



SIGMA

Support for Improvement in Governance and Management

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MONTENEGRO

**PUBLIC INTERNAL FINANCIAL
CONTROL (PIFC)**

ASSESSMENT MAY 2009

Summary

Main Developments since last year

Since last year's assessment, a number of steps have been taken in Montenegro to align the PIFC system to EU standards. The PIFC Law was passed by parliament on 26 November 2008. The PIFC Law covers the users of the government budget, budget of municipalities, state funds, independent regulatory bodies, public enterprises and other legal entities in which the government or the municipalities have a controlling stake. It is a framework law which defines the internal control system, that is, financial management and control as well as internal audit. It establishes a semi-decentralised internal audit system throughout the administration. It sets the requirement for the establishment of a central harmonisation unit (CHU) responsible for the development of methodology. It defines the specific responsibilities of management in relation to PIFC. The aim of the law was to formalise and upgrade previous Directions and documents relative to financial control and internal audit.

The choice of a semi-decentralised internal audit system was the response to having a small administration such as the Montenegrin administration. The internal audit is functionally independent of the operational business and reports to the head of the entity under review.

The Government Decree (No/ 73/08) issued on 12 March 2009 identifies 23 institutions that are obliged to establish their own internal audit units. Besides these institutions, the Decree obliges other institutions and public enterprises that employ more than 200 staff or that have annual expenditures exceeding 5 million EUR to establish their own proper internal audit function.

The rulebook on the manner and procedure of internal audit was adopted in May 2009.

The Directions on State Treasury Operations were amended on 18 December 2008 (No. 06-3224/1). They are basically an update of the previous instructions and deal with the authorisation to line ministries, execution, accounting and control of expenditure. It also defines Treasury responsibilities with regard to the centralised responsibility of ex ante control and payment as well as keeping the general ledger, reporting and closure of the annual accounts, which is part of the government's internal control system.

Main Characteristics (strengths and weaknesses)

Montenegro is committed to making efforts to comply with the requirements put forward by the European Commission as far as PIFC is concerned. Putting in place a legal framework, whilst important, is only one aspect of developing an effective financial control system.

The (Organic) Budget Law addresses good governance procedures and the implementation of accountability measures, as does the PIFC Law enacted on 26 November 2008. The above-mentioned amended Treasury Directions are an implementing guide for the responsibilities of the managers in line ministries regarding financial management. The Directions in themselves provide for sensible internal financial control within the government, but they only refer to the (Organic) Budget Law and no reference is made to the recently enacted PIFC Law. The legal structure between the (Organic) Budget Law, the PIFC Law and the Treasury Directions have become unclear for the user they aim to serve. The treasury system is part of the government's internal control system. Because of the lack of logical connections between the different laws and the Treasury Directions, the PIFC Law seems to be an "add-on" to the financial control system. The logic would be that the Treasury Directions provide guidance to the PIFC Law. This might indicate various problems, such as the law-making structure itself, but it might also be an indication that the PIFC reform has not yet been fully understood and managed, even at the centre.

There is no formalised process for carrying out budget reforms, including the establishment of linkages to budget execution, which comprise relevant components of financial management and control as well as internal audit. So far developments in budget reform and in public internal financial control have generally been independent of each other. This piecemeal approach seems to continue.

There is, however, an emerging change in that greater and also more explicit responsibility is being given to line ministries for the achievement of target objectives through performance budgeting. This means a switch to a different culture in terms of the way in which public finance is managed and implemented. It also means that a greater ownership of implementation is needed. Although the PIFC Law is “owned” by the Ministry of Finance, and even within a specific department in the ministry, it was developed and seems to have been passed with not a lot of involvement within the wider circle of core institutions reliant on the law.

The PIFC Policy Paper includes a clear and coherent medium-term strategy. The aim should be to establish a genuine financial management and control culture alongside the further development of managerial accountability, financial management and control, and internal audit. This will not be an easy task and there is a need for broader connections amongst the different actors within the Ministry of Finance and between different stakeholders. The main challenge therefore lies in applying the new features expressed in the upgraded legislative framework.

In order to step up the implementation of reform as quickly as possible, recruitment of staff for the internal audit area is needed. However, with the current economic projections, the taking on of new staff poses problems and may negatively affect the commitment to reform. However, new internal audit staff is not a prerequisite for applying the other features related to governance and managerial accountability.

