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CROATIA

EXTERNAL AUDIT

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1. Introduction

The State Audit Office of the Republic of Croatia was established by the State Audit Act of 30 June 1993, amended in 1995, 1999, 2001 (twice) and 2004. This act restricts itself to the basic and most important issues, a relatively rare feature in the region. The first Auditor General, appointed in April 1994, was reappointed in 2002.

The SAO is clearly the supreme audit institution (SAI) of the Republic of Croatia in terms of its role and organisation and the basic elements of its supporting law. However, it has no constitutional anchorage and thus lacks one of the most essential means of securing and protecting the establishment and independence of such an institution. At the moment only a law ensures the very existence and independence of the SAO. This is not uncommon among countries that emerged from the break-up of former Yugoslavia, but it would be desirable to fill this gap at the earliest opportunity. The SAO has repeatedly made unsuccessful requests to that effect, the last one in January 2007, and it is doubtful that anything can happen in the short term, given that the period to come is an election time. A series of EU accession-related constitutional changes, as has happened in various candidate countries, could offer a good vehicle for this legal consolidation.

In 2007 the staff of the SAO number 274, of whom 217 have an auditor qualification, and most of the staff are directly involved in audit activities. Most auditors are based in the 20 local offices, which on average employ seven or eight auditors. The target staff figure of the SAO is 301, which is not out of reach but remains ambitious.

The SAO is headed by an Auditor General, who is appointed by parliament for an eight-year term. The SAO does indeed have a clear SAI-office type of structure. Collegial bodies composed of senior managers exist within the office but carry out their functions on the sole basis of internal regulations (rulebooks and statutes).

The central office of the SAO comprises eight specialised departments, four of which are devoted to audit and the other four being responsible for support, horizontal and development functions; each department is led by an assistant auditor general. In addition, there are non-formalised structures, such as the small collegium (meeting of the central management at least once a week), the broader collegium (small collegium and heads of local offices, meeting at least twice a year), and the expert council (composed partly of management, partly of external academics).

The budget of the SAO was established at 40.1 million HRK (5.5 million EUR) in 2004, 42 million HRK (5.7 million EUR) in 2005, and 45.8 million HRK (6.3 million EUR) in 2006. The execution of the budget was 40.1 million HRK (5.5 million EUR) in 2004 and 40.9 million HRK (5.6 million EUR) in 2005. The State Audit Office of Croatia is currently finishing a substantial twinning project (30 months) with the UK National Audit Office.

2. Baseline Questions

2.1. *Does the SAI have clear authority to satisfactorily audit all public and statutory funds and resources, bodies and entities, including EU resources?*

The SAO was established to perform the audit work defined by the State Audit Act of 1993. This work covers the audit of public income¹ and expenditure; audit of financial statements and financial transactions of government units and local and regional self-government units, legal entities that are partly or wholly financed by the budget, public enterprises, companies and other legal entities owned in major part by the Republic of Croatia or by local and regional self-government units; audit of the use of EU funds and funds of international organisations or institutions for the financing of public needs (article 1). This article goes

¹ This is a recent addition. The initial text did not mention the audit of the income side of the budget. Such a missing provision did not appear to be a problem, but it might have led to misunderstanding. The situation has now been clarified.

further in specifying that “government incomes and expenditures comprise all incomes and revenues, and expenditures being financed from the state budget or from appropriate funds at the national level, and from the budgets at the level of local and regional self-government units”, and further indicates that “as government units are understood all legislative, executive and judiciary bodies, as well as agencies, institutions and other subjects at the level of the Republic of Croatia and at the level of local and regional self-government units, financed from the state budget or budgets of local and regional self-government units”.

This legal definition is clearly made to cover all public institutions or any flow of public funds, without exception. The law was amended to make a clear reference to the competence of the SAO in relation to EU funds, and this body is in general authorised to audit the end-user, so that this specific requirement in the context of EU accession appears to be well established in legal terms. Audit of the performance of EU-funded projects was undertaken in 2006-2007.

