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Republic of Ecuador Country Financial Accountability Assessment

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ABBREVIATIONS AND ACRONYMS

BCE	Central Bank of Ecuador
CFAA	Country Financial Accountability Assessment
CGE	Contraloría General del Estado (Supreme Audit Institution)
COSO	Committee of Sponsoring Organizations of the Treadway Commission
FT	Fiscal Transparency
FSAP	Financial Sector Assessment Program
FTSRL	Law on Fiscal Transparency, Stability, and Responsibility
GOE	Government of Ecuador
IAU	Internal Audit Unit
IDB	Inter-American Development Bank
IFAC	International Federation of Accounting
IFI	International Financial Institutions
IIA	Institute of Internal Auditors
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
LOAFYC	Organic Law of Administration and Control
LOCGE	Organic Control Law
MEF	Ministry of Economy and Finance
NFPS	Non-financial Public Sector
ODEPLAN	National Planning Office
PAC	Plan Annual de Caja (Annual Cash Flow Projection)
PCU	Public Credit Undersecretary
PER	Public Expenditure Review
PFM	Public Financial Management
PPC	Plan Periódico de Caja (Periodic Cash Flow Plan)
PSC	Public Sector Committee
PSFMP	Public Sector Financial Management Project
ROSC	Report on Observance of Standards and Codes
SIGADE	Debt Management software
SIGEF	Integrated Financial Management Information System (<i>Sistema de Gestión Financiera</i>)
WB	World Bank

IDB

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EXECUTIVE SUMMARY

Context

In 1999, Ecuador suffered its worst economic crisis, which caused real per capita income to plummet 9 percent as a result of severe external shocks and domestic factors. The external shocks included: (a) the repercussions of the Asian crisis in other emerging markets; (b) the impact of the El Niño phenomenon on the climate; and (c) the drop in international oil and shrimp prices. The domestic triggers of the crisis were: (a) weak fiscal management, which led to default on Ecuador's external public debt in August 1999; and (b) the banking crisis, which caused the closure of almost half the banks in the system. During the crisis, the former currency of Ecuador, the Sucre, underwent a series of devaluations until the Government opted for dollarization in January 2000.

Despite positive economic signals in 2002 and 2003, Ecuador's public finances remain precarious, largely because of weaknesses in government systems and oversight for the non-financial public sector and dependence on volatile fiscal revenue from oil. More than 96 percent of total public expenditure is fixed (public sector wages and salaries, social security benefits, debt service and other contractual arrangements), reducing the scope for discretionary spending.

CFAA Objective

The strategic objective of the present CFAA is to contribute to strengthening of Ecuador's economic governance, and associated social and economic development, by identifying weaknesses and recommending remedial action in areas where current Public Financial Management (PFM) institutional arrangements, practices and systems, limit the efficiency and transparency of public sector management. This being the first CFAA for Ecuador, the study reviewed the practices and systems of the Central Administration of Government.

In recent years, two important pieces of legislation concerning public financial management have been issued which have helped to strengthen the legal and regulatory framework. The Fiscal Transparency, Stability and Responsibility Law (FTSRL), the Organic Control Law (LOCGE) and their accompanying regulations were issued in 2002. In addition, in 2003 the Government of Ecuador (GOE) reactivated the reform of the integrated financial information system (SIGEF) in order to improve efficiency of operations and promote transparency and accountability. There are also a number of projects, which are being implemented in the areas of modernization of the state and institutional reform and anti-corruption.

Summary of Principal Findings

Legal and Regulatory Framework

- The 1977 LOAFYC provided the basis for a systematic and integrated approach to financial administration and governmental control and at its inception was considered to be a piece of pioneering financial administration legislation in Latin

America. The systemic focus was however subsequently undermined by a rapid proliferation of “special purpose laws” and norms starting in 1992 as a result of competing pressures of pro-poor spending versus pro-fiscal discipline. The current framework has therefore, become increasingly fragmented and incomplete, making it difficult to distinguish between current requirements and those which have been repealed and superceded by new regulations.

Information Systems

- Implementation of the Government’s integrated financial management system (SIGEF) has brought some order to the administrative and financial functions at the executing unit level, however, there remain some fundamental issues related to SIGEF’s conceptual design that limit its effectiveness as a management tool to promote accountability and transparency in public financial management. Three important shortcomings relate to: i) the lack of commitment controls during budget execution; ii) the fact that the accounting entries are not automatically generated along the budget cycle, and iii) the technological platform comprised of a set of independent technology tools and applications, which in some cases are not compatible, and use physically and logically decentralized databases.

PFM practices and operational procedures

- The bulk of current budget decisions are directed toward financial discipline and austerity, within individual financial years (near-term), with inadequate consideration of the long-term consequences for fiscal policy. Stronger linkage between budget decisions and program goals, and improved cash flow forecasting and management, would improve the use of scarce resources.
- The rigidity and incrementalism of the budget, along with the practice of making in-year adjustments to approved budgets without clear rules and guidelines, makes it difficult for spending ministries to plan and commit expenditures in support of their programs, and undermines the transparency and credibility of the budget as a statement of government priorities.
- The administration of the official bank accounts by the Central Bank guarantees the Treasury authorities an adequate mechanism to control available funds. In addition, implementation of the Single Treasury Account has facilitated an important reduction in idle funds and has provided a mechanism for increased efficiency in the payments to suppliers and other beneficiaries.
- Expenditure control is not exercised on budgetary commitments, causing floating debt to accumulate and making it difficult to comply with the quantitative rules of the LOAFYC, exceeding the international benchmark of 5 percent.
- The Accounting Undersecretariat is under-resourced, in terms of staff numbers, skill profiles and information technology, which makes the unit unable to discharge its role in promoting fiscal transparency. Information provided for decision making and control is often incomplete and untimely, and there is a lack

of confidence in the consistency of budget performance, accounting and financial reporting, and their usefulness in promoting transparency and accountability.

- The legal framework for debt management provides adequate orientation for debt reduction in the short term, however, there is no formal strategy for new borrowing, no analysis of long-term capacity to repay or creditworthiness of public entities, and no functional coordination between the various agencies involved in debt management.
- Internal audit units do not provide regular and adequate feedback to line ministry management on the reliability and integrity of financial information and there is no systematic approach to the evaluation of internal control nor to governance processes within line ministries and agencies.
- The Organic Control Law empowers the Supreme Audit Institution with operational independence, financial autonomy, and access to the full range of state entities; however, this independence has not been fully exerted. In spite of the new responsibilities, the focus has continued in the area of ex-ante control of public procurement and ad hoc reviews, and up until early in 2004, no external financial audits have been performed on Budget Execution nor the Consolidated Financial Statements of the Central Government.
- As in many developing countries, the Congress does not have a tradition of rigorous examination and debate of the budget, nor oversight of public financial management. Efforts have recently begun to engage the Parliament in its roles of promoting financial accountability of the Government to the electorate.
- Civil Society is increasingly lobbying for Government's financial accountability, but the effectiveness and impact has been curtailed due to the complexity of the budget process and a lack of timely and reliable information on public expenditures.

Summary of Main Recommendations

Most of the CFAA's recommendations and remedial actions can be considered "quick wins" that would help to promote efficiency and possibly increase the Government's headroom for discretionary spending. In order to implement the recommendations, the Team has proposed an action plan which will serve as the basis for discussion with the authorities.

These are the CFAA's main recommendations.

Legal and Regulatory Framework

- In the short term, compile and order the existing laws and regulations on PFM into one consolidated text, repealing those dispositions that are no longer

applicable or contradictory. In the medium term, in order to reestablish the systemic approach and to streamline and improve the efficiency of Budgeting, Treasury, Financial Accounting and Reporting, a new organic law should be approved and implemented, bringing to a conclusion the GOE's own initiative to modernize the legal framework, which has been in abeyance for some time. The framework should lay down principles, leaving the procedural details to be established in regulations.

- Prepare and implement supporting regulations to the proposed new law, to assure that (a) the budget is realistic, comprehensive, and policy-based and that there is linkage between the development plan and the recurrent and capital expenditures proposed in the budget; (b) adequate information on budget management and performance is produced and disseminated to meet decision making, control, management and reporting purposes; (c) the procedures for making in-year adjustments to budget allocations are clearly articulated and complied with; (d) internal control arrangements are in place for the exercise of stewardship of public funds; and (e) there are adequate arrangements to enhance legislative and civil society capacity for scrutiny of public finances.

Information Systems

- To optimize the decision-making process, SIGEF should be re-engineered and its technology platform upgraded. In keeping with the Government's initiative already underway, the redesign should consider (a) at the institutional level, invert the logical flow of data so that the accounting transactions are an automatic by-product of budget execution, as opposed to the current logic where budget commitments are only reflected when accounting entries are posted; (b) upgrade the information technology platform beyond the current client-local server approach of the institutional systems, promoting use of communications and Internet-based technologies, and real-time updating of the system's central databases; (c) establish limits to manage preparation of the draft budgets (prior approval and consolidation) and ; (d) establish of commitment controls within SIGEF to ensure orderly payment functions and prevent over-commitment in times of austerity. The latter two actions need to be addressed in the short term and necessitate close coordination between accounting and information technology aspects.

Practices And Operational Procedures

- Develop and implement a methodology and procedures which would link the annual development plans to the Budget and ensure consistency of the institutional annual plans with budgeted activity costs.
- Transfer the responsibility for central coordination of the periodic cash management plans to the Treasury Undersecretariat, in the short term and

establish institutional arrangements to allow the Treasury Undersecretary to access and use the Central Bank's central databases on government financial transactions. In the medium term, the Interbank payment mechanism may be expanded to cover all items of expenditure, eliminating the revolving payment accounts and the use of checks.

- Design and implement a capacity building program for the Accounting Secretariat which will upgrade the accounting framework, ensure appropriate numbers and mix of personnel and make available technological tools which would allow the unit to prepare periodic and annual financial statements in a complete and timely manner and provide capacity for evaluation of budget reports and financial statements.
- Elaborate a borrowing policy and strategy on which the activities of authorization and contracting new financing can be based, and create appropriate mechanisms for coordination among the various agencies involved in debt management. In addition, procedural manuals should be developed and implemented, which specify roles and responsibilities and operationalize the borrowing policy.
- Implement a systematic approach to evaluation, management and control of risks by strengthening the internal audit units within line ministries, providing them with adequate staff (numbers and profiles) and establishing procedures for conducting day to day oversight of budget execution .
- In order to match its chief responsibility to perform government audits and special examinations and to oversee the controls implemented to manage public finances and promote transparency and accountability, the organization, staffing and procedures of the Supreme Audit Institution (CGE) should be realigned with its mandate, eliminate ex-ante controls on public procurement and paying more attention to ex-post financial audits and special examinations. In addition, increase the number, depth and frequency of financial audits of line ministries, the consolidated financial statements and the annual budget statement.
- Legislative scrutiny of government expenditures increases transparency and strengthens governance by calling Government to account for its stewardship of public expenditure. In order to enhance financial accountability, the institutional capacity of the Congressional Finance and Budget Committee should be strengthened, establishing policies and practices that will ensure adequate briefing of the legislature on issues of public finance and management, to better equip them to advocate on budget priorities and effectively oversee budget execution, control, evaluation and external audit corrective action.
- Upgrade the Government's Internet portal, and provide more user-friendly access to information on budget execution and financial performance. In addition

mechanisms to sustain and increase consumer demand, through consultation with key sectors of society and the Congress, should be implemented.

Fiduciary Risk

The CFAA concludes that fiduciary risk in Ecuador is currently **substantial**.¹ Of particular importance in arriving at this rating are the following weaknesses that undermine efficiency, transparency and accountability:

- An outdated classification system and significant amounts of extra-budgetary resources hinder budget realism and limit the government's ability to plan, control and direct expenditures.
- Timely and comprehensive fiscal, revenue and expenditure records and information are not produced, maintained or disseminated to meet decision-making, control, management and reporting purposes.
- The lack of timely and centralized information for cash and treasury management results in cash rationing mechanisms and persistent domestic arrears.
- The lack of prompt and virtual consolidation of the budget, and the lack of information available to the public undermine transparency and accountability.
- A weak internal control environment contributes to operational inefficiency and a lack of accountability and stewardship in the use of public funds;
- Arrangements for external transparency and scrutiny of public finances by the legislature and civil society are inherently weak.

At the same time, there is an expectation that risks will decline as the reforms in progress are completed, in part through the adoption and follow up of the recommendations discussed in this study. The positive outlook underlying the risk rating has also taken into consideration the Government's program for PFM improvement that is fully owned and currently being implemented including:

- Strengthening of the legal framework through passing the FTSRL, the LOGCE, and in 2002, their accompanying regulations.
- The administration of the official bank accounts by the Central Bank guarantees the Treasury authorities an adequate mechanism to control available funds.
- Reactivation of improvements to SIGEF in order to improve efficiency of operations and promote transparency and accountability.
- Implementation of several projects with other donors in the areas of modernization of the state and institutional reform and anti-corruption.

¹ Risk classification for the purposes of CFAA are: 1) low, 2) moderate; 3) substantial; and 4) high.

1. BACKGROUND, COUNTRY CONTEXT AND CFAA METHODOLOGY

A. Country Economic Policy Issues

1.1 Ecuador, one of the smallest countries in Latin America, possesses large oil reserves, fertile Andean valleys, and a vast, unpolluted Amazon region, which enable it to compete successfully in hydrocarbon and agricultural export markets. Its population is ethnically diverse, with a rich mixture of languages, cultures, and traditions. Despite these advantages, real per capita income has stagnated for the past two decades and the majority of the population is still living in poverty.

1.2 In 1999, Ecuador suffered its worst economic crisis, in which real per capita income plummeted 9 percent as a result of severe external shocks and domestic factors. The external shocks included: (a) the repercussions of the Asian crisis in other emerging markets; (b) the impact of the “El Niño” phenomenon on the climate; and (c) the drop in international oil and shrimp prices. The domestic triggers of the crisis were: (a) poor fiscal management, which led to default on Ecuador’s external public debt in August 1999; and (b) the banking crisis, which caused the closure of almost half the banks in the system. During the crisis, the former currency of Ecuador, the Sucre, underwent a series of devaluations until the Government opted for dollarization in January 2000.

1.3 Despite favorable economic signals in 2002 and 2003, Ecuador’s public finances remain precarious, largely because of (i) weaknesses in public administration systems and in oversight for the non-financial public sector; (ii) dependence on volatile fiscal revenue from oil, and (iii) a high degree of inflexibility in public expenditure: more than 96 percent of total public expenditure is committed to public sector wages and salaries, social security benefits, debt service and other contractual arrangements, reducing the scope for discretionary spending.

1.4 Since the beginning of 2003, the Government’s strategy has been to bring Ecuadorian citizens together to launch a concerted fight against poverty through coordinated advances on the economic, social and governance fronts. As expressed by one of the governance pillars, the Government of Ecuador is committed to fighting corruption and improving public service delivery and transparency.

1.5 The principal medium-term development challenges facing Ecuador, as enunciated in the World Bank’s (WB’s) Country Assistance Strategy and the Inter-American Development Bank’s (IDB’s) Country Strategy are (a) consolidation of the macroeconomic framework laying the foundations for diversified and sustainable economic growth and poverty reduction; (b) improving social equality and extending the benefits of economic growth to all of society, especially the most vulnerable groups that are left on the margins of the development process or below the poverty level; (c) strengthening governance by building an accountable, transparent and efficient government, the services of which are accessible to all Ecuadorians.

B. Role and Objective of the CFAA

1.6 In November 2003, the WB and IDB (the participating Banks) agreed to execute jointly a Country Financial Accountability Assessment (CFAA) for Ecuador. The role of the CFAA is twofold:

1. The *development objective*: To contribute to strengthening of Ecuador's economic governance, and associated social and economic development, by identifying weaknesses and recommending remedial action in areas where current Public Financial Management (PFM) institutional arrangements, practices, and systems limit the efficiency and transparency of public sector management.
2. The *fiduciary objective*: To support the participating Banks' fiduciary responsibilities by identifying the strengths and weaknesses of Public Financial Management (PFM) arrangements so that the potential risks to the use of public finances, as well as International Financial Institutions loan proceeds and donor funds (primarily in the case of balance of payments and budget support), can be assessed and managed.

C. Relevance of the CFAA to the Country Context and Development Challenges

1. Reforming Public Institutions and Strengthening Governance

1.7 In recent years, Ecuador has consistently ranked among the countries with the highest perceived incidence of corruption in Latin America, according to Transparency International. For 2003, the Transparency Index for Ecuador was 2.2 out of a possible 10. Ecuador ranked 113 out of 133 countries (at the same level as Congo, Sierra Leone and Iraq). These statistics indicate a need for improvement in financial accountability and its critical elements: well-organized, effective public financial management systems and efficient spending of public funds. Rules and restraints (for example, sound budget policies, robust accounting and financial accounting, and internal and external audit) reduce the opportunities for the budget to be used for political purposes, allow for tracking of the flow of funds, inhibit the misuse of public resources, and promote public sector effectiveness and good governance. Improved public financial management also enhances prospects for economic development, and good governance is indispensable for growth and equitable development.

