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Public Financial Management



CENTRE FOR INTEGRITY
IN THE DEFENCE SECTOR



Norwegian Ministry
of Defence

CENTRE FOR INTEGRITY IN THE DEFENCE SECTOR

The Centre for Integrity in the Defence Sector (CIDS) is promoting integrity, anti-corruption measures and good governance in the defence sector. Working with Norwegian and international partners, the centre seeks to build competence, raise awareness and provide practical means to reduce risks of corruption. CIDS was established by the Norwegian Ministry of Defence in 2012.

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FOREWORD

The primary objective of the Centre for Integrity in the Defence Sector's Guides to Good Governance (GGGs) is to present key issues that are of relevance to the field of 'good governance'. The guides are usually brief, at the same time they do not overly simplify matters.

In this seventh GGG, the authors introduce civil servants and armed forces staff to the concept of public financial management (PFM). The guide explains the meaning and role of PFM, analyses key actors and explains the different phases of the financial management process. A special focus is on budget preparation, execution and oversight. In the fourth part of the guide, the authors explain the unique characteristics of classified budgets.

The guide is written by Aleksandra Rabrenovic and Jelena Kostic, both research fellows of the Institute of Comparative Law in Belgrade. I would like to thank the authors for their contribution to a fundamental aspect of good governance. Public confidence in how public

resources are managed is vital for a well-functioning democracy.

I would like to thank the Centre's editor, Bård Bredrup Knutsen, and our publications co-ordinator Åse Marie Fossum for their contributions to this guide.

The Centre hopes that this GGG will be utilized by a broad audience, not only within the defence-, and public sector, but also by citizens at large as it is the taxpayers who should hold the Government accountable for how the public resources are allocated and spent.

CIDS is happy to receive feedback to the guide.

Oslo, 22. May 2018



Per Christensen

Director

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1. Introduction

This guide has been prepared for civil servants and armed forces staff of ministries of defence seeking to acquire or deepen their knowledge of public financial management (PFM). It caters to the needs of newcomers in the field who want to familiarise themselves with PFM concepts, as well as financial officers who want to broaden their PFM expertise. The guide, however, may be used by other civil servants who have an interest in public finance management issues.

The paper is divided into four main parts. The first part provides an overview of the meaning and role of public financial management and explains the concept of budget and key budget principles. The second part analyses the key actors in public financial management. It highlights the specific roles of the executive, parliament and supreme audit institutions in the budget cycle. The third part sheds light on the separate phases of budget management, with a special focus on budget preparation, execution and oversight, while the fourth part discusses the special characteristics of classified budgets.

1.1 MEANING AND ROLE OF PUBLIC FINANCIAL MANAGEMENT

Public financial management is a comprehensive area encountered by most civil servants and armed forces staff at some point in their career. When a member of staff participates in the preparation of the budget of a programme, proposes a purchase order, reviews an expenditure report, or prepares a document for internal or external audit scrutiny, he/she undertakes a step in the public financial management process.

From a finance professional's point of view, public financial management includes several broad activities: mobilisation of revenue, allocation of raised funds to various activities and accounting for appropriated funds. In this paper, we will not deal with revenue management, which is an important element of the PFM system, as it requires extensive analysis in its own right.¹ We will, instead, deal with the second and third activities:

- the allocation of raised funds to various activities, which includes expenditure planning, approval and execution, and
- accounting for appropriated funds.

The various public finance processes are structured around the budget cycle. This annual cycle aims to ensure that public expenditure is well planned, approved, executed and accounted for.

The budget cycle is an important part of the public financial management, which aims to ensure that public expenditure is well planned, approved, executed and accounted for.

1.2. BUDGET AND PRINCIPLES

The budget is a central policy document of governance. Although to an outside observer, a budget may be viewed as a technical illustration of various financial numbers, it is actually much more than that. In a democracy, the budget is a government's response to citizens' needs and priorities. These needs are articulated into policy objectives, which may be qualitative (for example, increasing the security capacity of the country), or quantitative (for example, correcting market imbalances). Most policy objectives require public financial resources, which can come only in the form of taxes and fees. As these resources are limited, the expenditure side of the budget shows how the government plans to prioritise and resource the achievement of its annual and multi-annual objectives through investing public resources.

National practices on budgeting vary widely across countries in light of distinct political, legal, constitutional, institutional and cultural practices. It is appropriate for countries to determine and manage their national frameworks in light of such country-specific circumstances, while giving due respect to certain higher-level budgetary principles and guidelines.

A state budget management framework is usually regulated by substantive budget legislation, which may be called "an organic budget law". An organic budget law regulates all the phases of the budget process, starting from its drafting through approval, execution and over-

¹ It is important to keep in mind that revenue management interacts closely with expenditure management, particularly when determining the overall budget and when managing in-year cash flow.

sight. It also includes key budget management principles.

The preparation and execution of the budget should be based on internationally agreed budget principles. These principles provide an overview of best international practices and can serve as a guidance in all the phases of the budget cycle – in this booklet we especially focus on the security sector.

BUDGET PRINCIPLES WITH A SPECIAL FOCUS ON THE SECURITY SECTOR

1. **Prior authorisation** – *The parliament should authorise the executive to carry out expenditure.*
2. **Unity** – *All expenditure and revenue should be presented to parliament in one single consolidated budget document.*
3. **Periodicity** – *The executive is expected to adhere to a regular time-frame for presenting the budget every year to the parliament. Periodicity also involves the need for specifying the time-frame during which the money allocations will be spent.*
4. **Specificity** – *The number and descriptions of every budget item should result in a clear overview of the government's expenditure. Therefore, the description of the budget items should not be vague and the funds related to a budget item should not be too large.*
5. **Legality** – *All expenditures and activities should be carried out in accordance with the law.*
6. **User-friendly structure/transparency** – *The executive is expected to acquaint the parliament with a plan of estimated expenditure that is manageable and understandable to the wide and diverse audience that is usually present in parliament.*
7. **Comprehensiveness** – *The state budget concerning the different aspects of the security sector has to be all-inclusive and complete. No expenditure should go unaccounted for, including the budgets of all security services, i.e., the military, other state militarised organisations, police and intelligence services as well as private military companies hired by the executive.*
8. **Publicity** – *Every citizen (individually or organised) should have the opportunity to express his or her opinion on the budget. This requires that all budget documents have a user-friendly structure and that they be made available for reading everywhere in the country (for example by sending copies to local libraries).*
9. **Consistency** – *Clear links should be established between policies, plans, budget inputs and performance outputs.*
10. **Means and ends/value for money** – *The budget explanation should be able to communicate clear understandings of the aims of the budget in terms of: resource inputs, performance or capacity objectives to be achieved and measurable results on plans. A flexible budget should allow changes in any of these three parameters.*

Source: IPU, DCAF, "Parliamentary Oversight of the Security Sector", 2003.

The fundamental principle of financial management in countries with good governance is that the executive branch of government can

neither take money from the public nor make any expenditure from that money, except by the approval of the legislature as the representative body of the citizens.² The approval of the expenditures by the parliament is usually given in the form of law – an annual budget law – as will be discussed in the course of the ensuing analysis.

The principle of unity of budget is also essential, as it ensures comprehensiveness and transparency of all expenditures (and revenues). Although the defence sector has its specificities, it is essential to respect the principle of unity and avoid supplementary budgets, off-budget expenditures and revenues, or any kind of preferential treatment outside the general principles that regulate budget decisions. This principle also ensures full transparency and excludes the possibility of external funding without the knowledge of the parliament.

The principle of periodicity guarantees the existence of a regular time-frame for the budget preparation and its presentation to the parliament. Although budgets are usually approved on an annual basis, they should also include a multi-year outlook. Many projects and programmes take more than one year to implement or may have future financing implications. The multi-year outlook is usually handled through the preparation of an extended budgetary framework for the medium term (MTBF), which sets out medium term expenditure priorities and specific budget restraints

against which sector plans can be developed and refined.

