



SIGMA

Support for Improvement in Governance and Management

A joint initiative of the OECD and the European Union, principally financed by the EU

BOSNIA AND HERZEGOVINA

PUBLIC INTERNAL FINANCIAL CONTROL (PIFC)

ASSESSMENT MAY 2008

1. Legal Framework

The system of public internal financial control (PIFC) in Bosnia and Herzegovina, including internal audit, is now covered in all three organic budget laws, but in a very inconsistent manner, as the related provisions of each text seem to cover different issues and are generally not comparable. However, there is no reason why different systems should apply here, as the foundations and challenges are similar.

At the state level as well as for the two entities, the Ministries of Finance have central responsibility for further defining applicable PIFC systems and procedures. However, until recently only the BiH Budget Act and the Federation framework legislation called specifically for the setting up of internal audit functions.

This legislation regulates financial control and internal audit in only a very general way, however, and therefore specific internal audit legislation was being drafted by the state and the entities in 2003. As a matter of fact this exercise was interrupted after a while. Ministries of Finance developed rulebooks in early 2005 and distributed them to budget-users as guidelines for the introduction of internal control, but very few institutions have written rules and regulations on internal control. The system review conducted in 2004 attempted to compare the existence and degree of efficiency and effectiveness of the internal control systems in place at the various levels of government and found significant gaps and discrepancies amongst the various institutions. The BiH-wide Public Administration Reform Strategy adopted in 2006 envisaged the adoption of a single policy document to initiate and develop Public Internal Financial Control (PIFC), in accordance with European Commission recommendations. However, no further steps were taken. The practical impulsion was given to the development of PIFC by the drafting of laws on internal audit under World Bank auspices, followed by the launching of proper PIFC strategies at the three levels of government in Bosnia and Herzegovina. In any event, the process will take time, as it is constantly being impaired by political considerations linked to the prevailing conditions in BiH. In addition, it is clear that, regardless of the refinement or relevance of the control procedures in place, the persistent lack of capacities in the entire public administration in Bosnia and Herzegovina makes any effort in this area an unrewarding, if not vain, exercise.

2. Institutional Framework

The Ministries of Finance are responsible for the development of internal audit and the creation of internal audit units in ministries and other government institutions. These reforms have been constantly presented as a priority of the governments. However, due to a lack of funds and capacities, the process has barely started. Only some cantons have established internal audit units, and their staff have only received very limited training. A specific structure has been in place in the Federation's Ministry of Finance (MoF) since 2004.

The World Bank has set as a conditionality the introduction of harmonised legislation in the area of internal audit at state and entity levels. As a result, a drafting group, under the leadership of the state-level Ministry of Finance, was established and operated between June and November 2006, producing a draft framework Law on Internal Audit to be used as a common basis for all government components of Bosnia and

This document has been produced with the financial assistance of the European Union. The views expressed herein can in no way be taken to reflect the official opinion of the European Union, and they do not necessarily reflect the views of the OECD and its member countries or of the beneficiary countries participating in the Sigma Programme.

Herzegovina. In addition to the Ministries of Finance (including the financial unit of the Brcko district), the supreme audit institutions participated in this group as well as the major donors active in the public finance area.

The realism of setting such a conditionality for a loan as a priority is questionable, given the current context of operations in Bosnia and Herzegovina; more awareness about internal audit and the costs attached to its development would be required to ensure that the legislation is based on a realistic assessment and can be usefully implemented. The amount of resources that the authorities of Bosnia and Herzegovina can dedicate to the setting up of an internal audit system is by definition very limited, if any at all. **Furthermore, internal audit (IA) can only reach a significant degree of efficiency once a decent level of formalised internal control is in place, which does not seem to be the case in BiH at the moment.**

Thanks to the efficiency of the drafting group, the process resulted in a draft framework text that reflects the most demanding standards of a modern internal audit function, while leaving room for the necessary adjustments required by the specific institutional set-up of Bosnia and Herzegovina. This is in particular true for the typically PIFC-related functions of central harmonisation units (the structure of Bosnia and Herzegovina would require at least three such bodies). This is also the case for the setting-up of internal audit units, which cannot be done on a purely institutional basis (according to budget-users) unless an impossible number of internal auditors were to be recruited and disseminated to a high number of budget-users. Also somewhat problematic is the definition of the relation between the central entity level and the level of cantons, as far as the Federation of Bosnia and Herzegovina is concerned.

For unclear reasons, since the texts have essentially not been amended, it took a long time for the draft laws to be adopted by the respective parliaments, and the process was still not finalised in the Federation at the time of drafting this assessment.

