariat with employees of the Internal Audit Unit of the Ministry of Finance.

The position of Harmonization Center head is not assigned appropriate authority necessary to effectively discharge functions of coordination and harmonization of the Public Internal Financial Control reform as prescribed by the law. More specifically, Head of the Harmonization Center is not determined as a separate structural unit (position), where the person can be appointed by pre-determined term. Currently the role of the head of the Harmonization Center is taken up by the Minister of Finance. Also, the head of the Harmonization Center is not provided with the authority to assist Internal Audit Units in solving potential problems with their management.

***The independence of internal auditors is not assured by the mechanisms widely used in the international practice:*** The independence of the internal auditors is guaranteed by the Georgian legislation. One of the main factors affecting the independence of the internal auditors is methods of their appointment and dismissal, and appropriate definition of these methods is a safeguard for auditor's independence.

In this respect it is important, that the Georgian legislation takes into the consideration the best practice of the other countries and set the regulations so that the independence of the internal auditors is not affected by the procedure of their dismissal. In the countries with the better auditing practice, there are such mechanisms in place for safeguarding the internal auditor independence as rotation of the Certified Internal Auditors by pre-determined periods, agreeing the staffing issues with the Harmonization Center or Audit Committee.

***The Harmonization Center did not provide necessary support to the Internal Audit Units:***

Harmonization Center is experiencing lack of staff with sufficient knowledge and work experience. Under these circumstances it has proven difficult for the Harmonization Center to provide support to the Internal Audit Units by rational planning and providing quality methodological guidance.

Introduction of the Financial Management and Control component has not yet been started in the public sector. Without this component, it is impossible to fully introduce the Public Internal Financial Control. The separate unit within the Harmonization Center,

which according to the best international practice will be solely concentrated on the facilitation of the Financial Management and Control, has not yet been created.

Harmonization Center and ministries do not cooperate on the appropriate scale with international organizations, which have vast experience helping the countries in such a transition.

## **Recommendations**

### ***To the Ministry of Finance and Government:***

Ensure preparation and initiation of the legislative changes, in order to:

- ❖ Make the Harmonization Center accountable to the Minister of Finance
- ❖ Increase the functional ability of the Harmonization Center for it to become a permanent, independent and professional institution. In this regard, we recommend taking action in the following directions:
  - ✓ Eliminating the conflict of interest and restriction of functional independence, which is created by staffing the organizational structure of the Harmonization Unit (Council and Secretariat) with the employees of Internal Audit Units.
  - ✓ Appointing the head of the Harmonization Unit with appropriate term of tenure, and giving him/her relevant authority to effectively fulfill the Public Internal financial Control coordination and harmonization functions assigned by the law.
- ❖ To introduce internationally recognized practice that will safeguard the independence given to the Internal Audit Units by the law. Examples of such safeguards are the rotation of independent Certified Internal Auditors, increased authority of the Harmonization Center head in deciding on the staffing of the Internal Audit Units, or Audit Committee.

### ***To Harmonization Center:***

- ❖ Organize training courses tailored to the professional needs of the internal auditors (especially based on the new requirements of the law), that will be of continuous nature and have acknowledged certification of internal auditors as a final objective.
- ❖ Draft and refine and instructions and methodological documents - especially preparation of the instruction for Financial Management and Control in order to facilitate establishment of Financial Management and Control in practice.
- ❖ Take measures to raise own competence levels and actively use the channels of international cooperation, to successfully carry out its functions: namely, consider possibilities of cooperation with the international consultants, international organizations and other professional bodies.

*To Ministries:*

- ❖ Use flexible approach to recruit internal auditors possessing relevant competence and experience. Special attention has to be paid to the existence of the versatile knowledge base, which is especially important for conducting 3 new types of audit along the traditional ones at high quality according to the new requirement of the law.
- ❖ Ensure provision of opportunities for continuous professional development and high qualification of staff by organizing appropriate trainings, especially in those specific areas of ministry field of activities that won't be covered in the trainings provided by the Harmonization Center.

## 1. Introduction

### 1.1 Background information and audit motivation

#### *Public Internal Financial Control as integral part of Public Finance Management*

Significant progress has been made past decade on improving public financial systems in Georgia. This improvement has been largely related to the ongoing Public Finance Management reform (PFM), which is part of a broader European Neighborhood Policy and is aimed at harmonizing Georgian public administration to the European Union standards.

The main objectives of PFM reform are to maintain fiscal discipline and thereby facilitate macroeconomic stability of the budget system, to promote a strategic approach by ensuring that resources are directed toward key policy and strategy priorities, to deliver value for money by ensuring that resources are used effectively and efficiently, and to improve accountability in the use of public resources.

Support to the Public Finance Management reform has been high on the priority for both Government of Georgia and European Community. First agreement covered periods of 2007-2009 and was further extended for the periods covering 2011-2012 years. According to these agreements the Georgian side was to receive maximum amount of 26 million Euros for direct budget support and technical assistance. The cooperation in this respect is set to be carried on further.

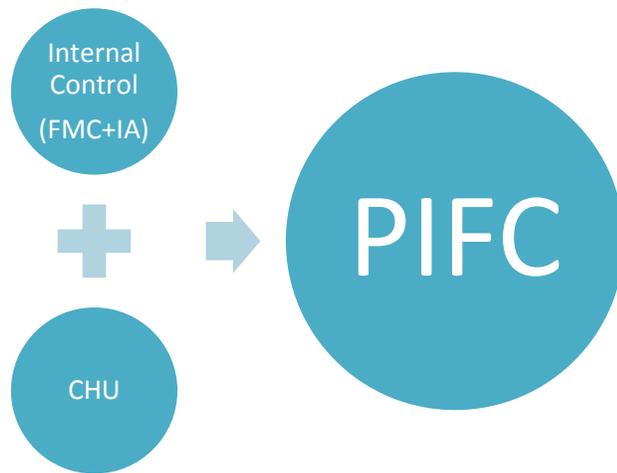
Strengthening of Public Internal Financial Controls has been one of the major components of the wider PFM reform. Public Internal Financial Control represents a structured model for guiding national governments in establishing modern control environment in their income and spending centers. Adequate system of Internal Control aims to give reasonable assurance that transactions comply with the principles of sound financial management, transparency, efficiency, effectiveness and economy, as well as with relevant legislation and budget descriptions.

European Commission has devised a concept of Public Internal Financial Control and produced a guideline document that sets its main principles. The document is designed to help the EU and EU Neighborhood Policy countries to establish relevant financial management systems. This guideline document was adopted by the Government of Georgia as a basis for its own Public Internal Financial Control Vision document produced in 2009.

In order to create legislative basis for the Public Internal Financial Controls, in March 2010 the Parliament passed a law on the “State Internal Audit and Inspection”. The State Audit Office, as an important stakeholder actively participated in the process of amending

the law, updated as “About Public Internal Financial Control” by the end of 2011 which resulted in bringing it closer to the PIFC requirements. According to the law, Central Harmonization Unit (Internal Audit Council with Secretariat) has been established along with internal audit units in 12 line ministries<sup>2</sup>.

