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265. STRATEGY OF PUBLIC INTERNAL FINANCIAL CONTROL (PIFC) DEVELOPMENT IN MONTENEGRO



MINISTRY OF FINANCE OF MONTENEGRO

**STRATEGY
OF PUBLIC INTERNAL FINANCIAL CONTROL (PIFC) DEVELOPMENT
IN MONTENEGRO**

Podgorica, November 2007.

1. Introduction

In the chapter “Sector policies” relating to financial control, of its Progress Report on Montenegro for 2006, the European Commission stated the following:

“Montenegro will have to substantially upgrade its system of internal and external control. The State Audit institution will need to be upgraded to a supreme audit institution fully independent and functional in line with international standards and the EU best practices. Montenegro should also upgrade its Public Internal Financial Control strategy as soon as possible and enhance internal audit capabilities.

It will be necessary to improve the system of public internal financial control (PIFC) in accordance with international standards of public internal control, international internal audit standards and the EU best practices. Specifically, there is a need to develop decentralized managerial accountability that will be supported by appropriate financial management and control system and functional independence of internal audit.

In order to harmonize financial management and control and internal audit it will be necessary to establish a central harmonization unit (CHU). The Central Harmonization Unit shall be placed in the Ministry of Finance and will be directly reporting to the Minister, on the development and progress made in the PIFC area. The Centralized Harmonization Unit would be in charge of discussions on PIFC principles in the public sector, development of strategic documents, drafting and enforcement of legislation, organizational structure as well as coordination of methodology and training of managers and the staff involved in financial management and control and internal audit.”

In December 2006, pursuant to the EC recommendations, the Government of RM adopted the Action plan for implementation of recommendations from the draft European Partnership, which in the part relating to the Sector policy concerning financial control, planned in its short term priorities, that the Ministry of Finance as the competent body should prepare the document “Strategy of Public Internal Financial Control in the Republic of Montenegro”. Subsequently in the Program of Work of the Government of RM for 2007, it was proposed that the Ministry of Finance would prepare the PIFC policy paper. In drafting this document, the Ministry of Finance has received an expert assistance from SIGMA program.

The purpose of this document is to describe the key elements of the current situation, development strategy for establishment and development of comprehensive and efficient public internal financial control in the Republic of Montenegro. The PIFC principles, which are described in this document, will be incorporated in the new law on public internal financial control system, by which Montenegro will harmonize its current legislation in this area with the requirements of the EU (acquis).

The PIFC development strategy will apply to both the national and the EU funds and will be very important for the EU integration process of the Republic of Montenegro.

The Public Internal Financial Control (PIFC) will be developing continuously and in that regard, the Government of Montenegro will be supplementing this document on the proposal of the Ministry of Finance.

2. Summary

Public Internal Financial Control includes part of the acquis principles that have been established by the EU as an overall system of internal financial controls for a good governance of the public funds, regardless of their source.

The PIFC model of the EU has separated the functions and responsibilities of financial management and control (FMC) covering ex ante, ongoing and ex post controls, and independent internal audit

To conduct an efficient PIFC model in the Republic of Montenegro, it will be necessary, first of all, to amend the current legislation framework by passing the Law on public internal financial control system (the Law on PIFC). This law will allow for the strengthening of a legal base for the introduction of the PIFC concept and will enhance the legislation in the area of financial

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management and control (FMC) and internal audit (IA) and provide for the development of managerial accountability.

In the Budget law and in the secondary legislation adopted based on this law as well as other laws, certain elements of internal financial control have been regulated. In order to proscribe the establishment of an unique overall financial management and control system and internal audit that will be based on the generally accepted international standards, it is necessary to adopt the PIFC law to clarify, in a better way, the role and meaning of all elements covered by this system which shall refer to all budget users on the state and local levels and extra budgetary funds.

