



**SIGMA**

**Support for Improvement in Governance and Management**

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**FORMER YUGOSLAV REPUBLIC  
OF MACEDONIA**

**PUBLIC INTERNAL FINANCIAL  
CONTROL (PIFC)**

**ASSESSMENT MAY 2009**

## **1. Summary**

### ***Main Developments since last year***

The main developments in public internal financial control (PIFC) that have occurred in the former Yugoslav Republic of Macedonia<sup>1</sup> over the last year are as follows.

- A new law on PIFC was sent to the government at the end of May 2009.
- A rulebook on the form, contents and arrangements for submitting statements on the quality of internal controls has been published.
- A twinning project supported by the Dutch Ministry of Finance has been completed. The aim of this project was to develop sound FMC systems and complete the PIFC legal framework, strengthen the administrative capacity of internal audit units in the public sector at central level and strengthen the administrative capacity of the Central Harmonisation Unit (CHU) in the Ministry of Finance. This twinning project has also provided valuable training, particularly for internal auditors.
- A revised Law on Budgets has been published, and the budget laws set the overall context for PIFC.
- A new audit team with specific responsibility for the audit of IPA funds has been established and a specialist audit manual has been developed for this purpose.

Changes have occurred in the laws and related matters affecting local government; these changes increase the financial capacity of local government and continue the reform of property tax arrangements.

### ***Main Characteristics (strengths and weaknesses)***

For most organisations (and there are some exceptions), the head of the organisation (a minister in a line ministry, for example) is the “manager” for the whole organisation. There is no concept of “professional management”, involving the active management of resources designed to deliver organisational strategic and performance objectives at an agreed standard and on time. Some heads of organisations apparently feel that they can only carry out their responsibilities properly if they take all decisions. These heads therefore consider that there can be limitations on the delegation of responsibility or even a complete lack of such delegation. Public internal financial control (PIFC) arrangements cannot work effectively in such circumstances.

While financial management and control systems are being put in place and internal audit is being implemented (but so far not in all public organisations that are required to appoint internal auditors), the levels of understanding of the technical concepts and requirements as well as the standards of application generally appear to be limited. There is also some evidence of a degree of “literalness” in the interpretation of the legal requirements, which suggests that not all heads of organisations (or indeed internal auditors) understand what the objectives of the law really are.

Internal audit is being extensively introduced and considerable progress has been made in establishing the physical presence of internal audit. The determination of the numbers of internal auditors who should be appointed to internal audit units is based on a formula that determines the minimum, and in practice the minimum generally seems to be applied. The formula does not take into account risk and the complexity of the activity.

Some areas of activity are potentially vulnerable to error and fraud. No evidence was available, however, to indicate that there was any recognition of this vulnerability or that steps were being taken to counter these risks.

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<sup>1</sup> In this report the former Yugoslav Republic of Macedonia will hereafter be referred to as “Macedonia”.

The law clearly provides for an appropriate division of responsibilities for the approval of payments. This is to be welcomed, although fundamentally this division is concerned with “financial control” rather than “financial management”. While this allocation of responsibility will serve to ensure that spending is properly authorised, what it will not do is contribute to the achievement of value-for-money, which will require a more active engagement by senior management in the financial management process.

In practice the main systematic element of internal financial control is the operation of the Treasury system. This is a very effective tool for ensuring that expenditure is managed in line with the budget and that spending is controlled. However, this control does not ensure that spending “provides reasonable assurance that the objectives of the entity are accomplished” or that spending represents the “transparent, regular, economical, efficient, and effective use of the disposable means”, the terms used in the draft PIFC law.

Internal audit focuses mainly on ensuring that transactions (not systems) follow the appropriate rules. So its effectiveness is limited and as a result it may not be adding the value that is required for its acceptance by heads of organisations (i.e. management) as an important aid to successful management.

In making these comments, it should nevertheless be borne in mind that Macedonia is at a relatively early stage in the development of PIFC, and in the short term what is essential is that basic audit skills and basic financial management and control systems operate effectively. This would mean that at this stage the focus of PIFC (including internal audit) development should be on ensuring that financial systems are robust, which in turn means that the management of expenditure and revenues conforms to the budget and to the law and that good quality systems audits are developed.

