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The Government of Malawi

Assessment of fiduciary risks in the use of the country PFM system for investment lending projects

March 2012

Africa Region Financial Management (AFTFM)

CURRENCY AND EXCHANGE RATES

Currency unit = Malawi Kwacha (MWK)
US$ 1 = MWK 151.219 (As of May 24, 2010)

Financial Year or Fiscal Year (FY): July 1 to June 30

ACRONYMS AND ABBREVIATIONS

ACB	Anti Corruption Bureau
AFR	Africa (Region)
AFTFM	Africa Technical Financial Management
AG	Auditor General
AGD	Accountant General's Department
ARV	Ant Retroviral Drugs
BAAC	Business Action against Corruption
CABS	Common Approach to Budget Support
CBRLDP	Community Based Rural Land Development Project
CE	Chief Executive
CIAU	Central Internal Audit unit
CO	Controlling Officer
CPAR	Country Procurement Assessment Report
CPO	Central Payment Office
CPS	Central Payment System
CSAAC	Civil Society Action against Corruption
DFID	Department for International Development (UK)
DPL	Development Program Loan
FIMTAP	Financial Management Transparency and Accountability Project
FM	Financial Management
FMR	Financial Monitoring Report
FRA	Fiduciary Risk Assessment
GAC	Governance and Anti Corruption
GDP	Gross Domestic Product
GFEM	Governance, Financial and Economic Management
GoM	Government of the Republic of Malawi
HRMIS	Human Resource Management Information System
ICT	Information Communication Technology
IDA	International Development Association
IFMIS	Integrated Financial Management Information System
IFR	Interim Financial Report
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
IPC	Internal Procurement Committee
IPSAS	International Public Sector Accounting Standards
LOA	Loans Department
LoC	Letter of Credit
MDA	Ministries, Departments and Agencies (of government)
MEPD	Ministry of Economic Planning and Development

MFAAP	Malawi Fiduciary and Accountability Action Plan
MGDS	Malawi Growth and Development Strategy
MOF	Ministry of Finance
MOIWD	Ministry of Irrigation and Water Development
MTR	Mid-Term Review
NACS	National Anti Corruption Strategy
NAO	National Audit Office
NGO	Non-Governmental Organization
NLGFC	National Local Government Finance Committee
O&M	Operation and Maintenance
ODPP	Office of the Director of Public Procurement
OP	Operating Policy
OPCS	Operational Policy and Country Services
ORAF	Operational Risk Assessment Framework
PAC	Public Accounts Committee (of Parliament)
PAD	Project Appraisal Documents
PAF	Performance Assessment Framework
PAYE	Pay As You Earn (Employment Tax)
PDO	Project Development Objective
PEC	Project Executive Committee
PEFA	Public Expenditure and Fiduciary Assessment
PFEM	Public Financial and Economic Management
PFM	Public Financial Management
PFMA	Public Financial Management Act
PIU	Project Implementation Unit
PMU	Project Management Unit
PRSC	Poverty Reduction Support Credit
PSC	Project Steering Committee
PSIP	Public Sector Investment Program
RBM	Reserve Bank of Malawi
SFPDP	Smallholder Flood Plains Development Project
SOE	Statement of Expenditure
SPU	Specialized Procurement Unit
SWAp	Sector Wide Approach
TA	Technical Assistance
UCS	Use of Country Systems
USAID	United States Agency for International Development
WBG	World Bank Group
WUA	Water User Association

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A. EXECUTIVE SUMMARY

1. This study was undertaken to assess fiduciary risks in using the Malawi Public Financial Management (PFM) system for implementing Bank-financed investment projects and to identify risk mitigation measures required for such use.[1] Consistent with the Financial Management (FM) Sector guidance note and the Africa Technical Financial Management (AFTFM) framework methodology in Annex 5, this study uses a risk-based approach. The risk-based approach identifies and ranks fiduciary risks as High, Substantial, Moderate, and Low. The decision to use the country PFM system for a specific investment lending project then rests with the task team, guided by the Country Management Unit, taking into account this fiduciary risk assessment and other factors such as the nature and complexity of the project, the guidance contained in Annex 5 and an assessment of implementing ministries.

2. Overall Malawi is progressing with its PFM reform agenda. Since 2004 there has been good progress in tightening fiscal controls and putting in place a robust PFM legal framework, supported in execution by an Integrated Financial Management Informationm System (IFMIS) and Human Resource Management Information System (HRMIS). However, as the Public Expenditure and Fiduciary Assessment (PEFA) scores show and as evidenced by sector assessments, weaknesses still exist in implementing PFM reforms and enforcement of the legal framework. Public sector capacity is weak and limited human resources are stretched. Particular areas of concern in relation to fiduciary risk are budget execution, procurement and internal and external audit. However, reform programs are in place in all these areas, providing assurance that the key risks are being mitigated.

3. The depth and breadth of corruption in Malawi remain a real concern. The December 2011 Transparency International Corruption Perception Index scored Malawi 3 out of 10, a drop from 3.4 in 2010. Earlier in July, Civil Society Organization presented a petition to government to address 20 economic and political governance concerns, three of which were on transparency and corruption issues. Although Malawi has an extensive legal framework and a number of agencies to fight corruption, implementation and enforcement of the legislation is weak, and reports point to insufficient capacities within the mandated institutions and selective application of rules. The nature of corruption in Malawi indicates that even ring-fenced FM arrangements for

[1] To "use the country FM system" means to rely on the existing FM system or any of its components in implementing an investment project. For example, in the area of accounting and reporting, use of country systems means using the government accounting system, national accounting standards, and government financial statements. For treasury and funds flow, it means using the government treasury system, regular treasury banking arrangements, and treasury procedures for effecting project expenditures. For internal controls, it means using existing national rules and procedures for implementing the project. For external audit, it means using the country's supreme audit institution to audit the project financial statements and relying on the national audit standards.

projects are not immune to the maladies affecting the national systems , hence calls for robust control and monitoring mechanisms.

4. The study concludes that key system elements to move towards substantial use of the country PFM system for investment lending projects, implemented by MDAs that are on Budget, are present, but require implementation refinement. This includes integration of Bank-funded investment lending projects into the planning and budget processes, appropriation, expenditure control, funds flow, accounting and reporting through the IFMIS and internal and external audit arrangements. Specific areas of refinement include the following –

a. During project preparation, specific consultation is needed with the Ministry of Economic Planning and Development (MEPD), Ministry of Finance (MOF) and National Audit Office (NAO) regarding inclusion of the project in the budget, Parliamentary appropriations, warrants, fund flow, use of IFMIS for project control, accounting and reporting, internal audit and external audit.
b. Key generic decisions that will be required include the following –
    i. The specific expenditure account for the project as per the GoM Chart of Accounts. The specific account combination identifies the specific project (Project number), project components (Cost Center) and the financier (Donor Code).
    ii. Project effectiveness will in all likelihood not coincide with the annual approval of the Budget by Parliament. Project expenditure can only be incurred upon authority and process established in the PFM Act. Procedures to proceed with project implementation need to be agreed with the Ministry of Finance and Development Planning, until such time as the project can be included in the estimates for Parliamentary approval.
    iii. Protection of project funding against virement needs to be agreed and controls need to be established, also in the IFMIS.
    iv. A project specific bank account (designated account) needs to be opened into which withdrawals of the loan / grant will be deposited by the Bank. This could be in either a foreign or local currency, dependent of project requirements. This Designated Account also need to be incorporated into the IFMIS, and the requisite reconciliation procedures and responsibilities need to be agreed.
    v. The process to submit withdrawal applications and the required documentation to the Bank also need to be established, together with authorized signatories. Documentation could include interim financial reports, statements of expenditure, copies of invoices, and other information as agreed with the Bank based on the disbursement procedures agreed for the project.
    vi. Project expenditure – the normal procedures and controls prescribed in the PFM Act, regulations and other instructions will be applied to the project, subject to compliance to procurement arrangements agreed in

the Financing Agreement. Specific IFMIS access controls need to be established for authorized project users.

vii. The format of the quarterly interim financial report for the project needs to be agreed. If feasible this could be defined directly in the IFMIS, or reporting could be supported outside of the IFMIS with a template into which the required project revenue and expenditure data is exported.

viii. End-of-year procedures for the project need to be agreed, including treatment of project cash balances. The development and maintenance of fixed asset registers for projects.

ix. The annual financial reporting requirements for the project need to be agreed, including the formats and accounting standards that need to be consistently applied.

x. The internal and external audit requirements need to be agreed.

5. In summary, key risks introduced by substantial use of the country PFM system for investment lending projects are summarized in Table 1 below –

Table 1 – Summary risk assessment

Risk Area	**Key Risk Element**	**Risk Assessment**	**Proposed Mitigation**	**Residual Risk**
Planning and budgeting	Inadequate budget appropriation for the project	High	Ensure that financing agreement binds GoM to full appropriation of loan proceeds over the life of the project.	Low
	Project implementation may be delayed as a result of late appropriation	Moderate	Procedures to proceed with project implementation need to be agreed with the MEPD and MOF, until such time as the project can be included in the estimates for Parliamentary approval.	Low
	Diversion of project funds	Moderate	Protection of project funding against virement needs to be agreed and controls need to be established, also in the IFMIS.	Moderate
	Overall	Moderate		Low
Accounting and reporting	Delays in recording of transactions	Low	Set up in IFMIS specific bank accounts, expenditure accounts, access controls, accounting responsibilities and reconciliation controls for each project.	Low
	Weak audit trail	Moderate		Low
	Unauthorized access and unreliable data	Substantial		Moderate
	Unreliable and late financial statements	Low	Define project reporting requirements directly in the IFMIS, or reporting could be supported outside of the IFMIS with a template into which the required project revenue and expenditure data is exported.	
	Non-compliance with acceptable accounting standards	Substantial	Agree standards and format of the project annual financial statements.	Moderate
	Overall	Substantial		Moderate
Treasury and funds flow	Inadequate funds available	Low	Establish authority, capacity and process to timely submit withdrawal applications and the required documentation to the Bank.	Low
	Unpredictability in the availability of funds	Moderate		Low
	Diversion of project funds	Moderate	A project specific bank account (designated account) needs to be opened, incorporated into the IFMIS, and the requisite reconciliation	Low
	Inability of Treasury	Low		Low

Table 1 – Summary risk assessment				
Risk Area	**Key Risk Element**	**Risk Assessment**	**Proposed Mitigation**	**Residual Risk**
	and RBM to support project banking needs		procedures and responsibilities need to be agreed.	
	No access to project funds over year-ends	Moderate	End-of-year procedures for the project need to be agreed, including treatment of project cash balances.	Low
	Overall	Moderate		Low
Internal control and internal audit	Ineffective control framework and procedures	Moderate	Normal project expenditure procedures and controls prescribed in the PFM Act, regulations and other instructions will be applied to the project, subject to compliance to procurement arrangements agreed in the Financing Agreement. The development and maintenance of fixed asset registers for projects needs to be agreed.	Moderate
	Ineffective internal audit	Substantial	Agree specific internal audit requirements for each project, which could include scope, approach and reporting requirements. Provide Central Internal Audit Unit (CIAU) with appropriate capacity development support.	Moderate
	Overall	Substantial		Moderate
External audit	Delayed submission of audit reports	Low	Agree specific external audit requirements for each project, which could include scope, approach and reporting requirements. Provide NAO with appropriate capacity development support.	Low
	Low capacity and skills at the NAO to perform financial statement audits	Substantial		Moderate
	Lack of independence	Moderate		Moderate
	Unacceptable audit standards and non-compliance with audit standards	Moderate		Moderate
	Overall	Substantial		Moderate

6. Recommended implementation steps are as follows -

- ***Discuss with the country management team.*** It is important to share the assessment report with the country management team and discuss the findings; this approach helps in reaching consensus on the next steps and getting the country systems agenda on the radar screen of the country management team.

- ***Incorporate the findings of the assessment report in the Country Assistance Strategy (CAS).*** The next CAS should consider the use of country FM systems as one of the key goals of Bank support to the country; this provides strong incentives to the government and a clear message to task teams.

- ***Reach agreement with the authorities on cross-cutting issues and proposed mitigating measures.*** The country team should reach agreement with the government authorities on such cross-cutting issues as modalities for ensuring timely and credible flow of funds for project implementation and timely approval of Bank-financed projects, general formats of periodic and annual financial reports to be generated using the government accounting system, and other matters outlined in Table 1 above. Such issues need to be tackled on a portfolio-wide basis rather than project by project.

- ***Focus Bank / donor support to the government's PFM reform program.*** It would be important for the team to review how the PFM reform program also support the use-of-country-system agenda.

- ***Carry out supplementary FM assessment of sectoral ministries for pipeline investment projects.*** Despite apparent uniformity in structure and systems, ministries and departments might vary in their actual practices and capacities. For each investment lending project, therefore, it would be important to supplement the results of the assessment of central institutions and systems with an assessment of implementing ministries/institutions. Task teams may seek inputs from INT's Preventive Services Unit in designing specific corruption risk mitigation measures.

- ***Ongoing monitoring of country fiduciary risks.*** As PFM diagnostics are updated (for example, when a repeat PEFA assessment is carried out), it is good practice to update the fiduciary risk assessment report.

7. ***Supervision of Projects Using Country FM Systems.*** Since it is expected that greater use of country PFM systems would result in streamlined supervision activities, sample supervision reports for projects using country systems will also be added to provide practical examples of supervision methods and unique issues. It is expected that current weaknesses in internal and external audit arrangements will require focused capacity development support before moderate risk levels will be reduced over time to a more acceptable level. The Bank's implementation review and support efforts are therefore not expected to be reduced at this time.

