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ALBANIA

PUBLIC INTERNAL FINANCIAL CONTROL (PIFC)

ASSESSMENT MAY 2008

1. Legal Framework

Progress in developing the legal framework for public internal financial control (PIFC) in Albania has continued, but the pace of this progress has varied, with most emphasis having been placed on drafting the new Organic Budget Law (OBL) and the Internal Audit (IA) Law. Some progress has been made in developing financial management and control arrangements. Framework provisions were included in the new draft OBL, which was approved by the Council of Ministers (CoM) in March 2008; approval by parliament is foreseen before the end of its summer session. Internal audit is regulated in a new law passed on 9 June 2007.

The Policy Paper on Public Internal Financial Control (PIFC), approved in June 2005, is the baseline document for both legal and institutional developments. This document outlines a development strategy for implementing the PIFC system in Albania in accordance with European Union and international standards. This strategy consists of:

- Clear separation of tasks between financial management control and internal audit functions, and strengthening of independence for internal audit, including a procedure for the appointment and dismissal of internal auditors;
- Establishment of a central service within the Ministry of Finance (MoF) as a special body for the development of methodology and the co-ordination and harmonisation of the PIFC system;
- Strengthening of managerial responsibility at all levels and establishment of a system of reporting to the MoF to ensure transparency in the use of public resources;
- Improvement of budgeting procedures and implementation of detailed description of goals, objectives and procedures for the various components of the PIFC system;
- Strengthening and improvement of the chief accountant role in public units;
- Development and implementation of risk assessment methodology and its management, and of the audit trail concept;
- Long-term professional training organised by a public institution with specific curricula for public sector auditors.

The PIFC Policy Paper is supported by an Action Plan with 25 activities. It should be noted that the present government had endorsed the overall approach in this policy paper but reassessed its priorities after it came into office in 2005. These priorities include the early introduction of the Organic Budget Law and the Internal Audit Law, an expansion of the coverage of financial management and control in these laws, the setting up of two Central Harmonisation Units (CHUs) for internal audit and financial management and control, the introduction of a new debt management law, new laws on public accounts with supporting software, and a new integrated treasury system.

The activities carried out in 2006 had mainly related to the development of the internal audit function within the Albanian administration. In 2007 the main focus was on drafting a new IA law, in which issues such as the independence of IA and the establishment of a CHU/IA were formalised. The Internal Audit Law was adopted by parliament on 9 June 2007. The planned activities related to financial management and control have not been carried out.

Key features of the Internal Audit Law of June 2007 include widening of the scope of internal audit functions to cover all public sector bodies; establishment of the functions of the General Directorate of Internal Audit (GDIA) in the Ministry of Finance, including its central harmonisation role for internal audit; the setting of responsibilities of public sector management with regard to internal audit; the functional independence of internal audit; appointment dismissal and disciplinary measures; the setting-up and establishment of functions of the Internal Audit Committee; and relations between the GDIA and other independent institutions, e.g. the High State Control. The law gives strong powers to the Minister of Finance, i.e. the GDIA. Several institutions have questioned whether the GDIA should have the authority to instruct and control independent institutions. Although independent institutions are also obliged to establish and maintain a sound financial management system (they also use taxpayers' money), as the GDIA is an instrument of the executive branch, it should not have powers over institutions belonging to the legislative or judicial branch (parliament, High State Control, etc.).

The draft Organic Budget Law introduces medium-term budget programming and the placement of managerial accountability in each budget unit at the level of the highest civil servant (secretary-general or equivalent), rather than at the level of minister or chairman of the council (local authority mayor). Broad provisions are made in the new draft law with regard to financial management and control, internal audit and financial inspection. As such framework paragraphs were considered to be insufficient to provide clear direction for financial management and control, reference is made in the draft OBL to more detailed provisions to be made in new legislation. The drafting of new legislation for financial management and control is foreseen under a PIFC twinning project with the National Audit Office of the United Kingdom (NAO/UK) and the Polish Ministry of Finance, to be started in September 2008. As a consequence of the new OBL, revisions of the PIFC Policy Paper and Action Plan and of the 2007 Internal Audit Law will also be needed. These revisions will be a part of the twinning project as well.

Until these new laws are implemented, public internal financial control in Albania is based on existing legislation, which does not reflect modern, recognised PIFC standards. The existing laws include the Organic Budget Law adopted in 1998, the Internal Audit Law of 2007, the Local Budget Law of 1993, the Accountancy Act of 2004, and the Civil Service Status Law of 1999. Accordingly, at the time of this assessment, Albania remains in a period of transition, with the outstanding need to finalise laws and procedures and, more importantly, to introduce the proposed new arrangements, especially in the financial management and control area.

