



SIGMA

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SERBIA

PUBLIC INTERNAL FINANCIAL CONTROL

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1. Legal Framework

The Budget System Law of 2002 (BSL) incorporates a series of provisions and introduces the framework for public internal financial control (PIFC) in Serbia, including the requirement to establish internal audit (IA) in the public sector.

The BSL relates to: central government; local governments; all public institutions; “other indirect beneficiaries of budget funds; public enterprises and legal entities established by public enterprises; and/or legal entities over which the Republic, or local government, has direct or indirect control of more than 50% of the capital or has more than 54% of the votes in the board of directors.”

Formally, the BSL provides a good basis for establishing management accountability and delegation, proper segregation of duties and central government monitoring of financial regularity. Specifically, the BSL provides a legal basis for:

- assigning responsibility for legal, correct, economical and effective use of budgetary appropriations to the Heads of Direct Budget Beneficiaries (DBBs), while granting them the right of delegation;
- assigning responsibility for establishing sound financial services and internal control systems in DBBs and Indirect Budget Beneficiaries (IBBs);
- segregating payment order authority, accounting and financial control functions; and
- establishing a central, government-wide Inspection and Audit Service in the Ministry of Finance.

In accordance with the BSL, the Heads of DBBs assume responsibility for the legal, correct, economical and effective use of budget appropriations. Direct Budget Beneficiaries are required to establish “financial services” to prepare and execute the budget. In some cases, DBBs have also appointed controllers who are independent of the financial services to perform ex ante checks of the legality of individual commitments and payments. In other cases, legality is ensured via the double signature of the head of the DBB and the head of the financial service authorising commitments and payments.

Section VII, articles 64-69 of the BSL covers IA and Budget Inspection (BI). The Budget System Law does not clearly define the differences between internal control, budget inspection and internal audit.

A draft law on internal audit and internal control was prepared in early 2006 by the technical assistance project, and this law would normally help clarify the various notions linked to PIFC and set up a system that would be more aligned with the common framework recently developed in Central and Eastern Europe, in particular in neighbouring countries. This initiative will need to be taken over directly by the Serbian authorities.

2. Institutional Framework

The Serbian Government has not yet adopted an overall strategy and action plan for implementing an internal control framework that would facilitate implementation of the Budget System Law, and as a result the very wording of the Budget System Law still has little impact. This situation appears to be a major factor inhibiting reform progress. Ex ante financial controls have been reinforced but still need a sound internal control framework, including, amongst other, comprehensive written procedures. However, technical assistance projects in the area of PIFC have taken the initiative in this area, although at the expense of local ownership (e.g. a first PIFC Policy Paper was produced by external consultants just after July 2003 and was formally approved on 22 October 2003; needless to say, the commitment and ownership of the Serbian authorities, in particular the Ministry of Finance, with regard to this policy paper were definitely questionable).

On the basis of the current legal arrangements (Budget System Law, Decree on Budget Inspection and Audit, Internal Control Rulebook, By-law on the Financial Department of Direct Budget Beneficiaries), several aspects of financial control, including internal audit and inspection functions, have been assigned to:

- Ministry of Finance Budget Inspection Department;
- Ministry of Finance Internal Audit Department; (IAD); and
- Internal Controllers of Direct Budget Beneficiaries.

The tasks of the above three groups relate more specifically to internal audit and inspection. More relevant for financial management and control tasks are:

- Treasury Control Co-ordinators;
- Treasury Internal Control Department; and
- Finance Departments of Direct Budget Beneficiaries and Indirect Budget Beneficiaries.

Ministry of Finance Budget Inspection Department (MFBID)

The MFBID has 17 employees, including the Head of Budget Inspection. Almost all of the staff had previously been employed in the Public Payment Agency as financial inspectors.

The Budget System Law and the Decree on Budget Inspection and Audit describe as follows the tasks of the MFBID:

“The Budget Inspection performs control of financial records, reports and other documentation held by budget beneficiaries, organisations of compulsory social security insurance and other legal parties, with the purpose of establishing whether the funds were used in accordance with legislation and purposes [for which they were planned].”

“Control operations are performed in accordance with the programme agreed by the Minister of Finance, or the authorised executive body of local government. Budget inspection can also perform additional controls at the request of the minister or the authorised executive body of local government.” As a matter of fact, the amount of work carried out upon request represents on average more than one-third of the total activity.

The Budget Inspection Department works on the basis of the Budget System Law and the General Administrative Procedures Law. There is a clear “disciplinary flavour” attached to its activity, while focusing on financial aspects, such as checking whether resources were used in accordance with the intended purposes.

