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DAC Task Force on Donor Practices

FINANCIAL MANAGEMENT AND ACCOUNTABILITY SUB-GROUP

Conceptual framework for harmonization

DISCUSSION PAPER

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Background

1. OECD-DAC Members have set as a priority to help "build partner country capacities for effective public management so that [they] may better assume ownership of their own development process and implement their development programs".[1] Members have identified how "differing and complex procedures of donor agencies put a serious burden on partner country public management", including the different reporting and auditing requirements they must meet. Where many donors are involved, "these multiple procedures overstretch the public management capacity of partner countries and hinder efforts to strengthen fundamentally the basic elements of a sound public management system, such as financial accountability, effective co-ordination and efficient procurement." Excessively detailed donor financial controls and "ring-fenced" approaches to project implementation are not sustainable in the long run, further weaken government capacity, and add to transaction costs for both donors and partner countries.

2. The DAC has established a Task Force on Donor Practices whose objective is "to strengthen ownership through identifying and documenting donor practices which could cost-effectively reduce the burden on the capacities of partner countries to manage aid and lower the transaction costs involved." Financial management and accountability has been agreed as one of the three priority areas that the Task Force should address.[2] At its first meeting in May 2001, the financial management and accountability sub-group of the Task Force agreed that it should develop a conceptual framework for financial management harmonization that would guide the sub-group's work program and provide a reference point for individual DAC Members and other donors in considering possible changes to their own policies and procedures.

3. This paper sets out a suggested conceptual framework for discussion by the Donor Practices Task Force. It outlines the objectives of harmonization in financial management and accountability (paragraph 4) and suggests the broad scope of the harmonization effort (paragraphs 5 and 6). It identifies the key elements of a financial management framework that need to be in place for all forms of donor resource transfer (paragraphs 7 through 13). It examines the role of standards in supporting financial management harmonization (paragraph 14) and looks at some procedural issues that can enhance the prospects for success in harmonizing financial management practices (paragraph 15). Finally, the paper suggests number of questions that members of the Task Force may wish to consider at its next meeting on November 7 through 9, 2001 (paragraph 16).

Objectives.

4. The objectives of harmonization of donor practices in financial management and accountability are as follows:

- To provide better assurance to developing countries and external partners that development cooperation resources are used for agreed purposes. Ensuring that resources are used appropriately is both a necessary condition for the effectiveness of development cooperation and a core fiduciary

1 *DAC Task Force on Donor Practices – Terms of Reference* 12 April 2001. Ref. DCD/DAC/TFDP(2001)1

2 The other two groups are examining the pre-implementation phase of the project and program cycle, and reporting and monitoring of projects and programs

responsibility of both developing country governments and external partners with respect to the use of public funds.

- By making the country's development programs and institutions the focal point of donor efforts, to support the country's leadership of the overall development process, help build sustainable capacity in the management of all public finances (including those provided by donors), and strengthen partnerships between developing countries and external partners.
- To reduce the transaction costs of development cooperation to both developing countries and their external partners.

Scope of financial management and accountability.

5. There is no single agreed definition of public financial management and accountability. At its broadest, it covers the entire legal and institutional framework for the management of public finances in a country.[3] The breadth of the subject matter has led to specialization among international organization and donors—some take the lead on certain aspects of public finances (e.g., the IMF on monetary policy and foreign exchange management), while others have specialized departments that address certain sectors (e.g., state-owned enterprises), cross-cutting themes (e.g., governance), or overall country macro-economic performance. Individual donors will focus on different dimensions of financial management from one country to another, reflecting differences in their overall country support strategy.

6. All areas of financial accountability can impact the effectiveness of development cooperation. To meet the Task Force target date of December 2002, the sub-group proposes to give priority to budget preparation and execution, reporting and auditing.[4] The approach to these priority areas will be shaped by the country's overall poverty reduction strategy,[5] and will take into account its broader governance and financial accountability environment.[6] Strategies in individual countries will reflect issues such as the level of government (federal, state or local), the geographic region, the sector, and the implementing entity to which support is to be provided. These issues will also influence the choice of resource transfer instrument. For this purpose, three broad types of instrument have been identified—the traditional project-based model, general untied budget support to federal or state governments, and an intermediate form of transfer broadly focused around sector programs.