The concept of Public Internal Financial Control (PIFC) consists of the following components:



**Internal Control** plays important role in organization, helping the management to achieve its strategic, operational, financial and compliance goals. Internal Control on the other hand, consists of Financial Management and Control (FMC) and Internal Audit (IA).

**Financial Management and Control (FMC)** - Management is responsible for establishing and adequate functioning of the Financial Management and Control. It provides reasonable assurance that resources are used in an optimal, effective way and according to the legislation.

**Internal Audit (IA)** - Aims to independently assess the Internal Control effectiveness and provide management with recommendations for its improvement. Internal audit is serving as an advisor to the management, facilitating the organization to successfully carry out its functions. It serves important preventive function, assisting to establish such governance that brings probability of human or systemic errors to the minimum, be the error deliberate or inadvertent. Internal audit fundamentally differs from the Inspection function, in that that its main goal is to add value for the organization by means of optimizing

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<sup>2</sup> According to the law, the Internal Audit Units must be created in Ministries(4 Ministries out of 16 are obliged to establish the Internal Audit Units before 2014), Ministries of Autonomous Republics, in the Legal Entities under the Public Law funded from the state budget and in the local self- government bodies by decision of the local councils

management processes and operations rather than to uncover violations that took place in the past and deliver sanctions. Well- functioning Internal Audit function is particularly important in the public sector, as management and administration of public funds requires high level of accountability and transparency to the society.

*The Central Harmonization Unit (CHU)*-Central Harmonization Unit is created as an independent body within the organization which is in charge of the Public Internal Financial Control introduction project. According to the Public Internal financial Control principles, such entity is Ministry of Finance. The Central Harmonization Unit is tasked with the coordination of the whole process, providing methodological support, training, guidance and monitoring.

### **Audit Motivation**

The decision of the Parliament of Georgia to introduce Public Internal Financial Controls is an important step towards establishing systemic approach to the public funds administration. This cross-government endeavor has a potential to significantly improve the management of public finances and should lead to the improved economy, efficiency and effectiveness in use of resources. The ultimate and most important outcome of the change project is better functioning public sector for the benefit of Georgian citizens.

### ***Objective of the ongoing reform***

Creation of the comprehensive and integral system of Internal Control and its appropriate legal regulation is of utmost importance, as it represents on one hand, effective mechanism of self-control for public entities and is facilitating the external audit work on the other. Internal Control in conjunction with External Audit forms an effective system for public fund management and monitoring.

With the ongoing Public Financial Management reform the Parliament of Georgia has set clear objective in relation to the improved government accountability and transparency on its expenditures. This was demonstrated by passing the law on the Public Internal Financial Control modeled on the PIFC concept, where the law foresaw the introduction of modern Internal Controls in public entities. Besides the creation of the appropriate institutional and organizational structure, the new approach implies to commence new, modern types of audit such as Performance, System and IT audits from 2013.

State Audit Office, as main watchdog for public finance expenditures, has a solid interest to support establishment of Internal Controls in the public sector. Interrelationship

of external and internal auditing is strong and full cooperation can benefit both sides. Thus the State Audit office is one of the main participants and stakeholders for the cross-government Public Internal Financial Control implementation effort.

### ***Indications of unfavorable developments***

In addition, implementation of the Public Financial Management reform and namely, Public Internal Financial Control is an obligation that Georgia has undertaken to European Community and is regularly assessed on its success.

In previous years, within the framework of its financial audits, the State Audit Office has been evaluating Internal Control function in the line ministries, pointing out material weakness of the Financial Management and Control and limited effectiveness of Internal Audit. This view concurs to the EC –commissioned assessment by international consultant, “Review of the implementation of PFM SPSP (Sector Policy Support Program)” assessment report.<sup>3</sup> The report noted that only “minimal progress” has been made in implementing Internal Audit and making basic arrangements for establishing Internal Control. However, a positive trend in the development of the Internal Control has been noted by the following mission of October, 2012 which stated that basic steps have been taken for the introduction of this component.

## **1.2 Audit objective and criteria**

Based on the factors listed above, the State Audit Office carried out the performance audit of the actions taken by the entities participating in introduction and establishment of Public Internal Financial Control. The aim of the audit was to assess the implementation of the reform according to the decision of the Parliament. In order to identify and address systemic deficiencies that hinder the effective implementation of the reform and come up with the recommendations that would address those deficiencies, the audit team sought to answer following questions:

1. To what extent does the work carried out by the Internal Audit Units meet the requirements of the International Standards of Auditing?
2. To what extent does the existing organizational structure for Public Internal Financial Control correspond to the European Commission recommended model?
3. Has the Harmonization Center achieved the objectives set by the legislation?

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<sup>3</sup> Review of the implementation of PFM SPSP , 21/06/2011

In recent years important reform has taken place within the State Audit Office, related to introduction of International Auditing Standards in its work and this institutional experience could be beneficial for the public entities in the complex process of modernization of their internal controls.

### ***Criteria used***

Audit criteria is derived from the Georgian law on the “Public Internal Financial Control”, Strategic Vision Document of PIFC by the government of Georgia, Public Internal Financial Control model of the European Commission, International Professional Practice Framework (IPPF) standards, “Internal Control guidelines in Public Sector” by the Organization of International Supreme Audit institutions (INTOSAI), other regulations and best international practice. These criteria will be further elaborated throughout the report in the course of answering the audit questions.

### **1.3 Audit scope and methodology**

Systemic approach has been adopted for conducting the audit, that implies examination of the actions taken by all relevant parties participating in the implementation of the Public Internal Financial Controls, as well as assessment of whole organizational structure, legislative basis and other relevant issues influencing the subject matter, as the introduction of the Public Internal Financial Controls, due to its wide scale and importance should not be seen as a sole responsibility of any given public entity.

The scope of the audit covers actions taken by the Government of Georgia, 12 ministries having established the Internal Audit Units and Harmonization Center designed to introduce the Public Internal Financial Control in the public sector.

The audit covers period from March 2010 to the end of June 2012. Those data and events that fall outside the audit scope are presented to facilitate the reader in better understanding the contents of the report and explain dynamics of the development of events.

Several methods have been used for conducting the audit. In order to process obtained data, the audit team used quantitative and qualitative analysis. Except the documentary analysis, the audit team conducted 9 interviews with the representatives of the Internal Audit Units, Harmonization Center and EU consultant.

The auditee was given the opportunity to check the text for the factual errors and provide their comments on the draft report.

***Audit limitation:*** Due to the fact that the Central Harmonization Unit (Legal Entity under the Public Law-National Center for Internal Control) was revoked, the audit team could not obtain detailed information related to the trainings conducted in 2010.

## **Audit findings**

### **2. Quality of work carried out by the Internal Audit Units**

While adopting the Strategic Vision document for Public Internal Financial Control, the Government aimed to “Establish in each ministry Internal Audit Units working according to the best international practice, in particular in compliance with the Standards of Institute of Internal Auditors<sup>4</sup>”.