1.8 These being the subjects of the CFAA, the results of this diagnostic review can be an important source of information on the efficiency of the public financial management system and institutional capacity, and can be used to nourish ongoing country dialogue and assistance strategies and programs, and to contribute to achievement of Ecuador's development objectives.

2. Debt and Cash Management Systems

1.9 Adequate information systems for recording of public debt and contingent liabilities are critical to ensuring the completeness of information for decision-making. The CFAA evaluated: (1) the adequacy of the institutional arrangements for debt management; (2) the efficiency of coordination between the Ministry of Finance, the

Central Bank and the public entities participating in the debt process; and (3) the strategic and operational orientation of debt management.

3. Efficiency of Public Expenditure

1.10 Adverse macroeconomic conditions and fiscal instability pose major risks to economic development and also have an impact on the interests of International Financial Institution loan proceeds and donor funds, as demonstrated by current default episodes and delays in debt payments. A comprehensive, realistic budget and a clear set of rules governing the process would contribute to aggregate fiscal discipline and efficiency in the use of scarce resources. Given the inflexibility of government expenditure and limited headroom for discretionary spending, it is essential that (1) public expenditure become efficient and transparent; (2) compliance with the budget be monitored on a timely manner through meaningful financial reporting and; (3) internal control and external audit act as effective and timely mechanisms for evaluating public spending. Given the fundamental role of management control and independent oversight in promoting efficient public financial management, the CFAA assessed the overall budget cycle, accounting and reporting framework, internal control, internal and external audit, and legislative scrutiny of public sector financial management.

D. CFAA Approach

1. Partnerships and Collaboration

1.11 The assessment lead by the IDB was conducted jointly with the WB and linked to the joint IDB/WB Public Expenditure Review (PER) and the IMF Report on Observance of Standards and Codes for Fiscal Transparency (ROSC-FT). The three diagnostic studies were conducted simultaneously and a number of synergies and coordination/information sharing mechanisms were agreed upon and implemented to promote efficiency, reduce overlaps and administrative burdens on the client, and reduce time and cost associated with the diagnostics. From the outset, responsibilities were divided between the various studies to ensure full coverage. In the case of the ROSC-FT/CFAA collaboration, the team produced a single joint questionnaire, designed to collect a common set of information useful to both teams. The joint information-gathering questionnaire, (translated into English), based on good practice widely recognized by the OECD countries, is available in the project files. Interviews with the participating ministries and agencies were also conducted jointly.

1.12 While all three teams covered the budget process, each viewed it through a different lens. *The PER team* assessed the wisdom of government decisions relative to resource allocation and public expenditure and considered whether the budget process enables a clear articulation of government priorities and addressed issues of aggregate fiscal discipline, allocation of budgets to strategic activities, and operational efficiency. It also reviewed public expenditure management at sub-national levels. *The CFAA team* assessed whether the Central Government's Financial Management systems, practices and accountability arrangements are adequate to ensure that wise decisions with respect to resource allocation can be actually implemented and reviewed the core budget processes (formulation, execution, monitoring and transparency) and the extent to which actual appropriations and actual spending correlate to the original allocations. *The FT*

ROSC team expanded the analysis to include verification of the degree of compliance with the Code of Good Practice on Fiscal Transparency and issues of revenue management, quasi-fiscal activities, and public sector entities.

2. Areas of Analysis

1.13 The CFAA covered the following areas of the Central Government's FPM:

1. Budget
2. Treasury and Revenue Management
3. Accounting and Financial Reporting
4. Public Investment
5. Debt Management
6. Internal and External Control and Auditing Systems
7. Legislative Oversight of Budget Execution

1.14 In each of these areas, the CFAA reviewed the legal and institutional framework, operating policies and procedures, the technological enablers used where appropriate, the control environment, and the actual practices followed.

1.15 The CFAA did not review the banking sector, nor the private sector accounting and auditing framework. These two areas were covered by the Financial Sector Assessment Program (FSAP) and the Auditing and Accounting ROSC, the results of which are being submitted to the Government of Ecuador and are being discussed with the relevant authorities.

3. Country Performance and Risk Analysis

1.16 A financial management risk assessment is designed to identify gaps (in terms of quality and relevance of financial information, oversight and overall transparency and accountability) between generally accepted performance measures and actual practices. As a by-product of the assessment, a conclusion is reached on the risk that donor and public funds will be used for unintended purposes or that misuse of funds will go undetected.

4. Government Participation

1.17 The Public Investment Undersecretary was responsible for overall coordination of the three studies and the government retained the services of a technical consultant, who worked full time to ensure that participating agencies were apprised of the objectives of the studies. During the assessment, line ministries and agencies completed questionnaires and were interviewed by the CFAA team, who solicited their views on the current state of public financial management, the adequacy of the regulatory environment, and their own practices. The key stakeholders included the Ministry of Finance and the Economy (Undersecretaries of Economic Policy, Public Investment, Budgeting, Treasury, Public Credit, Accounting, and the SIGEF project); the Controller; the National Council on State Modernization; the Office of Planning of the Presidency

(ODEPLAN); the Ministry of Education, Culture, Sports and Recreation; the Ministry of Labor and Human Resources; the National Anti-Corruption Commission; the Central Bank; civil society; the Internal Revenue Service, the Ecuadorian Customs and quasi-fiscal entities (PetroEcuador, Solidarity Fund, Deposit Insurance Agency, National Development Bank, State Bank, Ecuadorian Institute of Social Security). Throughout the process, staff from of the Ministry of Finance accompanied the Team during the interviews and gave the perceptions on the areas for improvement and reform.

5. Dissemination

1.18 The preliminary conclusions and proposed recommendations of the PER, CFAA, and IMF ROSC-FT were presented during a joint workshop, arranged by the Government and held in Quito May 19-21, 2004. A technical report was advanced to the government to facilitate the workshop and provide the officials with a working document of the strengthens and weaknesses of the practices and accountability arrangements of the PFM system. The meeting was well attended by the ministries and agencies that participated in the various diagnostic studies (except for the congress), who used the opportunity to give feedback on the main findings and recommendations. This exercise of examining public financial management issues from three different, but complementary viewpoints was seen by the Government as extremely timely and useful. It is expected that a continuing common dialogue for dissemination and implementation of actions by all partners will improve the leverage of the recommended reform programs. As part of the dissemination effort, the MEF is preparing a comparative analysis of the findings and recommendations of the three diagnostic studies.

2. CFAA ANALYSIS AND CONCLUSIONS

2.1 This chapter describes the legal and institutional framework, operating policies and procedures, and the technological tools at the disposal of the government in each of the areas covered in the CFAA, as well as the actual practices observed. Professional judgments have been made on the extent to which, the financial accountability framework, procedures and practices promote an efficient and transparent public sector, in keeping with the stated objectives of the CFAA. The report also suggests the likely impact of observed weakness on the medium-term development objectives of fiscal consolidation and strengthening governance.

A. Public Sector Financial Management

2.2 Public Financial Management (PFM) covers the programming, organization, direction, execution, coordination and control for budgeting and public credit, revenue estimation and collection, accounting (for financial resources, goods and services), financial reporting reflecting (revenue, expenses and national assets, and internal and external audit.

1. Organic Structure

2.3 The Non-financial Public Sector (NFPS) in Ecuador is comprised of (a) central government, the spending ministries, and their dependencies (schools, hospitals); (b) the autonomous and decentralized entities; (c) the Social Security Institute; and (d) public higher education institutions. The autonomous and decentralized entities (*regimen seccional autónomo*) include the legislative and judicial branches and their dependencies, the superintendencies and control entities, state-owned companies, and sub-national governments.

2.4 Overall responsibility for issuing policies, norms, and practices necessary for implementation of the public financial management systems is divided between the Ministry of Finance and the Economy (MEF) and the Supreme Audit Institution (CGE). MEF is responsible for budgeting, public credit, revenues, and treasury, and GCE is charged with overall responsibility for governmental accounting and control.

2. The Legal Framework

2.5 A clear and enforceable legal and regulatory framework that systematically integrates and regulates public financial management is essential for establishing benchmarks for enforcing accountability and transparency. The legal and regulatory framework for financial accountability in Ecuador is embodied mainly in (1) the Constitution, (2) the 1977 Organic Law of Financial Administration and Control (LOAFYC, Decree 1429) and its modifications, plus the complementary budgetary and accounting instruments, created by interministerial agreement, (3) the 2002 Fiscal Transparency, Stability and Responsibility Law (FTSRL) and its accompanying technical norms (Decree 96, 2003), and (4) the 2002 Organic Control Law (LOCGE) and its accompanying regulations.

2.6 The 1977 LOAFYC provided the basis for a systematic and integrated approach to financial administration and governmental control and at its inception was considered to be a piece of pioneering financial administration legislation, the principles of which were subsequently embedded in many of the financial administration laws in the region. The LOAFYC remained intact until the rapid proliferation of “special purpose laws” and norms, including the 1992 Public Sector Budget Law. These changes, considered necessary in order to facilitate the process of decentralization of operations, were influenced by alternating and sometimes contradictory objectives that failed to maintain the delicate balance between recognition and enforcing of fiscal discipline on the one hand, and economic expansion, on the other—the right of entities to spend their approved budgets without restrictions. As a result, the legal framework for PFM lost its systemic focus.

2.7 The superimposing of contradictory rules and regulations, many of them in force at the same time (pro-poor spending versus pro-fiscal discipline) has undermined the systemic approach embodied in the 1977 law. As a result, the framework has become increasingly fragmented and incomplete, making it difficult to distinguish between current requirements and those which have been repealed and superseded by new regulations.² Annex II outlines some of the numerous laws and norms which currently relate to public financial management in Ecuador.

3. Operational Procedures And Information Systems

2.8 Each of the six areas under review in the CFAA is supported by specialized systems and operating procedures. SIGEF (*Sistema de Gestión Financiera*) is used to support the policies and procedures regulating budgeting, treasury management, and accounting and financial reporting. SIGADE is used for debt management, and SIGOB is the tool used to record the inventory of public investment projects.

2.9 Ministerial Agreement 181 of December 1999 designated SIGEF as the official information system to be used by entities in the Non-financial Public Sector. At the end of 2000, norms and instructions were approved in order to facilitate progressive implementation of SIGEF, with effect from January 1, 2001. In February 2002, the WB approved a loan for a Public Sector Financial Management Project (PSFMP), a US\$13.3 million operation to support the consolidation of reforms in financial management and control that. Two of its components will support the expansion of SIGEF and upgrade its technological base. The WB loan became effective in September 2003.

2.10 SIGEF was designed to collect, process, and summarize information on budgetary, financial, economic and asset management, and to bring together the overall results of public sector management. It was conceived as a tool to give functional autonomy to decentralized levels, in keeping with the decentralization thrust, and to balance the practice of excessive centralized control, which had been traditionally exercised by the MEF. The decentralization of SIGEF regulations appears to have been a reaction to the excesses of the previous period, during which control was centralized in the MEF under the ample powers given to it in the LOAFYC; MEF was empowered to

² Specific examples appear in the sections on Budgeting and Accounting and Financial Reporting.

authorize expenditure entitlements (*cupos de gasto*) for taking on commitments or obligations. Under the current approach, financial entities work directly with MEF as the oversight body of the budget system, without going through or coordinating with the sector agencies that are supposed to monitor and supervise their performance. In essence, this approach would tend to emphasize guaranteeing the rights of executing units to spend their appropriations rather than upholding principles of fiscal discipline in management and oversight.

2.11 SIGEF components. The conceptual design of SIGEF includes five sub-systems, three of which are in operation: *SIGEF Institutional*, the core subsystem which includes seven modules (Administration, Loans, Budget, Accounting, Treasury, Payroll and Fixed Assets); *SIGEF Integrador*, a system of data collection that allows entities which do not have the core version to comply with their responsibility to submit information to the Budget and Accounting Undersecretaries, and *SIGEF Global*, a data consolidation tool used by the Budget and Accounting Undersecretaries. The other two subsystems, to be designed and implemented under the PSFMP, are aimed at entities that have simpler financial operations than those contemplated under the core subsystem (*SIGEF Light*) and at sector-level institutions (*SIGEF Sectorial*). *SIGEF Institutional* is the only transaction-based application.

2.12 Coverage and degree of implementation. The core subsystem still needs to be implemented in a significant number of entities (Table 1). In the case of the Treasury which is charged with debt service and transfers to sub national governments, only 52 percent of the budget is reported and executed within SIGEF.

Table 1. SIGEF Coverage

Sub-Sector	No. Of Executing Units	Executing Units Connected to SIGEF		% Of sub-sector budget covered by SIGEF
Central Administration (excluding Treasury)	2,393	98	4%	26%
Treasury	1	1	100%	52%
Central Government including Treasury	2,394	99	4%	78%
Autonomous and Decentralized Entities	85	7	8%	22%
Total Budget Excluding Social Security Institute	2,479	106	4%	71%

2.13 Based on observation of the operation of SIGEF Institutional in six entities (Ministry of Economy and Finance, the Ministry of Education and Culture, the Ministry of Public Works, Ministry of Social Welfare, Ministry of Labour and Human Resources, the Controller), the implementation of SIGEF has brought an improvement and discipline to the administrative and financial functions at the executing unit level, in the areas of budget formulation, submission of draft budget proposals, budget execution and accounting. However, in these six entities, only three substantive modules were being used: those for budget, treasury and accounting. Parallel systems were being used for handling the payroll and benefits systems, and the module for recording and control of fixed assets had not been implemented.

2.14 This pattern stems from important capacity constraints: SIGEF is comprised of a set of independent technology tools and applications some of which are incompatible, and which use physically and logically decentralized databases. Moreover, these tools are client-server oriented, which makes it difficult to integrate information from executing units that are geographically dispersed, a difficulty that is compounded by inadequate telecommunications facilities.

B. Operation of the Financial Management System

1. Budget

2.15 A comprehensive, realistic budget and a clear set of policies and procedures governing the process contribute to aggregate fiscal discipline and efficiency in the use of scarce resources. The CFAA therefore evaluated the procedures and practices surrounding budget programming, planning, execution, monitoring and control, and reporting.

2.16 Reliable, timely, and accurate information are essential to support reform policies and processes and increase the capacity for strategic decision-making. The CFAA evaluated (1) the appropriateness of the internal control framework and the accountability arrangements to ensure that the budget is implemented as authorized; (2) the coverage, depth and efficiency of SIGEF; (3) the extent to which information generated by the system is used for decision-making at the agency level, within the executive branch and in legislative deliberations; and (4) public availability of information on fiscal activities of the Government of Ecuador.

2.17 The key issues that emerged from the CFAA analysis were (1) a classification system that is not detailed enough to be useful in tracking expenditures, (2) a high degree of discretion in budget execution, (3) lack of a link with the development plan and lack of mechanisms to reflect sectoral priorities in the budget. The first shortcoming limits executive control of budget execution, the second limits accountability in the use of funds, and the third deprives the budget of strategic content.

Budget Coverage and Classification

2.18 The National Budget covers the revenue and expenses of the Non-financial Public Sector (NFPS), with the exception of the sub-national governments and state-owned

companies. The central government directly accounted for about 60 percent of total spending. Fiscal decentralization has meant that the relative share of the rest of the public sector has increased.

Table 2. Allocation of Public Spending by Tiers of Government.

	2001		2002		2003	
	US\$ Mln	Percent	US\$ Mln	Percent	US\$ Mln	Percent
Non-Financial Public Sector	4,853	100.0	6,117	100.0	6,585	100.0
Central Government (less transfers)	3,206	66.1	3,773	61.7	3,952	60.0
Rest of Public Sector	1,281	26.4	1,992	32.6	2,289	34.8
Of which:	706	14.5	982	16.1	1,102	16.7
Subnational Gov'ts						
Institute of Social Security	252	5.2	546	8.9	656	10.0
Universities and Technical Schools	171	3.5	222	3.6	305	4.6
Public Enterprises*	252	5.2	356	5.8	295	4.5
o/w PetroEcuador	164	3.4	282	4.6	210	3.2

Note: * Includes only non-operating and capital expenditures.

Source: Central Bank, MEF, and IMF.