All in all, this means that the SAO is meant to perform the audit of nearly 900 different institutions, and in principle on a yearly basis. Obviously in practice this is totally impossible, unless of course the number of staff were to increase well beyond what is acceptable or even feasible. This leads to ad hoc solutions, notably for local government, where the 22 largest cities and the 20 counties are fully audited on a yearly basis, while the rest of the municipalities are divided into three groups so that each group is audited at least once every three years. Municipalities that are not submitted to audit are at least subject to a quick review in the form of a “desk job”. This approach is far from uncommon in the region, but it is in principle supported by a specific legal provision, which is not the case in Croatia. However, it is possible to say that the approach is based on an assessment of risks, and the SAO is conscious that this activity should evolve in relation to the development of public internal financial control systems, including internal audit, at the local government level. Other possible approaches could be considered, such as auditing groups of municipalities or a succession of years for a single municipality.

The SAO has a broad remit covering all public institutions. As far as local government is concerned, the capacity of the SAO is, and will remain, insufficient to carry out the work, which includes a full statutory audit each year, and there is still a need to identify and implement alternative solutions, notably taking into account the increasing development of internal control and internal audit within local government.

2.2. *Does the type of audit work carried out cover the full range of regularity and performance audit set out in INTOSAI auditing standards (1.0.38-1.0.44)?*

The definition of audit given by the State Audit Act covers both the examination of documents and systems to determine whether financial statements truly reflect financial activities – in compliance with accepted accounting principle and standards – and the examination of the legal utilisation of funds. This is a fair definition of the financial audit, including its regularity aspect. The scope could be considered to be rather narrow, as it prioritises the aspect of compliance with accounting standards, whereas the aspect of legality, so important in the European public sector, comes second. In practice this narrow definition does not seem to result in a restrictive scope of activity. In practice this does not seem to be a prohibiting factor leading to a restrictive scope of activity.

Furthermore, the act defines audit as an assessment of the efficiency and effectiveness of activities, as well as an assessment of efficiency in pursuing the objectives of a specific project. This is a good description of performance audit. There is no further elaboration in the act of these concepts, which are normally to be implemented in the work of the State Audit Office.

The SAO does not perform a specific audit of the consolidated state accounts, in the absence of such a document at the moment, and not even of the execution of the state budget as a whole. The annual audit of the state budget consists rather of compiling and summing up the results of the separate audits performed on each budget institution. In fact the current approach seems almost totally disconnected from the overall budget process. The annual audit report does not focus on the overall execution of the budget. In practice,

the annual report is sent to parliament well after the annual accounts of the state are produced and after the submission of the draft budget. It would be worthwhile to direct attention to the production of an overall audit opinion on the execution of the state budget, based on the concepts of risk and materiality.

The performance audit activity is still in a very early stage, although some aspects of performance audit are sometimes included in the financial audit report. At the present time 12 specific pilot performance audits, or largely covering efficiency and value-for-money elements, have been or are being completed as self-standing exercises (they cover, amongst other things, the management of regional parks, revenue from gravel and sand concessions, collection and use of tourists' fees, and audit of projects financed by CARDS and PHARE funds). The development of performance audit was one of the components of the current twinning project but still on a limited scale. This is fully understandable at this stage as the SAO needs to develop its capacity to undertake more work in the area. One element in that development is the staff, and the State Audit Act has been rightly amended to expand the range of qualifications for recruitment to the SAO so that persons with backgrounds different from law, economy or accountancy may contribute their skills to audit work, namely in the area of performance audit (e.g. engineers). The expansion of performance audit will certainly be one of the major inputs of the new strategy for the period 2008-2012.

The new Strategic Development Plan should provide a good avenue for the definition of specific performance audit goals, including criteria designed to focus the SAO's still limited resources on issues that are relevant to the public interest and of real importance in the current Croatian framework, while allowing adequate practical training of SAO auditors. The SAO has started to engage in cross-sectoral audits but more is needed in that direction, e.g. an audit of the reformed Public Internal Financial Control (PIFC) system.