Budget specificity and a user-friendly structure – in short, transparency – is of utmost importance for ensuring good governance. Over the past decade, a number of international organisations and think tanks have devoted special attention to ensuring budget transparency in countries all over the world.³ It is believed that budget transparency leads to a greater degree of accountability and value for money in the use of public funds, especially in the sectors that spend a high share of public funds, such as the defence sector.⁴

In order to ensure consistency and transparency in the use of public funds, many countries use programme budgeting, which is becoming a standard of good governance. Programme budgeting is a method of organising and classifying the budget according to programmes with shared objectives, instead of along administrative or input lines. The programme approach focuses attention on outcomes rather than inputs. One of the first programme budgets for the defence sector was introduced in the USA in 1960s, as explained in more detail below (PPBS).

2 S. Schiavo-Campo, "The Budget and its Coverage", in A. Shah, *Budgeting and Budgetary Institutions, Governance and Accountability Series*, the World Bank, p. 53.

3 International organisations such as the Organization for Economic Co-Operation and Development (OECD), NATO and the Organization for Security and Co-Operation in Europe (OSCE) have advanced their own publications manuals arguing for increased levels of budget transparency alongside analysis, advice and assessment methods to aid countries with reform. The UN also offers a significant platform for defence budget transparency through its Instrument for Standardized International Reporting of Military Expenditures, which dates back to 1980. An international think tank – International Budget Partnership – is conducting regular annual surveys of budget transparency all over the world. Transparency International has also recently introduced a system of assessment of budget transparency. Cf. Transparency International UK (2011), *The Transparency of National Defence Budgets- an Initial Review*, Transparency International UK, Defence and Security Programme.

4 Transparency International has also recently introduced a system of assessment of budget transparency only in the defence sector. Cf. Transparency International UK (2011), "The Transparency of National Defence Budgets- an initial review", Transparency International UK, Defence and Security Programme.

PLANNING, PROGRAMMING AND BUDGETING SYSTEM (PPBS) IN THE US IN 1960S

"(...) Planning, programming, and budgeting system (PPBS) was firstly used in the United States [in the early 60s] for defence budget development [and is currently used in many other countries] (...). A typical PPBS cycle consists of an initial planning phase, in which the security environment, as well as national interests and threats are analysed in order to determine the tasks, the composition, and the structure of the armed forces. Considering these imperatives, programmes are developed. The programme, a form of business plan, identifies the concrete objectives to be met. It is a crucial link in the cycle as it works to relate the identified objectives to the financial resources. In this way, PPBS parts with the practice of allocating resources according to the stated needs and instead looks to plan and programme according to given and forecasted budgetary constraints. Hence, it is important that the programmes are developed on a priority basis, where the most immediate needs for the armed forces are met. Risk assessments dealing with the consequences of not meeting a given objective can be used for setting the priorities. Completing the cycle in the end is a performance measurement phase during which the ministry in particular and society as a whole can determine to what extent the objectives have been met at the end of the year. An efficient distribution of resources can thus be achieved..."

Source: Defence Budget Transparency on the Internet, by Kate Starkey and Andri van Meny Information & Security, Vol. 5, 2000. C4 in Defence of Reengineering; IPU, DCAF, "Parliamentary Oversight of the Security Sector", 2003

Defining and measuring performance is also becoming increasingly important for budget management, and the defence sector should be no exception. While defining and measuring performance in the defence sector is more difficult than in many other sectors, a focus on readiness/capability as a performance indicator has been shown to be helpful in defining the role, structure, performance, and resource needs of defence.⁵

As the defence sector shares many of the characteristics of other sectors, the defence budget process should be integrated in the overall government planning, policy-making and budgeting system in a manner consistent with democratic and civil control of the defence forces. Citizens of any country will benefit from a defence sector that is accountable to democratic, civil authority and subject to the same broad set of rules and procedures as other sectors. As security is legitimately a high priority for any government and frequently involves issues that refer to other states, the defence sector should be allowed to keep a certain level of confidentiality in the handling of information concerning sensitive national security issues. It is, however, important not to allow the genuine need for some degree of confidentiality to be used as an excuse for evading the general rules and procedures of good financial management.⁶ Lack of respect of financial management principles and good practices may bring about adverse consequences and reduce the capacity of the defence forces to carry out their statutory tasks of protecting the state and its citizens.

⁵ N. Ball, M. Holmes, "Integrating Defence into Public Expenditure Work", UK Department for International Development, 2002.

⁶ *Ibid.*

2. The Institutional Framework

the responsibilities of the different actors involved in budget preparation and policy formulation must be clearly defined. in parliamentary democracies, in accordance with the principle of the division of powers, the budget is prepared by the executive but must be approved by the legislature, i.e., the parliament or national assembly. the necessity of parliamentary authorisation of expenditures (as well as taxation), in british constitutional tradition called the “power of the purse”, is a focal point in the parliament’s authority to hold the government to account. if authorisation is denied, the government will not have the constitutional right to spend the money and may, if the entire national budget is involved, be forced to resign. if, on the other hand, approval is granted, it means that the parliament has entrusted public money to the government that is responsible for ensuring that arrangements are in place to use these funds as agreed, efficiently and effectively.

2.1. THE ROLE OF THE EXECUTIVE

2.1.1. THE COUNCIL OF MINISTERS (GOVERNMENT OR CABINET)

the council of ministers (also called the government or the cabinet in some countries) is the supreme executive organ in parliamentary systems. it is composed of ministers responsible for individual portfolios, including the minister of defence, and is chaired by the prime minister, also called the chairman or president of the council of ministers in some countries. the council of ministers normally makes decisions collectively. it must balance the needs and priorities of ministers and their individual sectors with the needs of the government as a collective body and in accordance with overall policy.

With respect to public financial management, the Council of Ministers has two key roles. In the case of any conflict that may arise between different ministers regarding the allocation of resources for the upcoming year,

the Council of Ministers has the authority to resolve it. The second role of the Council of Ministers is to approve the draft budget law to be submitted to parliament, as individual ministers cannot seek funds from the parliament. It is normal that the individual ministers favours increased spending within their own sector, which may collide with the Council's collective interest in reducing the total expenditures and revenues, for example, keeping taxes down and avoiding excess borrowing. During the process of budget preparation, the Council of Ministers has an important role in balancing overall policy and the financial needs or ambitions of individual sectors.

A central government institution (the Government Secretariat, State Chancellery, or the Ministry of Finance) has an important role in supporting the Council of Ministers in coordinating financial priorities and policy formulation on public financial management issues. They coordinate the work of all ministerial portfolios, including priority-setting, strategic planning, linking policies and resources, quality checking of submitted proposals and – once decisions have been made – monitoring their implementation. It is very important that the individual ministries, including the Ministry of Defence, have a close and constructive cooperation with the central government institution that coordinates financial management.

Coordination in the budget process between central governmental institutions, responsible for financial management, is very important. Formal rules of procedure and clear lines of communication are needed to ensure that coordination and systematic consultations between these actors takes place.

2.1.2. THE MINISTRY OF FINANCE

The Ministry of Finance (MoF) normally has a very central role in the budget cycle management. The role of the Ministry of Finance is not simply to mechanically assemble figures, as used to be the case during the period of central state planning in countries with a communist system. In most countries, it usually has a strong authority to set an expenditure ceiling and negotiate on priorities and financial proposals with individual ministries. Hence, it plays a key role in the budget process.

The Ministry of Finance plays an active role in all budget cycle phases. It first sets the guidelines for budget preparation which are sent to all ministries, including the MoD. After receiving the budget requests, it starts negotiations with individual ministries, ensuring the overall consistency of the draft budget with policy and macroeconomic objectives. The MoF is formally in charge of the preparation of the draft budget law, and for developing the key arguments and financial justifications to be used in the parliament. Once the budget law has been adopted, the MoF is responsible for coordination of its execution and its timely, efficient and effective implementation.

The central budget office in the MoF should have the competence and capacity to assess the relevance of all budget requests, including the defence ministry's budget request. In this regard, it is important that finance ministries have the capacity to critically evaluate security programmes, just as they should have the capacity to analyse other government programmes. The MoF should assess the MoD's annual spending proposals within a medium-term framework and should seek to ensure tight links between strategic planning, defence planning, and budgeting. While a given

budget ceiling must be respected, it is crucial to ensure that defence objectives, procurement decisions, and long-term sustainability goals are attained.

