



SIGMA

Support for Improvement in Governance and Management

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

CROATIA

**PUBLIC INTERNAL FINANCIAL
CONTROL (PIFC)**

ASSESSMENT MAY 2009

1. Summary

In this assessment references are made to a peer assistance review carried out by Sigma in 2008. The text of this assessment is for a large part based on the peer review findings, which have been updated where necessary.

Main Developments since last year

The most significant development since the last assessment has been the adoption of a new Budget Law, which came into force on 1 January 2009. Besides budget-related issues, the law also covers accounting, budgetary control and other issues in relation to public internal financial control (PIFC) in Croatia. The process of change in the area of PIFC, which commenced in 2007, has continued into 2009, with the latest phase being the development of a new PIFC Strategy designed to ensure that the arrangements for PIFC are compatible with the “Strategy for the Development and Modernisation of the State Treasury 2007-11”, which was first published in October 2007.

The Central Harmonisation Unit (CHU) was reorganised at the beginning of 2009 in order to improve co-ordination between the financial management and control (FMC) and internal audit (IA) sectors of the CHU.

In the area of EU funds management, an Agency for the Audit of the Implementation System for the European Union (EU) Programmes was established by Government Regulation 35/2008 of 20 June 2008. By Government Decision of 30 July 2008, a third pillar of the Croatian system for the fight against fraud with EU funds, the Anti- Fraud Co-ordination Services (AFCOS) Network was established¹.

Main Characteristics (strengths and weaknesses)

A coherent and comprehensive legislative framework supports the implementation of PIFC. Previous inconsistencies between legislative acts, particularly between the PIFC Law and the Budget Law, seem to have been removed. In terms of practicalities, too much detail concerning the operation of PIFC remains in the PIFC Law, but this has been recognised by the Ministry of Finance.

Systems and procedures for the management and control of the state budget and of EU funds are largely in place. Significant reforms to public expenditure management will occur with the implementation of the Treasury Strategy and the implementation of the provisions of the 2008 Budget Law. The arrangements for PIFC need to be reformed in order to ensure that they complement the developments in public expenditure management. The focus of these arrangements should be on the role and responsibilities of management rather than just on technical issues, and therefore a better balance needs to be achieved between institutional and legal procedural aspects on the one hand and practical working aspects on the other, so as to keep PIFC from becoming a matter reserved for some specialist functions only.

There is still a detailed and legalistic approach to PIFC, which will not facilitate its functioning as an effective management tool and will still be expensive to implement. The FMC arrangements have resulted in an improvement in “control”, defined in a narrow sense, but do not encourage or facilitate improvements in the quality of public expenditure by obliging management to address “value-for-money”. This is inconsistent with the objectives of the Treasury Strategy. The CHU in the Ministry of Finance has recognised this problem, and a new PIFC Strategy now being developed is intended to deal with this issue. To improve the quality of public expenditure, some relaxation of detailed control by the Ministry of Finance is essential, but before that can occur, confidence needs to be built in the quality of public management in budget organisations. This process will take time and will require not only a reform of the technical approaches to PIFC but also a better understanding by management of the purpose of PIFC. Rather than regarding PIFC as an imposed external requirement,

¹ The other pillars are the Department for Combating Irregularities and Fraud in the Ministry of Finance and the Network of Irregularity Officers.

managers need to realise that it is a fundamental element in ensuring that they fulfil their own role efficiently and effectively.

The design of a functionally independent internal audit service does exist in Croatia. Most of the institutions required to establish internal audit units have done so, although the majority is – sometimes considerably – understaffed. The internal audit service is fully supported by the PIFC Law. For the audit of the programme of the Instrument for Pre-accession Assistance (IPA), an agency (Audit Authority) has been established and has been fully operational since May 2009.

Although there has been an increase in internal audit activity, the focus still seems to remain on compliance. This limited role of internal audit will need to be addressed in the new PIFC Strategy. An upgrading of the internal audit role is needed to match the management changes that the Treasury Strategy and EU funds will bring, but the new PIFC Strategy should also take into account the impact that the understaffing of internal audit units has on the further development of the internal audit profession in the public sector. Considerable efforts are needed to create a sustainable internal audit environment. Training will be an issue in the future, for all management functions and for internal auditors. To avoid too great a burden falling on the CHU (which is the main trainer), additional arrangements need to be made.

Systems have been developed to deal with irregularities and to recover amounts lost. The Department for Combating Irregularities and Fraud in the Ministry of Finance, established in 2008, is the leading entity in developing an anti-fraud strategy; the department is the official contact point for the European Anti-Fraud Office (OLAF).

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. Deadlines should be set to ensure a real understanding of the new policies, allocation of adequate resources, and – in the end – solid implementation. Reform is essentially about achieving cultural change within management (at both the political and official levels) and not just technical change. Technical change is relatively easy to achieve, but this technical change alters the whole way in which public expenditure is managed, especially as it is now intended to shift the focus from “control according to the budget and the law” to improving the quality of public expenditure.