The MFBID produces annual plans, reports for each control activity carried out, and annual reports, but there are no job descriptions or procedure manuals.

Internal Audit Department of the Ministry of Finance (MFIAD)

The Budget System Law (articles 67-70) established the Internal Audit Department as part of an Inspection and Audit Service located in the Ministry of Finance, headed by an assistant minister. The MFIAD has 11 staff, including the Head of Internal Audit. Almost all of the staff had previously been employed in the Public Payment Agency as financial inspectors, like their colleagues in MFBID.

In the absence of an assistant minister (the post has been vacant for two years), the Head of IA reports to the Secretary of the Ministry of Finance.

The mandate of the MFIAD is described by the Budget System Law and the Decree on Budget Inspection and Audit as follows: “Audit performs an evaluation of the manner and procedures for operation of bodies and organisations. It means previous investigation of internal control procedures and rules, adequacy and completeness of internal control systems, with the purpose of establishing whether the funds were used efficiently, economically, effectively and in accordance with legislation.”

“Audit has an advisory role in the promotion of risk management procedures, control procedures and management procedures in bodies and organisations, as well as in the implementation of new systems and procedures of internal control.”

“Audit offers to managers of bodies and organisations an independent and objective opinion on the adequacy and efficiency of internal control systems.”

“Audit operations are conducted in accordance with the audit plan agreed by the Minister of Finance or the authorised executive body of local government.”

“Audit can also perform additional investigations at the request of the minister or the authorised executive body of local government.”

The Internal Audit Department carries out “audits of direct and indirect budget beneficiaries; mandatory social security organisations; public enterprises founded by the Government, legal entities founded by such enterprises and/or legal entities in which the Republic has direct or indirect control exceeding 50% of the capital or 50% of votes on the management board, as well as legal entities where public funds comprise more than 50% of the total revenue”.

This is a very wide remit for IA. The current level of staffing is totally inadequate to provide meaningful assurance of the adequacy of the systems of control in all of these organisations. In theory, the staff numbers would need to increase substantially to provide a level of audit coverage and an assurance that would be acceptable to heads of organisations and to the Minister of Finance. However, it is highly questionable whether such a centralised internal audit service is relevant in Serbia, even in a short-term perspective. The expected setting up of an external audit institution (see below) will increase the risk of overlapping and redundancy of both functions, although it is probably inevitable in the short term and even for a longer period that a certain concentration of internal audit resources will take place.

The issue is made even more complicated by the fact that in the law as in practice, there is very little difference between the activities of the Budget Inspection Department (BID) and those of the Internal Audit Department (IAD). It can be said that, while BID normally works on the basis of requests, notably from the minister, IAD operates in the framework of an annual programme. However, the common professional background and qualifications of the staff, as well as the institutional linkage, rather favour similar working methods and approach. It is in any case also possible for the minister to request the IAD to perform special audits, with the result that for an external observer the border between inspection and audit becomes really blurred.

The Internal Audit Department develops annual work programmes, which are endorsed by the Minister of Finance. The results of audit work are compiled by the IAD into semi-annual and annual reports, which contain findings and recommendations stemming from audit work as well as from all other IAD activities, including training.

For the first time, the annual programme of IAD for 2006 has been developed on the basis of a risk assessment of the budget beneficiaries to be audited. In addition, it clearly and rightly focuses on checking the existence and efficiency of control systems and procedures in the auditees.

The IAD has benefited from numerous manuals and other working tools received from consultants in the framework of technical assistance. The extent to which this material is applicable as such to the current context of operations of the IAD remains to be seen, as well as whether it is used at all by internal auditors. A rulebook has been partially developed, but it does not seem to fit the needs of the IAD, so that it is possible to say that at the moment there is very little of support documentation for internal audit work. A new internal audit manual is currently being drafted by the technical assistance project, and the Ministry of Finance now seems to be well involved in the development of this tool.

There is no Central Harmonisation function and no reference in any legal document to such an arrangement. The activities currently carried out in the area of training, methodological harmonisation and co-ordination are carried out de facto in the framework of technical assistance projects, which cover other beneficiaries besides the Ministry of Finance.

Internal Control Units within DBBs

The mandate for establishing internal audit units (IAUs) in DBBs is provided by a 2004 decree on “Direct Budget Beneficiaries (DBBs) that Organise Special Internal Audit Body and on Common Criteria for Internal Audit Organisation and Procedure of DBBs and Mandatory Social Insurance Organisations”. This decree requires the establishment of internal audit units in 18 DBBs and in the mandatory social insurance organisations. There is currently no audit service covering local authorities and public enterprises in which these authorities have an interest. The audit responsibilities listed in the decree are strictly focused, however, on inspection and compliance activities, rather than on assessment of the effectiveness of internal control systems. Another decree, the “Decree on the Method of Operation and Authorities of Budget Inspection and Audit”, was also adopted in 2004 and reflects more modern internal audit terminology, but its actual implementation has been hindered by the current overall system design as well as by the level of understanding of the relevant activities.