2.1.3. THE MINISTRY OF DEFENCE

Line ministries, including the MoD, are responsible for preparing their sector programmes and budget proposals within the policy directions and financial framework decided by the government/Council of Ministers. The MoD should ensure that there is a balance in resource allocation between different entities of the defence sector, in accordance with agreed policy priorities. It should also ensure that the budget will assist in a sustainable development of the whole sector – that there is a correspondence between available means and policy objectives.

Finance officials in the MoD have to mediate between the Ministry of Finance and the individual defence agencies that are subordinate to the MoD in order to ensure that the overall budget is consistent with the financial limitations as decided in the annual budget cycle. Bearing in mind that the MoD is a fairly large sector in most countries with a number of organisational units, it is important the MoD provides budget directives as early as possible, so that subordinate units have enough time to set internal priorities and elaborate a credible budget proposal within their own areas of responsibility. Once the budget framework for defence has been set – by the Council of Ministers and the Ministry of Finance – the MoD takes the lead in developing initial budget projections in collaboration with the different services and defence agencies: army, navy, air force, intelligence, etc.

Like other line ministries, the MoD is also responsible for budget implementation, within

regulatory controls set by the Ministry of Finance. The MoD is accountable for improving public sector productivity within its field of responsibility whenever this is possible, including by identifying the areas in which savings can be made without negative impact on the operational capacity of the armed forces.

2.2. THE ROLE OF THE LEGISLATURE (PARLIAMENT/ NATIONAL ASSEMBLY)

As pointed out earlier, the legislative body plays a fundamental role in authorising public spending and it holds the government accountable for how money are being spent. As the security and defence sector consumes a fair amount of the state budget, it is essential that parliament approves monitors and keep the government accountable for how public resources are spent.

Parliaments have an important role to play in the budget cycle phases –approval, execution and oversight. In the budget approval phase, parliaments should be involved in an in-depth discussion on policy priorities, defined as the allocation of resources within the defence sector. In the course of the budget execution phase, parliament should scrutinise the government by reviewing reports on expenditures, asking critical questions and conducting other means of parliamentary control and oversight, in order to enhance transparency and accountability. During the final stage of oversight, the parliament should make sure that the budget allocated to the MoD is spent in accordance with approved appropriations and in accordance with the principles of economy, efficiency and effectiveness, i.e. the value for money principle. Frequently, a parliament conduct that function through a national audit institution that reports directly to the parliament.

In order to carry out its role effectively, the parliament normally works through parliamentary committees that more or less may reflect the organisation of ministries. Different committees deal with different areas of financial management. The usual practice is that the budget and finance committee review revenues and expenditures in all sectors, including within the defence sector, while standing committees with sector responsibilities, for example the security and defence committee, deals with policy and budget within their specific sector. A good practice is to have a separate committee responsible for accountability and control which is responsible for reviewing the audit reports for the entire national budget, including the defence budget. Such a committee ensures legislative oversight and control and cooperates closely with the supreme national audit institution.

Parliaments should have access to all necessary budget documents and data and work in a transparent manner. The legislature and its individual committees should have access to independent expertise for proper budget scrutiny and to any information from line ministries that it considers relevant, including from the MoD. The MoD should present to parliament fully documented reports on how it spends the money allocated to it, if requested. Furthermore, bearing in mind parliament's mission to represent the interests and concerns of the citizens, transparency in the conduct of parliamentary debates in connection with security issues is crucial – insofar that this is compatible with important security requirements and international obligations. It is also very important that the public and the media have access to parliamentary debates and hearings.

2.3. THE ROLE OF SUPREME AUDIT INSTITUTIONS

In parliamentary democracies, external audit provides a key mechanism which scrutinises on behalf of the taxpayer how the government uses the money granted to it and, thereby, holds it accountable. National auditing bodies are established and tasked to examining the legality and efficient use of public funds, and hence report their findings to the higher auditing institution, normally to the parliament. Although the organisational arrangements and practices differ from one country to the next, reflecting various administrative cultures and traditions, the work of the audit institutions are the same: organisational and financial independent, competence to decide on its own work programme, and the right to freely report its findings.

It is for each supreme audit institution (SAI) to determine its priorities in conducting different types of audit in accordance with a self-determined programme and in line with the legal framework. A SAI should have access to all records and documents related to financial management, and should be empowered to request, orally or in writing, any information necessary to fulfil its tasks.

SAIs are usually authorised to audit the legality of financial management as well as to conduct specific performance audits. The objective of audits of legality is to ensure that public funds are spent in accordance with the legislation and relevant regulations, principles and procedures. The appropriated public money can be used only for the purposes intended by the budgetary authority – the parliament at the national level – usually by means of an annual budget law and other relevant decisions. Performance audits, on the other hand,

are oriented towards examining the economy, efficiency and effectiveness in the use of public funds. The audit of “economy” aims at determining whether the minimum costs have been incurred in carrying out a certain activity, while “efficiency” measures whether the maximum output has been achieved from a given input (‘spending well’). “Effectiveness” checks the extent to which the given policy objectives have been achieved (‘spending wisely’).

The SAI is normally empowered to report its findings independently, and annually to the parliament or other responsible governmental institution. In accordance with public transparency legislation, such reports should be available to the public. This ensures extensive distribution of the SAI’s findings and encourages a public discussion on weaknesses or wrongdoings in the spending of public funds. The latter enhances the potential need to follow-up findings of the SAI.

The parliament and/or its designated committee, usually a Public Accounts Committee, should be obliged to seriously consider the SAI’s reports, and the government should be

obliged to formally and publicly respond to the findings of the reports. It is important to ensure an effective follow-up of the SAI’s recommendations and to make sure they are being rightfully implemented. The parliamentary responsibility in that respect is a fundamental aspect of a democratic checks-and-balances system in which parliament’s role is to control the executive power, i.e. the government.

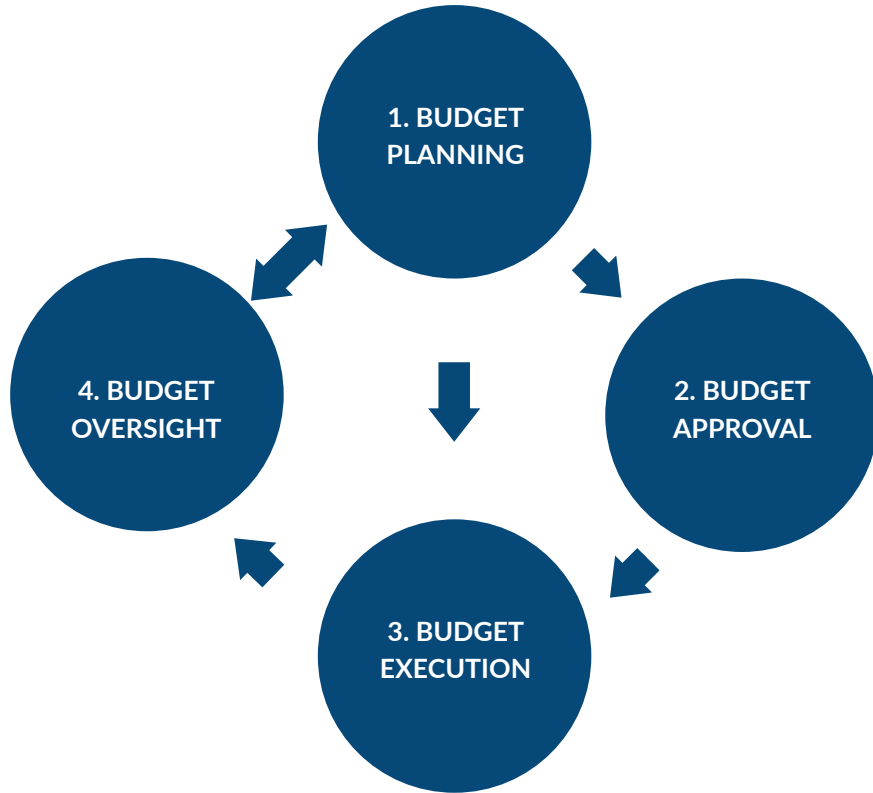
The defence and security sector is not always placed under the general oversight of the SAI. According to a survey made by Transparency International (2011), nearly a quarter of the countries covered, 22 out of 92, either did not conduct a regular audit of their security sector, nor did they conduct a partial one – excluding military intelligence agencies or other security sector bodies altogether. Furthermore, in most of the countries the SAIs did not have a sufficiently high number of qualified staff to carry out effective audits in the defence sector.⁷ In terms of good governance, that is a weakness which needs to be addressed.