2.19 The budget classification system does not facilitate a direct link between programs and executing agencies, neither does it conform to international standards. In Ecuador there are five budget classifications. (1) administrative (representing 20 sectors, generally made up of institutions linked to one of the branches of government or ministry); (2) expenditure type (e.g. recurrent, capital, debt repayment); (3) function; (4) geographic location, and (5) source of financing. There is no provision for the use of economic or programmatic classifications. The annual budget is approved by sector and type of expense, at a very aggregated level, setting the maximum amounts for each sector's revenue and expenditures, providing no detail by individual agency. Approval of the budget at aggregate level by sector allows the executive flexibility and agility during execution, since reallocations among programs within the same sector can be made during execution without returning to Congress. However, since the responsibility to use public funds in an efficient manner rests with each institution and not with the sector as a whole, the way in which the budget is presented makes it difficult to monitor compliance and ensure accountability at the institutional level.

2.20 In contrast, when standard international classifications and practices are applied, tracking scarce resources allocated to poverty reducing and other expenditures can be facilitated. More generally, a robust classification system facilitates the tracking of spending on an administrative, economic, functional, and program level. The use of programmatic classifications would make it easier to link objectives, goals, and programs to the budget allocations that are designed to achieve such objectives.

Budget Preparation

2.21 By constitutional mandate, the Draft National Budget Proposal (the pro-forma budget) is prepared by the Executive Branch and submitted to the Congress by September 1 (preceding the January 1 start of the fiscal year). By November 30, the Congress is required to approve or amend the budget. The budget is approved by sectors, setting the

maximum amounts for each sector's revenue and expenditures. If Congressional approval is not given within the established timeframes, the draft proposal becomes effective.

2.22 The Central Bank is required to provide timely initial and mid-term macroeconomic assumptions to be used in the preparation of the pro-forma budgets. At the beginning of the second trimester in each year, the MEF is responsible for a simulation of economic scenarios for the coming year, with a view to establishing the macroeconomic programs on which the budget limits (*techos presupuestarios*) will be based.

2.23 **The budget is not linked to the development plans.** The Constitution requires that the National Budget be based on and linked to a development plan. In addition, in accordance with the 2002 FTSRL, the incoming President is required to lay before the Congress a Pluri-Annual Plan covering the four years of his term, including objectives, goals, strategies, and policies. Both the Constitution and LOAFYC require the National Planning Office (ODEPLAN, a technical body reporting to the Presidency), to determine the sectoral priorities, as well as the programs and specific projects which should be included in the National Budget. In practice, ODEPLAN has not been successful in articulating the development plans and ensuring that decisions on recurrent and capital expenditure are synchronized with the sectoral priorities it recommends. In addition, goals and objectives included in the institutional annual plans and budgets are mainly descriptive and do not link achievements with unit or activity costs, and there is limited ability to reconcile policy objectives and scarce resources.

2.24 **SIGEF has facilitated and improved the process of consolidation and adjustment of draft budgets.** The widespread use of the modules that facilitate the formulation and consolidation of the pro-forma budget by ministries and agencies has brought some order to the budget process and other financial management procedures. As a result, the budget calendar is largely adhered to, and consolidation and modifications to the pro-forma budget can be handled quickly. However, SIGEF's budget formulation module does not allow for automatic control of limits during the formulation process, so spending agencies can in fact ignore the limits communicated by the MEF, further contributing to the lengthy process of modifications and negotiations.

2.25 **The estimation of recurrent revenues for the Treasury Budget follows an standard methodology** that limits the risk of overestimation at the pro-forma budget stage. In addition, the methodology is explicitly detailed in the documentation that accompanies the pro-forma budget. Preassigned income is calculated by each entity and these calculations are revalidated at central level, based on the relevant legal dispositions and historical data.

2.26 Although there are no comprehensive and reliable estimates of extra-budgetary resources, they are known to be significant—more than 10 percent of budgetary revenues. In contradiction with norms contemplated in LOAFYC that prohibit earmarked funds, special-purpose norms have been issued that allows earmarking. The estimate of revenues not included in the budget represented 27 percent of total budget for 2004, and

earmarked funds represented 9.5 percent of to sectional governments' total budgets, 9.9 percent of tax revenue, and 6.4 percent of petroleum revenues for debt repayment³.

2.27 The budget formulation process is orderly, however there is limited involvement of the central coordinating units of the line ministries. The MEF establishes the policies and methodology governing the budget cycle: programming, formulation, presentation, approval, execution, modification, evaluation, and final liquidation. Adequate guidance on the basic steps in the formulation process is provided to the spending ministries and agencies, and the budget calendar is largely adhered to. However, each executing unit submits information directly to MEF and there are no tools or mechanisms to allow coordinating units in each sector to intervene in the approval and consolidation of the pro-forma (draft) budgets of the executing agencies within their control. For example, in the case of the Ministry of Education and Culture, 1,800 schools remit their pro-formas directly to the MEF. The process of formulating the budget with no real participation by senior ministry officials reduces their capacity to influence government priorities in their sector, and by extension, reduces ownership of the budget. Greater involvement of the sectoral authorities would increase efficiency and transparency, along with the likelihood that scarce resources are allocated towards pro-poor expenditures.

2.28 Insufficient consideration is given to exploring the strategic alternatives for reducing specific budget programs or initiatives during budget formulation. Budgeting is based on incremental behavior and there is limited discussion during budget preparation on the possibility of eliminating potentially obsolete or secondary programs. The instructions for formulation of the budget that are sent out by the MEF do not set clear and quantifiable ceilings on expenditures. As a result, during the process of consolidating the pro-forma budget, there is a lengthy process of modification to bring it in line with the limits envisaged by the MEF. Although there is some negotiation with the line ministries and agencies, the rationale for adjustments remains opaque. Given the scarcity of financial resources and the limited headroom for discretionary spending, the formulation process should be more focused toward identification of priority areas for spending and promoting cost reduction initiatives, rather than setting spending limits.

Budget Execution⁴

2.29 During execution, adjustments are made to budget allocations without clear rules and guidelines. The budget is managed mainly on the basis of austerity and cash rationing, which means that the release of funds from treasury to spending units is unpredictable, and this can have an adverse impact on the availability and quality of resources. This practice also runs the risk of reducing ministerial ownership of budgets and sectoral priorities, increasing the perception that the budget is a tool for the Ministry of Finance itself, rather than one that helps spending ministries to plan and commit

³ The scope of the IMF Fiscal Transparency ROSC included a detailed analysis of revenue estimating, earmarking, and extra-budgetary funds.

⁴ Budget execution is linked to Treasury Management, and the analysis is complemented in that section of the report.

expenditures in support of their goals and programs. Poor predictability in being able to utilize funds prevents managers from being able to plan their spending. In any administration, in-year adjustments to budgets will often need to be made in light of unanticipated events impacting revenues and/or expenditures, the impact on the predictability and on the integrity of the original budget allocations can be minimized by specifying an adjustment mechanism that relates the adjustment to the budget priorities in a systematic and transparent manner.

2.30 Since 2002, the reliability of the budget on an aggregate basis has generally increased. In 2002, actual expenditures accounted for 98 percent of budgeted expenditures, as opposed to overspending of 11 percent in 2001, and 12 percent over the period 1995-99. On a sectoral basis, however, there have been cases of persistent overspending in some sectors (including administration, finance, defense), which demonstrates on the one hand the inability to properly budget for what are known expenditures. Due to the shortfalls of the SIGEF systems, there is a lack of timely information on actual expenditures (delays up to four months are typical). MEF knows the actual amounts transferred to the institutions, but there are delays (up to several months) in the availability of information on actual expenditures and up-to-date reconciliations that would show the level of idle funds in the agency accounts. In light of the weak commitment controls and the ensuing accumulation of floating debt described below, it could be argued that the reported figures do not reflect the extent of the Government's economic activity, since there is the risk that commitments have been made but not reported in the actual expenditures, and a corresponding risk of misstatement in financial reports.

2. Treasury and Revenue Management

2.31 Efficient treasury and cash management is necessary to ensure orderly execution of the budget, synchronization of borrowing with cash inflows and outflows, and avoidance of idle cash balances and unnecessary interest payments. The CFAA evaluated the effectiveness of cash flow forecasting, planning, management, and monitoring.

2.32 The key issues that emerged from the CFAA analysis were (1) good payments management through Central Bank's handling of single treasury account, (2) weak cash management and expenditure control. The first means that payments are made efficiently and in a timely manner, but the second implies that unreported floating debt accumulates throughout the year.

2.33 The key elements of the legal and regulatory framework for treasury management have remained enforceable and intact since the 1977 LOAFYC. Creation and operation of the single National Treasury current account to handle all the financial resources for the central government budget, and designation of the Central Bank of Ecuador to act as the sole and exclusive depository for public funds of the National Treasury's single account, have been essential in promoting efficiency of cash management and reducing system payment risk.

2.34 The administration of the official bank accounts by the Central Bank guarantees the Treasury authorities an adequate mechanism to control available

funds. The *Cuenta Unica* has facilitated an important reduction in idle funds and has provided a mechanism for increased efficiency of payments to suppliers and other beneficiaries. The National Treasury has access to the bank accounts of the executing entities of the non-financial public sector covered by the National Budget (transit or T-accounts, revolving revenue account, and revolving payment account). The revolving revenue accounts and payment accounts are zero-sum, that is, only the revolving payment account would show liquidity, which would be equal to the amounts released and awaiting payment. The liquid funds of the executing entities are shown in the T-account held by the Central Bank and these accounts are subsidiary accounts of the single National Treasury current account. In addition, the Central Bank has set up a mechanism through correspondent banks under which the entity requesting funds must forward aggregate information on how those funds would be spent, under broad expenditure categories. This information is stored in the Central Bank's databases and could serve as a useful tool to permit detailed planning of cash transfers. Moreover, recently, the Central Bank through the Interbank payment system has implemented a mechanism for disbursing the Government's payroll by means of a direct deposit to employees' accounts, taking a major step toward modernization of the cash management system, and improving control on both cash flow and payroll.

2.35 Cash management and forecasting mechanisms are cumbersome. The cash management authority, the Treasury Undersecretary, does not have real-time information on expenditure commitments nor obligations pending payment by the entities. Due to SIGEF's conceptual design, accounting entries are not automatically generated at appropriate intervals throughout the budget execution cycle, but only at the end of the cycle when payments are made and posted in SIGEF. Since payments are reflected in SIGEF at the end of the month and not as they arise, the Treasury does not have real-time information about obligations and payments and is unable to do meaningful cash flow monitoring. There is no clear institutional mechanism to prevent imbalances in financial flows during budget execution, since planning and overseeing execution of budgetary outlays is handled by the Budget Undersecretary with little participation from the Treasury Undersecretary, who is responsible for accessing liquidity to meet payment obligations. In several countries,⁵ once public budgets are approved, almost all the countries put budget programming and execution tools, mainly cash plans, in the hands of financial management departments in charge of the public treasury, without the intervention of the unit that formulated the budget.

2.36 Expenditure control is not exercised on budgetary commitments, causing floating debt to accumulate and making it difficult to comply with the quantitative rules of the LOAFYC. The Periodic Cash Flow allocation (*Plan Periódico de Caja* or PPC) is the instrument used to control budget execution and constitutes the limit of cash transfers which will be made to the entities. This kind of cash-rationing results in accumulations of arrears and debt because it fails to control the rate at which budget commitments and

⁵ A comparative study of Public Financial Institutional arrangements in Latin America, North America and Europe, Annex 1, Colombia CFAA, World Bank (LCOAA), May 2004. Compiled by staff from organic laws relating to financial management from 13 countries, including Brazil, Argentina, Mexico, Chile, Peru, Bolivia, Ecuador, El Salvador, and Paraguay.

accruals can be made. In the absence of this basic internal control, line ministries and agencies have been able to continue making commitments. The pace of generation of budget commitments and obligations is not synchronized with the evolution of inflows, and the result is over expenditure and/or an ever-increasing accumulation of accounts payables to contractors for goods and services delivered. Payment delays reduce the incentives to provide goods and services and this could interrupt service delivery. There is also the inherent risk of over-pricing of services to the government, due to the inherent carrying costs.

2.37 The volume of the floating debt is known only at the end of the year, since there are no reporting mechanisms, nor is information on the size and aging of amounts owed available through SIGEF. Expenditure arrears are a form of non-transparent financing, which must be carried into the next fiscal year, weakening the execution of that year's allocation. Nor is there a line item in the budget that allows the inclusion of accounts payable obligations contracted and unpaid at the end of the previous fiscal year. This implies that floating debt brought forward is not included in the calculations and assignment of either Annual or Periodic Cash flow projections.

2.38 **The Tax Administration has improved as a result of a comprehensive institutional reform.** Since the late nineties, tax revenues increased significantly when measured as a percentage of GDP; in 2001 for the first time in more than 30 years, the share of tax revenue was higher than non-tax revenue (mainly oil). In 1998, the Revenue Authority (SRI) was given the managerial autonomy to simplify procedures, impose sanctions and serve the taxpayers; these efforts complemented by improvements in technology and training were supported by an IDB technical cooperation. The modernization of the Tax Administration allowed for improved mechanisms for tax collection and audit, internal control and resource management, as well as modern information systems that facilitated a daily reporting and monitoring of the revenue that is collected and transferred to the National Treasury.

2.39 **The sustainability of the institutional reform of the tax administration critically depends on the modernization of the legal and regulatory framework.** First, legal dispositions of the Tax code are out dated in relation to the administrative and jurisdictional procedures reducing the capacity of the SRI to litigate against tax offenders. Secondly, there is a clear need to convert Law 41 of 1997 of the SRI into an Organic Law in order to deepen the autonomy of the SRI and set up the bases for the special human resource management regime, that was a key element for the modernization of the institution, and that was repealed by the general regime established under the new Civil Service Law.

3. Accounting And Financial Reporting

2.40 Fiscal reporting should be timely and identify deviations from budget. Control of expenditures and timely and accurate reporting reduce the risk of overspending, which, if allowed to go uncontrolled, may result in arbitrary cuts and a disproportionate impact on service delivery. The CFAA evaluated: (1) the appropriateness of the adopted accounting

standards and their compatibility with the International Public Sector Accounting Standards as published by the Public Sector Committee of the International Federation of Accountants; (2) the procedures and institutional arrangements; (3) the alignment of the Chart of Accounts with internationally recognized classification systems for Government Financial Statistics; (4) the comprehensiveness and quality of financial information and in-year control of actual expenditure; (5) the procedures governing the reconciliation of accounting records, bank accounts and budget appropriations; (6) the adequacy of controls for safeguarding and management of assets; and, (7) public access to government financial information. The ROSC Accounting & Auditing study findings on professional qualifications, licensing, and monitoring of accounting and audit practitioners are also summarized by the CFAA.

2.41 The key issues that emerged from the CFAA analysis were that despite a sound legal and regulatory framework, (1) there is a major disconnect between accounting and budgetary information in the SIGEF system, (2) SIGEF's internal control and reconciliation features are not used, (3) interim budget execution and accounting reports and year-end financial statements are not produced in a timely way. The first and second shortcomings mean that discretion is required for posting all transactions and there is little confidence in the accuracy and consistency of accounting reports, and the third means that critical elements of transparency are lacking. The ROSC found that academic standards, licensing requirements and monitoring of professional obligations need to be raised in order to ensure compliance with ethical standards and improve the quality of professional work.

Legal Framework and Institutional Capacity

2.42 **The legal and regulatory framework carves out a central role for accounting and financial reporting in promoting transparency of government operations.** The 2002 LOCGE and its accompanying regulations establish governmental accounting as a key element of internal control and transparency. The responsibility for financial accounting and reporting rests with MEF's Accounting Undersecretary. Interministerial agreements establish the principles and norms of accounting, and these are contained in the Government General Accounting Manual.⁶ The regulatory framework, although not fully compatible, can be readily harmonized with the International Public Sector Accounting Standards (IPSAS) as defined by the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC)⁷. Recent regulations issued in support of the LOCGE have attempted to re-establish a central role for government accounting, by setting out broad basic principles on which the Accounting Undersecretary should operate.⁸ The regulation re-emphasizes earlier requirements set out in the Constitution, which included preparation of budget execution statements as well as complete financial statements showing results of operations, cash flow statements, and a balance sheet (assets, liabilities and capital). In practice, the benefits of this regulation have not yet materialized and, except for the preparation of the year-end statements for 2003, due to

⁶ Ministerial Decree Nos. 182 of 2000 and 113 of 2002.

⁷ In particular; Financial Reporting under the Cash Basis of Accounting; and Transition to the Accrual Basis of Accounting: Guidance for Governments and Government Entities.

⁸ Article 19, 2003 Regulations for the LOCGE.

weak institutional capacity, the Accounting Undersecretary has not yet begun to comply with its mandate to ensure orderly accounting and basic record-keeping.