Recommendations for Reform

In the short term (next 12 months), priority should be given to the following:

- The development work on the new PIFC Strategy should be consistent with the Treasury Strategy and consequently should focus on the impact of PIFC on improving the quality of public expenditure. A key addressee of the Strategy should therefore be “management”. Connections should therefore be established in the Strategy between implementation of the concept of managerial accountability in the PIFC framework and development of strategic planning in relation to budget preparation and budget execution as well as related reporting obligations. This will also impact on the role of internal audit.
- The CHU should review some of the current requirements expressed in both primary and secondary legislation to ensure that those requirements are relevant to all organisations to which they apply at present and to remove or allow greater flexibility for the interpretation of requirements, as appropriate.
- The primary concern so far (and quite properly) has been on the establishment of organisational structures related to PIFC. The next stage is to develop monitoring arrangements designed to assess and improve the operational quality and effectiveness of those structures, especially where they support top management in the delivery of performance objectives.
- Advice and guidance on the application of PIFC should properly reflect the operational and managerial circumstances of the organisations that will be the targeted recipients of that advice/guidance.

- The success of PIFC very often depends on the governance arrangements set up within institutions, and the CHU should therefore consider the preparation of advice on the application of “corporate governance” principles, to be provided to budget organisations (including local government organisations).
- The focus of the CHU’s activity should gradually shift towards support and networking, with training according to CHU specifications to be provided by other bodies.
- Arrangements should be made for the establishment of professional training for internal auditors, leading to an appropriate qualification.

In the medium term (next two years), priority should be given to the following:

- Given the thrust of the Treasury Strategy and the complementary PIFC Strategy, the finance function within public organisations should be strengthened so as to support top management by providing the underpinning analysis and support systems that are required. Once that capacity-building has occurred, the head of the finance function should have responsibility for deciding on the organisational structure of that function and its mode of operation within the organisation, in accordance with broad guidelines.
- Risk management should be developed, taking into account “business risks” as well as systems risks, and embedded in the management process of all budget organisations.
- Arrangements for specialist and horizontal audits should be strengthened.
- Arrangements to externally review the quality of internal audit should be developed to enable the implementation of such external quality reviews on a regular basis.

2. Baseline Questions

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

The most significant development since the last assessment has been the adoption of a new Budget Law. This law regulates the planning, preparation, passage and execution of the budget, asset and debt management, public debt management, borrowing and guarantees. It also covers accounting, budgetary control, and other issues related to public financial management. This law applies to state budget organisations, local and regional self-government units, extra-budgetary funds, companies and other legal persons in which the state or the local/regional self-government has “a decisive influence on the management, or on the preparation of financial plans, cash management, borrowing and issuing guarantees, accounting, producing and submitting reports and carrying out the budgetary control, which are, with regards to financing sources, included in the general budget” [article 2 (2)]. It also specifically requires budget funds to be used “in accordance with the principles of sound financial management, and especially in accordance with the principle of cost-effectiveness and efficiency” (art. 11). This is particularly significant in terms of developing the system of PIFC, although the Budget Law does not define these principles, leaving therefore considerable scope for the application of the principles in different circumstances. The head of the budget-user (i.e. top manager) has responsibility for the planning and execution of the budget, the collection of revenues and the legality of actions that are taken as well as specifically for the efficiency and cost-effective management of budgetary funds. An appropriate separation of responsibilities is required. Accounting arrangements are also regulated by this law, with the details provided in a rulebook on budget accounting and on the content and organisation of the chart of accounts. Accounts are to be kept using modified accrual accounting as the basis. An additional rulebook on financial reporting in budget accounting is also to be published.

The Budget Law applies equally to European Union funds and specifically refers to these funds as being part of the state budget. It also aims to ensure the protection of the financial interests of the European Union by establishing a system for the prevention of irregularities and fraud (Anti-Fraud Co-ordination Service –AFCOS).

As in the previous (2003) Budget Law, the new Budget Law also regulates the budget supervision arrangements. Budget supervision is defined by the law as “a procedure of monitoring the lawfulness, purposefulness and timeliness of the use of budgetary funds which prescribes measures for eliminating the identified unlawfulness and irregularities, as well as measures for the improvement of the situation.” (art. 115). Other functions (such as internal audit and financial control) described in the previous Budget Law are not introduced in the new Budget Law. However, the key law relating to PIFC is now the PIFC Law.