The type of audit work, as defined by law, covers the full range of regularity and performance audit set out in INTOSAI auditing standards. For the moment this conformity remains formal, as in practice audit work is mainly of a legality-compliance type, with limited room for financial audit, in particular for the annual audit on the execution of the budget. Performance audit is developing in a prudent and progressive manner and this is appropriate, but a more explicit strategy for the future in this area would be of interest.

2.3. *Does the SAI have the necessary operational and functional independence required to fulfil its tasks?*

The existence of the State Audit Office is not protected by a constitutional provision, and this issue will need to be addressed in due course when the opportunity arises. The independence of the SAO partly results from the fact that it is only accountable to parliament. The Auditor General is appointed for eight years by parliament and can be reappointed; this is a standard situation found in many SAIs. The State Audit Act, although in a cursory manner, spells out the motives for dismissal, but no procedure is described and some motives may be subject to interpretation. The current provision nevertheless seems to provide sufficient protection to the Auditor General. On the other hand, there are no particular provisions for either the management or staff of the SAO.

Auditors were removed from the scope of the civil service legislation, apparently to relieve the SAO from the patronage of the executive branch as far as SAO staff were concerned. This was notably the case for the establishment of salaries, as the recent law on the salaries of auditors allows for higher wages than for a comparable level in the rest of the public administration. Parliament is now directly responsible for setting the "coefficient" applicable to the salaries of the SAO, making these positions even more attractive than they used to be. However, the general civil service legislation remains applicable to SAO staff. In any event, the real challenge for the SAO will be to develop a human resources policy that will keep at a high level the attractiveness of the work in this institution, while developing the quality of the audit activity.

Only the independence of state auditors, in terms of prevention of conflict of interest, is regulated by the State Audit Act.

The State Audit Act does not contain explicit provisions with regard to the drafting and adoption of the SAO's budget. The budget of the SAO is formally separate from that of other budget-users, although the SAO submits its budget to the Ministry of Finance, which controls the submission to parliament. Similarly, any reallocations in the course of budget execution are submitted to the Ministry of Finance, as for any budget-user.

The SAO is free to decide on its audit programme. However, except for local entities, its room for manoeuvre appears to be limited with regard to the number of mandatory audits it has to perform. No interference in the audit programme is reported, but the law is not explicit as to the procedure that applies to the programming of activities, which seems to be largely left to the discretion of the Auditor General. In practice, advisory bodies are involved in programming. Parliament has the right to request audit work from the SAO and there have been three or four such cases since the establishment of the SAO, leaving aside of course the specific audit work performed on privatisations, which corresponded to an explicit request of parliament as an institution. These requests thus remain very limited. It would be preferable to establish some procedure for regulating the way in which parliament uses its right to request that audits be undertaken.

The institutional structure of the SAO, with its number of local branches – in most cases small – can raise various concerns about its efficiency but also its independence, as it has so far been accepted that auditors remain assigned to a local office for their entire career. A minimum level of rotation is desirable in order to prevent the lack of staff mobility developing into a routine, if not a loss of independence vis-à-vis the auditees.

The right of access to all documents and data that may be useful for audit work is stated in article 5 of the State Audit Act. In addition, penal provisions are applicable to those who deny this access to authorised auditors.

The independence of the SAO does not seem to be a matter for concern, in spite of the relatively vague provisions regarding the status of the management and of the staff. The SAO seems to be provided with the financial means to enable it to accomplish its tasks, and it is entitled to use its allotted funds under a separate budget heading, which is in line with basic INTOSAI principles. The practical situation of local branches with regard to independence is questionable and consideration should be given to this issue.

2.4. Are the SAI's annual and other reports prepared in a fair, factual and timely manner?

In the Budget Act, precise dates are set for submission of the consolidated statement of the budget accounts by budget-users, line ministries and the Ministry of Finance. In addition, according to the Budget Act [art. 128 (5 and 6)] the government is required to submit the annual statement of budget accounts to the State Audit Office and to parliament at the beginning of June. According to the State Audit Act [art. 11 (2)], the audit report must be submitted no later than five months following expiry of the date for submission of annual financial statements. The annual statement of budget accounts is usually submitted to parliament at the beginning of June and approved by parliament by the end of June. This time frame is satisfactory. However, it is very surprising to observe that the State Audit Office's audit report is submitted to parliament only in October or November. The accounts are thus approved without an audit report being available. This situation would need to be revised, and the report should be produced early enough so that it can be communicated to parliament at the same time as the final state accounts.