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3 It encompasses not only central government (itself large and complex in most countries) but also lower tiers of government, the activities of state enterprises, and extra-budgetary funds. It includes the collection of taxes, duties and other revenues as well as the management of public expenditure, including public procurement. It also includes complex areas such as revenues from privatization, minerals and oil, the management of public debt and guarantees, and the foreign exchange regime.

4 Because most donors have separate specialized units that deal with procurement, the sub-group will not specifically address the issue of public procurement. However, DAC Members recognize the need for, and commit to, very close collaboration between financial management and procurement activities in their aid programs.

5 The strategy will normally be set out in a Poverty Reduction Strategy Paper or similar document.

6 This broader environment includes the political and administrative accountability framework within which public finances are managed, as well as the comprehensiveness, clarity, transparency, and predictability of the management of public expenditure.

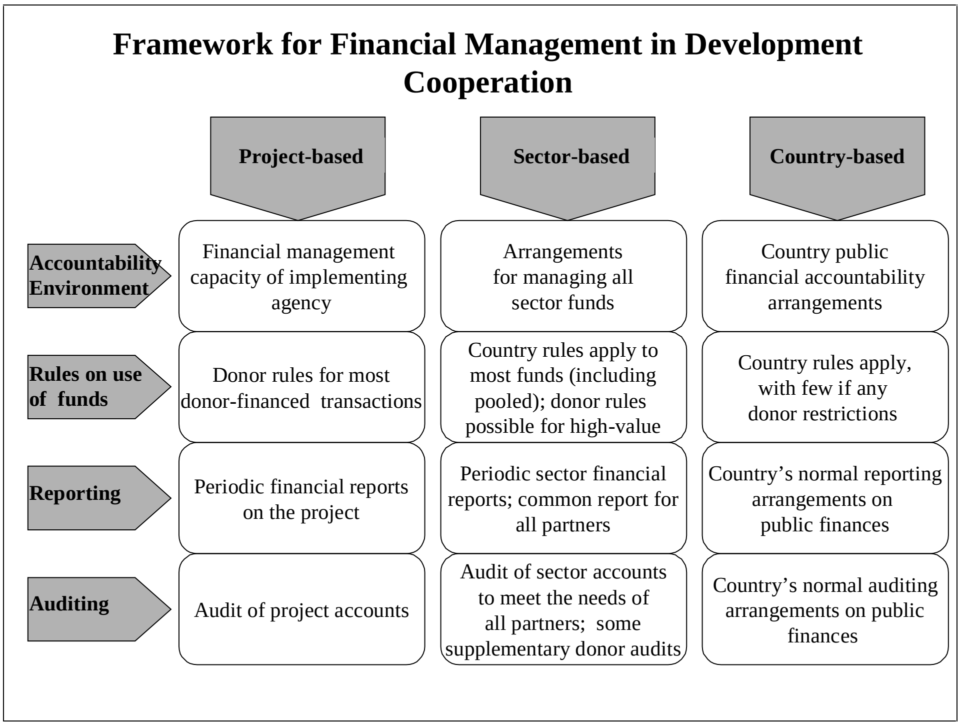
Overall Framework.

7. For each form of resource transfer, donors need to be able to answer four broad questions:

- What is the *financial accountability environment* into which resource transfers are planned?
- What are the *rules* that will govern the use of these resources?
- What *reports* should be provided to donors on the use of resources?
- What *ex-post verification* is needed that the rules have been followed and that the reports provided are reliable?

8. Each of these questions is considered more fully in the following paragraphs. Figure 1 provides an outline graphic representation of the framework.

Figure 1



Financial accountability environment.