⁷ Cf. Transparency International UK (2011), “The Transparency of National Defence Budgets- an initial review”, Transparency International UK, Defence and Security Programme.

3. The Budget Cycle

The budget cycle consists of four key inter-related phases: planning, approval, execution and oversight. Although the phases clearly follow each other, budget planning is preceded by budget approval etc., the different phases tend to be mutually inter-connected. Thus, for example, the budget approval process can be effective only if the budget is prepared in a transparent and understandable manner, so that the members of parliament are able to appreciate the objectives and reasons for the various items, and to discuss them and – if desired, amend them – in a meaningful way. Furthermore, an approved budget cannot be properly executed if it has not been

well planned. Finally, the oversight over the budget execution cannot be effective if the budget has not been prepared well, and in a well-argued and transparent manner. For all these reasons, the planning phase of public financial management should be given proper attention in all line ministries, including in the MoD. Finally, the oversight function is very important as it gives feedback on the effectiveness of the previous budget, which should be taken into account in the planning for the next budget period.



An effective execution and oversight of budget funds assumes a good planning of expenditure.

All institutions using public funds, including the MoD, should establish clear lines of responsibility, accountability and delegation of authority in the budget process. This is especially important in the defence sector where democratic control over the armed forces is essential and where the civil service of the MoD executes oversight and control of the armed forces on behalf of the Minister of Defence.

Delegation of authority serves as an important mechanism and is a guarantee against excessive centralisation of authority, which in many countries tends to be concentrated at the high-

est political level in the ministry. One negative consequence of that occurs when one person (usually a head of an institution) assumes an excessive financial authority which prevents him/her from concentrating on strategic policy and management issues, and creates bottle-necks in the decision-making process.

Delegation of authority means that a clearly defined set of responsibilities is delegated to units further down in the institutional hierarchy – to non-political staff, i.e. professional civil servants. As for all public functions, special attention should be paid to assessing whether any person to whom some specific financial authority is delegated may be in a position of conflict of interest. The civil servant(s) concerned will, as in all public functions,

be obliged to carry out the delegated tasks in accordance with the relevant legislation.

The establishment of appropriate arrangements for financial management – especially the delegation of authority and managerial accountability – will normally be considered in the context of wider public administration reform. Giving more responsibilities to non-political officials necessitates a clear distinction between the role and duties of the political level as opposed to the civil service and administrative staff. While the former needs to focus on policy and overall strategy, the latter should concentrate on tasks of a more professional nature, like the delivery of services or the implementation of activities within given political priorities and objectives.

The Secretary General or other designated personnel to whom financial authorities have been delegated in the MoD should be held accountable for the legality of their work and the value for money in the use of public funds. The civil servants concerned should report on the implementation and use of budget funds, not only regarding the management of the MoD but also regarding bodies that are subordinate to the MoD. These reports should go to external oversight bodies such as a supreme audit institution, as well as to the responsible parliamentary committees.

Institutions which use public funds, including the MoD, should establish clear lines of accountability and delegation of authority in the budget process within their organisation. These budget processes and relationships should be defined in more detail by internal rules of procedure (e.g. budget management guidelines)

The delegation of authority and all other issues concerning the budget management within an institution should be regulated by internal rules and procedures (e.g. budget or financial management guidelines), in order to set out clear lines for responsibility and accountability of the different actors involved in the budget cycle. This is especially important in large sectors, which consist of several institutions or other units and have a fairly large number of staff, such as the Ministry of Defence.

3.1. BUDGET PLANNING

3.1.1. INTRODUCTION

The budget planning process includes the following phases: (i) preparation of the macroeconomic framework; (ii) preparation of a budget circular, which gives guidelines for the preparation of sector budgets and expenditure ceilings by sector; (iii) preparation of the line ministries' budget on the basis of these guidelines; (iv) budgetary negotiation between the line ministries and the Ministry of Finance; (v) finalisation of the draft budget; and (vi) submission to the legislature.⁸ As the preparation of the macroeconomic framework and budget circular and the finalisation of the draft budget are the responsibilities of the Ministry of Finance, in this subsection we will primarily focus on the preparation of line ministries' financial plans, with a special emphasis on the Ministry of Defence.

The first key issue for line ministries in the budget planning phase, including for the MoD, is allowing for a free flow of information within the ministry. Financial planning and management work well inside an organisation if information systems are reliable and allow for timely and accurate exchange of information between all of the units concerned. This re-

⁸ R. Allen, D. Tommasi (2001), *Managing Public Expenditure – a Reference Book for Transition Countries*, OECD publishing.

quires a close cooperation between all MoD departments and subordinate bodies. As financial planning, by its nature, is a continuous activity inside an institution, successful financial planning (and execution) requires close cooperation among all of its departments.

The second key issue to take into account in financial planning, is ensuring it is affordable and within the given budget ceiling. As a sustainable macroeconomic balance is critical to the long-term economic health of a country, it is essential to respect the overall budget limits set out at the beginning of the budget cycle by the Council of Ministers. Once the overall budget framework for defence is set by the Ministry of Finance, the MoD should take the lead in developing initial budget projections in collaboration with the defence services, as appropriate (army, navy, air force, intelligence, etc.). All sectors within the MoD will compete for funding during this phase of the budget formulation – on the basis of strategic priorities and past performance. To keep the consolidated budget within the given aggregate resource constraint, there will normally be a subsequent “tug-of-war” and a need for compromise.

The final and perhaps the most important issue in budget planning is to make sure it is in line with priorities and defence policy as defined at the political level – the Minister of Defence and the government. As in most other parts of the public sector, defence budgets should be prepared in line with a sectoral strategy, for example, a Strategic Defence Review and Long-Term Development Plan for the armed forces. The purpose of such strategic documents is to identify the needs and key objectives of the defence sector and the specific missions that the defence forces may be asked to undertake, and what that implies in

terms of equipment, personnel, etc. Without a clearly articulated and long-term defence policy, it is impossible to devise an appropriate budget on how to allocate funds on a yearly basis in order to meet the needs of the defence sector in a long-term perspective.

However, the budget planning process of the MoD also needs to take into account the overall governmental – political and strategic – objectives, like achieving macroeconomic stability, accelerating and meeting the requirements of EU or NATO accession processes, etc. A defence budget is, after all, only one part of a larger national budget plan.

Financial planning in the MoD must be based on defence policy and strategic governmental priorities

3.1.2. MULTI ANNUAL AND ANNUAL FINANCIAL PLANNING

National governments are increasingly required to present budgetary information within a medium-term framework and to set medium term-fiscal objectives. This especially refers to countries that are (potential) candidates to the European Union (EU). Once they become EU members, they will have to ensure financial stability and meet financial convergence requirements, all of which entail an important element of a more long-term fiscal framework.⁹

Both multi annual and annual financial planning are coordinated by a country's central financial authority, usually the Ministry of Finance. The Ministry of Finance sets out, in an annual circular, the overall approach, timetable and assumptions that underpin and pro-

⁹ *Ibid.*

vide the foundation for the budget estimates of the various public institutions, including the MoD. Hence, the MoD must comply with the government's budget circular and provide the Ministry of Finance with comprehensive, accurate and transparent estimates. As for the planning of the next annual budget, estimates are for the upcoming budget year. For multi annual planning, the estimates includes the upcoming budget year, and usually two or up to four budget years beyond.

