



## **SIGMA**

### **Support for Improvement in Governance and Management**

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

## **MONTENEGRO**

### **PUBLIC INTERNAL FINANCIAL CONTROL (PIFC)**

#### **ASSESSMENT MAY 2008**

#### **1. Legal Framework**

The (Organic) Budget Law, adopted in August 2001 and amended by parliament in November 2007 (to better support planned developments in public expenditure management), together with the Treasury Regulations issued in accordance with the Budget Law, 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 law covers the government budget and the budgets of municipalities (art. 1 of the Budget Law).

The Treasury Directions enacted on 29 December 2001 further define the legal framework of financial control, among other areas, and establish the availability of records for audit by the Deputy Minister of Finance as well as for external audit (paragraph 273).

The Budget Law empowers the Minister of Finance to prescribe internal audit procedures and approaches. There is no law on internal audit, but a public internal financial control law is currently being drafted. According to the “Rulebook on the Internal Structure and Organisation of the Ministry of Finance”, enacted on 26 September 2003 and updated in January 2008 following the adoption of the Public Internal Financial Control (PIFC) Policy Paper on 20 December 2007, establishes an Internal Audit unit and a unit for Audit Standards and Planning in the Ministry of Finance. Section 8 of the “Rulebook on the Internal Structure and Organisation of the Ministry of Finance” defines the tasks, responsibilities and competencies of these units.

In February 2004 an Internal Audit Charter and an Internal Audit Manual were adopted. The 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.

#### **2. Institutional Framework**

The Ministry of Finance (MoF) is divided into six main functional areas, each of which is headed by a deputy minister – treasury; budget; tax and customs; economy, finance, international co-operation, lotteries and gambling; internal audit; and corporate services.

The above-mentioned Treasury Directions clearly define the roles and responsibilities of 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, who is personally liable for the due performance of financial tasks and may be held financially responsible, at the discretion of the Minister of Finance, for any losses, inaccuracies or errors during the performance of those financial tasks (paragraph 21 of the Treasury Directions). The Directions ensure the segregation of duties; an official cannot at the same time have responsibility for authorisation, execution, accounting and control.

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.

The total number of staff 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, 42 in the Treasury and seven in Internal Audit. This staffing is quite modest compared to that of most European countries. However, the number of staff seems rather proportionate compared to the staffing levels in other ministries.

The MoF uses the accounting software SAP R/3, which is an integrated accounting system. The aim is to use five of the basic modules of the SAP R/3 system. However, only two functions related to budget expenditure are operative (payments and reporting), while the other three functions (cash flow management, fixed assets and debt management) are not yet active. Almost all of the 75 governmental spending units are connected to the SAP system. There are no immediate plans to include municipalities in the Treasury system, although this issue has been on the agenda.

Currently, the Internal Audit Unit of the MoF is formally responsible for internal audit in the MoF, other ministries, spending units, and municipalities. The establishment of internal audit units in other budget organisations is under way following the guidelines contained in the PIFC Policy Paper and in the PIFC Law, which is currently being drafted.

The following main topics are included in the Action Plan for implementing the PIFC Policy Paper following the adoption of the PIFC Law:

- Development of a manual for financial management and control, including relevant training of managers and employees;
- Revision of the current internal audit manual;
- Establishment of internal audit 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.

However, it is crucial in Montenegro to carefully consider how to build an internal audit system that is relevant for a small administration. The plan is to develop a semi-decentralised internal audit system and it is therefore foreseen to establish internal audit units 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 it is established and to which it reports. The third category is comprised of institutions that are 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.

The three-year internal audit strategic plan, covering the period from July 2004 until June 2007, was not revised. It was not considered appropriate to revise the plan in view of the anticipated changes to the scope of work of the Internal Audit Unit following the passage of the PIFC Law. The annual audit plan covers all auditable areas in the MoF, other ministries, spending units, extra-budgetary units and municipalities. The Internal Audit Unit of the MoF completed 21 audits during 2007. The 2008 annual audit plan schedules 13 audits: two audits concern organisations that were not covered in 2007 and the remainder are audits of organisations audited last year. Five audits have already been completed so far in 2008, and it is anticipated that the actual number of audits will exceed the number indicated in the 2008 audit plan. 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.

