



SIGMA

Support for Improvement in Governance and Management

A joint initiative of the OECD and the European Union, principally financed by the EU

CROATIA
EXTERNAL AUDIT
ASSESSMENT MAY 2009

1. Summary

Main Developments since last year

The State Audit Office (SAO) has developed a Strategic Plan for the period 2008-2012 to streamline its further development efforts. This Strategic Plan is accompanied by a Human Resources Development Strategy and an IT Strategy for the same time frame. The Strategic Plan focuses on improving audit quality, increasing professional and ethical qualities of staff, and ensuring a high level of IT support and IT tools for audit. The Plan is now being implemented on the basis of annual operational plans.

There has been some progress in inserting in the Constitution a provision ensuring the SAO's existence and independence, but this work has not yet been completed. It is envisaged that such a constitutional amendment, which the SAO has been involved in drafting, might be adopted towards the end of this year.

The number of SAO staff has grown only slightly compared to 2007, the year of the last Sigma assessment, from 272 to 280. However, the number of certified auditors has grown more substantially, from 217 to 232. The level of IT support has increased. Quality control has been strengthened and formalised in steps that are part of the IT system for planning and implementing audits. Quality assurance has been set up as a major task for internal audit. The maintenance of the audit manuals developed under the twinning project has been ensured through a committee of experienced audit managers.

The SAO's relationship with parliament has been strengthened.

Main Characteristics (strengths and weaknesses)

The SAO has a strong reputation as the independent supreme audit institution of the Republic of Croatia. The SAO has arrived at this position by doing a professional job and through good communication with auditees - and by ensuring that its recommendations are followed up. Its reports are taken seriously by auditees. Apart from its own performance and the commitment and professional attitude of the management and staff, the twinning project has certainly contributed to this situation. However, the SAO suffers from the legal obligation to audit approximately 900 entities annually, which causes severe resource constraints and materially affects the independence of the institution. As a consequence, the further development of performance audit, as desired by parliament, is not possible. Also, potential gains from the twinning project could not be captured because of this handicap.

The SAO has not taken steps to initiate changes in this situation, apart from auditing only a selection of smaller entities on an annual basis and the rest in a three-year cycle. Neither has the SAO identified this issue as a problem to address in its Strategic Plan 2008-2012. At a more general level, a more strategic vision has been missing as to how the SAO should develop, given the challenges of the current situation, developments in the audit environment, and the demands – which have sometimes perhaps not yet been articulated – of SAO's stakeholders.

Although in compliance with the law, the annual report of the SAO is issued much too late if parliament is to use it as input for the approval of the budget implementation report. Nevertheless, a routine has been established for dealing with the annual report from the SAO. Parliament has also requested additional reports from the SAO in order to meet its own information needs, and these reports are being prepared by the SAO. More generally, it is important for the SAO management to demonstrate its perseverance in profiting further from the investments made during the twinning project and continuing on the path towards the modernisation of audit practice; there is a certain risk that, after the finalisation of the twinning project, momentum will be lost.

Recommendations for Reform

The SAO should further strengthen its capacity to think strategically and to elaborate a vision of how the SAO should develop and formulate long-term priorities.

In this regard, the SAO should seek alternative solutions for dealing with its mandatory audit tasks, which are too heavy – solutions that go beyond a three-year cycle for smaller municipalities – and develop options for increasing the use of performance audit in the near future.

Furthermore, the SAO should continue the path towards the modernisation of audit practice, deepen financial audit, and move away from the identification of individual irregularities and in the direction of an assessment of the functioning of internal control systems.

The SAO should prepare itself for its future task of auditing the management systems of EU structural and cohesion funds.

According to the State Audit Act, the certified state auditor is to sign the audit report. This requirement may seem to guarantee his/her independence, but in reality it creates a potential conflict between the certified state auditor and the institution in which he/she is employed. The SAO may wish to reconsider the current practice of reporting and make it more explicit that reports are issued on behalf of the institution.