Beyond this – rather fundamental – issue, there is no indication that the timeliness of the report is a problem. Any objection to the audit report from an audited entity must be made within eight days of submission of the report. The Auditor General is to decide on the matter within 30 days. The initial time frame gives a very short deadline by all standards, and a delay of 15 days for making an objection would be more appropriate.

As far as fair reporting is concerned, the State Audit Act does not enter into great detail and simply states that the audit report is to be prepared in accordance with audit standards, thus implying that audit findings

are supported by appropriate evidence. The time allocated to the auditee to consider the contents of the report, its findings and recommendations represents a minimum. It seems, however, that an informal contradictory procedure takes place during the audit process and before the draft report is produced. The quality control procedure is well established but is above all based on hierarchical supervision of the reports up to the level of Auditor General, although the reports are signed only by the team leader. In order to further improve the quality and consistency of working methods and approaches across the institution, the SAO should consider the possibility of a more comprehensive quality assurance policy, so that quality concerns are given attention at all steps of audit work and reporting and that the work is less dependent on external scrutiny. The further standardisation of procedures and working methods is amongst the foreseeable key components of the new strategy document currently being prepared.

The annual report is produced in accordance with the deadline set by law. However, to be efficient and produce the necessary impact, this report should be submitted much earlier to parliament and should be more closely connected to the budget process (including the production of the execution accounts or financial statements). The procedural relations with the auditee could be slightly improved, but there is above all a need for a comprehensive quality policy at the level of the SAO.

2.5. *Is the work of the SAI effectively considered by parliament, e.g. by a designated committee that also reports on its own findings?*

The annual report on audits performed is submitted to parliament, and this can be done by the SAO until the end of the year following the year covered by the report. In practice, this occurs in November but, according to the law, individual audit reports may be sent beforehand to parliament “in case of specific interest”. The annual report is also the activity report of the SAO. The normal recipient is the budget committee of parliament, but there is no body within parliament that has been specifically set up to deal with the reports.

In practice the report is first discussed in the budget committee and then, as the case may be, in other relevant specialised committees, and finally in the plenary session of parliament. There is no obligation, however, for the government to participate in the discussion of the report. The practice of parliament in the past two years has been to request the government, as well as audited entities, to report on the implementation of SAO recommendations. At the moment this practice is not considered to have had much impact, and generally there seems to be less interest in parliament in the audit reports than would be expected. This could be partly linked to the paucity of resources in parliament to deal with the audit reports, but also to the risk, in the current political context in Croatia, of politicisation of the audit work. Recent events in the framework of the twinning projects have helped to achieve a better awareness of key parliamentarians of the importance of a close and efficient relationship between the SAI and parliament. The changes that may result from the upcoming elections could offer an opportunity to build the relations between those two bodies on a renewed footing.

In any case, parliamentary channels do not constitute the only way of ensuring the implementation of SAO recommendations. A first basic procedure is what the SAO can follow directly. Monitoring the implementation of former recommendations is part of any new audit task and of the resulting report. All auditees are requested by the SAO to report within 60 days on what they have done or plan to do in relation to the recommendations that the SAO has previously made. On the basis of the information provided through this procedure, 1467 of the 3140 recommendations made in 2006 were implemented.

In the event of fraud or a risk of other penal qualifications, the SAO notifies the prosecutor in the course of the audit without waiting for finalisation of the report.

The echo of audit reports in parliament is still weak and the reasons for this would require further analysis. Other ways of following up recommendations are available to the SAO. The specific impact of audit activity is still difficult to assess, but the SAO is committed to developing this aspect of its work.