The PIFC Law sets out in detail specific PIFC concepts and procedures and brings up to law level the provisions relating to internal audit, previously contained in secondary legislation (rulebook). The PIFC Law places the responsibility for PIFC on the head of the budget-user (as in the 2008 Budget Law) and also refers to the need for efficiency and effectiveness in the management of public services, principles that are defined in this law. It also defines in more detail than the Budget Law the responsibilities of the head of the budget-user towards PIFC, and it requires the appointment of a financial management and control head and a financial management and control co-ordinator to ensure the establishment of a robust financial management and control system within the budget-user organisation. In other words, responsibility for PIFC falls on the top manager, but to ensure an appropriate division of responsibilities that top manager has to appoint other officials to be specifically responsible for the process of FMC within the organisation.

The PIFC Law also refers to the need to develop risk management. Annually, a report is to be sent by the head of the budget-user to the Central Harmonisation Unit (CHU) on the functioning, effectiveness and efficiency of financial management and control. A report on “the functioning, effectiveness and efficiency of financial management and control” is not the same as a report on the efficiency and effectiveness with which the organisation has delivered on its objectives, which is,

quite properly, the responsibility of the top manager, but the PIFC system should support the top manager in exercising this responsibility, which extends beyond the stewardship functions that are implicit in the description of responsibilities of the Financial Management and Control Head and the Financial Management and Control Co-ordinator. There was no evidence of systematic analysis within budget-users or of reporting required by the Ministry of Finance with regard to the efficiency and effectiveness with which budget resources are used.

The PIFC Law also prescribes in detail the arrangements to be made for internal audit within budget organisations and how internal audit is to operate. The law provides for the independence of internal audit, the reporting arrangements directly to the head of the budget-user, and the security of the head of the internal audit unit. Internal auditors are required to use an internal audit manual to be prepared by the CHU, which also has the responsibility of maintaining the relevance of this manual. Other references in the PIFC Law are to an internal audit charter, a code of ethics and internal audit planning arrangements. The internal audit plans are to be sent to the CHU and followed up by an annual report on internal audit activity. Internal audit is also to cover EU-funded projects. This law makes specific provisions for the role of the CHU and prescribes the activities of the CHU.

The PIFC Law provides for the establishment of a PIFC Council to advise the Minister of Finance, in particular with regard to the further development of PIFC, including a review of the self-assessments that budget-users are required to undertake, the approach to risk assessment, and the safeguard of the independence of internal audit.

In the 2008 assessment, concern was expressed about the tendency of the PIFC Law to over-regulate, at the expense of flexibility and adaptation capacity, and it pointed to the need for better co-ordination between that law and other existing (and applicable) laws, in particular the 2003 Budget Law then in effect. Inconsistency between the PIFC Law and the new Budget Law does not now appear to be a problem.

Under the terms of the 2003 Budget Law, secondary legislation relating to internal audit was to have been prepared. This legislation had been completed with the adoption of the budget-users' internal audit rulebook in August 2004, which a new rulebook of 12 December 2005 revised completely. This more recent text adequately covered most issues that are now addressed in the PIFC Law, and the rulebook format was in many respects more appropriate than a law format for internal audit-related issues. In March 2008 a rulebook relating to financial management and control (FMC) was published by the CHU (with the support of a CARDS project).

At the present time a revised PIFC Strategy is being elaborated to reflect the requirements of the 2008 Budget Law. This work has to be completed by the end of June 2009. At present there is no intention of revising the PIFC Law, although it is recognised that some articles may need to be changed. However, during the period 2009-2011 (the period covered by the Treasury Strategy and also proposed for the new PIFC Strategy) the implementation of the law will be monitored in order to identify any changes that may be required. In addition, as the PIFC Law is very detailed, some specifics dealing with methodology could be excluded from primary legislation in an eventual revision and included instead in secondary legislation (rulebooks and manuals). This problem has been recognised, but the degree of reform required will be assessed during the period 2009-11.

A coherent and comprehensive legislative framework supports the implementation of PIFC. Previous inconsistencies between legislative acts, particularly between the PIFC Law and the Budget Law, seem to have been removed. In terms of practicalities, too much detail concerning the operation of PIFC remains in the PIFC Law, but this has been recognised. However, a measured approach to further reform is proposed, and such an approach should be supported.

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

The main innovation of the PIFC Law is that it defines the concept of financial management and control, its purpose and organisation. It defines more specifically than the 2003 Budget Act did the responsibility of the head of a budget-user and how his/her function can be delegated. It furthermore introduces two new functions in addition to the head of the budget-user: the head of financial

management and control (responsible for setting up and implementing financial management and control), sometimes referred to as the “FMC champion”, and the co-ordinator of financial management and control (responsible for “operationally carrying out and co-ordinating the establishment and development of financial management and control”). From the mere wording of the PIFC Law, the difference between these two functions is not very clear (both are involved in the establishment of the FMC system, but the co-ordinator is more involved with operational tasks).