To improve the impact of its annual report, the SAO should adapt its annual reporting procedure to the government's reporting procedure to parliament on the execution of the budget.

2. Baseline Questions

2.1 *Does the SAI have clear authority to satisfactorily audit all public and statutory funds and resources, bodies and entities, including EU resources?*

The State Audit Office (SAO) of the Republic of Croatia was established in 1994 on the basis of the State Audit Act of 30 June 1993, amended in 1995, 1999, 2001 and 2004. The first Auditor General was appointed in April 1994 for a term of eight years. She was reappointed in 2002 for a second term.

The SAO clearly has the role and position of the supreme audit institution in Croatia, as laid down in the State Audit Act. It has achieved over the years a good reputation in Croatia, which has contributed to its position as an independent and unchallenged institution. However, this position, let alone its mere existence, is still not ensured in the Constitution of the Republic of Croatia. The SAO has made several requests to that end in the past, but it has taken a long time before a proposal was taken forward to amend the Constitution so as to ensure the SAO's existence and independence. As part of a package of constitutional amendments prepared by a politically broad committee representing parliament and the government, this amendment will be tabled in the near future, with the objective of having it passed before the end of 2009. The SAO has been involved in drafting the text of the amendment and is satisfied with the result.

The SAO has 280 staff, of whom 232 are certified state auditors. In the SAO's central office in Zagreb are 94 staff, and the remaining 186 are working in one of the 20 regional offices. This distribution of staff is linked to the mandate of the SAO, which also covers counties, municipalities and public companies all over Croatia. The central office is organised in eight departments, responsible for auditing the central government, co-ordination of audits, and support functions. The eight Assistant Auditors General are each responsible for a separate area, largely in line with the areas of responsibility of the departments. The Deputy Auditor General is responsible, amongst others, for the Legal Service, an important support service in the rather legalistic Croatian administrative culture. The Internal Audit Unit, also responsible for quality assurance, reports directly to the Auditor General. Regional offices have a varying number of staff, ranging from about 6 to 15. The distribution of regional offices follows the administrative structure of Croatia. The SAO is aware of the economic disadvantages of its dispersion over the country but is awaiting the outcome of the debate in Croatia about restructuring territorial administration before modifying its own structure.

The Auditor General, the Deputy Auditor General and the Assistant Auditors General meet weekly in a rather informal "collegium" meeting. At least twice a year a broad "collegium" meeting takes place, involving also the heads of regional offices. These heads of regional offices have the same rank as directors of departments in the central office. An expert council, consisting of the small "collegiums" and seven external experts (university professors, experienced audit practitioners), was established to advise the SAO, more specifically in the area of strategic development and in the implementation of the SAO's Strategic Plan. The expert council is to meet once a month according to its own rules, but in practice it meets three or four times a year, with intensive informal contacts in between these meetings.

The State Audit Act lays down the mandate of the SAO to audit public expenditure and income – more specifically, the audit of financial statements and transactions of government units and local and regional self-government units, legal entities that are partly or wholly financed by the budget, public enterprises, companies and other legal entities owned in major part by the Republic of Croatia or by local or regional self-government units. The State Audit Act also establishes the SAO's mandate in auditing the use of EU funds and funds from international organisations or institutions to meet public needs.

Although clear from the point of view of the legal foundation of its mandate, the SAO is consequently confronted with the task of carrying out audits on approximately 900 entities, in principle on an annual basis. This is still a problematic issue, as the resources of the SAO do not allow for such a huge task. This problem is for the time being resolved by using a three-year cycle for the audit of the

smallest entities, such as small municipalities, taking into account certain risk-based criteria as well. This situation was further aggravated by additional audit obligations, such as the audit of ISPA projects and the audit of funding of political parties. In total more than 70% of the SAO's audit resources are used for mandatory audit tasks, which leaves little room for selected tasks and has a negative impact on the SAO's material independence.

