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Establishment & Strengthening of Internal Audit Function in Khyber Pakhtunkhwa



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ASP-RSPN

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Acronyms

ASP	Assessment and Strengthening Program
BISE	Board of Intermediate and Secondary Education
C&W	Construction and Works
DEO	District Education Officer
DIAC	Departmental Internal Audit Cell
GoKP	Government of Khyber Pakhtunkhwa
IA	Internal Audit
KP	Khyber Pakhtunkhwa
PIAC	Provincial Internal Audit Cell
P&D	Planning and Development
RSPN	Rural Support Programmes Network
SE	Superintending Engineer
SOPs	Standard Operating Procedures
USAID	United States Agency for International Development
XEN	Executive Engineer

2. Context and Overview

Audit is the corner stone of good governance. It ensures that state business is conducted with accountability and integrity. Whereas external audit is well established practice in Pakistan, internal audit function remains to be institutionalised.. Realizing the importance of having strong internal control mechanisms, GoKP took a major decision of establishing internal audit function across its departments. Finance department sought technical assistance from ASP-RSPN for implementation of this reform agenda. A charter laying down a solid foundation for building an effective internal audit function was approved. Elementary & Secondary Education, Communication and Works and Health departments were selected as pilots for this exercise. ASP-RSPN provided support in developing internal audit framework, methodology and toolkits in line with the international best practice and global audit standards. After the success of the pilot the GoKP now plans to scale this exercise up to six more provincial departments. This is recognition of the efforts of USAID and ASP-RSPN to develop institutional capacity building of public sector organizations which is guided by a consultative approach that focuses on development of workable solutions which are owned and championed by the government.

All audits, regardless of the nature, involve providing assurance on the design and effectiveness of the system of internal controls

3. ASP-RSPN – An Introduction

Assessment and Strengthening Program – Rural Support Programmes Network (ASP-RSPN) is a five year program funded by the USAID. USAID aims to implement a substantial portion of its development portfolio in Pakistan through public sector partner organizations. One of the predicaments of this aid delivery mechanism is that many local institutions face institutional capacity issues especially in the area of internal control. This leads to a higher degree of risk, inadequacies in outcomes and consequently serious repercussions for development. ASP's mandate therefore is to build capacity of Pakistani organizations for effective delivery of aid.

ASP's support to recipient organizations is based on three pillars:

Pillar-I: The basic principle followed by ASP-RSPN approach towards capacity building is to devise an organization-specific, customized and relevant capacity building plan without using a “one-size-fits-all formula” approach. This enshrines the golden rule of building on the existing structures, systems and policies without re-inventing the wheel.

Pillar-II: ASP believes that the reforms should be demand driven and should have the full ownership of the recipient organization.

Pillar-III: The sequencing of interventions is critical and should be carefully timed in order to avoid the possible blow-back which usually happens when reforms are either too drastic or hasty.

ASP-RSPN sees itself as a catalyst whose job is to point the way towards reforms and give a roadmap of how to get there. It is for the government to decide whether it wants to tread that path.

Under this guiding principle, ASP has partnered with the federal and provincial governments for several capacity building initiatives in the areas of financial management, human resource management, public procurements, budgeting and planning. One such important initiative has been the establishment and strengthening of internal audit function in Khyber Pakhtunkhwa.

4. Internal Audit – Why is it Important

As pointed out, audit is the cornerstone of good governance. It ensures that state business is conducted with transparency, accountability and integrity. Audit instils confidence among citizens by providing unbiased assessment of whether public officials are managing public resources responsibly, effectively and honestly. Auditor's role supports the governance responsibilities of oversight, insight, and foresight. Oversight addresses whether public sector entities are doing what they are supposed to do; funds are being spent on intended purposes and laws are being complied with. *Insight* assists decision makers by providing an independent assessment of public sector policies, programs, operations, and results. *Foresight* identifies trends and emerging challenges.

