

**Restoring Financial
Accountability:
A Time for Change?**

June 2013





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promotes good governance,
transparency and
accountability in the use
of public funds

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EXECUTIVE SUMMARY

“Change is the law of life and those who look only to the past or present are certain to miss the future”

John F. Kennedy, 35th President of the United States

Since the introduction of the *Public Management and Finance Law* (the “PMFL”) in 2004 the Government and the wider public service has struggled to meet its requirements to provide accountability for the management of its financial resources. Whilst budgets have continued to be set and authorised by the Legislative Assembly every year, reporting the achievement of results against those budgets has never been effectively achieved in nine years leading to a breakdown in accountability to the Legislative Assembly, the residents of the Cayman Islands and other international interests. Without having the ability to report credible financial and operational information on a timely basis, the basic principles of public financial management are ultimately undermined.

Whilst there has been progress in the last couple of years, there are still significant challenges for the Government to establish a regime that will provide effective accountability, let alone what was envisioned under the PMFL. The results of the work we have been performing over the last nine years and outcomes from other reports prepared for Government have clearly indicated to me that there is a need for change to the financial framework that supports the principles in the PMFL, and to consider what the framework should look like to:

- enable sustainable financial and performance management, accountability and transparency for the use of public resources; and
- provide this in an economic and efficient manner for a jurisdiction the size of the Cayman Islands.

In my view the Government’s financial and performance management framework needs to be fundamentally revised with a more straightforward and less complex model. Ultimately it is up to Government to review and consider what the framework should look like and ensure it meets the needs of its stakeholders. This report provides my considered opinions on actions that I believe Government should consider taking to deliver a more sustainable framework for the management of public resources.

These considerations include:

- simplifying the financial and performance reporting framework for core government;
- simplifying the budgeting framework;
- developing a practical performance reporting framework;
- providing leadership, clear roles and accountability for the implementation of an effective financial and performance reporting framework across the public service;
- implementing shared services across core government and the wider public sector;
- strengthening accountability and responsibility across government for complying with the financial and performance reporting framework; and
- implementing additional transparency measures around the use of public resources.

Since being appointed Auditor General, it is evident that restoring trust in Government and the public services is important to the people of the Cayman Islands. I believe that the recommendations made in this report would help Government to achieve that outcome.

INTRODUCTION

1. Over the last five years the OAG has reported extensively on the progress by Government to implement the requirements of the Public Management and Finance Law (“PMFL”) with respect to the reporting of performance and financial results of Government and its entities. Our reports have discussed problems with the implementation of the PMFL while identifying and reporting on significant issues that have shown a breakdown in accountability for use of public resources by Government since its introduction in 2004.
2. As we have most recently reported there has been progress to the restoration of accountability over the last two years. However there are still significant gaps in the accountability of Government for its use of resources: in particular the audited consolidated position for the whole of Government has never been publicly reported in over eight years, leaving legislators and citizens with no reliable information on how Government has generated and used significant public resources. Until financial reporting and broader performance reporting is effectively achieved across the public sector in line with statutory timetables, and in particular reliable financial statements for the consolidated position for the whole of Government are produced, accountability by the Government for its use of all its resources will not be achieved. There will also continue to be significant risks to the efficient, effective and appropriate use of those resources.
3. We have previously made a number of observations and recommendations on the strategic issues that need to be addressed to enable a sustainable financial and performance management and accountability framework for the public service. For example, we have made recommendations around:
 - leadership of the financial function; and
 - developing a strategic plan and timeline for providing timely credible financial reporting.
4. This report builds on our previous reporting and highlights the key issues which we believe the Government should address in respect of: strengthening of the financial function; and the development of the financial and performance reporting, to ensure that effective accountability is restored and maintained, that it is resilient, and it promotes the efficient and effective use of resources.

5. As the Auditor General, it is normally not my role to be prescriptive in my recommendations. However, because of its importance to the future of the Cayman Islands, the significant time since the introduction of the PMFL and the continuing deficiencies in the framework I am taking this step to suggest some options that should be considered to ensure that the Cayman Islands has a financial and performance management framework which meets the needs of its stakeholders.
6. This report is based on the findings and observations from our audit work since the introduction of the PMFL and contains some broader considerations around the right fit for Cayman and the efficiency of the framework.

BACKGROUND

7. The PMFL was introduced in 2004 with the objective of advancing management of public resources and accountability by introducing an improved budgeting and accounting framework linked to a performance management system.
8. The need for improvement in financial management was identified in the late 1990's when it was realized that separate initiatives for change had not been successful and a more holistic approach was necessary. At that time a number of problems were identified with the central one being that the management system was not focused on performance. In addition the strategic policy priorities of government were not clearly outlined, the budget process was poor and there was no top down direction given to departments. There was little fiscal discipline and supplementary appropriations were common place.
9. It was also recognized that the roles of ministers, chief officers and the heads of departments were not well defined. There was confusion as to who was responsible for the day to day operations of government and performance expectations for civil servants were not clearly linked to the priorities of government.
10. Due to many services being centralized, managers at the time were not able to appoint or discipline staff which created difficulties in holding them accountable for entity performance. There was no annual reporting that linked back to performance expectations.
11. In response to these problems and others identified at the time, the PMFL was enacted. In summary the Law had four main objectives:
 - redefine performance to focus on results;
 - develop stronger strategic processes linked to the budget;
 - clarify roles; and
 - establish effective accountability mechanisms.
12. The PMFL included clear roles and responsibilities for government officials, who could then be held accountable for the management of public resources. It also provided a means for government entities to operate more business-like, and it introduced modern public sector financial management concepts that would lead to significant changes for organisations, skills and management capacity.