With a view to raising awareness of heads of organizations on their roles and responsibilities (managerial accountability), first of all, the definitions and mutual relationships should be clarified, and the key elements of the PIFC system should be clearly determined including a need to enhance current internal controls and their functioning in all institutions of the public sector. When establishing new controls, it is important to ensure that they will be reasonable and cost effective relevant to the operational activities of each institution.

This law shall provide a firm legal framework for implementing the PIFC that will cover managerial accountability, financial management and control, the establishment of functionally independent audit in the institutions of the public sector and will also allow for creation of the central harmonization unit which will be in charge of harmonization and coordination of financial management and control and internal audit methodologies.

The Ministry of Finance is the competent body of the public administration and is responsible for setting up and enforcement of policies in the PIFC area. This function will be performed within a separate newly created sector (CHU) in the Ministry of Finance, which shall coordinate and monitor application of this strategy and the manager of this sector will report to the Minister directly. It is necessary to improve the staff qualifications and structure of the CHU through the recruitment of additional staff and education of the existing employees to make this unit successful in playing the role of a centralized body in charge of the development of this system.

It is also necessary to improve professional qualifications of the staff in all institutions of the public sector which is involved in the practical application of the enhanced PIFC system and those which provide the financial resources that are necessary for the development of methodologies, professional advancement of employees and establishment of new functions in the overall public sector.

3. Basic elements of the Public Internal Financial Control (PIFC) policy concept

Based on the internationally accepted standards and the EU best practices, the term »public internal financial control« (PIFC) includes an overall, integrated system that is to be established by the Government to carry out internal control and audit of the usage of the national budgetary and EU funds. The system is aimed at ensuring compliance with legislation, transparent, economic, efficient and effective managing of public funds (national and EU funds) also providing for their control.

Public Internal Financial Control includes all measures for controlling all public revenues, expenses, property and liabilities. It also covers all internal control systems and procedures in the public institutions and assists in creating a safe environment for public funds to be spent and to ensure a return of the value invested.

Public internal financial control system (PIFC) consists of the following elements:

1. Financial management and internal control (FMC)
2. Functionally independent internal audit (IA) and
3. Central unit for harmonization and coordination of financial management and control system and internal audit methodologies (CHU).

Appropriate establishment and functioning of the PIFC system is based on managerial accountability principle. According to this principle, heads of institutions are directly responsible for the **overall management** and development of their organisation. Thus the establishment, implementation and development of a system of public internal financial control within the institutions, which also includes setting up rules aimed to achieve efficient, effective and economic usage of available funds (including foreign funds), is the responsibility **of the head of the institution**. Their basic functions include planning and organization of activities, introduction of the **risk** management process, ensuring an adequate **internal audit** function, carrying out of permanent **supervision** and maintenance of adequate **internal control** aimed to achieve **reasonable assurance** that the organization will meet its goals. Managerial accountability is not limited only to the financial aspect of the institutions activities but includes **all** activities and processes in the institution. Therefore, the heads of the institutions are to have a broad understanding of the concept of internal control (FMC and IA) and to promote it among the employees of the organization. In addition, the heads of the organization have an obligation to submit reports to the CHU on their activities and results related to the efficiency and effectiveness of financial management and control systems and internal audit in the institutions they manage.

3.1. Financial Management and Control System

Financial management and control (FMC) covers the entire system of the financial and other controls which is integrated in all activities of an institution including organizational structure, methods and procedures which are applied not only to financial systems but to operational and strategic systems of the budget users as well.

It is the responsibility of each employee of an institution to carry out financial management and control in accordance with the business processes and operations and job description. It is necessary to prepare written instructions and procedures for all processes in which control activities are to be carried out, stating clearly the methods to be used and the responsibilities of both the managers and employees.

The primary goal of FMC is to provide:

- Successful fulfilment of goals and tasks of the institution;
- Safety, reliability, timeliness and completeness of information, especially financial;
- Compliance of operation with the law regulations, policies, plans and procedures;
- Property protection;
- Economic, efficient and effective use of resources.