### ***Recommendations for Reform***

In the short term the following would be beneficial:

- A concerted effort to introduce or improve the managerial approach to strategic planning and delivery of public services, which would involve the delegation of budgets and control responsibilities, apart from those of the greatest significance (without such delegation it will be extremely difficult to introduce a fully functioning PIFC system);
- Inculcation of management (heads of organisations) with the idea that PIFC is an essential mechanism for ensuring the efficient and effective utilisation of Macedonian public resources rather than an “add-on” existing only because of European Union requirements;
- Greater awareness of what public financial management (including internal audit) is actually about, i.e. it is more than just ensuring that the financial control arrangements specified in the treasury system are followed;
- Development of professional training programmes for those responsible for financial management to improve the quality of financial management processes and similarly for internal auditors;
- Development of human resources policies for financial management and internal auditor staff that would lead to effective career structures based on experience, qualifications and performance;
- Promotion of the development of systems audit and in general development of quality control;
- Provision of specialist internal audit training, where appropriate;
- Development of awareness on the part of both the management and internal auditors of the potential risk of fraud and error in vulnerable systems;
- Development of networking between internal auditors.

In the longer term, developments should include:

- Increased focus on improving the quality of public expenditure through better value-for-money;
- Promotion of the development of risk management;
- Enhancement in general of the skills of internal auditors.

## 2. Baseline Questions

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

The basic law relating to public internal financial control (PIFC) in Macedonia is the Law on Public Internal Financial Control published in the *Official Gazette* no. 22/07, which is currently being superseded. The Law on Internal Audit in the Public Sector was published in the *Official Gazette* nos. 69/04 and 22/07, and the Law on State Audit was published in the *Official Gazette* nos. 65/97, 70/01, 31/03, 19/04, 70/06 and 133/07. The Law on Budgets, the latest consolidated version of which is dated 3 August 2005 (with subsequent amendments, the latest of which was in 2008), provides the framework for public expenditure management and covers the central government, local government units and extra-budgetary funds. The Law on Accounting for the Budget and Budget-users of 18 July 2002, which entered into force on 1 January 2003, covers all specific accounting procedures and control responsibilities of budget-users and also defines the role and responsibilities of the accountant within an organisation. These laws and related texts, such as the Law on Procurement, the laws on local government, and the annual Budget Execution Law, together provide the overall framework for internal financial control, defining roles and responsibilities and setting the overall financial context within which PIFC occurs.

In February 2008, a Strategy for Development of PIFC was finalised. This policy paper was not adopted by the Minister of Finance or by the government, but the government adopted the National Programme for the Adoption of the *Acquis* (NPAA, which) includes a passage on the development of PIFC, using the terminology and concepts of the draft PIFC Law.

A new PIFC Law was sent to the government at the end of May 2009. It will be forwarded to parliament after approval by the government. The contents of this new law, which reflects the policy envisaged in the Strategy for Development of PIFC, has been the subject of extensive discussions with the European Commission. While the draft PIFC Law does facilitate the development of PIFC, some uncertainties appear to remain, which suggests that perhaps there is still no real appreciation of at least some elements of PIFC. Thus, the draft law defines “financial management and control as a system of policies, procedures and activities established by the head of the entity, in order to provide reasonable assurance that the objectives of the entity are accomplished”. This definition does not encompass the idea of being responsible for the achievement of value-for-money. The same legislation then defines “sound financial management and control” as the “transparent, regular, economical, efficient, and effective use of the disposable means”. The adoption of a single definition of financial management encompassing both points would be more appropriate, namely that “financial management and control is a system of policies, procedures and activities established by the head of the entity, which provide reasonable assurance that the objectives of the entity are accomplished in a transparent, regular, economical, efficient, and effective manner”

The draft PIFC Law envisages the continuation of the arrangement whereby the head of the organisation is to provide a certificate of self-assessment of the quality of internal financial controls. This is an ambitious objective, in particular as the experience of other countries has been that the process can be rather mechanical and at best can only provide information about the organisational arrangements that have been put in place. What really matters, however, is the quality of the financial control processes and what has been done to correct errors and reduce losses when they have occurred. (Evidence of what has gone wrong should be a required component of the certificate of self assessment, as well as information about what has been done to correct the situation. At a later stage, requiring the internal auditor to confirm the assessment could provide a valuable assurance that the certification had been accurate.)

The draft law also refers to the use of risk management. This is a difficult area to develop, especially when there is such a concentration of responsibility on the head of the organisation, with little practical delegation. Risk management is only effective when clear objectives have been set, defined by standards and time. The risk to an organisation is about not meeting those objectives on time and to standard. The draft law has a limited approach to risk management, and this is perhaps inevitable

given the present approach to public service management. It is nevertheless an area of activity that will need to be developed in the future.

