



SIGMA

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CROATIA PUBLIC INTERNAL FINANCIAL CONTROL ASSESSMENT JUNE 2005

1. Introduction

This report is the first standard assessment report on Croatia against the baselines that have been applied by Sigma since 1999 for the assessment of public internal financial control in EU candidate countries. This report is based on information gathered up to May 2005.

Sigma had previously provided to the European Commission a comprehensive report on governance and public administration in Croatia as part of the *Balkans Public Administration Reform Assessment*, dated 30 January 2004.

Sigma found that progress had been achieved since the above-mentioned 2003/2004 report with regard to the legal framework, institution-building, and understanding of the concept of Public Internal Financial Control (including, to a degree, the distinction between “control” and “audit”).

Financial control in the Croatian public administration is currently subject to substantial changes. To a large extent, these changes are a consequence of the new status of the country as a candidate for EU accession. Although the process of reform – e.g. with the introduction of internal audit – started some years ago, the pace of change and the actual implementation of decisions taken in that area have only speeded up in recent months.

The main actor in the area of internal financial control is the Ministry of Finance, which recently (officially in March 2005) established a Department for Harmonisation of Internal Audit and Financial Control, now focusing on the development of the legal framework and institution-building in the area of Public Internal Financial Control (PIFC). This new department is in the process of becoming the Central Harmonisation Unit (CHU) for PIFC.

2. Baseline Questions

2.1. Is a coherent and comprehensive statutory base in place, defining systems, principles and functioning of financial control?

The Organic Budget Law of 3 June 2003 (OBL) provides the overall framework for internal financial control, defining the role and responsibilities of the various actors and the concept of “budget-user”. The head of a “budget-user” is responsible for budget planning and execution. The OBL further introduces the tasks of internal audit and budget supervision as well as the function of financial controller.

However, the numerous by-laws foreseen by this act are far from being finalised at the moment. Only the regulations on accounting, financial reporting, budget supervision and internal audit are currently enacted. Even if important ground has already thus been covered, substantial work remains ahead in terms of secondary legislation.

As part of the efforts related to the accession process, Public Internal Financial Control has been subject to an overall approach, leading to the *Policy and Vision of the Internal Audit* of July 2003, followed by a first *Development Strategy of PIFC in the Republic of Croatia*, adopted by the government on 2 September 2004.

While constituting a substantial improvement in the area, the latter document was considered too vague and allusive to be really useful as a basis for the development of PIFC. A second version of the strategy has been drafted in close co-operation between the Croatian authorities (with the new Department for Harmonisation of Internal Audit and Financial Control in the lead, but also involving sample line ministries and the Supreme Audit Institution, i.e. the State Audit Office) and the technical assistance providers in place. This new draft is due to be adopted by the Council of Ministers by the end of June 2005. The text summarises the achievements so far in this area and makes further suggestions for the full development and refinement of the current system. In particular, it foresees the drafting and adoption of a new framework law on PIFC that will incorporate the PIFC principles described in the strategy. The draft legal text should be ready by 30 September 2005, with a view to adoption by the Croatian Parliament by 31 December 2005.

While some new aspects of PIFC need to be translated into primary law to strengthen their status, it is rather unclear if they are numerous enough to justify passing an overall law, and the draft strategy is not very explicit in this regard. The necessity of having a comprehensive text is questionable; it is difficult to see – from the mention of such a text in the draft PIFC strategy – how an overall law would differ from existing provisions (with the exception of new ideas, such as the Internal Audit Council, which to date has no legal support). In addition, there is a risk of over-regulating in this area, as is often the case in former or current candidate countries, at the expense of flexibility and adaptation capacity. It would perhaps be preferable to select whichever existing provision is still in need of implementing legislation (secondary legislation) and other practical guidance in order to be fully in place. A review of the possible synergies between PIFC policies and measures and change processes currently ongoing in the public finance area – including the development of management and control of EU pre-accession funds – would be useful so as to make best use of scarce resources and to ensure coherence between various projects.

Other important texts regulate the control environment in Croatia, such as the Law on Organisation and Scope of Work of Central State Administration Bodies, Act on Civil Servants and Civil Service Employees (currently subject to review), and the various secondary legislation linked to these texts. The whole set of different rulebooks describing the detail of organisation and procedures in each administration, together with the systematisation of job positions, provides a very complete picture of the systems in place and encompasses elements related to financial processes (in the Ministry of Finance, this concerns in particular the above-mentioned rulebooks on accounting and budget supervision).

