



SIGMA

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Controlling public money: internal financial control and external audit

Conference Paper

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CONTROLLING PUBLIC MONEY: INTERNAL FINANCIAL CONTROL AND EXTERNAL AUDIT

“Basics” in Public Finance Structures and procedures to ensure fiscal discipline and accountability

A key feature of a decent public administration system is to have a sound public finance system in place. The issue here is in the first place to make sure that public finance is managed in a way that minimizes deficits and ensures value for money (VFM) to taxpayers. This is a **crucial aspect of fiscal discipline**, which represents the very basic concern for everyone involved. It is also to make sure that resources are properly allocated, that political decision-makers are able to base their decision on a solid institutional and procedural basis, as well as to secure a system that would also give some guarantees that errors of a large magnitude, fraud and extravagance are, if not completely eliminated, at least very unlikely to occur or to prosper.

One could sum up in saying that the usual control objectives within an organisation also find application at a state level, i.e. ensuring:

- The reliability and integrity of information.
- The compliance with the applicable legal framework.
- The safeguarding of assets, including an efficient and legal collection of state resources, starting with taxes and custom duties.
- The economical, efficient and effective use of resources.

In order to reach these goals, there are absolute prerequisites in the absence of which, any refinement in terms of programme or performance budgeting, accrual accounting, sophisticated financial management and control systems with tribute paid to cutting edge risks assessment/management models, will only, at best, be resource-wasting, in terms of wrong priority setting. The history of technical assistance in public administration is full of such horror stories.

What are these basic prerequisites? Various internationally relevant or accepted documents can be used as sources: World Bank PEFA framework, Sigma assessment baselines amongst others.

Together with the experience of the Sigma practice, these requirements can be synthesized as follows:

- A. A strong and well organised Ministry of Finance equipped with the necessary administrative capacity.**
- B. Supported by a legal framework allowing it to fully exercise its authority in the area of public finance.**
- C. Cost-effective internal financial control systems across the entire public administration.**

D. Independent and professional external audit.

A) A strong and well organised Ministry of Finance equipped with the necessary administrative capacity

The MoF has to be central to a system ensuring the sound financial management of public institutions. This normally requires:

- A **robust budget system** both from the political/institutional point of view (constitutional aspect of public finance: relations between Parliament and Government, and their respective roles) as well as from the administrative point of view (relations within the Executive, between the Government and the MoF, between the MoF and the line ministries and other budget units).

The **distribution of tasks between Government and Parliament** has to be clearly spelled out in the Constitution, the organic budget law and as appropriate the Parliament rules of procedure. The role of Parliament is to authorize the collection of taxes and other resources and the public expenditures for the year to come. This process of approval is also a political one in the sense that it is the formal approval of the policies that the government intends to implement during the year of execution. This happens whatever the form of the budget, but is certainly more easily done when the budget is presented in programme form. The stress should primarily be on budget discipline and cash control, which an input-based budget is more likely to ensure.

However the trend should normally go in the direction of less importance given to budget approval and more to the discussion and approval of the annual report on the budget execution and, as case may be, the financial statements. A number of reforms are heading in that direction like the introduction of programme budgeting.

Between Ministry of Finance and line ministries, two extreme situations are to be avoided:

Either the **extreme centralization** where all responsibilities regarding budget planning and execution are borne by the MoF; this results in cumbersome procedures, micro-management and encourages line ministries or other institutions to look for by-passing arrangements of all kind (e.g. “quango”-type of bodies), with all risks of fraudulent practices attached to it

Or alternatively a **very loose system** (which was more or less the situation in many transition countries where the MoF was barely more than a statistical and bookkeeping unit) where budget discipline is not ensured, very little information is available at the central level, thus opposing a sound cash management policy, and paving the way for weak accountability and control.

A desirable situation is somewhere in-between, where MoF is in a position to create and maintain a robust framework for public finance, where line ministries and other budget users have developed their own capacity of financial and budgetary management so that it is both possible:

- at the stage of preparation to organise a serious and relevant budget discussion at the administrative level;
- at the stage of execution to have budget managers enjoying the appropriate degree of autonomy in order to really “manage” the appropriations, with of course the caveat of having in place strong internal control systems and ensuring a proper reporting.

The MoF gives the lead and is the focus of the system. This can be obtained through authority and competence, not via micro-management and control freakiness.