Recommendations for Reform

Managing the change to accountability, as outlined in the PIFC Policy Paper and the PIFC Law, will require time and technical capacity, long-term political commitment and effective arrangements, including within the Ministry of Finance. Special attention should be given to change management in particular, and the need to alter working methods in order to achieve the objectives spelled out in the PIFC Law.

One of the reasons for the lack of a comprehensive approach is most probably the lack of real awareness that good governance requires sound and close pragmatic working relationships both within the core sectors of the Ministry of Finance and other stakeholders such as, for example, the State Auditors Institution. As new approaches are very new to the administration at large, it would be advisable to carefully manage the change of the culture of governance and accountability and provide extensive efforts via coaching in order to contribute to raising awareness for key stakeholders, including ministers and senior officials, so as to ensure the successful implementation of this new system. Strategic planning is therefore necessary on how to reach these objectives, coupled with an extensive training agenda adapted to different groups of senior officials involved at various levels.

In addition, it is crucial that the various departments within the Ministry of Finance agree on the comprehensive governance system that they aim to set up through the existing laws. Therefore the departments of budget, treasury, internal audit and the CHU also need to improve their internal communication and professional dialogue to ensure that they are all striving towards the same objective, that the different systems support each other, and that the small administration in Montenegro has a clear, basic and comprehensive approach to the development of the budget process and PIFC reform.

1. Legal Framework

The (Organic) Budget Law, adopted in August 2001 (as amended in November 2007), the Public Internal Financial Control (PIFC) Law passed by parliament on 26 November 2008, together with the Directions of Treasury Operations amended on 18 December 2008 (No. 06-3224/1) govern public finance in Montenegro. Public finance comprises arrangements for budget preparation, adoption of the annual budget, management, execution, internal control, accounting and auditing of the budget. The scope of the Budget Law covers the government budget and the budgets of municipalities (Art. 1 of the Budget Law). The Budget Law is being amended to reflect amongst other items the new Law on PIFC. Before the PIFC Law was passed, internal audit was a centralised service established within the Ministry of Finance.

The PIFC Law covers the users of the budget of Montenegro, budget of municipalities, state funds, independent regulatory bodies, public enterprises and other legal entities in which the government or the municipalities have a controlling stake.

It is a framework law which defines the internal control system, such as financial management and control as well as internal audit systems, and it establishes a semi-decentralised internal audit system throughout the administration. It sets the requirement for the establishment of a central harmonisation unit (CHU). It also defines management's specific responsibilities in relation to PIFC. The aim of the law is to formalise and upgrade previous directions and documents relative to financial control and internal audit, which were developed through assistance from the international community.

The head of the entity is thus responsible for the proper functioning of the financial management and control system, and for the preparation and implementation of strategic planning and action programmes for achieving the objectives set in the strategic plans. The head of the entity is also responsible for risk management and compliance with laws, economic, efficient and effective use of available funds, and reporting, as well as introducing internal rules and procedures for the financial management and control systems. He/she is also responsible for the establishment of the internal audit function.

The internal control procedures developed aim implicitly to prevent fraud and irregularities. The head of the entity is also responsible for undertaking the actions necessary and for informing the responsible public authorities should fraud or serious irregularities be discovered. Similarly, the head of the internal audit unit is responsible for reporting cases of fraud or serious irregularities to the head of the entity in writing.

Under the PIFC Law, article 18, the internal audit system has been upgraded from a centralised internal audit system to a semi-decentralised internal audit system. The semi-decentralised internal audit system has been carefully chosen as a response to a small administration. Internal audit units should therefore be established in larger line ministries and in spending units, where it would make sense to have at least three staff (head of internal audit included). Smaller spending units would be dependent upon the internal audit of the line ministry in which they were established and to which they reported. A provision has also been made for a third category of institution to ensure that internal audit can be established also in smaller administrations, for example, outside the executive, such as the judiciary, the supreme audit institution or the Office of Parliament. These smaller institutions would avail themselves of the internal audit services, of a common unit for internal audit, or of other internal audit services, subject to approval of the Ministry of Finance.