2. Institutional Framework

As with the legal framework, progress in moving the institutional framework towards recognised international standards has continued. Similarly, this progress has been at a varied pace between topics, and many areas have yet to be implemented.

The structure of budget spending-units in Albania follows the normal pattern of first, second and lower-level bodies. There are some 2000 spending-units in total, 14 of which are ministries, 60 government agencies and 367 local government bodies.

The area of public internal financial control (PIFC) consists primarily of the following two levels of *ex ante* checks:

- i) Within each budget spending-unit, specifically designated finance offices undertake checks reviewing actions from commitment to end of transactions, including checks on invoices, contracts and available funds. Policy and technical units provide little or no input to these checks.
- ii) Treasury regional offices (36) undertake checks on legality and regularity of each transaction and are also responsible for cash control. At present there are some 200 Treasury staff in these regional offices. Additionally, 16 Treasury staff at central level check centrally generated payments. The Treasury Directorate headquarters does not systematically monitor and evaluate the quality of the work carried out by its regional offices.

The Albanian authorities recognise that more efforts are required to meet standards of managerial accountability and financial management and control, as laid down in the new OBL, which go beyond the above controls. An important step was taken in spring 2008 in the setting up a Central Harmonisation Unit for Financial Management and Control (CHU/FMC) as a Directorate for Co-ordination and Harmonisation of Financial Management in the General Directorate of the Treasury, with six staff members (including the director). By mid-May 2008 the establishment of the CHU/FMC was still not formalised by the Prime Minister. This delay might influence the start of the new twinning project, as one of the EU conditions of the twinning project is that a fully staffed CHU/FMC must be operational before the project starts in September 2008.

The CHU/FMC, together with assistance under the new twinning contract, should both develop an understanding of public internal financial control requirements for management in all budget spending-units and provide supporting guidance. This will be an extensive task, involving training and document preparation and will require a high level of resources. It will be important to also develop a realistic time frame for the introduction of the broader concept of financial management and control throughout central and local spending-units and of the necessary reporting so as to ensure the efficiency and effectiveness of the financial management and control systems in place in these organisations.

The concept of internal audit was introduced in the public sector in May 2000 in the central financial control department responsible for internal audit within the MoF, in customs and tax departments, and in authorities under the control of the MoF. Furthermore, in the period 2001-2005/2006 internal auditing units were established in all line ministries and central institutions, and a General Directorate of Internal Audit (GDIA) was set up in the MoF.

In 2007 the staff of GDIA numbered 22. The General IA Directorate consists of two directorates: the Directorate of Methodology and Harmonisation (DMH – ten staff) and the Directorate of Audit, Surveillance and Investigation (DASI – nine staff). Each directorate consists of two sectors: DMH comprises the Methodology and Education Sector (three staff) and Generalisation and Statistics Sector (five staff); DASI comprises the Audit Sector (four staff) and Supervising and Monitoring Sector (four staff).

The Methodology Sector is in charge of developing and implementing standard procedures and methodologies for internal audit, and it has professional authority over all internal audit units. Under a twinning project carried out in 2005-2006, the GDIA drafted several key documents on audit methodology, including an Internal Audit Manual and Methodology, an Internal Audit Charter and a Code of Ethics for Internal Auditors. The task of drafting standards and methodology is formally set out in the Internal Audit Law of 2007. Assigning this task to the GDIA is in line with international standards but in contradiction with article 21 of the Supreme Audit Institution Act, which declares that application of the audit standards of the Albanian SAI, the High State Control (HSC), is compulsory for the government's internal audit bodies. The HSC declared that it had never referred to this article in practice; it is foreseen to revise this article together with other HSC Law amendments.

In ministries internal audit units have been established, most of which are fully staffed by auditors (on the average seven-nine staff) and are fully operational .However, most of the internal audit units at the secondary spending level are still staffed by inspectors instead of certified auditors

In addition to the general procedures established in the Law “On the Status of the Civil Servant”, the Labour Code and other laws regulating work relations, article 19 of the Internal Audit Law indicates the following requirements for recruitment as an internal auditor:

- To have completed university studies in economics, finance, accounting, law or other disciplines determined by the General Director of Internal Audit;
- To have work experience of no less than three years in the areas of audit, finance, accounting, and other related subject matters;
- To have passed the qualification examinations before a state commission and subsequently to have been qualified as an “Internal Auditor in the Public Sector” (until the end of the two-year period following passage of the new Internal Audit Law of 2007, which will come into effect in 2009).