The PIFC Law devotes detailed provisions to the quotation of the basic components of the “COSO” internal control model. Control activities are mentioned in a non-exhaustive list, but the decision regarding which activities are to be selected and implemented in the specific organisation is left to the head of the budget-user.

The progress being made by budget organisations in implementing the provisions of the PIFC Law is monitored by the CHU through the annual self-assessments. Heads of financial management and control (“FMC champions”) and FMC co-ordinators (and FMC working groups, which are required by the secondary legislation) have generally been appointed in larger budget organisations, although the process may not have been fully completed in smaller budget organisations (especially in some municipalities).

The financial management and control manual produced by the CHU with the support of the CARDS project constitutes, in addition to the legal framework, the foundation for the development of the PIFC system in Croatia, and it uses as its base the COSO framework. Budget organisations are required to prepare “FMC system establishment and development plans”. These plans should in principle be based on a self-assessment exercise, which is meant to evaluate the five financial management and control components taken from the COSO framework. This evaluation should be supplemented by a description of the “business processes”, including the audit trail attached to each process. The Sigma peer review completed in 2008 was concerned about this process, partly because of the amount of work associated with the description of each business process (especially for smaller budget organisations). It also considered that many business processes had no relevance to financial management at all and therefore an analysis of these processes for the purposes of assessing “business risk” would be of limited usefulness. The peer review also pointed out that “risk” could not be defined by an analysis of systems alone and would need to take into account many other factors, such as the existence of business objectives, performance information and external environmental factors. It was also concerned that, while references were made to “efficiency and effectiveness”, the primary focus of the FMC arrangements was on the traditional aspect of “control” and that efficiency and effectiveness tended in practice to be regarded in terms of their compliance with the budget and the law. A further concern was about the seeming complexity of the arrangements, especially concerning the allocation of responsibilities between the FMC head and the FMC co-ordinators.

The arrangements for “governance” had also not been addressed when considering how FMC had developed, except in a most limited manner based on the COSO analysis, and therefore no regard had been paid to such issues as:

- the need for clarity regarding the purpose of the organisation and the intended outcomes for citizens and service-users;
- the need for clarity regarding the functions and responsibilities of the various groups within the organisation, from ministers down to lower executive levels of responsibility;
- the need for clarity when defining and putting organisational values into practice, with all staff of the organisation, from the minister down to lower executive levels, behaving in accordance with those values and with the publication of those values;
- the need to ensure that decisions are taken in a rigorous and transparent manner and that good quality information and advice are utilised before those decisions are made (decisions should be based on evidence and not on irrelevant information).

The overall impression is that FMC has been developed in an overly legalistic manner and that it may be disproportionately expensive to implement and may not achieve the intended objective, apart from

strengthening “control” in a narrow sense, whereas FMC is also concerned with supporting the top manager in delivering on objectives so as to secure value-for-money in the use of budget resources.

In that broader sense there has been no real understanding of the purposes of the processes being implemented. The self-assessment questionnaires were successful, insofar as stewardship is concerned, in helping the CHU to determine the extent to which FMC systems had actually been put in place. What those questionnaires did not do, however, was determine the quality of those systems or the adequacy of those systems to support top management in delivering value-for-money. Also, judging by the findings of the peer review, which analysed a number of questionnaire responses, not all who responded to the questionnaire had completed them in the same way, and the self-assessed judgments about the quality of the PIFC systems seemed to vary considerably.

These weaknesses in the approach to PIFC could potentially inhibit the achievement of the objectives of the Treasury Strategy. To achieve them will require a longer-term approach to planning, greater clarity in the development of objectives, the establishment of performance information, and the introduction of a programme approach to budgeting. The underlying aim of this Strategy is to improve the quality of public expenditure through a greater focus on achieving objectives and on obtaining value-for-money in the process. All of these requirements should impact on the PIFC arrangements. There has also been some (although limited) relaxation in the detailed control over spending exercised by the Ministry of Finance.

The weakness in the current approach to PIFC has been recognised by the Ministry of Finance CHU, which has started a review of the present PIFC Strategy so as to take into account the peer review recommendations. Although the initiator of the strategy review and its driving force is the CHU, line ministries and other agencies are contributing to the review as members of a working party. Once approved, the new PIFC Strategy will be supported through training workshops. However, overcoming these weaknesses will require a considerable emphasis on the training of management, not just for them to learn new procedures but also to increase their understanding of the role that PIFC plays in the whole management process, that is, in meetings objectives and delivering performance. Top managers – but also those with delegated tasks – need to understand that PIFC is not an “add-on” required as a condition of entry into the European Union, but a fundamental element in the effective management of public resources and the use of those resources in the most efficient and effective manner once Croatia becomes a member of the EU. Therefore the main target for the new PIFC Strategy proposals should be “management” rather than those concerned with the day-to-day practicalities of public internal financial control.