2.43 Institutional capacity for oversight of and reporting on financial transactions is weak. The Accounting Undersecretariat is under-staffed, both in terms of numbers and skill profiles, and is unable to discharge its role effectively. There are 26 persons in the Accounting Undersecretary, four of which are public accountants. The General Accounting Manual introduced in 2002 represented an important step forward in establishing basic accounting principles, however, its expansion to include guidance for users would facilitate understanding of the accounting rules and procedures and would promote compliance. For example, there is insufficient guidance on the use of the budget classifications, the Chart of Accounts, and the procedures for modification to the Chart of Accounts. Users have access to create and modify the Chart of Accounts, without supervision by the MEF. Given the highly deconcentrated nature of government operations (dispersed executing agencies with operational responsibilities), the absence of sufficient guidance increases the risk of a lack of uniformity in the application of accounting principles and selection of budget categories, and this could lead to distortion of reported expenditures and misrepresentation in financial statements.

Accounting Practices

2.44 The installation of SIGEF has brought some discipline to the accounting procedures, in those entities where it has been established; however, there is a lack of confidence in the consistency of accounting reports. SIGEF *Institutional* is installed in 160 financial entities of the 2,600 in the NFPS, representing 78 percent of the consolidated budget. Some 600 other entities submit summary accounting information, through the data collection module (SIGEF *Integrador*). The accuracy and consistency of the accounting information from these 600 entities cannot be guaranteed, since the transactions that are reported are not subject to the internal controls that operate within SIGEF *Institutional*. The remaining 1,840 entities submit information on magnetic media and paper copies.

2.45 On account of SIGEF's conceptual design, accounting entries in all entities are not automatically generated: posting a transaction requires human intervention and discretion in the choice of budget account. Efficiency in accounting operations could be enhanced if the accounting module were designed to generate financial information from the budgetary information, as occurs in the majority of Latin American countries, through a conversion matrix based on the Chart of Accounts, thereby reducing avenues for human error and manipulation of accounting entries. Given the current scarcity of resources and cash flow limitations, reliable records and record-keeping systems that accurately reflect the financial position of the Government are essential elements for analysis and strategic decision-making to properly prioritize expenditures and allocate resources.

2.46 Inadequate use is made of some important control features of the SIGEF accounting modules and there are no follow-up mechanisms to ensure compliance. In those entities where SIGEF *Institutional* is installed, there are several modules which are not used, due to insufficient capacity within the entities or lack of incentives for

compliance. These modules include the bank reconciliation module, the payroll, and the travel payments modules. There are therefore no in-year or annual reconciliations of suspense accounts and advances that would provide greater assurance on the accuracy of the accounting records to support managerial decision-making and resource allocation. This increases the risk of errors, compromises data integrity, and diminishes public confidence in the usefulness of accounting and financial reporting in promoting transparency.

2.47 Reconciliations of fiscal data held in the Government books and bank accounts are not performed on a regular basis. Within the SIGEF *Institucional*, a module for facilitating bank reconciliations has been developed, however this module is rarely used by the entities, mainly because payments and transfers are made through systems that are independent of SIGEF, eliminating the possibility of automatic reconciliation of bank and accounting data. The practice of preparing and consolidating financial statements which are not reconciled to bank account data increases the risk that decisions to reallocate scarce resources may be taken on the basis of incomplete and inaccurate information.

Reporting

2.48 Interim budget execution and accounting reports are not produced on a timely basis, due to cumbersome consolidation routines and non-compliance of some entities in the submission of information. Under the Constitution, the Executive is required to present semiannual reports to Congress on budget execution as well as the Annual Statement. Ministerial Agreement No. 182 of 2000 establishes the requirement for entities to submit to MEF monthly financial statements comprised of a balance sheet, a statement of revenue and expenditure, cash flow statement, a budget execution statement, and a statement of execution of the cash program. In practice, there is uneven and untimely submission of information by entities and in-year reports are prepared with an average lag of four months. In some countries in the region, the budget is made public on the same day it is sent to the legislature and data is published every three months, within 60 days of the month end.

2.49 SIGEF *Global* was designed to facilitate aggregation and consolidation of financial statements, however some basic features that would ensure data integrity and accuracy have not been implemented, e.g. exception reports and data validation routines, consistency checks, automatic upload of information received through the SIGEF *Integrador*, interface with budget data, and elimination of transfers to avoid double-counting. Preparation of consolidated financial statements is therefore time-consuming and labor-intensive. The time lag in the control of expenditures increases the risk of overspending and puts increased pressure on the scarce cash resources of the government. Monitoring of budget performance and the ability to identify new actions to get the budget back on track are therefore impeded.

2.50 Consolidated year-end financial statements are not prepared on a timely basis. Under the Constitution, the annual financial statements should be presented by March 31 of the following year. Given the thrust to decentralize, the emphasis has been

on ensuring that most decentralized levels have access to information on their financial performance. While this is in fact desirable, the current system does not provide capability for efficient and timely consolidation of information at national, ministerial or sectoral levels. The ability to produce such financial statements in a timely fashion, covering revenues, expenditures and fiscal position in aggregate and composition, is a key indicator of how well the accounting system is operating and of the quality of the records maintained. These are critical elements of transparency in the system, and timely publication of results would go a long way to engender public confidence and reduce the perception of corruption.

Accounting and Auditing Professions

2.51 As part of the Reports on the Observance of Standards and Codes (ROSC) initiative, the World Bank recently conducted an assessment of accounting and auditing practices in Ecuador's corporate sector, which conclusions are currently under discussion with the authorities. This ROSC Accounting and Auditing study found that efforts are needed to strengthen the accounting profession's capacity to apply accounting and audit standards of quality, especially by improving academic curricula in that field, and by mandating continuing professional education (CPE) for all licensed auditors. Indeed, CPE is currently not a practice among the accounting profession since it is not a requirement of either the professional bodies or the regulators. Another improvement suggested by the ROSC is that the licensing of auditors be based on a due process of professional examination with minimum professional experience in the audit practice as a prerequisite.

2.52 Moreover, the current lack of effective monitoring of audit practitioners' compliance with statutory and professional obligations is detrimental to the quality of the audit practice in the Country. Accordingly, the ROSC has suggested that an auditor oversight board should be established under the Ministry of Economy and Finance. Its functions would cover all key aspects of the audit practice, including the licensing of statutory auditors, ensuring effective compliance with auditing and ethical standards, and fostering efforts by the profession to increase the quality of the audits.

4. Public Investment

2.53 The public investment system, encompassing the set of rules and procedures that guide, authorize, monitor and evaluate publicly funded investment projects, has traditionally been an element of the planning system. The legal framework governing the national planning system is based on a number of laws that assign regulatory functions to the Planning Office of the Presidency of the Republic (ODEPLAN) and to the MEF.

2.54 The key issues that emerged from the CFAA analysis were that despite the creation of a temporary project database, (1) the institutional responsibilities for investment monitoring are not clearly delineated, in the law or in practice, (2) investment and budget systems are not connected. These weaknesses affecting the clarity and effectiveness of the investment management system.

2.55 Since its creation in 1998, ODEPLAN has faced major difficulties in fulfilling its function as regulator of the public investment system, that have resulted in a discontinuance of active monitoring of investment projects and in a decline of the quality of the annual investment plans. The need to strengthen fiscal programming in the context of dollarization forced Government to reassign certain key investment programming functions to the MEF in 2001, creating the Undersecretariat for Public Investment (USPI) in order to undertake extensively internal reviews of the annual plans to incorporate the projects into the public budget. As for most of the countries in the region, since the early 1990s, the adoption of strategic guidelines to orient the operational plans of the entities leads to the migration of information systems on public investment from planning organizations to ministries of the economy and finance, in order to ensure integration with the budget process.

2.56 After the approval of the LORETF in 2002, the GOE has initiated a process of legal redefinition of institutional functions and responsibilities for guiding and conducting the processes of planning and programming public investment, mainly by linking investment projects to the development plan of the Government and delimiting the areas of intervention of the MEF. Currently, the responsibilities of USPI include the validation of investment projects for their inclusion in the budget, the management of the public investment information system, the reconciliation of investment plans with macroeconomic and borrowing guidelines, and the tracking of investment project execution.

2.57 Since its creation, the USPI has made important progress toward fulfilling its mission in relation to the validation of projects, the investment project database, and the mechanisms for monitoring project implementation. The project database has been implemented using the SIGOB, a Web-based general information system. This system is also used to assist the USPI in performing project monitoring tasks. SIGOB is considered an ad-hoc and temporary solution, since in the future the USPI is expected to use an integrated and transactional computational tool. In addition, in order to comply with the legal mandates of the LOREFT, the USPI has established procedures for validating projects financed through domestic or external debt before their incorporation into the budget⁹, including a review of the project proposals by an internal committee of the USPI and a mandate that the committee's decision shall be published on the Web, thus fulfilling with the obligation of the LOREFT regarding the provision of public information of the decision-making process.

2.58 However, the ambiguity of functions between ODEPLAN and the MEF has not been fully eliminated and the legal basis of the investment systems remains weak. This feature, together with the lack of integration between the national systems of planning, public investment and budget, constitute the major weaknesses of the investment system, affecting the clarity and effectiveness of the methodologies, information systems and procedures. The confused institutional scenario may be further complicated with the creation of a specialized unit in charge of evaluation and monitoring of investment

⁹ Projects financed by tax revenues are included in the budget with the ranking assigned by the National Secretariat of Planning and Development (SENPLADES).

projects by the Ecuadorian Institute of International Cooperation (INECI) of the Ministry of Foreign Affairs¹⁰.

5. Public Debt Management

2.59 The objective of public debt management is to ensure that the Government's financing needs and its payment obligations are met at the lowest possible cost, consistent with a prudent degree of risk.¹¹ The CFAA evaluated: (1) the adequacy of the institutional arrangements for debt management; (2) the efficiency of coordination between the Ministry of Finance, the Central Bank, and the public entities participating in the debt process; and (3) the strategic and operational orientation of debt management. In addition, the study evaluated the extent to which contingent liabilities are quantified, managed, taken into account in the budget preparation process, and included in the government's financial statements.

2.60 After dollarization, the Government improved its fiscal position. The public debt ratio declined from 58 percent of GDP in 2001 to 53 percent of GDP by the end of 2003, and all accumulated external and domestic arrears were cleared. The legal framework for debt management was strengthened by the enactment of the FTSRL. These initiatives are important giving the fact that the current level of public debt is still high in relation to GDP and is the second highest in the region..

2.61 The key issues that emerged from the CFAA analysis are (1) sound targets for debt reduction have been set, but the institutional coordination mechanism and the analytical capacity are not sufficient to ensure successful implementation of a debt reduction effort, (2) The MEF only keeps information on non-financial public sector debt¹², and there is no link between the debt software and the financial information system where debt obligations and payments are reflected, (3) there are no procedural manuals or operational indicators and no audit over reliability of debt accounts is performed on any regular basis. The consequence of the first shortcoming is that Government responds passively to bilateral initiatives and debt managers are not equipped to make decisions about levels and composition of debt. The consequence of the second and third issues is that there is no assurance that debt account figures are complete and accurate, and financial public sector indebtedness is not covered.

Legal and Institutional Framework

2.62 **The legal and regulatory framework for debt management is extensive.** The country has a long-standing tradition in legislation and regulation of public credit in general and debt management in particular. The legal framework for debt management is exhaustive and encompasses direct and guaranteed debt of the central government, public enterprises, sub-national governments, private external debt, and external and domestic

¹⁰ INECI is currently responsible for negotiating and coordinating non-reimbursable international cooperation grants.

¹¹ IMF Public Debt Management Guidelines.

¹² The Central Bank keeps the records on debt of the financial public sector.

public debt. The various laws and regulations also define the centralized function and responsibility of the Ministry of Economy and Finance's Public Credit Undersecretary (PCU) in conducting and regulating debt management.

2.63 The enactment of the 2002 FTSRL provided targets for debt reduction and mechanisms to reduce debt. The law introduced macroeconomic and fiscal targets, quantified levels of debt reduction to be achieved, and set limits on indebtedness. The indebtedness ratio (Total Public Debt/Gross Domestic Product) was to be decreased by 16 percent to 40 percent over a four-year period starting January 15, 2003. The law also set up limits of indebtedness for sub-national and regional governments, and prohibits central government from borrowing or providing guarantees to the private sector, limiting access to new debt for investments only.

2.64 However, the operative regulations of the FTSRL do not give sufficiently precise directions on the integration of sub-national governments' new financing within the overall framework of debt reduction established by the FTSRL, nor does it cover or define the activities of the financial public sector, thereby limiting the intent or impact of the law.

2.65 Unclear roles and responsibilities and a lack of functional coordinating mechanisms result in duplication of effort and reduce the efficiency of debt management practices. The regulations covering debt management are dispersed, and some of their provisions create inconsistencies, assign roles to entities with limited institutional capacity, and duplicate functions and responsibilities among the various agencies involved in debt management. In particular, certain functions are assigned to both MEF and the Central Bank: public debt is mandated to be registered at both institutions, a requirement unique to Ecuador. Decree 341013 requires the PCU to analyze private external debt, a function usually assigned in most countries to the Central Bank. This Undersecretary does not have the capacity to assume this function and in fact, the Central Bank has taken it over. Besides creating a duplication of functions, the laws and regulations do not specifically name one institution as the official registrar of public debt, nor create any mechanism for coordination between the two agencies.

2.66 Several commissions and committees have been created to coordinate the borrowing policy of the country and to implement the FTSRL. Executive Decree No. 96 creates two technical commissions. The first of these, the Stabilization, Productive and Social Investment and Public Debt Reduction Commission, is composed of a representative of the Presidency, the Ministry of Economics and Finance, and the Central Bank; the Central Bank is also responsible for this commission's Technical Secretariat. This commission's main function is to review proposals and requests for external financing and assess the financial conditions and economic impacts. It also rules on the desirability of providing guarantees for external credits. The second technical commission is comprised of a representative of the *Procuraduría General del Estado*, Ministry of Economics and Finance, the Central Bank, and PetroEcuador and its mandate

¹³ Consolidated Text of Legislation of the MEF, January 2003.

is to submit to Ecuador's President proposed regulation that would detail the net resources required to finance the FEIREP.

2.67 There is however, no single interinstitutional committee that would define the overall debt strategy and borrowing policy and integrate the various agencies involved in debt management and macroeconomic policymaking. Some commissions have met occasionally, while others are not functioning at all, such as the Committee of Public Debt (created by Executive Decree 3410 of January 2003 and composed of the Minister of Economy and Finance plus all his undersecretaries), and in any case, none of them has detailed terms of reference. The absence of a permanent technical secretariat may be one reason why these committees have not been convened. The establishment of a single interagency committee with its technical secretariat within the MEF would result in improved coordinating mechanisms and enable debt managers to obtain information from the authorities on the actual and future liquidity needs of the country and help to ensure that debt management is consistent with the country's debt plan and its objective to develop the domestic capital market.

2.68 **There is no formal borrowing policy and strategy on which the activities of authorization and contracting new financing can be based.** In the past, Ecuador has followed an ad hoc approach to debt renegotiations, rather than working from a sound assessment of domestic debt capacity and a clear strategy. In general there has been little coordination between the various agencies (PCU and Central Bank) in the renegotiation of public debt. There is no clear methodology for analyzing the financial capacity to repay of the different public sector entities (central government, sub-national governments, public enterprises, financial system). There is also a lack of basic information on creditworthiness, based on common and consistent denominators that would minimize the discretionary aspect of the approval process.

2.69 Furthermore, the lack of documentation on the country's experiences of the various negotiations through the Paris and London Club means that no institutional memory has been created that could facilitate further negotiations.

2.70 Despite the fact that the Government of Ecuador has made a substantial effort in producing a debt reduction plan, the country needs to elaborate external and domestic borrowing strategies and incorporate them into the debt reduction plan within a debt sustainability analysis framework, in order to ensure that new financing takes into account the financial capacity for repayment and the medium to long-term sustainability of the total public debt, and that this analysis is reflected in the budget proposals.

Procedures and Practices

2.71 **In general, the front office functions are performed in compliance with the requirements of the legal framework.** . These activities related to mobilization of domestic and external resources, and debt renegotiations are mostly the responsibility of MEF's PCU, however the PCU cannot fully control the borrowing terms, since it is the responsibility of each borrowing entity to seek its own financing.

2.72 **The middle office capacity for debt analysis and strategy formulation is limited.** Recently, the MEF has elaborated a debt reduction plan which is based mainly on macroeconomic indicators at an aggregate level. The level of debt reduction specified in the FTSRL was determined based on the country's experience, and is consistent with the preliminary IMF studies for medium- and high-income developing countries.¹⁴ Although there is no international benchmark or threshold to determine whether a country's debt is sustainable or not (as is the case under the HIPC Initiative), the IMF studies show that countries whose debt to GDP ratio is below the 40 percent level have minimal probability of a debt crisis or correction, at around 2 to 5 percent; in other words, there is a 98 percent probability that a crisis will not occur.¹⁵ In accordance with FTSRL and its regulations, the MEF has drawn up two debt reduction plans in 2003 and 2004. Therefore, Ecuador's debt reduction policy should be sufficient to bring it to sustainable level, and minimize the risk of future debt crisis.