13. The introduction of the PMFL required significant changes for a new financial framework including:
- all financial statements produced in line with internationally recognized accounting and reporting standards, on a full accruals basis;
 - individual annual ministry/portfolio financial statements;
 - quarterly reporting of results to the Legislative Assembly;
 - budgeting and reporting on the basis of outputs; and
 - increased need for accounting expertise within government.
14. The introduction of the PMFL significantly increased the financial and performance accountability reporting requirements for the Government. Each ministry, portfolio and office within core government has been required to prepare a set of annual financial statements on an accruals basis and in accordance with International Public Sector Accounting Standards, and a set of output statements to report their performance (until its suspension in 2011). Each entity in core government is also required to prepare an annual report that includes the financial statements and information explaining its performance. Additionally, the Government is required to prepare a consolidated set of financial statements that includes all the statutory authorities and government companies (SAGCs) and the executive transactions (the transactions for which Cabinet is directly accountable for).
15. Prior to the introduction of the PMFL, core government produced one set of financial statements on a cash basis. Whilst straightforward to prepare and understand, and not requiring the same level and quality of professional accounting resources, cash accounting does not provide a holistic view of the financial condition of an entity. The information in cash based financial statements is easy to manipulate and provides incentives for politicians to ignore medium to long term liabilities while focusing on short term cash outlays, thus potentially creating the illusion of current solvency while not reporting on future financial challenges. The sovereign debt crisis of recent years, and the exposure of governments, can be attributed to a significant degree to their archaic cash accounting practices and inability to understand their true financial condition. The benefits of an accruals based public sector accounting system include:
- providing complete financial information;
 - enabling better planning, management and decision-making;
 - providing an ability to change behaviours; and
 - enabling an assessment of financial resilience.
16. Prior to 2004, the Government prepared 16 sets of financial statements, including SAGC's. Since the introduction of the PMFL in 2004, the number has now increased to 43.

THE OBJECTIVES OF THE PMFL HAVE NOT BEEN ACHIEVED

17. I believe that most stakeholders agree that the objectives behind and the principles underpinning the PMFL are essential for delivering effective financial and performance management of Government and ensuring there is strong accountability for the management of public resources. If its objectives had been achieved, it would have put the Cayman Islands at the forefront of public financial management, with many G20 countries still struggling with the move from cash to accruals based accounting.
18. However, over the past nine years, my Office has reported that the PMFL has not delivered the benefits it was designed to in the management and accountability for Government resources. The evidence of this has been plain to see with entities struggling to present reliable, credible and timely financial and performance information. Whilst the intent of this report is not to discuss all the issues that have been identified, some of the clear examples that effectively demonstrate that the system has not worked include:
- Audited entire public sector financial statements have not been presented to Legislative Assembly since the enactment of the PMFL.
 - Ongoing delays and quality issues with entity financial statements.
 - Quarterly reporting of financial results as required by the PMFL was never implemented (and has now been suspended).
 - There have been significant delays in tabling annual reports or annual financial statements in the Legislative Assembly once audited. In most cases, annual reports have not even been prepared.
 - The links between the Strategic Policy Statements and the outcomes desired by the Government and the outputs included in the budget statements are unclear and disjointed.
 - The output budgeting process is cumbersome, time consuming and complex.
 - Reporting on the basis of outputs was never effectively implemented and has not been achieved in any meaningful way.
 - For budgeting and management purposes, there are a large number outputs and associated measures that aren't focused on the key outcomes and deliverables of the Government. A large number of the output measures also do not report on results of what has been delivered to citizens, but more on the activities of government.

- There has been little or no attempt to report on outcomes; the information needed to demonstrate that the Government’s programs and initiatives are delivering the results promised and that demonstrate their effectiveness (for example reporting on indicators that demonstrate the desired outcome of “improved public health”).
 - A sizable increase in the cost of human resources to manage the financial function in government entities, with no clear tangible benefits so far.
 - Significant internal control weaknesses in many entities of Government resulting in risks of error and loss of public resources.
19. The economic downturn has brought these issues into stark relief with the need for reliable financial information at a premium to enable ministers and officials to make effective decisions, and the desire for legislators and citizens to know where their resources are being used.
 20. We have previously reported on the lack of accountability and transparency in the use of government resources to deliver outputs and outcomes for citizens, and on the issues and causes that have contributed to various failures in the system to deliver its desired objectives.
 21. In effect, my Office’s reports since 2008 have included consistent findings and messages that demonstrate that Government officials have not implemented appropriate financial management and reporting practices as required by the PMFL.
 22. While there have been improvements in the timeliness and quality of entity financial information in the last two years, there is still a significant journey toward the achievement of sustainable financial and performance management and accountability, and achieving the objectives envisioned by the PMFL. At present it is my view that there is a significant risk that the Government will ever complete this journey.
 23. The complexity of the PMFL’s financial framework has proved challenging for the Government to implement such a large scale undertaking. When the PMFL was first introduced there was no parallel running of systems and frameworks to provide an opportunity to iron out challenges and issues of the new financial regime prior to full implementation. With the passage of time, it has become increasingly difficult to implement certain provisions of the PMFL with critical components being suspended over the last few years as Government was unable to implement them effectively.
 24. The move to accruals budgeting and reporting from a cash basis is a significant challenge for most jurisdictions in itself. In the Cayman Islands, the move from cash based to accruals based budgeting and accounting was also undertaken at the same time as the move to output budgeting and reporting. This was closely followed by a significant increase in the number of entities within core government that were required to report individually and internal charging was adopted for services within core government.