The structure of the MoF should somehow reflect this situation and distribution of tasks. We thus expect to find the following basic functions in place, i.e. functioning in an effective and efficient way:

- A **solid macroeconomic forecasting capacity** in the budget area. It should not necessarily be completely or exclusively performed by the MoF. It is as important to support such capacities outside the MoF: Central Bank, university, private research centre. A problem worth mentioning in that respect is the, on average, rather fragile statistical base of the WB countries (very short time series because of the initial weak system, disruptions or problematic data collection). This jeopardises the concept of introducing multi-year budgeting beyond a very indicative projection, without serious impact on the “real” budget planning on a yearly basis.
- A budget preparation/planning division with **real analytical capacity**, in order to be able to discuss budget claims, but also throughout the whole year to react or anticipate draft acts or policies with budget implications. Dealing with the budget is not a seasonal activity, but a permanent one, as it is not only deal with the annual budget law. There is a need in skills and number to be able to interact at the right level with other key actors: parliament, line ministries, and external auditors. Some experienced staff should be devoted to methodological/strategic issues, including in due course the work on multi-year budgeting (MTEF and the like).
- Budget execution sector preferably based on a **Single Treasury Account** system to allow for efficient cash planning and cash management with economy of scales and the possibility to cover the whole public (budget) sector.
- A comprehensive and efficient budget accounting and reporting system is a basic prerequisite.

This does not necessarily mean accrual accounting. Accrual accounting is mainstream and certainly the goal to achieve for public sector organisations. It is, however, a huge undertaking per se, and can only add value if the management processes are also changed and if internal control is in itself fully reliable. Other prerequisites are necessary (as for instance, the existence of strong and enforceable standards since accrual accounting can, much more than cash accounting, be the open door towards “creative accounting” as the margin for manoeuvre is broader with this system; one can also add a solid culture of legal compliance and the existence of a skilled and resourceful professional external audit...). Of the many advantages of accrual accounting, some can be obtained in a cash context without changing the entire system (cf. commitment accounting system, recording fixed and other assets with e.g. an asset register in place and updating procedures, practice of inventories etc.).

- **Efficient public debt management unit**, with strong internal control procedures and a clear back/middle/front offices division. A public debt strategy in the form of a policy document should be made explicit in particular for each fiscal year.
- (p.m.) of course fully fledged tax and customs administration which may or may not be in the form of separate agencies.

B) The legal framework should provide support allowing it to exercise fully its authority in the area of public finance.

We advise keeping to classical budget principles; to those principles that really seem basic as they are able to be translated into objective conditions. The following three principles are deemed as basic key principles:

- i. **Principles of unity** and of budget accuracy: there is only one budget to cover all public expenditures and resources. This normally excludes the existence of extra-budgetary funds (which can be voted by Parliament even if not included in the overall budget and even more the case of “hidden” accounts).
- ii. **Principle of annual authorisation**: the budget is an annual authorisation to spend the money and to collect the revenues. There is, however, no obligation to spend it and it can in some circumstances and respecting certain procedural constraints, offer the possibility of committing funds for periods beyond the year of approval, thus pre-empting the parliament’s authorization. This is true for capital expenditure, and for some carry-over.
- iii. **Principle of universality** wants all expenditures and all revenues to be recorded in the budget, excluding any kind of compensation or net budgeting. This normally rules out earmarking specific revenues for specific categories of expenses.

Of course, these principles are liable to exceptions as any others, but the exceptions should:

- Have a legal basis.
- Be restrictive, e.g. possibility of carry over expenses should be limited to a certain percentage of the appropriation.
- Subject to regular review to check whether the exception has not been misused or is still justified by the circumstances.

Other legal pre-requisites:

- iv. **Principle of transparency** is the basis for the public and timely disclosure of the budget figures and their communication to the Parliament. It requires that the budget be accompanied by non-budgetary information which is key, in order to understand the budget or assess the risks attached to it. This can be the case for the information related to borrowing-lending operations or for the guarantees granted or any list of routine subsidies to NGOs or companies.

These principles should take place in a consistent and simple organic budget law.

Other forms of support to the Budget system

Other provisions to support the entire budget system are covered by relevant statutory legislation (accounting, treasury, local financing, debt management...).

The legislation must secure the empowerment of the Ministry of Finance in financial management (ensuring fiscal discipline, adequate monitoring and timely accounting and reporting) including its capacity to take direct decisions on some points related to budget execution (e.g. transfers at least under a certain level), to receive proper information from ministries etc. To a large extent these powers can be enforced directly by the Ministry and do not need to be sanctioned by the Government or its head (Prime Minister).

The legal framework shall also contain clear rules for in-year budget revisions (rebalances), including conditions for it, so that there is on the one hand proper budget rebalancing when the budget plans are obviously obsolete for any reason (e.g. most likely inaccurate revenue forecasting), and on the other hand an excessive budget instability is avoided (let alone the complex and resources-consuming nature of budget rebalances).