Pursuant to internationally accepted standards, financial management and control covers the following five linked components:

- Control environment
- Risk management
- Control activities
- Information and communications
- Supervision/monitoring (excluding internal audit function)

Control environment represents a base for all other components and creates conditions for efficient control activities. It considers overall behaviour, understanding and management activities in terms of financial management and control and its importance for the institution. Control environment includes the personal and professional integrity and ethic values of employees, managing style, determination of mission and goals, organizational structure including division of responsibilities and the establishment of an appropriate reporting line.

Risk management includes an overall process of determination, assessment and monitoring of risk, taking into account the objectives of the budget users, and undertaking of necessary actions especially through changing of financial management control system in order to reduce risk.

Control activities are the mechanisms based on the written rules and principles, procedures and other measures set up to achieve the organizations goals and objectives and to reduce a risk to an acceptable level. The control is carried out throughout the organization, on all levels and over all functions, provided that the control expenses do not exceed the benefits gained. The control activities are classified as ex-ante, on going and ex post controls.

The ex ante control represents: total preventive control activities necessary for taking decisions on the collection and usage of public funds; undertaking of obligation; conducting procedure of public procurement; conclusion of contracts and related payments; and return of incorrectly made payments. The examples of these controls include determination of duties, procedures for authorization and approval, access to property control and verification accounting procedures before making payment.

On going control is carried out during the execution of a management decision and the performance of financial and economic operations.

Ex post control is carried out after undertaking business activities or business processes and it has been designed to discover any potential errors, deviations or irregularities and it has been also aimed at reducing the risks of undesirable consequences, since it allows for corrective actions to be taken.

For successful functioning of the FMC, it is compulsory to apply the principle of an adequate separation of duties. A manager of an institution is obliged to divide the duties and to give necessary authorization to the officers within the organization.

Information and Communication. A good system of communication is crucial for an organization to maintain an efficient system of financial management and control. The communication system consists of methods and records to identify collect and exchange useful information. Information is considered to be useful if it its timely, sufficiently detailed and appropriate for the user. The information must be determined, obtained and communicated in the form and in time that enable employees to perform their duties and obligations. The development of an appropriate information system should provide for management to have necessary reports on successfulness of the operation as compared to the goals set. The accounting system is an important information system, which includes a sequence of tasks and book keepings for processing transactions and maintenance of the financial records. The information should flow in all directions as to keep all employees informed and to enable them to coordinate and report on all decisions and activities of various organizational units in institutions.

Monitoring includes consideration of activities and transactions of the organization aiming at evaluating a quality of work within a certain period of time and at assessing successfulness of controls. Management should direct monitoring activities toward the FMC system and completion of the organization's mission. Monitoring and assessment of financial management and controls will be carried out by permanent monitoring and self-assessment.

3.2 Functionally independent internal audit

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.¹

Within the EU, the PIFC concept of internal audit considers this function to be carried out by an authorized functionally independent unit within the organization .It means that internal audit is

¹ IIA – Institute of Internal Auditors

independent from an activity which is subject to auditing and that it reports directly to the manager of an auditing authority who has no influence on its decision making or the area to be audited. Functional independence considers internal audit not to be a part of any business process or institution, and to report on its work to the manager of the public authority directly.

The role of Internal Audit is to carry out an independent, professional and systematic assessment of financial management and control systems, which includes auditing of all functions and operational processes and controls established. It objectively collects, checks, analyzes, estimates and projects data to be reported to the management for decision making. This activity is carried out by using auditing programs based on risk, by which all procedures and systems within the organizations are systematically checked. One of the main auditing focuses is the checking of FMC system functioning in an institution.

Internal audit is in charge of giving the professional opinion and recommendations as to allow for management and control systems to be established in accordance with the regulations, standards and principles of good financial governance.