9. A sound knowledge of the financial accountability environment into which resource transfers are planned supports informed decision-making by developing countries and external partners on whether and how to proceed with development projects and programs. This knowledge can be acquired from several sources. In recent years, a more systematic approach has emerged through the use of diagnostic assessments and reviews. The scope of these reviews reflects the nature and level of planned development cooperation—for general budget support, the overall country financial accountability arrangements would normally be examined; in the case of a sector program, the focus would be on the sector concerned (recognizing that sector performance is affected by the overall country accountability environment); and for individual projects, the entity or entities with responsibility for implementation. By helping to identify

risks, these reviews allow external partners and developing countries to adapt development cooperation programs accordingly and to design risk mitigation measures. In planning any diagnostic work, external partners will first take into account the availability of all or part of this information within developing countries.[7]

10. Collaboration between developing countries and external partners in carrying out these reviews offers several advantages: (a) it builds a common understanding of the development cooperation environment, thus enhancing the prospects of consistent, cost-effective approaches to obtain the assurance needed on the use of resources, mitigate risk, and support capacity building programs; (b) it supports an increased focus on developing country systems; and (c) costs are reduced when reviews are carried out jointly and the results are shared with developing countries and their external partners. There are few if any policy obstacles to greater collaboration among developing countries and external partners in carrying out and sharing the results of diagnostic reviews, suggesting that this be a priority area for harmonization efforts.

Rules governing the use of donor resources.

11. There are two broad categories of rules that apply to development cooperation resources: those that developing countries commit to follow in managing the funds provided, and those that define oversight by external partners on the use of those funds. Each donor has its own set of rules[8] on what comprises eligible expenditure, how that expenditure will be committed (e.g., the procurement procedures to be used), and how the funds will be disbursed once committed. The diversity of rules among external partners is often rooted in national legislation or the legal founding documents of the donor concerned. In general, donor rules tend to be specified in greater detail where discrete activities are financed (typically found in project-based models of resource transfer) and for technical assistance. Donors place greater reliance on the country's rules when resources provided are not tied to financing specific transactions (e.g., through budget support, adjustment lending, and debt relief) and in sector programs. Many donors use value thresholds to define the rules that apply (e.g., relying on the use of partner country procedures for transactions below a certain value).

12. In recent years, the proportion of aggregate resource transfers not tied to financing specific transactions has increased. This area may be a priority objective of the harmonization effort for donors for the following reasons: (a) its growing importance as a form of resource transfer; (b) the fact that individual donor procedures tend to be more broadly defined, suggesting that there may be fewer obstacles to harmonization; (c) the importance of the performance of developing country institutions (a key objective of the Task Force) to the assurance needed by external partners on the use of these forms of funds; and (d) the potential for a common framework of rules (sometimes known as "standards" or "good practices") to emerge to which all developing countries and external partners can subscribe. On the other hand, developing countries see simplification and harmonization of costly donor rules for project-based resource transfer as a priority. The challenge in financial management harmonization is to seek convergence towards a common set of practices that meet the objectives of developing countries and

[7] Sources of information in developing countries include published financial reports of the government, reports of the supreme audit institution, debates in parliament and its committees, academic research, and the media.

[8] "Rules" is used in a broad sense here to include the policies, procedures, regulations, standards, guidelines and codes that govern how donors make funds available.

external partners, while permitting those external partners who wish to remain with their current practices to continue to support country-led development programs.

Reporting on the use of resources.

13. The multiple reporting and auditing requirements of individual external partners has been identified as a significant burden on developing countries, exacerbating for many their already weak capacity in this area. The challenge is to find solutions whereby external partners receive the information they need in a way that will build sustainable financial management capacity, improve the overall quality of reporting on all public finances, and reduce costs to both developing countries and external partners. Donors could advance these objectives by committing to (a) making developing country systems, and the reports they produce, the primary focus of their reporting requirements; (b) committing to support improved financial reporting systems in those areas (project, sector, region or country) in which they provide support; (c) committing to make information on donor flows available to developing countries to allow them to be appropriately reflected in their financial reports; (d) striving, as far as possible, to align reporting requirements with developing country reporting periods, currencies and formats, and to agree on common reports for all donors; and (e) agreeing that information needs of donors not met by regular developing country reports should be provided by means of reports or schedules that are supplemental to the country's normal reports rather than through parallel reporting systems.

Ex-post verification.