Extra-budgetary funds are not recommended but are sometimes inevitable for political or even technical reasons (e.g. commercial or business-like activities of state or foreign donor's demand for "transparency", traceability and extra-monitoring). They shall then be subject to strong (possibly restrictive) and unambiguous controls. It is important to ensure that the use of extra budgetary funds is not conceived as an easy way of escaping fiscal discipline or stringent appropriation management rules.

The legal framework naturally establishes the Budget classification: there is here no particular requirement except that economic classification (input + administrative classification), is a valuable tool for budgetary controls, monitoring and administration. Classifying expenditures by programme, serves to identify and clarify the objectives and policies and monitor the operational performance with relevant indicators. The problem is that in most transition countries where programme budgeting is supposed to have been introduced, this only happens at the stage of budget formulation and not at the stage of budget execution. Programme budgeting is thus made a rather abstract and vain exercise and all the more so since reporting on programmes is often not formally required. In such cases, it will be less resource demanding to stay with classical input budgeting.

If programme budgeting is taken seriously and intended to be put in place, it has to be kept simple and accountable! Programmes are not by themselves accountable, managers of programmes should be clearly designated and held accountable for programme implementation. Their life will be made easier if the performance indicators are limited in number, relevant, simple to understand, using accessible data and related to daily work. A typical example could be the average duration of delivering a license or any productivity ratios.

C) With (cost-effective) internal financial control systems across the entire public administration.

If the former elements (strong MoF, consistent legal framework) are not in place, the other components will not be as efficient as they should be since they certainly are second in rank. However they can, to a large extent, be developed in parallel and contribute in an interactive way to the strengthening of the basic elements of the system if these are not fully in place.

Here the framework is well-known as it largely results from the activity and influence of the European Commission, which, starting from its initial concern relating to the EU funds management and control, has developed an overall concept applicable to the entire public administrative sector. Reference is made here to the Public Internal Financial Control framework (PIFC) which has been progressively developed, namely through the pro-activeness of DG Budget during the recent years and has practically become a standard.

The content is well known and has, at varying degree, started to be implemented in the Western Balkans countries as well now in the European Neighbourhood Policy (ENP) area, at least its Eastern European component.

There are three basic components for the definition of PIFC. The three pillars of managerial accountability-based PIFC are composed of:

- Financial management and control systems and procedures

- Internal audit
- Central harmonisation functions

Advantages and importance of the PIFC framework

The main advantage of that formula is that it offers an integrated approach. It is then far more valuable than the constant tendency of the international community - and this might have included the Commission some years ago - to address the issue of internal control in a piecemeal way. This has indeed happened either with regard of the technical areas it covers (the development of internal audit has been extremely popular with very little idea of what this implied in terms of financial management), or in relation to the institutional coverage (the assistance or the demands only focus on one specific sector, like the sector in charge of EU funds management or foreign assistance projects, and misses all other budget sectors).

A partial or piecemeal approach showed inter alia the following drawbacks:

- The pressure to get internal audit services in place, frequently presented as a “universal panacea”, without taking into account the managerial context and a number of conditions have quite often led to cumbersome or inefficient solutions.
- The limitation of the bearing of reform to certain sectors, where actually donors are more interested faces the risk to end up in dual systems with different set of standards or organisational models, leading to confusion and waste of resources.

What is important here with the PIFC approach, is probably less so the detailed prescriptions of what should be done, than the fact that countries concerned are or should be strongly encouraged to first try to develop a policy before starting legal drafting, training or project implementation. This would not only allow them to get the most coherent set-up respecting both the demands of external partners such as the European Commission and to reflect on the capacity of the existing national system to incorporate them or not, but also to get an idea of the work that is necessary to achieve this process. Ideally this would include the aspect of the resources to invest in a revamped financial control system. Too often countries commit themselves to complying with external recommendations or set themselves realistic targets to do so, without realizing that implementation means resources and financial resources in the first place.

Cost-effectiveness of PIFC

This leads to the consideration that, just as internal control systems at a budget institution level, being risk-driven, have to be **cost-effective**, nationwide PIFC systems need to be so too. This entails at least two observations:

- A lot of activities, supported or not by assistance projects, contain one way or another PIFC related inputs, like risk assessment exercises, writing procedures, establishment of control systems and the training attached to it. There are a number of possible synergies and resources to mobilize which get unnoticed by the beneficiaries themselves. This could provide concrete and contextual examples of what is expected to be in place, in particular as far as internal control is concerned. These practical examples are indeed often missing in the implementation of PIFC, thus causing delays and misunderstandings.
- In Western countries, internal audit has been set up according to needs and as an answer to practical challenges. This results in a remarkable, maybe regrettable, diversity of situations within the same country. It is, however, the result of a pragmatic approach, rarely based on a