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B. INTRODUCTION

i. Background

1. The Bank's Operational Policy (OP) 10.02, Financial Management, provides clear direction for the use of country systems by stating that, where feasible, the Bank will use existing financial management (FM) arrangements that are an integral part of the borrower's institutions. The GAC Strategy also states that the World Bank Group (WBG) will strive to strengthen, rather than bypass, country systems2. It is recognized that better national institutions are a more effective and long-term solution to governance and corruption challenges and to mitigating fiduciary risks for all public money, including that provided by the Bank. Despite this authorizing environment and although the Bank has made some progress in the use of country FM systems for implementing Bank-supported projects, a pivotal theme running through various Bank reports to the Board is that there continuous to be a need to accelerate and deepen efforts in this regard.

2. This work assumes additional significance in view of the targets specified in the Paris Declaration, to which the Bank is a signatory. For 2010, the Paris Declaration aims at a two-thirds reduction in the percentage of aid to the public sector that does not use partner countries' public financial management (PFM) systems. The Accra Agenda for Action, adopted by donors and partner countries in 2008, reiterates the importance of using country systems and exhorts donors to accelerate and deepen that use and to explicitly state the reasons when not using the country system.

3. Country FM Systems are routinely used in poverty reduction support credit (PRSC) and other development policy lending (DPL) operations. In addition, some elements of the country FM system are used regularly in investment lending projects in Malawi. For example, all investment lending projects are audited by the Office of the Auditor General or by his or her nominee. Annex 1 provides an overview of the extent to which projects in Malawi uses the country PFM system. However, greater use of the country FM system is hampered by a lack of a general assessment of the fiduciary risk of using country FM systems to its fullest extent.

4. *Fiduciary risk* is the risk that Bank funds will not be used for the intended purposes or that they will be used without due attention to economy and efficiency. In projects using country FM systems, Bank funds are potentially commingled with the country's own funds; therefore, a fiduciary risk assessment also needs to consider broader country PFM risks that could affect the fiduciary risk.

[2] "Country systems can be defined as a country's normal institutional arrangements and processes for financial management"; see *Making Greater Use of Country Financial Management Systems: An Approach Note*, Financial Management Sector Board, May 20, 2004. In practical terms country FM systems means country's national budget systems, accounting and reporting systems, internal control and internal audit systems, treasury and funds flow systems, and supreme audit institution.

5. The objectives of this study are –

- To inform the Country Assistance Strategy (CAS) on the approach to future project delivery in Malawi. Identifying the use of the country FM system as one of the key goals of Bank support to the country in the CAS provides important incentives to the government and a clear message to task teams.

- To get an understanding of overall fiduciary risks in the use of the country FM system. By comparing such risks to fiduciary risks using traditional ring-fenced arrangements, staff can highlight any differential and/or incremental steps in terms of risk-management approaches, when using country FM systems for implementing a new project.

- To identify the steps the Bank or the government would need to take to make greater use of country FM systems. This assessment would highlight cross-cutting issues requiring agreement with the authorities at the country level rather than at the project / sector level. Engaging with the authorities at an early stage to address such issues helps ensure that the minimum FM arrangements are in place for projects considering the use of country FM systems. It is important to emphasize here that the objective of the assessment is not to prepare an overall PFM reform program for the country, but rather to identify specific steps for making greater use of country FM systems.

- To inform the design of future projects in order to move towards greater use of the country PFM system for its implementation.

6. There are several important reasons why the Bank should use country FM systems to implement investment projects:

- ***Scale up development impact.*** Capacity-building efforts within a PIU often do not strengthen the ministry where the PIU is located, and using PIUs can also reduce the sustainability of results. The Bank can have broader impact, well beyond the activities it funds directly, if its work more systematically strengthens the country's systems and practices themselves, and results in improved systems that can be used for all government expenditures.

- ***Increase country ownership.*** Client ownership is higher when projects use the systems already in place in the country. Using country systems also aligns the incentives of borrowers and the Bank to strengthen these systems and close the gap between policy and actual practice, thus helping to ensure sustainable development impact.

- ***Build capacity.*** The use of country systems approach focuses attention on whether that system follows broadly accepted good practices and whether the country has the capacity to successfully implement and sustain implementation of such practices. Thus it brings capacity building to the forefront of the interactions among borrowers, the Bank, and other development partners who support the use of country systems, with immediate benefits at the project level. It can also form the basis of larger-scale programs to enhance the borrower's institutional capacity over the longer term.

- ***Facilitate harmonization.*** Using country FM systems is one of the most appropriate ways to achieve harmonization among different donors.

- ***Increase cost-effectiveness.*** Using the country's FM systems reduces transaction costs to the country—for example, the costs involved in creating new structures, often staffed with highly paid consultants.

ii. Scope and Methodology

7. The FM Sector has issued draft guidelines on assessing fiduciary risks in the use of country FM systems in investment lending projects to bring uniformity and consistency across the Regions[3]. These guidelines were used in carrying out this fiduciary risk assessment. For example, as the guidelines recommend, this assessment drew on available sector work in the area of public financial management (PFM) in Malawi, particularly the Public Expenditure and Financial Accountability (PEFA) report. (A summary of PEFA scores is provided in Annex 2; details of other references are provided in Annex 4.)

8. In addition, the Africa region is developing further guidance for staff in the construct of FM arrangements for investment lending projects that would substantially use country PFM systems. A draft assessment framework has been developed and is presented in Annex 5.

9. Key PFM arrangements, that will qualify investment lending projects as being **substantially** managed through a country's PFM system, has provisionally been identified by AFTFM as follows -

- The legal agreement between the Government and the Bank assigns implementation accountability to a government entity that annually receives an appropriation through the budget, as approved by Parliament.
- The relevant government entity's annual appropriated budget contains the estimated annual cash flow for the project (a cash budget as currently being used in African states).
- The project funding flows through the Government's bank account configuration, for exclusive use and accountability of the government entity that received the appropriation and is charged with project implementation.

[3] http://intranet.worldbank.org/WBSITE/INTRANET/OPERATIONS/INTRANETFINANCIALMGMT/0,,contentMDK:20139184~menuPK:1911762~pagePK:210082~piPK:210098~theSitePK:275851,00.html

- The project expenditure is incurred and paid for using the government entity's authorized procedures and controls for procurement, commitment and payment.
- The project expenditure is recorded and accessible, together with all related source documents, in the government entity's own accounting system.
- The project activities, expenditure and results are subject to the government entity's own internal audit arrangements.
- The financial performance and position of the project are annually reported in the government entity's own financial statements, or in project specific financial statements.
- The project activities, expenditure, financial statements and results are subject to the government entity's own external audit arrangements.

10. The above arrangements would require a fit with normal Bank fiduciary arrangements for investment lending projects – a designated bank account, sound financial management arrangements, interim financial reporting, reconciliation of project expenditure the approved budget, withdrawals and balances on the designated and other project bank accounts, and audited annual financial statements to ensure the funds are used for the intended purpose.

11.

12. This assessment uses a risk-based approach, consistent with the guidance note and the approach used for regular FM assessments. The risk-based approach does not provide a “go / no go” answer to the question of whether country FM systems can be used; instead it ranks fiduciary risks as High, Substantial, Moderate, and Low. The decision to use country systems then rests with each task team, guided by the country team, the fiduciary assessment and other factors such as the nature and complexity of the project.

13. This assessment focuses on the fiduciary risks in using Malawi’s central institutions and systems, such as the central treasury system or the central government accounting system, in Bank-financed investment lending projects. It is, however, important to note that despite apparent uniformity in structure and systems, there is wide variation in actual practices and capacities across various ministries and departments. It will therefore be important to supplement the results of this assessment with a limited assessment of implementing ministries when considering a specific investment lending project.

14. This review does not cover systems used by local governments or state-owned enterprises. However, the methodology and approach used in this review could be replicated for a review at the local government level. This review focuses on FM issues and excludes procurement issues.

iii. Structure of the Report

15. This report is structured as follows. Following this Chapter 1 on the background, scope, and methodology of the study, Chapter 2 explains the country background and economic background, provides a brief overview of PFM and the PFM reform program in the country, discusses corruption issues, the project portfolio and implementation arrangements. Chapter 3 presents the fiduciary risk assessment of using country FM systems in investment projects, and Chapter 4 provides overall fiduciary risk ratings and an outline of the next steps. Annexes provide additional information.

C. OVERVIEW OF THE COUNTRY AND PROJECT PORTFOLIO

iv. Country Background

16. Malawi, a landlocked agrarian economy, is one of the poorest countries in the world ranking 160th on the Human Development Index. Unlike many of its neighbors, Malawi does not benefit from significant mineral endowments; however, recent discovery of mineral deposits in different parts of the country has increased the potential of the mining sector as an export-based source of growth. The country remains heavily dependent on external aid, with aid contributing over 10 percent to GDP in 2010, but efforts are underway to move away from dependency on donor support.With around 85 percent of the population based in the rural areas, farming is the main occupation for most households. Agricultural production is predominantly subsistence and rain fed and subject to high volatility causing frequent food shortages.

17. The overall progress in combating poverty and improving the quality of life has been positive in recent years. In 2005, the poverty headcount was 52.4 percent, unchanged from levels reported in the Second Integrated Household Survey 1997/98.) In education, there have been improvements in school attendance levels. During the last decade, the proportion of men who had never attended school dropped from 21 percent to 12 percent, while that of women dropped from 47 percent to 23 percent. There have also been improvements in several health indicators over the past few years. The 2008 Welfare Monitoring survey indicates that chronic malnutrition is now at 36 percent, compared to about 49 percent in 2005. Immunization for children less than one year for measles has improved from 82 percent in 2005 to 89 percent in 2008/09, and is likely to reach the Malawi growth and Development Strategy (MGDS) target of 90 percent by 2011. Life expectancy is now at 49 years from 39 years, partly because of improved nutrition and free anti-retroviral treatment (ARV). Similarly, Malawi appears to be making progress in containing the spread of HIV/AIDS, as adult prevalence rates dropped from 14.4 percent in 2004 to 12 percent in 2007.

v. Country Economic Background

18. Since independence in 1964, Malawi's growth record has been extremely volatile; and stagnant for a good part of the last three decades. Apart from the weather effects on agricultural production, this also points to a policy environment generally not being conducive to sustained growth. Indeed, per capita GDP (in constant 2000 US$ terms) hovered below the 1979 peak of US$160 for nearly three decades before taking a strong upward trend past the peak. Incomes strongly declined following the oil price shock in 1979, accompanied by severe deterioration in the terms-of-trade. Malawi's terms-of-trade collapsed by 25 percent at the end of the 1970s beginning a long deteriorating trend.

Furthermore, civil war in Mozambique 1985-1992 damaged transport infrastructure and blocked the ports of Nacala and Beira raising transport costs.

19. Malawi has experienced uninterrupted solid growth between 2006-2010 with real GDP growth averaging about 7.4 percent, compared to an average of 2 percent for 1999-2004, amid a decline in inflation to mid-single digits. This robust growth was largely supported by sound economic policies. In addition to a positive macroeconomic environment, good weather and a fertilizer subsidy program have also made significant contributions to agriculture growth -mainly attributed to smallholder producers, and in particular, improvements in maize yields that have led to a significantly enhanced food security situation.

20. However, persistent external imbalances compounded by the reduced donor inflows, low tobacco proceeds and other supply side bottlenecks have contributed to the weakening of macroeconomic performance over the past 12 months. This has in turn contributed to a widening of balance of payment and budget gap and the slowdown in real economic activities. An off-track IMF Extended Credit Facility (ECF) program and governance concerns have also affected budget support and the Millennium Challenge Corporation's (MCC) US$350 million energy compact. The intensification of foreign exchange controls and the overvaluation of the Kwacha have led to: (i) persistent fuel supply shortages; (ii) constraints on companies' operations arising from the rationing of foreign exchange and consequent compression of imports of key intermediate inputs (and subsequent retrenchment of workers); (iii) the dislocation in import supply arrangements stemming from the build-up of external payments arrears by the private sector (over US$400 million backlog) and the widening of exchange rate premium to more than 60 percent.

vi. Overview of Public Financial Management in the Country

21. Malawi is a constitutional democracy with power sharing between executive, parliament and the judiciary. Many years of a one party regime has also left its legacy in terms of the 'Presidential' characteristics of democracy. So, whilst the formal 'checks and balances' are in place, in reality the power of the President and hence the Executive is normally comparatively stronger than Parliament and the Judiciary.

22. During the period 2006 – 2009 the functioning of Parliament had improved and the PAC had become far more active in scrutinizing the budget and MDA's performance than ever before. However, Parliament had also become the arena for point-scoring between political parties, and heightened tensions had led to disruption of normal government business, including delays in Parliament approving the national budgets for 05/06, 06/07, 07/08 and 08/09. Malawi now has a majority government and the effect of this on Parliamentary scrutiny and PAC oversight over budget execution is under serious test. PAC has continued to perform well in reviewing financial performance of MDA's but parliamentary scrutiny of the budget has virtually disappeared with the majority of MPs who belong to the President's party rubber stamping the budget. However there is

growing dissent among the MPs in the President's party and the full impactt of this on budget scrutiny will be tested during the midterm budget session in February 2012 and then the annual budget session in June 2012 .Judged from how these MPs have debated on a number of bills brought by Government it is likely that the budget will be subjected to greater scrutiny by MPs across political parties.