2.6. *Has the SAI adopted internationally and generally recognised auditing standards compatible with EU requirements, and how far have they been implemented?*

The State Audit Act specifically states in article 4 that the audit method and procedures are to be performed in compliance with the established INTOSAI auditing standards. It is doubtful, however, that such a provision is fully implemented, as no SAI in the region is in a position to comply with a somewhat demanding requirement. The Croatian SAO has nevertheless decided to place itself in that framework and to develop along those lines. The INTOSAI standards were translated into Croatian and published in the *Official Gazette* as early as 1994, but the extent to which this has impacted on the activity of the SAO has been progressive, in particular at the level of local branches. In addition, the internal structure of the SAO, with its numerous and often small local branches, risks making the compliance with standards a more difficult task than it would be in a more streamlined organisation.

The EU guidelines for implementing the INTOSAI standards were similarly translated and disseminated throughout the institution in 2001.

An audit manual, in place since 2000, is meant to cover the various areas of work of the SAO. This manual has been supplemented and upgraded in the framework of the current twinning project with specific components on financial and performance audit. These documents, produced by a working group, have been tested in practice, and in principle they should have been implemented by now throughout the institution.

In addition, a specific manual on the audit of EU funds has been produced in the framework of the twinning project.

The working procedures resulting from this documentation, when in force, are mandatory for auditors and are made available in various forms, including on the SAO Intranet. There is an intense developmental activity in this area, which should in principle result in a higher quality and increasing relevance of audit work.

The SAO has formally adopted the INTOSAI standards and developed tools, such as audit manuals, which are now generalised across the SAO. However, this process is still in a development phase.

2.7. *Is the SAI appropriately aware of the requirements of the EU accession process?*

From nearly the beginning of its operations, the Croatian SAO has sought to familiarise itself quickly with the EU requirement process and to disseminate its knowledge. This was clearly spelled out, for instance, in the strategy document adopted in 2003, which is, inter alia, based on the provisions of the European Guidelines for the Implementation of the INTOSAI Auditing Standards.

In general, the current Strategic Development Plan contains numerous commitments related to the accession process and to some extent goes beyond the strict requirements of the negotiating framework. This is namely the case of the plans related to international activity, where the stress is largely on EU issues, but also for more general policies, e.g. human resources policy (when employing new auditors, the SAO gives consideration to the selection of candidates with such additional qualifications as “an understanding of the EU background”). A training programme for the “acquisition of expert qualifications for understanding the European environment, revision of administrative adjustment to European regulations and management of EU funds” has been organised for 120 auditors.

Before the candidate status of Croatia was granted, the SAO took part as much as possible in networking activities of SAIs from Central and Eastern Europe. It plays an active role as an observer in the Contact Committee established among EU Member State SAIs in application of the EU Treaty.

Probably more than in any other candidate country to the EU, the Croatian SAI has been closely involved in the process of establishing and developing public internal financial control (PIFC) systems and

procedures across the public administration, as requested by the European Union, and this from the very beginning of the initiation of a PIFC policy in Croatia. More specifically, the SAO has regularly liaised with the Ministry of Finance in this area, and it has been involved in the drafting of the first PIFC policy paper adopted in 2005 and of related amendments to the Budget Act. It has been involved in the monitoring of assistance activities dealing with PIFC implementation. In addition, the current head of the sector in charge of PIFC in the Ministry of Finance is a former Assistant Auditor General. Similarly and in the framework of international activities (INTOSAI, EUROSAI), the SAO has been very active in the promotion of internal control concepts and the contribution of external audit to their improvement and development in practice. Furthermore, the SAO is represented on the negotiating team of Croatia, in charge of issues related to negotiating chapter 32 on financial control.

This intensive activity has had a concrete translation into SAO practice with the setting up of a department specialised in the audit of EU funds. In addition, the State Audit Act has been specifically amended to cover the right to audit EU funds and programmes and the beneficiaries thereof (although this capacity could be deduced from the previous text). The SAO has not considered acting as the certifying body for the SAPARD programme in Croatia, but will carry out the functions of winding-up body for the ISPA programme. It has recently carried out pilot performance audits of pre-accession funds.