legal framework as internal audit is seen as a management tool, not something to regulate or to legislate. In transition countries, the approach has been more systematic and law based in the first place, resulting in a rather institutional concept. In many cases the result is a dissemination of very small, sometimes single –staffed internal audit units because on the one hand all budget institutions were meant to have one internal audit unit (possibly above certain thresholds), but on the other hand there was no possibility to hire more people. My point, based on the experience, is that an autonomous budget entity should only have internal audit to the extent it really needs it, and that in any case, it is inappropriate to set up too small units which will not comply with the quality criteria (internal audit work is by construction a team work), and are facing risks about their independence and ability to perform the audit work as it should be. In such a situation it might be preferable to avoid a permanent internal audit structure. But to provide internal audit service, not necessarily in-house, is a completely different thing. It should be possible to think of different ways of providing an efficient service from the existence of a central service (a really central service, or a unit servicing one ministry and all subordinated budget institutions, or pooling services or outsourcing, which is not something I would however encourage).

Location of central harmonization unit: preventing duplication

Another point concerning efficiency and cost-effectiveness is linked to the issue of the central harmonisation unit and in particular of its location in the Ministry of Finance.

There is no particular difficulty as far as internal audit is concerned. The main difficulty here in transition countries comes from the fact that people are appointed to exercise a certain monitoring and quality control of an activity, which they themselves have never performed. Their competence and legitimacy can be disputed but it is inevitable as the system builds up.

The financial management and control function is a lot trickier as we know that, albeit incomplete, inefficient or rough, financial procedures are already in place. As a rule and in most cases, the Ministry of Finance already plays a fundamental role in the definition, development and maintenance of the key internal control procedures and systems. Internal control procedures probably go beyond financial management and in particular expenditure management but certainly are linked to them in the first place. In addition the role of a harmonisation unit in that area comes very close to the role of a budget or an accounting directorate. Having a central harmonisation unit built up outside of this last area is not impossible but can be a source of complication and a waste of resources. Whenever this issue is raised, it is worth considering the option to have this type of body located where it naturally fits in. In any case, appropriate linkages have to be set up between those in charge of financial management and control development and those busy with budget and accounting procedures.

In general there is a strong case to coordinate the financial management and control related activity to whatever is done in the area of budgeting and accounting.

A framework for managerial accountability

This is where the specific problematic of managerial accountability has also to be addressed. It is the most recently defined component of the PIFC framework and is by the same token the less well understood.

Managerial accountability as such is hardly ordered by decree and there are a lot of parallel things to be taken care of if this is supposed to be more than an empty expression. The extent to which managerial accountability operates depends on the degree of decentralization of power that exists at all level of management. In administrative or public finance systems like the ones prevailing in the Balkans, one will find in most cases that:

- A large number of legal prescriptions strongly constrain the power of initiative of a budget user (civil service rules, procurement rules, accounting rules etc.)
- The level of details with which budget are approved give very little room for manoeuvre to a budget user.
- There is a strong tendency to keep at the central level the decision to decide on each transaction or procedure.

All this would probably need at least to be reassessed before speaking of managerial accountability in the full meaning of it.

Another condition to make managerial accountability possible is at least that managers are clearly identified. We are again dealing with systems where the responsibility is both highly centralized in terms of signature and quite diffused at the same time. Everybody has nearly a same type of responsibility from the storekeeper to the Deputy Minister, but there is very little idea of the concept of the higher manager being responsible for what is done by the level that is supposed to report to him or her.

There are also some **conditions to fulfil before an efficient internal audit** can be set up. The conditions relating to the audit architecture have been presented above. Some others could be mentioned and I would like to refer to the necessity of a realistic approach to the methods and standards to be applied by internal audit in a building phase. What internal audit has to do and in what type of work it has to do, will essentially depend on the appreciation of the “control environment” in the country and institution in which it operates. In transition countries, especially in the Balkans, the control environment very often has been seen as weak and this has consequences on the audit approaches, i.e. fraud-related problems are more likely to be addressed by internal audit activities than in a more “advanced” set-up. Integral checking may be preferred to risk based sampling, at least in the first stages of operations.

Public finance in Montenegro

Many countries in South East Europe have opted for quite an advanced public financial management reform, including Montenegro.

The (Organic) Budget Law (adopted in August 2001 and amended by parliament in November 2007) and the Treasury Regulations (issued in accordance with the budget law) together govern Montenegro’s public expenditure management. The scope of the Budget Law covers the government budget and the budgets of municipalities (art 1). Intergovernmental fiscal relations are mainly regulated by the law on Financing of Local Self-Government.