It is necessary to make distinction between internal audit and financial management and control systems. A manager of the institution is responsible for financial management and control systems. Internal auditors are not responsible for establishment, functioning and development of the FMC system but for an assessment of the functioning of those systems, their potential weaknesses, shortfalls and irregularities and for giving recommendations for improvement and undertaking of corrective activities. The head of institution is responsible for the implementation of recommendations given by internal audit.

3.3 Central Harmonization Unit (CHU) for financial management and control system and internal audit

The Central Harmonization Unit is an integral part and the necessary condition for successful approach and development of public internal financial control and this concept is to become a part of PIFC itself.

The Central Harmonization Unit is responsible for development and application of methodology and standards for the FMC systems and internal audit in public sector. It is focused on the development of the procedures and audit trails² for the FMC and on preparation of manuals, proposals of the internal audit charter and code of ethic for the public servants involved in internal audit. This unit will also develop a methodology for risk assessment to be used by all institutions, and will develop methodology guidelines relating to the FMC and internal audit, evaluate activities performed by internal audit and the FMC, monitor execution of these requirements and analyze the functions of the internal audit units and the FMC in the ministries or in other authorities of the public administration. The unit reports to the Government on the development of the FMC system and IA, on the progressing of implementation of adopted standards, common weaknesses and necessary measures for its improvement.

The Central Harmonization Unit is also responsible for coordination and appropriate training of the managing structures and employees in the public sector in the area of financial management and control and internal audit in public sector.

Based on EU good practices, the best location for the CHU would be the Ministry of Finance.

4. Analysis of current situation of internal financial control in Public Sector in Montenegro

4.1. Institutional framework

² Audit trail is a written procedure for accounting and other transactions which determines chronology of documents and business process from the beginning to the end.

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Internal financial control systems in the Republic of Montenegro have been established within various institutions of the public sector, reflecting the specific procedures within the competences of these bodies

Major institutions in which financial and other types of controls have been carried out are the following:

- **The Parliament of Montenegro** being the representative body of the citizens and the carrier of legislative power in the Republic of Montenegro, inter alia, passes the laws and adopts the budget of the RM, conducts elections, announces appointments and dismissals and controls the operation of the Government of the RM and other carriers of the public functions which report to the Parliament in accordance with the Constitution and the law; it reviews annual report on the audits carried out and the operation of the State Audit Institution. The findings of the state audit are discussed at the sessions of the individual committees of the Parliament followed by discussions at the plenary session of the Parliament as to draw up certain conclusions. The sessions of the Parliament are opened to the public and passed via electronic and printed media that provides for transparency of the findings and recommendations of the state audit.
- **Government of Montenegro**, inter alia, proposes to the Parliament of the RM the laws, and other acts; the budget of the Republic and the final statement; it also enforces laws and other decisions of the Parliament ; issues decrees for enforcement of laws; pursues foreign and local policies; directs acting and carries out supervision over the ministries' operations and over other bodies of the public administration; it takes care of economic development of the country; directs acting and development of public services and performs other works specified by the Constitution and the law.
- **State Audit Institution** being a supreme auditing body, carries out an external audit of the operations of the bodies and organizations which manage the budget and property of the state as well as the local government units, extra budgetary funds, the Central Bank of RM and other legal entities in which the state has an ownership part. The State Audit Institution examines regularity, effectiveness and efficiency of operation of the subjects to auditing. This institution carries out an audit over the enactments and operations of the subjects that have or may have financial effects on: revenues and expenses; state property; indebtedness, issuance of guarantees and super guarantees; rational usage of funds. It reports to the Parliament of RM on its operation and the audits that have been carried out. .
- **Ministry of Finance** based on the decree on organization and manner of work of the public administration, carries out, inter alia, all operations relating to preparation, planning, creation and execution of the budget; supervision over the earning of revenues and execution of expenses of the state budget; preparation of final statement of the budget; financial control through accounting system based on planned liabilities; development and keeping of the accounting of the state budget and management of IT system; management of the available monetary funds held on the consolidated Treasury account; management of debt arising from securities and foreign debts, foreign donations, aids and credits; creation and realization of the custom and tax polices; internal audit with all budget users, extra budgetary funds and local government units; etc. By the Decree on amendments to the decree on organization and manner of work of the public administration, issued at the end of 2006, the Ministry of Finance has been responsible for the development of internal financial control systems in the public sector, in accordance with the international standards.

