



SIGMA

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SERBIA

PUBLIC INTERNAL FINANCIAL CONTROL (PIFC)

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1. Legal Framework

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

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

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

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

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

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

A draft Law on Internal Audit and Internal Control was prepared in early 2006 by the technical assistance project, and this law would normally help clarify the various notions linked to PIFC and set up a system that would be more aligned with the common framework recently developed in Central and Eastern Europe, in particular in neighbouring countries. This initiative will need to be taken over directly by the Serbian authorities. There has been little progress in the PIFC area, as the issue was obviously not on the agenda of the former Assembly and government. When a new government was formed, the development of PIFC seemed to reappear as a priority in the public finance area. The draft law prepared earlier by the TA project was not taken up, but other relevant initiatives started, such as amending the Budget System Law and

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allocating the responsibilities for central harmonisation in the area of PIFC to the Budget Inspection and Audit Department currently in place.

It had been previously, decided to establish a Central Harmonisation Unit (CHU) within the Treasury sector. The systematisation of the Ministry of Finance was amended to that effect, and such a unit formally appears on the organisational chart of the Treasury, but in practice no unit in the Treasury carries out any of the expected functions of a PIFC CHU.

Amendments to the Budget System Law should have clarified this ambiguous and misleading situation and supported the location of the CHU within the core body of the ministry and next to the Internal Audit Department. The amendments were prepared and approved at both ministry and government levels, and they were incorporated into the new draft Budget System Law promoted by the then government and approved unanimously by the National Assembly, but not timely enough to be put in force before the government resigned and early elections were called for.

This complex situation illustrates the still missing overview and vision of what is comprised under PIFC and of what should be undertaken to smoothly set up a revised system in a way that is consistent. This is normally entrusted to a PIFC strategy paper.

However, the Serbian Government has not yet adopted an overall strategy and action plan for implementing an internal control framework that would facilitate implementation of the Budget System Law, and as a result the very wording of the current BSL still has little impact. This situation appears to be a major factor inhibiting reform progress. The technical assistance project in the area of PIFC took the initiative in this area, and a first draft PIFC strategy/policy paper was produced by the project in 2004, with a supporting draft action plan. No further action has been taken, and this policy paper has not been formally approved. This process might be regarded as being pursued at the expense of local ownership (e.g. a first PIFC Policy Paper was produced by external consultants just after July 2003 and was formally approved on 22 October 2003; needless to say, the commitment and ownership of that policy paper by Serbian authorities, in particular the Ministry of Finance, were questionable). The PIFC strategy initiated by the technical assistance project was reviewed in mid-2007 after a new government was formed and apparently PIFC issues have gained more status on the public agenda. However, the document as such remains a document and no further steps appear to have been taken prior to the resignation of the government in March 2008.

In parallel to the above-mentioned legal initiatives, two pieces of secondary legislation were prepared in the form of rulebooks, one on financial management and control and another on internal audit (both concerning joint criteria and standards for these activities in the public sector). These rulebooks, both of which were adopted in August 2007, contain provisions reproducing the common elements pertaining to PIFC. The extent to which these two documents have been implemented in practice to date is not clear. It is possible that the rulebook on internal audit has been partially implemented, insofar as internal audit units have been established in the budget beneficiaries listed in the document and the relevant recruitment of staff has taken place. It is certainly not the case for the rulebook on financial management and control, which basically reproduces standard definitions and wording concerning the COSO framework; such concepts are far from the daily concerns of the Serbian public administration.

2. Institutional Framework

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

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

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

- Treasury Control Co-ordinators;
- Treasury Internal Control Department; and

- Finance Departments of Direct Budget Beneficiaries and Indirect Budget Beneficiaries.