The (Organic) Budget Law was amended in November 2007 to better support planned developments in public expenditure management. The main changes related to:

- budget consolidation (previous extra budgetary funds are now part of the state budget and treasury single account system);
- preparations for programme budgeting, including providing more flexibility for the government to shift funds between programmes; and
- incorporating the issues related to public debt fully into the budget law (the law on Debt Contracting and Public Debt Management is no longer in effect).

The Treasury Regulation defines rules for ex-ante checking and authorisation before payments was updated last February.

The Ministry of Finance is moving towards performance budgeting and objectives have already been approved in the 2009 budget. Performance indicators will be developed and included in the budget for 2010.

The Government of Montenegro has also declared its commitment to take ownership from the European Commission when implementing IPA-funded programmes. In this respect, the Ministry of Finance has initiated preparations for the decentralised management of EU-funded programmes. The decentralised implementation system (DIS) for IPA is closely related to the institutional developments of public expenditure management. This has particular relevance for the Treasury. In February 2008 the responsibilities among government bodies were decided and the key responsibilities of the Ministry of Finance were also designated.

Public Internal Financial Control (PIFC) in Montenegro

The Ministry of Finance developed a comprehensive PIFC Policy Paper which was adopted by the Government on 20th December 2007. It describes the ways in which the Ministry of Finance is now working hard on developing the legislation necessary for implementing the ideas presented in the Policy Paper. We advocate a phased approach and such an approach also means that the development of a new system takes time, however the sequencing of the development is very important.

Thus an action plan was attached to the Policy Paper. The action plan covers different steps from drafting the PIFC law to rulebooks on how to apply the PIFC law including training for both financial management and internal audit. It covers the period up to 2012. The Parliament adopted the PIFC law on 28th November 2008. This is a framework law and the secondary legislation in forms of rulebooks are now in the process of being drafted by the Ministry of Finance.

Montenegro is a small country with a small administration. This means an extra challenge for the implementation of internal audit. A semi-decentralised approach has been chosen. The PIFC law therefore prescribes that internal audit will only be established in larger line ministries and that those units or agencies that belong to a 'parent' line ministry will be audited by the internal audit service of the 'parent' line ministry. A decree is in development for defining the line ministries which will have to establish internal audit units. It is also anticipated that a decree on internal audit titles as set forth in the PIFC law is to be adopted in the coming months.

There is a central harmonisation unit which is responsible in the first instance for developing the legal framework but then to give advice on how to implement the legislation as well as to monitor and report to Government on the implementation on financial management and control as well as internal audit.

D) Independent and professional external audit

In a not so distant past, the existence of an independent external audit of government activities would probably not have been mentioned in such a presentation as it was hardly seen as a key component of the public financial system. It is only over the last 10 to 15 years that with an increasing demand for accountability and stronger concern on the way public money is spent that public external audit has been regarded as one of the attributes of a living democracy, and of a transparent public system. It now seems to be a commonplace and Supreme Audit Institutions (SAIs) and public external audit definitely belong to the basic elements of an efficient public finance system.

Audit institutions are indeed not “stand-alone” bodies but are part of an administrative/financial system and cannot operate in a way that is disconnected from their context. This is a typical risk which we have seen occurring many times in relation to external technical assistance in form of twinning or consultancy. I can also mention circumstances where the timing and impact of the technical assistance was so large –the assistance started before the institutions were fully in place, that the external audit quickly reached a stage when what was done by it was simply not understood by the auditees, who were living and working in a completely different world. Thus the audit reports are produced in high amounts without any impact. In this respect, I tend to say, as an external auditor, that a country with a weak external audit but benefiting from a strong Ministry of Finance is more trustworthy than a country in the opposite situation.

What is at stake here?

Link to existing accountability schemes (and the right to reform them!)

The prevailing public accountability system should be reflected in the way external audit operates. A “corporate-type” accountability with government as a whole (or line ministers) reporting to Parliament with fully fledged financial statements in the framework of a discharge procedure would normally require a typical financial attestation audit. But other types of financial audits are possible. True, the activity of the audit institution can also contribute to transform the contents of the existing accountability schemes (even to establish them). In any case, it is clear that scarce resources should, here as elsewhere, focus on the main risk issues. Priority is to be given to obtaining assurance on the soundness of the financial and control systems and procedures. This suggests that financial and compliance audits are the first and foremost tasks to be carried out by public external audit institutions in countries where such functions are relatively new and where the entire system of public finance is either building up or in a state of thorough transformation. Sophisticated types of audits will have to come in due course, presumably later, but once a good assurance that the basic delivery of an audit activity is ensured.

Independence: more than a buzzword

The independence of the audit institutions: The concept of an independent external audit may be difficult to establish initially and has taken centuries in countries where it seems now to be well in place. Either it is understood as yet another police function (the concept of “audit” is often not understood) or as a political tool that you can “use” to the benefit of political forces (there have been attempts to regulate it in Supreme Audit Institution laws as a way to discipline an otherwise “wild” practice). It seems now to have been accepted by most key actors (Government and the MoF in the first place, Parliament, public opinion, the media and the institutions themselves!).