The legal framework for PIFC still needs completion, as a number of relevant by-laws to the Organic Budget Law have yet to be adopted. In addition, once the PIFC strategy has been adopted, a review should be made of the legal framework to ensure its consistency with the strategy in terms of both substance and terminology.

2.2. Are relevant management control systems and procedures in place?

The Organic Budget Law establishes that the head of a “budget-user” is responsible for the lawful and proper planning and execution of the budget [art. 5 (3)]. This very general provision needs detailed implementing rules, and some are still missing (e.g. the decrees and rulebooks foreseen in article 8 of the Organic Budget Law). In addition, since each budget-user is responsible for the production of its own specific rulebooks, there is a risk – and there is already some evidence – of, discrepancies or even gaps in the areas where the Ministry of Finance rulebooks did not provide any particular guidance.

Section VIII of the law provides, however, some more details about the responsibilities of the “budget-user’s head”, as well as the responsibilities of the financial controller and chief accountant. The principle of managerial accountability can be derived from this text. This function can be delegated, however, and in that event, the delegation is normally to the Secretary General or to an equivalent ranking person in a budget-user organisation. It was not possible to assess the actual extent and concrete conditions of this delegation in practice (in particular, how the principle of managerial accountability is maintained).

The exact role of the financial controller according to the Organic Budget Law is unclear. The law does not provide an exhaustive description of the tasks of the financial controller, and the way in which these tasks are

mentioned does not make them distinct enough from those of the chief accountant of a budget-user. In any case, it seems that the function is in practice far from being established throughout the Croatian administration and that very few persons, if any, have been appointed as financial controllers. In the end, the effectiveness of the system is in all respects conditioned by the professionalism and formal standing of these key actors.

The contents of the various functions, in particular those of the financial controller, are somewhat more elaborated in the draft strategy for PIFC. There is an attempt to better define the tasks of the accounting officer, authorising officer, financial officer and paying officer. It is, however, not clear how all of these posts correspond to the Organic Budget Law terminology. The draft strategy also provides guidelines for the setting up and performance of so-called “ex post control”. As a matter of fact, the description of this activity of ex post control focuses on inspection work, with the aim of distinguishing it from the – otherwise established – internal audit activity. It is nevertheless questionable whether the definition given will really ensure a clear differentiation between those two ex post types of scrutiny. Additional work and guidance seem to be necessary in this respect. Indeed, in parallel to the setting up of internal audit units, units for financial management, internal supervision and control are progressively being established. Such an autonomous unit has been foreseen in the organisational structure of the Ministry of Finance since the decree of March 2005 on the internal organisation of this ministry.

In general, on these issues the draft strategy tends to focus more on the institutional aspect of financial management and control than on the practical aspects, such as the description of processes and working tools that would help an internal control culture to permeate the Croatian administration. Financial control is still very much understood in practice as a matter for specialist bodies or individuals in an organisation, or as a set of specific procedures. This perception also results from the action plan that is appropriately attached to the draft strategy, where the measures planned for the development of financial management and control are small in number compared to those listed for internal audit. In all cases, the action plan’s timetable displays very tight deadlines, which in reality could hardly be met.

To steer the financial management and control (FM/C) process, the Ministry of Finance has created a sub-division for methodology and co-ordination of financial management and internal control as part of the central harmonisation unit, which at this early stage of development is fully appropriate. This body is at the moment not really operational, having only two staff (four are planned), and since the main contribution in terms of substance – as well as for networking and co-ordination with the various budget-users – lies with the providers of technical assistance. This sub-division should develop in the coming months, as it seems to be appropriately supported by the description of its tasks in the draft strategy. Once this strategy has been translated into a legal text, it will be necessary to allocate proper resources to these developments.

Some ministries have been identified to act as pilot budget-users for the implementation of the new FM/C schemes. This is the case, among others, of the Ministry of Health. It would be helpful if the Ministry of Finance could give credibility to the FM/C schemes by implementing them as well, e.g. by initiating pilot exercises in the ministry, such as the development of audit trails and the performance of control self-assessments, thereby paving the way for risk identification, assessment and management actions.