2.73 Although the FTSRL model currently fulfills the needs for the preparation of the debt reduction plan, it does not determine other operational indicators that would help public sector institutions adhere to the Debt/GDP reduction path, nor does it provide for integration of macroeconomic projections for macroeconomic sensitivity analysis on the one hand, with assumptions about borrowing and disbursement at a disaggregated level for individual creditors, and assumptions about debt restructuring at a disaggregated level for Paris and non-Paris Club debt and debt buybacks, on the other.

2.74 The PCU has developed some institutional capacity in carrying out **back-office activities**. It has not suffered from high staff turnover and is staffed with very experienced professionals. In response to the challenge of debt reduction, the PCU has implemented appropriate operating procedures to ensure approval of new financing, registration of public debt and timely servicing of debt payments. Since 1996, Ecuador has acquired SIGADE to register its public debt, software developed and updated by UNCTAD that satisfies all the requirements of a modern debt information system. The software has been installed both at MEF and the Central Bank. The debt database of the MEF is complete and contains information for all loans made by and to all public sector entities (central government, direct and indirect debt, guarantees, public enterprises, as well as on-lending). The Central Bank database also includes private sector external debt. However, the databases of the two institutions are maintained in parallel and are reconciled on an ad hoc basis. There is no formal link between the SIGADE system and SIGEF where debt obligations and payments are reflected, and the audit over the reliability of the debt accounts is not performed on a regular basis. Monthly reconciliations would help to ensure that debt figures are complete and correctly reflect public sector indebtedness.

2.75 There are no procedural manuals to reflect the duties and responsibilities of members of the PCU. Procedural manuals are an integral part of the internal control framework, but in Ecuador, there are no procedural manuals to reflect the duties and responsibilities of members of the PCU. Elaboration of such manuals would enhance the

¹⁴ For further details see *Assessing Sustainability*, IMF Board document prepared by the Policy Research and Review Department, International Monetary Fund, May 28, 2003.

¹⁵ Idem, page 25.

overall operating and analytical capacity for debt management. They should be prepared to (a) identify clearly the institutions and units involved in the various processes and specify in a practical and detailed fashion, the roles, functions, and responsibilities of these entities, indicating the organizational architecture of the debt process while distinguishing the various levels of responsibility (decision, supervision, and operational); (b) organize clearly and formally the flow of information within and between international, national, official and private institutions and organizations; (3) indicate the periodicity and modalities of the flow of information, the rules and steps to be followed in registering and treatment of the information in the database, and the disbursement and debt service payment procedures.

6. Internal Control, Auditing and Internal Auditing Systems

2.76 Effective, independent scrutiny of government expenditures supports transparency, accountability, participation and trust, and is critical to the ongoing reform of public institutions. The CFAA evaluated: (1) the capacity of the internal and external audit functions, including adequacy of professional staffing and coverage of public financial institutions; (2) the appropriateness of the internal and external audit norms, methodology and reporting, and their alignment with internationally accepted practices; (3) the institutional arrangements governing the follow-up and enforcement of compliance of both internal and external audit; (4) the adequacy of institutional arrangements for the independence of external audit; and (5) the clarity of the roles and responsibilities of the internal and external audit functions and the degree of coordination between them.

2.77 The key issue that emerged from the CFAA analysis is there are no norms, methodology, procedures or practices for internal control or for staffing of internal audit units, and implementation of internal auditing norms and procedures is weak. Weaknesses in internal control and audit mean that criteria are applied subjectively, accounting information cannot be relied upon and the risk that errors and frauds go undetected is increased. CGE has recently begun to address these shortcomings with the design of a systematic framework for oversight of internal audit units.

2.78 **The LOGCE has appropriately underscored the centrality of internal control and internal audit in effective oversight of public finances.** Internal control is the responsibility of the highest level of management within each entity/line ministry and an appropriate internal control environment needs to be created to ensure efficiency of operations and to safeguard the use of public resources. Three levels of internal control are recommended in the LCGCE: (1) ex-ante control, to be exercised by the employees within each institution, in order to ensure legality, efficiency, relevance and conformity with the approved budget; (2) concurrent control, also to be exercised by employees through inspections and stocktaking of goods and services received; and (3) ex-post control to be performed by the internal audit units within each entity/line ministry who are responsible for reporting to the external audit function.

2.79 **However, in practice these systems have not been effectively implemented.** The norms on internal and external control have not been adequately promulgated

throughout the line ministries and agencies. There is no common methodology, procedures or practices that address compliance with rules, prevention and detection of mistakes and fraud, and safeguards for information and assets. As a result, accounting information cannot be relied upon and the risk that errors and frauds go undetected is increased. Review of the reports of Special Examinations performed by the external audit teams in the Ministries of Health and Education revealed material weaknesses in the internal control environments; lack of controls over fixed assets, cash safekeeping, and reconciliation of petty cash funds; incomplete financial information; and noncompliance with contractual obligations. These weaknesses imply that there is limited assurance that management objectives are being achieved, that financial transactions comply with the law, and that possible fraud and mismanagement of public funds will be detected.

2.80 In the area of internal auditing, the existence and implementation of norms and procedures is uneven and generally weak. Internal Audit Units (IAUs) report to the head of the particular entity or line ministry, for administrative matters, but report to and depend on the CGE for technical guidance. The law requires the institutions to propose, and the CGE to accept internal audit appointments. Since the introduction of the new law, this process has been functioning adequately, but there are many appointees who were appointed before the law, about whom the CGE does not have complete information about their background and professional experience and suitability for the role of internal auditor. In addition, capacity assessments of the internal audit units have not been performed on a systematic basis and in practice many internal audit units are not adequately staffed. As a result of interviews with and review of the methodology and reports of the Internal Audit Units of the Health and Education Ministries, the CFAA observed that, in the case of the Ministry of Education, no reviews or testing of the internal control environment was performed during 2003. Instead, work had been directed to special reviews on schools and colleges and not to the financial and administrative operations of the ministry itself.

2.81 The lack of a methodology, procedures and practices governing internal audit units results in the subjective application of criteria and inadequate assurance about the existence and operation of a sound internal control environment. Adoption and implementation of internationally recognized internal control and internal audit framework and standards-respectively, Committee of Sponsoring Organization of the Treadway Commission (COSO) and Institute of Internal Auditors (IIA) –would contribute to strengthen and systematize those functions.

2.82 During 2003, efforts have been initiated by the CGE to create a systematic framework to oversee the functions of the Internal Audit Units (IAUs), however this is still largely in the initial design phase. The department responsible for coordinating the work of the IAUs does not have a complete profile of the number of employees within the 150 such units in the public sector. There is no norm that provides guidance on how there internal audits units should be created and staffed (numbers and professional background). In April 2003, an official notice sought to bring the IAUs back to the forefront by setting the key focus of the IAUs to include operational and administrative audits, identification of and evaluation of internal control systems, follow-up of

recommendations, observance of independence, and standards of ethics.¹⁶ Strong internal audit units with appropriate channels for enforcement of their findings would constitute a powerful risk mitigation strategy, acting as a catalyst for cultural change and a deterrent to misuse of public funds. Strong IAUs would contribute to strengthening the internal control environment and promoting accountability, transparency, and public confidence.

7. External Auditing Systems and Practices

2.83 The key issues that emerged from the CFAA analysis are that (1) while the supreme audit institution, CGE has functional independence, appointment of the Controller are subject to strong political influence, (2) while the legal framework, norms and procedures are adequate, audit procedures are largely manual, and resource limitations have severely limited external audit performance, (2) financial audits are limited because resources have been directed towards ad hoc special examinations and ex-ante controls, (3) no consolidated year-end financial statements have been validated by external audit certification. The first shortcoming means that public confidence is eroded in the ability of the Controller to perform *super portes* free of political interference. The second and third shortcomings mean that the credibility of the financial information is reduced, there is limited audit assurance on the reliability of financial statements, and public trust is undermined.

2.84 On the other hand, operational audits have been successfully piloted in the health and education sectors covering achievement of goals and resource efficiency. And a GCE audit of annual budget execution for 2000 to 2002 requested by the legislature is currently in progress and expected to be complete in 2004, with a similar exercise for fiscal year 2003 expected to be delivered by March 2005.

Legal Framework

2.85 **The legal framework is designed to promote transparency in the use of public funds.** Internal and external control are regulated, first in the Constitution, and more recently through reforms implemented through the 2002 LOCGE. Under the LOCGE, the role of the CGE was expanded to include responsibility for the National Control System and auditing and control of the functioning of the public entities, with a view to examining, verifying and evaluating compliance with the vision, mission and objectives of public financial management. Its three principal functions are to ensure (1) that public employees render accounts about the exercise of their roles, utilization of resources under their control, and the results achieved, (2) compliance with the attributes and objectives and respective duties, and (3) coordination with other institutions who exercise external control. One of the shortcomings of the legal framework is that it provides for ex-ante control of public procurement, which runs the risk of generating conflicts of interest during the ex-post audits.

2.86 **The external audit function is adequately empowered and covers all major entities in the public sector.** As referenced in Article 118 of the Constitution, the ambit of control spans the three levels of government, central, decentralized and line ministries

¹⁶ Official Register 28 of April 2003.

and covers (1) entities and dependencies of the legislative, executive and judicial branches, (2) electoral courts, (3) control and regulatory entities, (4) autonomous sectional entities, (5) entities created by the Constitution, and (6) legal entities created by legislative acts for provision of services at the sub national level. In addition, the operations of the CGE extend to private entities which receive subventions from the state, and entities designed to deliver social and public services whose capital, funds, or taxation revenues are comprised of 50 percent or more of state funds.

Supreme Audit Institution

2.87 The Supreme Audit Institution is independent of the Executive and by law, has unfettered access to the information required to perform its duties. Under the Constitution, the Supreme Audit Institution (*Controlaria General del Estado* or CGE), reports to the Congress and is empowered to control revenue, expenses, investments, resource utilization, administration, and custody of public assets. The CGE is charged with the responsibility to perform administrative, financial, performance and environmental audits, as well as special examinations and audits of public works and engineering. Based on the law, the CGE is empowered to make determinations about the legality, transparency and efficiency in the use of resources as well as to determine civil and criminal responsibility in cases of non-compliance with laws and regulations.

2.88 A Strategic Plan for the CGE has been prepared and aims to strengthen oversight capacity. A Plan covering the 2003-2007 period has been prepared by the CGE and contemplates some important activities that would strengthen its oversight capacity. The priority areas identified include implementation of the quality control system, decentralization and delegation of authorities to regional and provincial offices, professional development, strengthening of the internal control framework, definition of coordinating mechanisms with IAUs, consolidation of actions with other control entities, and updating of norms. The specific action steps have not yet been identified and successful implementation of this plan would require sequencing to ensure maximum impact on the governance arrangements of the public sector.

2.89 Successful implementation will assist the CGE in exercising one of its control objectives to determine the integrity and reliability of financial statements and budget execution reports, produced by the national information system. The WB's Public Sector Financial Management Loan (PSFMP) includes a US\$1 million component for strengthening external audit capacity. The component is comprised of equipment support, training and a co-sourcing arrangement with a private audit firm to help build capacity for computer-assisted auditing techniques.

2.90 Despite CGE's functional independence, the procedures for the nomination of the Auditor-General are cumbersome and subject to strong political influence. Under the Constitution, the Congress is responsible for the appointment of the CGE. A shortlist of candidates is first agreed upon by a two-thirds majority of the Congress. This shortlist should be presented within 20 days of the position becoming vacant, however, the position of the Auditor-General has been vacant for almost one year, and agreement cannot be reached among the political parties on a preferred list of candidates. This delay

has eroded public confidence in the ability of the eventual appointee to carry out the duties of the office, free from political interference and with the functional and economic independence that is envisaged in the law.

2.91 Overall, the organizational structure to audit the Central Administration is appropriate, but the number of staff dedicated to financial audits and review of the national consolidated financial statements is limited. As part of the plan to modernize its operations and promote efficiency, the CGE has begun a process of decentralization of administrative functions. The current organization structure comprises four levels: (1) the executive (auditor-general, sub-auditor-general, secretariat and general coordination); (2) advisors for general and internal audit; (3) support services (administration, planning and evaluation, finance, revenues, human resources, communication and public relations); (4) operations (legal, training, public procurement, sanctions, revenue control, audit teams); and (5) regional and provincial offices. The annual training plan for external auditors and public employees is comprehensive. The annual plans are widely disseminated and public employees and staff of the CGE have access to a wide variety of training on issues related to public financial management, e.g. financial administration, control, technology and legal issues.

2.92 CGE staff number about 800 persons, however audit assignments are unevenly distributed among the audit teams and the number of professionals with experience in financial audits and the resources assigned to oversee internal audit units is considered insufficient. For example, the audit team assigned responsibility for almost all audits of line ministries, state enterprises, National Consolidated Financial statements, and Consolidated Budget statements (*Auditoria IV*) is comprised of 40 members, less than five percent of the staff complement of the CGE. Only six persons are dedicated to monitoring and follow-up of IAUs. More than half of the staff are assigned to carry out ex-ante controls of government procurement processes. Strengthening the internal control environment within line ministries could be accompanied by a redirection of the resources now used for ex-ante control to carry out instead financial audits, that are critical to ensuring accountability.

Procedures and Practices

2.93 The norms and procedures governing external audit are adequate and in keeping with international standards. However in practice, financial audits of line ministries and agencies are limited in scope, depth and frequency. The norms and methodologies are appropriately aligned with internationally accepted practices promulgated by the International Organization of Supreme Audit Institutions (INTOSAI), and operating manuals, and procedural guidelines are up to date and comprehensive. However, auditing procedures are largely manual and there is limited access to efficiency-enhancing information technology tools. Resources have been directed towards ad hoc special examinations, rather than to covering the full range of financial audits. The limited number of financial audits means that there is limited audit assurance on the reliability of financial statements, the regularity of transactions, and the functioning of the internal control systems within line ministries and agencies.

2.94 In practice, external audit independence has not been fully exerted, insufficient resources are directed towards evaluating budget execution and the quality of information on which the budget is based, and the consolidated year-end financial statements have not been validated by external audit certification. Until early in 2004, no external audits of budget execution had been performed in Ecuador. In addition, no opinions on the consolidated financial statements have been issued, as required by the LOCGE. The Congress has requested the GCE to perform an audit of annual budget execution for 2000 to 2002, and this work is currently in progress with the first results expected to be delivered by June 2004. Thereafter a similar exercise will be conducted for fiscal year 2003 and the results are expected to be delivered by March 2005. The lack of an independent timely opinion on the quality of the information produced by the government when implementing the budget, and scrutiny of government expenditures during execution, reduces the credibility of the financial information and undermines public trust. In a survey of comparative performance of the SAIs in the region, public perception of the capacity of Ecuador's CGE was rated as 13 on a scale of 1 to 100, compared to the highest rating of 48.¹⁷

2.95 There is incomplete information on the level of compliance and implementation of corrective actions recommended by external audits. Although the law requires a formal response to audit findings, this response is not provided in a timely manner. Follow-up on pending corrective actions is inhibited, the tools available for follow-up of recommendations are embryonic and labor-intensive and therefore follow-up is neither systematic nor comprehensive. In the Annual Report of work performed by the CGE, only one department published statistics on the level of compliance and indicated that the percentage of corrective action taken in response to the previous report was 41 percent.¹⁸ System-wide data on the major areas of control risks, percentages of non-compliance, and the status of corrective actions are essential for gauging the overall control framework at national level. These indicators could be used for determining training and capacity-building priorities and for allocation of external audit resources towards high-risk sectors and activities. Such indicators can be used to prepare communication materials for the general public on the efficiency of government operations.

2.96 Despite the poor results of financial audits, operational audits have been successfully piloted in the health and education sectors. During 2003, 73 such reviews were initiated and 43 completed. Their scope included a review of the extent of achievement of goals and objectives established in the Annual Operating Plans and the degree of efficiency in use of human and financial resources. Where appropriate,

¹⁷ *Latin America Index of Budget Transparency: A Comparison of 10 Countries*, 2nd ed., Ford Foundation Mexico, Open Society Institute, and USAID, 2003.

¹⁸ *Informe a la Nación 2002*, CGE, January 2003. On an annual basis, a summary of the audits performed and the principal findings is published, summarizing the activities undertaken by each functional unit within the CGE. This document is publicly available, however it is not presented to the Congress or other auditing subcommittee nor is it subject to Congressional debate.

efficiency enhancements were recommended and implementation of corrective actions has started, albeit slowly.