23. The Government is taking a multi-pronged approach to tackling corruption. The principle agency responsible for tackling corruption in Malawi is the Anti-Corruption Bureau (ACB). Established in 1997, the ACB has been strengthened with support from DFID and other development partners (Norway, USAID). Internal capacity of ACB has improved, as evidenced by the number of ACB officers trained and improvements in reporting on corruption. Staffing levels have also improved. As of January 2008, ACB had a post-filled rate of 79% compared to 64% in 2004. Government's commitment to ACB and other oversight bodies (DPP, Ombudsman and judiciary) is also evidenced by increasing spending, up by 21.5% in real terms in 2006/2007 when compared to 2005/06 funding, with a 26.2% increase for ACB (CABS March 2008). The Anti-Corruption Bureau (ACB) operated without a substantive Director between July 2006 and November 2007, which affected its prosecution function. However, the appointment of a substantive Director in late 2007, coupled with an increase in budget allocations to ACB , establishment of integrity committees in MDAs and the development of a National Anti-Corruption Strategy (NACS) in April 2008 present optimism. The incumbent Director started with a lot of enthusiasm which has since dissipated amidst accusations of political interference. In the eyes of the public the Bureau has failed to move on clear corruption cases involving high profile politicians. The latest example given is the sale of houses at the Malawi Housing Corporation where several high ranking ministers were involved. Instances have been reported in the press and confirmed by the Bureau whereby political heavy weights start being investigated once they leave Government, a clear admission that corruption exists but politics limits the Bureau in exercising its mandate.

24. The main legal framework governing Public Financial Management (PFM) in Malawi is the Public Finance Management Act, 2003. This specifies the responsibilities of the Minister of Finance, together with the powers he or she may delegate to senior officials. The Act also defines the responsibilities of the Secretary to the Treasury (ST), as well as those of the Controlling Officers (CO), who are appointed by the President to be the Head of a Ministry or Department and are responsible for the collection, receipt, disbursement of public money.

25. Another key PFM-related Act is the Public Procurement Act of 2003. This established the Office of the Director of Public Procurement, who is responsible for regulating and monitoring public procurement arrangement in all public institutions Malawi. It also enables the setting up of internal procurement committees (IPC), as well as specialized public procurement units within each Ministry, Department or Agency (MDA). The Act describes the rules for and methods of public procurement, which are to be applied, as well as setting out the main principles and procedures for the different types of procurement available to the MDA's.

26. The Central Internal Audit Unit led by a Director in the Ministry of Finance was established to co-ordinate, facilitate and provide quality assurance for internal audit units being established in the Ministries, Departments and Agencies (MDAs) and District Assemblies (DAs). A Central Audit Committee was established during the 2005/06 to review the findings of the audit reports produced. Individual reports are produced by Ministry based Internal Audit teams in accordance with an Annual Audit Plan and an agreed Work Plan and submitted to Controlling Officers. Although a Risk Analysis approach has not yet been implemented (when drawing up the Audit Plan and Work plan) and the quality of the Audit Reports remains variable, nevertheless, an overall 6-monthly Report is also produced by the Director of Internal Audit and submitted to the Secretary to the Treasury. This report highlights some of the key findings identified by the individual audit teams. However, despite the significant change of emphasis (to a management audit approach), which has been made in recent months as a result of a World Bank-funded project, the legal framework for the Internal Audit function (the PFM Act) has not yet been amended to further embed some of the key elements of the operation of the internal audit function.

27. The Public Audit Act of 2003 also defines the responsibilities of the external audit function. The National Audit Office (NAO), Malawi's supreme audit institution, audits and reports on the public accounts committee of Parliament and all public offices. The NAO is funded directly from the Consolidated Fund which has been cited by some as hindering its independence, although it is constitutionally independent. The AG is appointed by the President and approved by Parliament. Until very recently, the position of Auditor General remained vacant following the death of the previous AG, which prevented the presenting of audit reports to Parliament and has had a debilitating impact upon the rest of the staff within this function. An Auditor General has recently been appointed by the President, and was approved by Parliament, but with the majority opposition absent. It was feared that this would be open to legal challenge which could undermine the position of the AG. . The AG has been presenting his reports to Parliament without any problems.

28. Capacity problems also remain within both audit functions, although strengthening of NAO is ongoing and there have been some improvements, for instance, the recruitment and training of new auditors. A functional review has been conducted and a new organizational structure agreed. Training is being conducted on performance audit, procurement audit, forensic audit and IT audit. However, NAO still suffers from capacity constraints. An interim strategy to increase level of audit cover has been submitted to donors for funding.

29. The management of the PFM system is mainly concentrated within the the Ministry of Finance and Development Planning . The Secretary to the Treasury has a key responsibility for budget planning and execution, while the Accountant General has responsibility for producing timely and appropriate management and financial accounts. Within MDAs it is the Controlling Officers who have overall responsibility for effective PFM. The Group on Finance and Economic Management (GFEM) was formed in 2006

and this provides a management steer of PFM reform through participation of both GoM and donors.

30. At a sub-national level, each Assembly should appoint a Chief Executive (CE), who is held accountable for the efficient utilization of the resources allocated to or raised by the Assembly to enable it to discharge its statutory responsibilities. In the larger Assemblies, the CE is normally supported by a Director of Finance, who leads on the PFM issues within that body. Each statutory body (e.g., the parastatals) should have a Board of Directors (appointed by the GoM), which exercises overall responsibility for the effective management of its own financial resources and is held accountable for the decisions it takes in relation to these. A number of senior staff are appointed to each statutory body - often, (depending upon their size) including a Director of Finance.

31. Four Public Expenditure and Financial Accountability (PEFA) assessments have been conducted in recent years, in 2005, 2006, 2008, and 2011. Annex 2 provides a summary of these PEFA PFM Performance scores and a trajectory since 2005.

32. The 2008 assessment found that a number of improvements had been made since the 2006 assessment, including transparency of inter-governmental fiscal relations, oversight of fiscal risk from other public sector entities, recording and management of

Box 1: Summary Conclusions of 2008 PEFA

- **Credibility of the budget**: very good scores at an aggregate level for both revenues and expenditure, but low credibility of the budget for some specific votes.
- **Comprehensiveness and Transparency:** average to good scores with evidence of gradual improvement. Better progress on comprehensiveness of budget than on transparency.
- **Policy-based Budgeting:** average to good scores, however uneven progress recorded since the 2006 PEFA.
- **Predictability and Control in Budget Execution:** average scores, gradual improvements recorded since 2006 PEFA.
- **Accounting, Recording and Reporting:** average to low scores with little progress recorded since 2006 PEFA, with the exception of timeliness of accounts reconciliation which has improved markedly.
- **External Scrutiny and Audit:** very poor scores, reflecting three-years without an Acting Auditor General and capacity constraints at National Audit Office.

- **Box 2.Public Financial Management Assessment, 2011 – Major Findings (extract from PEFA report)**

- ***Credibility of the budget:*** The period as a whole was characterized by persistent over-spending in comparison to original budget which contrasts with the previous three years each of which reported under-spending. On the revenue side actual revenue was consistently above budget, as it had been in the previous three years. Again, therefore, the credibility of the budget is called into question - this time in terms of its ability to provide a reliable indication of the GoM resource envelope.

- ***Comprehensiveness and transparency:*** Though Malawi scores well in a number of areas associated with comprehensiveness and transparency, various issues remain - Treasury Funds are not reported in the Estimates and only appear in the Annual Appropriation Accounts as net figures. There is significant room for improvement in terms of public access to key fiscal information
- ***Policy-based budgeting:*** While the orderliness of the annual budget process has improved relative to the last PEFA assessment, challenges lie ahead in terms of concluding the new MGDS II and alignment of MTEF with the new priorities in the MGDS II.
- ***Predictability and control in budget execution***: Reforms are on-going in the Malawi Revenue Authority. The Ministry of Finance has improved the cash management process. Debt management and payroll system are being operated efficiently. The Procurement system continues to be unable to provide statistics with regard to the implementation and comprehensiveness of competitiveness in public procurement. The IFMIS rollout process has been concluded to the central government and 22 Local Authorities. Although awareness seems to be rising with regards to internal control, the evidence does not yet support the finding of improved control and internal audit procedures and processes being implementing and taking effect.
- ***Accounting, recording and reporting:*** Progress in the period under review has featured the improved timeliness of the closure of the accounts and the production of the financial statement for audit. Also, in-year budget execution reports are produced on a timely basis and with some improvements is quality. However, management information at service delivery units stills needs to improve. A serious control concern identified is the backlog in bank reconciliations since July 2010. Timely bank reconciliation is an essential discipline in the ongoing checking and verification of accounting practices across Government and it also provides assurance as to the integrity of data used for reporting.
- ***External scrutiny and audit***: The period covered by this assessment has seen a backlog of external audits and Public Accounts Committee (PAC) scrutiny cleared. However, there are still weaknesses in the actions and follow up based on the recommendations of the National Audit Office (NAO) and PAC. In summary, NAO and PAC scrutiny has been characterized by periods when there has been no public scrutiny followed by intense activity to clear backlogs. In respect the Parliamentary Finance Committee, there is more opportunity for scrutiny of the draft budget than for budget execution.

cash balances, debt and guarantees, effectiveness of internal audit, quality and timeliness of annual financial statements, and legislative scrutiny of the annual budget law. The assessment reported that regardless of progress being made, weaknesses remain in external auditing, particularly, timely submission of audit reports to Parliament and follow-up, effectiveness of payroll controls, and public access to key fiscal information. Since the assessment was done, progress has been made in a number of areas. The Government has taken steps to clear the audit backlog and is on course to be current soon. In addition, Government has undertaken a Human Resource Management Information System (HRMIS) review and a payroll audit. Implementation of recommendations from these exercises will help improve management of the payroll. Government established a dedicated unit to coordinate implementation of the Public

Finance and Economic Management reform agenda within the Ministry of Finance, which is already operational as noted in the PFM reform section below.

33. DFID updated their fiduciary risk assessment (FRA) in November 2008, concluding that the overall level of fiduciary risk was 'substantial'[4] but considered to be closer to the 'moderate' than the 'high' rating, given significant recent improvements in PEFA scores and good prospects for a continuing positive trajectory. Fiduciary risk had been assessed as 'high' in the 2007 FRA. The main conclusion that can be drawn from the 2008 PEFA assessment is that the positive trajectory in PFM reform has been consolidated in the last three years with improvements in five out of the six PEFA criteria, with only external scrutiny and audit showing overall 'no improvement', reflecting the lack of Auditor General and capacity constraints in audit. The 2008 Public Expenditure and Financial Accountability (PEFA) Assessment concluded that out of the 28 PEFA indicators, 11 scored B and above; 9 scored C, 4 scored D and 3 were not able to be scored. The most recent CABS review in March 2008 also recognized good progress with 83% of PFM indicators met.

vii. PFM Reform Program in the Country

34. A Public Financial and Economic Management (PFEM) Action Plan was established in November 2006, building on the 2003 Malawi Financial Accountability Action Plan (MFAAP) and the PEFA reports from 2005 and 2006. The reforms are supported by donors through the Common Approach to Budget Support (CABS) Group who have been providing assistance to the Government of Malawi (GoM) since 1997. The reform efforts are coordinated between the Government of Malawi and donors through the Group on Financial and Economic Management (GFEM) meetings that are jointly chaired by the Secretary of the Treasury and a representative from the donors. World Bank participates in CABS. The World Bank also played a role in the PFM Reform program through the Financial Management Transparency and accountability Project (FIMTAP) through which capacity development assistance was provided to Internal Audit, External Audit and the Office of the Director of Public Procurement – for more details refer to Annex 3. The project also supported the acquisition, installation and operationalization of the IFMIS, the Government Wide Area Network and general governance improvement among others. Through the Malawi Social Action Fund

[4] A '**High**' rating represents a situation where the structure of PFMA system shows a significant divergence from good international practice and/or there is widespread lack of compliance with many of the controls within the system, and commitment to a credible reform program may be weak. A **'Substantial'** rating represents a situation where the structure of PFMA system fall short of good international practice in a number of areas and/or there are numerous and/or material weaknesses in compliance with many of the controls within the system. Reform plans may need to be strengthened and prioritized. A '**Moderate'** rating represents a situation where the structure of PFMA system broadly reflects good international practice, although there may be some gaps and inefficiencies, and where there is a credible commitment to addressing key weaknesses.

(MASAF), the Bank helped in building capacity including FM capacity at the District Level.

35. The PFEM Action Plan and donor supported programs supporting different activities has represented a credible program, covering all the main areas of PFM. The box below (DFID Fiduciary Risk Assessment, 2008) provides a snapshot of how Malawi's PFM reform program conforms to the criteria of a credible reform program:

Box 3: Criteria for a Credible Reform Program

Features of a Credible Reform Program	**Malawi**
1. **Government-led** – enabling full political ownership and leading to effective harmonization and donor intervention.	**Yes.** PFEM Action Plan led by ST. PFEM Steering Committee and Technical Committee government led. Strong ownership in development of new PFEM program. GFEM monthly donor/Government coordination forum chaired by ST.
2. **Realistic and achievable** – based primarily on available local capacity and set within an appropriate timeframe.	**Mostly.** PFEM Action Plan sets out prioritized actions with 33 indicators. Nov 2007 assessment: 17 (more than half) were completed or nearly completed, 12 under implementation and only 3 had little or no action. However, more needs to be done to prioritize given weak capacity in Malawi.
3. **Comprehensive framework** which is **effectively sequenced**	**Yes.** PFEM Action Plan is comprehensive framework. More work is needed on its sequencing and prioritization, which Government has stated is its intention. The PAF indicators reinforce priority areas (e.g. targets on procurement, audit, payroll)
4. **Relevant and sustainable** – adapted to country context, targeted to meet key fiduciary risks and avoiding over-reliance on external TA.	**Mostly.** PFEM Action Plan developed on analysis of local context and PFM weaknesses drawing from 2006 PEFA. Due to weak capacity (high HIV Aids and brain drain effect), there is a high reliance on TA but working alongside Government counterparts.
5. **Developing local capacity**	**Yes.** All donor-funded programs have focused primarily on developing local capacity: in ODPP, NAO, Ministry of Finance (budget division, Debt & Aid Division), Parliament, and MEPD.
6. **Build demand for change** - promoting a sustainable track record of improvement based on previous success	**Yes.** Early focus has been on putting in place systems (e.g. IFMIS, HRMIS, internal procurement units) creating demand for them to function effectively. E.g. IFMIS introduced to some MDAs, but demand for it to be introduced to others and rolled out to districts.
7. Include specific **performance indicators**	**Yes.** PFM Action Plan and PAF include specific PFM performance indicators. PFM action plan monitored at monthly GFEM meetings and PAF at twice-yearly CABS reviews.