The Institute of Internal Auditors is the most authoritative organization providing standards and guidance, as well as administering certification programs for the internal auditors worldwide. The International Professional Practice Framework<sup>5</sup> (IPPF) is a conceptual framework that organizes authoritative guidance promulgated by the Institute of Internal Auditors and breaks the guidance into the mandatory and strongly recommended guidance for professional practice.

The most important of the mandatory guidance is the International Standards for Professional Practice of Internal Auditing, which lists attribute and performance standards for the Internal Audit function. The attribute standards describe the attributes of the organizations and individuals performing internal auditing. The performance standards provide qualitative criteria against which performance of the Internal Audit Unit can be measured.

#### **2.1 The old approach has not changed**

According to the Law on Public Internal Financial Control the Internal Audit Units were created in 12 Ministries. Practically Internal Audit Units have been established on the

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<sup>4</sup> The government Strategic Vision Document of PIFC, page 19.

<sup>5</sup> The Institute of Internal Auditors issues widely accepted guidance principles for Internal Audit professionals, which is organized in the International Professional Practice Framework-IPPF. The framework consists of 3 mandatory parts: Code of Ethics, Definition of Internal Audit and International Standards of Professional Practice of Internal Audit(The Standards)

basis of the General Inspection Units that meant simply changing inspectorate charters without the accompanying training or re-education of the inspectorate employees.

The duties and tasks differ greatly between the inspectorate and auditors. The inspection function is very different from that of the audit, as the foremost is part of the managerial responsibility and is based on the ex-post examination of complaints or a set program while auditing is an independent assessment of the Financial Management and Control systems.

The main way how the Internal Audit Units can improve management and control processes is to produce competent, reliable reports and provide them to those charged with governance on a timely basis. These reports should independently assess the Internal Control components of an organization, take systemic approach and in nature be preventive, concentrating to put control measures in places with highest risk in order to avoid occurrence of irregularities.

Internal audit and inspection are not mutually exclusive and could exist at the same time in the organization. Currently ministries have discretion to define the place of the inspection function in the organization. From the Public Internal Financial Control perspective, it's necessary that these functions are clearly separated. This means the possibility of the Internal Audit and Inspection Units to exist with a precondition that they have clearly defined separate objectives and necessary staff to carry out own functions.

## **2.2 Internal audit reports fall short of International Audit Standards**

In order to assess the overall impact of the internal audit function as such, the audit team reviewed internal audit reports issued in 2010-2011 and first half of 2012 years<sup>6</sup>. In the audited period two types of internal audit reports were issued by the ministries - compliance and financial. These reports are basically unchanged from the previous revision - type examinations, concentrating on identification of the financial and legal violations and distributing punishment. They do not assess Internal Controls with a prospect of practical recommendations as how to make them more adequate.

As the internal audit reports still incorporate great deal of inspection techniques and approach, the added value for the improvement of management operations is insignificant. Adding value to the management operation is a primary requirement for internal auditing according to the IPPF Performance Standards. Over the audited period there is little tangible improvement in the quality of the internal audit reports in general.

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<sup>6</sup> See Annex

### **2.3 Lack of adequate human resources affect Internal Audit Units**

To produce internal audit reports of appropriate quality availability of competent and sufficient staff is a decisive factor. The IPPF lists the competence and continuous professional development as one of the basic attribute of the internal auditors.

According to the Public Internal Financial Control principles, it is not realistic to complement all the Internal Audit Units with Certified Internal Auditors on the initial stages, but the qualification of public internal auditor should not be granted on the basis of crash courses. The position of internal auditor should imply professional training and experience of at least 2 years<sup>7</sup>. This document also recommends that as a general rule, people from law enforcement backgrounds formerly employed in the General Inspectorate are less suited for the internal auditors' position, as their views are significantly different from modern audit approach.

To complement staff with required competence new employees can be recruited or existing ones given a comprehensive training. For recruitment and retention of experienced staff, the payroll expenses have to be optimized, enabling public entities to offer market based competitive salaries and compensation schemes to the auditors. One of the main functions of the Harmonization Center is to set minimum required qualifications for public internal auditors, carry out training needs assessment and act as a coordinator or supervisor of the establishment of sustainable training arrangements leading to the professional certification. In this process cooperation with the State Audit Office, local academic circles and professional private organization is advised.

According to the Harmonization Center survey<sup>8</sup>, about half of all internal auditors have not had any training at all or had training less than 5 days. Out of the 95 internal auditors currently employed in the line ministries, 37 have been former inspectorate employees. By the end of 2011, only 17 out of 92 have had more than 2 years' experience in auditing.

### **2.4 Trainings organized by the Harmonization Center are not sufficient**

Taking into the consideration the fact that profession of internal auditor is relatively new to Georgia, there is a shortage of experienced internal auditors on labor market. Consequently, in order to gain critical mass of the competent internal auditors, well organized trainings for the existing employees were necessary.

From the outset, Harmonization Center has not set minimum acceptable qualification and skills level for the internal auditors. Since the inception of the reform in 2009 till 2012

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<sup>7</sup> Welcome to the World of PIFC, European Commission, page 11

<sup>8</sup> CHU annual report 2011

the Harmonization Center organized 2 conferences and 1 training. First conference organized by Harmonization Center was prepared by the consultant and has been designed for senior representatives of the ministries. Second, two day conference was for inspectorate employees. The purpose of this conference was introduction of the law and Public Internal Financial Control principles as noted by the trainees in the interviews. The consultant gave another one day training course on risk assessment and strategic planning to internal auditors from the regional governments and ministries of Autonomous Governments of Georgia. The trainees thought the conferences and the training course was just a source of gathering information on general topics such as the law, Public Internal Financial Control and risk assessment.

Under the circumstances where the support from the Harmonization Center to broaden the knowledge of the staff was insufficient, the line ministries have shown little initiative for searching alternative ways to fill the education gap for their employees. One positive exception is the Ministry of Agriculture, whose training project for internal auditors has been funded by the USAID.

The pilot audits or practical on- the- job trainings yet have to take place to transfer practical knowledge and technical skills to the prospective internal auditors. Normally Harmonization Center can play a key role in organization of training activities, particularly in cases when finding quality training providers within the country is difficult. Under such circumstances the Harmonization Center, based on the economy of scale of the whole public sector and good international contacts, is in better position to find training providers on international stage more economically compared to the separate ministries.

By the end of 2011 the Harmonization Center has made agreement with the GIZ (German International Cooperation agency) in order to assist with the implementation of the Public Internal Financial Control reform. Within this cooperation, several trainings have been held by the international experts at the Financial Academy of Ministry of Finance.

The GIZ has assisted to provide the following trainings:

- ✓ Basics trainings in internal audit
- ✓ Training for trainers producing 4 Georgian trainers
- ✓ Training in risk assessment
- ✓ Training on fraud and corruption audit

These were short trainings aimed at transferring general knowledge and skills to the internal auditors, as many of them have not had any training until 2012 and aimed to build capacity by producing the first generation of the Georgian instructors.

As the Ministries are set to start conducting new, more challenging types of audit from the beginning of 2013, there is a need for the specific trainings in order to equip the

internal auditors with the skills to carry out the IT, System and Performance audits. The skills and knowledge required for each kind of audit is different but the internal audit units should collectively possess the ability to balance audit teams to carry out all types of audit required by the law at high quality according to the standards.