Ministry of Finance Budget Inspection Department (MFBID)

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

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

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

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

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

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

Internal Audit Department of the Ministry of Finance (MFIAD)

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

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

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

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

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

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

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

This is a very wide remit for internal audit. The current level of staffing is totally inadequate to provide meaningful assurance of the adequacy of the systems of control in all of these organisations. In theory, the staff numbers would need to increase substantially to provide a level of audit coverage and an assurance that would be acceptable to heads of organisations and to the Minister of Finance. However, it is highly questionable whether such a centralised internal audit service is relevant in Serbia, even in a short-term

perspective. The expected setting up of an external audit institution (see below) will increase the risk of overlapping and redundancy of both functions, although it is probably inevitable in the short term and even for a longer period that a certain concentration of internal audit resources will take place.

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

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

The IAD has benefited from numerous manuals and other working tools received from consultants in the framework of technical assistance. The extent to which this material is applicable as such to the current context of operations of the IAD remains to be seen, as well as whether it is used at all by internal auditors. A rulebook has been partially developed, but it does not seem to fit the needs of the IAD, so that it is possible to say that at the moment there is very little support documentation for internal audit work. A new internal audit manual has been produced by the technical assistance project, and the Ministry of Finance now seems to be well involved in the development of this tool. The rulebook issued in August 2007 does not seem to have been really enforced for the moment.

The central harmonisation function as such has not been identified, and activities in the area of training, methodological harmonisation and co-ordination have been carried out de facto in the framework of technical assistance projects, which have covered other beneficiaries besides the Ministry of Finance.

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

Internal Control Units within DBBs

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

DBB Finance Departments

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

- “preparing and making proposals for the financial plan”;
- “distributing assets to indirect budget beneficiaries within the approved appropriation”;
- “preparing and completing documentation for executing the financial plan”;
- “performing tasks relating to the management of state property in charge of the direct beneficiary”; and
- “bookkeeping and harmonisation with the General Ledger and making semi-annual and annual financial statements and other financial business”.

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

3. Reform Agenda and Capacities

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

The technical assistance project, in place until early 2008, took steps to help Serbian authorities respond positively to the European Union request by producing a proposal for a draft Law on Internal Audit and Internal Control, which was not endorsed by the counterpart. The project then prepared a draft Strategy Paper on PIFC (the previous project had taken a similar step in 2004) and made procedural recommendations for its adoption. However, this proposal also remained unimplemented for various reasons, including of course the political context. In the period before the resignation of the government, some operational steps had been taken by the Ministry of Finance, in the first place to appoint a state secretary responsible for PIFC, a position that has been missing for a long time; such an appointment is still in abeyance due to the early parliamentary elections. As this assessment has been prepared before a new government is in place, it is not possible to predict, even if PIFC formally remains in a high position on the political agenda, what will be undertaken and in what form by the new government. In any case, in the end it should be up to the Serbian key actors to demonstrate their commitment to the process of introducing and developing PIFC and their intention to allocate adequate resources for its implementation. The political context since 2006 has not favoured substantial developments in this respect. In addition, internal rivalries and power struggles within the Ministry of Finance have prevented the adoption of consistent and sustainable policies and measures in this area.

4. Assessment

There is still a long way to go before an overall PIFC policy is reflected in practice. General awareness, at both senior management level and lower operational level, together with severe capacity constraints, will need to be addressed before any concrete implementation can be envisaged. In addition, the current scope of application, covering all budget beneficiaries, including local government, is too broad to achieve satisfactory results in the short term.

Accountability mechanisms need to be further developed within the public administration. The need for institutional reform and administrative capacity-building permeates all sectors and levels of the administration. Useful instruments and significant new systems, such as the new Treasury system, have been developed and have contributed significantly to the general improvement of financial control. However, an overall and clear PIFC concept is still missing. A number of cultural differences remain, which have to be addressed if the concept of internal control and internal audit is to be introduced successfully. A policy for public internal financial control still needs to be developed, which takes into account the present state of affairs in Serbia but is as flexible as possible to enable future development towards modern principles. A Serb-conceived strategy should be designed to ensure and then implement this policy in a structured and methodical way. A strong and clear relation with the budget and budget execution arrangements should be established. These tasks have to be performed in the first place by the Serbian authorities, with support by technical assistance as needed; to date the most apparent changes in this area have been the result of technical assistance activity rather than of efforts by the local actors themselves. This situation has resulted in piecemeal and ill-designed systems, a still limited understanding of what needs to be in place, and a lack

of co-ordination between the various activities related to the development of PIFC. A stronger ownership by the Serbian authorities will require more political commitment and drive at a high level in the Ministry of Finance. This is of course linked to the overall stability and long-term perspective of the Serbian public administration.