The weak formalised internal control has prompted the European Commission to suggest that the authorities of Bosnia and Herzegovina envisage a proper framework for Public Internal Financial Control and prepare an overall strategy addressing the various related issues. The development of internal audit as such would be a key component of a broader system of controls, as in principle was the case in most EU candidate countries. Bosnia and Herzegovina actually subscribed to the PIFC concept in its European Partnership strategy document, where it committed to developing a public internal financial control strategy, with special reference to “the principles of decentralised managerial accountability and functionally independent internal audit in accordance with the internationally accepted standards and EU best practice”.

In this sense, a first step would be to recognise the concept of managerial accountability and to stipulate, preferably in a legal framework, how it could be applicable in Bosnia and Herzegovina.

Overall, modern financial control and internal audit (IA) systems are at early stages of development in BiH. Prior to its dismemberment, the Payments Bureau (ZOP), an independent government agency, was the key element in the internal control systems for the public sector, as was the case in all former Yugoslavia.

Under the ZOP system, the internal control functions of the Ministries of Finance were limited to basic, documentary controls over accounting and reporting of spending units and to custodial-style oversight.

Prior to the introduction and development of treasury systems across all levels of government, the public internal financial control (PIFC) systems were easy to circumvent. Decisions to release funds in line ministries were often communicated vaguely, and there were few follow-up controls to ensure that funds were spent for the purposes intended. Recent reforms have strengthened the efficiency and effectiveness of the control systems. Even if these developments have not been fully finished or implemented, the introduction of the Treasury system has proved to be a big step forward towards better management and control of public expenditure; however, much remains to be done.

State level

The introduction and full coverage of the treasury system makes the occurrence of deficits much more difficult now. The Ministry of Finance and Treasury (MFT) requires budget-users to produce monthly budget execution plans, and they cannot deviate from these plans when executing the budget.

The MFT has also produced instructions on internal control in budget-users. It is unsure, however, if this has produced an effective impact on actual procedures. The majority of budget-spenders still seem to lack their own clear rules on internal financial control. In addition, there is no clear segregation of duties between the various officials in charge of authorising or executing a budget transaction. This situation is partly linked to

the general shortage of staff in the public administration at both state and entity levels (except, within entities, local government).

Control mechanisms are still somewhat lacking, but in the first instance due to the ongoing weak administrative capacity. At BiH level especially, where institutions are slowly growing, it is not unusual for a single person to perform the majority of tasks related to finances. On the other hand, the fact that the accounting function is now centralised within the MFT should in principle ensure an increased level of reliability.

There are still important tasks ahead in addressing the issue of internal financial control, including internal audit. An adequate legal framework and qualified staff are absent.

The Law on Financing the Institutions of Bosnia and Herzegovina of December 2004 does not contain specific prescriptions on internal control as such, although it provides a number of rules that are related to internal control systems. In each budget-user, a finance officer is appointed and made responsible by law “for the establishment and maintenance of adequate systems of management and accounting control over approved budget funds (...) as well as for the implementation of audit recommendations” (article 4). This form of managerial accountability does not seem to be fully implemented at the moment, however.

A specific article (23) deals with internal auditing and requests the Ministry of Finance and Treasury to regulate the system of internal audit of budget-users in accordance with internationally recognised standards of internal audit. The contents of the article, which is not very detailed, could provide adequate support to the development of secondary legislation in this area. However, the article lacks specifics, such as leaving open the option of a centralised or decentralised system of internal audit and the performance of internal audit on an ad hoc or permanent basis. This provision should in any case be obsolete since the Law on Internal Audit has been adopted at the state level.

The MFT has already taken the first steps to implement this law. This implies amending the systemisation of the Ministry of Finance so as to permit the establishment of a central harmonisation unit and of a department of internal audit to provide internal audit services for those institutions that cannot afford specific in-house departments. The central harmonisation unit in the MFT should employ eight staff, in the areas of both financial management and control and internal audit, and ten staff in the internal audit department.

Federation of BiH

The Organic Budget Law (OBL) includes provisions related to internal control and internal audit. According to its current article 62, “budget-users have to establish an internal control system by applying international control standards in order to make sure that all of the core activities are performed”, and the Ministry of Finance is requested to provide relevant instructions in that area. There is similarly an obligation on budget-users to establish internal audit, with the possibility in exceptional cases that this internal audit would be performed by the Ministry of Finance. Here again, the implementing rules are to be defined by the Ministry of Finance (MoF) in the form of rulebooks, one for the performance of internal audit and another to define the ministry’s criteria to be respected by budget-users for establishing their own audit “in accordance with international internal audit standards”. These provisions apply to cantons and other local government structures.