Multiannual budget planning assumes the existence of medium-term strategic objectives, see documents at the sectorial level, with cost-estimates to be incorporated in the medium-term budget projections.¹⁰ This means that it is very important for the MoD to have a clearly defined medium-term defence policy, with procurement plans and operational activities that are costed and suitable for integration within the medium-term budget planning. Such a policy is normally based on a Strategic Defence Review and a Long-Term Development Plan that include the future costs of existing activities and the estimated costs of new policy priorities to be implemented during the medium-term period. The latter may imply additional funding requests, unless new costs are offset by savings through restructuring, etc. The medium-term budgetary framework may also refer to more long-term costs of investments to be incurred beyond the medium-term period.¹¹

The medium-term budget document should also be endorsed by the parliament and serve as a political commitment from the parliament regarding the medium-term funding level. This

commitment should preferably be shared by the Ministry of Finance and be consistent with the political priorities of the Council of Ministers. Such a joint understanding of priorities in the field of defence will increase the predictability and stability of the financial planning process in the defence sector in a medium-term perspective. It will also provide for better investment and procurement decisions. Nevertheless, the MOD will always need contingency plans if its Long-Term Development Plan for the armed forces is not followed up according to the plan.

In the course of the annual budget planning, financial officers need to pay special attention to the annual work programme of the MoD, which should be integrated within the annual budget estimates. Even if the MoD's annual work programme will normally be closely connected to its more long-term defence strategy documents, unexpected events and changed circumstances may turn out to draw on personnel resources as well as budget resources. Hence, even if the MoD's annual work objectives include a timeline for attainment of each objective – the methods/activities to be undertaken in order to attain them and the financial resources needed – there is always a risk that plans may need to be adapted when they are implemented. Bearing in mind the possibility that the budget may not provide sufficient funds for the realisation of all the pronounced objectives, it is necessary to define their priorities, in order to take account of uncertainty and what may realistically be achieved within a given budget year.

3.1.3. INVESTMENT CAPITAL AND CURRENT FINANCIAL PLANNING

Two key items in the budget planning are capital investments and current expenditures, for

¹⁰ SIGMA/OECD (2014), *Principles of Public Administration*, SIGMA/OECD publishing.

¹¹ *Ibid.*

example operations. Capital or investment planning are used to evaluate potential investments in specific projects or for specific purposes. When the MoD plans investment expenditures, it typically involves procurement of a specific asset – buildings, weapon systems, other military equipment, etc. Sometimes, the purpose is to replace or modernise outdated equipment or real estate and sometimes to invest in a new project. Capital investments include purchases that are expected to last beyond the current budget year. Current expenditure planning, in turn, tracks on-going expenses that occur on a regular basis, be it monthly, quarterly, semi-annually, or annually. Such financial spending includes all costs related to current operations – line items such as wages, human resources, utilities, office supplies, rent or lease payments, including maintenance costs. It also includes the regular running costs of military activities like education and training, exercises and military operations.

During the financial planning process, it is particularly important to get the allocation right between investment and current expenditures. Within the latter, it is also important to strike an appropriate balance between personnel costs, wages, education, etc., and other expenditures linked to operations and maintenance.

Capital investment and current expenditure planning often interact in budgetary terms. If, for example, the MoD purchases a new piece of military equipment, then that investment will come out of its capital budget, but since using the equipment implies operational costs and requires ongoing maintenance, these costs will be charged to operations or the current expenditures budget. For this reason, and for the purposes of budget transparency and

management, procedures used for preparing the current budget and the capital investment budget should be integrated.

Investment planning (capital expenditures)

Investment planning deserves special consideration in the financial planning process as it is future-oriented and goes beyond running operational costs from one year to the next. Preparation of an investment plan is a rather complex professional task. Capital expenditures planning, as a rule, aims at meeting future needs in terms of modernisation priorities and other political and operational priorities for a country's armed forces. Such investments normally take a longer period of time to plan and implement, and are meant to provide benefits for an extended period of time – years and, sometimes, decades. Investment planning, therefore, needs to take a long-term view in which the implications for running operational costs, maintenance, education and training of personnel, etc. should be included as part of the plan, in addition to the initial capital investment costs. In modern military planning, the term used is normally *life-time* costs that also include future disposal costs at the end of service.

Sometimes, investments may be a response to more immediate needs based on the current situation. However, military investments are usually embedded in a comprehensive and cost-evaluated plan for the armed forces – for example, for the next four years. Frequently, such a plan includes a more long-term perspective that points towards the next decade or longer.

The kind of defence planning indicated above will normally be part of what in NATO is referred to as a Strategic Defence Review (SDR).

Here, the objective is to consider future investments in military capabilities within a broad framework and within a defined time-frame. A broad framework means that the capital investment as such is seen together with the implications for future costs of personnel, maintenance and other related operational expenses. The result of the SDR should be a balanced future defence force that is both affordable and capable of meeting the tasks and objectives set by the government. The SDR is normally operationalised through a Long-Term Development Plan which includes the timing of each investment, annual budgetary consequences for investments that go over several years, the foreseen maintenance and other operational costs, etc. Investing in equipment that, once purchased, the armed forces cannot afford to operate, or that the armed forces will not have trained personnel to handle, is an example of a bad budget planning.

The SDR process is usually based on initial requests for investments from the branches of the armed forces, in combination with political directives and priorities given by the government. Such directives may, as an example, provide financial guidelines for future defence budgets.

Normally, NATO member states will make certain commitments to acquire specific military capabilities, as part of the Allied defence planning process. Such commitments are implemented through national budgetary and defence planning processes. For example, NATO expects that Allies invest at least 20 % of their total annual defence budget on modernisation. Since the NATO Summit in Wales in 2016, the long-term objective of NATO is for each member state to increase its defence budget reaching 2 % of gross national product

(GDP). Hence, for the members of NATO the SDR process will include an important international dimension in addition to national considerations that will always be very important.

Requests for investments from the armed forces should always include a justification, including the objective of the investment, operational requirements, desired timeline for implementation, information about the implementation phases, etc. As noted above, a procurement plan should include a timeline for budgetary spending, an evaluation of costs linked with operations and maintenance, and other life cycle costs of the investment.

The investment plan usually contains the following information: type of investment; construction, procurement, etc.; basic information linked to specific individual investment; an implementation schedule; total funding for the realisation of the investment; and how the proposed investment fits into the broader long-term framework of defence investment. The latter may frequently be important in order to secure funds. Social and economic feasible, international commitments, and other measures to be taken for successful realisation of the investment, will also be important.

Current financial planning

Key elements of current financial planning are 1) human resources planning and 2) material resources planning (for example, maintenance and other operational costs). It is important to strike an appropriate balance between these elements. Excessive personnel costs imply fewer resources for maintenance and other operational needs, which may pose a serious risk for the effectiveness of the defence sector. Together with a proper balance between investments and current expenditures, a prop-

er balance between personnel costs and annual operational costs is crucial.

Human resources (HR) planning enables an institution to make sustainable decisions on the number and composition of its human resources and their distribution within the organisational structure (the MoD, its subordinate agencies, and the armed forces proper). The ability to achieve the objectives of an institution should be at the centre of all HR planning. Such planning encompasses various human resources aspects, including recruitment, promotion, professional development, relocation of resources, the pension system, and discharge of redundant employees. For this reason, the human resources department in the MoD should be responsible for all aspects of the human resources planning process.

Human resource planning should be carried out by 1) analysing the existing human resources potential and expected turnover of staff in the MoD 2) defining the number and quality of human resources necessary for meeting future needs and policy objectives.

To achieve sustainability and a long-term view, close coordination of the defence planning process (SDR) is vital. The HR planning should include both numbers of personnel deemed necessary and their professional profiles and competences. This planning process should start with an in-depth analysis of the existing HR resources and expected turnover of staff in upcoming year(s). Information should furthermore be linked to future needs as defined through the SDR and Long-Term Defence Plan – in short, the MoD's objectives within defence policy, budget policy, and the development of future armed forces.