36. As Box 2 demonstrates, Malawi has most of the components of a credible reform program. Government ownership is strong and the PFEM Action Plan provides a comprehensive framework for reform. However, implementation capacity is weak and therefore reliance on external TA is a necessity to some extent. And more needs to be done to prioritize and sequence reforms, particularly given the weak local capacity.

37. The following are notable achievements:

- Improvement to the budget process – credibility, comprehensiveness and transparency and some improvement in fiscal discipline.
- Introduction of IFMIS and roll-out to all central government MDAs
- Development of integrated payroll management information system (HRMIS)
- Adoption of procurement law and establishment of IPCs in all MDAs
- More aid on budget - the 2006 PEFA noted this as one of two areas of major progress made.
- $150m increase in new donors/resources in 2006/2007, new debt and aid policy, new Development Assistance Strategy, and aid information management database.
- Progress on tax policy work, including developing new tax measures for the private sector and provided software for introduction of PAYE system which led to significant increased GoM tax revenue.

38. Despite the successes noted above, a number of weaknesses still exist and consolidation of reforms and a more prioritized focus on 'off track' areas is needed to sustain the positive trajectory. The legal framework, institutions and systems are largely in place (e.g. IFMIS, HRMIS, Procurement Law and committees); however, it is ensuring their effective implementation which is priority. Government has also expressed the wish for greater focus on outputs rather than on input/activities.

39. Moving away from the current 'fragmented but coordinated' approach of donor support to the PFEM Action Plan should also help to avoid duplication and ensure best use of limited resources. In this respect, discussions are currently underway to move towards a more coordinated SWAP-type or 'umbrella' approach to PFM reform. Government and donors are developing a road-map for design of a joint donor PFM program. The details of the program including funding modalities, implementing mechanism and areas to be covered have yet to be decided and this is likely to take up to a year. In the meantime, donors will continue interim or bridging funding to support priorities in the PFEM Action Plan. Given the weaknesses in audit and procurement capacity, these will be particular areas of focus and costed interim priority plans have been developed for donor funding. The Government has now developed a PFM Reform Program covering all areas of PFM and this will be funded through a MDTF that will be managed by the Bank. The Bank has already developed a Program document based on which funding partners are contributing to the MDTF. An administration agreement has already been signed with EU and discussions are ongoing with DFID. This new approach will fulfil the aim of having harmonized and properly coordinated PFM reforms.

viii. Corruption Issues in Malawi

40. The fight against corruption in Malawi is yet to register significant strides. Notwithstanding that the country has extensive legal framework in place and a number of agencies to fight corruption, implementation and enforcement of the legislation have been weak. This problem is exacerbated by reports indicating lack of political will to fight

corruption. There were increasing signs that the Government was committed to reverse this dismal performance of the fight against corruption (as detailed below) but latest inaction by ACB to pursue corruption cases involving high ranking politicians has cast doubt over ACB's independence and assertions of political interference seem vindicated.

41. Early results of the ACB have been encouraging with the ACB meeting all its PAF targets in 06/07. Fifteen cases completed in the designated period were completed in an average of 8.3 months (the target was 16 months). The number of cases recommended for prosecution has also steadily increased from 11 in 2001 to 81 in 2007. However, ACB failed to meet its targets for 07/08[5], most likely due to lack of a Substantive Director for a large part of 2007, but is confident it will continue to meet PAF targets now that a Director is in place.

Number of Cases recommended for prosecutions per year:

Year	2001	2002	2003	2004	2005	2006	2007
Prosecutions	11	24	22	28	74	67	81

42. Prosecution of complex high profile cases have inevitably been slower but with the support of specialist TA funded by DFID, progress has been recorded. The prosecution and jailing of a serving Minister in February 2006 and ongoing investigations of the ex-President and Minister of Finance were seen as early positive signals of intent. However, discontinuance of the case against the former Head of State and enforced resignations of the Director of the ACB and the Director of Public Prosecutions in 2006 were a setback. The appointment of a new Director in November 2007, accompanied by increased budget to the ACB, are however reasons for optimism. The optimism has of late been dampened by ACB's lack of action on suspected corruption cases involving cabinet ministers.

43. The ACB also carries out community awareness activities in addition to investigating and prosecuting anti-corruption cases. It has been proactively engaged in corruption prevention, working with MDAs and parastatal institutions identified as priority according to the 2006 baseline survey. This is addressing corruption at the service delivery front-end (e.g. police, immigration officials, road traffic authority), where citizens most come into contact with public officials. To date, ACB has supported Southern Region Water Board, Blantyre Water Board, Lilongwe Water Board, and Northern Region Water Board to develop Corruption Prevention Policies. The 2007 corruption perception survey indicated that people were more satisfied with the police (75%) compared to in 2006 (52%), however, satisfaction ratings with the other bodies above were not measured.

44. A National Anti-Corruption Strategy (NACS) was drafted in April 2008 and envisages that action plans be developed for 7 pillars - executive, judiciary, legislative, private sector, civil society, the media and traditional leaders. High level leadership is

[5] The ACB concluded 226 investigations against a target of 360 **[PAF indicator 25]**. Reporting against **indicator 26** was somewhat better, with the reduction in the number of cases in the court system for over 2 years from 22 to 17 cases – a 22% reduction. However the reduction still fell short of the 15-case target.

provided with a National Integrity Committee reporting on progress to the President every six months. However, the Action Plans for each pillar and a monitoring framework have yet to be developed and no budget provided for the implementation of the action plans. The strategy also does not seem to link well with other ongoing PFM reforms led by MoF. It will be important for these linkages to be made and for strong buy-in from key stakeholder institutions and line ministries for the NACs to succeed. It will also be important that subsequent surveys are able to measure both behavioral change and attitudes towards institutions that develop anti-corruption plans to measure their impact. DFID is in dialogue with ACB on this issue and ACB has committed to addressing these issues.

45. Regarding the criminalization of key corruption offences, in addition to the Corrupt Practices Act, Government has enacted several pieces of legislation that have a bearing on the fight against corruption, including the Public Procurement Act, the Public Audit Act, the Public Finance Management Act, and the Money Laundering, Serious Crimes and Financing of Terrorism Act. As the section on PFM indicates, the PFM legislation is having an impact in terms of putting in place the institutions and legal framework; however implementation and enforcement of the legal framework is weak.

46. The private sector and civil society are also engaged in the fight against corruption. The Business Action Against Corruption (BAAC) has developed a code of conduct guiding business enterprises to conduct honest and corrupt free business transactions, and a Civil Society Action against Corruption (CSAAC) has also formed. Whilst these organizations are undoubtedly raising the profile of anti-corruption efforts, it is yet unclear if they are having a real impact on reducing corruption.

47. The legislature is in the process of establishing the African Parliamentarians Network Against Corruption, Malawi Chapter. The impact of these initiatives is not yet known but does raise the profile of anti-corruption efforts. All MPs have declared their assets. A special Law Commission has been appointed to consider and draft legislation for the declaration of assets and liabilities by public officers but new legislation has been stalled in its development and is not likely to be passed before the next elections. However the passing of legislation is a PAF target which allows regular follow-up and pressure on this target. The recent removal of the Clerk of Parliament for not following proper procurement procedures has also shown evidence of Parliament taking a more active role in anti-corruption.

48. Sector Wide Approach (SWAp) partners provide significant support to financial management and procurement capacity in tackling corruption in the health sector (particularly focusing on procurement of drugs and reform of Central Medical Stores). Regular financial management and procurement audits and reviews, including a drugs leakage study and agreed follow-up actions in terms of SWAp milestones, mean that the opportunities for corruption are reduced and means of detecting corruption and abuse increased. Community drugs committees now in place in 93% of health centers. This increased scrutiny and support seems to be having a positive impact on reducing corruption at the service delivery end. In the 2006 perception survey, health and

education services seemed to experience low corruption with only 1% of citizens reported having to pay gratification for access. Other evidence of progress was in September 2006, the then newly appointed health minister took swift action against officials suspected of corruption in her ministry.

49. The 2004 Country Procurement Assessment Report (CPAR) found that in 2002, public procurement accounted for 16.2 per cent of GDP and that corruption in procurement was widespread, capacity low and sanctions for corrupt practices were not effective. The Government has, in response, attempted to comprehensively address these weaknesses. A new Public Procurement Act, based on international procurement standards became operational in 2004 with the establishment of the Office of the Director of Public Procurement (ODPP), headed by a Director and Deputy Director appointed by the President and approved by the Public Appointments Committee of parliament. ODPP has policy, standards and monitoring functions and does not directly procure. It has supervisory oversight of a decentralized procurement system that since 2006 has been receiving intensive support from the World Bank, UNDP and USAID. This includes training, by December 2007, of almost 800 procurement staff of Internal Procurement Committees (IPCs) and Specialized Procurement Units (SPUs) in ministries and departments; establishment of an ODPP Management Information System and website; developing the capacity within ODPP to undertake procurement audits; establishing ministry, department and agency prior review procurement thresholds based on capacity as assessed by ODPP; establishment of a referral system for mis-procurements identified in the ODPP prior review and procurement monitoring processes to the Ministry of Finance and the ACB for investigation; and, facilitation of the establishment of a professional body for procurement personnel. While challenges remain as evidenced with reports of corruption in the media, there have been significant advances in moving the public procurement system towards acceptable standards.

ix. Existing Project Portfolio and Implementation Arrangements

50. There are 11 active projects with a commitment of US$ 626 million and a cumulative disbursement of US$ 251 million. The Infrastructure Services Project was extended to June 30, 2012 to enable finalization of remaining activities that have already been contracted. The portfolio includes one GEF funded project and a catalytic growth facility complimenting the Agriculture Development Support Project and the Second National Water Project respectively. Fourof the eleven projects are being co-financed by the World Bank and other development partners – (i) Business Environment Strengthening and Technical Assistance Project (financed by World Bank and European Union); (ii) Irrigation, Rural Livelihoods and Agricultural Development Project (funded by the World Bank and International Fund for Agricultural Development); (iii) Agriculture Development Support Project (funded by the World Bank and the Norwegian Governmentand EDUCATION SWAp (financed by World Bank, DFID, GDC, UNICEF, Global Partnership for Education. The portfolio includes one regional project - Regional communication Infrastructure Project.

51. The general view is that implementation performance of the portfolio has improved as evidenced by the absence of problem projects. Several factors are attributed to this fact. The joint quarterly portfolio meetings between the Bank and Government, the weekly portfolio meetings by between the CMU and the fiduciary staff and the candid assessment of implementation support mission reports.

52. All the projects already declared effective on 1 February 2011,have submitted FMRS.. All have been reviewed and cleared by AFTFM.

53. Of the Audit Reports due for the year ended June 2011, all of the active projects were received except for the Project to Improve Education Quality in Malawi. Currently one closed project, the Avian and Human Influenza Control Project which was The audit report for the education project is expected to be reeived before end of March 2012..

54. Annex 1 presents an overview of the financial management implementation arrangements for the project, and the extent of use of country systems at this stage.

D. FIDUCIARY RISK ASSESSMENT OF USING COUNTRY PFM SYSTEM FOR INVESTMENT LENDING PROJECTS

55. The fiduciary risk assessment, for the purpose of this report, covers five aspects of the country PFM system - (i) Budgeting, (ii) Accounting and Financial Reporting, (iii) Treasury Management and Funds Flow, (iv) Internal Controls and Internal Audit, and (v) Audit and Oversight.

56. Fiduciary risks refer to risks that project funds will not be used for the intended purposes and will not be used economically and efficiently. In the context of the use of country systems for implementing Bank-supported projects, fiduciary risks need to be analyzed from the larger prism of use of budget funds – Bank funds are potentially commingled with budget funds, which in terms of investment lending fund release modalities in the Bank may provide difficulties to control and report the use of funds.

x. Planning and Budgeting

57. It is necessary to evaluate fiduciary risks associated with the projects fully included in the budget planning and appropriation processes. For example, what are the risks of annual budget appropriation being less than the estimated annual project cost? Is the annual budget approved on time so that project procurement could be initiated and implementation carried out in a timely manner? What are the chances that the approved project budget appropriation would be reallocated to other projects/activities during the course of the year? Does the budget classification system enable tracking of individual project expenditures?

58. **Adequate appropriation for the project in the annual budget.** The 2008 PEFA Assessment and other PFM diagnostics provide an insight into the budget-making process. Regarding PEFA PI-11, policy based budgeting and a multi-year perspective, the budget process is clearly set out in a draft budget calendar introduced in the 07/08 budget year, which outlines budget activities related to both the ongoing financial year and the next financial year. The budget ceilings are determined by the MoF in accordance with policy and cognizant of resource envelope constraints. Under the current budget preparation procedures the Department of Economic Affairs, which works in close cooperation with the IMF, is responsible for setting the total budget envelope and the allocation across the main functional and economic classifications. These IMF agreed ceilings are used to set the budget ceilings and the Public Sector Investment Program ceilings. The budget ceilings are approved by cabinet. Due to timing constraints the budget ceilings are usually communicated to line ministries as “indicative” ceilings at the time that they are submitted to Cabinet; to be confirmed approximately 10 days later as approved ceilings. Whilst it is the responsibility of the Line Ministries to prepare their budgets within their overall ceiling and submit their budget proposals by early May, line

ministries in practice have had only 2 to 3 weeks to prepare their budgets. This has forced them to prepare budgets on a historical basis using the previous year's ceilings adjusted and then modifying them retroactively upon receipt of the formal ceilings.