The draft PIFC Law also does not deal with the application of corporate governance principles, especially to public and municipal-owned enterprises. The application of such principles would serve to enhance the quality of performance and increase transparency. If the PIFC Law is not regarded as the most appropriate legal vehicle for such a requirement, other legislation should then include this requirement.

Following the adoption of the 2007 PIFC Law, the CHU produced a set of rulebooks addressing:

- the basic elements of financial management and control and internal control standards in the public sector;
- the form, contents and way of submitting statements on the quality and condition of internal controls;
- the basic elements of the manual for the performance, charter, annual plan and programme of internal audit.

These rulebooks were published in the *Official Gazette* between the end of 2007 and beginning of 2008 and are now mandatory for all public sector entities.

In addition, an audit manual has been produced. This manual is applied generally, although variations to the manual are permitted after agreement with the Ministry of Finance (an example is the manual specifically concerned with the audit of EU funds).

These rulebooks are likely to require an amendment on the implementation of the new PIFC Law, and the intention is to publish new rulebooks, where appropriate.

The CHU has the intention of launching a series of training programmes as part of the arrangements for promoting the new legislation.

Macedonia appears to be making every effort to comply with the legal requirements of the European Union for PIFC by drafting the legal framework, and the extensive discussions in the Commission on the new PIFC Law are evidence of those efforts. However, putting in place a legal framework, while important, is only one aspect in the development of an effective PIFC system. What is critical is that the principles underlying PIFC are wholly embraced by management at all levels. PIFC should be regarded as a day-to-day aid to ensure the efficient and effective utilisation of Macedonian public resources and should not be viewed as an “add-on” that exists only because of European Union requirements.

Sometimes it seems as though the law is being interpreted in a too literal fashion. For example, internal audit is perceived as being wholly independent of management, to the extent that management is not involved in the decisions on internal audit priorities and in the discussions on risk. The internal auditor takes the final decision and in doing so consults only with the head of the organisation (e.g. the minister in a line ministry). This suggests that the real meaning of the law is not well understood in practice.

This does not necessarily apply just to the laws introduced to meet EU requirements. Thus the law places responsibility for all decisions on the head of the budget organisation, and this can be interpreted as meaning that a single person - the head of the budget organisation - must take all decisions relating to that organisation. Thus in one ministry, for example, as the minister does not delegate responsibility for managing the budget of a particular unit to the manager of that unit, that manager does not know what resources are available to the unit. This situation is wholly inconsistent with the idea of PIFC. Again, in another line ministry, the minister personally signs all payment orders.

**Overall, it would appear that there is a coherent and comprehensive statutory base in place, defining the systems, principles and functioning of financial control. That base is currently being updated, and the aim is to ensure that the new PIFC Law is fully consistent with EU**

**requirements. However, the fact that a law exists does not automatically mean that the principles underlying that law are being applied in practice.**

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

The existing financial management control systems and procedures have been regulated in first and secondary legislation, such as rulebooks, systematisation and specific manuals (e.g. on execution of treasury operations by budget-users and spending-units). General compliance and budget discipline was increased with the introduction of the treasury system in 2000. The main provision concerning financial management and control had been set out in the Law on accounting for the budget and budget-users, which states that budget-users should have a regular system of internal accounting control (ex post) to ensure that transactions are executed in accordance with legal regulations, accounting documentation is appropriate, and financial statements are reliable. A key point has been to ensure that all revenues are properly collected and reported, as many budget-users still have own sources of income. Even though this legislation existed, the quality and efficiency of internal control varied between institutions, basic principles of implementation were lacking, and formal observance of the requirements did not necessarily reflect operational practice. The then PIFC strategy provided various examples of current shortcomings in this area. The draft 2009 PIFC Law seeks to remedy the previous deficiencies and in particular places clear responsibility on the head of the budget organisation and, as part of this responsibility, makes it clear that “value-for-money” should be a consideration in the financial management process.