The costs of operating and maintaining existing facilities and equipment are another important aspect of the financial planning process for annual budgetary expenditures. This should be based on an analysis of the state of existing facilities and equipment in order to determine the functionality and life expectancy of the basic resources available to the MoD and what it costs to operate them. The degree of deterioration of available assets, the need for on-going maintenance, the need to replace consumables and purchase spare parts, are important elements in that process. Such planning is an integral part of the preparation of annual budgets for current operations.

Procurement is an important part of current financial plans (current operations) as well as for capital investment plans. Procurement planning is the process of deciding what to buy (quantity as well as quality), when, and – sometimes – from what source. General public procurement rules will apply to procurement that is not of a defined military character. National security needs and objectives may apply to the latter category of procurement and define the source. Procurement procedures in the defence sector have their specificities, due to the nature of national defence and, for example, the classification of certain information for national security reasons and the objective to preserve a certain production capability or technological asset at the national level. Such exceptions from the regular procedures and rules that govern public procurement should not be broadly interpreted, however. As public procurement is a comprehensive field in its own right and deserves special attention, it will not be discussed in any detail in this booklet.

3.1.4. PREPARATION OF A FINANCIAL PLAN

The preparation of a financial plan for the MoD should be based on all previously mentioned processes within the MoD itself and its subordinate institutions:

- Investment planning
- Human resources planning (as part of current financial planning)
- Material resources planning (as part of current financial planning)
- Procurement planning (which includes both investment and current financial planning).

The different planning processes noted above provide a good basis for the preparation of an overall financial plan for the MoD. The latter plan should be aligned with the country's security and defence policy, long-term defence planning, other relevant policy documents, the annual work plan of the MoD, as well as relevant national legislation and international agreements. Special attention should be paid to the interrelationship between long-term capital investment projects and current financial planning. Past patterns may also help inform the preparation of the financial plan.



Financial plans need to be based on agreed budget classifications that typically include various administrative, economic and functional categories of expenditures. While the administrative category identifies the entity that is responsible for managing the public funds concerned (i.e. MoD), the economic category identifies the type of expenditure incurred, for example, salaries, goods and services or capital spending. The functional category organises government activities according to their objective or purpose (education, social security, defence etc.).¹² In the case of the MoD, its financial plan falls within the defence category.

3.1.5 NEGOTIATIONS WITH THE MOF AND PREPARATION OF A DRAFT BUDGET PROPOSAL

The MoD's financial plan should be negotiated with the Ministry of Finance (MoF) within a time frame usually specified in an organic budget law. Before its formal submission to MoF, the financial plan proposal, prepared by the MoD budget department, will normally be

¹² D. Jacobs, J. Helis, D. Bouely, "Budget Classification", IMF technical notes and manuals, December 2009.

discussed more informally with the MoF, so as to resolve potentially contentious issues in advance. If the comments of the MoF are accepted and the financial plan aligned with MoF's instructions, the MoD (at the top political or administrative level) will adopt it and formally submit it to the MoF. In the case of disagreement, discussions to resolve outstanding issues normally will take place at the ministerial level.

The Ministry of Finance is responsible for integrating the financial proposals of all sectors combined when drafting an annual national budget proposal. Once the draft budget proposal has been completed, it will be presented to the Council of Ministers for adoption. After the Council of Ministers has approved the draft, the government's budget proposal will be sent to parliament for its scrutiny and final approval.

3.2. BUDGET APPROVAL

The government/Council of Ministers submits the annual budget proposal to the parliament within agreed timelines, in order for the parliament to have sufficient time to evaluate and debate political priorities and the various spending proposals, and to vote on the budget, before the beginning of the new fiscal year. In most countries, the fiscal year coincides with the calendar year but some countries may have an alternative definition of the budget year. In so-called countries in transition, sometimes the budget proposal is submitted to the parliament within a very short time-frame before the final approval deadline (usually the end of the year). In most cases that is linked to a previous political tradition dominated by the executive power. In more mature democracies, especially those with a parliamentary political system, formal deadlines for submission of budget proposals are

normally strictly respected. Parliaments do not like to be ignored or taken for granted.

When the parliament scrutinises the government's budget proposal and political priorities, its most important influence is usually expressed by having the authority to amend the budget, including by adding new line items. In Western democracies based on a checks-and-balance system with division of power between the executive power, the legislative power and the judicial power, the parliament normally represents the supreme appropriating power (often referred to as "the power of the purse"). That means that the national budget needs to be approved by the parliament, and that gives the parliament substantial political power. In practice, however, the actual role of the parliament may depend on national traditions, the role of political parties, whether the government has a majority in parliament or whether it lacks a defined majority support, etc.

The parliament normally reviews the government's national budget proposal through its standing committees before the budget is discussed and voted on in plenary session. That means that the MoD budget will be scrutinised by the parliament's standing committee on security and defence, or international affairs and defence, or the equivalent. That implies that the discussion of the MoD's financial plan may become substantial and go into details, due to the greater expertise that members of defence committees normally have on the policy issues of that sector. The usual practice is that the parliament's budget and finance committee reviews the revenue and expenditure of all sectors, including the defence sector, in order to make sure that the total national budget is financially viable.

Finally, it is important to note that in its discussion on the draft national budget, the parliament's freedom to substantially change the budget will be restricted by mandatory spending (for example, paying down national debt, salaries of public employees, entitlement programmes like pensions, procurement contracts signed in previous years, etc.). Such expenditures, which normally represent a very substantial part of the national budget, may only be modified in the long term. New strategic defence policy priorities contained in a Strategic Defence Review, represent a good example of how more long-term modifications in the defence budget may have to be planned for and implemented over several years.

3.3. BUDGET EXECUTION

The main objective when the defence budget – like other sectorial budgets – is executed is to ensure that resources are used lawfully, efficiently and effectively in line with the parliament's budget decisions. That requires careful monitoring and evaluation of operational performance, both within the MoD, armed forces, and the defence sector's various subordinate agencies. While the political responsibility in parliamentary democracies will rest with the Minister of Defence, both military officers and civil servants may become liable for how public funds at their disposal are spent.

The first key requirement in budget execution is that the approved funds must be used in accordance with the principle of legality. In countries in which the parliament's decisions are made through a specific Budget Law, legality automatically implies that the appropriated money must be spent in accordance with the parliament's Budget Law. However, that requirement is valid also in countries in which the national budget is approved by parliament

through a separate budget procedure. Regardless of how the parliament makes its budget decisions, the legal framework for the spending of public money will be defined in great detail through a number of separate laws, for example, laws on public procurement, laws on civil servants, laws on the armed forces, etc.

In order to respect the principle of legality, the MoD will need to align its financial plan with the budget appropriations as determined by the parliament. In course of the budget execution, spending that is covered by the defence budget must comply with the budget's intended purposes and respect its limits. If there is a need for budgetary changes during the year, which often occurs due to changes in circumstances, the Minister of Defence will need to go back to the parliament and request a modification of the approved budget. In most countries, there are defined procedures for that. Budgetary funds that have been approved but remain unspent at the end of the year, must be returned unless the parliament's budget decisions specifically determine that they may be transferred to the next year.

The second key requirement for spending of appropriated budget funds is to respect the principle of value for money: economy, efficiency and effectiveness in the use of public funds.

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- *Economy – to minimise the amount of resources used or acquired – means spending less. Lack of economy could occur, for example, when there is overstaffing or when overqualified staff or overpriced facilities are used;*
 - *Efficiency – the relationship between the output in terms of goods or services relative to the resources used to produce them –*

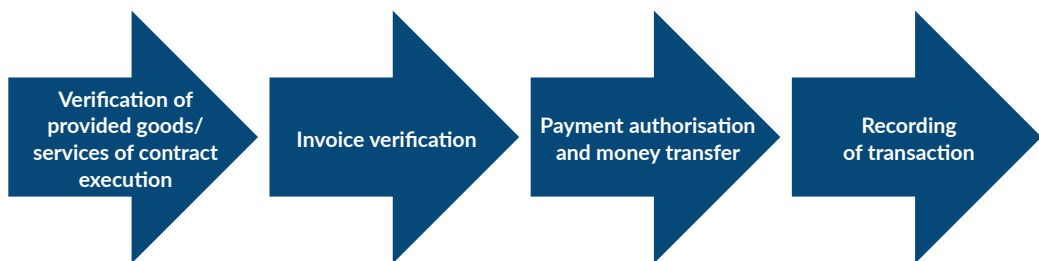
means spending well. It seeks to ensure that the maximum output is obtained from the resources devoted to achieve it, or alternatively, that only the minimum necessary level of resources is devoted in order to obtain a given level of output.