In fact, IAUs have recently been established in a number of DBBs, but they still have to develop their practices in line with international standards. As a matter of fact, they are still referred to in most documents as “internal control units”, which is a clear indication of the still to improve state of awareness about the internal audit function in Serbia at the moment. Nine such internal control units have been established in DBBs and in major mandatory social security organisations, with no apparent assessment of needs and levels of risk. A total of 70 staff have received training in internal audit from the EAR-funded technical assistance project. However, so far these units have not been required to work in accordance with recognised standards, as specific methodological guidance has not been available. This might be also linked to the fact, otherwise

quite common in such situations, that the staff of these newly established units consist mainly, if not exclusively, of former inspectors/controllers.

The legal basis for the existence and operation of these bodies is the Budget System Law and the Internal Controllers' Rulebook. The former states that:

“Mandatory social security organisations as well as direct budget beneficiaries that are organisationally complex shall organise a separate service of internal controllers.”

“Other DBBs may organise a separate service of internal controllers.”

The Internal Controllers' Rulebook requires that IAUs carry out both ex ante and ex post checks. In the procedure of pre-control of expenditure planning, the commitment process, and payment order execution, internal controllers shall in particular:

- “check and establish whether the expenditure is planned in accordance with the needs of a body or organisation”;
- “control the commitment process and execution of payment orders”;
- “control the document supporting business changes/transactions”;
- “check whether the transactions are correct and legitimate”;
- “check the preciseness of classifications”; and
- “certify the transactions”.

“In the procedure of post-control, the internal controller shall establish the transaction's lawfulness, accuracy and correctness in relation to revenues, expenditures, financial assets, liabilities, financial accounts and management of state property within a body or organisation.”

“The activities of internal controllers must be based on annual work plans.”

The confusion between control and audit functions – both ex ante and ex post activities – is quite obvious here.

In the area of financial management and control, the following bodies are operating:

Treasury Control Co-ordinators (TCCs) and Treasury Internal Control Department (TICD)

The legal basis for these two bodies is again the Budget System Law.

The 13 TCCs are in the Budget Accounting Department of the Ministry of Finance and the seven executors (senior controllers) of TICD are in the Ministry of Finance Treasury Department.

The TCC controls all payments that are less than 10,000 dinars (approximately EUR 115). The TICD controls all payments over this threshold. Both perform ex ante control of documents provided by DBBs to check budget approval and availability.

The reasons why the functions are separated are unclear. In any case, once the Financial Management Information System is fully in place and if the principle of managerial accountability at the level of DBBs is implemented, there will be less rationale for keeping this function in the Ministry of Finance, assuming that the ministry is satisfied with the reliability of the internal control system and procedures amongst budget beneficiaries. These units, notably the TICD, could in the future form the nucleus of a Central Harmonisation Unit for the Financial Management and Control system.

DBB Finance Departments

The By-law on the Finance Departments of Direct Budget Beneficiaries defines the tasks and responsibilities of these departments as:

- “preparing and making proposals for the financial plan”;
 - “distributing assets to indirect budget beneficiaries within the approved appropriation”;
 - “preparing and completing documentation for executing the financial plan”;
 - “performing tasks relating to the management of state property in charge of the direct beneficiary”;
- and

- “bookkeeping and harmonisation with the General Ledger and making semi-annual and annual financial statements and other financial business”.

DBB Finance Departments are to provide the heads of DBBs with the basic financial management support they need in order to prepare and execute soundly the budgets they are responsible for, and to report on implementation. A review of sample Finance Departments by the current PIFC technical assistance has revealed a number of shortcomings in the functioning of these services, including: the failure to follow the manuals for the execution of the budget (the “Blue Book”), a generally well regarded and useful document; controls that were not related to the perceived risks; and qualifications of staff sometimes left something to desire. There is a need for further efforts in terms of developing the financial management and control capacity of the DBBs, which should be seen as a matter of serious concern for the future.

3. Reform Agenda and Capacities

The European Council Decision of 30 January 2006 on the principles, priorities and conditions contained in the European Partnership with Serbia and Montenegro, including Kosovo, in particular requires Serbia to develop a Public Internal Financial Control (PIFC) Strategy and further “to develop and implement the principles of decentralised managerial accountability and functionally independent internal audit in accordance with the internationally accepted standards and EU best practice”. The reform agenda is thus clear but will prove to be heavy as absorptive capacity is weak, at least in quantitative terms. Whatever the point of application, the basic issue is to strengthen the Ministry of Finance so that more local resources, both quantitatively and qualitatively, are allocated to the development of PIFC in Serbia.