Such steps have as a matter of fact partly been taken in the specific area of management of EU funds, where the situation is not yet fully stabilised, however. A Central Financing and Contracting Unit was established in August 2001. It is currently headed by an assistant minister and has 14 staff. A National Fund was set up recently and the National Authorising Officer appointed. Procedures have started for the development of management capacities of agencies responsible for EU pre-accession funds – at the moment Phare, ISPA and ongoing CARDS support – in the framework of the Decentralised Implementation System. The process should start soon for the SAPARD programme, with a view to certifying the capacity of the responsible Croatian authorities (SAPARD Agency and National Fund) to manage this programme in a fully decentralised manner. While taking account of their differences, it is important that these different processes are well co-ordinated and that they make full use of their synergies. The systems and procedures required for the management and control of EU pre-accession funds, in particular for SAPARD, as well as the process to set them up, could serve as useful references for the domestic budget, and adequate linkage and co-operation should be organised in that respect.

Systems and procedures for management and control are only partially in place at the moment in Croatia. Their development is ongoing, although clarifications are needed on numerous points; in any event it is dependent on the overall strengthening of professionalism in the Croatian public service.

2.3 *Is there a functionally independent internal audit mechanism in place, with relevant remit and scope?*

Internal audit in the public sector is now based on articles 137 and 138 of the Organic Budget Law, which stipulate that each budget-user must establish an internal audit. These provisions are supplemented by the rulebook of 30 July 2004, which defines the requirements as internal audit, work standards and methodologies, as well as the CHU co-ordination role. It seems unrealistic, however, for each budget-user to set up an operational internal audit unit, considering the number of these bodies, and this factor has been taken into consideration in the draft PIFC strategy when defining the future audit role of the Government Office for Internal Control. However, no text defines the criteria and procedures for establishing an internal audit unit. Another important missing component is the status of internal auditors (and of course the plans for their incorporation into the civil service scheme and salary scale). It is also remarkable that, contrary to what has happened in most of the former candidate countries, no specific provision is envisaged to protect individual auditors or heads of internal audit units against arbitrary decisions of the management. This point has nevertheless not been overlooked, since the Internal Audit Council foreseen in the draft PIFC strategy should, among other functions, carry out an advisory procedure on the appointment or dismissal of heads of internal audit units. This procedure is only intentional at this stage, however, and it is not clear whether, once legally supported, it would apply to current positions. In addition, such a key point deserves more explicit mention in the draft strategy.

The planned composition of the future Internal Audit Council does not call for particular comments, except that there could be room to include the State Audit Office. In general, the relations between internal and external audit are good (in a context where internal audit is not yet fully operational), but a more structured relationship could be considered in the future. This could take the form of a formal agreement between the State Audit Office and the Ministry of Finance, covering as many relevant issues as possible (co-ordination of operational activities, co-operation in training, human resource policies). At the moment, these relations are highly facilitated by the fact that the current assistant minister in charge of the CHU is a former deputy auditor general.

In practical terms, internal audit units have been formally established in seven central ministries, which have amended their respective systematisation decrees to that effect. Other units are in the process of being set up, as internal auditors from a total of 14 ministries are participating in the training currently provided by technical assistance. The training scheme encompasses six mandatory modules and a set of six optional courses for more in-depth study of certain aspects. At the moment, 60 auditors have completed the six modules and are now attending optional courses, while 20 auditors are in the basic training phase. The CHU expects 100 internal auditors to be fully trained and certified by the end of 2005, and another 100 could be enrolled in qualification activities in 2006. The training is provided by the existing technical assistance project, and this will remain so in the medium term. At the moment, no particular plan exists in this area, but the CHU should start to design plans and identify or create training resources for the future, providing both initial and continuous training. A possible path to explore would be through co-operation with the external audit body in the area of training, considering the opportunity and interest of designing a common syllabus, as has been the case in neighbouring countries. The possible future contributions of the training resources of the Central Office for State Administration should also be taken into consideration.

It has been noted that the average internal auditor in the Croatian public administration already has considerable experience in other or related areas of administrative activity, such as the precursor of the financial police or other "control bodies". This fact speaks for the seniority and experience of most newly recruited internal auditors, but on the other hand may introduce the risk of a biased approach to daily internal audit work.

This risk is nevertheless difficult to assess, since in practice very few audits are performed at the moment, and most of them are in the Ministry of Finance. To a large degree, internal audit activity in Croatia is mainly a training activity. Rightly so, as it also covers activities aimed at raising the awareness of managers about the role and operating modes of internal audit.