The SAO should seek alternative solutions for dealing with its mandatory audit tasks, which are too heavy – solutions that go beyond a three-year cycle for smaller municipalities. Apart from the strengthening of public financial internal control at local level, which may ease the task for the SAO, more radical solutions to be considered would be to set a monetary threshold for the use of SAO auditors and, for municipalities below that threshold, to make counties responsible for financial oversight.

The SAO, established as the independent and unchallenged supreme audit institution of the Republic of Croatia, has a good reputation. The SAO continues to have a broad remit and a burden of statutory audit for which its capacity is now insufficient and will continue to be in the future. Alternative solutions are necessary, including those necessitating an amendment to the current State Audit Act.

2.2 Does the type of audit work carried out cover the full range of regularity and performance audit set out in the INTOSAI auditing standards?

According to the State Audit Act, the SAO is to perform the audit of the financial statements of all entities under its remit on an annual basis. In principle, the SAO has more freedom in selecting audit subjects for compliance audit and for performance audit, as the State Audit Act indicates that these audits are to be performed “as needed” [art. 3 (3)].

The SAO carries out both financial audit and performance audit, but to varying degrees. Financial audit has been much more structured since the twinning project, although not all potential gains from this project have been realised. More specifically, the SAO has not yet applied the recommended systems approach, whereby systems are assessed, including the necessary testing of procedures, thereby in principle reducing the total number of transaction tests needed. The application of this approach would save resources, which in turn would allow for increasing the depth of substantive testing.

Financial audit focuses on the accounts of entities, leading to audit opinions per entity. The risk analysis utilises signals from the media, including the local media, as well as previous findings, to focus on specific areas within the financial audit. Although financial audit should never neglect individual irregularities, the SAO should start to move away from the focus on irregularities to attend to its core business, which is to arrive at an audit opinion founded on a systems-based audit approach. This change in focus will be a necessary but challenging task, taking into account the general interest of the media and politicians in, precisely, individual irregularities.

The SAO has made a start with performance auditing, but it is suffering from overall resource constraints, which place at risk the investments made in training and in developing methodological guidance materials during the twinning project. During this project 140 auditors were trained in performance audit, but only a minority has been involved in performance audit since the completion of the project, and for the majority this involvement has been only for a couple of days on average. The SAO may consider a couple of options for increasing the use of performance audit in the near future. One of these options would be to include, in the annual financial audits, a central theme or topic co-ordinated by the head office in Zagreb, such as human resources management, and to report on this topic separately.

Another challenge in this area is to widen the scope of performance audit. The audit of the PIFC system, carried out under the umbrella of performance audit, was in reality more of a compliance audit, which checked compliance with the PIFC Law. Although as such this audit was certainly useful, it cannot be considered as a real performance audit or value-for-money audit.

Although the audit work carried out does in principle cover the full range of regularity and performance audit as set out in the international auditing standards, there is ample room for broadening the scope for performance audit and for deepening financial audit, moving it away from the identification of individual irregularities and in the direction of an assessment of the functioning of internal control systems.

2.3 Does the SAI have the necessary operational and functional independence required to fulfil its tasks?

The State Audit Office is accountable only to parliament, which contributes to its independent position. In addition, the fact that the Auditor General has a term of eight years makes this position, and hence the position of the SAO as a whole, a more independent one. In terms of budgeting, the SAO does not really have a special status. The SAO has to submit its draft budget to the Ministry of Finance, which takes care of submitting it to parliament. As for any budget-user, the SAO has to submit reallocation requests to the Ministry of Finance during the budget implementation. So far the SAO has not experienced any problems in this respect.