8. Legislative Oversight And Public Access To Information

2.97 Legislative scrutiny of government expenditures increases transparency and strengthens governance by calling Government to account for its stewardship of public finance management. The CFAA reviewed: (1) the degree of ex-ante, concomitant, and ex-post review of PFM functions; (2) congressional follow-up of the Supreme Audit Institution's recommendations; and (3) the impact of such follow-up.

2.98 The key issues that emerged from the CFAA analysis are (1) limited participation by the legislature in the budget debate and oversight of budget execution, (2) absence of any ex post review of budget execution by the legislature. These shortcomings mean that the legislature is not exercising its power of budget authority and Government is not held accountable for use of public funds, increasing the risk that fraud and mismanagement go undetected. On the other hand, pressure from civil society and NGOs has resulted in national dialogues on the annual budget, and Government's 2003 Transparency Plan is leading to greater dissemination of information on public finances and is supporting specialized NGO workshops on budget transparency issues. Also, the legislature requested that CGE complete its first ever review of budget statements for 2000-2003; prior to this work, begun in 2004, the CGE had never completed independent audit of the consolidated financial statements and annual budget execution reports for the legislature (or anyone else) to review.

2.99 **Legislative oversight of public financial management is limited.** The Ecuadorian Congress is similar to legislatures in most other Latin American countries, in that legislators have limited time to study the complex budget bills that come before them, and limited financial or professional resources to acquire the professional understanding of what those bills comprise. Authority and participation of the legislature in the budget is rated as 26 on a scale of 1 to 100, the highest in the region being 51.¹⁹ The annual budget bill is one of the more technically complex pieces of legislation to come before the two houses of Congress; and, faced with time and funding constraints, the only place where legislators can go for advice on the contents of the budget is their political parties. It is thus not surprising that the legislative discussion of the budget focuses on political issues and not public finance management. Similarly, Congressional review of reports from the CGE and the Ministry of Finance on financial performance tends to be unsubstantial. This is consistent with the quality of legislative oversight observed in Uruguay, Paraguay, Brazil, Bolivia, Colombia, Nicaragua and Honduras, which is cursory at best.

¹⁹ The budget transparency index ranks Ecuador last out of 10 Latin American Countries. ¹⁹ *Latin America Index of Budget Transparency: A Comparison of 10 Countries*, 2nd ed., Ford Foundation Mexico, Open Society Institute, and USAID, 2003.

2.100 Because the Congress lacks the capacity for professional oversight of public financial management, the key government agencies feel very limited pressure to complete their functions according to governing rules and processes. The annual budget statements are not remitted to the Budget Committee of the Congress in the time periods specified by the Constitution and information on budget execution is not published. No independent audit and evaluation of the Consolidated Financial Statements and Annual Budget Execution reports have been complete by the Supreme Audit Institution. At the request of the Congress a review of the budget statement for 2000 to 2002 was initiated at the end of 2003, but this work is still in progress. Ineffective independent scrutiny of government expenditures means that the Government is not held to account for its stewardship of public funds, increasing the risk of mismanagement and fraud. While numerous other countries in the region evidence similar problems, Ecuador's situation is cause for concern given that the country was the region's model for its advances in public financial management a generation ago.

2.101 **A culture of secrecy has surrounded the national budget and public expenditures in Ecuador.** Because of the weakness of legislative oversight, there is a perception that public financial management in Ecuador is not transparent, and that the Government has limited accountability for its decisions on allocation and spending of public resources. In the case of Ecuador, legislative participation in budget changes is rated 12 on a scale of 1 to 100, the highest in the region being 54. The lack of legislative participation is not offset by public feedback because the draft budget is not disclosed nor is the budget execution report published, and in fact there is no mechanism for civil society to step into the breach and participate in the budget formulation and monitoring processes. Given the lack of openness and explicit debate in Congress with regard to competing economic policy alternatives, it is difficult to prevent decisions that are systematically biased against the poor.

2.102 **Civil Society is becoming increasingly active in lobbying for government financial accountability.** Public access to information on government financial accounts has become a critical issue for increasing transparency, building trust and responding to civil society requests for more open and accountable government. In response to the increasing demand from civil society for enhanced access to budget information and greater participation in budget formulation and monitoring of public expenditures, the Congress has made attempts, albeit after approval of the budget, to raise public awareness and engage civil society in the budget dialogue. The Observatory of Fiscal Policy,²⁰ a highly credible non-governmental agency, has organized national dialogues on the annual budget, bringing together Congress and civil society and publishing resource material to assist civil society in understanding some of the complexities of the budget.

2.103 Since the budget is presented in a form that makes it difficult for non-experts to understand, there is as yet little popular pressure to improve the effectiveness of public expenditure. Currently, citizen participation in the budget in Ecuador is rated as 3 on a scale of 1 to 100, when compared to the highest rated country in the region with a score

²⁰ Sponsored by the United Nations Development Program and the United Nations Children's Fund.

of 20.²¹ Publication and accessibility of key fiscal information in an easily understood format would increase the general level of transparency that exists regarding fiscal plans, position and performance of the Government and would be a clear sign of the Government's commitment to promoting good economic governance. It would also enable civil society to play a broader oversight role with respect to resource allocation and public expenditure, which could potentially compensate to some extent for the legislature's performance, or even spur it to become more involved.

2.104 Several reform initiatives are being considered by the GOE as part of its Transparency Plan produced in 2003. These include (1) the upgrade of the SIGEF to provided consolidated financial information on the NFPS, providing monthly reports of executed expenditure, and making them publicly available through the Government's Internet Portal, (2) increasing dialog with civil society and making transparent the fiscal restrictions; and (3) providing technical assistance to the Undersecretary of Finance and the Observatory of Fiscal Policy, in the first instance to prepare and disseminate material which would allow civil society to better understand public financial information, and in the second to organize workshops to train citizens, media representatives and public officials on issues related to budget transparency. The implementation of this approach is the most likely to provide an effective oversight mechanism over the next decade.

²¹ *Latin America Index of Budget Transparency: A Comparison of 10 Countries*, 2nd ed., Ford Foundation Mexico, Open Society Institute, and USAID, 2003.

3. COUNTRY PFM PERFORMANCE AND FIDUCIARY RISK ASSESSMENT

3.1 A financial management fiduciary risk assessment is designed to identify gaps in the quality and relevance of financial information, oversight and overall transparency and accountability between generally accepted performance measures and actual practices. As a by-product of the assessment, a conclusion is reached on the risk that donor and public funds, primarily adjustment lending or budget support operations, will be used for unintended purposes or that misuse of funds will go undetected.

3.2 Strong public financial accountability mechanisms that encompass all of the country's public sector and its management of resources are often the most important consideration for the international lender. The domestic fiduciary framework provides evidence and assurance that funds are being used with probity, efficiency and effectiveness. Development policy lending in the form of budget support may be appropriate in a risky PFM environment where there is a strong and realistic program for PFM improvement that is fully owned and implemented by the Government. Thus an adequate PFM system may be an outcome of development policy support rather than a precondition.

3.3 The CFAA concludes that fiduciary risk in Ecuador is currently **substantial**.²² Of particular importance in arriving at this rating are the following weaknesses that undermine efficiency, transparency and accountability:

- A significant volume of government activities is not covered by the budget, which increases the risks that budget support could be diverted to off-budget activities for which there is little scrutiny or transparency.
- There are no commitment controls during budget execution, so entities can over commit beyond the Government's ability to service its payment obligations, placing additional burden on scarce resources.
- There is insufficient reliable and timely information on budget execution. Lack of such information may reflect a general lack of fiscal transparency.
- The internal control framework is sufficiently weak that misuse of public funds can go undetected, without any call for accountability.
- External audits of entities' financial statements are limited in frequency, scope and depth, and external financial audits of budget execution and the consolidated financial statements are not performed.
- Legislative scrutiny of public financial management is inherently weak.

3.4 **At the same time, there is an expectation that risks will decline** as the reforms in progress are completed, in part through the adoption and follow up of the recommendations discussed in this study. The positive outlook underlying the risk rating has also taken into consideration the Government's program for PFM improvement that is fully owned and currently being implemented including:

²² Risk classification for the purposes of CFAA are: 1) low, 2) moderate; 3) substantial; and 4) high.

- Strengthening of the legal framework through passing the FTSRL, the LOGCE, and in 2002, their accompanying regulations.
- The administration of the official bank accounts by the Central Bank guarantees the Treasury authorities an adequate mechanism to control available funds.
- Reactivation of improvements to SIGEF in order to improve efficiency of operations and promote transparency and accountability.
- Implementation of several projects with other donors in the areas of modernization of the state and institutional reform and anti-corruption.

3.5 In arriving at the risk assessment, the CFAA team took into consideration a combination of indicators from two measurement systems: (1) the Performance Measurement Framework that has been developed by a working group involving staff from the WB, IMF and the Public Expenditure and Financial Accountability Secretariat, which provides a set of high-level indicators that will enable the performance of country PFM systems to be monitored over time,²³ and (2) the recently developed IMF and WB survey tool called the Country Assessment and Action Plan questionnaire, which evaluates budgetary management practices worldwide of highly indebted poor countries (HIPC). The indicators for Ecuador are measured against a scale from A (strong PFM) to D (weak PFM).

3.6 In addition to the findings of the CFAA, the CFAA team drew on the results of the WB/IDB Public Expenditure Review and the IMF Fiscal Transparency ROSC that were conducted in parallel with the CFAA. The CFAA team concludes that Ecuador is slowly but progressively making advances in financial management reform. However, in some areas Ecuador's public sector is still far from exhibiting good PFM practices and adequate fiscal transparency, when assessed against performance indicators based on international benchmarks (Table 3).

Table 3. Review of Ecuador's Performance Indicators and Benchmarks

	Performance Indicator	Ecuador Rating	International Bench mark	Rationale for Ecuador's Rating
Budget Formulation				
1.	Fiscal reporting matches the IMF definition of general government sector with coverage (by value) of at least 95 percent, whether it is funded through the budget or not.	B	B	Coverage of the general government budget is 78 percent of the NFPS. Consolidated reporting of the general government is weak and untimely. Ex-ante reporting of activities by sub national government data is available, but ex-post reporting is available only since 2004, and does not include quasi-fiscal activities.

²³ Revised Consultative Draft on PFM Performance Measurement Framework. The need for such a framework was identified in the OECD-DAC Donor Harmonization Task Force.

	Performance Indicator	Ecuador Rating	International Bench mark	Rationale for Ecuador's Rating
2.	Government activities are funded through extra budgetary resources, but these funds represent less than 3 percent of total spending.	C	A	There is no comprehensive and reliable information estimating extra budgetary resources, but they are significant (estimated to be above 10 percent). Earmarked revenues not included in the budget represent 23 percent of total budget (corrected by off-budget financing) in 2004 alone. The budgets from the social security institute of the army and police, public enterprises, and autonomous institutions are not reported.
3.	The level and composition of the budget outturn is quite close to the original budget appropriations (deviations between 5 and 15 percent) for at least two years.	B	B	During 1995–02, deviations represented an average of 6 percent under budgeting. Although there was no dominant pattern of under- or over execution in those years, there was systematic under execution of the capital budget.
4.	Budget reports, full ex ante and timely ex post—include data on external financing—external loans or grants.	C	A	Ex-post reports on budget execution are neither timely nor complete. Grants, especially in-kind, are partly incorporated into the budget.
5.	Classification of budget expenditure is done on an administrative, economic, and detailed functional and programmatic basis.	C	B	Budget classification does not conform to international standards. There are no programmatic or economic classifications.
Budget Execution				
6.	No stock of payment arrears (or very few), with little accumulation of arrears over the previous year.	C	A	The level of arrears has declined, but is still above 5 percent.
7.	Internal control system is effective.	C	A	Internal financial audits are weak in their scope, depth, and frequency.
8.	Public expenditure tracking surveys (PETS) of funds are piloted to supplement weak internal control as a second best.	C	B	No PETS have been piloted or implemented. Efforts to perform performance audits are in the initial stages.
9.	Satisfactory reconciliation of fiscal and banking accounts is undertaken monthly.	B	A	The single Treasury account is reconciled daily and through electronic means, but institutional accounts can be delayed by up to 3 months. Statistical discrepancies in monthly reporting are still significant.
Accounting and Reporting				
10.	Internal budget execution reports are received between two and four weeks of the end of the relevant period.	C	B	Delays in receiving institutional reports of budget execution from spending units may be much longer than a month. Delays are particularly significant in decentralized execution units.
11.	Routine transactions are entered into the main accounting system within two months after the end of the fiscal year.	C	A	Transactions are entered within a six-month period.
External accountability, audit and scrutiny				
12.	An audited record of the financial outturn should be presented to the legislature between 6 and 12 months of the end of the fiscal year.	C	B	The CGE has not expressed a professional opinion on the consolidated financial statements as required by the LOCGE.

	Performance Indicator	Ecuador Rating	International Bench mark	Rationale for Ecuador's Rating
13.	Legislative committee examines the external audit reports and questions responsible parties about the findings of the report	C	Not. Av.	The Controller produces an annual report to the public summarizing the results of its audit work for the year, however there are no procedures for analysis of the report or for follow-up on recommended actions by the legislature.

A= Strong, B= Fair , C= Poor, D= Weak

Source: ROSC-FT, CFAA, and WB/IDB survey of Ecuadorian officials.

4. PRINCIPAL CONCLUSIONS, RECOMMENDATIONS AND ACTION PLAN

A. Conclusions

4.1 The principal findings of this CFAA are:

Summary of Principal Findings

Legal and Regulatory Framework

- The 1977 LOAFYC provided the basis for a systematic and integrated approach to financial administration and governmental control and at its inception was considered to be a piece of pioneering financial administration legislation in Latin America. The systemic focus was however subsequently undermined by a rapid proliferation of special purpose laws and norms starting in 1992 as a result of the competing pressures of pro-poor spending versus pro-fiscal discipline. The current framework has therefore, become increasingly fragmented and incomplete, making it difficult to distinguish between current requirements and those which have been repealed and superceded by new regulations.

Information Systems

- Implementation of the Government's integrated financial management system (SIGEF) has brought some order to the administrative and financial functions at the executing unit level, however, there remain some fundamental issues related to SIGEF's conceptual design that limit its effectiveness as a management tool to promote accountability and transparency in public financial management. Three important shortcomings relate to: (i) the lack of commitment controls during budget execution; (ii) the fact that the accounting entries are not automatically generated during the budget cycle, and (iii) the technological platform's composition as a set of independent technology tools and applications, which in some cases are not compatible, and use physically and logically decentralized databases.

PFM practices and operational procedures

- The bulk of current budget decisions are directed towards financial discipline and austerity during a single financial years (near-term), with inadequate consideration of the long-term consequences for fiscal policy. Stronger linkage between budget decisions and program goals, and improved cash flow forecasting and management, would improve the use of scarce resources.
- The rigidity and incrementalism of the budget, along with the practice of making in-year adjustments to approved budgets without clear rules and guidelines, makes it difficult for spending ministries to plan and commit expenditures in support of their programs, and undermines the transparency and credibility of the budget as a statement of government priorities.
- The administration of the official bank accounts by the Central Bank guarantees the Treasury authorities an adequate mechanism to control available funds. In

addition, implementation of the Single Treasury Account has facilitated an important reduction in idle funds and has provided a mechanism for increased efficiency in the payments to suppliers and other beneficiaries.

- Expenditure control is not exercised on budgetary commitments, causing floating debt to accumulate and making it difficult to comply with the quantitative rules of the LOAFYC, exceeding the international benchmark of 5 percent.
- The Accounting Undersecretariat is under-resourced, in terms of staff numbers, skill profiles and information technology, which makes the unit unable to discharge its role in promoting fiscal transparency. Information provided for decision-making and control is often incomplete and untimely, and there is a lack of confidence in the consistency of budget performance, accounting and financial reporting, and their usefulness in promoting transparency and accountability.
- The legal framework for debt management provides an orientation for debt reduction in the short term, however, there is no formal strategy for new borrowing, no analysis of long-term capacity to repay or creditworthiness of public entities, and no functional coordination between the various agencies involved in debt management.
- Internal audit units do not provide regular and adequate feedback to line ministry management on the reliability and integrity of financial information, and there is no systematic approach to the evaluation of internal control nor to governance processes within line ministries and agencies.
- The Organic Control Law empowers the Supreme Audit Institution with operational independence, financial autonomy, and access to the full range of state entities; however, this independence has not been fully exerted. In spite of the new responsibilities, the focus has continued in the area of ex-ante control of public procurement and ad hoc reviews, and up until early in 2004, no external financial audits have been performed on Budget Execution nor the Consolidated Financial Statements of the Central Government.
- As in many developing countries, the Congress does not have a tradition of rigorous examination and debate of the budget, nor oversight of public financial management. Efforts have recently begun to engage the legislature in its roles of promoting financial accountability of the Government to the electorate.
- Civil Society is increasingly lobbying for Government's financial accountability, but the effectiveness and impact has been curtailed due to the complexity of the budget process and a lack of timely and reliable information on public expenditures.