The recruitment of internal auditors is not a real problem. The turnover of internal auditors is less than 10%, even though the salaries are not extremely high. To ensure sustainability in the IA function, the GDIA has proposed to the MoF to upgrade the function from the level 3B (chief inspector level) to the level 3A1, which would imply a 25% salary increase.

The Internal Audit Law of 2003 set up a system of examinations for obtaining appropriate qualifications as an internal auditor. To comply with article 20 of the IA Law of 2007, the structure of the Qualification Commission would have to be revised. In December 2007 the Council of Ministers (CoM) agreed to the proposal of the GDIA with respect to this change (CoM Decision 886 of 19 December 2007). In 2007 of a total of 400 internal auditors spread across the state administration, 244 had been certified and 200 were in training for certification.

Important steps have been taken to achieve the functional and organisational independence of internal audit. The activity of internal audit units in line ministries is strictly separate from other operational work, and audit units report directly to senior management. All IA units have their own work plans, which are prepared annually by the public audit units and approved by the top managers of public entities¹, although it is understood that managers in general are still developing an understanding of the value of internal audit.

In accordance with the Law on Internal Audit of 2003, an Internal Audit Committee² was created to advise the GDIA and is currently functioning. This advisory body is in charge of developing strategies and improving internal audit performance throughout the public sector. To comply with article 14 of the Internal Audit Law of 2007, the composition of the Internal Audit Committee was extended from seven to nine members by Government Decision 228 of 14 March 2008.

In the area of co-ordination, the Central Harmonisation Unit for Internal Audit (CHU/IA) within the General Directorate of Internal Audit holds two monthly meetings with directors of IA units from budget spending-units. This is a positive approach, which should help with the ongoing development of audit operations. Co-operation of the CHU/IA with the HSC has improved. Planning documents and reports are exchanged at a working level, although in practice communication seems to be rather one-way: from the CHU/IA to the HSC.

At a higher level, the Standing Committee on Economy and Finance within the Albanian Parliament is to have a particular role in the establishment and strengthening of the public internal financial control system. The GDIA sends its report to this committee annually (in March) and, at the request of the committee, discusses the report's findings and recommendations.

3. Reform Agenda and Capacities

The Albanian authorities see the need to introduce at an early date public internal financial control that is in line with international standards, and this is reflected in the government's decision to set new priorities. Key elements of this reform include the approval of the Organic Budget Law, drafting an FMC law, revision of the Internal Audit Law of 2007, establishment of a CHU/FMC within the Ministry of Finance, and the new twinning contract for the development of financial management and control and the implementation of activities in the internal audit area. The proportion of activity under the twinning contract devoted to financial management and control is 70%, with 30% to be focused on internal audit. In the area of FMC much attention will be paid to revising the PIFC Policy Paper, drafting an FMC law and FMC manual and guidelines, testing the manual in practice, and providing support to the CHU/FMC and to the training of managers and financial staff. Support to IA will be limited to revising the IA law and IA manual and to a few training seminars/workshops for managers and internal auditors.

The greater emphasis on financial management and control is understood, as managerial accountability and financial management and control are neither in place nor, in our view, generally understood. However, this assessment has made it clear that substantial efforts are also still required to transform internal audit activities from the existing financial checking role to a modern internal audit approach

Important challenges will be the practical implementation of a revised PIFC Policy Paper and the introduction of a new law on FMC and a revised internal audit law. The Central Harmonisation Units for Financial Management and Control and Internal Audit will need to provide significant inputs in this area. As managerial accountability and financial management and control are developed, there will be a need for substantial training of senior management and of internal auditors, and the time frame for introduction of PIFC reforms throughout all public sector spending-units will need to be clearly planned and regularly

¹ Articles 15 and 16 of the Internal Audit Law

² The Internal Audit Committee is composed of nine members, who are appointed by the Minister of Finance: three professionals in the IA area, one professional at the local government level, two professors from the Faculty of Economics, one lawyer or accounting expert from the private sector, one expert from another professional body, and the General Director of Internal Audit, who is a permanent member of this committee.

reviewed. It has often been found that, in the initial period of PIFC reform, strong political support to both CHUs is indispensable and a phased approach brings the best long-term results.

4. Assessment

There is a clear political will to introduce public internal financial control in Albania and in the shortest time feasible, which is in part demonstrated by the setting of the PIFC framework in the new draft OBL and by the proposal to update the existing PIFC Policy Paper and Action Plan.

Internal audit legal arrangements have been introduced in recent years and the Internal Audit Law of 2007 has provided additional clarification on a range of issues, but the new OBL implies that more amendments to the IA Law will be needed. It will be necessary to redraft article 2 of the IA Law concerning independent institutions (see section 1 above). It will also need to be made clear that internal audit units' prime reporting function is to be directed to their respective heads of organisation and not to the General Directorate for Internal Audit within the Ministry of Finance. This means that the reporting clause in article 17.2 will have to be deleted. Furthermore, article 25 regarding the relation of the GDIA with the HSC should be clarified.