However, the primary form of financial control of expenditure is through the systems established as part of the Treasury system, and this will remain the case. The Treasury system seems to be very effective in controlling expenditure in line with the budget and in terms of managing cash flow. While the budget is planned on a three-digit code, budget execution is based on a six-digit code. All budget-users are required to submit quarterly cash flow forecasts and, at the beginning of each quarter, to prepare monthly plans for that quarter. A degree of transfer of funds can be allowed by the Ministry of Finance between budget heads, and there does appear to be flexibility on the part of the Treasury to accommodate cash flow revisions. (In fact, the Treasury observed that the quality of cash flow planning in budget-users is generally poor and that many revisions occur in practice.) Daily information is provided to budget-users.

Commitments are also entered into the system.

All budget-users are covered by the Treasury system, including individual municipalities. As part of the control arrangements, all budget-users are expected to submit a list of authorised persons able to approve payments, and a central register is maintained. This register is checked when payments are requested. Donor funds, apart from EU funds, are incorporated into the system.

Internal audit carries out checks on the operation of the Treasury system but seems to focus on compliance with the regulations. No IT audit is carried out.

Apart from the controls exercised through the Treasury system within public sector organisations where the initial PIFC processes occur, these organisations seem to be at various stages in the implementation of PIFC. One line ministry had no internal audit unit in place. In others such units had been established but were significantly understaffed. In others the units appeared to be fully staffed. Managers were generally concerned to demonstrate that the appropriate PIFC staffing arrangements had been made.

In some organisations the management had introduced additional control arrangements; an example of this was in the Health Insurance Fund, where an extensive ex ante control system had been introduced. The need for this system had arisen because of a requirement to bring health spending under control, which had resulted in major management changes with the introduction of a wholly professional management. The aim of this control system is to ensure before financial transactions are entered into that they are fully compliant with the relevant legal and budgetary provisions. The control system focuses on the contractual and other arrangements entered into by the Health Insurance Fund and ensures that they are being properly adhered to by all health institutions, that is, hospitals, clinics

and pharmacies. These controls, which are in addition to the controls in place within individual health care institutions, arise from the nature of the health care insurance arrangements in Macedonia. Furthermore, in the Health Insurance Fund there is an internal audit unit of six staff (one lawyer and the remainder economists), two of whom are junior staff. Training for these staff had been mainly provided as part of the Dutch twinning project.

Apart from these issues directly related to PIFC arrangements, other issues relating to financial management control systems and procedures ought to be addressed. For example, although considerable improvements have been introduced in the management of the Health Insurance Fund, there does not appear to be a long-term actuarially-determined assessment of the financial viability of the Fund. This is unlike the Pensions and Disability Fund, where an actuarial department exists and where forecasts have been prepared up until 2020. For the Health Insurance Fund, forecasts seem to be limited to a three-year horizon.

Again, in neither the Health Insurance Fund nor the Pension and Disability Fund was information available about fraud and error, which are both bound to occur with benefit transfer systems of this type. The tendency in other countries is towards an increase in fraud on the system (not necessarily fraud within the system, although that may be increasing too), and as benefits systems become more complex, the rate of errors also increases. One argument for the lack of such information was that the development of IT systems would make fraud difficult. This is not the experience of other countries, where the introduction of IT systems can result, if not in an increase in fraud, in different types of fraud.

Another example concerns local government. Property tax bills in some municipalities were not sent out pending the recent election. Such a decision is inappropriate. Bills should not be delayed for this type of reason, and such actions suggest that administrative systems and the administrative organisation are not robust enough to withstand pressure. (The suggestion was also made that a similar problem could occur with municipal enterprise bills.)

There appears to be no clarity about the overall state of the finances of municipal companies. No information appears to be collected, and it is not known what the level of accumulated losses (or surpluses) actually is. This level should be identified.

The main accounting system is the Treasury system. This system has fundamentally been designed for Treasury and budgetary control purposes. What is unclear is how far the information available from the system is relevant to the needs of line management in the wide range of budget organisations. It is also unclear, in cases where such organisations maintain their own accounting systems, whether arrangements exist to secure systematic reconciliation between the Treasury system and own accounting systems. An indication of this being a problem is provided by the difficulties of the Ministry of Finance in reconciling returns from some municipalities with the information supplied by the Treasury. Without adequate and relevant (i.e. relevant to the needs of individual organisations) accounting information, management will not be able to establish whether public expenditure is delivering value-for-money (and simple compliance with the budget and with the laws and regulations does not constitute value-for-money). Obtaining value-for-money should be a key element in the management process, and the PIFC arrangements should underpin this.