The Lima declaration of INTOSAI¹ of 1977 gives some guidance (but is not an international treaty!) the independence as a number of consequences or attributes in various fields: the institution as such (rules for appointments/dismissal at least for the management level, its financial management), the work performed (above all the programming of audit activities), the result: freedom of reporting and freedom of publishing the reports. But independence does not mean isolation and SAIs have competences and experiences to share to help build or reform public administration systems in a process of change. This is at least and in full legitimacy the case for everything related to the definition of e.g. accounting standards for the public sector, or in general to the financial rules and procedures applicable to it.

¹ International Organisation of Supreme Audit Institutions

Extensive coverage, but not unrealistic

No part of the budget sector should be “external audit free” (but not necessarily to be done by the SAI) but it is necessary to ensure that the central level is covered properly in the first place. In any case the competences of the SAI shall not be devised so that its work is made impossible because of insufficient resources. It would similarly be preferable not to mandate SAIs with the statutory audits of “marginal” institutions like political parties and NGOs (however, there should be procedure to allow SAIs to have access to beneficiaries of public subsidies, in particular in case of earmarked subsidies). Many SAIs are requested by law to audit political parties. This is often related to the desire to fight against corruption as parties are presumed to be an important factor of such misbehaviour, at least as far as the public sector is concerned. To include political parties in the SAIs’ audit remit may not be as efficient and useful as it seems, and there is a high reputation risk at stake here.

What does matter is not how parties use their legal funding, which is the main source of financing in most countries, they are after all independent, but rather how they can embezzle illegal funding from public procurement, or hidden assistance by public administration (civil servants de facto employed in parties, logistics provided by local government etc.). In most cases by definition they will not show up in the accounts, but rather in the financial reporting of the public bodies, subject to the audit by the SAI.

Audit follow-up and Parliament: preventing illusion

The priority target of the Supreme Audit Institution is of course the Parliament and a lot of thinking and efforts have been dedicated to strengthening the relationship between both institutions, with e.g. the setting up of specific bodies of the Parliament to deal with audit reports, and ensuring their follow up more or less along the “public accounts committee” model (as in the UK), or the “budget control committee” (as in Germany or in the framework of the EU institutions). This is commendable and logical as the experience in most Western European countries in the recent period has been a keener interest of parliamentary bodies for the external audit activities. This is more or less the “model” more or less underlying most if not all concepts, from general standards to specific guidance, and this in spite of the easily demonstrable fact that a large number of INTOSAI participant countries precisely do not benefit from a democratic parliamentary system.

There is, however, a certain risk at “forcing” an exclusive relationship between SAI and Parliaments so that any other possible forms of follow-up on audit reports would be either ruled out or completely depending on what can happen in Parliament (for example as is the case in certain legislations, to subordinate the release of audit reports to the sanction of the Parliament).

Unfortunately the “Westminster model” is not likely to be in place everywhere, at least in the short term, and some features of Parliament in transition countries should be properly assessed before defining the relationship with the SAI. The capacity of Parliament to follow up on audit activity cannot be taken for granted. At a very practical level, Parliaments lack resources and support skills. Specialised committees need competent staff in order to proceed efficiently with their work, even more so in the case of the audit activity, which will require a degree of authority in matters often technical.

Parliaments are thus in need of training and resources. But beyond this, they are in need of political will and democratic culture. It is of the utmost importance, that the contribution of the SAIs through their reporting, and via the parliamentary follow-up is not used or misused to settle political scores. The current state of understanding of the audit work by its external stakeholders still makes possible such misconceptions. An opposite misconception is that the Parliament understands its relationship to SAI as a controlling function. Parliament or rather its relevant committees like budget, finance etc. regards itself as

responsible for protecting auditees against inappropriate or even abusive ways in which SAIs may deal with their “clients.

Types of external audit activity (legal compliance, financial, performance): first things first!

SAIs are keen to rush towards 'modern' forms of audit and thus to develop performance or VFM audits. This is risky as long as the proper capacity of performing financial audit has not been put in place and has been stabilized. Again resources are scarce and should be, as a priority, focused on risk areas. As long as there is no complete assurance, even reasonable as people say about the reliability of the system of internal control there is little point in using the audit activity to other purposes, at least in the short term. There is a rather logical sequence to follow which corresponds to the evolution followed by most external audit systems in the public sector, from pure legal compliance to so-called financial audit, addressing the systems more than the transactions themselves, and then moving to performance audit. In reality there is no substitution between these categories and at an advanced stage of the process, more or less all kinds of audits are carried out by the same institution, the financial audit remaining however the core business activity. As a matter of fact, in those most advanced institutions these distinctions tend to be eroded, and either you find occurrences where only performance audit is carried out because the managers are requested to report on their performance as a whole, including the financial regularity aspect of it and the legality in general, or the audit approach is a mix of financial and performance audits, or the degree of reliance on the internal control system is such that the amount of financial-audit type of work is reduced to the strictest minimum.