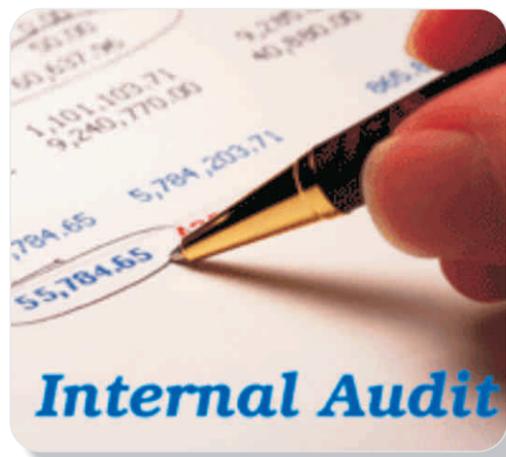


Figure 2: Functions of Internal Audit

Audit has two dimensions; internal and external. Whereas external audit is carried out post facto, internal audit is an on-going mechanism. External audit is a review of financial statements for compliance; internal audit on the other hand seeks to ensure value for money for the management. It is therefore more useful in helping the management of an entity to identify risks and take mitigating actions before things go wrong. Internal Audit is a powerful tool of empowerment in the hands of key managers and administrators.

External audit is well established in Pakistan in the form of statutory audit which is conducted by the office of the Auditor General. Internal audit however has not been institutionalised in many public sector entities. Several governance assessments have identified lack of internal controls as an area of high risk in government departments¹. As a result internal audit has started to take root as a good practice to preempt irregularities which result in subsequent audit observations.

¹Deloitte conducted one such assessment of GoKP in March 2010.

5. Khyber Pakhtunkhwa – a Pioneer of Reforms in Internal Audit

Government of Khyber Pakhtunkhwa became the first provincial government in the country to introduce reform measures in this area and decided to establish internal audit function across all provincial government departments, offices,

autonomous bodies, etc. The decision was taken at the highest level, i.e., the Provincial Cabinet which showed a strong political resolve behind this reform agenda.

As a follow up of this landmark decision Finance Department GoKP approached ASP-RSPN for providing technical assistance in implementing this initiative. ASP's strategic intervention aimed at providing support in establishing the structures, systems, policies and procedures for internal audit in line with the international internal auditing standards and building capacity of government departments for implementing the internal audit.

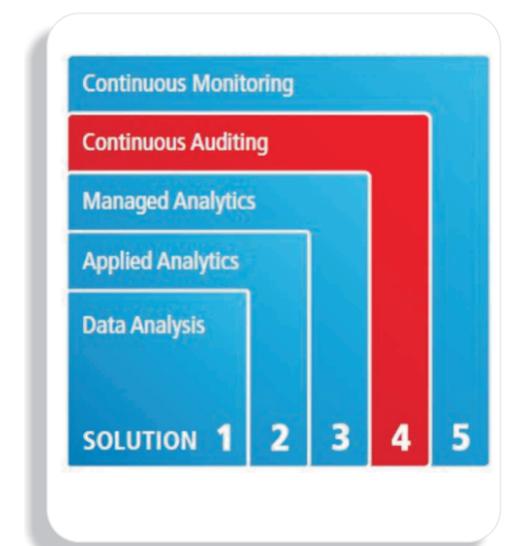


Figure 3: Work Flow of Internal Audit Cells

6. ASP's Support to GoKP

As a first step the Finance Department developed an Internal Audit Charter. The Charter lays down legal and institutional foundation for establishing an effective internal audit function in the province. It gave the mission, vision, scope and purpose of the internal audit function and the institutional arrangements for its implementation.

In the next phase ASP-RSPN provided technical assistance to GoKP in developing internal audit structures for three departments that were selected on pilot basis i.e. Communication and Works (C&W), Education and Health.