A Government Decree (No. 73/08) was issued on 12 March 2009 to further define the mandatory establishment of internal audit. This means that 23 institutions have been identified as major institutions which will have their proper internal audit function. Of those 23 budget units, 11 refer to ministries, such as the Ministry of the Interior and Public Administration, Ministry of Defence, Ministry of Finance, Ministry of Economic Development, Ministry of Transport, Maritime Affairs and Telecommunications, Ministry of Agriculture, Forestry and Water Management; some others refer to other major administrations such as Customs and Tax Administrations, Transport Directorate and Public Works Directorate, as well as the extra-budgetary funds, such as the Pension and Disability

Fund, the Health Insurance Fund, the Employment Office and the Development Fund. The only municipality identified in the list is the capital city, Podgorica.

The same decree also obliges other administrations or institutions to establish internal audit. Thus any institution or public enterprise that has more than 200 employees or that has annual expenditures exceeding 5 million EUR are subject to the establishment of internal audit.

According to the PIFC Law, the internal audit unit is functionally independent of the operational business under which it operates and it reports to the head of the entity under review.

The PIFC Law also prescribes that risk management should be carried out. A rulebook is being drafted for further guidance.

The PIFC Law was developed by a working group consisting of members of three departments of the Ministry of Finance (internal audit, budget, and state treasury). Sigma provided assistance and expertise throughout the drafting process.

The PIFC Law informs the user that implementing legislation is to follow. A first step was the amendments to the Directions on State Treasury Operations, which were amended on 18 December 2008. However the Directions make reference only to the Budget Law; they do not make any reference to the PIFC Law, although article 9 of the PIFC Law requires that control activities be established, such as those described in the Directions.

The Directions define line ministries' authorisation, execution, accounting and control of expenditure from the budget of Montenegro. They also define the Treasury's responsibilities with regard to the centralised responsibility of ex ante control and payment as well as keeping the general ledger, reporting and closure of the annual accounts. The essence of these rules is sensible and the rules define financial control and form the core of the financial management and control system as defined in the PIFC Law.

As the single treasury system is part of the internal control system of the government, it should therefore follow the descriptions and the obligations defined in the Public Internal Financial Control Law as well as the overall responsibilities for the Ministry of Finance provided for in the Budget Law.

The lack of connections between the different legal documents does not give a clear picture to the user and makes the entire PIFC system seem unclear. Cross-references need to be made, at least to the PIFC Law, to ensure that the legal framework is comprehensive and that inconsistency in its implementation is reduced.

The Directions have not changed in essence and they are basically an update of the previous instructions. Some of the changes made relate to revenue collection and recording, some of them to the use of the Instrument for Pre-accession Assistance (IPA)¹ funds, and others to the removal of redundant (old) articles. However, the most important change has not been made; the guidelines should at least also refer to the PIFC Law rather than only to the (Organic) Budget law.

The Treasury Directions clearly define the roles and responsibilities of the key persons in budget-spending units exercising financial tasks; they also define the hierarchical structure of control in the authorisation process of undertaking expenditures and their payments. The Chief Finance Officer, appointed *ex officio*, represents the budget executor. The second in line is the finance officer who is personally liable for the due performance of financial tasks and may be held financially responsible for any losses, inaccuracies or errors during the performance of those financial tasks (art. 11). However, there is no time limit set for this personal liability. All pecuniary obligations should nevertheless be subject to time limits. Even the money due by the state should be subject to time limits and, depending on the EU Member State, this time limit ranges normally from between three and seven years. Obviously it should be possible to challenge the allocation of blame before the court, but consideration should be given to redrafting this article to bring it more in line with respect to individual rights.

¹ Council Regulation (EC) No1085/2006 dated 17 July 2006. For the implementation of this Regulation, a Commission Regulation (EC) No: 718/2007 is published on 12 June 2007.

The Directions also ensure the segregation of duties; an official cannot at the same time have responsibility for authorisation, execution, accounting and control, and thus officials such as the certifying officer, the authorising officer, the officer for control of requests for payment, the receiver and the cashier are defined.

However, the Directions are somewhat unbalanced in nature. In some parts they resemble a guide and in some others they are quite detailed, for example, indicating where instructions are to be given, what information the statements for collection of revenue should include, including salaries and allowances. However, hardly any other guidance is given with regard to assurances to be provided in the ex ante control and authorisation process of other types of commitments or spending of government money.