On the other hand there is a risk that either the external audit institution itself is as such not ready to conceptually carry out performance audit tasks. There have been occurrences where the law, often revised under international consultancy's influence, provided for the possibility or even worse the obligation to assess the economy, efficiency and effectiveness of one auditee's activity. This resulted in a big disarray for the external audit staff that produced reports with a special section dedicated to these famous three Es generally with no real substance, this was reported as the result of a law which prescribed this activity to be carried out, but according to the auditors did not define the concepts nor explained how to proceed. In fact, as much as you do not legislate performance, you do not legislate the audit of performance beyond basic procedural aspects, normally applicable to all kind of audits. Another risk is the fact that auditees as well as other stakeholders, like Government, Parliament and the public opinion as such are not prepared to receive performance audit reports, which are not normally of a repressive nature, whereas it is expected that the SAI's role is to search, find and punish.

Role of SAIs in the fight against fraud and corruption: avoiding the expectation gap

SAIs are often mentioned, including e.g. in project documentation, as key contributors to the fight against fraud and corruption, an area now very high on the agenda of international assistance and consultancy. It is important to understand what the proper role of external audit is in order to avoid expectation gaps in this domain. There is unfortunately a severe expectation gap indeed, between what international standards pronounce and what SAIs are expected to deliver and there is a serious reputation risk at stake: SAIs indeed should not and cannot be the central tool to combat fraud and corruption, however, awareness and reaction on their side are necessary.

The point is here more about the perception of the fundamental role of the SAIs (in particular by external partners, stakeholders or donors where appropriate), in comparison to what they are statutorily requested to deliver, rather than to look at what they do in practice (which can of course relate with more or less stress to cases of fraud and, more unlikely, of corruption). SAIs are not created nor equipped to combat fraud and corruption. Their role is to check, in various ways, that internal control systems are in place and operate well, from a legal (including financial regularity) as well as from an efficiency point of view.

Referring to the internationally accepted documents which inspire if not govern the activity of most SAIs, and certainly the European ones, we can see that the Lima Declaration of INTOSAI is more about the independence and basically leaves no room for the issues of fraud and corruption. The issue of fraud is cautiously mentioned in the INTOSAI auditing standards but not a specific topic, even less the issue of corruption.

There are hardly occurrences of fraud let alone of corruption cases mentioned in the reports of the European Court of Auditors (ECA), which is supposed to define/apply good practices and to “set the standards” vis-à-vis its peers. Moreover so far there has been no ECA report specifically focusing on such topics.

This being said, it is clear that external auditors cannot ignore risks of fraud and shall:

- a. Take these risks into account when designing their audit plans (and this has several consequences).
- b. Take appropriate measures in case of disclosure of a fraudulent case or behaviour in the course of an audit task (which can extend from investigating further, up to a limit, signal to management, mention at the reporting stage, send to police, prosecution or any competent law-enforcement/investigative body, and of course making the appropriate recommendations to either deal with the case or prevent a new occurrence (basically strengthening the internal control systems and procedures). Using again the example of ECA you would expect them as case may be to refer certain cases back to e.g. OLAF.

Corruption is a distinct case and the constant tendency of putting fraud and corruption “in the same basket” is regrettable, as, while linked, these phenomena are in the substance quite different. Corruption poses completely different challenges for the external auditor does not normally have access to documents (in principle of a private nature like private bank accounts, “under-the-table” agreements), which could support the disclosure of a corruption case. It is possible to demonstrate that a tender procedure was illegal, but that it was also subject to corruption (e.g. using bribes to get a contract awarded) will be very difficult and results in detracting resources from the normal audit work (if only the mandate to do it exists, which is generally not the case). Of course in cases where corruption is suspected (but this is again very difficult), the SAI should forward the case to the competent judiciary/police authorities (in most cases audit reports are not regarded as sufficient evidence in courts and the investigation has to be conducted following the proper judiciary investigation procedures). Rather there is a serious risk for a SAI, trying to be proactive in this area, to destroy or invalidate evidence, or to allow the suspected persons to take shelter.