The Central Harmonisation Unit (CHU) for PIFC in the Ministry of Finance is headed by a director. The systematisation of the CHU is 27 staff, i.e. besides the director and secretary there are 25 staff for operational tasks. The staff number of 27 to carry out CHU tasks seems high, especially compared with the staff numbers of CHUs in other countries, where the CHU has never been a large central organisation. The quality of staff is often more important than the quantity for achieving good results. In May 2009 the CHU had 14 staff members. It was reorganised in 2009 and now has three components, one for methodology and standards, one for co-ordination of training and quality assessment, and one for international activities. The first two components have two subdivisions, one dealing with internal audit and the other with financial management and control. The component dealing with methodology and standards has an establishment of ten staff, the component for training and quality assessment has eight, and the component for international activities has seven. The primary reason for this reorganisation was to achieve much better co-ordination between FMC and internal audit than had existed under the previous arrangements, where only the director had an overall perspective. The separation of international activities into a special service arose because of the scope of these activities, which includes co-operation with international organisations, professional associations and European Union bodies aimed at aligning the *acquis communautaire* concerning PIFC; monitoring of international activities, and fluent use of English at operational level. The CHU has been, and still is, the driving force for the development of PIFC, whether it be in terms of producing policy documents and legal texts, raising awareness about PIFC and advocating the concept, organising and delivering training, and interacting with the Commission in the development of PIFC. It is also the main provider of training.

The CHU produces annually a “Consolidated Annual Report on Public Internal Financial Control in the Republic of Croatia”. This report is based on the annual reports on the establishment of financial management and control systems produced by all budget-users.

The PIFC Law provides for a high-level PIFC Council to act in an advisory capacity to the Minister of Finance and as such to support the activity of the CHU. The PIFC Council, which replaces the former Internal Audit Council, consists of 23 members and is chaired by the Minister of Finance. It has only met once, compared with the three times a year that were anticipated when it was established, mainly because of the 2007 elections. The Sigma peer review of April 2008 expressed concern that the meeting of the PIFC Council had been so affected by the elections, especially as PIFC is essentially a technical activity aimed at providing assurance to heads of budget-users that PIFC is being properly implemented.

In October 2009 new members (among others, the Chief State Treasurer, the National Authorising Officer, and the Director of the Agency for the Audit of Implementation of EU Programmes) of the PIFC Council were appointed by the government. The newly assembled Council met on 24 February 2009 and discussed the detected weaknesses of the internal financial control system. Following the Council’s proposal, on 18 March 2009 the government passed a Conclusion, delegating responsibilities to heads of budget-users to fill vacant posts in internal audit units (particularly heads of budget-users that are beneficiaries of EU pre-accession funds). Furthermore, the above-mentioned Conclusion obliges these heads of budget-users to place the co-ordination of the creation and development of financial management and control under the authority of the existing finance and budget units.

In the area of management of EU funds, the Central Finance and Contracting Unit was established in 2001. In October 2007, a Government Regulation was passed, establishing a Central Finance and Contracting Agency – CFCA (OG 90/07, 114/07), replacing thereby the Central Finance and Contracting Unit within the Ministry of Finance. This decision was taken in response to the need to enhance the capacity and the quality of work on tendering and contracting CARDS, PHARE and ISPA projects. The CFCA officially started its operations on 1 February 2008 after the Transfer Agreement between the CFCU and the CFCA and the Memorandum of Understanding between the European Commission and the Government of Croatia on the Establishment of a Central Finance and Contracting Unit were signed by the Minister of Finance and the Head of the EC Delegation in Zagreb. The CFCA is headed by a director general, and in May 2009 has 95 employees. The National Fund has been set up, and one of the state secretaries in the Ministry of Finance has been appointed as the National Authorising Officer. Management capacities for managing the EU pre-accession funds Phare, ISPA, CARDS and Sapard have been developed and accredited in the framework of the Decentralised Implementation System (DIS). The accreditation process for the Instrument for Pre-accession Assistance (IPA), which replaces all former EU financial pre-accession support schemes, is nearly finished. The systems and procedures required for the management and control of EU pre-accession funds, as well as the process for setting them up, have been used in the drafting of the new PIFC Strategy as useful references for the domestic budget.

Systems and procedures for the management and control of the state budget and EU funds are largely in place. There is still a detailed and legalistic approach to PIFC, which will not facilitate its functioning as an effective management tool. The FMC arrangements will facilitate an improvement in “control” as defined in a narrow sense but will not encourage the FMC system to adapt to the requirements imposed by the new Budget Act (and the Treasury Strategy) unless a reformed approach is adopted. However, this problem has been recognised by the CHU of the Ministry of Finance, and a new PIFC development strategy is being prepared.