25. Therefore the key questions that I believe need to be considered are:

- whether sustainable financial and performance management and accountability is truly achievable under the current PMFL framework;
- is the PMFL financial management and reporting framework the right one for the Cayman Islands; and
- if it can provide effective accountability and transparency for the use of public resources in an economic and efficient manner.

26. Whilst poor implementation, leadership and management have been contributors to the absence of accountability over the last nine years, it is my view that the PMFL is too complex for the Cayman Islands Government to deliver effective accountability and transparency for the use of resources.

LOOKING FORWARD

27. In my opinion, the financial and performance management framework needs to be fundamentally revised with a more straightforward and less complex model that addresses the following basic principles:

- meets the needs for effective management of the Cayman Islands Government;
- enables sustainable financial and performance management and reporting;
- operates efficiently and effectively; and
- implementable by Finance officials within a reasonable timeframe.

28. In doing so the Government should consider some of the key attributes that a strong financial framework delivers: It produces **credible** financial information that is **understandable**, **useful** and available on a **timely** basis; the financial information is subjected to **analysis** by the people in the finance function, with the resultant advice integrated into the decision making process; and the financial information is assembled with **efficiency**, using technology to the greatest extent possible.

- **Credible:** Financial information produced by the finance function, both for internal use and publication externally, should reflect financial reality. Put simply, users must be able to believe it. Credible financial information is achieved through consistent application of generally accepted accounting principles. Credibility is also evidenced through an opinion, without modification, from an independent auditor.
- **Understandable:** The financial information produced by the finance function should be concise, succinct and crafted in a way that users with a reasonable knowledge of the organisation can understand. It should contain enough information for analysis, but not too much detail. In other words, users should not be intimidated by massive amounts of detail, when they simply need a financial overview.
- **Useful:** User friendly indicators of financial health can help readers of government financial statements recognize the significance of the numbers shown.
- **Timely:** To have a chance of making a difference or influencing events, sound financial decisions must be made as soon as possible after problems are identified. The financial information produced by the finance function should therefore be available as soon as possible after the reporting period ends, taking into account the costs of doing so.
- **Analysis:** Good finance functions should be integrated into management decision making. With the advances in technology requiring less manual intervention they should be freed up to analyse and interpret financial information and to make recommendations to management. Increasingly finance functions are more focused on the future than on the past.

- **Efficiency:** Financial information should be accumulated and reported as quickly and economically as possible, and should be capable of timely use for analytical purposes. Little time should be required to process period end adjustments, with more time devoted to analysis and advice.

29. Ultimately the framework should enable the Legislature and other stakeholders to effectively scrutinize the plans of Government and subsequently hold them accountable for the resources authorised and used to deliver those plans.

30. The recommendations contained in this section provide my considered thoughts on the actions that Government could consider taking through the implementation of revised legislation and/or administrative policy to deliver a sustainable framework for effectively and efficiently managing public expenditure. My recommendations are based on our audit findings and our experience with the audit of various frameworks in other jurisdictions while taking into account the recommendations made in previous reviews and audit reports.

SIMPLIFY THE FINANCIAL AND PERFORMANCE REPORTING FRAMEWORK

STREAMLINE FINANCIAL REPORTING

31. With respect to the presentation of financial statements we fail to see the public need for each individual ministry and portfolio to prepare separate International Public Sector Accounting Standards (“IPSAS”) compliant financial statements, to enable effective decision making on the use of resources or to provide effective accountability to stakeholders.