B. Recommendations

4.2 The proposed recommendations are fully compatible with other reform initiatives already in progress in the areas of financial accountability and transparency. The challenge for the Government of Ecuador is to ensure coherence of the activities being financed by the various donors and interested parties, streamlining insofar as possible, activities in progress to encompass the already harmonized recommendations of the CFAA, PER and IMF ROSC, and then establishing priorities and sequencing to ensure maximum impact.

4.3 The main recommendations are:

Legal and Regulatory Framework

- In the short term, compile and order the existing laws and regulations into one consolidated text, repealing those dispositions that are no longer applicable or contradictory. In the medium term, in order to reestablish the systemic approach and streamline and improve the efficiency of Budgeting, Treasury, Financial Accounting and Reporting, a new organic law should be approved and implemented, bringing to a conclusion the GOE's own initiative to modernize the legal framework, which has been in abeyance for some time.
- Prepare and implement supporting regulations to the proposed new law, to ensure that (a) the budget is realistic, comprehensive, and policy-based and that there is linkage between the development plan and the recurrent and capital expenditures proposed in the budget; (b) adequate information on budget management and performance is produced and disseminated to meet decision-making, control, management and reporting purposes; (c) the procedures for making in-year adjustments to budget allocations are clearly articulated and complied with; (d) internal control arrangements are in place for the exercise of stewardship of public funds; and (e) there are adequate arrangements to enhance legislative and civil society capacity for scrutiny of public finances.

Information Systems

- **Redesign SIGEF functions and upgrade its technology platform** in order to enhance the internal oversight environment in public finance. In keeping with a government initiative already underway, the redesign should consider (a) at the institutional level, the system logic needs to be inverted so that the accounting transactions are an automatic by-product of budget execution, in contrast to the current logic where budget commitments are only reflected when accounting entries are posted, (b) upgrade the information technology (IT) platform beyond the current client-local server approach of the institutional systems and promote intensive use of communications, the power of the web, and real-time updating of the system's central databases, (c) establish limits to manage the pro-forma preparation process and (d) establish commitment controls within the SIGEF to prevent over commitment in times of austerity.

PFM Practices and Operational Procedures

- Develop and implement a methodology and procedures which would link the annual development plans to the Budget and ensure consistency of the institutional annual plans with budgeted activity costs.
- **Transfer the responsibility for central management of the periodic cash management plans to the Treasury Undersecretary**, creating the institutional arrangements to allow the Treasury Undersecretary to access and use the Central Bank's central databases on financial transactions, in order to improve capacity for cash flow forecasting and overseeing expenditure. In addition, the Interbank payment mechanism should be expanded to cover all items of expenditure, eliminating the revolving payment accounts and the use of checks.
- **Design and implement in-year budget reporting and annual financial statements** that reflect the financial position of the Government. The information should cover revenues, expenditures, as well as financing gap and provide both aggregated and disaggregated data. These statements should be prepared, consolidated and published on a timely basis in order to provide evidence that budgeted resources are reaching spending units in a timely and transparent manner, and to allow line ministries to be called to account for managing their affairs and achieving their objectives.
- **Restructure and professionalize the Accounting Undersecretariat** in order to promote a uniform control environment, thereby fostering public confidence in the usefulness and integrity of the Budget Execution and National Consolidated Financial Statements. A capacity-building program should include upgrading the accounting framework and making personnel and technological tools available for evaluation of budget execution and preparation of financial statements. To address the subsystem's current weakness, adjustments and regulatory refinements are needed that would (a) uphold the principle of "a single record of transactions and non-transaction events" for the various different analytical frameworks, such as for the budget and national accounts, implementing accrual-basis accounting; (b) develop, also in accordance with the single-record principle, the different catalogues and classifications needed to satisfy, from one and the same record of transactions and data and in an integrated manner, the needs of the different analytical approaches; (c) harmonize accounting standards with those issued by the Public Sector Committee of the International Federation of Accountants; (d) re-examine the role of the Government Accounting Office so that it takes on responsibility for integrating financial information (budget, Treasury, and equity) and submitting consolidated financial statements.
- **Elaborate a borrowing policy and strategy** on which the activities of authorization and contracting new financing can be based, by creating a mechanism for bringing the various agencies involved in debt management together to analyze long-term capacity to repay and agree on how to measure creditworthiness of the entities empowered to borrow, especially financial sector institutions and sub national governments.

- **Create procedural manuals** specifying roles and responsibilities and the rules for registering debt information, and debt service payment procedures.
- **Restructure and professionalize the Internal Audit Unit.** In order to promote effectiveness and efficiency in operations and reliability of financial reporting and compliance, internal audit units within line ministries should be adequately staffed and a systematic approach should be implemented to evaluation, management and control of risks.
- **Realign the organization, staffing and procedures of the Supreme Audit Institution and eliminate ex-ante control work,** in order to redirect the focus of its activities towards its chief responsibility for government audits and special examinations and for oversight of controls implemented to manage public finances. Based on the spirit of the law, the realignment should include (1) establishment of mechanisms and procedures to ensure that on an annual basis, the CGE issues a timely opinion on budget execution and on the government's consolidated financial statements, in order to improve transparency of the fiscal accounts; (2) a comprehensive risk assessment of public expenditures in which risk factors are used as guides to the allocation of audit resources, allowing staff to be deployed to assist in fixing those problems that will have the greatest impact on satisfactory program delivery; (3) increasing the percentage of qualified and experienced auditors by adjusting the skills mix and assignment of staff to increase the number of professionals dedicated to follow-up of IAUs and the number of staff assigned to external audit units; (4) definition of a methodology to ensure effective monitoring of the internal control environment by internal auditors in line ministries; (5) training of public officials in norms and procedures of internal control; (6) establishment of a mechanism for effective oversight of internal audit units; (7) implementation of a systematic approach to coordination of activities of key oversight agencies; and (8) implementation of automatic, technology-driven mechanisms for performance monitoring and follow-up on implementation of corrective actions.
- **Strengthen institutional capacity of the Finance and Budget Committee of Parliament,** establishing practices that will ensure adequate briefing of the legislature on issues of finance, financial accountability, and planning and allow it to better advocate on budget priorities and effectively oversee budget execution, control, evaluation, and external audit corrective action
- **Expand the Government's Internet Portal** in order to provide access to information on government *financial* accounts and increase transparency, build trust, and respond to civil society requests for a more open and accountable government. Mechanisms are needed to sustain and increase consumer demand, through consultation with key sectors of society. In order to respond to the needs of citizens, portal content should be updated regularly, providing timely information regarding budget laws, regulations and execution; definition of technical terms related to the budget and budget manuals and other supporting information; and information on current-year budget execution and month-by-month comparisons of actual and budgeted revenue and expenditures by institution, sector, and geographic location.

C. Action Plan

4.4 The Team has proposed an action plan which will serve as the basis for discussion with the authorities. The recommended activities have been divided into three categories in order to reflect the priorities identified by the CFAA : (1) short-term actions needed immediately to improve PFM performance and mitigate fiduciary risk, (2) medium-term actions required to promote improved fiscal performance and build institutional capacity, (3) legal and regulatory changes required to strengthen the regulatory environment and provide the underpinnings for medium-term policy and procedural improvements. Expected time frames required for each activity are indicated in the Action Plan, but real target dates will be set in conjunction with the Government, taking into account its institutional priorities and other reform activities already in progress,

4.5 The CFAA team believes that some of the remedial actions required to implement the recommendations, especially those required to mitigate fiduciary risk, could be funded through appropriate modifications to the PFM improvement programs under implementation (for example the SALTO project and the SIGEF re-engineering under PSFMP). In order to gain fiscal headroom and increase impact, these actions need to be accompanied by appropriate civil service reform and Government's commitment to eliminate programs that are not efficient.

4.6 The Action Plan on the following pages outlines the specific actions to address weaknesses in public financial management, reasonable timeframes within which actions should be completed, the units responsible, and possible sources of financing.

ECUADOR CFAA ACTION PLAN

	Proposed Actions in order of priority	Estimated Duration	Responsible Unit	Vehicle
1	Short-term Fiduciary Risk Mitigation Measures			
1.1	Complete external audit of budget execution and the consolidated financial statements for 2002	3 months	Supreme Audit Institution	Own resources
1.2	Implement in-year budget reporting and evaluation of financial statements.	6 months	Accounting Undersecretary and SIGEF Implementing Unit	Own resources and PSFMP
1.3	Compile and order the existing laws and regulations into one consolidated text, repealing those dispositions that are no longer applicable or contradictory	6 months	MEF	Own Resources
1.4	Restructure and professionalize the Internal Audit Function within line ministries and agencies.	12 months	Supreme Audit Institution, line Ministries	Own resources
1.5	Enhance SIGEF to allow for limit controls during budget preparation and commitment controls during budget execution.	6 months	Budget and Accounting Sub secretaries, and SIGEF	PSFMP
1.6	Modernize rules governing the budget process.	8 months	Budget Sub-secretary, Finance and Budget Committee of Parliament	SALTO
1.7	Transfer responsibility for cash for periodic cash management to the Treasury Sub secretary.	6 months	Treasury Sub secretary	Own resources
1.8	Develop mechanism for Treasury Sub secretary use of the Central Bank's central payments database.	6 months	Treasury Sub secretary, Central Bank	To Be Determined
1.9	Complete external audit of Budget Execution and the consolidated financial statements for 2003.	9 months	Supreme Audit Institution	Own Resources
1.10	Develop a borrowing strategy on which the activities of authorization and contracting of debt can be based.	9 months	MEF	To be determined.
1.11	Develop procedural manuals for Public Credit Undersecretariat	9 months	Public Credit Undersecretariat	IDB

	Proposed Actions in order of priority	Estimated Duration	Responsible Unit	Vehicle
2.	Medium-Term efficiency-enhancing and capacity-building initiatives			
2.1	Restructure and professionalize the Accounting Sub secretary.	12 months	Accounting Undersecretary	To be determined
2.2	Strengthen institutional capacity of the CGE and eliminate ex-ante controls.	18 months	Supreme Audit Institution	Own resources plus PSFMP
2.3	Re-engineer SIGEF (technology platform, accounting, tools for management at the sectoral level).	24 months	MEF	PSFMP
2.4	Develop and implement a comprehensive transparency strategy, in which the transparency Internet portal serves as a central element, for publishing timely information on budget execution, establishing mechanisms to raise civil society awareness.	12 months	MEF, NGOs and civil society	WB-funded Fiscal Consolidation for Growth and Competitiveness II and other donor funds
2.5	Expand Interbank payment system to all expenditure items and eliminate all general State budget revolving payment accounts.	24 months	MEF, Central Bank, Entities	To be determined
2.6	Strengthen Investment system and the capacity to analyze public spending	12 months	MEF, Vice Ministry of Economy	IDB
3.	Legal and Regulatory changes			
3.1	Prepare and approve new unified organic law on Public Financial Management	18 months	MEF, Line Ministries, Legislature	To be determined
3.2	Develop and/or amend the regulations governing public sector accounting.	9 months	MEF, Line Ministries	Own resources

ANNEX I

LAWS PERTAINING TO FINANCIAL MANAGEMENT

<i>Laws</i>	<i>Characteristics</i>
Ley Orgánica de Administración Financiera y Control – LOAFYC – Supreme Decree 1429 – RO 510 May 16, 1977	Systematic and integrated approach of the following processes: budgeting, and public credit, financial public resources management; accounting registration; financial statements and external and internal audits. Originally 397 articles that have been “modernized” by Ley de Presupuestos del Sector Público and abrogated by the Ley Organica of the CGE - titles VI to XII.
Ley de Regulación Económica y Control del Gasto Público – Ley # 122 – RO/Supplementary 453 March 17, 1983	Management of specific aspects of the budgeting processes such as: deadlines for the draft budget presentation by entities; monthly cash flow programs included as part of the draft proposal; approval of autonomous entities budgets
Ley de Presupuestos del Sector Público – Ley # 18 – RO/S 76 November 30, 1992	This Law is considered of special application and modernizes LOAFYC dispositions applying the regulatory principle of centralization rules and operating decentralization regarding the budgetary systems. This Law is applicable to SPNF and delegates MEF as regulator of the national budget; furthermore, establishes budgetary principles; controls The Single Treasury Account; and controls pre-assigned incomes; monitors the formulation, approval, execution, evaluation and liquidation of budgets and establishes MEF as the entity in charge of collections and payments through the Banking System.
Ley Orgánica de la Función Legislativa (LOFL), RS 862, 28-January-1992 Reformed RO 73, on November 24, 1998.	Creation of specialized Committes (Comisión de lo Tributario, Fiscal y Bancario) to review proposed modifications to laws. The committees are able to request any information on the draft presented by the Executive. Likewise, it is in charge of monitoring public management and analyzing officials accusations of corruption made by public employees.

<i>Laws</i>	<i>Characteristics</i>
Ley de distribución del 15% a Gobiernos Seccionales – Ley # 000 – RO 27 March 20, 1997	Regulates the transferences of 15% from the total current incomes of the central government budgeting where MEF is responsible of having adequate mechanisms to convert transferences into cash.
Ley de Descentralización - # 27 – RO 169 October 8, 1997	Sets out intergovernmental mechanisms covenants to transfer competences in a gradual process. This implies a governmental decision to finance this exercise of gradual competences transferences through governmental funds.
Ley para la reforma de las finanzas públicas – Ley # 24 – RO/S 181 April 30, 1999	Establishes tax parameters including modifications to the fiscal code in order to improve collection activities, and introduces quantitative restrictions of expenditures growth and payrolls control mechanisms through the creation of the Consejo Nacional de Remuneraciones del Sector Público.
Ley Orgánica de la Defensoría del Pueblo, RO 7, February 20, 1997	The Defensoría del Pueblo was created through Article 96 of the CPRE. The Law controls its operations and faculties Defensoría del Pueblo to monitor the quality of public services including expenditures control.
Ley de la Comisión de Control Cívico de la Corrupción, RO 253, August 12, 1999.	The CCCC was created through Articles 220 and 221 of the Constitution where CCCC is authorized to act as a receptor of accusations of illicit acts carried out by public institutions, as well as to investigate accusations and request judicial judgments and sanctions respectively. CCCC has to inform the Ministerio Público and CGE of the result of these investigations.

<i>Laws</i>	<i>Characteristics</i>
Ley Orgánica de Responsabilidad, Estabilización y Transparencia Fiscal – LORETF – Ley # 72 – RO 589 June 4, 2002	After the financial crisis, this Law mandates the preparation of Pluri – annual - four years and annual operating institutional plans to frame budgets; quantify fiscal macro rules. It provides for the stabilization of the debt reduction fund (FEIREP) prescribes the rules for debt reduction and introduces rules of fiscal transparency and citizen control including sanctions caused by noncompliance.
Ley Orgánica de la Contraloría General del Estado – LOCGE – Ley # 2002-73 – RO/S 595 June 12, 2002.	This Law repeals LOAFYC regulations regarding governmental accounting, control and responsibility systems and substitutes these regulations through a new system called “Sistema de Control, Fiscalización y Auditoría del Estado”. Regarding financial management issues, this Law abrogates prior legal dispositions regarding governmental accounting and defines MEF as the primary oversight institution for the accounting system. (Art. 13)

ANNEX II

NO OBJECTION TO PUBLICATION AND COMMENTS FROM GOE



Oficio No. MEF-SGE-2004 7387

Quito, 17 DIC. 2004

Señor
Marcelo Giugale
DIRECTOR DE PAÍS PARA ECUADOR
BANCO MUNDIAL
Presente

Estimado Marcelo:

El objetivo de la presente, es comunicarle que el Ministerio de Economía y Finanzas, a través de la Subsecretaría General de Economía, no tiene objeción a la publicación del Informe "Evaluación de la capacidad de la gestión financiera gubernamental", preparado conjuntamente por el Banco Mundial y el Banco Interamericano de Desarrollo.

El borrador del Informe fue presentado, en mayo de este año, a funcionarios de instituciones del sector público ecuatoriano y ha recibido comentarios al interior del MEF, los mismos que adjunto a la presente y que han sido enviados a los autores para su análisis e incorporación correspondientes.