The best contributions of a SAI to the fight against corruption can be described in the following way:

- The SAI should firstly, ensure that their own management and functioning is properly protected against fraud and corruption, and that the highest standards of integrity and compliance are abided by. Through their own strong internal measures and their firm compliance policy, they ought to be regarded as “fraud and corruption-free zones” and implement the adequate procedures to evidence this qualification, e.g. transparency and proper documentation of work etc.
- The audit guidance should contain appropriate tools to deal with fraud and corruption.
- This would cover the necessary assistance to deal on reporting to prosecutors if necessary, and the establishment of adequate liaison with the prosecutor’s office, in order to favour the

establishment of useful routines between the audit institutions and the judiciary, and the exchange of views an experience in general.

- The training curricula for auditors should make room for specific modules dedicated to the fight against fraud and corruption.
- The SAIs should reflect upon how to fine tune their recommendations on strengthening of internal controls in order to suggest efficient fraud prevention procedures to their auditee.
- Finally, it could be considered, as some SAIs have done, to devote some performance audit activity, when it exists, to the efficiency and effectiveness of the anti-fraud/anti-corruption policies in the country concerned, including, if requested, the performance of the judicial system.

State Audit Institution in Montenegro

The State Audit Institution (SAI) was established in 2004. This establishment contributed considerably to the accountability mechanisms in Montenegro. The independence of the SAI is ensured by the fact that it primarily reports to parliament and that the members of the SAI Senate and the President of the Senate are appointed by parliament; its independence is also ensured by provisions in the Constitution. These improvements constitute a good step forward in strengthening its capacity to contribute to a sound public finance base in Montenegro and to ensuring the validity and efficacy of accountability mechanisms. The development of a supreme audit institution takes time. The SAI is making good progress in meeting INTOSAI and EU good practice auditing standards. Annual Audit reports are made public and the SAI has produced a number of annual audit reports to parliament since its establishment. The institution has embarked on an ambitious plan to further build its internal capacity through a strategic development plan.

Conclusions

For the sake of the presentation, the public finance issues were described in four components. They are obviously interlinked but these linkages are of a broader nature when the totality of public administration is considered.

At a strategic level, none of the processes can be seriously regarded as completely separate items: beyond techniques, financial governance is a component of public governance. Budgetary issues link with administrative structures. Budget classification, its more or less flexible character; is concerned with the relations between executive and legislative (transparency vs. efficiency?), the execution procedures of the budget, the degree of management capacity left to “managers”. The internal control procedures as such, the possibility of delegating functions and the reporting rules and practices. This all largely relates to the civil service arrangement and the administrative procedures. Launching reform in these areas imply at the minimum an appropriate degree of communication, cooperation and coordination to make sure that there is no obvious discrepancies or contradictions between policies and practices, existing or planned. Rather they should reinforce each other.

At a practical level, you walk before you run. Unified and transparent budget have priority over programme budgeting, fiscal discipline over introduction of accrual accounting, financial control procedures over internal auditing, financial over performance auditing. There is a strong element of sequencing: a number of modernizing reforms cannot obtain the desired level of efficiency and impact because the system is simply not ready for them. This of course is not only true of the public finance issues, but this area certainly has been par excellence a field for a large number of window-dressing activities: programme budgeting in place not only as a way to describe the budget not to implement it or even report on it, half way accrual accounting in reality not used as a management tool, internal audit

systems in place because the official designation of inspection staff has been changed, performance audit carried out in cases where there is no performance management in place, not even performance objectives to refer to etc.

Finally a few words about challenges. There are also a lot of challenges linked to reform. Reform means changes and changes cause conflict and friction. New concepts are in themselves quite complex, and may be difficult to put into practice. The previous finance system was a crude input based system and gradually there is a move towards an outcome focus. This represents a dramatic change in administrative culture and priorities. There are common obstacles e.g. capacity shortages, especially in line ministries, a reluctance by staff to adopt changes, underestimation of time and resources required, and in many cases, the existence of more pressing priorities or more basic reforms to be put in place.

The successful introduction of reforms such as performance budgeting requires parallel reforms in public sector management and human resource practices. Some countries have attempted to strengthen output control, while retaining traditional input controls. It is very difficult for managers to improve their efficiency or effectiveness if they do not have the authority to take decisions regarding allocation of resources or deployment of staff, and consequently they will be reluctant to accept any increased responsibility for the performance of their organisations.

The Organic Budget Law for Montenegro addresses good governance procedures and the implementation of accountability approaches, as does the PIFC Law. Managing the change to managerial responsibility outlined in the PIFC policy paper as well as in the PIFC law will require time and technical capacity, long-term political commitment and effective arrangements. Special attention should be given to change management in particular, and the need to change working methods in order to achieve the objectives spelt out in both the organic budget law and the PIFC law. Administrative decentralisation does not mean losing control, but it does require different structures and guidelines for devolving authority and responsibility.