## **2.5 Ministries could not hire the competent staff in their Internal Audit Units**

Ministries are expected to make every reasonable effort to recruit staff with appropriate qualifications. In the audited period, they were not able to recruit at least one employee with modern audit knowledge, experience and technical skills in the Internal Audit Units. Benefits of having people of relevant competence in their Internal Audit Units could potentially far outweigh relatively high salaries required to recruit and retain such employees. The presence of the experienced internal auditor in the team/unit would have trickle-down effect and facilitate knowledge sharing within the Internal Audit Unit.

To recruit the right candidates with the appropriate skill and experience, the competitive remuneration package has to be offered based on the labor market rates. This may be higher than average salaries offered in the public sector for the same position.

Nonetheless, by means of optimizing the payroll fund and correct recruitment practices the public entities can recruit appropriate personnel with required skills and qualifications. Another important factor to take into the consideration while recruiting is to look for different knowledge base and experience of the auditors. Till now, the internal auditors have been conducting only financial and compliance audits that required knowledge of accounting standards and Georgian legislation. Currently, besides improvement of competence in traditional types of audit, with the requirement to commence new types of audit, the Internal Audit Units will require personnel of various knowledge base and experience, such as informational technologies, governance and risk management, skills for improving processes both in financial and operational areas, etc. In addition, knowledge of English language is very important as it will enable the auditors to keep abreast of the latest developments in the profession and draw on the Institute of Internal Auditors' resources before comprehensive material is created in Georgian.

## **2.6. Conclusion:**

Qualified staff within the Internal Audit Units is a key precondition for writing reports that are in line with the IIA and INTOSAI standards. The recent developments in 2012 with the commencement of training at the Academy of the Ministry of Finance and cooperation of the Harmonization Center with the GIZ can certainly be seen in a positive

light. However, in order to bring the financial and compliance audits closer to the international standards and to successfully respond to the imminent challenges presented by the introduction of the IT, Performance and System audits from 2013 much more intensive and specific trainings will be required.

Harmonization Center has to assume a key role in this process, ensuring sustainability and efficiency of the trainings that will ultimately lead the internal auditors to the acknowledged certifications.

If the line ministries are unable or reluctant to offer the competitive salaries based on the market conditions to the internal auditors, it is unlikely that the Internal Audit Units will manage to attract best available candidates for the position. This coupled with the insufficient training both in-house and on the central (Harmonization Center and Ministry of Finance) level will continue to affect the quality of the internal audit work of the line ministries. Without adopting their recruitment policy to the new challenges presented by the initiation of the new types of audit, requiring wide range of skills and background between the applicants, it will be hard for the line ministries to effectively address new requirements for internal audit function that came into force in 2013.

### **3. Structure of Public Internal Financial Control in Georgia**

The Public Internal Financial Control Structure in Georgia is mainly defined by the law on “Public Internal Financial Control” that foresees existence of the Harmonization Center. Harmonization Center is created by the Government decree and is accountable to the Government of Georgia. Composition, functions, and procedures of the Harmonization Center is defined by its charter. According to the charter, the Government defines who will be the members of the Council. Harmonization Center consists of the Minister of Finance, heads of the Internal Audit Units and other members.

Harmonization Center is named Internal Audit Council (the Council), where Secretariat is created to assist it with operations. The material-technical support of the Secretariat is provided by the Ministry of Finance, with the Minister of Finance complementing the Secretariat with Ministry of Finance employees and other members by the individual decree.

On the lower level, Internal Audit Units are located in 12 ministries (all but the exception of 4 Ministries) and other local and self-governing bodies. By legislation, they are independent and report directly to the heads of their organizations.

### 3.1 Unclear distribution of responsibilities

According to Public Internal Financial Control guidelines, the PIFC Policy document should set out main issues of the reform, such as: objectives of the reform, its main stages and deadlines, main stakeholders, entities responsible for the implementation of the PIFC, gap analysis and an action plan.

In the “Strategic Vision document of PIFC,” that serves as a policy document, the responsibility for the implementation of the reform is not clearly defined. In this document representatives of the ministries and local self-government declared their consent to the principles of the PIFC and confirmed their commitment to its implementation within their competencies. However, there is no mentioning as to which public entity is responsible and accountable body for overall implementation of the reform on the state level.

The law of Georgia on “Public Internal Financial Control” gives the Ministry of Finance the obligation for coordination and development of the Public Internal Financial Control. On the other hand, according to the same law, the participation of the Ministry of Finance in this process is limited only to staffing the Secretariat and providing material – technical support to it.

The fact that the practical function and role of the Ministry of Finance is not clearly formulated by the legislation has been further translated in the vague organizational structure, as it is shown in the following part of the report. In addition, concrete duties and responsibilities of line ministries and timescale for their action haven’t been determined.

### 3.2 The Ministry of Finance not in charge of the PIFC implementation:

Appropriate and clear distribution of the responsibilities at the top level of the management is an important pre-condition for the effective functioning of the public administration. As the implementation of the Public Internal Financial Control is a long and complicated process, the strong ownership from the central financial authority is crucial for the success of the reform. Ministry of Finance is at the heart of the implementation of the Public Financial Management reform and, consequently best placed to be in charge of introduction of the PIFC.

Normally, the Harmonization Center carries out the practical activities for introducing the Public Internal Financial Control in the public sector. Ministry of Finance on its part, is responsible for the overall state of public finances and consequently, has to monitor the Harmonization Center performance. Ministry of Finance has to regularly inform

the Government, Parliament and the State Audit Office on the state of the public finances in the country.

According to the Public internal Financial Control principles, the role of the government in the implementation of the reform is limited to the participation in the consultations and discussions with the Ministry of Finance. Reason for such participation is to discuss important issues and implementation of the agreed policy within their competence. From the previous experience, in the countries where the commitment to the PIFC by the Ministry of Finance has been insufficient, the reform had been seriously hindered.

By the existing legislation, the Harmonization Center is created by the Government of Georgia and is accountable to it. In practice, it means that the Government of Georgia is in charge of the implementation of the Public Internal Financial Control. Making the collective body-the Government of Georgia responsible for the implementation of the reform has significant drawbacks, as the introduction of the Public internal Financial Control is not a direct responsibility of the Government.

### **3.3. Public Internal Financial Control structure contradicts with the accepted model:**

According to the Public Internal Financial Control principles, Harmonization Center should be an entity that would independently organize and coordinate activities necessary for implementation of the reform, and report directly to the Minister of Finance. To ensure functional independence, it is emphasized that the Harmonization Center is not a part of the Internal Audit Unit of the Ministry of Finance, as it has completely different, wider objectives and responsibilities.

In the organizational structure currently in place in Georgia, Harmonization Center is not a separate, independent unit accountable to the Minister of Finance. The Harmonization Center is represented by Internal Audit Council (Council), with Secretariat within the Council. Internal Audit Council represents a decision-making body and its members convene several times a year. Minister of Finance chairs the Internal Audit Council. The Council primarily consists of the heads of the Internal Audit Units of the ministries.