**Relevant management control systems and procedures focusing on payment processes or revenue collection processes are in place. A wider perception is nevertheless essential if improvements in the quality of public expenditure are to occur. Overall the PIFC system should be designed to secure a strong control that will ensure the maximum level of fiscal discipline (over both revenue and expenditure). In time internal auditors, who are currently focusing on compliance with regulations, should have the capacity to encourage the development of such arrangements. In addition, particular attention should be paid to the risks arising from fraud and error in potentially vulnerable systems. IT systems can be prone to fraudulent attack, and internal auditors over time should have received the training to enable them to test the capacity of these systems.**

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

The Law on Internal Audit in the Public Sector of October 2004 establishes the function of internal audit in a wide range of public sector institutions, as it covers not only budget-users and extra-budgetary funds but also local authorities and public enterprises, as well as legal entities where the state is the “dominant shareholder”. It therefore extends well beyond the mere “budget sector”. The definition of internal audit given in this law is the most modern one provided by the Institute of Internal Auditors. This is quite ambitious in view of the very beginning level of understanding of this function across the public administration in Macedonia. The implementation of internal audit in accordance with this definition will take time.

The 2009 draft Law on Public Internal Financial Control (draft PIFC Law) describes the role of internal audit, its position within organisations, the independence of internal audit, and the protection of the head of the internal audit unit. This draft law also requires the preparation of strategic and annual audit plans (a continuation of previous legislative requirements), and it stipulates that the CHU is to be informed of any variations in those plans. In addition, this draft law prescribes the responsibilities of the CHU, covering both internal audit (IA) and financial management and control (FMC). At the time of writing, amendments were still being made to the draft law to reflect suggestions made by the European Commission.

There has been a considerable growth in the extent of internal audit over the last four years, as follows:

	2005	2006	2007	2008
Established IA units	15	23	62	78
Internal auditors	37	67	97	112
IA reports	107	230	311	
Recommendations	779	1927	2128	
Percentage of implemented recommendations	42	44	56	

The reasons given for the relatively low proportion of implemented recommendations differ. Some were reported to not have been accepted because they were very general or unclear. Other reasons seemed to arise from differences between the auditor and the manager about their appropriateness.

The size of the PIFC unit (CHU) in the Ministry of Finance is currently 20 staff. The distribution of staff is the following: five focusing on IA, seven on FMC, and eight in the central IA unit.

The general impression is that internal auditors are independent of the management and report directly to the head of the organisation. Some internal auditors seem to involve senior management in preparing their audit plan, but others seem to consult only the head of the organisation, who may or may not consult senior managers. The final decision about the contents of the audit plan may be taken either by the internal auditor or by the head of the organisation. All internal auditors indicated that the audit plan was based on an assessment of risk. At the draft report stage, however, discussions do seem to involve the appropriate line managers. Discussions with internal auditors suggested that in general audits focused primarily on compliance with the law and regulations rather than on systems.

Training generally appeared to be limited, and this is potentially a serious weakness in the arrangements for the development of PIFC. A protocol has been signed with the supreme audit institution (State Audit Office) for co-operation on training. The Dutch twinning project, under which pilot audits were carried out, appears to have been particularly helpful, and the continuation under the MATRA arrangements will be of great assistance.

What is important is that the training of internal auditors should focus on basic audit skills and not seek to transmit, at this stage of internal audit development, advanced internal audit skills, especially when management would not have the capacity to respond. Two qualifications to this remark should nevertheless be indicated. The first qualification is that there ought to be special training in IT audit

for those internal auditors concerned with the audit of systems that rely heavily on IT; examples are the Treasury system and the Pensions and Disability Fund system. (IT audit is envisaged in the draft PIFC Law.) The second qualification is that, as the volume and range of new capital investment in Macedonia will increase (largely funded from EU funds), internal auditors concerned with the audit of capital investment projects should receive specialist training in contract audit (i.e. internal audit should not be confined to ensuring that payments made to contractors are in accordance with the signed contract).

A formula has been developed, which is set out in the law, to determine the minimum size of internal audit units for individual organisations. While such a formula is helpful as a guide for determining the number of internal auditors who should be appointed, there was no evidence that internal audit staffing exceeded that minimum, even though some organisations are complex and have a much higher degree of risk than others. Therefore, much more flexibility should be encouraged rather than strictly relying on a set formula.