The assessment has made it clear that the internal audit function has been embedded in the first-level spending-units. Most units are fully staffed and two-thirds of the staff are certified public internal auditors. The IA units work according to three-year audit strategies, which are annually updated (rolling-forward principle) and based on a risk analysis. The annual planning does foresee a contingency of around 200 days, which are to be used for ad hoc requests of ministers (mostly concerning investigations on violations of laws). Except for the requirement to send copies of audit reports to the GDIA, the reporting procedure is in accordance with international standards. The recommendations relate to:

- administrative measures;
- recovery measures;
- disciplinary measures; and
- court procedures.

Follow-up of audit recommendations takes place in thematic audits. Although the IA units report more and more on structural deficiencies, most of their recommendations concern violations of laws and regulations. With regard to the fight against corruption, repressive measures are certainly needed and useful, but the preventive side of this fight, where an adequate FMC system and IA could play an important role, is still underdeveloped.

The IA units are satisfied with the written material supplied by the GDIA, but they considered that the audit manual was too comprehensive with regard to risk analysis and materiality and that there was a need for a set of rules and procedures. Furthermore, the manual was perceived as a manual for inspections and not for internal audit.

The GDIA reviews once every two years the work of the IA units in terms of compliance with the IA manual and standards and of the quality of the work. In general, the GDIA concluded in 2007 that the work of the IA units had improved but that the quality of supervision and reporting, as well as the attention given to legal aspects, could be improved. A real concern is the quality of the work carried out by the IA units in second-level spending-units, which is still inspection type of work.

On the basis of the IA audit reports, the GDIA reports quarterly to the Prime Minister, via the Audit Committee and the Ministry of Finance. In 2007 the GDIA reported to the government mainly on the need for improving the budget and procurement procedures and on irregularities in incidental income (fees).

The GDIA also carries out audits in areas where no internal audit institution has been established. These audits also have the character of inspections and could be done at the request of the MoF. According to the EU concept of PIFC, a CHU/IA should not be involved in operational work and certainly not in inspection type of work. Although in the GDIA audit work is separate from the development of methodology, it is recommended to reconsider the whole structure of the GDIA. In the revised PIFC Policy Paper consideration should be given to possible scenarios for the future structure of the GDIA, taking into account the future position of the inspection function in Albania. In any event, an increase in the number of staff of the Methodology Sector seems necessary. The current number of staff (three) is certainly not sufficient in view of the tasks to be performed.

The supervision of the functioning of the GDIA by the Internal Audit Committee in 2007 was satisfactory. The Committee met 26 times last year, mainly to discuss drafts of the Internal Audit Law of 2007 and of the CoM decrees. The tasks and duties of the Committee have been regulated in the IA Law of 2007 but have not been regulated in detail in an implementing regulation. Thus the rules for the frequency of meetings, voting, reporting, documentation, etc. have not been developed.

We conclude that a fundamental reassessment of audit methodology is also needed, as current audit activities are still not aligned with current international practice. For instance, internal audit units in ministries have not drafted an internal audit charter and have not demonstrated an awareness of the importance of such a document for their relations with their minister and with auditees, despite the fact that the GDIA drafted and officially launched an Internal Audit Charter in 2005.

In addition, although several training activities were carried out with the support of a twinning programme in 2005-2006 to increase internal auditors' skills and to raise awareness in preparation for their certification as functioning public auditors, it is clear that day-to-day audit operations are still very basic and still relate more to the previous role of financial inspection than to modern internal audit activities. Awareness of the internal audit function by managers is still limited.

It is very disappointing that after a period of eight years the role of internal audit is still misunderstood and confused with *ex post* control.

Financial management and control and managerial accountability in accordance with EU requirements does not yet exist, but an outline of the concept is set out in the new draft OBL which, as indicated above, will be developed under the new twinning arrangement. It will be important at an early date to provide more detailed information and training on what these concepts cover, how controls are to be implemented and by whom, and how they will be monitored. This information will need to cover such issues as personal accountability, delegation of responsibilities and the respective roles of ministers, secretaries-general, chief accountants, inspectors and other senior management. Whether this information is set out in additional laws, regulations or guidance is a matter for debate, but clarification is needed at an early stage. The Central Harmonisation Unit for Financial Management and Control will need to provide a significant input in this area, which will require high quality staff with strong co-ordination abilities. Without such a solid foundation, there is a real risk of non-achievement. A detailed action plan will also be necessary. It is understood that the new twinning project will pay special attention to raising awareness on FMC and managerial accountability.