According to the Public Internal Financial Control principles, positions of the Harmonization Center head and the Minister of Finance are clearly separated. In the audited period the regular activities of the Harmonization Center were carried out by 6 employees of the Secretariat. These employees at the same time worked in the Internal Audit Unit of the Ministry of Finance. Consequently, these employees do not have functional independence from the Ministry of Finance.

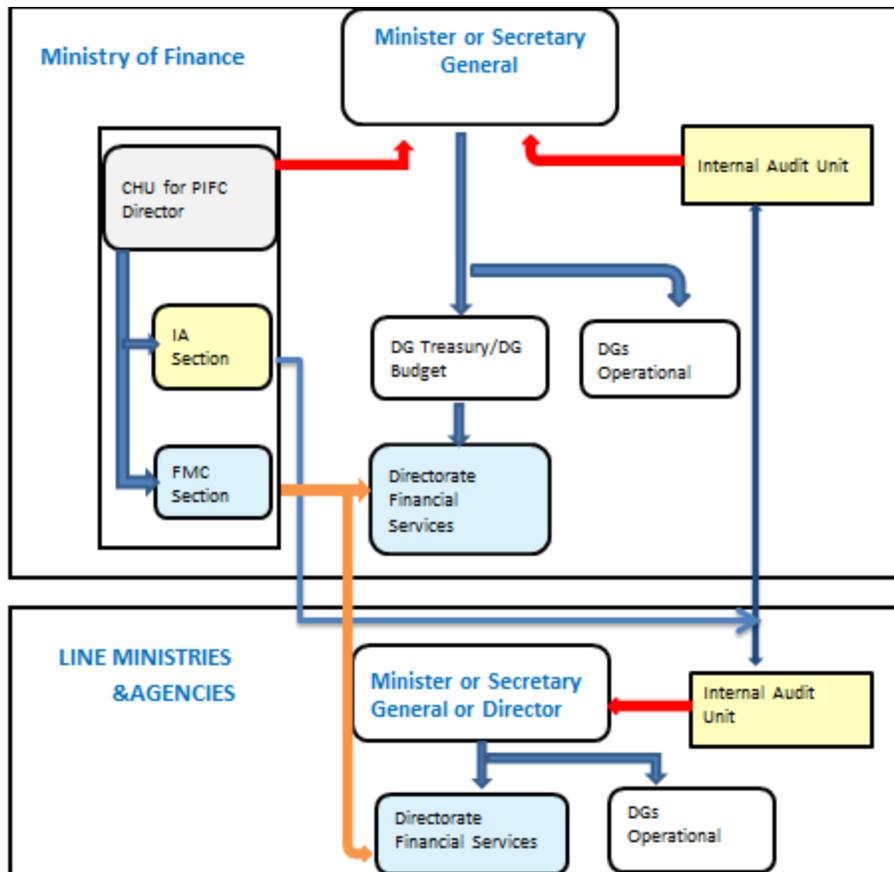
Such structure of the Harmonization Center can't ensure relevant organization due to the following reasons: by Law the Council, as a main component of the Harmonization Center, has a full responsibility for implementing the reform, whereas the Secretariat provides support to it. The existing Internal Audit Council, in its current form is not an efficient, well- functioning permanent entity with necessary competence. Practically almost all of the functions of the Council ascribed to it by the law are carried out by the Secretariat. In addition, as the Council is staffed with the heads of the Internal Audit Units, which are responsible for the internal audit functions in their respective ministries, the management and practical implementation of the reform is in the same hands. This creates a risk of the conflict of interest on the various stages of the Harmonization Center activities.

The Internal Audit Council is required to assess the work carried out by the internal audit units of the Ministries throughout the year and carry out monitoring. As the most of the Internal Audit Council members are the heads of the internal audit units of the line Ministries, they come to evaluate work conducted by their own respective units.

The current structure of Harmonization Center is different from organizational point of view as well: conventional Harmonization Centers have 2 units—one for Financial Management and Control and another for Internal Audit. Each part is responsible for its own direction and there is no overlap or interference in each other's activities. The part responsible for the development of FMC can be located under the budget directorate of treasury, as the treasury is the body issuing regulations regarding the FMC in the public sector, whereas the internal audit part has to be accountable directly to the Minister of Finance. Currently the Internal Audit Council is only concerned with Internal Audit activities. From the organizational point of view, there is no separate entity in the Harmonization Center dedicated to the introduction and facilitation of the Financial Management and Control in the public sector. The PIFC recommended model is given below<sup>9</sup>:

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<sup>9</sup> Robert de Koning, PIFC page. 170



### 3.4 Status of the CHU head not provided in the legislation:

According to the best international practice, the Harmonization Center head should be given a special status and authority provided for in the legislation. He or she should be free from political pressure, not subject to changes in the political landscape and serve as a guarantor of the long-term PIFC policies, because success will depend on the lasting commitment. In order to be a guarantor of consistency of the Public Internal Financial Control, the head of the Harmonization Center should be appointed with appropriate term.

Visibility is another important issue - Harmonization Center head should be regarded as Internal Auditor General, capable of resolving conflict of interest between auditors and their hierarchy and providing an opinion on nomination, transfer or dismissal of the internal audit staff. In addition, the head of the Internal Audit Unit should inform him/her about the instances when the head of the entity is blocking certain issues from the annual audit plan. In the Georgian legislation and current organizational structure, such authority and characteristics of the Harmonization Center head are not provided.

### 3.5 Independence Issues:

The independence of the internal audit function and its auditors is a single most important requirement of the International Standards for Internal Auditing. According to the law on the “Public Internal Financial Control” and standard internal audit charter, Internal Audit Units are independent entities created within the organizations reporting to the head of the organization (minister). Internal Audit Unit heads possess functional independence in devising, executing and reporting its own work as well as discretion in administrative matters, such as staff training arrangements, allocation of resources etc.

However, the head of the organization has the right over the appointment or dismissal of the head of the Internal Audit Units, as well as internal auditors. In the countries with the better PIFC and internal audit practices, the functional independence of the internal auditors is safeguarded in number of ways. For example Harmonization Center agreeing or in some instances even approving nomination or dismissal of the internal auditors. In other cases, the government creates a pool of the independent Certified Internal Auditors, from which they are selected to work in the designated ministries on the rotation basis for a given number of years.

Another popular solution is a creation of the audit boards/committees with an expert panel addressing the internal audit independence and quality issues in the public sector. The audit boards and committees function separately from the Central Harmonization Units (CHUs). CHUs have the technical capacities and responsibilities to develop the internal audit, whereas Audit Boards are high-level political sounding boards for providing advice to the Government and CHU. So the boards, provided they have a proper and balanced composition, should be capable to add value to the overall control environment.

### 3.6 Conclusions:

Current organizational structure creates ambiguity in the distribution of the responsibilities at the very top level of the reform management. The coordination function of the Ministry of Finance in the establishment of the Public Internal Financial Control provided by the law is limited by the fact that the Ministry of Finance does not possess effective tool for the coordination and monitoring of the reform. Making the Harmonization Center accountable to the Government reduces ability of the Ministry of Finance to be in charge of the reform and monitor its development.