32. Preparing IPSAS financial statements is technically complex and only required when there is a clear need for public accountability for a particular entity that has full responsibility for the resources it is accounting for. Therefore, we believe that accountability could effectively be achieved through the provision of one auditable IPSAS compliant set of financial statements for the whole of core government (excluding the independent offices), containing appropriate segment reporting for each ministry and portfolio, and clear reporting against the appropriations voted by the Legislature. In conjunction with this step, Government should also consider the following:

- preparation of a Management Discussion and Analysis which provides a commentary on the results provided in the financial statements and other matters, including prospective fiscal information. It is worth noting that the IPSAS Board are planning to issue a new standard which will make the preparation of a management discussion and analysis, a requirement of public sector entities preparing financial statements under the IPSAS framework;
- Implement a number of other transparency measures discussed at paragraph 66; and

- Implement a framework of formal delegated responsibilities and accountabilities across chief officers, heads of department and financial officers linked to the provision of assurances to the officials principally accountable to the Legislative Assembly for the use of financial resources (Deputy Governor/Financial Secretary). These assurances could include, for example, the state of internal control, compliance with laws and regulations, and compliance with accounting and financial reporting requirements.
33. With respect to quarterly reporting of results, this should be reintroduced to promote transparency and accountability throughout the financial year, but again at the core government level. Quarterly reports should not require full IPSAS compliant financial statements, but be focused on the primary schedules included in financial statements and key disclosures including segment reporting (financial information at the ministry and portfolio level) along with key operating ratios and indicators of financial performance. With the maintenance of a well-functioning accounting system including good internal controls, we believe the quality of interim quarterly reports to the Legislative Assembly would be an extremely valuable tool to inform Members about the administration's management of public resources. This is discussed further in the next section.

STRENGTHEN MANAGEMENT ACCOUNTING AND REPORTING

34. The system of financial accountability needs to be supported by robust and timely management accounting, cash management and monthly financial reporting to support effective decision making by senior government officials and Cabinet.
35. The reliability and timeliness of financial information available to support decision making has been seriously deficient. Through our financial audits over the last nine years, my Office has identified significant issues with the financial records that have been maintained across government, which apart from impacting significantly the ability to produce reliable and credible annual financial statements, have effectively undermined the financial information available for decision making at the entity level, the core government level and at the Legislative level. While I do not discuss the specific issues in this report, it is suffice to say that the lack of good internal controls and a well-managed accounting system have contributed significantly to the poor quality and timing of the financial reports of Government.
36. By simplifying the financial management framework (which we discuss in more detail later in this report), senior finance officials would be able to focus on implementing effective internal controls and providing reliable monthly financial information with sound financial analysis to aid effective decision making.

SIMPLIFY THE BUDGETING FRAMEWORK

37. The budgeting framework should provide legislators and other stakeholders with information about how the Government has allocated resources to deliver its policy objectives and desired outcomes. It should clearly communicate where and how Government plans to get its revenues and how much it plans to spend on the programs and services it would like to deliver so that Legislators can make informed decisions on the nature and scope of Government's operations.
38. A sound budgeting framework should promote robust cost control and sound financial management, and most fundamentally, enable legislators to:
- effectively scrutinize and authorise the resources that Government can use to deliver its objectives; and
 - hold the Government accountable for the use of those resources.
39. It is my opinion that the Government needs to simplify the current budgeting framework. I have reservations about the output based budgeting framework and at a minimum I believe it needs to be radically simplified by having the framework:
- focused on key outputs, which are results focused ;
 - better linked to the plans of the elected Government and the measureable outcomes it desires to achieve;
 - having output and outcome measures that are SMART (specific, measurable, achievable, reliable and time-bound); and
 - giving consideration to having administrative functions (e.g. finance, human resource management) managed by the cost of the services rather than using outputs.

DEVELOP A PROPORTIONATE PERFORMANCE REPORTING FRAMEWORK

40. Jurisdictions across the world struggle with effective performance reporting and this is an area that continues to evolve and develop. However it is fundamentally important that Government reports on its overall performance annually, and not just its financial results, to ensure effective accountability for their policies and the use of resources. This needs to be done in a way that it is meaningful to legislators, citizens and other stakeholders.
41. It is our view that the Government should consider designing and implementing a system of performance reporting based on measuring the achievement of the high level impacts and outcomes as set out in the Strategic Plans, and not just on outputs. It should also ensure that there is effective and transparent reporting of spending against the appropriations authorised by the Legislative Assembly along with cash and debt level requirements.

42. This could be achieved through a combination of narrative reporting and the use of a small number of high level key performance indicators and measures which demonstrate the results achieved and progress towards the desired outcomes.

DO NOT SEPARATELY MANAGE AND CLASSIFY EXECUTIVE AND ENTITY TRANSACTIONS

43. The PMFL classifies Government's financial transactions and account balances in one of two categories: Entity or Executive. The PMFL defines the two categories, but in essence entity financial transactions and account balances are those that the individual ministry or portfolio incur or control in order to produce outputs, and which chief officers are directly accountable for, whilst executive transactions are financial transactions and account balances the Governor in Cabinet i.e. Ministers, incur or control in order to purchase outputs from ministries and portfolios or other suppliers, and to pay for expenditures authorised by legislation or regulations.
44. This distinction adds complexity to the financial framework, with each ministry and portfolio required to effectively keep two sets of financial records, one for the individual entity and one for its related executive transactions. In addition to these challenges our current governance audit has highlighted that:
- whilst chief officers are clearly accountable for ensuring adequate controls are in place over entity expenses, in practice executive expenses are not always subject to the same controls and that each executive expense is handled differently; and
 - there is at times a blurring of the lines between the roles of Ministers and Officials in the administration of entity and executive transactions, contributing to a lack of accountability.
45. Executive transactions and account balance are only reported through the Entire Public Sector Financial statements. Therefore, there has never been any accountability for these transactions and balances since the introduction of the PMFL. In other words, for over eight years, government has not provided any audited information to the Legislature or the public relating to the actions taken and spending of public funds by the Governor in Cabinet.
46. It is our opinion that the distinction of transactions and account balances between executive and entity be removed with the introduction of other compensating checks and balances such as having the Governor in Cabinet approve specific types of transactions e.g. the sale of government assets (over specific limits).