For example, the staffing of the internal audit unit (six internal auditors) in the Health Insurance Fund seems to be inadequate for an organisation with such a range of problems, scope of activities and potential risks, and especially given the size of the Control Department. Again, the Ministry of the Interior has only three internal audit staff. Generally, the size of internal audit units is small, and this is particularly true in municipalities and second-level organisations. Their small size (one or two staff) is not sufficient to achieve any real audit strength, and yet small organisations cannot afford larger units. To overcome this problem, some form of sharing arrangement should be encouraged wherever very small internal audit units exist, or for second-level organisations, the first-level organisation could perhaps provide the internal audit service, and/or some strengthening of the central internal audit team in the Ministry of Finance could serve as an initial step until internal audit has become better established (although such an approach entails risks that would need to be carefully managed).

Overall, this reliance on a formula, while it may be helpful in introducing internal audit when there is no history or experience of the value of internal audit, does suggest that management (for whom internal audit is a tool) does not yet have a real appreciation of the value of internal audit.

While considerable growth has occurred in the numerical strength of the cadre of internal auditors, the more difficult question is how effective internal audit has been in influencing management. The above statistics concerning the percentage of implemented recommendations suggest that internal audit has had only limited success. There are probably three basic reasons for this. One is the lack of trained internal auditors (and "trained" means more than short-course training). A second reason is the lack of understanding by management of the role of the internal auditor. A third is the relatively small size of some internal audit units. Collectively, these three reasons would suggest that internal audit has not yet sufficiently established itself to be able to add value to the management process.

During the period of preparing this assessment, it was not possible to review internal audit reports or to make any reliable assessment of the impact that internal audit is making in Macedonia. To really assess the development of internal audit in the Macedonian public sector would require more in-depth work, e.g. in the form of a PIFC peer review, as previously suggested by the European Commission.

As far as EU funds are concerned, in 2008 a new internal audit unit for EU funds was established. This unit is to audit the activities of the National Authorising Officer (NAO), who is a state adviser in the Ministry of Finance. The unit is located within the NAO (although the EC is apparently recommending that this unit be moved so as to be part of the Ministry of Finance). The purpose of the internal audit function, no matter where it is located, would be to review the operational effectiveness of the systems put in place by the NAO. In carrying out this review, the internal auditor would cover all areas of work of the National Fund (NF), the Central Financing and Contracting Department (CFCD), and the Instrument for Pre-Accession Assistance (IPA) structures in line ministries, IPA beneficiaries and other relevant bodies. Considerable preparatory work has been undertaken, but the process is not yet operational. The internal audit unit is to undertake a risk assessment and to review, for example, the systems set up for ensuring that the control and management systems:

1. in line ministries and beneficiary institutions have enabled the programming function to be exercised in line with the IPA regulations and procedures;
2. in line ministries and beneficiary institutions have enabled the technical preparation processes for tender documentation and the establishment of evaluation committees to be in line with the IPA regulations and procedures;
3. in the managing authority the programme monitoring process has been enabled in line with the IPA regulations and procedures;
4. in the managing authority the evaluation process has been established in line with the IPA regulations and procedures.

The Financial and System Control Unit (FSCU) of the NAO is expected to also review the operational effectiveness of the systems as part of the management function. Line ministry internal audit units are expected to review the implementation processes for a particular contract, partly to ensure compliance with the appropriate laws and regulations (including IPA regulations) and partly to ensure that the delivery and payment arrangements are in line with the contract. In addition, the Audit Authority is to undertake the further review of all of the processes and procedures in accordance with the specific requirements of the EU.

From this brief analysis it can be clearly seen that there are potential areas of overlap between management systems (as expressed by the FSCU) and the NAO internal audit, between the NAO internal audit and line ministry internal audit, and between these internal audit units and the Audit Authority.

**Considerable progress has occurred in developing the number of internal audit units and the number of internal auditors, and it could therefore be construed that a viable and independent internal audit service is emerging. However, the evidence is that before it can become a fully functioning service to management, considerably more development work will be required. There also needs to be developed on the part of management a greater awareness of the benefits of internal audit and its usefulness as a management tool. Progress has also been made in developing arrangements for the audit of EU funds, although there appears to be some risk of duplication of audit and control systems, and therefore some rationalisation of these activities may be required in the future.**

#### ***2.4. Are systems in place to prevent and take action against irregularities and to recover any amounts lost as a result of irregularity or negligence?***

The 2008 PIFC Strategy for the Development of PIFC envisaged that, following the adoption of the new law on PIFC, a decree aimed at preventing irregularities and fraud in the public sector would be issued. This decree would cover co-operation, deadlines and method of reporting.