Table 1: Internal Audit Compendiums developed for three departments and their sub-entities

Internal Audit Compendiums		
	Entity	Sub-Entities
Internal Audit Toolkits	Education Department	Directorate of Schools & Colleges
		Board of Intermediate and Secondary Education
		District Education Officer
		School
	C&W Department	Secretariat
		Chief Engineer's office
		Superintending Engineer Office
		XEN's office
	Health Department	Secretariat
		Director General Health Services

The structure was approved in the provincial budget for the financial year 2013-14. It envisaged setting up independent internal audit cells initially in these three departments and then rolling them out to other departments. After approval of the internal audit structure ASP-RSPN deployed its team of experts who developed internal audit methodology and toolkits. In each department the team documented business processes; identified risks associated with each process and suggested controls to mitigate these risks. It also designed audit programs and templates to help field auditors in planning and reporting their work. As a result of this unique exercise which - was first of its kind in any government department - a model of internal audit has been developed which is based on international best practices and is robust enough to be replicated in other provinces.

7. Internal Audit Framework

The framework translates the objectives of Internal Audit Charter into an implementation mechanism comprising of management structure, reporting lines, audit guidelines, policies and procedures for conducting internal audit in different departments of the Government of Khyber Pakhtunkhwa. Under this framework GoKP would establish internal audit cells in the provincial departments to help them accomplish their objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of risk management. There will be a Departmental Internal Audit Cell (DIAC) headed by a Chief Internal Auditor who will report to the administrative secretary and a

Provincial Internal Audit Cell (PIAC) which will receive the annual audit plans and annual audit reports from all departments and present these to the Chief Secretary in a consolidated manner.

As envisaged in the Charter, the internal audit cell will determine whether a department's governance processes, internal controls and risk management systems are adequate and functioning in a manner to ensure that the application of risk management procedures and methodologies is effective; significant information is accurate, reliable and timely; employees' actions are in compliance with the internal control policies, standards and applicable laws; the department's resources and assets are economically acquired, efficiently used, properly accounted for and adequately safeguarded; quality and continuous improvements are fostered in the department's control processes and significant legislative and regulatory issues impacting the department are recognized and appropriately addressed. The basic premise is that internal controls should be built "into," not "onto" the existing business processes.

8. Internal Audit Methodology

After developing internal audit framework ASP's team developed an internal audit methodology which draws on international internal auditing standards². The methodology lists step by step procedures to be followed during planning, execution and reporting stages of the audit. It uses a risk-based approach which emphasizes timely identification of risks and adoption of mitigating measures depending upon the risk appetite of an organization. Audit

²International Standards for the Professional Practice of Internal Auditing developed by the Institute of Internal Auditors (IIA).

methodology consists of three components:

- i. Audit planning which includes strategic and operational planning, underpinned by a risk-based approach for identification of audit universe and prioritizing on the basis of assessed risks.
- ii. Execution which includes engagement, assigning of responsibility, sample selection, evidence gathering, selection of audit criteria and detailed audit procedures.
- iii. Compilation of results which includes, structure and contents of the audit report, initial draft and final audit report along with the timelines.