In the framework of the current PIFC technical assistance project, internal auditors are provided with substantial documentary support. The department for internal audit and control (precursor of the CHU) has issued an internal audit guide, which can be regarded as a basic manual for the performance of systems and regularity audits. The guide refers to generally accepted standards in the area and covers the basic technical

needs of a public internal auditor. Not enough audit work has been completed to date to judge the usefulness and effectiveness of this guide.

The development of internal audit should lead to redefining or clarifying the role of at least two “control” bodies. The creation of the Budget Control or Supervision (*nadzora*) Service in the Ministry of Finance is based on section XI (articles 133-136) of the Organic Budget Law, but can be traced back to former provisions. The service is in essence responsible for verifying the “lawfulness, purposefulness and timeliness of the use of budgetary funds” and for proposing measures or sanctions to remove and/or punish misdemeanours and other breaches of financial/budgetary law, on the basis of the Law on Administrative Procedure and the Organic Budget Law (section XII contains a long and very detailed list of penalty clauses).

A Government Supervision (*nadzora*) Office was created in January 2001 as a part of the Prime Minister’s Office, with the functions of co-ordinating internal control bodies set up in accordance with the provisions of the then applicable budget law, and of carrying out such control tasks throughout the Croatian administration. According to the Organic Budget Law of 2003, the role of the Government Supervision Office should evolve so that this body becomes the Government Office of Internal Audit. It is to act as an internal audit body for those budget-users too small to justify the existence of a permanent internal audit unit.

Internal audit is basically in a phase of institution-building at the moment, and considerable efforts will still be needed in order for this function to be in place and to meet the assessment baseline.

2.4. *Are systems in place to prevent and take action against irregularities and to recover any amounts lost as a result of irregularity or negligence?*

Amounts lost as a result of irregularities or negligence are recovered in the same way as taxes and other receivables (such as health insurance and pension fees). After notification is given to the debtor, followed by a reminder, the Tax Administration can impose an obligation and freeze the debtor’s account. Property can be seized and sold by the administration on the basis of a court decision in the event of continuing non-compliance. It remains to be seen whether such a procedure is efficient in practice and can be regarded as sufficient to fulfil the demands for safe and prompt recovery of illegal spending of EU funds (in particular for SAPARD), as well as for the timely and comprehensive collection of EU resources. The activity of collection and recovery is performed by the Tax Administration on behalf of one-half of the local authorities on the basis of contractual arrangements (other local receivables are collected directly by the creditors).

At the moment of the assessment visit, the Croatian authorities had still not designated a contact point for the European Anti-Fraud Office (OLAF). The Office for the Prevention of Corruption and Organised Crime has been considered as a possible candidate for this function, as has the State Prosecutor’s Office. It is important that the expected functions of the Anti-Fraud Co-ordinating Service (AFCOS) are properly analysed and understood before any decision is taken in this regard. Other bodies could be considered to play this contact role in view of the future management of EU pre-accession and post-accession funds, as well as domestic funds, in particular in the Ministry of Finance.

Systems seem to be partially in place to deal with irregularities and to recover amounts lost.

3. Capacity to Further Develop the System

The Croatian Ministry of Finance has recently shown an intense determination in the development of PIFC with the establishment and strengthening of the CHU and the redrafting of the PIFC strategy to illustrate the commitment of the whole government to support this new policy. There also seems to be a serious involvement of all line ministries and other central agencies, at least the most important among them, which can only have a snowball effect. The recent past has seen a speeding up of activity in this area, as the Croatian authorities are clearly committed to make up for lost time in the change process related to accession.

On the other hand, delays and difficulties are a normal consequence of certain deficiencies, starting with the paucity of human resources in the public service, both quantitatively and qualitatively, in the PIFC area as in other public policy areas.

The capacity to further develop the system would be greatly enhanced by ensuring that the many inputs of external assistance provided to Croatia – and to the Ministry of Finance in particular – operate in a co-ordinated way as far as policy substance is concerned. Ongoing improvements with respect to public expenditure management, budget processes and development of the treasury system are relevant for the development of PIFC as such, as well as the introduction of procedures and methods applicable to the management and control of EU funds.

4. Summary and Next Steps

The PIFC system in Croatia is still largely in an institution-building phase. The development of internal audit is linked to the implementation of the current technical assistance project, as the new internal audit staff are either in training or in a probationary period. On the financial control and management side, most secondary legislation and practical working documentation still have to be produced. The filling of these gaps should normally result from the PIFC framework legislation envisaged in the draft PIFC strategy. The future content of this legislation remains unclear at the moment, however.