All in all these provisions, while a positive step forward, in particular the recognition of the leading role of the Ministry of Finance in this area, are of a vague character and illustrate the weak understanding of the PIFC concept. It seems that article 62 of the OBL in fact relates to internal audit, since it is used as the basis for the Decision of the Ministry of Finance, which entered into force on 12 December 2006, to request budget-users with more than 50 employees or with an approved budget of over 4 million BAM (approximately 2.04 million EUR) to establish their own internal audit units. In addition, the Ministry of Finance has published a rulebook on internal audit for the Federation budget-users. These provisions will need to be adjusted as a consequence of the expected adoption of the Federation’s version of the framework Law on Internal Audit.

In practice, systematisations have been or are being amended, so that office space and budget posts are now allocated to internal auditors. In particular, the new systematisation of the Ministry of Finance of FBiH has separated the internal audit function from internal control and established an IA unit that responds directly to the minister. This was done as a follow-up to recommendations made by the Supreme Audit Institution of FBiH. This small internal audit department (three staff only) is responsible for this activity within the Ministry of Finance and also for about 30 other budget users. Twelve budget users have in principle

established their own internal audit units. The activity of the MoF's internal audit department, despite its limited size and the general lack of technical support, seems to produce relevant results in terms of methodology and reporting, which could create a good basis for future developments.

It can be said that neither the institutional set-up nor the staffing situation is adequate, and consequently compliance with the rules is still seriously lacking.

A majority of cantons either already have an internal audit unit functioning at government level or are in the process of transforming the budget control unit into an internal audit unit. This development does not seem to be taking place on the basis of an overall, targeted strategy, and the nature and quality of the work performed by these units and their compliance with internal audit standards would need to be further assessed.

Republika Srpska

The Law on the Budget System of Republika Srpska (RS) also contains provisions relating to internal control and internal audit. These provisions are similarly vague and often difficult to understand, as the text reflects the classical confusion between control, audit and inspection. However, the Ministry of Finance (MoF) has the leading role in internal audit and financial control. It has produced its own rulebook and has provided instructions to budget-users concerning the establishment of internal control. However, at the moment it is difficult to assess the impact of such prescriptions. The authorities of Republika Srpska made a first attempt at preparing a draft internal audit law, which was considered to be of good quality and a rather comprehensive text. In spite of the lack of practical implementation, this text has been used as the basis for the draft framework law for the whole of Bosnia and Herzegovina. The specific Internal Audit Law of the Republika Srpska (in force since February 2008) was the first of the three draft texts to be adopted. Its implementation has now started, with the setting up of a Central Harmonisation Unit (CHU) within the Ministry of Finance. The ongoing recruitment process concerns the appointment of three staff, including the head of the CHU; this number should be more than enough to carry out the CHU functions at this entity's level.

A budget inspection already exists in the RS Ministry of Finance, and the RS authorities are aware of the possible need to review the functions and methods of this body when the Internal Audit Law as well as the PIFC policy are implemented operationally. However, this is the type of issue that might need to be addressed in common by all levels of government. Unfortunately, the main actors in this area do not really seem to perceive the interest of a common approach to these (purely technical) issues.

3. Reform Agenda and Capacities

There is an increased understanding in Bosnia and Herzegovina that the introduction of PIFC is necessary. However, the severe lack of capacity hampers any rapid developments, if any, in this area. Moreover, the recognition of a need is essentially linked to discussions with donors and less connected to a deep understanding of the issue as such.

A first concrete opportunity was offered by the initiative to set up an intergovernmental/ inter-entity working group, in response to the World Bank's conditionality of having to draft, and possibly adopt, a framework law on internal audit at state level by September 2006; the group produced such a framework law by the end of 2006. At the time of this assessment, two specific Laws on Internal Audit had been adopted (at state level and in Republika Srpska). A great deal of work remains to be done in terms of the practical implementation of these texts.

This effort should have been closely co-ordinated with the conclusions of the Public Administration Reform Strategy, which envisaged the production of a specific strategy for PIFC by the middle of 2007 and the adoption of relevant legislation by the end of 2007. This did not happen in the way foreseen, and the working group was reconstituted in order to produce a more comprehensive PIFC strategy, in which internal audit legislation would normally find a place. The process has proved to be longer and more difficult than expected because of the general context, which has prevented a common approach of the three levels of government towards PIFC. A first set of three draft policy papers (instead of a single one, as initially envisaged by the PAR Strategy) has been produced and could be formally adopted before the end of 2008. The adoption of these policy papers has been set as a condition for the provision of technical assistance in this area by the European Union. In any case, much will remain to be done in terms of the practical

implementation of these texts, whether they be the laws or the policy papers. Some progress can however be noted more quickly in the specific area of EU funds' management in the framework of the Decentralised Implementation System (DIS).