14. Donors, in common with the public in developing countries, require assurance on compliance with the rules governing the use of resources and on the accuracy of financial reports. This assurance is normally provided by audits. Donors can advance the goals of harmonization in financial management by (a) seeking to agree, where appropriate, on a common scope of audit work and on the qualification criteria for acceptable auditors; (b) striving, where appropriate, for a single audit to meet the needs of all donors; (c) improving the coordination between financial audits and other special reviews (in particular ex-post procurement reviews); (d) seeking to build in-country audit capacity where weaknesses have been noted; and (e) agreeing that additional audit needs of donors should be provided through audit reviews that are supplemental to, rather than duplicating, the audit of the developing country's own reports.

The role of standards, guidelines and codes.

15. Each developing country has its own legal requirements, policies, procedures and regulations on the use of public funds. Similarly, each external partners has a set of rules governing how the development assistance it provides is to used and accounted for. While there are broad similarities among external partner requirements, their multiplicity and diversity adds substantial costs to developing countries and the donor community alike. At the global level, a broad range of standards, guidelines and codes that cover many of the features of financial accountability found in developing country and external partner frameworks alike have been developed by standard-setting organizations.[9] These standards, guidelines and

[9] Among these are the International Public Sector Accounting Standards issued by the Public Sector Committee of International Federation of Accountants (www.ifac.org), private sector International Accounting Standards issued by the International Accounting Standards Board (www.iasb.org.uk), the International Standards of Auditing issued by the International Federation of Accountants (www.ifac.org), public sector auditing standards issued by

codes can play an important role in supporting harmonization by providing an internationally-recognized body of recommended practices to which all developing countries and external partners can subscribe as a common underpinning for their programs. Indeed, it is difficult to see how external partners can move away from their current individual practices—and thus how harmonization can succeed—in the absence of an agreed framework of rules that they can support. However, before these standards, guidelines and codes can be accepted as an underpinning for harmonization, a number of questions need to be addressed:

- Do the standards, guidelines and codes have legitimacy? Have developing countries been sufficiently involved in their preparation? Are they sufficiently robust to be applicable in the weak capacity environments of many developing countries?
- Is the current standards framework complete and up-to-date? If not, what steps are being taken, or need to be taken, to address them?
- How should donors operationalize the standards, guidelines and codes?

Going forward.

16. This note attempts to outline a conceptual framework for the harmonization of donor practices in financial management and accountability. But the objectives set by the group will only be achieved when more effective partnerships and procedures are applied on-the-ground in individual projects and programs that support country-led poverty reduction strategies. Success depends on many factors. The overall harmonization vision needs to be actively communicated in ways that demonstrate its benefits while showing that risks posed by changes introduced can be prudently managed. The involvement of representatives of partner countries in the process is essential. Members are encouraged to document and share good practice examples of collaboration with their staff in each country. Information technology can be harnessed to improve donor collaboration, advance harmonization in financial management, and enhance development outcomes. Specifically, harmonization web-sites can assist by facilitating dialogue and the exchange of ideas, common approaches and good practices. Collaboration is needed with other harmonization groups, especially the MDB financial management working group, the SPA work in financial management and, in due course, all UN agencies to avoid divergent outcomes. And each external partner will need to address the "governance" implications of the harmonization process on its ability to set its own policies and procedures in financial management going forward.

Issues for Discussion.

17. The Task Force may wish to discuss the following questions:

- Do members agree on the objectives for financial management harmonization set out in the paper?
- What are the views of members on the scope of the paper? Do members feel that it strikes an appropriate balance between positioning financial management in a broader governance and accountability context and the need to focus on tangible areas in which the group can make progress by the scheduled end of the task force's work in December 2002? The paper suggests that the main focus should be on budget preparation and execution, reporting and auditing. Do members agree that the important areas of procurement and value-for money auditing should be handled in other DAC fora? Do members agree that the management of public revenues should be considered as a possible subsequent work area?

INTOSAI (www.intosai.org), and the IMF's Code on Fiscal Transparency (http://www.imf.org/external/np/fad/trans/index.htm).

- Do members agree that the four broad issues identified—understanding the accountability environment, rules on use of funds, reporting and auditing—are the main elements of a financial management framework?
- What are members views on the priorities for future action by the group?
- Do members agree with the need to strive for a common set of practices—variously known as standards, guidelines, codes, and good practices—to underpin financial management harmonization efforts?

October 31, 2001