By distancing the Ministry of Finance from its primary responsibility field such as the management of Public Internal Financial Controls and transferring it the Government, the ownership and effectiveness of the reform is reduced. The restriction to the Harmonization Center functional independence created by the Secretariat falling under the internal audit

unit of the Ministry of Finance impairs its independence to oversee the Internal Audit Unit of the Ministry.

The Internal Audit Council of the Harmonization Center has a limited ability to really lead the ongoing reform. Its irregular working schedule, consultative character, lack of competence and existing conflict of interest does not facilitate successful discharge of responsibilities as foreseen by the Public Internal Financial Control principles for the Harmonization Center.

Absence of the unit within the Harmonization Center, which would be concentrated on the introduction of the Financial Management and Control will hinder the implementation of this important component of the Internal Controls on all stages, from preparation of basic legislation through the practical implementation.

The fact that the head of the Harmonization Center is not provided with necessary authority by legislation and is not appointed with an appropriate term in order to strengthen his/her role as a guarantor of the stability and consistency of the reform, creates problems for the Harmonization Center to effectively run its operations.

For the effectiveness of the Internal Audit Unit work, it is fundamental that its independence is secured. Without the safeguards of its independence that can take different forms such as Central Harmonization Unit, Audit Boards or independent auditor rotation system, Internal Audit Unit independence can be weakened.

#### **4. Support of the Public Internal Financial Control by Harmonization Center**

The initial efforts to introduce the PIFC to Georgian public sector started since 2009, based on the results of Public Expenditure Framework Assessment (PEFA) that was carried out in 2007. Progress has been made among the most of the components that were included in the Public Finance Management reform agenda along the Internal Controls. However, progress is relatively small in the introduction of the Internal Controls. After three years since the adoption of the Strategic Vision of the Government on the PIFC in 2009, there is little indication that this component of the reform is being implemented in efficient manner.

The State Audit Office looked into the main pre-requisites that the key stakeholders in the process had to put in place in order to achieve desired results. These pre-requisites are:

- ✓ Creating functional Central Harmonization Unit
- ✓ Strategic and annual planning
- ✓ International cooperation

## 4.1 The Harmonization Center can't manage the reform effectively

### *Frequent organizational changes*

The Central Harmonization Unit is of such a decisive importance in the implementation of the Public Internal Financial Control reform that by definition it is the part of the PIFC itself. The Harmonization Center in Georgian public sector has undergone number of transformations: the very first CHU has been created in May 2009 by the Government decree “Financial Management and Control and Internal Audit Council-Harmonization Center”. The Harmonization Center consisted of 5 members of staff and its objective was to initiate changes for preparation of ground for the Public Internal financial Control reform.

It was succeeded by the Legal Entity of Public Law- “National Center of State Internal Control” (The Center) in April 2010. The Center employed approximately 25 people including administrative staff. Further, in November of 2011 after the abolishment of the Center new Central Harmonization Unit-Internal Audit Council has been formed.

### *Lack of expertise and practical experience in the Harmonization Center*

The Public Internal Financial Control document describes characteristics that the Harmonization Center should possess in order to be successful: First of all, head of Harmonization Center should be appointed a person with vast knowledge and experience in internal audit and proven track record in management of modern financial systems. This person should be functionally independent, only accountable directly to the Minister of Finance and free from other managerial responsibilities (except the Harmonization Center management). These characteristics are important because the Central Harmonization Unit head should be a driving force behind the reform and has to coordinate PIFC efforts across the government, providing training, methodological support to the Internal Audit Units.

As it has been mentioned in the 3.3-3.4 sections of the report, the position of Harmonization Center head as such is not defined in the legislation and consequently, Harmonization Center is not headed by person with described qualifications and experience. In case that person of such background is hard to find in the country, the PIFC foresees possibility of hiring an international consultant. In addition, Harmonization Center is lacking people with practical internal audit and managerial experience.

### ***Methodological Support to the Internal Audit Units:***

The Harmonization Center has provided 5 guidance documents for the Internal Audit Units to assist them with conducting audits according to the International Standards. These documents are:

- ✓ Internal audit methodology
- ✓ Code of ethics for internal auditors
- ✓ Guiding principles for internal auditors
- ✓ Internal audit standards
- ✓ Risk management manual in the public sector

Almost all manuals provided by the Harmonization Center needed several amendments till the final approval, as there was no quality control carried out from the relevant experts during their preparation.

The sequence of producing the methodology has not always been ideal. The risk management manual which is recommended by the PIFC to be produced one of the last, has been produced when there is no methodology for introduction of Internal Controls and consequently, no Internal Controls to use the risk management for. The concept of risk assessment and risk management has been one of the last to be developed under PIFC. The risk assessment and management approach presupposes that Internal Control systems work appropriately and are regularly assessed by internal auditor and audit recommendations are systematically followed up by management. Risk management must be underpinned by an integrated system of internal control and internal audit. PIFC recommends that adequate risk assessment and management can only be one of the last elements to be developed in the progress toward modern public Internal Control.

Several important pieces of legislation, such as FMC implementation instructions have yet to be produced.

### ***Adequate attention is not paid to the Financial Management and Control part of the Internal Controls :***

According to the principles of managerial accountability, organization management is responsible for establishing the FMC within the organization that adequately responds to the risks that the organization faces. Normally, the FMC is based on documented risk assessment procedures which are carried out by the organization management with the strategic objectives in mind. Within the Georgian public sector some elements of FMC do exist, that are required by the various laws and regulations governing the accounting and administration procedures.

However, the organizations differ from each other according to their mission, objectives, size, funding, environment, staff levels and other important criteria that require the organization management to take individual approach to tailor the FMC measures on their individual organization requirements. In this regard, the FMC measures in the public sector are fragmented and few are based on the comprehensive and documented risk assessment procedures.

Currently Harmonization Center activities are concerned with actions related to the development of internal audit function in the line ministries, whereas the FMC support is equally important. Without well-functioning FMC, organizations won't be able to reduce the risk of irregularities to the acceptable level and will miss out on the opportunity to significantly improve their operations. In this regard, since the initiation of the PIFC reform, the Harmonization Center only issued a risk management manual for public sector.

Under the current law, the government entities are required to establish their FMC systems according to the Georgian legislation only after the Harmonization Center produces instruction about FMC rules and procedures. The Harmonization Center has not yet produced the above mentioned instruction and currently its preparation is planned for 2013. However, has to be emphasized that to establish the FMC system only provision of instruction is not sufficient and with methodological support training of management and employees will be necessary.

#### **4.2 Overall planning of the PIFC.**

Appropriate planning is a key element of successful and timely implementation of the PIFC reform. The strategic and annual plans help parties involved in the reform to put the problem into the perspective and break them down according to annual plans, with milestones along the way. The planning facilitates setting objectives, identifying responsible bodies and allocation of needed resources. The plan needs updating with new developments and is a useful for benchmarking and evaluating achieved results.