59. PI-12 assesses the existence of multi-year perspective in fiscal planning, expenditure policy and budgeting and has seen recent significant improvements. From 2005 Malawi has prepared a multi-year budgetary framework that forecasts fiscal aggregates allocated across functions. The GoM has issued a medium term national development framework, the Malawi Growth and Development Strategy (MGDS), 2006-2011 that clearly states the medium term policy objectives. It was developed within a macro-fiscal framework and has an activity costing schedule which within the identified priority areas of government. Investment requirements are costed but exclude any recurrent expenditure impacts. At present, fiscal forecasts of revenue and expenditure aggregates are prepared for three year horizons following the budget year based on GFS standards. The MoF publishes the fiscal forecasts and includes them in the budget documentation submitted to parliament. The first ever review of the MGDS took place in 06/07 and was completed in mid-2008.

60. Given the disconnects and potential for weak budgetary inputs from line ministries, there is a high risk that a project may not receive an adequate allocation in the annual budget. Based on 2011 PEFA this has remained fairly constant with P1-11 scoring a B from C+ in 2008 and P1-12 scoring a C+ from B in 2008. The perceived risk will therefore remain the same.

61. **Timely approval of annual budget.** Due to political problems encountered by the minority Government over the issue of Section 65, passing of the budget has been delayed for the last three years, resulting in it being one month late in 2007, nearly 3 months into the financial year in 2008 and four months in 2009. This accounts for the fall in dimension iii) of PI-11, and the overall fall for PI-11 from B in 2006 to C+ in 2008. However, at the same time, a positive development has been far greater scrutiny of the budget than previously. It is of concern that delayed approval by Parliament may delay project implementation and procurement processes – this is somewhat offset by the legal provisions that should the budget not be authorized in time, MDAs can continue to spend up to one third of its previous year's approved budget. There is therefore a moderate risk that large-value procurement could be delayed and may need to be compressed to fit into the remaining nine months of the fiscal year. Continuous project implementation may suffer as a result. The 2011 PEFA has scored P-11 a B despite dimensions i and iii being at C. The GoM currently hold a majority in Parliament and since 2010 the budget has been passed on time. This is likely to be the case up to at least 2013. The perceived risk based on 2008 PEFA assessment should therefore be reduced to low from medium in recognition of timely approval of budget by legislature in years 2010 and 2011 and the likelihood of the same happening for 2012 and 2013. The situation from 2014 will depend on the composition of the new parliament after 2014 general elections.

62. **Diversion of approved budget allocations.** The PEFA indicator PI-1, composition of aggregate expenditure out-turn to original approved budget is a very

important measure of budget credibility. Large deviations would suggest significant distortions to the original policy objectives captured in the original budget estimates. To obtain a measure of how much the reallocations between budget lines have contributed to variance up and above the deviations in the overall levels of expenditure, an analysis of budget deviations between budget estimates and actual out-turns by budget head was performed during the PEFA assessments for the years 2004/2005, 2005/2006 and 2006/2007. The estimate and actual figures presented exclude interest payments and capital projects funded by grants and loans. For all three fiscal years reviewed, the aggregate actual primary expenditures were within 10% of the aggregate primary budget estimates indicating good aggregate fiscal discipline exercised in budget execution in the last three years. However the excess of the variance of expenditure out-turn for the budget entities up and above aggregate expenditure deviation (PI-2) indicated that there are weaknesses in the PFM system's ability to allocate resources in accordance with budgetary objectives. As the 2008 PEFA report notes, page 24 - *"These deviations are substantial and are consistent with weak bottom up elements to the budget formulation and implementation processes (see PI-11). The cash flow forecasting system is still rudimentary and affects budget implementation. Variations …. are evidence of a less than strong coupling between the original budget and the budget execution process brought about through repeated variations made to the budget releases allocations in spite of fairly strong commitment control processes. It raises questions about Malawi's PFM systems being able to deliver fully on the strategic intent of its budget and ensuring that budget implementation is ultimately in line with the policy objectives set out in its national development framework, the MGDS."* The PFM Act, regulations and IFMIS serve to control virements. For in-year budget amendments, there are clear rules in the Constitution (Section 177) and this is supported by budget control in the IFMIS. The PEFA report notes that 'these are normally respected', with a supplementary budget being passed by Parliament at the mid-year review of the budget. Regarding availability of funds for commitment to expenditure (PI – 16), an overall 'B' score reflects the fact that a fairly robust system of cash management is in place. Annual cash flows are prepared by the line ministries and updated each quarter. Line ministries are provided with three-monthly ceilings and actual funding releases are done on a monthly basis. But the Cash planning system still needs improvements and the Accountant General is in the process of setting up a cash planning unit. The risk of diversion of project funds is assessed to be low. The 2011 PEFA comments on significant budget reallocations in all three years considered(2009, 2010, 2011). The expenditure composition variance was less than 10% in only one of the three years and over 20% in one year and concludes that this indicates that the budget process has been ineffective as a tool for allocating scarce resources in line with policy priorities as set out in MDGS. On the revenue side the report states that actual revenue was consistently above budget just like in the other three years assessed before and concludes that this calls in question the credibility of the budget in terms of its ability to provide reliable indication of the GoM resource envelope.

63. **Adequacy of the budget classification system.** The budget classification (PI-5) is presented on a modified cash accounting basis employing functional, sub-functional, program, sub-program, economic and administrative classifications. The budget classification (as identified in the budget documents and macro-fiscal tables) identifies

only 4 main functions; however the sub-functional structure permits a translation of these using a mapping table to a standard consistent with the COFOG functional classification. The macro-fiscal tables and the chart of accounts are consistent with the budget structure and hence the exercise of expenditure controls within that budget classification. However, at the present time the budget formulation process includes top-down and bottom-up reconciliation at the administrative budget head level, but not within the functional and sub-functional classification.

64. The segments in the IFMIS Chart of Accounts are depicted in Table 2 below - provision is made for tracking of donor funded transactions, with the feasible intent to channel, manage and report donor funding through the Government’s own bank account configuration and financial management system.

Box 4 – Chart of Accounts									
Segment 1 Responsibility Accountability						**Segment 2** Performance Related Budget	**Segment3** Analysis	**Segment 4** Accounts	
Sector	Vote / Head / Dept	Account Type	Cost Center	Prog / Sub Prog	Donor / Project	Objective/ Target / Activity	District	GFS Classifi-cation	Item / Sub Item
x	Xxx	X	Xxx	xxxx	xxxxx	xxxxxx	xx	xx	Xxxx

65. **Conclusion.** Key fiduciary risks in the area of budgeting—the risks of inadequate budget appropriation for the project, of delays in the annual budget approval process, and of diversion of budget appropriation for the project to other activities—are overall assessed to be moderate. However, these risks stems from weaknesses in processes, rather than inherent risks. It also needs to be viewed in the light of the degree of government ownership for the project and importance of the project in the sector strategy. Where strong linkages between the project and the sector strategy ensure the Government's strong commitment to the project objectives, there is less likelihood that the project will receive inadequate appropriation in the annual budget. To minimize some of the risks associated with the budgeting process, task teams should ensure that the project is part of the approved sectoral strategy and that the Government is strongly committed to the project objectives. Roll-over of project funds could be used as a measure to ensure continuous project implementation and need to be further discussed with the GoM.

xi. Accounting and Reporting

66. The key fiduciary risks in the area of accounting and reporting are delays in recording transactions in the accounting system, inability of the accounting system to prepare Interim Financial Reports (IFRs) in a format acceptable to the Bank within 45 days or to produce annual Financial Statements in a format acceptable to the Bank, weak security in the IFMIS system that compromises the integrity of the financial data, and the inability to track transactions in the accounting system.

67. The Public Finance Management Act (PFMA), 2003 and its supporting regulations provide the legal and regulatory framework for financial management of public funds in Malawi. Section 83(1) of the PFMA requires the Secretary to the Treasury to prepare and submit financial statements to Auditor-General for audit by October 31. Section 83(5) requires the audited financial statements together with the reports of the Auditor-General to be presented to Parliament not later than 6 months from the end of financial year to which they relate and if Parliament is not in session, at the commencement of the next ensuing session.

68. IFMIS, based on EPICOR software, was introduced in 2004 and is being implemented in all Ministries. There is a centralized payment system, using the Reserve Bank of Malawi, to support the operation of the Consolidated Fund from which the Budget is annually appropriated.

69. **Delays in accounting for the transactions.** The transactions of Ministries that operates IFMIS are recorded on a timely basis which indicates that the accounting records are reliable and up to date. The timeliness is further supported by good score in PI-22 (PEFA, 2008) that rated timeliness and regularity of accounts and reconciliation as B+. The supporting dimension for bank reconciliation has received an A rating and clearance of suspense accounts and advances a B rating. Therefore, the risk of delays in recording transactions is low. The 2011 PEFA noted a significant decline in the rating under timeliness and regularity of accounts reconciliations with a score of D . Both dimensions of bank reconciliations and clearance of suspense accounts/advances received a score of D. The low risk assigned based on 2008 PEFA should therefore be downgraded to moderate risk as supported by 2011 PEFA..

70. **Reliable and timely financial statements**. If decision makers do not have access to reliable and timely financial information for monitoring performance, the fiduciary risk in the use of funds increases. The IFMIS has contributed to issuance of monthly, quarterly and annual reports on a timely basis. PEFA 2008 report rated the indicator P1 – 24, dimensions (ii) timeliness of the issue of reports and (iii) quality of information, as A and B respectively. The Expenditure Returns are prepared through IFMIS by the Accountant-General on a monthly and quarterly basis and submitted within 10 days of the close of the month. The returns are consistent with the budget format and facilitate expenditure statements by budget head and economic classification. However, it does not provide commitment information. Besides lack of inclusion of commitments, there are no material concerns regarding accuracy. The consolidated financial statements were submitted to the Auditor-General within 4 months in 2006/7, in line with the requirements of PFM Act. It is envisaged that the requirement will consistently be met in future. We therefore consider the risk of unreliable and late financial statements to be low. The 2011 PEFA rating are the same as 2008.

71. **Acceptable accounting standards for the preparation of financial statements.** The Government of Malawi applies the cash basis of accounting, recognizing transactions as and when paid. This is done without applying an internationally recognized accounting standard to prepare its financial statements, such as the IPSAS Cash Standard. However, standard format templates are applied consistently (over time). It was indicated that Malawi intends to migrate to the IPSAS Cash Standard. On Dimension (iii) of PEFA indicator PI-25, relating to use of accounting standards, Malawi scores C mainly because it does not apply a specific national standards and fact that assets and liabilities are not included in the consolidated financial statements. The parastatals apply International Financial Reporting Standards, though their financial information is not consolidated. The risk of non-compliance with acceptable accounting standards is substantial.

However, since the Bank's guidelines[6] provide flexibility for the format of the project financial statements and the format of project financial reporting is normally negotiated as part of the legal proceedings, we consider the risk to be low for the project financial statements being prepared in an unacceptable format. To enhance on reporting on projects, the Bank should agree at project preparation stage on the format of financial reports with the government and request establishment of project assets registers. In addition, recommendation should be made for immediate implementation of International Public Sector Accounting Standards (start with cash based standard before moving to accrual): a process that should begin by developing a detailed implementation guideline. Government should also start consolidating parastatals information in consolidated financial statements and should initiate a process to start recording liabilities in IFMIS. To strengthen accountability at Ministry level, a legal change should be made to require Ministries to prepare annual financial statements that should be audited.

72. **Ability to track project related transactions in the accounting system.** Weak accounting systems may make it difficult to track resource transfers to and expenditures of actual service providers, increasing the probability that funds may not be used for the intended purposes. The IFMIS configuration, user setup, chart of accounts and audit trails provide the ability to control access to and to record and track project related transactions. IFMIS currently includes donor development projects and has capability for inclusion of additional codes. The revisions being undertaken on the chart of accounts to align it with GFS 2001, to be implemented from 1 July 2010, will further strengthen the ability to tract transactions in the IFMIS. Therefore, the risk of not tracking project transactions is low.

73. **Integrity and reliability of data stored in the IFMIS system.** The off-the-shelf EPICOR software, functioning as the Government IFMIS, has all appropriate security features. However, no specific security audit has been performed on the IFMIS as implemented and being used by the Government. Automated financial management systems are not only vulnerable to cyber attacks but can be manipulated if the system controls are lax. Most organizations implementing highly integrated systems undergo systems audit by systems security professionals to continuously validate the robustness of the system controls. In Malawi, there are no specialized skills in internal and external audit units and further there is lack of IT facilities for use by the two units to perform security audit. Since no security audit has been done and manual controls to ensure validity, accuracy and completeness of data are often weak, we consider the risk of data reliability to be moderate. The internal and external audit units should be resourced (skills and equipment) to perform regular security audits on the IFMIS.

74. **Other factors affecting fiduciary risks in the area of accounting and reporting**. There are systems that are not linked to IFMIS, hence integrated manually - Debt & Aid system, Human Resource system, Revenue Authority. In addition, transactions of donor projects that are included in the budget are recorded into the IFMIS using manual cash controls that are sent to Accountant-General at end of the month. There are reported delays in receiving such cash controls. The manual integration

[6] Guidelines: Annual Financial Reporting and Auditing for World Bank-Financed Activities.

increases the risk of manipulation of data. The government has strengthened reconciliation mechanisms that lower the risk of manipulation and are in the process of requiring all donor funds that are included in the budget to be processed through the IFMS.