### **3. Reform Agenda and Capacities**

Significant reforms have been carried out and further developments are foreseen in various areas related to public finance management. The Organic Budget Law addresses good governance procedures and the implementation of accountability approaches, as does the PIFC Policy Paper approved by the government on 20 December 2007.

There is still no comprehensive reform strategy for public expenditure management in which PIFC should be placed.

Managing the change to accountability, as outlined in the PIFC Policy Paper, will require time and technical capacity, long-term political commitment and effective arrangements. Special attention should be given to

change management in particular, and the need to change working methods in order to achieve the objectives spelled out in both the organic budget law and the PIFC Policy Paper. Administrative decentralisation does not mean losing control, but it does require different structures and guidelines for devolving authority and responsibility. The Policy Paper is welcome in this regard, as the aim of that document is to put financial control and audit into the overall budget execution.

#### **4. Assessment**

The management of the MoF has started to implement a number of different reforms but, as the commitment to implement these reforms has not been made within a Montenegrin strategic development context, medium-term sustainability has for years been less than external counterparts had expected. One reason for the slower implementation and occasional resistance to reform might be the intensive donor activity in the country. The presence of so many initiatives at the same time has exceeded the absorption capacity of the Montenegrin ministries (in addition, most short-term projects seek to achieve very ambitious medium-term objectives).

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 (PIFC) have generally been independent of each other. Accountability requires follow-up procedures for budget execution, including follow-up reporting. However, it will be challenging to implement the PIFC Policy Paper, as there are new features that will require awareness-raising activities for the top management. The commitment to enhance PIFC nevertheless seems strong, as the ministry has started to draft the PIFC Law, as foreseen in the Policy Paper. The plan is to have the PIFC Law adopted in early autumn 2008.

In addition, there is a need for a stronger co-ordination role for line ministries and for decentralised functions from the MoF regarding financial management and control. As there is no comprehensive expenditure management reform, there is an increased risk that the areas of budget preparation and execution will be developed without sufficient phasing of activities or the necessary co-ordination between these activities and related issues regarding financial management and control as well as internal audit.

The existing Treasury Directions are rather detailed and in some parts resemble a guide rather than a strict regulation. They are also outdated and need considerable revision by the MoF. This revision is also planned, in accordance with the PIFC Policy Paper. In general it seems that monitoring and analytical procedures are also lacking, and much of the control is concentrated on individual transactions. The quality of these checks and controls could nevertheless be enhanced, as also indicated by the State Auditors Institution.

The apparent absence of a financial inspection system will facilitate the further implementation of audit. It is envisaged to include a section in the PIFC Law indicating that heads of institutions are to report to the MoF to other appropriate authorities on the measures undertaken to prevent, monitor and take action against fraud, serious irregularities and corruption in respect of both EU funds and national funds.

Internal audit is emerging, and the establishment of internal audit units in line ministries is under way through the development of the PIFC Law.

#### **5. Recommendations**

The PIFC Policy Paper includes a clear and coherent medium-term strategy, in line with the capacities of the various institutions to fulfil their mandate and tasks. 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, as the PIFC system under development is based on the COSO/INTOSAI standards for internal control<sup>1</sup>. This approach is very new to the administration, and it would therefore be advisable to carefully manage the change and to provide extensive awareness-raising activities for key stakeholders, including ministers and senior officials, so as to ensure the successful implementation of this new system.

On the basis of the decisions taken in the PIFC Policy Paper, internal audit capacity and the future architecture of the system should be enhanced and the PIFC Law should be finalised and adopted.

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<sup>1</sup> COSO (Committee of Sponsoring Organizations of the Treadway Committee), INTOSAI Guidelines for Internal Control Standards for the Public Sector

The internal audit guide, as well as the Treasury Directions, should be revised in accordance with the framework of the PIFC Law (also scheduled to be completed in the second half of 2008). As this law is to be a framework law, a comprehensive set of accompanying regulations is also needed. It is necessary to increase the transparency of the Treasury's work in order to develop in further detail the procedures for both cash and asset management.

## **6. External Assistance**

No specific assistance is provided to Montenegro on PIFC. However, an important USAID project, covering a very broad range of tasks, aims to implement institutional reform and strengthen macroeconomic, fiscal and financial management. Under this project some assistance has been provided to the MoF for the development of financial management and control systems and for the establishment of internal audit. This specific part of the project ended in March 2006, and the entire USAID project will end by June 2008.