RESTRUCTURE GOVERNMENT FINANCIAL FUNCTIONS

LEADERSHIP OF THE FINANCIAL FUNCTION

47. Whilst the recent improvements in the production of annual financial statements have stemmed from direct action and leadership, there has been over the period since the introduction of the PMFL a lack of clarity, understanding or acceptance over the responsibility for ensuring effective financial management and reporting across government. It has been our view that the PMFL provided responsibility to the Ministry of Finance for ensuring the effective implementation of the framework.
48. However, we believe there is a need to explicitly assign administrative responsibility for ensuring the effective operation of the financial function including the implementation of the financial framework outlined in the PMFL or as it might be amended. The individual assigned should be responsible and held accountable for ensuring the effective implementation of the financial framework, and should have a direct line of accountability for the effective operation of the financial function and financial framework to the Deputy Governor, who as the as the Head of the Civil Service, is ultimately responsible for its effective administration.

STRENGTHEN THE CENTRAL FINANCIAL FUNCTION

49. From the issues we have encountered during the financial audits, we have come to the conclusion that there is a need for a strong central financial function responsible for ensuring the effective operation of the financial management and reporting framework, including responsibility to ensure that resources are being managed within the limits prescribed by legislation. The central finance function should be responsible for directing the financial reporting requirements across the whole of the public sector, including the statutory authorities and government companies. We envision that a stronger central financial function would have as some of its main responsibilities:
- oversight of financial management and reporting (including cash management) across government;
 - ensuring effective continuing professional development of finance professionals across the core government and wider public service;
 - setting appropriate accounting policies and directives that would ensure compliance with IPSAS and that they are consistently applied across government;
 - providing clear guidance on the implementation of accounting and financial reporting standards;
 - setting clear standards and expectations for the levels of service for financial management and reporting across the public service;

- ownership (or representation of associated financial interests) of the financial accounting system and approval of any modifications and changes required to the system; and
 - provision of advice and guidance on complex financial transactions.
50. Within core government it should act as a robust financial controller, reviewing the financial results across ministries and portfolios throughout the year, to ensure they are in line with expectations and challenging significant deviations.
51. Based on our observations, we would support a clear split of roles and responsibilities between the strategic planning/budget management function of Government and the financial management, accounting and reporting functions. Whereas the two functions are currently managed within the same ministry, I believe there is a clear justification for these two functions to be in separate entities.

SHARED SERVICES

52. At present all financial transactions within core government are processed at the ministerial, portfolio or departmental level; including the thousands of transactions related to accounts payable and accounts receivable. This leads to resources being distributed across government in individual silos leading to:
- diseconomies of scale;
 - inconsistent internal controls, policies and practices;
 - a weakened internal control environment; and
 - limited support and cover for absence, leave etc.
53. While there is a clear argument, at least for larger ministries and portfolios to have strong financial management capacity embedded within their organisations to support robust financial accounting and analysis, and provision of information for decision making, it is our view that government should consider centralizing the processing of all routine financial transactions such as accounts payable. Through this Government could create efficiencies, improve internal control, and provide greater support and cover while leaving accountability for the transactions themselves with the entities.
54. If the Government agrees to the change to producing one set of core Government financial statements, there is also an argument for the centralization of the entire financial function. However it is our view that it would be important under this scenario for ministries and portfolios to have strong financial capacity to ensure robust financial accounting and management, and support decision making by chief officers and senior officials. However this needs to be appropriate and proportionate to needs, and in a number of instances this could be provided by effective shared services arrangements, particularly for smaller portfolios and ministries.

55. Similarly there are a number of statutory authorities and government companies that have had difficulties with preparing annual financial statements, providing sound financial management and implementing reasonable internal control frameworks due to their size and capacity. There is a clear argument for shared services arrangements to provide these entities with effective financial management and reporting, as well as other corporate services functions such as procurement. With some clear criteria for this type of shared service, it could easily provide a more efficient and effective capability in the Government's current management framework.