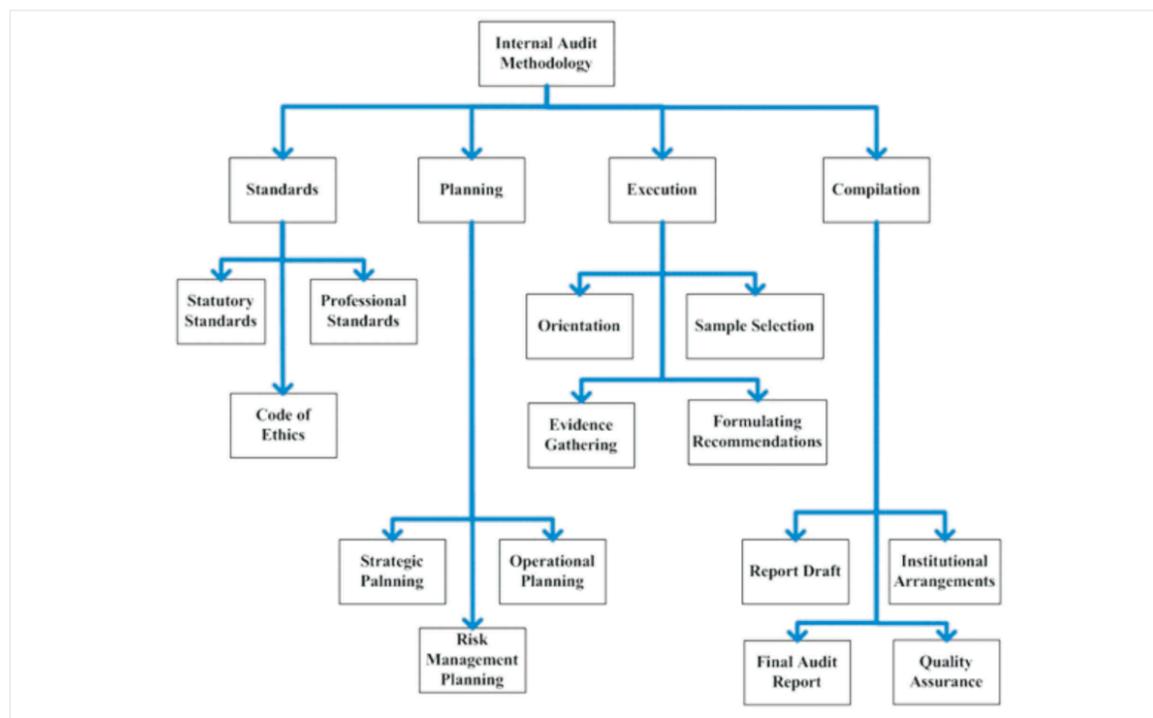


Figure 4: Internal Audit Methodology

9. Internal Audit Toolkit:

After developing internal audit methodology ASP prepared two sets of toolkits for C&W, Education and Health departments. The first set contained operating procedures and guidance notes at the department i.e., Secretariat level. The second set delved deeper and contained toolkits for use at the sub-entity level³. The department specific toolkit has two benefits; first it translates internal audit methodology into actionable points and second it provides the internal audit team with a ready reference of the existing processes of an entity and saves their time and effort.

9.1 Structure of Internal Audit Toolkit

The internal audit toolkit consists of the following sections:

1. Permanent file templates
2. Process documentation
3. Audit checklists and programs
4. Report writing

Section I relates with developing a general understanding of the entity. It gives information about the nature and objectives of the entity and an assessment of internal and external factors that can affect its operations. It then defines the approach and methodology for planning internal audit and provides standardised templates for work planning. A completed template has also been included in this section as an illustration. The methodology requires auditors to record all information in a permanent file that would become a reference point for future audits.

Section II is entity-specific and captures the 'as-is' state of affairs. It contains detailed mapping of business processes and explains them with the help of visually-appealing flows charts. Process mapping can vary according to the nature, objectives, operations and size of an entity. This section also contains a risk and control matrix. Risks associated with each process are identified and related controls are evaluated for their efficacy. Based on risk assessment and existing controls, remedial measures are suggested.

³In all, 11 toolkits were developed. For Education Department these were for Secretariat, Directorate of Schools & Colleges, BISE, DEO and a school. For C&W these were for Secretariat, Chief Engineer's office, SE Office and XEN's office. For Health Department these were for Secretariat and DG Health.