The managerial or organisational setup of the SAO is not specifically mentioned in the State Audit Act; only the Auditor General is mentioned. Article 12 states that the Auditor General is appointed by parliament for a (renewable) eight-year term, and that dismissal is only possible if he/she no longer has the ability to carry out the duties of auditor general or if he/she has been found guilty of a crime. The State Audit Act does not mention the Deputy Auditor General or the Assistant Auditors General. Also, no requirements are set for regional offices – the only provision in this respect is that the SAO has its seat in Zagreb. The State Audit Act lays down specific provisions concerning the “certified state auditor”, the auditor employed by the SAO who has the responsibility to carry out audits on behalf of the SAO. These provisions include the requirement of impartiality in respect of auditees and compliance with a code of ethics. The State Audit Act also stipulates in article 7 (1) that the certified state auditor is to sign the audit report. This requirement may seem to guarantee his/her independence, but in reality it creates a potential conflict between the certified state auditor and the institution in which he/she is employed.

Independence needs to be counterweighted by transparency and accountability. In that respect the SAO should look at the arrangements made for the audit of the SAO as budget-user. So far this has been carried out by the Internal Audit Department within the SAO, reporting to the Auditor General. It may be worthwhile to consider other options, allowing for an external involvement and publication of the resulting report and opinion.

The SAO enjoys an independent position, although its independence does not in all respects stem from legal provisions. In any event its financial independence is not guaranteed. The position of certified state auditors in relation to the SAO as employer and as the supreme audit institution may need clarification. In addition, the way in which the SAO is audited as a budget-user needs to be reconsidered.

2.4 Are the SAI's annual and other reports prepared in a fair, factual and timely manner?

The SAO takes care to ensure that auditees have the possibility to respond to a draft report and to verify that the final version is factually correct. This contradictory procedure allows the auditee eight days to react to the draft report. The auditee is to respond in writing to all findings, including findings with which it is in agreement. The response is integrated in the final version of the report. Usually the responsible audit team will hand the draft report to the auditee, allowing for oral explanation of its contents. The SAO has established a quality control system to ensure that the draft report is fair and factual, with a crucial role for either the head of the regional office or the head of department of the central office. All draft reports are assessed by one of the Assistant Auditors General before they are sent to the auditees, and all draft reports are also checked by the Legal Service. In addition, the Legal Service is often consulted by auditors on specific legal issues, for example in the case of procurement.

The State Audit Act contains a provision for an appeals procedure, in the event that an auditee disagrees with the report and opinion. The Auditor General is to decide within 30 days on the matter. This appeals procedure does not seem to fit into the usual provisions for factual clearance of audit findings between auditee and auditor. It may serve a function, but it is peculiar that the head of an external audit institution decides on appeals from auditees against audit reports issued by the audit institution headed by the same person.

This point is linked to the practice that audit reports are signed by the audit team, not by the hierarchy, let alone by the Auditor General. This arrangement formally allows for an appeals procedure through which the Auditor General has the final say. However, the auditors are employed by the SAO to carry out audits on behalf of the SAO, and the quality control procedures ensure that responsibility for the text of draft reports is at least at the level of an Assistant Auditor General. The SAO may wish to reconsider this current practice, and make it more explicit that reports are issued on behalf of the institution.

All audits are meticulously planned in terms of resources, steps in the quality control process and timing. The reports on separate audited entities are thus issued in a timely manner – but only in respect of the auditees, not in respect of other stakeholders, such as parliament.

The State Audit Act states in article 11(1 sub 4) and article 11(2) that the SAO is to submit to parliament before year-end an annual report on audits carried out and on its own activities during the year. This report, which is usually issued in October/November, summarises the results of the separate reports prepared by the SAO on the basis of its financial audits of all entities. In addition, the report contains analyses of trends and progress achieved. Although this report is useful, the timing of its submission makes it difficult for parliament to seriously take its findings into account when deciding on the next draft budget. Moreover, the annual report of the SAO arrives four to five months after parliament has approved the budget implementation report, which is submitted to parliament at the beginning of June. Parliamentary approval of the budget implementation thus takes place without a report from the external auditor. Parliament recently asked the SAO to submit a report on the follow-up of irregularities before the end of June. However, this report cannot replace a regular audit report with an audit opinion, and it may focus too much attention on individual irregularities instead of on the overall picture.