The PIFC Law requires each head of a public sector organisation to appoint an “irregularities officer”. Whenever an irregularity is uncovered, the irregularities officer is to report it to the Public Prosecutor’s Office and to the Ministry of Finance’s Financial Police. It is not yet clear exactly how these officials will operate and whether or not there will be special appointments of additional staff for this purpose.

To protect the financial interests of the EU, the Financial Police in the Ministry of Finance are to co-ordinate their activities with OLAF and provide guidelines to institutions for the reporting of irregularities. Through these arrangements, the Financial Police are to consolidate information with regard to fraud involving EU funds or funds that are co-financed by the state and the EU. A department for co-ordination of the prevention of fraud (AFCOS) is to be established in the Financial Police administration and is to serve as a national focal point for working with the European Anti-Fraud Office (OLAF). An appropriate rulebook will be published. The aim had been to have the appropriate department established by the end of 2008, but at the time of writing this had not yet occurred (this process has been envisaged for some time and was referred to in Sigma’s previous assessment report in 2008). A Division for International Co-operation and Detection of Financial

Infringements regarding EU and domestic funds, currently with three employees, has been established in the Financial Police administration.

As a general rule, amounts lost as a result of irregularities are recovered according to the provisions of the Criminal Code. With regard to collection resources, the tax administration is entrusted with special enforcement powers enabling expedient recovery, such as account-freezing, confiscation and other temporary securities, and seizure. In the case of irregular expenditures, only a court decision can result in similar action.

**Systems are not yet in place to prevent and take action against irregularities and to recover any amounts lost as a result of irregularity or negligence other than those that have traditionally existed. The intention is to legislate so as to strengthen arrangements to facilitate co-operation with OLAF.**

### 3. Capacity to Further Develop the System

Considerable work has been done to put arrangements in place and as necessary new legislation is being drafted. The energy that has so far been devoted to the development of institutional infrastructures and processes has been impressive. However, the more difficult question is how to create the vision that is needed for really successful implementation, which will require extensive political understanding and support.

The real concern is not the willingness of the Ministry of Finance to develop the necessary legislation but rather the practical possibilities of implementing that legislation in substance, rather than just in form, within the Macedonian public administration. As has been shown above, there is a concern about the “literalness” of the interpretation of legislation and a lack of understanding of what management actually means and of how internal audit fits into the management process. There are also rather broader issues that a strict interpretation of public financial management (“strict” being interpreted as a focus on procedures) will not address, and to secure an improvement in the quality of public expenditure (which is what PIFC is really about), those broader issues do need to be addressed.

Whether or not the Macedonian institutions will have the capacity to absorb the benefits of PIFC will depend fundamentally on their willingness to adopt a managerial approach to the delivery of public services. This will require a shift away from an approach that requires the head of the organisation to take all decisions (sometimes the most trivial of decisions) and towards a system where the role of the most senior manager is to set the strategic direction and objectives, monitor performance in the achievement of those objectives, and ensure that the whole approach within the organisation is designed to comply with the law and regulations and to provide value-for-money.

All of the above will require the adoption of different attitudes at the most senior levels and will entail greater delegation, leaving those senior managers (heads of organisations) more time to focus on strategy, objectives and overall performance.

In addition, a number of key technical developments will be needed. These technical developments will include the setting up of benchmarking, costing and statistical information systems, and ways of using financial information to improve efficiency and effectiveness. These developments will have an impact not just on training but on the organisational structures of budget organisations. They will be longer-term developments and will require the appointment of skilled staff knowledgeable in the way in which effective financial management can create successful organisations (as would occur in the private sector) that are capable of delivering objectives on time and at the standard required by the consumer of those services.

These developments represent a major agenda for the CHU and will require the continuation of significant support over time before real results will emerge. However, underpinning this support to the CHU there will have to be substantive political support, and unless that support is forthcoming the embedding of PIFC will be very hard to achieve. In the meantime, important steps can continue to be taken by the CHU, not least the building of skills of both the cadre of officials responsible for FMC

and the cadre of internal auditors. A key activity is nevertheless the building of the understanding and commitment of line ministry officials.

**In summary, the willingness to develop PIFC does exist and there is every impression that at the technical level there is a determination to achieve the objectives of PIFC. Doubts about capacity lie not here but in the management approaches that exist in Macedonia, and considerable efforts need to be directed towards reform at this level.**