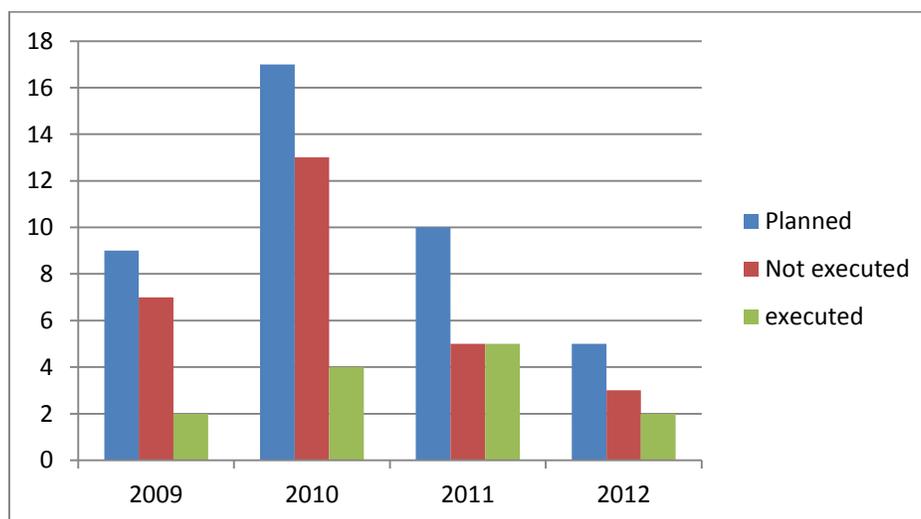
*2009* - After the Strategic Vision document of PIFC, the first action plan was prepared and finalized by the government. 2009 action plan was an attachment to the Strategic Vision document that consisted of those general operations that was supposed to be adopted by the CHU. Out of 9 activities from 2009 action plan 7 were carried over to the year of 2010.

*2010* Action plan - consists of 17 activities for the year 2010 and 13 out of those 17 either were carried over to the following years, were not implemented at all or require revision.

*2011* - Further, Harmonization Center produced another action plan with the assistance of Ministry of Finance in 2011, which has been amended twice within the year.

2011 (first version) action plan consists of fewer activities compared to the previous year but 4 out of the 6 activities were not implemented as of the first half of the year 2011. Those activities that were not implemented were trainings, pilot audits, risk management manual and adoption of unified form for Internal Audit Unit Annual Reports. However, in the first half of the 2011 Harmonization Center managed to revise Internal Audit Unit charters and discuss and review annual plans and strategic documents.

**Dynamics of the planned and executed tasks of the Harmonization Center for the years 2009-2012**



2011 (second version) action plan has adopted more activities by the second half of the year. Harmonization Center also produced Risk Management Manual by the end of the year and organized Council meetings, where Internal Control issues were discussed and approved by the members of the Council. Harmonization Center also developed an action plan for 2012 and 2013 with the support of GIZ. It consists developing better recruitment system in CHU and attracting qualified staff.

By these developments can be seen that at the original stages from the Harmonization Center and Government there was little preparation and understanding of the difficulty of the task at hand and the resources it required. This led to overly ambitious targets in the original stages of the planning. Consequently, the actions taken in order to implement the PIFC have been carried out with significant delays, some of them are still to be started.

The planning deficiencies resulted in the number of hold-ups and delays in the implementation. For example, Public Internal Financial Control document recommends that

the training for the management and internal auditors should start no later than when the Policy Document is adopted in order to raise awareness of the management of the Internal Controls and transfer practical auditing skills to the auditors.

After the adoption of the Policy Document in 2009, till 2012 there has been very few training activities. This resulted in the lack of capacity of the Internal Audit Units for this period and limited the success of the PIFC development. In the same line, the Internal Audit Units are required by the law to conduct system, IT and Performance Audits starting January 1, 2013. These Audits are far more complex than conventional audit types, require special skills and experience and as there has been no particular preparation for these specific tasks in the preceding years the capacity of Internal Audit Units to do this kind of work remains unclear.

#### 4.3 International Cooperation

The Public Internal Financial Control guideline document suggests that without the international help and cooperation it would be almost impossible to successfully introduce PIFC. Consultants, twinning partners, SIGMA, OECD World bank and other organizations have delivered valuable services to the countries initiating the change to the PIFC.

In addition, as the PIFC is a relatively new development, there is much to be gained from the exchange of knowledge and experience between the CHUs and external networking with the co-operation with the State Audit Office, the private internal audit organizations, professional audit and accountancy bodies and relevant academic niches inside the country as well as to international contacts.

At the initial stages of the reform the international consultant was involved in the framework of the "Support to the Ministry of Finance in Internal Audit" project, covering periods of March 1, 2010 to April 30 2011. This involvement was aimed to help the Ministry of Finance in taking first steps. Objective was to provide the basic legislation and manuals, set up a functional Central Harmonization Unit and to provide initial trainings.

In the report<sup>10</sup> provided at the conclusion of the timeframe provided by the project, the consultant provided an account where she described personal and organizational difficulties encountered in the process. It is clear from the report that the full cooperation between the parties did not take place and an opportunity to expedite the reform by getting most from the project has been missed.

Since the expiry of the project the Central Harmonization Unit has not drawn on any kind of support from the outside sources and during the period attempted to do things on its

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<sup>10</sup>Support to the Ministry of Finance in Internal Audit, 2011

own. Since the beginning of 2012 the GIZ undertook the obligation to assist the Harmonization Center and internal audit units by providing trainings in Georgia as well as organizing study tours abroad.

With the view of the task at hand - introduction of 3 challenging new types of audit from 2013 along the two already existing ones and taking into the consideration that the work on FMC part of the PIFC has not really started yet, the Harmonization Center needs to get as much competent help from the outside world as possible. This can take various forms, such as twinning, conducting pilot audit and etc.

Rational planning is necessary to avoid the duplication of the tasks already undertaken by the GIZ and other donors. Long period of time of time has been passed and the Harmonization Center and Ministry of Finance need to really make most of the available resources in international cooperation to expedite the process of implementation of the PIFC in Georgia.

#### **4.4 Conclusions:**

Lack of staff with appropriate knowledge and experience in the Internal Control is limiting the ability of the Harmonization Center to manage the ongoing Public Internal Financial Control reform in an efficient and timely manner. This issue is important as the Harmonization Center should act as a center of excellence in the field of the modern Internal Control system, providing needed guidance and consultation to the public entities.

Support with modern Internal Control methodology and correct organizational planning is key for the Public Internal Financial Control reform to be implemented in accordance with the international practice, in an effective way.

The Harmonization Center and public sector in general already have the experience as to what negative consequences unrealistic planning and shortage of qualified human resources could entail for achieving the set objectives. The full implementation of the Public Internal Financial Control is impossible without the introduction of the Financial Management and Control. As the law requires the public entities to start implementing the FMC only after the Harmonization Center issues instruction for establishing the Financial Management and Control, the non-existence of such an instruction can delay the implementation of core component of the PIFC.

Without the cooperation with international organizations which have vast experience in helping the countries in establishing the PIFC model and close ties with local professional and academic circles, the successful implementation of the reform can't be ensured.