The draft Public Internal Financial Control strategy will contribute to progressively bringing Croatian financial control arrangements in line with good practices of other candidate countries and EU Member States. However, some clarification is still needed with regard to the different key functions. A better balance should be sought between institutional and legal procedural aspects on the one hand and practical working aspects on the other, which would keep PIFC from becoming a matter reserved for some specialist functions only. Besides the further development of the still new internal audit function, priority should now be given in practical terms to the development and improvement of internal control systems and procedures and to the strengthening of the Central Harmonisation Unit. To date the design and implementation of policies have been very closely linked to the technical assistance provided in recent years. The concern about ownership and sustainability has been repeatedly expressed by providers as well as by the direct counterparts in assistance projects. Technical assistance will continue in the medium term and presumably for as long as Croatia is a candidate country; it is therefore important that policies and measures in the area of PIFC are designed and implemented as a self-standing and fully-fledged Croatian administrative reform activity. These policies and measures should take into particular account their efficiency and operational character beyond the period of technical assistance. This advice holds true most specifically for training and qualification activities.

It is normal that recent efforts have been mainly focused on internal audit development. Practical aspects in the development of financial control now need to be steadily addressed. Similarly, the Croatian authorities will have to obtain the full involvement of local and regional levels in the elaboration of PIFC-related policies. Ensuring the availability of properly resourced internal audit at these levels of government – without running the risk of scattering – is an important task. If this issue is not adequately addressed, there is a risk that these scarce audit resources will become uneconomical and useless.

Finally, the ambitions of the Croatian authorities to rapidly develop their PIFC system are quite legitimate. Experience in Croatia – as elsewhere – has shown that these developments need time and will not happen overnight without huge risks for the practical implementation. More relaxed deadlines should be set to ensure a real understanding of the new policies, allocation of adequate resources, and – in the end – solid implementation.

Priority should be given to the following actions:

A) Should be applied (or started) in the short term (next 12 months):

- The draft PIFC strategy has to be adopted at government level, but some points related to financial management and control should be clarified.
- The contents and deadlines of the timetable attached to the draft strategy require a review for the sake of realism.
- The secondary legislation foreseen by the Organic Budget Law should be finalised.

- The Ministry of Finance should also ensure the co-ordination in substance of the various technical assistance activities with PIFC components.
- A proper strategy for PIFC at local government level is needed.
- The CHU should develop its own work plan with the establishment of priorities. This plan should include the proper reinforcement of the CHU as well as the strengthening of its networking and guidance activities. It should also ensure, inter alia, that PIFC development is co-ordinated with other ongoing change processes in the area of public finance or related areas (e.g. development of the treasury system, reform of budget systems, introduction of performance measurement tools, civil service reform). In the longer term, it is expected that internal audit units will also be introduced at an early stage, as appropriate, to the new policies of the budget-users where they are located.
- The contents of the draft PIFC framework law should be better defined.
- The development of PIFC could benefit from the elaboration of policies and measures in the area of management and control of EU funds; the CHU should share information in that respect with the National Fund.
- The introduction of appropriate internal audit methodologies and development of manuals should continue.
- More pilot internal audits should be carried out and in budget-users other than the Ministry of Finance.
- The awareness of managers with regard to internal control and internal audit policies and functions needs to be further developed.
- Improvement of relations between public internal financial control and external audit, including the conclusion of an agreement describing possible areas of co-operation and co-ordination, should continue.
- Production of audit trails, control self-assessments, and risk identification/assessment/management policies could be undertaken as pilot exercises, preferably in the Ministry of Finance, which would then serve as examples of financial management and control (FM/C) procedures, to be disseminated across the whole Croatian administration.
- Systems to prevent and take action against irregularities and to recover amounts lost need to be reviewed.
- A decision needs to be taken concerning the contact point for the European Anti-Fraud Office (OLAF) and an appropriate anti-fraud co-ordination structure.

B) Should be applied (or started) in the medium term (next two years):

- Based on the above-mentioned policy, the plans for public internal financial control at local level should be implemented.
- Beyond the definition of the status of internal auditors as part of the Croatian civil service, an appropriate human resources policy for internal auditors will have to be developed by the CHU.
- In that context, schemes and organisation of future training of internal auditors should be developed, in particular in view of the sustainability of results once technical assistance has terminated.
- The designated Anti-Fraud Co-ordinating Service (AFCOS) and other competent authorities should endeavour to produce an anti-fraud strategy.