In the medium to long term, consideration could be given to decentralising financial controls from the Treasury to budget spending-units and to widening the responsibilities in these units beyond the finance offices to all management. However, how far this process is extended to the lowest budget spending-units is a matter for careful assessment.

To implement managerial accountability to the fullest, annual reporting on the status of public internal financial control and on the material findings of internal audit is required as well. Article 66 of the new draft OBL formalises this requirement. Such reporting is usually co-ordinated through the Ministry of Finance's Central Harmonisation Unit departments and results in summarised reports being presented to parliament and to the HSC via the Council of Ministers. This reporting will supplement the existing monitoring of budget expenditure and the monitoring to be carried out under the proposed medium-term budget programming. The development of such a system is a task of the CHU/FMC and should be one of the activities included in the Action Plan of the revised PIFC Policy Paper.

One further element that will need to be developed is managerial responsibility for developing policies for handling, reporting and remedying fraud and irregularity cases, both inside and outside the organisation.

With internal audit moving away from the traditional role of *ex post* control by a central financial inspection service, it is important to reconsider this financial inspection function. It is noted that article 70 of the new draft OBL refers to a financial inspection law for following up complaints and potential financial violations in the budget. Experience in Central and Eastern Europe has shown that during the transition from financial inspection to internal audit it is indeed important to have a strong inspection capability. It is recommended to draft the new financial inspection law in parallel with the drafting of a FMC law and with the revision of the IA law in order to ensure full coverage and consistency in terms of terminology, scope and methodology. Furthermore, a specific central inspection service dealing with complaints might function more effectively than the ad hoc teams foreseen in article 70 of the new draft OBL, at least during the transition period.

Perhaps the biggest hurdle will be moving from the theory, as set out in policy and laws, to actual implementation, with a full understanding of PIFC and with procedures in place. This transition should not

be underestimated and as public internal financial control is developed there may well be a need to reappraise certain aspects of the PIFC Action Plan and time frame.

Taking all of these points into consideration, it is important for the Albanian authorities to recognise that the current transition period will last for several years and, while regular progress is essential, the full implementation of public internal financial control will be spread over several years. The Public Finance Sector Strategy time frame of 2007-2013 would not be an unrealistic period.

5. Recommendations

We recommend the following priority actions:

- The CoM should consider the need for a specific central inspection service to deal with complaints and reported cases of violation of public internal financial control – at least during the transition period.
- The MoF should ensure that the Central Harmonisation Unit for Financial Management and Control is set up and operational during the first half of 2008; this unit will need to have sufficient resources and high quality staff capable of assuming a substantial co-ordination role.
- The MoF should consider transferring financial controls from the Treasury regional offices to budget spending-units in the medium or long term.
- When revising the PIFC Policy Paper, the CHU/FMC and the GDIA should reassess the timetable for the full implementation of financial management and control, which might include a phased programme; the time frame proposed for the Public Finance Sector Strategy (2007-2013) would not be unrealistic for the implementation of public internal financial control; this time frame should be regularly reviewed in the light of actual progress.
- The GDIA should reappraise at an early date the current internal audit methodology and operational functions, which still appear to place greater emphasis on financial checking than on a modern internal audit approach; revised implementation/training plans should be developed as necessary.
- The GDIA should seek additional external assistance to help develop the internal audit function further. The GDIA should draft an implementing regulation for the functioning of the Internal Audit Committee.
- Consideration should be given to ensuring that the CHU/FMC, in developing detailed procedures for managerial accountability and financial management and control, provide appropriate guidance and training on the concepts of personal accountability and delegation of responsibilities as well as on the respective roles of key management.
- The CHU/FMC should develop a procedure for annual reporting on the status of financial management and control and on the material findings of internal audit.
- The CHU/FMC should develop policies for handling, reporting and remedying fraud and irregularity cases, both inside and outside the organisation.

6. External Assistance

Up until October 2006 the UK NAO and the Ministry of Finance of the Netherlands carried out a twinning project on public internal financial control with the General Directorate of Internal Audit of the Ministry of Finance. This co-operation focused mainly on developing internal audit within the Albanian administration. A second twinning project is expected to start in September 2008 for the further development of public internal financial control, as described above. The World Bank has in place a significant project to strengthen the Treasury. This project includes the supply of hardware, implementation of an interim Treasury software solution, and supply and configuration of a long-term solution. Support to more basic financial management procedures will be provided by an EU-financed IT project for strengthening financial management, which is foreseen to start in 2010.