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

The exercise of effective internal controls implies an effective budgeting, accounting and financial reporting system and an independent audit activity. The budgeting system in particular determines the reports that are required, the responsibilities that impact on the top management (heads of

budget-users) and hence the risks that top management faces, not least in the efficient and effective use of budget funds. In particular, as internal audit activity should be based on an assessment of the risks that organisations face, those systems, and not least the budgeting system, also impact on the direction of internal audit activity. Given the reforms envisaged in the Treasury Strategy and incorporated into the Budget Law, changes will also be required in the approach to internal audit, especially as that Strategy envisages an added focus on performance in achieving objectives for which budget funds are made available. Internal audit will need to be able to respond to the introduction of three-year planning, clearer objectives, performance measures and programme budgeting if it is to remain a relevant management tool. The new PIFC Strategy therefore intends to address the development of the role of internal audit, with a view to ensuring its relevance in the revised financial management environment.

These changes, however, will not affect the underlying role of internal audit, nor its status and independence, although as the Sigma peer review pointed out, “independence does not mean isolation from management”. To be effective, extensive co-operation with line management is required, especially in increasing the understanding of risk and in the formulation of audit plans. Indeed, the independent nature of internal audit activity has tended to be overstressed, with the result that internal auditors have had only one speaking partner (and addressee of reports), the head of the budget-user. The effectiveness of internal audit as a management tool depends very heavily on how well management (top management as well as those with delegated tasks in line management) works with internal audit and regards it as a service that can add value to their own activity. In other words, internal audit should be embedded in the management process and not isolated from it. If internal audit works only for top management its effectiveness will be limited.

Internal audit in the public sector is based on articles 16 to 33 of the PIFC Law, which to a large extent reflect the contents of the rulebook of December 2005. This rulebook remained applicable until the new secondary legislation on internal audit was issued with the rulebook “on user of internal audit” in March 2008 (OG 35/08).

Considering the number of budget-users, it is unrealistic, and inappropriate in quality terms, for each budget-user to set up an operational internal audit unit. The PIFC Law therefore provides for co-operation between internal audit units and for an audit service to be set up by another ministry or other public organisation. Ministry of Finance approval is required for such co-operative arrangements. The new rulebook of March 2008 provides more detail on such arrangements aimed at ensuring greater flexibility.

According to the rulebook on internal audit, of the 108 state-level budget-users, 42 are obliged to set up internal audit units. At local government level, of the 127 organisations, 43 are required to set up internal audit units. The number of these units that had prepared strategic plans were 28 at state level and 31 at local government level. Annual plans were produced by 29 internal audit units at state level and 33 at local level.

Internal auditors' jobs are incorporated into the civil service scheme and salary scale. They are consequently included in the decree of 30 May 2005 amending the decree on titles of positions and job complexity coefficients in state administration, which defines the respective salary levels of civil servants in a way that makes the job competitive. Although the complexity of job coefficients was increased in 2005, resulting in an increase in the salaries of internal auditors, the understaffing of internal audit units at a level between 30% and 50% is becoming more and more of a problem. Salaries in the private sector have increased considerably since 2005. Certified and experienced internal auditors leave the public sector more frequently, and the recruitment of new staff appears to be problematic.

To protect internal auditors or heads of internal audit units against arbitrary decisions of the management, the PIFC Law provides for the CHU to be informed prior to disciplinary measures, transfers or dismissals of internal audit personnel by the head of a budget-user. The PIFC Council, among other functions, may be asked to evaluate the justification of reasons for the dismissal and/or transfer of the head of an internal audit unit. The law specifies that internal auditors cannot be dismissed or transferred to other positions on account of their reports and recommendations (art. 23 §

1). This should go without saying, but unfortunately the law does not enunciate further the procedures on these points and the extent to which the Minister of Finance, once the CHU has been informed and can provide an opinion on individual measures (art. 35 § 1, e), can oppose unjustified decisions. Such a key issue deserves more procedural details than the provisions currently contained in the law.

Internal audit activity has increased in recent years, according to statistics prepared by the CHU on the number of audit reports and recommendations made.

Training for internal auditors is mainly provided by the CHU rather than by third parties. The training scheme encompasses seven mandatory modules and a set of seven optional courses for more in-depth study of certain aspects. The Ministry of Finance adopted in March 2007 a new programme for professional training and examination for the qualification of public certified internal auditor. This programme will serve as a basis for further training and examination. However, there are no permanent training resources for the future that provide both initial and continuous training. This imposes a significant strain on the resources of the CHU, which has been exploring the possibility of alternative training arrangements.