- **Effectiveness** – *the relationship between the intended and actual results of public spending – means spending wisely. Effectiveness indicates whether the intended results have been achieved, independently of the resources used to achieve those results.*

Information regarding budget execution should be accurate and reliable and provided in a timely manner. The MoD's financial department must be duly informed by other departments or the armed forces about signed contracts or legal commitments that represents financial obligations for the institution. The financial department should also be timely informed about changes in signed contracts, for example, changes concerning the amount, terms and conditions of any such payment. The MoD's human resources department

should also provide the financial department with timely information about spending linked to the MoD's personnel.

As a general rule, the process of making payments should be in accordance with specific procedures. Before making a payment, the responsible financial officer should check: a) that a competent person has verified that the goods have been received or the service has been delivered as agreed through the contract (verification of provided goods/services), and b) that the invoice and other documents requesting the payment are complete (invoice verification). It is important to note that although the finance department authorises payments, other departments, as appropriate, should be involved in the process of verification, as described above. Once the verification is complete, it is possible to authorise the payment, that is, sign for its execution. All invoices should be verified promptly upon reception and all transactions duly recorded. Concrete rules and procedures should regulate the process as illustrated below:



The MoD should design internal procedures that ensures credibility, reliability and legal clearance of documents before payments from its budget are made.

An inventory of all property for which the MoD is responsible should be made and updated on an annual basis. The actual situation regarding properties should be harmonised with the accounting records. Budgetary implications, for example, the need for maintenance or modernisation, should be recorded

during the budget year, in time for preparation of a new budget.

Reallocation of appropriations must be done in accordance with the national legislation and defined procedures. The details of how and to what extent money may be reallocated, for example, for it to be spent differently than what was planned in the budget, should be regulated by internal regulations. As noted above, more significant changes in the approved budget may need to be agreed by the parliament.

Financial statements should be prepared within the time frame set out by the legislation. The manner and timeline of the MoD's preparation of financial statements may be prescribed in greater detail by internal regulations.

All financial activities should be transparent and every action should be properly documented and reported. Every action with financial implications should be subject to independent, professional and unbiased audit and review. The MoD's officials should consider the recommendations of internal and external audit carefully, keeping in mind that the MoD's rules and procedures may need to be improved. Unless there are very good reasons not to, the MoD should comply with the recommendations provided both by internal and external audit.

3.4. BUDGET OVERSIGHT

Budget oversight represents an institutionalised system to check how resources are being spent, in terms of legality, as well if it follows the principles of economy, efficiency, and effectiveness. It consists of both internal and external accountability mechanisms. *External* oversight is normally done on behalf of the parliament, the branch of government with appropriating power, and may be seen as part of the checks-and-balances system among the three branches of government. *Internal* oversight and control is an instrument of the institution's top-level leadership, ensuring that the different units, for which the top level is responsible, operates within the law, the given budget, and within relevant rules and procedures. Many recent reforms in the budget oversight area are geared towards better managing various risks of corruption. This includes strengthening good management practices and reducing inefficiencies, as well as reducing unnecessary secrecy and other non-transparent practices. In short, budget oversight represents an important element of good governance – in the defence and security sector as well as in the public sector in general.

Below, special attention will be paid to three elements of budget oversight: 1) financial reporting, 2) internal financial control, which includes financial management and control as well as internal audit and 3) mechanisms of external scrutiny, such as parliamentary oversight and external audit.



The MoD should design internal procedures that ensure credibility, reliability and legal clearance of documents before payments from its budget are made.

3.4.1. FINANCIAL REPORTING

Financial reporting is a useful oversight instrument and provides a basis for assessing the government's operations and performances in all public sectors. Financial reporting entails extracting and presenting data from the accounting system in ways that facilitate analysis. Financial reports should be detailed and disclose accurate and timely information regarding the budget execution. These reports should provide information on all expenditure items, including wages and salaries, equipment, sales and property disposal.

Financial reports should be transparent and designed to fit the needs of the different users (the parliament, the public, budget managers, policy decision-makers, etc.). Today, most reports are (or should be) published on the website of the institution concerned, during the fiscal year and at the end of the year, making them readily available to the public. All reports should be made available to parliament and the national supreme audit institution.

Typical reports include daily reports on cash flows, monthly reports on budget execution,

revenue reports, mid-year reports and annual financial statements or fiscal reports. These are internationally recognised minimum requirements for fiscal reporting and constitutes the basis of the annual audits of accounts carried out by the supreme State audit institution.

Another key element that has become part of financial reporting during the past decades is the use of performance indicators that cover all of the Government's operations, including the defence sector. Performance information is an important component for assessing the value for money; the economy, efficiency and effectiveness principles, in the use of budget funds. It also supports future policy improvements and the political and budgetary planning process. This general trend implies greater focus on measuring performances in the defence sector and in the public sector as a whole.

3.4.2. INTERNAL FINANCIAL CONTROL

There are three key components of internal financial controls that are required for achieving efficient and effective use of public resources within the state institutions:

- financial management and control systems;
- internal audit;
- a central harmonisation unit for developing methodologies and standards relating to the two above mentioned components, including reporting.

The first component is a system for financial management and control. Such a system may be defined as the institution's policies and procedures used to help ensure that the various institutional programmes achieve their intended results; that resources used to implement these programmes are adequate to achieve the objectives set, and that the institution's programmes are protected from waste, fraud and mismanagement.

The system for financial management and control within the Ministry of Defence should scrutinise:

- all relevant areas of the MoD's activities, such as: expenditure, procurement, and revenue management;
- all major stages of the life-cycle of real estate management and procurement, including planning, execution, reporting, archiving and monitoring.

Financial management and control pre-supposes the existence of policies and procedures within the institution used to detect fraud, waste, abuse or error.

For a good financial management and control system to function as intended, clear rules and procedures for the handling of budgetary resources are necessary, as pointed out earlier in the text. Delegation of authority should specify the boundaries – scope – of the delegation, the objectives behind the delegation, as well as the reporting routines to follow.

The second component of internal financial control is the establishment of a functionally independent internal audit mechanism with a relevant remit and scope. Internal audit should

report directly to the institution's top administrative level. Internal audit is geared towards assessing institutional and managerial performance, not only legal compliance. In countries where internal audit has been introduced, it does not necessarily cover all areas of public administration. The standards for internal audit are progressively being developed, especially by the Institute of Internal Auditors.¹³ Change is taking place for the COSO and INTOSAI standards for internal control as well. While financial management and control is a type of *ex ante* control, internal audit represents *ex post* control.

The internal audit function of the Ministry of Defence collects, verifies, and analyses information that may be divided in two parts: 1) information on the design of the Ministry's system of financial management and control, and 2) how it function in practice. The purpose is to establish whether the system, both in its design and in actual operations, is functioning in accordance with internationally accepted standards and principles of sound financial management, cf. the standards referred to above. The internal audit function should be organised as a separate unit within the Ministry of Defence.

The internal audit analyses how the system of financial management and control functions in practice. It assesses possible systemic risks and provides recommendations for their mitigation.

Although the internal audit function is subordinated to the head of the MoD, it should as far as possible be organised as a functionally independent unit. Organisational independ-

¹³ <https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx>

ence means that the internal audit should be independent of the activities which are the subject of its auditing, which means it should not be part of any other organisational unit. Furthermore, it should report directly to the top management of the MoD. Functional independence means that the internal audit – based on how it assesses risks and potential problem areas – should choose the areas to be audited independently: the manner of auditing and how to report. The internal auditors, whether they are appointed for a limited period of time or not, must have free access to information and decision-makers. National legislation should define and protect the independence of the internal audit and include provisions on the auditors' obligation to objectivity and high ethical standards.