STRENGTHEN ACCOUNTABILITY

RESPONSIBILITIES AND ACCOUNTABILITIES

56. In paragraph 47 the need for effective leadership of the financial function across government is outlined. In addition to leadership, the roles and responsibilities of all parties involved in the financial framework across government should be clarified and reinforced.
57. In the fifth schedule of the PMFL, the chief officers are identified as being responsible for “establishing and maintaining a system of internal control designed to provide reasonable assurance that the transactions recorded in the financial statements are authorized by law and properly record the financial transactions of the entity”.
58. Specifically the accountabilities and responsibilities of Chief Officers (including Managing Directors and Chief Executive Officers) and their senior finance officers, for the use of public resources should be formally documented requiring them to provide formal assurance that:
- proper financial procedures are followed and that accounting records are maintained in a form that meets management's requirements as well as in the form prescribed for published accounts;
 - the public funds for which they are responsible are properly managed and safeguarded;
 - assets for which they are responsible are controlled and safeguarded;
 - the resources for which they are responsible are used economically, efficiently and effectively;
 - any delegation of responsibility is accompanied by clear lines of control and accountability together with reporting arrangements;
 - procurement activity is conducted in accordance with legislative and policy requirements;
 - effective management systems appropriate for the achievement of objectives, including financial monitoring and control systems, have been put in place; and
 - risks, whether to achievement of business objectives, regularity, propriety or value for money, are identified, that their significance is assessed and that systems appropriate to the risks are in place to effectively manage them.

59. A key element of all Chief Officers' and senior financial officers' performance agreements should include details of what is expected for the establishment and maintenance of the system of internal control; the management of resources; and ensuring that they meet their responsibilities. Effective administrative sanctions at both the individual and ministry level should also be in place to deal with significant issues of non-compliance.
60. With respect to reporting relationships of senior financial officers within ministries and portfolios, it is our opinion that they should have at least a functional/professional reporting relationship to the Chief Officer of the central financial function as well as an accountability relationship with the relevant Chief Officer in their own organisation.

STRENGTHEN THE ROLE OF INTERNAL AUDIT AND ESTABLISH AN AUDIT COMMITTEE

61. The establishment and operation of an effective internal audit function forms a key element of effective public sector governance and stewardship. It can provide senior management with independent and objective assurance and advice that adds value and improves operations. It can help an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance frameworks.
62. With respect to Government's internal audit unit, there are significant challenges for it to provide adequate levels of assurance to core government and the wider public sector because of the following reasons:
- insufficient resourcing to provide the level of assurance expected under Internal Audit Standards;
 - lack of independence due to where internal audit reports in the current organisational framework;
 - insufficient status within government; and
 - lack of an appropriate framework to ensure internal audits reports, findings and recommendations are appropriately actioned.
63. It is our view that the status, position and resourcing of the internal audit unit needs to be fundamentally addressed to enable it to provide appropriate levels of assurance and add value as a result of its work. This would include:
- a fundamental review of the scope of its client base and resourcing to enable it to comply with the requirements of Internal Audit Standards;
 - reporting directly to Office of the Deputy Governor; and
 - establishing an Audit Committee for core government where reports are discussed and officials are held accountable for taking action on recommendations.

64. As the Head of the Civil Service, the Deputy Governor requires assurance that effective arrangements are in place for risk management, governance and internal control, and that these arrangements are working effectively during the course of the year. In both private sector and public sector organisations, it is common place in many jurisdictions to use an audit committee to provide this assurance. Effective audit committees can provide objective advice and insights into a public entity's strategic and organisational risk management framework, as well as identifying potential improvements to governance and internal control practices.
65. It is our view that the establishment of an audit committee at the core government level would also provide a sound way for the Deputy Governor to obtain independent advice on strategic, performance, assurance, and compliance matters. Audit committees have been implemented in a variety of forms in the public sector in other jurisdictions, but a key element is the independence of the membership, and the transparency of its operations.

IMPROVED TRANSPARENCY FOR FINANCIAL INFORMATION AND TRANSACTIONS

66. To support increased accountability I would recommend that the government implements transparency measures, through legislation or administrative policy, across the public service, particularly in respect of Board and senior staff remuneration and areas of sensitive expenditure. Suggested measures could include:
- publication of all accountability documents including strategic and operational plans, financial statements, annual reports, and both internal and external audit reports;
 - regular and timely publication of the travel and related expenses of ministers, board members and senior management on entity websites;
 - regular and timely publication of the hospitality/gifts given and received, for ministers, board members and senior management on entity websites;
 - regular and timely publication of expenditures and contracts over pre-determined thresholds;
 - the publication of details of the remuneration of each minister, board member and senior official;
 - the publication on entity websites, or its availability for inspection, of a register of interests of board members and senior management; and
 - the inclusion within the annual financial statements of any frauds or losses incurred by an entity.