The main focus of internal audit activity appears to have been on compliance with laws and regulations. While this is an important element of internal audit activity, it represents only a limited approach. This in turn means that the opportunities that the availability of internal audit provides for management are not being fully exploited. While it appears that management is generally supportive of internal audit, this may not remain the case if the implications of the Treasury Strategy fully mature, thereby increasing significantly the demands on management. At present, managers do not appear to feel the need for other types of audit, including more systematic ones, as they are not accountable in practice for improving internal control systems and procedures within their organisation, let alone for reporting on the achievement of objectives and performance. One of the consequences of this rather limited role of internal audit is that the meaning, role and objectives of monitoring, supervision, inspection, internal control and internal audit still seem sometimes to be unclear to managers. Should the Treasury reforms, aimed at enhancing the managerial capacity of managers, be introduced, a programme of management awareness-raising will then be required, as well as a significant advance in the types of audit that are being conducted. These requirements will impact on training and hence on the resources of the CHU.

The CHU provides internal audit units with methodological support in terms of documents, such as an internal audit manual (now in its third edition) and an internal audit charter template. This methodological support is certainly useful, but it tends to be presented to internal auditors less often as examples and more often as mandatory documents from which it is impossible to deviate, even if justified by local circumstances. This approach is not necessarily appropriate and, for example, to follow the internal audit manual precisely requires, for some audits, the completion of redundant forms. Again, with regard to the internal audit charter, the individual charters should reflect organisational circumstances and it would be unusual to find that they were all much the same. The peer review recommended that internal audit units have the capacity to adapt such documents to suit their particular needs, provided that the CHU is informed. (A particular example of where such adaptations would be needed is with local government, as the material produced by the CHU specifically for local government apparently does not properly reflect the operational circumstances at local level.)

Heads of internal audit units are required to report annually about performed audits and other internal audit activities, in accordance with the guidelines issued by the CHU. This report has to be endorsed by the head of the budget-user. The PIFC Law lists the general issues to be covered by the annual report. The report includes the annual audit plan and information on the contents of the audit reports themselves, specifying cases where the recommendations had not been followed. This reporting system opens the opportunity for interference by the Ministry of Finance in the management activities of budget-users and contradicts the general thrust of the PIFC concept, which is to strengthen managerial accountability, thus implying a degree of autonomous capacity *vis-à-vis* the Ministry of Finance. The issue is different if the objective of the reporting is simply to assess the quality of internal audit activity. It is then quite normal and useful for those in charge of the quality assessment

to have in due course access to the audit plans and to the contents of audit reports. There is no evidence that this is a problem at present, but it does represent an issue to which careful thought should be given in the future, i.e. how to balance the needs of the CHU for information on institution-building and competency of those institutions with actions that could represent a diminution of managerial accountability.

A quality assessment could be conducted on a regular basis by the CHU, but periodically it would be useful if an external quality review could be commissioned (perhaps every five years). Such an arrangement could provide valuable support to the CHU.

An issue that does need to be addressed is how to develop a capacity to carry out “horizontal” audits (such as audits on salaries and procurement) and audits requiring specialist skills (such as contract, procurement and IT audit). At present arrangements do not appear to be in place to facilitate such audits and yet a need exists. These arrangements could be met by agreeing that one internal audit unit with a particular interest in a speciality would serve as the “expert” in that area, making its skills widely available as needs arose. Another solution could be to bring in specialist audit expertise, bearing in mind that a public official would have to define the type of work required, establish the contract and supervise the outcome. A designated organisation (perhaps the Ministry of Finance) could be given the responsibility of conducting “horizontal” audits.

Internal audit is a recent development in Croatia (barely more than three years old as an operational activity). There has been a recent increase in the number of reports, but according to the peer review, relatively few fully fledged internal audit reports have been prepared. Their format is similar (following the structure of the manual), as are the objectives and results of the audits (mainly concerned with compliance). Objectives such as improvement of procedures and processes have not been the main focus of the auditors, and recommendations still seem very general in a number of cases.

The role and function of the Budget Supervision Division in the Ministry of Finance has been revised in the new Budget Law. This traditional inspection activity is now organised as a central service, which investigates complaints of citizens or requests of governmental institutions. In early 2009 the division started to consider the scope of its future activities and its future operating arrangements.

In June 2008 the Agency for the Audit of the Implementation System for EU Programmes (ARPA) was established under the Ministry of Finance. This agency is the Audit Authority for the five components of the IPA programme and will also take care of auditing the SAPARD programme.² By March 2009 ARPA had been set up: it had moved to new premises, staff had been recruited (24 out of 27 in the systematisation), and manuals had been drafted. By May 2009 ARPA was fully operational and started its first three audits. Organising co-operation with internal auditors in auditing the IPA programme is a high priority of ARPA and of the CHU.