75. **Conclusion**. Implementation of the IFMIS had enabled timely and reliable recording of transactions and financial reports. The system has the ability to record donor funded transactions, yet this is not yet fully used with the IFMIS used online for project expenditure, control, recording and reporting. The government should – (i) adopt recognized accounting standards (cash basis IPSAS and later accrual basis IPSAS); (ii) record commitments in IFMIS; (iii) improve consolidation procedures to bring in parastatals in the consolidated financial statements; (iv) capacitate (people, software and computers) internal and external audit to perform IFMIS security audit; and (v) initiate a process to integrate the different systems that logically relate to accounting control in the IFMIS. If Bank-financed projects are transferred to the IFMIS system, the implementing ministry could prepare IFRs and annual project financial statements on a timely basis. However, as part of project preparation, the task team needs to agree on the reporting format and establishment of project asset register. The overall risk associated with accounting and reporting is assessed to be moderate.

xii. Treasury Management and Funds Flow

76. The IFMIS has been designed to not authorize commitment or payment above the allocated limit on a budgetary line. A Central Payment System (CPS), using a set of bank accounts provided by the Reserve Bank of Malawi, has been implemented in order to ensure efficient and effective cash flow management.

77. Under CPS, MDAs may generate payment vouchers both manually and computerized, since IFMIS is not yet fully networked to all budget agencies. Individual MDAs (cost centers) that are not online prepare payment vouchers manually and submit them to the Central Payment Office (CPO) for processing and payment.

78. The AGD is the IFMIS system owner and administrator, and is also responsible for flow of funds through the bank accounts supporting the operation of the Consolidated Fund. The CPS disburses funds from four Central Payment Offices (CPOs) based on payment vouchers generated by MDAs:

- Accountant General's Department Headquarters, which services MDAs in the Central Region.
- Blantyre Regional Treasury Cashier that caters for MDAs in the Southern Region.
- Mzuzu Regional Treasury Cashier which caters for MDAs in the Northern Region.
- Zomba Treasury Cashier which services MDAs in the Eastern Region.

79. In addition to the above, institutions responsible for security (Malawi Defense Force and Malawi Police Service, as well as State Residences) have their own CPOs.

80. The Front Office at the CPOs is the main interface for MDAs not yet connected to the IFMIS, operating as a Cash Office where staff from MDAs transacts with CPO staff by submitting the necessary documentation (payment vouchers and supporting documents) for processing and payment.

81. With the operation of CPS, a few bank accounts should be functional in order to effectively manage cash as well as avoid duplication and minimize bank service charges. Central Government maintains all bank accounts at Reserve Bank of Malawi (RBM).The following are the bank accounts maintained at RBM:

- Main Account (MG A/C No. 1) - Account which GoM receipts shall be deposited into and funds disbursed from.
- Revenue Accounts - Revenue bank account that holds all revenue of MDAs. However, any MDA that does not have authority to hold a Revenue Account deposits central government funds directly into the MG A/C No 1.
- Malawi Revenue Authority and Donor Accounts - These are further Revenue Accounts for Central Government.
- Operating Accounts for each CPO through which funds from MG A/c No 1 are disbursed to Ministries. Each CPO shall hold the following Operating Accounts:
  - Recurrent Account;
  - Development Account (to cater for both Part I and II);
  - Deposits Account;
  - Advances Account;
  - Statutory Expenditure Account.

82. Besides bank accounts at RBM, MDAs hold at designated commercial banks virtual bank accounts, against which cheques from CPOs are cashed using the bank clearing system with the RBM on a daily basis.

83. If the Bank were to move from dedicated Project Implementation Units (PIUs) to full use of country PFM systems for its investments development projects, then project funds will be required to use the GoM treasury systems and flow of funds arrangements. Such projects will also be required to use the Integrated Financial Management Information Systems (IFMIS) and its controls over flow of funds. It will also imply use of the payment system through the Reserve Bank of Malawi that exists for the execution of the budget of the GoM.

84. In the past one project, the Health SWAp, used the country PFM system. The project activities were approved as part of GoM budget and appropriated through the Treasury. In practice Health SWAp did not suffer from any lack of funds and its cash requirements were met.

85. The key risks under treasury management and funds flow include – (i) the risk of inadequate funds being provided for project implementation; (ii) the risk of uncertain or unpredictable cash flows for effective project implementation; (iii) the risk that project funds may be diverted to other uses; (iv) the risk that the treasury will be unable to make payments in foreign currency or to a foreign supplier, or to open a letter of credit; and (v) the risk that unutilized project funds at year end will not be available to support continued project implementation.

86. **Risk that inadequate funds will be made available for project implementation.** There is the possibility that when project funds are passed through the country PFM system, it may be diverted for other pressing government needs other than the project. In practice Bank-funded investment lending projects are required to open dedicated designated bank accounts that receive funds for project activities. This allows Bank staff to monitor transactions and track payments relating to each project, thus ensuring a level of control over the use of funds. It also provides of mechanisms to track if funds were taken out of such bank accounts for non-intended purposes. When the Treasury Bank accounts at the RBM are used, the Bank's ability to make such checks may be impeded. The ability to maintain separate project designated bank accounts at the RBM and within the IMFIS need to be agreed for each project, in order to ensure continuation of current Bank disbursement procedures. For PEFA indicator PI 16, on predictability in the availability of funds for commitment of expenditures, Malawi is rated as B. An earlier assessment has already probed RBM capability to provide this services and a decision has already been taken the all projects should use the RBM for its banking needs - presently special designated bank accounts are opened at the Reserve Bank of Malawi (RBM) for projects and transfers are made into local currency commercial accounts. The IFMIS has also been set up to allow for satisfactory tracking of donor funds, in the sense that the source of funds gets coded at the point of entry. This risk in this regard is therefore assessed as low. The 2011 PEFA P1-16 is also B.

87. **Risk of unpredictable funds availability.** Effective and efficient project procurement and implementation require predictability in the availability of funds. As has been indicated above, projects that have used the Treasury banking arrangements have not experienced significant issues with inadequate funds and in general funds flow have been fairly predictable. From a GoM budget execution perspective, there is also a fairly predictable level of funds releases, as ministries are provided with quarterly expenditure commitment ceilings based on the annual cash flows and receive monthly releases for their budget execution. The quarterly expenditure commitments serve as ceilings for the Ministries against which the ministries can draw. It also allows the Ministry of Finance (Accountant General's Department) to set these ceilings within the IFMIS as control, thus preventing Ministries to over commit / spend their budget ceilings. Although the amount of cash released may change due to changes in the pace of some activities, Ministries have a chance to adjust their cash flows requirements on quarterly basis. These changes must still be within their overall budget allocation. There is therefore significant amount of certainty on availability of funds. On Dimension (ii) of the PEFA indicator PI 16, regarding the reliability and horizon of periodic in-year information to Ministries ceilings

for expenditure commitment, Malawi is rated as B (also B in 2011 PEFA). However, there is high risk of disconnect between the timing of withdrawal applications and the IFMIS budget and cash controls. This area will require detail assessment for each project and MDA and appropriate measures designed to mitigate this possible disconnect. The risk of unpredictability in the availability of funds for project implementation is therefore rated "Moderate".

88. **Risk of diversion of projects funds despite the availability of budget appropriation and budget allocation.** There is always the possibility that project funds under the control of Government may be used for purposes other than for the projects. However, the access controls, budget controls and audit trails in the IFMIS provide a fair level of assurance that when the approved budget are programmed in the IFMIS, the system will only allow expenditures to be charged against approved budget lines. IFMIS ensures strict controls over virements as they require Ministry of Finance approval and subsequent adjustment in IFMIS. Only credible justifications are allowed for any such virements and so once the project budgets are approved and entered into the IFMIS it is likely that the funds will be available for implementation.

89. **Risk that the treasury is unable to make payments in foreign currency or to open a letter of credit.** The Treasury has been making payments in foreign currencies to foreign suppliers in the normal execution of GoM budget, and for Bank financed projects that maintain the designated special bank accounts at the RBM. The RBM has been doing this and there have been no documented complaints on the part of projects with their designated accounts with the RBM. On the RBM's ability to open letters of credit (LoC), the RBM confirmed its ability to do that and that it had done that for Government in the normal course of budget execution. There is therefore no perceived problem with the ability of the RBM to execute LoC.

90. **Risk that unutilized project funds at year end will not be available to support continued project implementation.** As is mandatory for most government systems, authority to spend unutilized budget funds lapse at the end of the fiscal year. The risk therefore exists that should budget appropriations for the following year be delayed, on-going projects may stall due to lack of funds. The risk is partly mitigated by the requirement that GoM budgets are normally approved before the beginning of each year. Should there be delays the law also allows Ministries to spend up to one third of its previous year's approved budget. This risk in this regard is assessed as moderate.

91. **Conclusion**. In general the risk in using normal GoM treasury management arrangements and flow of funds procedures for Bank-financed investment lending projects is assessed to be moderate, mainly because of possible disconnects between Bank requirements and system capabilities. To ensure MDAs are very certain on how to bring project activities on budget and have a full understanding in its application, there is a need to develop and agree detail guidelines.

xiii. Internal controls and internal audit

92. If the Bank was to move from Project Implementation Units (PIUs) with ring-fenced FM arrangements to substantive use of country PFM systems for investments lending projects funding, then in terms of internal controls the major changes would be use of the internal controls embedded in the regulatory framework and IFMIS as opposed to an internal control system designed and implemented by the PIU. This would mean that the Bank would place reliance on the government internal controls as stipulated in the PFM Act, 2003 and further detailed in the Desk Instructions "Government Financial Control Accounting Procedures under Integrated Financial Management Information System". The need for separate specific internal control systems for each new project would no longer exist.

93. Similarly, PIUs would no longer be required to set up internal audit departments but to engage the Central Internal Audit Unit (CIAU) to provide the internal audit oversight needed to monitor and evaluate project execution in line with the agreed objectives.

94. The aforementioned changes, whist addressing some risks inherent in PIUs, may also raise new risks which would need to be managed. The main fiduciary risks in the area of internal controls and internal audit include – (i) weak payroll controls that could lead to payroll leakages; (ii) weak procurement systems that could lead to irregular and uneconomic use of funds; (iii) weak internal control in non-salary expenditures that could lead to irregular, uneconomic and ineffective use of public funds; (iv) delayed and infrequent reconciliation of financial data may create conditions for diversion and/or misuse of funds; (v) delayed or irregular reconciliation of physical assets with records; and (vi) weak internal audit which would further undermine internal controls over project funds.

95. **Internal control risks.** The government of Malawi has put in place internal controls such as segregation of duties, authorization, supervision, documentation requirements, bank account reconciliations and budget controls that, if strictly followed, would be effective in mitigating the misuse or diversion of funds. These accounting and internal control procedures are documented in the "Desk Instructions – Government Financial Control Accounting Procedures under Integrated Financial Management Information System", in line with the requirements of the PFM Act, 2003.

96. Malawi scored a B+ in the 2008 PEFA indicator PI-22 "Timeliness and regularity of accounts reconciliations". In terms of payroll controls the rating for PI-18 was C+: while the country scored an A on payroll and personnel record reconciliations and an A on control over changes on the payroll, the overall score was adversely affected by the fact that an independent payroll audit had not been undertaken at the time of the 2008 PEFA. Subsequent to the PEFA assessment a payroll audit was done by an independent consultant and the GoM has since started implementing its recommendations. The 2008 PEFA did not score Procurement, owing to lack of data. During the 2011 PEFA the country's P1-22 rating deteriorated to D attributed to a lot of bank and other accounts

reconciliation backlogs leading to poor regularity and timeliness of account reconciliations.

97. The findings of this assessment are that the internal control framework and procedures are working reasonably well and are well embedded in the IFMIS set-up. The PFM system at the moment has the disadvantage that fixed asset registers are not maintained. This would be addressed in the medium term by activating the asset register module within IFMIS, but for now COs would be asked to set up and maintain manual fixed asset registers. <u>The overall risk on internal controls is therefore considered to be moderate.</u>

98. **Internal audit risks.** The Central Internal Audit (CIAU) was established in 2003 and according to its Audit Charter, is responsible for the provision of independent and objective assurance about the effectiveness of the internal control system. In pursuit of this objective, the CIAU has made some commendable strides, especially when one considers that its reports are taken into consideration by the Supreme Audit Institution. The function has received a C+ for PEFA indicator PI-21. However, it is noted that the CIAU has an opportunity to perform much better if the following were addressed:

- The CIAU has a capacity challenge both in terms of staff numbers and qualifications and resources at its disposal to carry out its mission. The CIAU has 110 auditors of whom only 11 are qualified. These are required to audit 21 ministries, a number of departments. Agencies and projects. Their coverage is therefore only around 50% of the transactions. The GoM has engaged development partners to assist in training the internal auditors, especially under the FIMTAP. However, staff retention has been a major challenge. Furthermore less than 50% of the auditors have access to computers and the CIAU has been operating without a Director or Deputy Director for a significant period. The Director of CIAU has currently been appointed but is abroad pursuing some course.
- Lack of computers and ICT training has led the CIAU to carrying out only manual audits. No computer based audit capability exists.
- The CIAU applies a transactional / compliance audit methodology. Changing to risk-based methodology is recommended, which would entail a change in management systems, staff skills and updating of manuals and audit programs.
- There is need to clarify the CIAU’s legal mandate and articulating the CIAU’s reporting lines to enhance independence. There is a provision under the PFMA for the creation of CIAU. The Internal Audit Charter has been approved by the Minister of Finance.
- While the CIAU produces some quality internal audit reports, certain of which are relied upon by the Supreme Audit Institution, there is little evidence that its recommendations are taken seriously and implemented. This could be due to weak legal backing and the fact that some ministries do not have active audit committees.
- The scope and practices of the CIAU need reviewing in light of the above and there is need to comply with appropriate internal auditing standards.