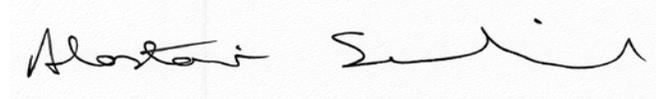
FINANCIAL ACCOUNTING SYSTEMS NEED TO BE IMPROVED

67. The current main financial system used by core government, Oracle Financials (“IRIS”), was implemented to support the implementation of the provisions within the PMFL. Since its implementation, it has been subject to over 2300 customizations. As a result of the customizations, it has subsequently not been upgraded for updates for new releases of the software and Oracle Financials, the supplier of the system, has indicated that it will no longer support the version being operated by Government effective November 2013.
68. We are currently in the process of preparing a report on the IT controls and security for the key systems that impact financial management, including IRIS. The results of this work highlight significant deficiencies in the IT control environment generally and IRIS specifically. It is clear from our findings and discussions with the finance community that IRIS in its current configuration is not managed effectively and does not support the financial community in carrying out its primary role for managing and recording Government’s financial transactions and to facilitate accurate and timely financial reporting.
69. The Government is presently actively moving forward a re-implementation of Oracle Financials to address concerns about the system not being supported after November 2013 and is undertaking a project to update IRIS to the most current version of Oracle Financials. We have provided our initial views to the Government project team during the planning phase and will consider it further following its completion.
70. However, because of the large investment being contemplated by Government, we would like to emphasize the importance of getting this project right and ensuring that the new version of IRIS will be sufficiently flexible to effectively support any changes in the financial framework and the structure of government. For example, the system update should include the flexibility for Government to centralize more of the financial processing of accounting transactions and modify the chart of accounts in the event the financial control framework in the PMFL is amended. If the system update by Government doesn’t provide flexibility for future operating requirements, there is a high risk that Government would have to invest more resources in the future.
71. It is also important that it addresses concerns about:
- using its functionality more effectively;
 - responsibility for its day to day development and administration;
 - reporting;
 - consistency in use (for example ensuring there are standard operating procedures, effective chart of accounts with clear definitions and standard template reports); and
 - supporting an environment which provides effective controls and enables the production of timely and credible financial information.

CONCLUSION

72. In my first report as Auditor General in December 2010 I indicated that it was time to review whether all the provisions within the PMFL financial framework were appropriate for the needs of the Cayman Islands Government and ensuring effective accountability. At that time I raised a number of questions that I thought Government needed to consider about the financial framework- see Appendix A for details.
73. While my Office continues to support the intent and principles behind the PMFL, it is my opinion that the financial framework needs to be fundamentally changed, and a more straightforward and less complex model implemented. My experience over the last three years has reinforced and strengthened my initial views presented in December 2010. I believe the evidence of the last nine years when accountability has been effectively lost demonstrates a need for this. Through undertaking such a review and implementing a revised framework, I believe there are significant opportunities for the Government to:
- enhance accountability and transparency;
 - support more effective decision making;
 - reduce the bureaucratic burden and generate efficiencies;
 - achieve better results for the use of public resources; and
 - ultimately, increase public trust in Government.
74. I have made a number of suggestions or recommendations in this report that I believe would support the Government of the Cayman Islands in ensuring the effective management of public resources. **However, my primary recommendation to the Government is to immediately commence a far reaching and comprehensive review of the *Public Management and Finance Law* and consider seriously what kind of financial management, performance management and accountability reporting framework it needs, and the organisational structure it would require to deliver it effectively and efficiently.**
75. Any decisions, investments and activities around changes to financial management policies, practices and systems should await the outcome of this review.

76. In this report I have identified a number of areas which the Government should examine and fundamentally revise. I have prepared it with the intention of helping the Government move forward with the delivery of an effective financial framework and I look forward to assisting the senior officials involved achieve this objective.

A handwritten signature in black ink, appearing to read 'Alastair Swarbrick', written on a light-colored background.

*Alastair Swarbrick MA(Hons), CPFA
Auditor General
George Town, Grand Cayman
Cayman Islands*

12 June 2013

APPENDIX A – QUESTIONS RAISED

Questions originally raised in my report on Financial and Performance Reporting published in December 2010:

- Do the governance arrangements contained within the PMFL provide sufficient clarity about the roles and responsibilities of all relevant officers, including clear leadership for financial management and reporting across Government and its entities?
- Why have entities been able to comply with the budgetary requirements of the PMFL but been unable to provide robust financial reporting? Are the consequences of not complying with budgetary requirements tangible compared to those of financial reporting? If so, how can this be addressed?
- Effective financial management is necessary in all ministries and portfolios to support effective decision making and accountability, but do they have the capacity to prepare individual ministry/portfolio IPSAS compliant financial statements and, to provide financial accountability, do they need to?
- Have there been any unintended consequences as a result of the introduction of the PMFL as part of the financial management initiative that have impacted on behaviors and expenditure adversely?
- Are the output measures that are being reported on, effectively reporting what a ministry or portfolio has delivered? Are they reporting on the key areas that are important to their stakeholders including the outcomes that the programs were designed to achieve and service levels the Government should be providing?
- How can the annual reports of government entities provide a clearer picture of the operations and activities of entities that is more easily understandable to the reader?
- How does the separation of executive transactions from core ministries and portfolios support efficient and effective governance and accountability? Should there be greater clarity about what types of transactions should be classified as executive and why?

APPENDIX B - RESPONSE TO THE REPORT FROM THE OFFICE OF THE DEPUTY GOVERNOR



**Office of the Deputy Governor
Grand Cayman
Cayman Islands**

June 11, 2013

**Alastair Swarbrick
Auditor General**

**Re: AUDIT REPORT "FINANCIAL ACCOUNTABILITY IN THE CAYMAN
ISLANDS GOVERNMENT: A TIME FOR CHANGE"**

Dear Alastair,

Thank you for meeting with myself and Mr. Gough regarding the above mentioned report and the opportunity to comment on your most comprehensive report. I hope we can work together to achieve the agreed recommendations.