A functionally independent internal audit service exists in Croatia. Most of the institutions required to establish internal audit units have done so, although a majority is understaffed, sometimes considerably so. The internal audit service is fully supported by the PIFC Law. For the audit of the IPA programme, an agency (Audit Authority) has been established and since May 2009 it is fully operational. Although there has been an increase in internal audit activity, the focus still seems to remain on compliance. This limited role of internal audit will need to be addressed in the new PIFC Strategy. An upgrading of the internal audit role is needed to match the management changes that the Treasury Strategy and EU funds will bring, but the new PIFC Strategy should also take into account the impact of the understaffing of internal audit units on the further development of the internal audit profession in the public sector of Croatia. Training will be an issue in the future, for both management and internal auditors. To avoid having too great a burden fall on the CHU (which is the main trainer), additional arrangements need to be made.

² The State Audit Office (SAO) will remain in charge of the audit of the other pre-accession funds (Phare, CARDS and ISPA) and will consequently act as Audit Authority until the end of the pre-accession programmes. This task does not change the responsibility of the SAO for auditing EU funds.

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?

Under the PIFC Law the head of a budget-user is required to act in a way that takes into account risks related to irregularities and fraud and to take actions against such irregularities and fraud when they are discovered. The head of a budget-user is also required to appoint an “irregularities officer”.

Internal auditors, persons involved in financial management and control, and other employees are required to report suspicions of fraud or findings of irregularities simultaneously to both the head of the budget-user and the “irregularities officer”. The “irregularities officers” are to be notified of irregularities and suspected cases of fraud, and they can also act on their own initiative. When informed of an irregularity or suspicion of fraud, the “irregularities officer” (as well as the head of the budget-user) is to take “adequate measures”, including informing the State Attorney and “the body in charge of irregularities and fraud within the Ministry of Finance”, and within 15 days to inform in writing the person who had reported the irregularity or suspected fraud of the measures taken. A whistle-blower protection system has also been established, and the body in the Ministry of Finance responsible for this system is the Department for Combating Irregularities and Fraud. Irregularity officers have been appointed at central state level and some have also been appointed at local level. These innovative solutions demonstrate a degree of commitment on the part of the Croatian authorities in relation to the issue of irregularities. Few candidate countries, if any, have opted for such arrangements, and this may explain why there seems to be some difficulty in exactly defining the role and functions of these public officials.

The Department for Combating Irregularities and Fraud was initially established as part of the Budget Supervision Service of the State Treasury in the Ministry of Finance, but it has now been set up as a separate division in the Ministry of Finance. In 2008 this department (three staff out of the five in the systematisation) developed guidelines for risk assessment and a training needs assessment. The department is the official contact point for reporting irregularities to the European Anti-fraud Office (OLAF). By Government Decision of July 2008, an AFCOS network was established, comprised of representatives of enforcement bodies (administrative and criminal). The Department for Combating Irregularities and Fraud, irregularity officers, and the AFCOS network constitute the Croatian anti-fraud system. On the instigation of OLAF, this “system” is developing an anti-fraud strategy for the period 2009-2012 (in May 2009 the strategy had not yet been finalised).

Systems have been developed to deal with irregularities. The Department for Combating Irregularities and Fraud in the Ministry of Finance, established in 2008, is the leading entity in the elaboration of an anti-fraud strategy, and it is the official contact point for OLAF.

3. Capacity to Further Develop the System

The Croatian Ministry of Finance has constantly shown willingness and ability to develop PIFC, with the recent establishment and strengthening of the CHU and the 2009 revision of the PIFC Strategy to complement the Treasury Strategy. These activities illustrate both a recognition of weaknesses in the present arrangements and the commitment of the Ministry of Finance to support not only PIFC but to ensure its relevance as circumstances change. There also seems to be a serious involvement of line ministries and other central agencies, and through the working party arrangements for the development of the new PIFC policy they are demonstrating a practical commitment to maintaining the relevance of PIFC as circumstances change.

In addition to this high degree of commitment, the request of the Ministry of Finance for Sigma support in the elaboration of the PIFC Strategy and for help with the development of the budget supervision activity, AFCOS, and other activities arising from the 2008 Budget Law, as well as its request for a PIFC peer review in 2008 illustrate its acceptance of external scrutiny and its willingness to improve.

However, the initiative for reform and the main work associated with reform now occurs within the Croatian public administration. This is a sign of increasing maturity and confidence. Thus the

Treasury Strategy was designed by professionals in the Ministry of Finance, as is the new PIFC Strategy, which ensures strengthened local ownership of reforms.

4. Recommendations for Assistance

The Croatian Ministry of Finance is under considerable pressure to comply with chapter 32 of the *acquis communautaire*. Besides the technical assistance projects in the Treasury and Budget Execution Department, Sigma assists the Ministry of Finance in several PIFC-related areas, such as support in drafting the PIFC Strategy and Anti-Fraud Strategy and assistance to ARPA and the Budget Supervision Service in preparing for their new roles. The implementation of the recommendations of the Sigma peer review will probably require technical assistance or twinning assistance in 2010 or 2011.