A new development is the partnership agreement that will be signed between the SAO and the European Court of Auditors, defining the conditions of the contribution of the Croatian SAI to the audit activity on pre-accession and EU funds. This agreement could prove a very innovative step forward, as few EU Member State SAIs, if any, have entered into such arrangements.

The SAO has put nearly all of its development activity under the umbrella of EU accession, in a way that few SAIs of candidate countries have done.

3. Capacity to Further Develop the System

The State Audit Office has continued to show interest in continuing its development in the recent period. Its main results were accepted by the SAO and incorporated into a Strategic Development Plan, which not only laid out the directions for future work, but also set up a structured process of follow-up and monitoring of implementation. Some of the recommendations made in the peer report were rapidly translated into the SAO legal framework.

The Strategic Development Plan is now nearly achieved, to a large extent with the assistance of the ongoing twinning project, and the results of its implementation show a high level of completion. The SAO has now started its process of developing a new strategic document: a special working group, composed notably of external experts from the academic world, has defined the mode of operations for reviewing the objectives and strategy of the SAO. The creation of this working group demonstrates that the SAO is still committed to reform and to modernisation. The approach at the moment is largely a “bottom-up” one, with the eight central departments requested to contribute their own respective visions to the Strategic Development Plan. The whole process is due to be finalised by the end of 2007. The permanent and very active involvement of the SAO in European and international activities also speaks for its willingness to keep abreast of the current evolution of audit practices in the public sector.

4. Summary and Next Steps

External audit in Croatia generally meets the requirements of the INTOSAI auditing standards for effective and efficient audit of public funds and resources.

The Croatian legal framework has been a source of inspiration for a couple of neighbouring countries in the region, which speaks for its easily understandable nature.

The State Audit Office of Croatia as an institution has made progress during the past few years in an evolving environment. It has endeavored to take ownership of the reform process by adopting a long-term

development strategy, which is being implemented in the framework of an important twinning project with the UK National Audit Office, and is now entering a new phase, with a revised Strategic Development Plan. The revision of the strategy document makes use of inputs and views of audit staff and middle management. The intentions of the new plan are to further strengthen audit tools as well as the training of staff, in particular with a view to developing performance audit.

Parliament does not seem to take all possible benefit from the work of the SAO in order to control the government's activities. This could prove to be an obstacle to the efficient impact of audit reports on the development of sound financial management in Croatia.

In addition to the efforts being made in the audit of EU funds, the SAO still has to develop its financial audit, with a view to delivering an overall audit opinion on the consolidated financial statements of the state, and to continue carrying out performance audit in selected areas. Important reforms are now taking place in the public finance sector in Croatia, such as the introduction of PIFC, including an internal audit function, and significant improvements of the treasury functions. The SAO will need to take these developments into account in the design of its audit work, including its evaluation of internal control systems and risk assessment.

Priority should be given to the following actions:

- Finalise the new Strategic Development Plan, setting relevant and realistic goals;
- Define policies and procedures to cover the current broad audit remit of the SAO, and consider the possibility of making suggestions to reduce the number of budget-users;
- Keep informed of key developments in the public finance sector, notably the establishment of public internal financial control (PIFC) – in particular internal audit and development of financial management and control systems – as well as of other reforms, such as the development of the treasury system and the linkage between strategic planning and budget preparation;
- In due course, review working procedures with parliament in order to improve the follow-up on audit reports in parliament;
- Continue to assume an active approach to international co-operation and contribute to the exchange of working methods and experience;
- Reconsider the concept of the annual audit on the execution of the budget, with a view to expressing an opinion on the budget process as a whole, based on risk and materiality;
- Evaluate the effectiveness and efficiency of the impact of audit work on the organisation and policies of budget-users;
- Continue developing the performance audit capacity and design plans and strategies for future implementation, selecting topics with a potentially useful impact that are related to the current needs of the public sector;
- Initiate more pilot audits and cross-sector activities;
- Consider seeking further peer advice on assessing the progress achieved in more than a decade of SAO operations;
- In due course, seek an opportunity to ensure the constitutional position of the SAO.