Detailed below are my formal comments for inclusion in the report:-

1. I agree with your recommendation to a review of the PMFL with a view to simplifying it, and I will support the Ministry of Finance with that task, providing any changes made do not undermine the performance management system which I require to manage the civil service. Budgeting, accounting and performance management must be on the same basis to be effective.
2. I will support all your efforts to improve parliamentary accountability and to improve the accountability of my Chief Officers.
3. The FFR has validated the financial principles which the PMFL is based on, and therefore I do not support any changes which weaken or undermine those principles.
4. The underlying principle of the Cayman Island's Government Management Model is still valid "**improving performance of the public sector**". The key features of the model are:-

- **Explicit focus on results**
 - Outputs and outcomes (Not Inputs)
 - Appropriations from LA to Cabinet on an Output Group Basis
 - Performance Assessments on all staff
- **Improved financial measurement**
 - accrual accounting
- **Improved transparency**
 - regular forecasting and reporting
- **Improved accountability** (Cabinet, Chief Officers, Heads of Departments)
- **Greater delegation** of input authority for HR and Finance to managers

These principles should be maintained when proposing any changes to the PMFL.

5. The report focuses on financial reporting and accountability, making it easier to produce accounts to have fewer accounts to audit etc. However, this has to be balanced with two things, firstly public accountability and transparency and the citizens right to know in detail, not only what money we are spending on their behalf, but also what they are getting for their money. One financial statement to the LA could seriously undermine that requirement.
6. Secondly, as Head of the Civil Service I have the responsibility for the performance of Chief Officers I need a measurement regime that has more than a financial component.
7. Any changes to the PFML should not reduce the accountability of my Chief Officers for the proper management of the financial affairs of their Ministry. Any changes with regard to centralization should not undermine their accountability, and any change in reporting relationship of their Chief Financial Officers should not interfere with their management relationship.
8. The suspension of inter agency charging has reduced the accountability of the central agencies and has increased cost. In addition we are now not able to truly cost the services we provide as a significant proportion of our operating costs are borne by central departments, e.g. computer services and DVES (fuel). The concept of interagency charging is a good one if we are going to strive for better value for money for the citizens of this country we need cost the services we provide. Otherwise we will have no real cost data to use for decision making (to compare any service that could be open to competition to the private sector).

9. I agree that outputs from some ministries have not been written very well and are too detailed and may have only a tentative link to outcomes. However, unless they are reported on there is no incentive to improve them. We need to learn from our variances. I will encourage all Chief Officers to review their outputs in light of the broad outcomes that will be established by the new government.
10. I firmly believe and agree that unless we start with measureable outcomes and report on them we can not demonstrate true parliamentary and citizen accountability.
11. I think we should publish more information about what we are doing both in financial and performance terms not less. I understand that it would be easier for audit to deal with one set accounts but as I said earlier we do not want to compromise accountability and transparency
12. I agree with the reintroduction of quarterly reporting, we now operate in a dynamic environment and I would go as far as introducing monthly output reporting. I would add that we need to get back to performance reporting on a regular basis, I need to know what my Chief Officers are achieving and where they are failing, institutional learning comes from analyzing our variances.
13. Performance management is not just about financial management and reporting, at present outputs are the only measurements in place and they are the major contributors to Government outcomes. I accept the points raised about simplifying them and tying them more closely to outcomes. How are we going to assess value for money if we cannot evaluate the ratio of inputs to outputs?
14. Appropriations should be focused on what the parliament wants the government of the day to spend their money on to achieve the broad outcomes of government within expenditure limits set by parliament.
15. I have some concerns about your proposals for leadership of the finance function. “the PMFL has provided clear administrative responsibility to Ministry of Finance officials”, the Minister of Finance who has the constitutional responsibility for finance 9Section 54(1)b of the 2009 Constitution. All the main responsibilities set out in the report are covered in the PMFL, regulations, accounting policy etc and all point to the Ministry of Finance.
16. I do not agree with splitting the strategic planning/budgeting function of finance functions from the accounting and reporting function this would lead to inefficiencies.
17. I am not sure what is meant by functional/professional reporting to the Chief Officer, Public Finance. The Chief Financial Officer is more than just an accountant; he/she is

very much an integral part of the strategic management team. As long as this relationship does not conflict with direct management relationship with the Chief Officer, I have no problem with it.

18. . The issue of moving the Internal Audit Unit to come under the Deputy Governor's Office is currently being discussed by the Rationalization Team, I do not disagree with this recommendation.
19. The combining of executive and entity expenditure although convenient for accounting simplicity does compromise the role clarity and accountability issues between the Minister and the Chief Officer. Transfer payments like scholarships, Poor Relief, Ex-Gratia Payments to Seaman and Ex Servicemen are in the power of the Minister and not part of the Chief Officers service delivery responsibility.

If there are any points on the above you wish to discuss further please let me know.

Yours Sincerely



Franz Manderson

Deputy Governor

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Complaints

To make a complaint about one of the organisations we audit or about the OAG itself, please contact Garnet Harrison at our address, telephone or fax number or alternatively email: garnet.harrison@oag.gov.ky

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Media enquiries

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June 2013