Within the Ministry of Finance:

- The budget sector performs the works relating to: preparation procedures, planning and making of budget, proposing guidelines of middle term macro-economic framework for preparation and planning of budget, execution, amending and assessment of the budget; carrying out analysis of the spending units' requests, extra budgetary funds, appropriation of budgetary funds and proposing of their changes; preparation of the state budget law; supervision over gaining of income and completion of tasks etc.

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- The State Treasury sector performs the works relating to: making payments based on relevant documents and data submitted by spending units, management of accounting system of the state receipts and expenses; keeping of the Treasury ledger; preparation of final statement of the budget; monitoring and execution of the spending funds appropriated under the annual budget law; development and keeping of the budget accounting and managing the financial information system; managing of available monetary funds on the consolidated treasury account; policy of the public debt; management of local and foreign debt; management of foreign donations, aids, loans; keeping records on the state debt etc.
- The Internal audit sector carries out internal audit of accounting documents receipts, contracted obligations and spending units' expenses, extra budgetary funds and municipalities (local government units).
- **Tax administration** is a body of the public administration which has the competence to determine and collect taxes introduced by the Republic, based on the Law on Tax Administration. This law regulates the rights and obligations of the tax authorities and the tax payers through the procedure of determination, collection and control of taxes and other rates. The tax inspectors carry out subsequent financial control to better realizing the budget revenues. The basic task of the tax inspectors is to carry out financial supervision aiming to strengthen the financial discipline of tax payers to ensure realization of the budget revenues.
- **Customs administration** performs the operations of customs supervision over the income collected by the customs service based on the Law on Customs, the Decree on enforcement of the Law on Customs and the Law on Customs Service. The above mentioned legislation, inter alia, regulates obligations, authorizations and the ways of acting in terms of control of income collection. The department for internal audit, which is responsible for auditing all business activities of the administration, has been formed within the Customs Administration and reports directly to the Director of the Customs Administration.
- **Ministries and other authorities of the public administration** have been pursuing the policies and implementing programs of responsible usage of the public funds thus providing services within their competences.

In some ministries and administration authorities inspection supervision (**ex post control function**) over the application of legislation is carried out, in the following areas: turnover of goods and services, work performance and protection at work, energy supply, mining, constructions, tourism and agricultural activities and other areas. According to the special laws, inspection supervision are carried out by direct review of general and individual enactments with entities being subject to control. An inspection in accordance with separate laws is carried out by review of general and individual enactments of the entities being subject to inspection, aimed at ensuring that laws, other acts and general enactments are kept and taking administrative or other measures to correct irregularities. An inspection supervision is carried out by the inspectors and other public servants being authorized to conduct supervision as specified by a separate law. Such activities are separate from the PIFC requirements.

- **Directorate for Public Procurements** is an authority of the public administration which is in charge of public procurement procedures, that provide economic, efficient and transparent usage of the public funds and creates competitive and equal conditions for bidders .
- **Public Commission for Control of Public Procurement Procedures** examines the correct application of the Law on Public Procurements and proposes and takes measures to eliminate irregularities found which provides for competitiveness and transparency of the public procurements procedures.
- **Municipalities** in which self-government is implemented, prepare the plans and programs of development, budget and the final statement of the budget, according to the laws.

4.2. Legislation framework

The Law on Budget is a framework law of the existing system of public internal financial control in the RM.