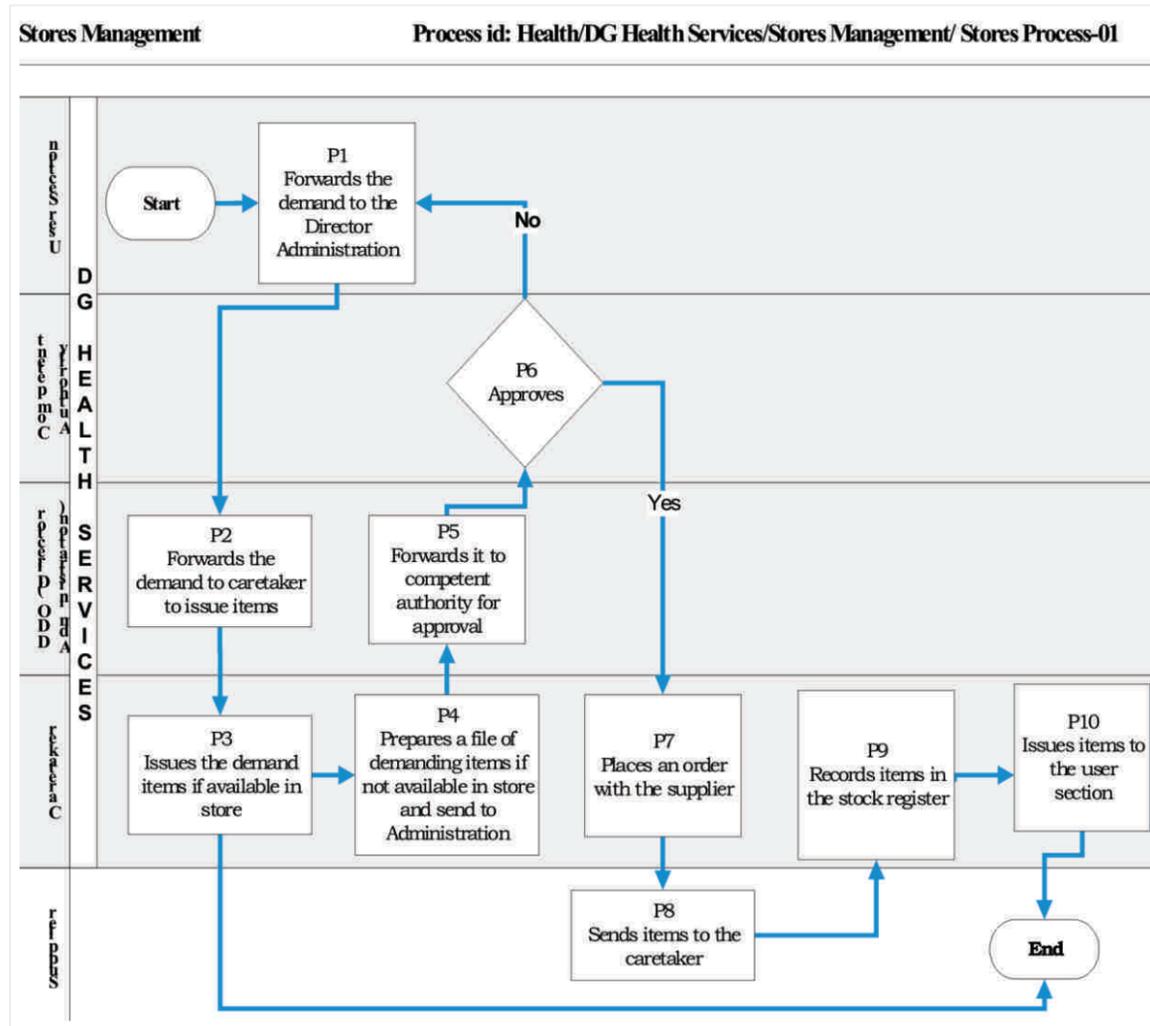


Figure 5: Illustration of Work flow of a Process

Section III provides guidance on how to carry out the audit with the help of checklists for each step and templates for audit programs. These have been developed on the basis of the process mapping documented in section II of the toolkit.