Although in compliance with the law, the annual report of the SAO is issued much too late for parliament to use it as input to the approval of the budget implementation report. Reports on separate audited entities are communicated to auditees as soon as they are finalised. Reports on performance audits are also summarised in the annual report.

2.5 *Is the work of the SAI effectively considered by parliament, e.g. by a designated committee that also reports on its own findings?*

Within parliament the Finance and Central Budget Committee is the competent committee for dealing with reports from the SAO. So far, the committee discusses the annual report of the SAO and gives its opinion on the report to the plenary. The corresponding resolution voted in parliament highlights both good and bad examples of the use of the central budget. Another element in the procedure is the request to the government to report to parliament before the end of June, and therefore before the budget implementation report is approved, on the follow-up of SAO recommendations since the debate on the SAO's annual report at the end of the previous year. This report and the report of the SAO on the follow-up of irregularities are considered by the Finance and Central Budget Committee as means of increasing the importance of the mid-year debate. The risk is that parliament will focus too much attention on individual irregularities. In its follow-up report the SAO should try to redirect interest towards more structural issues.

Although the reports that the SAO issues on individual ministries, central government departments and other public entities are in principle public as soon as they are finalised, they are not sent to parliament. The impact of individual reports could be raised by sending them to parliament as soon as they are finalised, allowing the Finance and Central Budget Committee to analyse these reports as part

of their preparatory work for the debate on either the budget implementation report or the SAO's annual report. Some members of parliament expressed their interest in performance audit reports. However, the report on one of the performance audits carried out by the SAO, on the use of the tourist tax, did not draw any attention from parliament, although it was sent to parliament as a separate report. The SAO does not actively present its reports to parliament, for instance through briefings.

According to the State Audit Act, parliament has the right to request an audit from the SAO, but no request has been made recently. The wording in the State Audit Act does not leave room for a refusal of such a request by the SAO, which may put the independence of the SAO at risk. However, since the number of requests is so minimal, this risk so far has not materialised.

At the regional and local levels the SAO sends its reports to the executive, the auditee therefore, who is requested to forward a copy to the assembly or council. The SAO does not systematically follow up on what the assemblies or councils do with these reports, and it does not put additional effort into explaining the reports or stimulating an in-depth discharge debate. Given the resource constraints, this situation cannot be changed in the short term, but it should be kept in mind when the SAO sets its priorities for the next Strategic Plan period.

Parliament has shown interest in the SAO's annual reports. It intends to ensure their follow-up by requesting the government to inform it regarding the implementation of the SAO's recommendations. Parliament has also initiated the practice whereby the SAO is to report on the follow-up by public authorities of irregularities identified in previous audit reports. The SAO might improve its leverage by submitting separate audit reports to parliament as soon as they are finalised, by arranging for better communication to the media, and by considering the communication of audit reports on local and regional entities to the respective representative bodies.

2.6 *Has the SAI adopted internationally and generally recognised auditing standards compatible with EU requirements, and how far have they been implemented?*

The State Audit Act specifies that the SAO is to perform its audits in compliance with established INTOSAI auditing standards. This provision of course serves as a strong legal basis for living up to international auditing standards, but it is not sufficient to ensure adherence. The twinning project strengthened the potential of the SAO to effectively comply with international auditing standards. The SAO now has state-of-the-art audit manuals for both financial audit and performance audit, and auditors have been trained in how to use these manuals in practice.

It is important that the SAO goes further in using international standards and guidelines in audit practice. Training, quality control and quality assurance are essential, and a structure is needed to guarantee the regular update of the manuals. The solution of establishing this structure in the SAO, with a committee of experienced audit managers, seems an appropriate choice given the scale of the office.

All auditors have access through Intranet to an IT system that provides good support for the planning, performance and reporting of financial audits, with an inbuilt "module" for carrying out quality control, allowing managers to check the progress of individual audits whenever they wish.