Internal audit is different from financial inspection. The auditors check the adequacy of the systems in place in terms of economy, efficiency, and effectiveness. Their key role is to perform internal audit with a view to highlight potential weaknesses that could jeopardise the fulfilment of the objectives of the institution. Recommendations should help to improve the financial management of the institution, reduce risks of corruption and other unethical practices, and eliminate – if possible – the misuse of appropriated funds or other assets. In short, the internal audit should help to make sure that the institution's leadership is in control over how money and other assets are managed.

The third component of internal control is the existence of a central harmonisation unit that guides, coordinates and supervises the arrangements for financial management and control – including internal audit – of different public bodies (ministries, agencies etc.). This

means that there should be an organisation responsible for the proposal of regulations, coordination and harmonisation of the implementation of financial management and control and internal audit throughout the entire public sector, including reporting requirements and practices. Such a body may also establish and coordinate training activities. Usually this body is organised within the Ministry of Finance. The purpose of having such an organisation is to provide consistency in the internal financial control systems within the public sector, and to ensure dissemination of best practices and provide new and enhanced guidance.

3.4.3. MECHANISMS FOR EXTERNAL SCRUTINY

The key mechanisms for external scrutiny may include a number of means, including the civil society. Institutionally, however, the main mechanisms are the work of the supreme audit institutions and the parliamentary oversight bodies. As these institutions have already been discussed above, the following paragraphs may serve as a reminder:

The supreme audit institution (SAI) constitutes a key mechanism by which a national institution – on behalf of the taxpayers – scrutinises how the government spend the money appropriated by the parliament, in this way it holds the government accountable. The set-up and functioning of arrangements for external audit is outside the powers of the executive. However, its effectiveness and impact are dependent on cooperation with the government and its various institutions. It is crucial that – for example, the various ministries, including the MoD – provide the SAI with comprehensive, accurate and timely information on spending, revenue, and other financial and economic decisions, and that they

formally, publicly, and within a reasonable timeframe respond to comments and reports published by the central audit institution. In turn, the SAI should operate in an independent, accountable and transparent manner. The SAI also has an important role to play in making sure that efficient internal financial control operates as an integral part of both financial management and control and performance audit in all public institutions. Effective follow-up of the SAI's recommendations is vital and normally part of the oversight of the parliament.

The supreme audit institution should audit defence ministry accounts regularly, along with those of the armed forces and other subordinate defence agencies. Such audits should focus not only on the legality of how funds are spent but also on whether value for money has been achieved and the given objectives have been reached. Value for money audits by the SAI should help focus attention on financial efficiency and effectiveness in the defence sector.

The audit results should be reported in a timely fashion to the parliament. One of the best ways to address identified inefficiencies is to make sure parliaments are directly engaged in the follow-up of the SAI's recommendations. The parliament's defence committee and/or public accounts committee should be engaged in the discussion and hold the MoD's officials accountable for how they use appropriated funds. Furthermore, the parliamentary hearings on the audit reports should be open to the public and published by the media in order to reach a broad as possible segment of society. Members of the defence committee should be vetted in order to be able to access classified information related to national security

and military intelligence, when such information is not suited for the public.¹⁴

As security sector organisations use a substantial share of the state budget, it remains essential that parliament monitors the use of the state's limited resources. It is crucial for parliament to receive comprehensive, accurate and timely information on the government's intentions and decisions regarding security issues and the security sector. The parliament will not have a proper constitutional position if the government briefs it only after having reached a final decision. In parliamentary democracies, the parliament should not be confronted with a 'fait accompli' – it should do more than just approving or rejecting government decisions. Supreme audit institutions may serve as an important source of information and expertise to the parliament, hence advise on how the government should be held accountable. In the defence sector, as in other public sectors, how budget funds are spent will always be a key indicator.

The parliament's oversight role over the defence sector and government as a whole, may be greatly assisted by the work of the national supreme audit institution. The opposite is equally crucial – the SAI needs full backing by the parliament. The SAI may assist the parliament with its substantive expertise on audit issues, while the parliament may assist the SAI in ensuring that their findings and recommendations are fully noted and followed up. Together, parliament and the supreme audit institution may represent a special and strong alliance in holding the government to account for the use of public funds.

¹⁴ Transparency International (2011), *Building Integrity and Countering Corruption in Defence and Security*, Transparency International UK.

4. Special Considerations Related to Classified Budgets

In all democratic countries – those in transition, as well as in more mature democracies – striking a balance between the principle of budget transparency and the particular nature of national security is frequently a problematic area. There is a tendency on the part of most state authorities across the world to classify a considerable amount of information related to national security, including that related to defence expenditure. Especially in situations characterised by uncertainty and new or emerging security challenges, risks and threats, there is a tendency to keep such information away from the public eye. The reasons for that may certainly be justified but, if used automatically and too frequently, such lack of transparency may undermine the democratic functioning of a society.

The key challenge when dealing with classified budgets is to ensure that secrecy is used only where and when it is essential. The key requirement in keeping defence expenditures confidential is that they may be convincingly

justified – for example, that transparency may threaten an important strategic objectives, for example the protection of territorial integrity of the state vis-à-vis an external threat; the set-up of an adequate defensive system, etc. There should be an internal procedure in place that stipulates the exact mechanisms by which expenditures may be classified.¹⁵

In spite of their confidential nature, classified budgets should not be excluded from all scrutiny, and definitely not from parliamentary oversight. When the government's budget proposal has been submitted to the parliament, one approach may be to differentiate between the regular categories of budget proposals and budget proposals that are classified due to their special nature. For example, classified items could be presented in aggregate figures, while unclassified items could be presented in considerably more detail. An often cited example of how to deal with classified budgets approval is the case of South Korea, as presented in the box below:

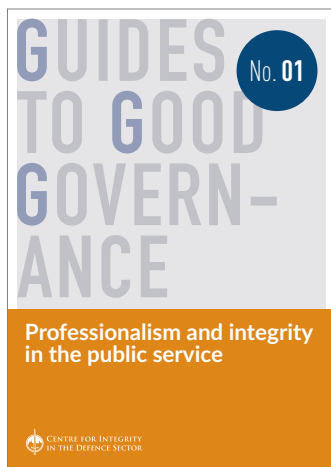
¹⁵ Transparency International UK (2011), "The Transparency of National Defence Budgets- an initial review", Transparency International UK, Defence and Security Programme.

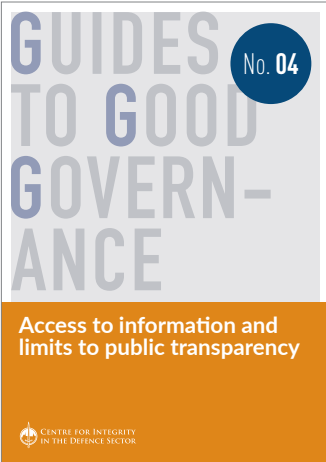
South Korea's government separates its defence budget into three categories of differing secrecy. Category A budget items are presented for discussion in the National Assembly in aggregated form; Category B items are presented to members of the National Assembly Committee of National Defence in disaggregated and detailed form; Category C items are further disaggregated and presented to the Committee of National Defence. Previously, members of the legislature were given only a lump sum figure for debate.

Source: Chul Choi, Jong (1998), 'Chapter Six: South Korea' in Pal Singh, Ravinder, ed. *Arms Procurement Decision Making Volume I: China, India, Israel, Japan, South Korea and Thailand*, http://books.sipri.org/product_info?c_product_id=156#contents TI UK (2011), "The Transparency of National Defence Budgets- an initial review", Transparency International UK, Defence and Security Programme.

Classified items in the MoD's financial statements should be audited by the supreme audit institution, which may issue a classified audit report. Such a report should also be submitted to of the parliament, in order to uphold the key democratic accountability mechanism which holds the executive accountable for use of public funds.

Guides to Good Governance series





Guides to Good Governance is a series of small booklets each of which discusses a particular topic of importance to good governance in the defence sector. The guides can be read by individuals with an interest in learning more about one or several topics of direct relevance to good governance in the defence sector – or the public sector more generally – and they can be used for educational purposes.

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