In addition, article 40 sets some requirements for completing payment requests and it is stated that a “copy should be retained at the spending organisation as written evidence used for audit purposes, and must be attached to the supporting documentation” [of the payment]. The objective for audit purposes is rather strange as the primary objective would rather be the obligation for the organisation to have sufficient assurance of its own control procedures than the obligation to show what has been done at the time of external review.

With regard to implementing legislation for internal audit, the rulebook on the manner and procedure of internal audit was adopted in May 2009. It describes the need for an internal audit charter, audit planning, fieldwork, documentation, reporting and follow-up of the audits. The Internal Audit Charter and an Internal Audit Manual adopted in February 2004 are still applicable but will need revision due to the evolution of the legal framework on PIFC. This is already foreseen as one of the actions defined in the action plan attached to the PIFC Policy Paper adopted on 20 December 2007. The current manual sets up a framework for internal audit and gives guidance on good audit practices. It sets out audit requirements and procedures, provides an overview of approaches to performing audits, and describes how the methodology relates to relevant auditing standards and guidelines. It also outlines key issues to be considered when using the methodology.

Progress is being made in upgrading the PIFC system to EU standards. The passage of the PIFC Law and efforts to align the related Decree and Directions on State Treasury Operations for implementation of the law are examples of commitment. Necessary prerequisites for establishing internal audit throughout the administration have recently been put in place. However, the Directions on State Treasury Operations seem to stand apart from the PIFC Law and a logical, comprehensive approach seems to have been somewhat lost. In addition, consideration could be given to developing a manual for further guidance on details of what is to be controlled and authorised through the ex ante control process. Such a manual would help to ensure that laws and rules are understood and it would contribute to improving the quality of their application throughout the administration, the local administration included. However, the logic of the core legal framework needs to be sorted out first.

2. Institutional Framework

The Ministry of Finance is divided into six main functional areas, each of which is headed by a Deputy Minister – Treasury; Budget; Tax and Customs; Economic Policy and Development, International Co-operation and EU Integration; Internal Audit; and Corporate Services and Property-Legal Obligations.

An organisational change has taken place since last year’s assessment to better respond to the need for further economic development and to requirements for the use of IPA funds. Thus two departments were established, the Department for Economic Policy and Development as well as the Department for Finance and Contracting of EU Funds.

The total number of staff currently employed in the most relevant areas for public finance (budget, treasury and internal audit) is approximately 66. Sixteen of these staff work in the Budget Sector, 30 in the Treasury and seven in Internal Audit. This staffing is quite modest when compared to that of

most European countries. However, the number of staff seems to be in proportion compared to the staffing levels in other ministries.

Programme budgeting has been on the agenda for a number of years and the ministry is continuing its gradual approach to a step-by-step implementation. Hence the ministry decided to use a method less complicated and more easily understood by the administration. This improvement is welcome and is an indication of commitment to adopt a framework that also works in reality. The previous requirements developed by international donor assistance were deemed too sophisticated and difficult to understand and apply. A Decision was issued on 20 June 2008 (No. 38/08) on the new, more basic method of developing programmes for budget contents and programme indicators. The entire 2009 State Budget is described in terms of programmes for the first time. However, all budget users' activities are defined as one programme, although in some cases there are two programmes: one for the core activities and the second for administrative activities. Programme indicators will be developed for the 2010 budget

The Treasury department responsible for cash and debt management also performs ex ante control of all payments. Administrative decentralisation does not mean losing control, but it does require different structures and guidelines for devolving authority and responsibility. There is a shared responsibility for ex ante control of payments between line ministries and the Treasury, which is explained in the above-mentioned Directions on State Treasury Operations. However, as the new system settles, with additional guidance and training ex ante controls would improve over time. Consideration could therefore be given to setting a threshold on the ex ante controls performed by the Treasury, with the aim of controlling cash management and with fewer ex ante control checks of individual transactions, thereby making line ministries fully responsible for decisions taken through the ex ante control procedures. This should be a process over time, set in various stages to manage the change. In this way the Ministry of Finance and the Treasury would also show how the new features of accountability apply to the general administration. This development would also go hand in hand with the establishment of internal audit units in line ministries and would thus provide extra assurance that necessary internal control procedures are in place and indicate whether they function satisfactorily.