5. Recommendations

- The Ministry of Finance should take the lead in the development of an overall concept for Public Internal Financial Control (PIFC), including promoting the adoption of a PIFC strategy paper at government level.
- In the new set-up of the Ministry of Finance, the appointment of a high-level official – at the level of state secretary or deputy minister – should be confirmed, with the task of developing and implementing a PIFC concept.
- A PIFC strategy should endeavour to set out the principles of managerial accountability with a view to enhancing and reforming the internal control systems and procedures.
- This strategy would furthermore set out the conditions for the development of a functional, independent internal audit, taking into account both the existing and potential levels of awareness of the key actors as well as the capacity constraints. An overall needs assessment, based on a risk approach, should be undertaken in order to design the most relevant system for setting up internal audit units. This system would probably involve maintaining the central internal audit function of the Ministry of Finance as long as resources to adequately staff and train internal auditors in line ministries and other direct budget beneficiaries (DBBs) are lacking. The Budget System Law and other regulations supporting effective financial control and the establishment of internal audit (IA) in Serbia should be reviewed and further developed on a comparative basis to ensure consistency and to put in place a system that is as appropriate as possible, given the Serbian circumstances. It is not sure whether the draft texts, which were produced before the resignation of the former government, meet these conditions. The reporting and accountability lines of all budget-users, and the substance thereof, should be subject to a thorough examination.
- Any strategic document should adequately deal with the issues of resources, in particular human resources in terms of staff numbers and quality, training and salaries.
- The establishment of a central harmonisation function in the Ministry of Finance, with appropriate solutions for dealing respectively with internal audit and financial management and control, will also need to be confirmed, and the choice will have to be accepted and implemented by all concerned parties in the ministry, which implies a clear, politically endorsed solution.
- Plans to set up, in a consistent and cost-effective manner, finance departments as well as fully-fledged internal audit units in DBBs, have to be developed and resources allocated for their implementation in due course.
- All of the above should be carried out in sequence, putting first in place the basic internal control prerequisites before developing internal audit further, let alone “modern” concepts, which it is obviously too early to implement in a beneficial way in the current Serbian circumstances.

6. External Assistance

The European Agency for Reconstruction (EAR) has supported four projects in related areas: the implementation of effective Public Internal Financial Control (PIFC) and in particular the establishment of effective IA throughout the government sector in Serbia; the creation and establishment of a supreme audit institution (SAI); the development of the Treasury function in the Ministry of Finance; and public procurement.

The PIFC assistance project has been split into two phases. The first phase, which ended in 2004, brought some improvements and certainly contributed to a better understanding of the key PIFC concepts. However, due to the feeble commitment and absorption capacity of the recipient, the absence of operative IA units and of prioritisation for the Treasury project, and basically the absence of a solid counterpart and a change champion in the Ministry of Finance, the project’s results did not live up to the initial expectations. Nearly

all of these obstacles were present at the start of the second phase, which was entrusted– like the first phase – to a private consultancy firm. It seems that, after a first inception period, a better response has been given to the input of the assistance provider, which – as mentioned above – has taken steps to place the current development of PIFC into a clear EU accession-driven perspective. The process has, unfortunately, again been slowed down, in particular because of the political agenda but also for internal reasons, including the lack of strong high-level support within the Ministry of Finance. The project is now over, and it seems necessary to take serious stock of all that has been achieved so far before starting any new substantial assistance. It is clear that the elusiveness of the counterpart has been a major hindrance in the smooth implementation of the project, a factor of course worsened by the political instability and the lack of unitary views, within the Ministry of Finance, on the ways and means to develop PIFC, if not on the objectives as such.

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