4. Assessment

Progress has been made in the area of PIFC over the past five years, with the greatest efforts made in late 2004 and early 2005, and again in 2007. It seems that at neither the state nor the entity level are there institutional structures and sufficient political support to foster an efficient PIFC system. As a consequence, progress in the area of internal financial control and internal audit throughout BiH remains sporadic and largely depends on the initiative of major donor organisations.

Some limited progress has been made by the FBiH cantons. The comparatively well-functioning external audit system makes the flaws in the PIFC system all the more apparent. However, the information provided by SAIs is not properly used for the development of an adequate internal audit and financial control system.

In the specific area of internal audit, it is worth quoting the report on the 2005 systems review of public administration: "If the concept of internal control is often misunderstood in the public administration institutions, the concept of internal audit is severely lacking. As 'controls' are often understood as an activity to be performed by full-time 'controllers' (and not as an integral part of the management system), the concepts of internal control and internal audit often get mixed up. If there is a distinction between internal control and internal audit by some of the civil servants in the public administration, the real role of internal audit is not understood correctly almost everywhere."

5. Recommendations

- Each Ministry of Finance needs to develop its capacities in internal audit and financial control and to take the lead in developing and implementing sound public internal financial control systems. This should be done in close co-operation amongst the three Ministries of Finance to ensure harmonised development throughout Bosnia and Herzegovina.
- The efforts and commitment demonstrated by the drafting of a framework internal audit law and a harmonised approach for the whole of Bosnia and Herzegovina should be maintained in the broader perspective of the development of financial management and control systems and towards a co-ordinated approach to PIFC components across the various levels of government, embodied in a strategic document on PIFC.
- The existing legal framework regarding public internal financial control has to be reviewed, amended and unified across the country, and at the same time aligned with good European practices.
- Co-ordination with other relevant legal frameworks and their implementation apparatuses should be ensured. This is in particular the case of the various existing organic budget laws.
- Ministries of Finance and SAIs should intensify their co-ordination, in particular when preparing the legislation and necessary by-laws and guidelines for internal audit and financial control, in order to profit from the SAIs' findings and experience. Common issues should normally find common solutions, and this process should be recognised as non-political, in particular by the entities. Co-operation and co-ordination in this area have strictly no influence or impact on the political developments in Bosnia and Herzegovina. Key members of the PIFC working group still give the impression that the political dimension of the exercise prevails, and consequently they tend to raise unnecessary obstacles by making nearly every technical point a political case.
- Moreover, a common strategy aimed at gaining acceptance and increasing the understanding of newly developed laws is an important issue, since the legal framework in Bosnia and Herzegovina has for the most part been created by the international community. The documents produced so far in relation to PIFC policies should be finalised and adopted as soon as possible in 2008 so that practical implementation may start. The implementation of these strategies will help to resolve a number of issues that could not possibly be resolved in the drafting stages.
- All efforts undertaken in this area should be closely connected to the overall Public Administration Reform Strategy and its attached Action Plan.

6. External Assistance

For the time being very little technical assistance is provided to Bosnia and Herzegovina in this area. At the state level a USAID Public Sector Accounting Project produced a manual on internal controls, which has remained an element of documentation as there was no ownership on the BiH side for this output. However, it has been made clear and it has been accepted that the Ministry of Finance and Treasury of BiH is to play a central role in the development of internal control systems. Also at state level, the EU-supported project aimed at establishing the structures and procedures for the management of EU funds should contain PIFC-related inputs, such as the development of control procedures – and their reflection in written procedures – and the development of audit trails.

The DFID project on public administration reform encompassed some basic information and training in internal audit.

To accompany the adoption of the internal audit laws, the World Bank has provided some training and organised awareness-raising events, in particular for parliamentarians and public sector managers. This activity has nevertheless been of a very limited nature and perhaps not totally in keeping with the realities of Bosnia and Herzegovina.

At the canton level, the OSCE carried out a project in financial management, which also included training and advice on internal audit and financial control. By its very nature this project was limited.

An EU-financed project of a sizeable magnitude is expected to begin in early 2009 and to address PIFC in a consistent and comprehensive way, using the adopted strategy papers as a basis; its main purpose is to help implement in practice the adopted internal audit laws. It is clear, however, that such a project can only have some chance of success if it finds the appropriate counterpart in the BiH administration. Such a counterpart hardly exists at the moment.