As was mentioned above under section 2.2, the SAO is still struggling to implement the methodology and approaches laid down in the audit manuals. There is a certain risk that following the completion of the twinning project a momentum has been lost. It is important for the SAO management to demonstrate its determination to profit further from the investments made during the twinning project and to continue on the path towards the modernisation of audit practices. This may be an additional strategic (sub-)objective for the current Strategic Plan period.

Although the SAO is committed to complying with international auditing standards and has developed, with the assistance of the twinning partner, state-of-the-art audit manuals, the effective performance of audits in line with these modern methods and approaches remains a challenge for the coming years.

2.7 *Is the SAI appropriately aware of the requirements of the EU accession process?*

At a general level the SAO is very well aware of EU requirements for accession. Already from the start of its operations the SAO developed a keen interest in the requirements for EU accession in the area of financial control and in the requirements for auditing EU expenditures. The SAO has played an active role in networking activities with other SAIs, from other countries in the region as well as from other candidate countries and EU Member States. The SAO has also invested in the accession process in the area of financial control, for instance by actively supporting the working group set up in Croatia for negotiations on chapter 32 and by promoting the concept of Public Internal Financial Control.

Within the SAO a separate department deals with the audit of EU funds and with performance audit. The SAO is the winding-up body for ISPA projects. This role implies a recurrent task for which three auditors, who have received specific training, are permanently employed. Phare and CARDS projects are audited in the context of the usual financial audits of government bodies. These audit obligations have contributed to the knowledge within the SAO about auditing EU funds and EU financial procedures. For IPA a separate Audit Authority has been set up (ARPA), which has employed several auditors from the SAO.

The SAO has not yet developed a strategy as to how it will audit EU funds management and control in the future. With ARPA as Audit Authority, and with the phasing-out of audits of ISPA, Phare and CARDS projects, the SAO needs to consider its future role in providing assurance to the Croatian Parliament as to the functioning of the internal control systems, including audit, for the IPA programme.

The SAO has been and remains fully aware of the requirements of the EU accession process, and it has been active in disseminating its views and experiences in this respect. It is now time for the SAO to consider its future task of auditing the management systems of EU structural and cohesion funds.

3. Capacity to Further Develop the System

The State Audit Office, in its Strategic Plan for the period 2008-2012, has set as objectives to increase audit quality, to increase professional and ethical qualities of its employees, and to ensure a high level of IT-tools in supporting and performing audits. The Strategic Plan is combined with a Human Resources Development Strategy for the period 2008-2012 and an IT Strategy for the same period. The Strategic Plan is translated into annual operational plans. The Strategic Plan 2008-2012 builds on the results achieved under the previous Strategic Development Plan, which covered the period 2003-2007 and focused on six main activities, ranging from the strengthening of the legal framework through the development of the audit methodology to the development of external relations. In the implementation of this previous Plan, the SAO was supported through the twinning project.

The level of ambition of the new Strategic Plan is high, and so is the commitment to adhere to the values of the SAO. At the same time the Strategic Plan is quite general and there is the risk that it does not give sufficiently clear directions concerning the contents of operational plans. More generally, the SAO should further develop its capacity to think strategically and to formulate more clearly the priorities it wishes to set for the near future, taking into consideration the rapidly changing audit environment with its strengthened internal control systems and enhanced and professionalised internal audit. The current Strategic Plan focuses one-sidedly on improving audit quality through staff development. Although this development is certainly necessary, other instruments to improve audit quality cannot be ignored. One of these is a more selective programming of audits, in which greater attention is given to the relevance of audit topics for parliament and for the general public.

With its strong commitment to be at the forefront of supreme audit institutions in Europe, the SAO of the Republic of Croatia certainly has the capacity to take up the remaining challenges and to develop its working practices in such a way as to be able to fulfil its mission.

4. Recommendations for Assistance

The SAO should consider how it could effectively use possibilities for extended technical support to ensure the sustainability of the results of the twinning project (see 2.6).