This section also gives useful examples of how to fill the templates. An Illustration of Risk and Control Matrix

Table 2: Illustration of Risk and Control Matrix

Entity	Process Step	Risk	Existing Control	Mitigating Measures
Health 1. Secretariat Planning Section	P2 –Issues instructions to DG Health Services along with guidelines to start compiling and collecting the relevant data.	Risk that instructions and guidelines are not issued to DG Health Services on time	Letters are issued through dispatch and diary section which keeps record of all dispatches on daily basis.	<ol style="list-style-type: none"> 1. Time service standards as per "APPENDIX-III Para 7 (c)" Manual of Secretariat should be followed. 2. To ensure adherence to above referred rules diary in and diary out must be reconciled on a monthly basis to identify cases outstanding for more than the prescribed time standards. 3. The reconciliation report should then be forwarded to the next higher authority for his/her review & signature. (where appropriate)

Section IV - the final section of the toolkit contains a standardised format for reporting the audit findings and a template for highlighting the deficiencies of the existing internal controls. The report on the internal controls design deficiencies is a by-product of the process documentation and contains indicators that can alert the management to the potential risks.

The toolkit and templates which the team has developed are user-friendly. They are easily comprehensible by the auditors as well as managers who are the end-users of internal audit exercise.

Summary of ASP's Achievements

1. Governance structure, reporting lines, work flow charts and mandate of PIAC and DIACs.
2. Process mapping of each line department and autonomous bodies, boards, authorities, corporations, institutes and projects under it.
3. Pilot audits of education and health departments and pension & payroll functions in the finance department.
4. Development of permanent files templates, forms and model illustrative files.
5. Critical processes documentation and identification of risks and mitigating control recommendations for education department (secretariat, directorates, DEO and schools).
6. Critical processes documentation and identification of risks and mitigating control recommendations for communication & works department (secretariat, chief engineer's office, SE office and XEN's office).
7. Critical processes documentation, identification of risks and mitigating control recommendations for health department including secretariat and the DG Health office.
8. Development of standardised audit report format incorporating critical processes such as financial management, HR management, assets management, information technology management and procurement.

10. Way Forward

ASP's partnership with GoKP for laying the foundation of internal audit has been a great success. This has been acknowledged by all stakeholders including the Finance Department and the line departments which participated in this exercise. Government of KP acknowledged ASP's efforts in the budgetary White Paper 2012-13 and adopted its recommendation of creating new positions of internal auditors in the pilot departments. 18 such positions were created in the current year's budget (2013-14) which is a testimony to GoKP's commitment and ownership of reforms.

To keep the momentum of reforms going GoKP has planned to replicate ASP's model across all provincial departments and has requested the USAID to continue supporting this initiative through ASP. GoKP has also asked for assistance in training and capacity building of staff for carrying out internal audit based on the methodology developed by ASP. Responding to GoKP's request ASP has developed a capacity building plan that will capitalize on the success already achieved in developing the internal audit methodology.

GoKP has constituted a steering committee to provide strategic direction to the programme. The fact that the Additional Chief Secretary (P&D) is heading this committee has further raised the profile of this reform programme. The committee has identified five new departments (Higher Education, Public Health, Irrigation, Agriculture and Energy) where ASP's model of internal audit will be replicated.

A critical step at this stage is for the government to deploy appropriately qualified human resource on the approved positions of internal auditors. It will then be possible to train the future auditors on understanding the tools and methodology developed by ASP-RSPN for an effective and efficient functioning of internal audit cells within each department. Another important initiative to be taken is to ensure gender integration and equal-opportunity policies within various operations of internal audit. Establishment of internal audit in KP is a sustainable solution for local institutions that will continue even after the phasing out of the outside assistance. Ultimately the success of this reform initiative depends on how successfully KP government adopts, owns and internalizes it.

"Internal audit is a formal exercise initiated by the government and already approved by the government". Secretary Finance, KP