99. In view of the foregoing, the overall risk on internal audit is substantial.

100. **Conclusion**. The assessment concludes that internal control risks in using the PFM system are not higher compared to separate PIU-designed and managed internal control systems for investment lending projects. On the other hand, the risks in using the CIAU for internal audit of projects are likely to be higher.

xiv. External Audit

101. In Malawi the law governing external audit, the Public Audit Act of 2003, requires the audit of all public funds to be carried out by the National Audit Office (NAO). The Public Audit Act also governs the National Audit Office (Auditor-General). Currently, even though the NAO is mandated, the practice is for the NAO to contract out the audit of some project audits to private sector auditors.

102. Key risks in using the NAO for project audits include – (i) the risk of delayed submission of audit reports; (ii) there is risk of low capacity and skills at the NAO to perform financial statement audits; (iii) the risk of lack of independence from the executive; and (iv) the risk of unacceptable audit standards and noncompliance with audit acceptable audit standards.

103. **The risk of delayed submission of audit reports**. The Bank requires copies of all audit reports of Bank-financed projects to be submitted within six months after the close of the related financial year. The Public Audit Act similarly requires the Auditor-General (AG) to report annually on the audit of GoM financial statements to the National Assembly, within six months after the end of the related financial year. Including project audits in the scope of the NAO will thus not impede on the already existing legal requirement. However, there has been some audit backlogs in the past, which are about up to date. The timely submission of audit reports for Bank financed projects in Malawi has also been an issue in the past, but the situation is now under control. This risk is regarded as low.

104. **The risk of low capacity and skills at the NAO to perform financial statement audits.** Because of staffing constraints within NAO, the audits of some of the Bank-financed projects are outsourced to professional private sector auditing firms assessed as acceptable to the Bank. Overall capacity of the NAO is low - the office has only three qualified professional accountants / auditors, in addition to AG himself. Even though the GoM financial systems are computerized, the AG's office has not got the requisite skills to audit the IFMIS adequately. The overall low level of capacity, absence of the required technology to back their work and lack of other requisite capacities will bring about substantial risk if full audit reliance is placed on the NAO. In the approved functional review of NAO there is a provision for development of IT audit skills as well as value for money audits. This is yet to be implemented and therefore the risks remain substantial.

105. **The risk of lack of independence from the executive.** For NAO to be effective, it should be financially and operationally independent from the Executive. The NAO of Malawi derives its independence from the Constitution and the Public Audit Act – these seem adequate in principle; however in practice there are some challenges. The NAO has indicated that its budget allocation is inadequate to enable it to carry out its mandate. There is also the likelihood that should resource constraints arise, budget cuts would be applied to all spending units, including the NAO. The NAO is also part of the Malawi Civil Service and subject to its service conditions, remuneration and recruitment processes through the Civil Service Commission. The established positions of the NAO have not been filled and the office is unable to retain the trained staff due to poor service conditions. There is also a concern in that there is no provision in any of the laws that compel the Minister of Finance to table the Auditor General's annual audit report within a stipulated time frame. <u>The perceived lack of independence of the NAO from the Executive will require addressing if the level of risk in this area is to be reduced from its moderate level. It is noted that NAO has come up with a Strategic Plan for 2009 – 2013 which if implemented would go a long way towards addressing most of the issues raised. The functional review has also provided for the independence of NAO in terms of both funding and operations.</u>

106. **The risk of unacceptable audit standards and noncompliance with audit standards.** The AG has indicated that NAO has fully adopted the INTOSAI Auditing Standards. Compliance with the standards depends to a large extent on the skills and training of audit staff in its application. The NAO has conducted initial training of staff on the INTOSAI standards, but practical application and more detailed training and coaching will be required if these are to be fully made operational. It is also important that staff is encouraged to study to obtain professional accountancy qualifications and the NAO has done that; however, the few that qualify often move to the private sector or other better paying employers. <u>Risk in this regard is considered to be moderate.</u>

107. **Conclusion**. Although the Constitution and the Public Audit Act provide adequate mandate and independence of the Auditor General, there are still operational constraints that limit his ability to achieve this. Currently some of the Bank financed projects are audited by the NAO, whilst others are outsourced by the AG to private sector auditing firms. The corresponding 2008 PEFA PI-26 rating is a D+. It is very clear that the NAO require support and resources to enable it to fully discharge its mandate independently as envisaged. <u>The risk of using the country system for audit is perceived as substantial.</u> There appears to be scope for a comprehensive needs assessment of the NAO, to support a program of capacity development. Immediate actions can include –

- Immediate training of staff in the right application of the INTOSAI standards.
- Agreement with Treasury and the Civil Service Commission on how the full established positions can be filled.
- Provision of resource and capabilities to enable the NAO to carry out an IT audit of the IFMIS.

- NAO to bring all audits to completion up to the year ended June 2009 and to submit this to the National Assembly.
- Government support for the NAO Strategic Plan 2009-2013

E. CONCLUSIONS AND NEXT STEPS

108. **To recap,** the benchmark used for concluding on the assessment results and to propose next steps are the key PFM arrangements provisionally identified by AFTFM that will qualify investment lending projects as being **substantially** managed through a country's PFM system -

- The legal agreement between the Government and the Bank assigns implementation accountability to a government entity that annually receives a Parliamentary appropriation through the budget.
- The relevant government entity's annual appropriated budget contains the estimated annual cash flow for the project (a cash budget as currently being used in African states).
- The project funding flows through the Government's bank account configuration, for exclusive use and accountability of the government entity that received the appropriation and is charged with project implementation.
- The project expenditure is incurred and paid for using the government entity's authorized procedures and controls for procurement, commitment and payment.
- The project expenditure is recorded and accessible, together with all related source documents, in the government entity's own accounting system.
- The project activities, expenditure and results are subject to the government entity's own internal audit arrangements.
- The financial performance and position of the project are annually reported in the government entity's own financial statements, or in project specific financial statements.
- The project activities, expenditure, financial statements and results are subject to the government entity's own external audit arrangements.

109. **Bank investment lending modalities continue to be applicable.** The above arrangements would require a fit with normal Bank fiduciary arrangements for investment lending projects – a designated bank account, sound financial management arrangements, interim financial reporting, reconciliation of project expenditure to the approved budget, withdrawals and balances on the designated and other project bank accounts, and audited annual financial statements.

110. **Malawi is not entirely new to the concept.** The 2008 PEFA report explains for indicator PI-7 that *"Budget documentation includes details of projects, showing donor contributions. The Government of Malawi, adopting as a basis the best practices for AID delivery through Government systems as resolved through the Paris Declaration, seeks to categorize donor funding that do not use government systems to be excluded from budget documentation…..Many of the major donors provide basic income and expenditure reports to the Ministry of Finance, Ministry of Economic Planning and Development (through the PSIP) and the Line Ministry under which the project is carried out. For most Donor projects the funding is deposited in the RBM. This provides the Government with an opportunity to track project implementation by monitoring actual disbursements. This, while a reasonable proxy, is not a substitute for actual expenditure reporting. The*

"Summary of Project Support Managed Outside Government Systems" is prepared by the Debt and Aid Unit of the Ministry of Finance in cooperation with the Development Partners. This fiscal report is submitted to parliament along with the budget documentation. This seems to suggest a mechanism (along with the Budget Documentation) for informing parliament of all income/expenditure information on donor funded projects. For active projects in the Bank portfolio the partial use of the country PFM system is outlined in Annex 1.

111. **Key system elements to move towards substantial use of the country PFM system for investment lending projects, implemented by MDAs that are on Budget, are present, but require implementation refinement.** This includes integration of Bank-funded investment lending projects into the planning and budget processes, appropriation, expenditure control, funds flow, accounting and reporting through the IFMIS and internal and external audit arrangements. Specific areas of refinement include the following –

a. During project preparation, specific consultation is needed with the MEPD, MOF and NAO regarding inclusion of the project in the budget, Parliamentary appropriations, warrants, fund flow, use of IFMIS for project control, accounting and reporting, internal audit and external audit.
b. Key generic decisions that will be required include the following –
    i. The specific expenditure account for the project as per the GoM Chart of Accounts. The specific account combination identifies the specific project (Project number), project components (Cost Center) and the financier (Donor Code).
    ii. Project effectiveness will in all likelihood not coincide with the annual approval of the Budget by Parliament. Project expenditure can only be incurred upon authority and process established in the PFM Act. Procedures to proceed with project implementation need to be agreed with the MEPD and MOF, until such time as the project can be included in the estimates for Parliamentary approval.
    iii. Protection of project funding against virement needs to be agreed and controls need to be established, also in the IFMIS.
    iv. A project specific bank account (designated account) needs to be opened into which withdrawals of the loan / grant will be deposited by the Bank. This could be in either a foreign or local currency, dependent of project requirements. This Designated Account also need to be incorporated into the IFMIS, and the requisite reconciliation procedures and responsibilities need to be agreed.
    v. The process to submit withdrawal applications and the required documentation to the Bank also need to be established, together with authorized signatories. Documentation could include interim financial reports, statements of expenditure, copies of invoices, and other information as agreed with the Bank based on the disbursement procedures agreed for the project.

vi. Project expenditure – the normal procedures and controls prescribed in the PFM Act, regulations and other instructions will be applied to the project, subject to compliance to procurement arrangements agreed in the Financing Agreement. Specific IFMIS access controls need to be established for authorized project users.

vii. The format of the quarterly interim financial report for the project needs to be agreed. If feasible this could be defined directly in the IFMIS, or reporting could be supported outside of the IFMIS with a template into which the required project revenue and expenditure data is exported.

viii. End-of-year procedures for the project need to be agreed, including treatment of project cash balances. The development and maintenance of fixed asset registers for projects.

ix. The annual financial reporting requirements for the project need to be agreed, including the formats and accounting standards that need to be consistently applied.

x. The internal and external audit requirements need to be agreed.

112. **In summary, key risks introduced by substantial use of the country PFM system for investment lending projects are** summarized in Table 1 below –

Table 1 – Summary risk assessment

Risk Area	**Key Risk Element**	**Risk Assessment**	**Proposed Mitigation**	**Residual Risk**
Planning and budgeting	Inadequate budget appropriation for the project	High	Ensure that financing agreement binds GoM to full appropriation of loan proceeds over the life of the project.	Low
	Project implementation may be delayed as a result of late appropriation	Moderate	Procedures to proceed with project implementation need to be agreed with the MEPD and MOF, until such time as the project can be included in the estimates for Parliamentary approval.	Low
	Diversion of project funds	Moderate	Protection of project funding against virement needs to be agreed and controls need to be established, also in the IFMIS.	Moderate
	Overall	Moderate		Low
Accounting and reporting	Delays in recording of transactions	Low	Set up in IFMIS specific bank accounts, expenditure accounts, access controls, accounting responsibilities and reconciliation controls for each project.	Low
	Weak audit trail	Moderate		Low
	Unauthorized access and unreliable data	Substantial		Moderate
	Unreliable and late financial statements	Low	Define project reporting requirements directly in the IFMIS, or reporting could be supported outside of the IFMIS with a template into which the required project revenue and expenditure data is exported.	
	Non-compliance with acceptable accounting standards	Substantial	Agree standards and format of the project annual financial statements.	Moderate
	Overall	Substantial		Moderate
Treasury and funds flow	Inadequate funds available	Low	Establish authority, capacity and process to timely submit withdrawal applications and the required documentation to the Bank.	Low
	Unpredictability in the availability of	Moderate		Low

Table 1 – Summary risk assessment				
Risk Area	**Key Risk Element**	**Risk Assessment**	**Proposed Mitigation**	**Residual Risk**
	funds			
	Diversion of project funds	Moderate	A project specific bank account (designated account) needs to be opened, incorporated into the IFMIS, and the requisite reconciliation procedures and responsibilities need to be agreed.	Low
	Inability of Treasury and RBM to support project banking needs	Low		Low
	No access to project funds over year-ends	Moderate	End-of-year procedures for the project need to be agreed, including treatment of project cash balances.	Low
	Overall	Moderate		Low
Internal control and internal audit	Ineffective control framework and procedures	Moderate	Normal project expenditure procedures and controls prescribed in the PFM Act, regulations and other instructions will be applied to the project, subject to compliance to procurement arrangements agreed in the Financing Agreement. The development and maintenance of fixed asset registers for projects needs to be agreed.	Moderate
	Ineffective internal audit	Substantial	Agree specific internal audit requirements for each project, which could include scope, approach and reporting requirements. Provide CIAU with appropriate capacity development support.	Moderate
	Overall	Substantial		Moderate
External audit	Delayed submission of audit reports	Low	Agree specific external audit requirements for each project, which could include scope, approach and reporting requirements. Provide NAO with appropriate capacity development support.	Low
	Low capacity and skills at the NAO to perform financial statement audits	Substantial		Moderate
	Lack of independence	Moderate		Moderate
	Unacceptable audit standards and non-compliance with audit standards	Moderate		Moderate
	Overall	Substantial		Moderate

113. Recommended implementation steps are as follows -

- ***Discuss with the country management team.*** It is important to share the assessment report with the country management team and discuss the findings; this approach helps in reaching consensus on the next steps and getting the country systems agenda on the radar screen of the country management team.

- ***Incorporate the findings of the assessment report in the CAS.*** The next CAS should consider the use of country FM systems as one of the key goals of Bank support to the country; this provides strong incentives to the government and a clear message to task teams.

- ***Reach agreement with the authorities on cross-cutting issues and proposed mitigating measures.*** The country team should reach agreement with the government authorities on such cross-cutting issues as modalities for ensuring timely and credible flow of funds for project implementation and timely approval of Bank-financed projects, general formats of periodic and annual financial reports to be generated using the government accounting system, and other matters outlined in Table 1 above. Such issues need to be tackled on a portfolio-wide basis rather than project by project.