## OVERALL CONCLUSIONS

The implementation of Public Internal Financial Control requires a significant commitment from the entire public sector during the whole process. In order for the reform to be successful, all levels of the public entities should be actively involved within their competence in the formulation of the state vision for the PIFC, and later on in its implementation.

It is very important that the Ministry of Finance, as an entity responsible for the reform, has the ability to effectively manage the reform by clearly articulated legal basis as well as by practical mechanisms.

Presence of the Harmonization Center under the Government creates unfavorable distribution of responsibilities, as under the conditions when by law the Ministry of Finance is responsible for the coordination and management of the reform, the actual implementing body of this reform-Harmonization center is created by and is accountable to the Government of Georgia.

Consultative nature of the Internal Audit Council, lack of competence and existence of the conflict of interest that is caused by presence of Internal Audit Unit heads in the Council impairs efficient organization of the Center and its effectiveness. In addition, functional independence of the Harmonization Center Secretariat is weakened by the employment of members of the Internal Audit Unit of Ministry of Finance.

With the current legislative and organizational system of the PIFC, which can't assure the internal audit independence in line with international practice, the independence of the internal auditors is not safeguarded.

The fact that the position of the Harmonization Center head is not defined by the legislation and he/she is not given the authority and characteristics that are prescribed by the PIFC principles, is negatively affecting his/her ability to successfully play a positive role in safeguarding the consistency and stability of the reform. This also impairs the Harmonization Center ability to assist the Internal Audit Units in resolving disagreements with their management.

The structure of the Harmonization Center, which does not have a separate unit that would be concentrated on the Financial Management and Control, limits the Harmonization Center's ability to successfully develop this component of Internal Control.

The beginning of trainings for the internal auditors by the Harmonization Center with international assistance from 2012 is a positive step for development of the internal

audit in the public sector. However, with trainings, which do not cover 3 new types of auditing and which is not leading to the recognized certification, it will be hard for internal auditors to conduct work corresponding to the international standard requirements.

The fact that the minimum qualification requirements are not defined for the potential internal auditors, can cause employment of the unqualified staff in the internal audit units that will affect the quality of work carried out by the Internal Audit Units and undermine their standing/prestige in the organization.

Until the Harmonization Center provides and Government approves the instruction “About the Rules and Procedures for Formulation of Financial Management and Control System” according to the law on “Public Internal Financial Control,” the public entities do not have the obligation of introducing such systems within their organizations, which hinders the introduction of one of the main components of the PIFC concept.

Based on the international experience, successful introduction of the PIFC is almost impossible without the qualified help from the external consultants and support from the international organizations with good background of assisting countries in the process of such reforms.

Without the ministries utilizing flexible approach in recruitment and offering remuneration package that corresponds to the market levels, they will not be able to attract most qualified internal auditors in the public sector. Meanwhile, traditional knowledge and experience base can't provide the skills necessary for the System, IT and performance Audits.

If the Ministries continue to have passive/neutral approach to the development of the internal auditing and will not provide own internal auditors with opportunities of continuous professional development, this will continue to negatively affect the quality of the work carried out by their Internal Audit Units.

## Recommendations:

### **Ministry of Finance and the Government of Georgia:**

To prepare and initiate the legislative changes, that will:

1. Make the role of the Ministry of Finance - main participant of the reform more concrete, clearly define its duties and responsibilities and make the Harmonization Center accountable to the Minister of Finance.
2. Improve the capability of the Harmonization Center, namely: Harmonization Center will be formed as an permanent, competent unit free from the conflict of interest and limitations of the functional independence, that are generated by:
  - A) Staffing the Internal Control Council by the heads of the Internal Audit Units and
  - B) Employing the staff from the Internal Audit Unit of Ministry of Finance in the Secretariat.
3. Create 2 units in the Harmonization Center, one responsible for the internal audit and other for the introduction of the Financial Management and Control in the public sector.
4. Practically implement the internationally accepted practice for safeguarding the independence of internal auditors granted to them by the legislation. Such practices include, among others increased authority of the head of the Harmonization Center in the staffing decisions of the Internal Audit Units, rotation system of the independent qualified internal auditors and an audit committee.
5. Ensure that the head of the Harmonization Center will be appointed with relevant period, made accountable directly to the Minister of Finance and be equipped with necessary duties and responsibilities that will facilitate the consistent implementation of the reform.

### ***Harmonization center:***

6. Determine and set the minimum acceptable level of qualification of the internal auditors and provide appropriate professional training courses tailored to the needs of internal auditors(especially in light of the new requirements of the law) that will carry continuous character, leading to the internationally accepted qualifications as an ultimate goal.
7. Ensure preparation, improvement and issue of the manuals and documents necessary for the introduction of the Internal Controls, especially preparation of the instruction

for the Financial Management and Control in order to start implementing it in practice.

8. Take action to improve own competence level and actively utilize channels for the international cooperation to ensure successful accomplishment of its functions, namely: consider possibilities of cooperation with the international consultants, other international and professional organizations.

***Ministries:***

9. To adopt flexible approach in order to recruit internal auditors with relevant skills and experience. Attention has to be paid to the issue of versatile knowledge base, becoming more relevant in light of the new requirements of the law - to conduct 3 new types of audit along with the existing ones with high quality.
10. Ensure the opportunities for the continuous professional development and required qualification by provision of the relevant training courses, especially in the fields specific to the Ministry activities and those areas that won't be covered by the trainings provided by the Harmonization Center.

## Glossary

**Internal Control-** The whole system of financial and other controls, including the organizational structure, methods, procedures and internal audit, established by management within its corporate goals, to assist in conducting the business of the audited entity in a regular, economic, efficient and effective manner

**Financial Management-** the set of responsibilities of the management (which is responsible for carrying out the tasks of government budget handling units) to establish and implement a set of rules aiming at an efficient, effective and economic use of available funds (comprising income, expenditure and assets). It refers to planning, budgeting, accounting, reporting and some form of ex-ante financial control. FM is subject to internal and external audit.

**Reasonable assurance-** Internal control, no matter how well designed and operated, can provide only reasonable assurance to management regarding the achievement of an entity's objectives. The likelihood of achievement is affected by limitations inherent in all internal control systems. These limitations may include faulty decision making with respect to the establishment or design of controls, the need to consider costs as well as benefits, management override, the defeat of controls through collusion and simple errors or mistakes.

**Ex-post-** When referring to audit, "ex post" usually means an audit performed after the initial legal commitment of a transaction. When referring to evaluation, "ex post" usually means an evaluation performed after the transaction has been fully completed.

**GIZ-** A federal agency that supports the German Government in achieving its objectives in the field of international cooperation for sustainable development. It is also engaged in international education work around the globe.

**Institute of Internal Auditors (IIA) -** The Institute of Internal Auditors was founded in 1941 and is an international professional association providing guidance materials, training, research etc. opportunities to members worldwide. The IIA is the internal audit profession's global voice, recognized authority, acknowledged leader, chief advocate, and principal educator.

**International Organization of Supreme Audit Institutions (INTOSAI)** - An international and independent body which aims at promoting the exchange of ideas and experience between Supreme Audit Institutions in the sphere of public financial Control.