The current technical assistance project has taken steps to help Serbian authorities answer positively the European Union request by producing a proposal for a Law on Internal Audit and Internal Control, which so far is still in draft form. The project then designed a draft strategy paper on PIFC (the previous project had taken a similar step in 2004) and made procedural recommendations for its adoption. However, in the end it should be up to the Serbian key actors to demonstrate their commitment to such a process and their intention to implement it and to allocate adequate resources for its implementation.

4. Assessment

There is still a long way to go before the PIFC strategy is reflected into practice. General awareness, at both senior management level and lower operational level, together with severe capacity constraints will need to be addressed before any concrete implementation can be envisaged.

Accountability mechanisms need to be further developed within the public administration. The need for institutional reform and administrative capacity-building permeates all sectors and levels of the administration. Useful instruments, such as the “Blue Book” on budget execution, and significant new systems, such as the new Treasury system, have been developed and contribute significantly to the general improvement of financial control. However, an overall and clear concept for PIFC is still missing. A number of cultural differences remain, which have to be addressed if the concept of internal control and IA is to be introduced successfully. A policy for public internal financial control needs to be developed, which takes into account the present state of affairs in Serbia but is as flexible as possible to enable future development towards modern principles. A strategy should be designed to ensure and then implement this policy in a structured and methodical way. These tasks have to be performed in the first place by the Serbian authorities, with support by technical assistance as needed; to date the most apparent changes in this area have been the result of technical assistance activity rather than efforts of the local actors themselves. This situation has resulted in piecemeal and ill-designed systems, a still limited understanding of what needs to be in place, and a lack of co-ordination between the various activities related to the development of PIFC. A stronger ownership by the Serbian authorities will require more political commitment and drive at a high level in the Ministry of Finance.

5. Recommendations

- The Ministry of Finance should take the lead in the development of an overall concept for Public Internal Financial Control (PIFC), including promoting the adoption of a PIFC strategy paper at government level.
- Such a strategy should endeavour to set out the principles of managerial accountability and functional, independent internal audit, taking into account both the existing and the potential levels of awareness of the key actors as well as the capacity constraints. An overall needs assessment,

based on a risk approach, should be undertaken in order to design the most relevant system for setting up internal audit units. This system would probably involve keeping for a while the central internal audit function of the Ministry of Finance as long as resources to adequately staff and train internal auditors in line ministries and other DBBs are lacking.

- The Budget System Law and other regulations supporting effective financial control and the establishment of IA in Serbia should be reviewed and further developed on a comparative basis to ensure consistency and to put in place a system that is as appropriate as possible given the Serbian circumstances. The reporting and accountability lines of all budget-users, and the substance thereof, should be subject to a thorough examination.
- Any strategic document should adequately deal with the issues of resources, in particular human resources in terms of staff numbers and quality, training and salaries.
- A Central Harmonisation function should be set up in the Ministry of Finance, with appropriate solutions for dealing respectively with internal audit and financial management and control.
- Plans to set up, in a consistent and cost-effective manner, finance departments as well as fully-fledged internal audit units in DBBs have to be developed and resources allocated for their implementation in due course.

6. External Assistance

The European Agency for Reconstruction (EAR) has decided to support four projects in related areas: the implementation of effective Public Internal Financial Control (PIFC) and in particular the establishment of effective IA throughout the government sector in Serbia; the creation and establishment of a Supreme Audit Institution; the development of the Treasury function in the Ministry of Finance; and public procurement.

The PIFC assistance project has been split into two phases. The first phase, which ended in 2004, brought some improvements and certainly contributed to a better understanding of the key PIFC concepts. However, due to the feeble commitment and absorption capacity of the recipient, the absence of operative IA units and of prioritisation for the Treasury project, and basically the absence of a solid counterpart and a change champion in the Ministry of Finance, the project's results did not live up to the initial expectations. Nearly all of these obstacles were present at the start of the second phase, which was entrusted— like the first phase — to a private consultancy firm. It seems that, after a first inception period, a better response has been given to the input of the assistance provider, which — as mentioned above — has taken steps to place the current development of PIFC into a clear EU accession-driven perspective.

The development of the Treasury function corresponds above all to the setting up of a Financial Management Information System, covering all budget beneficiaries and the whole territory of Serbia. The system would establish fundamental, built-in financial control in the public administration. Any future development should take this reform into account and be articulated with it.