The Internal Audit Unit of the Ministry of Finance is still formally responsible for internal audit in the ministry and also in other ministries, spending units, and municipalities as a transitional measure. However, according to the PIFC Law, and also to the above-mentioned Decree, users of State Budget funds and the capital city (Podgorica) are obliged to establish internal audit within 12 months. Other units are to establish internal audit within 24 months. The main challenge will be the appointment of internal auditors as required by the new PIFC Law, as the economic trend has put any further recruitment in the administration on hold until further notice.

The CHU function is established and the head of the department has been appointed. This function is carried out by two sub-sections, with one unit responsible for the financial management and control system and the other for internal audit. The Systematisation Act provides for, in addition to the head of department, three staff in the Financial Management and Control Department but only two positions have been filled, and four staff in the Internal Audit Department, where only three positions have been filled. The Financial Management and Control Department is closely linked to the Treasury Department and draws upon the Treasury's experience, although the Treasury remains responsible for some financial management and control procedures. During a transitional period, the staff in the CHU contribute to the Ministry of Finance's work on internal audit so as to ensure that internal audit is carried out throughout the transitional period.

The annual audit plan covers all auditable areas in the Ministry of Finance, other ministries, spending units, extra-budgetary units and municipalities. During 2008, 17 audits were performed. The plan is based on areas of material risk, with three main criteria: staff, budget and nature of activity. This framework is the same as for the previous year. The number of audits carried out is a little less than last year's 21 audits but corresponds to the annual audit plan. The reason is that internal audit staff have contributed to the drafting of the new legislation.

Internal audit mainly reports to the institution under review. However, an annual report is also produced and submitted to the government. It is a kind of synthesis report of the major findings. The findings seem to be based on transaction- oriented audits, and less consideration seems to be paid to audit of internal control systems that would identify systemic matters.

In general, it seems that monitoring and analytical procedures are less developed and that much of the control is concentrated on individual transactions. There is a need to change the culture from exercising controls for external use to spreading the spirit of management throughout the administration and to using controls for a management that is directed towards achieving the objectives developed for each institution, in accordance with the standards set to achieve those objectives. There is also a need for a stronger co-ordination role by the Ministry of Finance whereby the various departments within the ministry improve their internal communication and professional dialogue. In that way, they may ensure that they are striving towards the same objective, that the different systems support each other, and that the small administration in Montenegro continues to take a more pragmatic approach to the implementation of budget and financial control reform.

Internal audit is emerging, and the establishment of internal audit units in line ministries is underway through the adoption of the PIFC Law and the related decree.

Reform Agenda and Capacities

Recently, at least in the area of PIFC, the reform agenda seems to be comprehensive and the agenda is prioritised through the action plan attached to the PIFC Policy Paper adopted on 20 December 2007. Progress is being made with the topics included in the action plan. The basic legal framework is almost in place. Attention should be given to taking the next steps, such as

- Relevant training of managers and employees;
- Review of the Directions on State Treasury Operations to align them with the PIFC Law;
- Development of the manual for financial management and control;
- Revision of the current internal audit manual;
- Creation of internal audit posts as a priority in the central government and later in the local administration;
- Development of a training programme for internal auditors.

The above elements cover the period up to 2012.

It will be challenging to implement the reform as expressed in the PIFC Policy Paper as well as in the PIFC Law, as there are new features that will require extensive awareness-raising activities for the top management. It seems that the Ministry of Finance has not yet completely understood the full implications of the reform objectives, although the pace of development of the regulatory framework follows the timing shown in the PIFC Policy Paper.

There is also an increased risk that the areas of budget preparation and execution will be developed without sufficient phasing of activities or without the necessary co-ordination between these activities and the related issues of financial management and control as well as internal audit.

External Assistance

No specific assistance has been provided to Montenegro on PIFC. However, an important USAID project ended in June 2008. This project covered a very broad range of tasks, and aimed to implement institutional reform and strengthen macroeconomic, fiscal and financial management. Under this project some assistance has been provided to the Ministry of Finance for the development of financial management and control systems and for the establishment of internal audit. Sigma is providing some

technical assistance. However, much more intensive assistance would be needed to carry out the bulk of the work to produce various sorts of training materials aimed at various levels of the administration, focusing on both financial management and control and internal audit. It is also important to find a solution with regard to the training of internal auditors and to establish training curricula.