Reform of the public finance system in Montenegro was initiated by passing the organic budget law in 2001, which also made a base of the existing public internal financial control system.

The law on budget regulates in a unique way: planning, preparation, adoption and execution of the state budget, budget of the local self-government, indebtedness and issuance of guarantees, internal control, budget accounting and internal audit.

The previous concept of the budget execution functioned based on the principle of indirect control of expenses i.e. money was transferred to the budget users that were directly fulfilling their obligations toward suppliers and financial institutions.

By passing the Law on Budget, the Treasury system was established within the Ministry of Finance as a centralized model of managing the public finance. The Treasury system was based on the principle of a unique consolidated monetary account through which all financial transactions of the state budget have been made. The implementation of the programming budget by stages was initiated as a part of reform process of the public finance in 2004, aimed at providing good fiscal governance which is to improve transparency and responsibility in using public funds. By the Law on Amendments to the Budget Law, which was adopted in November 2005, in addition to the current budget, inter alia, creation of the capital budget was envisaged. Pursuant to the guidelines for creation of capital budget and the objectives envisaged by the Agenda of economic reforms in Montenegro, in the state budget for 2007, the capital budget for the capital projects was foreseen. In order to continue reforms in the public finance system, the project for including extra budgetary funds in the state treasury system was planned.

According to this law, the Ministry of Finance carries out internal audit of: accounting documents, receipts, contracted obligations and spending units expenses, extra budgetary funds and municipalities.

Based on the Budget Law the following secondary legislation was adopted:

- Instructions on the State Treasury Operation (Official Gazette of RM 64/01);
- Rulebook on unique classification of the accounts of the State budget, extra budgetary funds and the municipalities' budgets (Official Gazette of RM 35/05, 37/05 and 81/05);
- Rulebook on the manner of preparation, making and submission of financial statement of the budget, extra budgetary funds and local government units (Official Gazette of RM 3/06);
- Instructions on the manner and procedure of work of internal audit (Official Gazette of RM 53/04);

The budget for the current year was passed based on the Budget Law, as well as an annual balance sheet of the state budget.

In addition to the Budget Law and the secondary legislation adopted based on this law, there is other legislation partly referring to this area :

- Law on Public Administration
- Law on Public Servants and State Employees
- Law on Salaries of the Public Servants and State Employees
- Law on Salaries and other Income of Public Servants
- Law on Public Procurements
- Law on Control of the State Support and Aid
- Law on Tax Administration
- Law on Customs Service
- Law on Conflict of Interest
- Decree on organization and manner of work of the public administration

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- Decree on remunerations and other incomes of the public servants and state employees
- Decree on wage supplements of public servants and state employees
- Decree on extra pay based on more difficult work conditions of public servants and state employees in individual authorities of the public administration

At the level of local government, and on the basis of the Law on Financing of Local Self-Government, the instructions were prepared on the treasury operation of the local governments, which proscribed: the manner of budget execution of the local government, managerial accountability, financial control, expenses control, maintenance of cash, financial records and data protection etc.

4.3 Evaluation of current situation of FMC system

Certain elements of financial management and internal controls have been proscribed by the Budget Law and enactments adopted based on this law and also in some other laws, but the establishment of an overall FMC system based on generally accepted international standards of the internal control has not been regulated in fully comprehensive manner.

The Law on Public Servants and State Employees proscribes a procedure for getting employment, occupations, rights and obligations, responsibilities, assignments, evaluation, advancement and assesment of qualifications, advanced training, seizing of employment, protection of rights and management of human resources. The salaries of public servants and state employees have been determined on unique basis by the Law on Public Servants and State Employees.

The Law on Public Procurements regulates the conditions, manner and procedure of procurement of goods and services and awarding and performing of works depending on value of goods, works and services that are planed to be executed.

In all institutions of the public sector, in addition to the mentioned legislation, there are clearly defined organizational structures which clearly indicate who is responsible for each sector in the institutions. However, job descriptions in enactments on systematization are quite generalized.