- ***Focus Bank / donor support to the government's PFM reform program.*** It would be important for the team to review how the PFM reform program also support the use-of-country-system agenda.

- ***Carry out supplementary FM assessment of sectoral ministries for pipeline investment projects.*** Despite apparent uniformity in structure and systems, ministries and departments might vary in their actual practices and capacities. For each investment lending project, therefore, it would be important to supplement the results of the assessment of central institutions and systems with an assessment of implementing ministries/institutions. Task teams may seek inputs from INT's Preventive Services Unit in designing specific corruption risk mitigation measures.

- ***Ongoing monitoring of country fiduciary risks.*** As PFM diagnostics are updated (for example, when a repeat PEFA assessment is carried out), it is good practice to update the fiduciary risk assessment report.

- ***Supervision of Projects Using Country FM Systems.*** Perspectives on supervision issues specific to projects using country FM systems will be included in the planned revision of the FMPM. Since it is expected that greater use of country FM systems would result in streamlined supervision activities, sample supervision reports for projects using country systems will also be added to provide practical examples of supervision methods and unique issues.

End

ANNEXES

List of ongoing projects with details of extent of use of country PFM systems									Annex 1
Project ID	**Project Name**	**Implementing Agency**	**USD m**	**Closing**	**Part of National Budget**	**Accounting & Reporting on IFMIS**	**Follows Government Internal Controls**	**Day-to-Day Payments By Treasury**	**Audited By NAO**
P070823	MW-Education Sec Support SIL 1 (FY05)	Ministry of Education, Science and Technology	32	Sept.2010	Yes	No	No	No	No
P073821	MW-Multi-sectoral AIDS - MAP (FY04)	Ministry of Health	30	Dec.2012	Yes	No	Partial	Partial	Yes, subcontracted
P075247	MW-Community Based Rural Land Development (FY04)	Ministry of Lands, Housing and Urban Development	10	Sept.2011	Yes	No	Partial	Yes	Yes
P078408	MW-Fin Mgmt, Transpar & Account (FY03)	Office of the President and Cabinet	25	Sept.2009	Yes	No	Yes	Yes	Yes
P084148	MW-Irrigation, Rural Livelihoods & Agriculture Development Project SIL (FY06)	Ministry of Agriculture and Food Security	40	June.2012	Yes	No	Yes	No	Yes
P096336	MW-Second National Water Development Project SIL (FY07)	Ministry of Irrigation and Water Development	50	Oct.2012	Yes	No	Partial	Partial	Yes
P103773	MW-Business Environment Strengthening SIL (FY07)	Ministry of Industry and Trade	15	Dec.2012	Yes	No	No	No	Yes, subcontracted
P105256	MW-Agricultural Sector Development SIL (FY08)	Ministry of Agriculture and Food Security	32	Sept.2013	Yes	Yes	No	No	Yes
P106671	MW-Agriculture Development GEF (FY09)	Ministry of Agriculture and Food Security		Sept.2013	Yes	Yes	Yes	Yes	Yes
P110157	MW-Second National Water Development - ACGF (FY08)	Ministry of Irrigation and Water Development	25	Oct.2012	Yes	No	Partial	No	Yes
P110446	MW-3rd Social Action Fund APL II (FY08)	Ministry of Finance	50	Sept.2013	Yes	No	Yes	Yes	Yes

List of ongoing projects with details of extent of use of country PFM systems									Annex 1
Project ID	**Project Name**	**Implementing Agency**	**USD m**	**Closing**	**Part of National Budget**	**Accounting & Reporting on IFMIS**	**Follows Government Internal Controls**	**Day-to-Day Payments By Treasury**	**Audited By NAO**
P057761	Infrastructure Services Project	Ministry of Development Planning and Cooperation	40	Nov.2011	Yes	No	Partial	No	Yes
P111432	Regional Communications Infrastructure Project	Ministry of Finance Privatization Commission	18	Feb.2015	Yes	No	Partial	Partial	No
	PRSG 2	Ministry of Finance	54	Sept.2010	Yes	Yes	Yes	Yes	Yes
	Moz-Mw Transmission Interconnection Project	Ministry of Energy	40	June.2013	Eskom	N/A	N/A	N/A	N/A
	Regional Trade Facilitation Project	Ministry of Industry and Trade	10	June.2011	No	No	No	No	No

Annex 2

Summary of PEFA PFM Performance Assessments

Indicator	2005 PEFA	2006 PEFA	2008 PEFA	2011
Credibility of the Budget				
P 1 - Aggregate expenditure out-turn compared to original approved budget	C+	A	A	B
P 2 - Composition of expenditure out-turn compared to original approved budget	D+	D	D	C+
P 3 - Aggregate revenue out-turn compared to original approved budget	D	A	A	D
P 4 – Stock and monitoring of expenditure payment arrears	C	D+	<NS>	NS
Comprehensiveness and transparency of the budget				
P 5 – Classification of the budget	B	B	B	A
P 6 - Comprehensiveness of information included in budget documentation	C+	B	B	A
P 7 - Extent of unreported government operations	B	B	<NS>	NS
P 8 – Transparency of inter-governmental fiscal relations	D	C	B+	B
P 9 - Oversight of aggregate fiscal risk from other public sector entities.	D+	D+	C+	B
P 10 – Public access to key fiscal information	D+	B	C	C
Policy-based budgeting				
P 11 - Orderliness and participation in the annual budget process	D+	B	C+	B
P 12 - Multi-year perspective in fiscal planning, expenditure policy and budgeting	D	D+	B	C+
Predictability and control in budget execution				
P 13 - Transparency of taxpayer obligations and liabilities	D+	C	B	B
P 14 - Effectiveness of measures for taxpayer registration and tax assessment	D	C	C+	D+
P 15 - Effectiveness in collection of tax payments	D	D	D+	NS
P 16 - Predictability in the availability of funds for commitment of expenditures	D+	C+	B	B
P 17 - Recording and management of cash balances, debt and guarantees	C+	C	A	A
P 18 - Effectiveness of payroll controls	D+	C+	C+	B+
P 19 – Competition, value for money and controls in procurement	D+	D	NS	D+
P 20 - Effectiveness of internal controls for non-salary expenditure	D+	B	C+	C+
P 21 - Effectiveness of internal audit	D+	D+	C+	D+
Accounting, recording and reporting				
P 22 - Timeliness and regularity of accounts reconciliation	C+	B	B+	D
P 23 - Availability of information on resources received by service delivery units	D	D	D	D
P 24 – Quality and timeliness of in-year budget reports	D	C+	C+	C+
P 25 – Quality and timeliness of annual financial statements	D+	D+	C+	C+
External scrutiny and audit				
P 26 – Scope, nature and follow-up of external audit	D	D+	D+	D+

P 27 - Legislative scrutiny of the annual budget law	D+	<NS>	B	D+
P 28 - Legislative scrutiny of external audit reports	D+	D+	D+	D+

ANNEX 3

OVERVIEW OF FIMTAP

In recent years there have been three projects that had a substantial impact on the PFM agenda in Malawi.

The first was FIMTAP, which closed in September 2009. The objective of the project was to improve the effective and accountable use of public expenditures through capacity building and institutional strengthening for budget implementation and oversight and increased transparency of government institutions. The project sought to strengthen PFM by focusing on three primary components:

- Strengthening Accountability Institutions
- Improving Financial Management Systems
- Enhancing Human Capital Development

This project brought about the IFMIS, trained auditors (both external and internal) and trained procurement specialists, amongst others. The objectives were attained by September 2009, with a reasonable degree of success.

Further roll-out of the IFMIS to Local Governments is now supported through MASAF (Malawi Social Action Fund) III APL II.

Issues like improvements in the budget process, linking the budget with the MGDS, timeliness of financial reporting, strengthening payroll management, strengthening of external audit and internal audit are included as PAF indicators for the Poverty Reduction Support Grants.

ANNEX 4

REFERENCES

Websites: Ministry of Finance: www.finance.gov.mw
National Audit Office: www.nao.mw
Reserve Bank of Malawi: www.rbm.mw
National Assembly: www.parliament.gov.mw
Anti-Corruption Bureau: www.anti-corruptionbureau.mw
Office of Director of Public Procurement: www.odpp.gov.mw

List of Persons Met:

No	Name	Organization	Designation
1	Mr Randson Mwadiwa	Ministry of Finance	Secretary to the Treasury
2	Dr Naomi Ngwira	Ministry of Finance	Director – Debt and Aid
3	Mr Saulos Nyirenda	Ministry of Finance	Director - PFEM
4	Dr Andrew Tench	Ministry of Finance	TA - PFEM
5	Mr Wirima	Ministry of Finance	Deputy Director
6	Mr Ben Botolo	Ministry of Finance	Director of Finance
7	Mr Tayani Banda	Ministry of Finance	WB Desk Officer
8	Mr Simwaka	Ministry of Finance	Budget Directorate
9	Mr Phiri	Ministry of Finance	Budget Directorate
10	Mr Sam Maseya	Ministry of Finance	Deputy Accountant General
11	Mr Mganga	Ministry of Finance	Assistant Accountant General
12	Dr Kazombo	Ministry of Finance	Assistant Accountant General
13	Ms Chimwemwe Banda	Ministry of Finance	Assistant Accountant General
14	Mr Reckford Kampanje	National Audit Office	Auditor General
15	Mr Sam GoMani	National Audit Office	Deputy Auditor General
16	Mr Kanjala	National Audit Office	Assistant Auditor General
17	Mr Tchoka	National Audit Office	Chief Auditor
18	Ms Mercy Kumbatira	Reserve Bank of Malawi	Manager – Local Transactions
19	Ms Violet Chatsika	Reserve Bank of Malawi	Manager - Forex
20	Ms Mseka	Reserve Bank of Malawi	Director of Finance
21	Mr William Matambo	Reserve Bank of Malawi	Chief Internal Auditor
22	Mr Neil Nyirongo	Reserve Bank of Malawi	Director
23	Mr Bright Mangulama	ODPP	Director
24	Mr Arnold Chirwa	ODPP	Assistant Director
25	Mr Peter Chigwere	ODPP	
26	Mr R Banda	ODPP	
27	Ms Wezi Mjojo	NLGFC	Executive Director
28	Mr Silli Mbewe	NLGFC	Director, Financial Management
29	Ms Mary Phombeya	ACB	Senior Corruption Prevention Officer
30	Mr Ben Munthali	ACB	Corruption Prevention Officer
31	Ms Bea Parks	DFID	
32	Mr Jason Lane	CIDA	
33	Mr Don Taylor	DFID	
34	Mr O. Fritz	GDC	
35	Mr Fenwick Kamanga	AfDB	
36	Mr Chauncy Mwabutwa	EU	
37	Mr Alan Munday	EU	

38	Ms Kojlas Britte Hilde	Kingdom of Norway	
39	Mr Ernest Misomali	UNDP	
40	Mr Venge Nkosi	UNDP	
41	Ms Charlotte Duncan	DFID	
42	Mr Sam Kakhobwe	MCA	
43	Ms Susan Banda	MCA	
44	Mr GoMani	MCA	

ANNEX 5

Framework methodology for channeling investment lending projects through country PFM systems

Step	Key decisions: Legal and Institutional Arrangements	Key decisions: Operational systems		FM arrangement	Assessment required	Disbursement arrangements	Risk assessment
1	Is project implementation the accountability of an MDA that receives a vote in the annual Appropriation Act? (Even through a PIU embedded in the MDA). No			A. Ensure legal authority exist to not deposit project funding into the Consolidated Fund; ring-fence the funds flow, control systems, staffing, accounting and reporting arrangements for the project outside the country PFM system	Normal investment lending project FM assessment	Designated Account and normal withdrawal arrangements, including IFRs	Normal methodology
	Yes	No	No				
2	Is co-mingling of project funds with Government funding acceptable to the Bank? Yes	Is there a manual or computerized FM system that will effectively support the FM requirements of the project Yes	Are the Government staff, rules, procedures, controls, documentation and audit trail acceptable to support project execution at a level of acceptable fiduciary risk? Yes	B. Project expenditure appropriated in budget; project funding deposited into the Consolidated Fund, integrated and complete use of the country IFMIS or manual FM system for funds flow, control systems, staffing, accounting and reporting arrangements; project reported in MDA financial statements	PFM diagnostic	No designated account; reimbursement only	Incorporate PFM diagnostic into the project FM risk rating
	No						
3		Is it possible to set up a separate bank account, general ledger, cash book and other sub-ledgers for the project in the Government's computerized or manual financial management and accounting system, reporting financial transactions of the project reliably and timely using the most relevant accounting basis for the project? Yes	Are the Government staff, rules, procedures, controls, documentation and audit trail acceptable to support project execution at a level of acceptable fiduciary risk? Yes	C. Use the Government's computerized or manual financial management system for ring-fenced funds flow, control systems, staffing, accounting and reporting arrangements	PFM diagnostic; Checklists to assess ring-fenced use of TSA, IFMIS, staffing, control systems and project reporting	Designated Account and normal withdrawal arrangements, including IFRs	Incorporate PFM diagnostic into the project FM risk rating
		No - FM arrangement A	No - FM arrangement A				
4	Is the external audit of donor project funding in the mandate of the Auditor-general? Yes	Does the Auditor-general have the required independence, willingness and capacity to provide a reliable and timely audit service? Yes		D. Use the Auditor-general for the project external audit	SAI capability for investment lending project audit and ToR		Normal methodology
	No	No		E. Agree - (i) the use of a private sector auditor (under SAI oversight if in the mandate of the SAI) for the external audit of the project; and (ii) capacity development of SAI	PFM diagnostic; Private sector auditor capability for project audit and ToR		Normal methodology