Quiero, a través de usted, comprometer a los autores a realizar una presentación de las principales conclusiones del estudio, con el fin de difundirlas para que la sociedad ecuatoriana en general, y el sector público en particular, discutan y obtengan el mayor provecho de las recomendaciones que ahí se hacen.

Atentamente,


Javier Jaime Barrios
SUBSECRETARIO GENERAL DE ECONOMÍA

Comments of the Ministry of Finance on the Country Financial Accountability Assessment Report¹**I. General comments on public sector financial management**

1. The Country Financial Accountability Assessment (CFAA) is a valuable tool for strengthening government financial management, addressing as it does all aspects of financial management.
2. There is general consensus at the Ministry of Finance (MEF) on the need to enact and implement a new public financial management act. The current Fiscal Administration and Control Act (LOAFYC), in force since 1977 (not 1997 as stated in the document) is obsolete and in most respects not in keeping with the modernization of the legal framework. It is recommended that a process similar to the one used in drafting the proposed Fiscal Accountability and Transparency Act (LOREYTF)² be used to draw up the new bill.
3. The LOAFYC is fully consistent with the systematic, integrated approach it embodied, which applied until 1992. Previous consultants have found that this legal framework began to weaken in 1992 and gradually lost its systemic, integrated focus through the passage of related legislation such as the Budget Act. The situation was exacerbated by the earmarking of most tax revenue, which left little room for the economic authority to maneuver.
4. The current legislative situation should be viewed as an opportunity to complete the government's initiative to modernize the legal framework by enacting and implementing a new public financial management act, without which this recommendation cannot be implemented.
5. The summary of principal findings states that a fair number of government activities are not reflected in the budget. Those activities need to be stated even though they may be identified in the body of the document. It is worth noting that this year, for the first time, the MEF prepared a budget annex to be provided to the legislature and the general public.

¹ These comments also include the opinions of:

Jorge Recalde Yépez, Deputy Secretary for Government Accounting

Ma. Eugenia Navarrete, Deputy Secretary for Public Credit

Roberto Iturralde, Deputy Secretary for Economic Policy

Max Lascano, Coordinator, Office of the Deputy Secretary for Public Investment

Paula Suárez, Consultant, Office of the Deputy Secretary for the Economy.

² We recommend that this acronym be used to refer to the Fiscal Accountability and Transparency Act. We also ask that the acronym SGP be avoided.

II. Public debt management

1. Paragraph 2.61(2) states that debt information is available only for the nonfinancial public sector (NFPS) and concludes that the MEF's information on public debt is incomplete because it fails to reflect all public debt. The information on external public debt is complete and covers the financial and nonfinancial public sector, the central government, subnational governments, and other public-sector entities, as well as direct and indirect debt. With respect to domestic public debt, only the central government's public debt is included.
2. Paragraph 2.65 states that public debt is registered both at the MEF and at the Central Bank of Ecuador (contract registry), as the LOAFYC and LOREYTF both mandate, and recommends that debt be registered at the MEF alone. Because the Office of the Deputy Secretary for Public Credit is not in a position to analyze private external debt, the Central Bank should continue to perform this function.
3. Paragraph 2.72. It should be noted that the MEF has drawn up two public debt reduction plans, the first in 2003 and the second in 2004, in accordance with the LOREYTF and its implementing regulations.
4. Paragraph 2.66. Several commissions and committees have been created to coordinate the country's borrowing policy and implement the LOREYTF.
5. Paragraph 2.67. However, there is no single committee that would establish overall debt strategy and borrowing policy. Some commissions have met occasionally, while others are not functioning at all.
6. With respect to the comments in these two numbered paragraphs, the absence of permanent technical secretariats may be one reason why some high-level commissions are not functioning. No commission, apart from the Stabilization, Productive and Social Investment and Public Indebtedness Reduction Commission, has a technical secretariat. There is agreement that there should be a single interagency committee to set overall debt strategy and borrowing policy and whose technical secretariat would be based at the MEF.
7. Paragraph 2.72. It should be noted that the MEF has so far developed two debt reduction plans based primarily on aggregate macroeconomic indicators. The first plan was for 2003, and the second for 2004.
8. Paragraph 2.75. It should be noted that the interface is operational between the debt management software (SIGADE) and the Integrated Financial Management Information System (SIGEF), which reflects data on amounts disbursed and debt service of principal and interest that could be provided by SIGEF.
9. The new borrowing policy and strategy should be based on an assessment of borrowing capacity. In addition, experiences from various negotiations could be

documented so as to create an institutional memory. Procedural manuals could be prepared that would specify functions, rules for recording debt-related information, and debt-service payment procedures.

III. Cash management

In order to improve capabilities with respect to cash flow planning and spending supervision, it is recommended that responsibility for central management of periodic cash flow plans be transferred to the Office of the Deputy Secretary for Cash Management. Effective coordination between the Cash Management and the Budget Departments and the Central Bank is necessary to (i) maintain a proper payment mechanism through a consolidated account managed by the Central Bank, as well as (ii) strengthen the mechanisms for cash flow management and spending supervision.

IV. Public investment

1. The penultimate line of paragraph 2.56 states that the Office of the Deputy Secretary for Public Investment (DSPI) is responsible for “monitoring” investment project execution. The word “monitoring” is not correct; what it actually does is track investment project execution.
- 2.. Paragraph 2.57 indicates that the DSPI has established procedures for validating projects before their incorporation into the budget, and mentions a process involving an internal committee. It should be clarified that the DSPI validates projects financed through domestic and external borrowing, which are subsequently incorporated into the budget. Projects financed with tax revenues are included in the budget with the ranking assigned by the National Planning and Development Department (SENPLADES) and the relevant government agencies when the annual investment plan is prepared.
3. Both the Constitution and the LOAFYC provide that the National Planning Office (ODEPLAN) determines the specific programs to be included in the national budget. In practice, ODEPLAN has not succeeded in coordinating development plans or securing decisions on recurring and capital expenditures according to the sector priorities it recommends. The decision to link annual institutional plans to the costs of budgeted activities would require significant interagency coordination and cooperation in several areas, including legislation. This effort would fall to ODEPLAN, but its record indicates a weakness in leading such a process.
4. *However, as mentioned elsewhere in the CFAA, the mechanisms and procedures for incorporating projects into the national budget as amendments during the fiscal year are not well enough defined. Since the DSPI does not validate these mechanisms, they would also need to be defined.*

V. Accounting and financial reporting

1. In order to begin putting public finances in order, a single, integrated financial management system with connectivity features in keeping with current technology would need to be developed. The purpose of the system would be to establish, implement and maintain the collective standards, organizations, programming, direction and coordination of government budget and accounting procedures in the public sector institutions and entities.
2. The basic objectives of the new system should be to (i) manage public resources within a framework of accountability and transparency; (ii) establish mechanisms for coordination among public institutions in order to promote economy, efficiency and effectiveness; (iii) generate timely information for decision making; and (iv) provide effective instruments to support fiscal and financial budget assessment.
3. As the foregoing clearly indicates, the government's economic policy is implemented through the budget. In order for the budget to serve as an effective policy instrument, budget execution should be monitored in order to assess such things as the quality of spending and budget efficiency (e.g. variations between budgeted and actual performance).
4. These actions make use of the financial statements produced by the accounting function. Another important consideration is that the accounting function should serve as an instrument for cash planning, cash flow, effective cash management and, of course, disbursements for domestic and external debt service, thereby promoting interaction at home and abroad. Budget outturn and the consolidation of government accounts can then reflect the country's true position.
5. The legal framework should be consolidated and reshaped to provide the economic authority with express powers to assess penalties in regulating public finances and require oversight authorities to cooperate in accomplishing these goals.
6. The report notes that while SIGEF has contributed to order and discipline in administrative and financial functions at the executing unit level, basic problems persist as to the system's conceptual design that limit its effectiveness as a management tool to promote accountability and transparency in financial management. The report identifies three weaknesses:

a. Lack of commitment controls during budget execution:

- i. The report reflects a conceptual error: A "commitment" is defined under Ecuadorian law as a valid administrative act whereby the competent authority decides to procure goods, services or works from third parties; this results in a budget

appropriation which remains provisional until it becomes an obligation, and is monitored and supervised by each executing unit.

- ii. Commitment controls therefore do exist during budget execution—implicitly in certain cases, when the same entity recognizes the expenditure at the time the payment obligation arises, and explicitly in others, when an administrative act or contract to purchase goods or services is signed. These result in budget appropriations which remain provisional until they become obligations through the acceptance of the goods, services or works, and may be cancelled by the same contracting authority.
 - iii. Information on commitments incurred is reported to the budget oversight body on a monthly basis as part of the financial information submitted by all financial entities under the existing procedures using the institutional SIGEF Institutional or through the SIGEF Web integrator. The latter system is used by NFPS institutions without access to the institutional SIGEF to submit information produced by other existing systems or manual procedures.
 - iv. In Ecuador, the prescriptive role of the oversight body is combined with operational decentralization, which gives discretion and primary responsibility to the executing units. This leads to certain compatibility issues which should be addressed by strengthening the formulation of standards.
- b. *Accounting entries are not generated automatically during the budget cycle*
- i. This is certainly true; the system should accommodate this requirement, which would improve the reliability and timeliness of the financial statements.
 - ii. The entries generated in budget accounting systems—such as Mexico’s well designed system—provide for budget control in the financial statement itself through the use of suspense accounts. This involves the use of a single document that meets the needs of all readers.
 - iii. Under the current approach to conducting the analysis, the budget is taken as the consolidation of all registers, in which the ledgers and all transaction data are maintained. When economic policy should co-exist as the focus of

government policy, it is reflected in the government's budget as a projection and represented in reality by the financial statements. This facilitates budget execution and analysis of planned versus actual that indicates the extent to which the government achieves its policy goals.

- iv. In my opinion, the remarks by the report's authors stem from conceptual differences as to the nature of the accounting function; the Ecuadorian system provides for accrual accounting, rather than budgetary accounting.

c. *Technological platform*

- i. The SIGEF system was designed and developed according to a conceptual framework adopted and supported by legal provisions and is based on a stable, proven system architecture representing current technology at the time it was developed (1996). The system is based on technical studies approved by the then-Minister of Finance and Council on Modernization of the State, with the support of World Bank consultants and Leonardo Sánchez, a Chilean auditor working with a team of local experts in public sector financial management.
- ii. The design of SIGEF as the basic tool for public sector financial management incorporates a decentralized model of financial management in which responsibility rests with the financial entities that execute the plans and programs.
- iii. However, aggregation and consolidation of information within the apex agency was also considered, and it was decided to do so "initially" through periodic (monthly) delivery and receipt of data files; this is the reason for the existence of SIGEF Global, which remains unfinished to the detriment of the entire process.
- iv. Given the technological advances in communications systems and system platforms, a system redesign involving process integration is essential.
- v. The administrative systems rarely provide sufficient information for decision-makers, such that decisions are frequently made in an arbitrary fashion. Modifications to improve access to reliable information for financial transactions may be delayed for extended periods of time. Accordingly, the problem must be addressed on a sustained

basis, rather than sporadically. In other words, the redesign of SIGEF's functions and upgrading of its technological platform should be assessed as the system's coverage evolves over a period of one to two years. Thereafter, early warning indicators should be implemented to signal the existence of problems of coverage and quality of information.

7. The report maintains that the information provided by the Office of the Deputy Secretary for Government Accounting is unreliable, as well as incomplete and out-of-date. This should be reviewed over time, objectively, and in the full knowledge that the information produced by this administrative, not transactional unit merely aggregates and consolidates the information provided by NFPS institutions, and continues to use manual procedures due to the lack of consolidation tools to simplify presentation of the information. The source of the unreliable information is within the institutions, and it is this situation that must be changed by providing flexible, standardized, automated, online tools.
8. Beginning in January 2001, considerable efforts have been devoted to changing this situation: the installation of a new integrated financial management system, which initiates a transaction phase and would require an aggressive installation and rollout phase, accompanied by a considerable number of training events to improve the caliber of civil servants working in public sector finance and the implementation of operational tools to validate the information received, resulting in a high level of confidence in its reliability.

SUMMARY OF TRAINING ACTIVITIES FOR THE YEARS 2002, 2003 AND 2004

GOVERNMENT ACCOUNTING COURSES

Year	Number of Events	Invitees		Attendees	Number who Passed the Course			
		Institu-tions	Indivi-duals		No.	%	No.	%
2002	29	597	1157	958	818	85.4	140	14.6
2003	39	1169	1608	1503	1181	78.58	322	21.42
2004	44	134	270	207	154	74.4	53	25.6

The training activities carried out by the SCG are shown in the above table.

9. However, implementation of a program to strengthen the capacity of the Office of the Deputy Secretary for Government Accounting and the audit units should draw upon the conclusions of World Bank reports on observance of standards and

codes (ROSCs) for Ecuador's business sector, which make three recommendations: (i) strengthen professional accountants' ability to comply with accepted accounting and audit standards, particularly by improving academic curricula in this area and establishing continuing education requirements for all certified accountants, which is unusual among professional accountants; (ii) establish a professional examination process as a prerequisite for licensing auditors; and (iii) establish an auditor oversight board under the MEF to provide effective oversight of professional auditors' compliance with legal and professional obligations.

10. Coverage has increased substantially from 2001 to 2004, and efforts to monitor the quality and consistency of information are planned to begin in 2005 under a private system in which account analysts would be put in charge of certain entity segments and be responsible for improving the timeliness and reliability of information produced by the entities and received by the MEF.
11. The mechanism identified in the preceding paragraph will begin to remedy resource inadequacies at the Office of the Deputy Secretary for Government Accounting in terms of number and qualifications of civil servants, such that it can perform its functions efficiently and effectively.
12. In addition, the fundamental purpose of the information and the reason it is produced and processed is to make it available to the various users. Support for the development and implementation of the management systems to achieve these objectives is therefore indispensable, as is consolidation of the MEF portal.
13. The new design should keep the information online while integrating all processes and automating the transaction records. This will enable financial statements to be generated in real time so as to keep institutional databases online and available. The Comptroller General could use the information as a direct tool for review, analysis, early identification of irregularities and appropriate action, and prioritizing audits. For the central agencies that need to make decisions on the basis of this data, intensive use of communications will help to make the key information available in real time.
14. The report cites the need to reverse the financial system's logic, such that accounting transactions are an automatic byproduct of budget execution. Herein lies the main difference in opinion; the accounting function is much more than budget execution. The difference arises from adjustments for the use of fungible and nonfungible assets, amortization of intangible assets, recording of financial transactions not involving accruals, restated items, cumulative project and program costs, etc. Notwithstanding the foregoing, a mechanism to automatically record accruals in the accounting records should be considered.
15. The report's statement that Ecuador's budget commitments are recorded only when the accounting entries are recorded is not completely accurate.

Commitments made by the parties' expression of intent to do or buy something do not warrant an accounting entry under our methodology; economic events are not recorded until the transaction in goods or services between sellers and buyers occurs, or when adjustments are made as indicated above.

16. *Expansion of the interbank payment system to cover all types of outflows for every category of expenditure is advisable to eliminate revolving accounts and the use of checks and optimization of resources. This effort will be addressed in the final phase of the process.*
17. Programs should be designed and implemented to strengthen the capacity of the Office of the Deputy Secretary for Government Accounting, focusing on improving the accounting framework, ensuring appropriate staffing in terms of number and qualifications, and providing the technological tools to continually improve the completeness and timeliness of interim and annual consolidated financial statements.

VI. Additional comments

1. It has already been noted that the Office of the Comptroller General (CGE) has not performed its duties to the fullest, despite the new responsibilities attributed by law. Accordingly, it is unrealistic to suggest that the CGE could restructure and alter its procedures in a manner compatible with its mandate, to eliminate the practice of ex ante review of public sector procurements and pay greater attention to financial interventions and special audits. Restructuring of an entity like the CGE is imperative.
2. The implementation of mechanisms to support and encourage public demand requires the development of user-friendly ways of training and educating the public, the establishment of suitable channels for members of the public to express their concerns, and mechanisms for receiving suggestions from the public, without which the desired objectives cannot be achieved.
3. In order to reduce the risk of diverting resources to extrabudgetary activities lacking oversight and transparency, entities should be required not to leave activities unrecorded in the budget. A code of "good governance practices" should be instituted to this end. Currently, the Department of Production has instituted a process to raise public corporations' awareness of "good practices;" this recommendation can be included in the code and disseminated in this manner.
4. Finally, the internal control framework must be made more robust. This requires an expansion of its goals to include conducting operational and administrative audits, identification and evaluation of internal control systems, following up on recommendations, and adherence to the principle of independence and ethical standards.

5. With respect to civil society, the MEF is committed to transparency and has undertaken several activities to this end: dialogue with civil society, making tax restrictions transparent, and design of the MEF portal, which will focus on meeting the needs of internal and external users.