In some institutions, internal acts in which individual operation processes or special activities are described have been passed. For majority operation processes a manner of their performance has not been proscribed and it is to be done as to provide for their performance in accordance with principals of lawfulness, economy, effectiveness and efficiency. Also, audit trails have not been prepared (description of operation processes which should contain process graphs and procedures, description of activities, a person responsible for conducting of certain activities in the business process as well as the deadline for conducting activities.)

In establishing the existing control system, the goals which the institutions want to achieve and risks that influence the achieving of those goals haven't been taken into account. Besides, the existing controls are directed to provide lawfulness and regularity but not economy, efficiency and effectiveness.

The Law on Budget specifies that the budget executors (persons appointed to manage spending units) **are responsible** for accounting and internal control of :receipts, contracted obligations and expenses of the spending units (spending units in the sense of this law include: state authorities, ministries, administration authorities, local government bodies and local administration) and the units which are within their competences.

Based on the Law on Budget, the Minister of Finance issued the Instructions for the State Treasury in 2001, aimed at providing a good financial management. The Instructions defined rules, procedures and responsibilities of the employees involved in finance, budget execution, financial control and control of expenses etc.

According to the Instructions, finance officers are:

- Senior finance officer,
- Approving officer,
- Certifying officer and

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- Authorizing officer.

The Instructions defines that the persons appointed to manage spending units are at the same time the main employees to be in charge of finance in the spending unit. They are obliged to organize the work of the financial service in the spending units they manage.

According to the above Instructions, the senior finance officer (the head of the public authority) has the right to assign one or more public servants to perform duties and bear responsibilities in the capacity of the **approving officer** for that spending unit, and inform the Minister of Finance on the same. Approving officer performs financial task that refers to the function of approval of proposal or request for payment to be made by the public money.

Upon the written proposal of the senior financial officer, the Minister of Finance authorises one or more public servants in the spending organizations to perform duties and bear responsibilities in the capacity of the **certifying officer**. Certifying officer who performs financial task that refer to certification of correctness and validity of a proposal or request for payment to be made by the public money or checks out correctness and validity in collection of the public money.

The Minister of Finance has assigned the **authorizing officer (Deputy Minister for State Treasury)** who performs the financial task that refers to giving authorization for spending of public money on the spending proposal or request for spending the public money and also for money disbursements from the state banking account.

Functions of approving officer, certifying officer and authorizing officer are not connectible. Personal and financial responsibility of the finance officers for performing financial tasks in the spending units has been determined in the instructions.

Previous (ex ante) controls have been also proscribed, and should be followed by all officers assigned in the finance area within the spending units when performing financial tasks relating to: making of contracted obligation or spending of the state money, collection, management and control of the public money.

Namely, the state money from the consolidated treasury account can be disbursed after:

- The approving officer approves the spending proposal of the public money from the funds available ;
- The certifying officer certifies in writing that a spending proposal (payment request) is correct and valid ;
- Prior to authorizing the payments, the authorizing officer checks out whether the payment proposal or request was correctly certified and approved.

All proscribed phases of internal control of expenses must be documented and serve as written evidence for the auditing needs. The Instructions for work of the state treasury proscribed the procedures on taking measures in case of irregularities or fraud in the public money.

All mentioned control activities which have been defined by the Instructions of work of the State Treasury have been built in the IT system (SAP system). This system enables to the budget users direct access to the Treasury ledger, in the part referring to the specific budget user so that all documents (request for authorization of contracted obligation and payment request) are submitted in the electronic manner by direct entry into the Treasury ledger. This also enables budget users to review directly the payments and outstanding obligations, and expenses of its spending unit. In such way set up record keeping in the Treasury ledger makes a good base for the reporting system towards the Government, Parliament and other relevant local and international institutions which provides for transparency of the budget execution and the budget expenditures.

A number of institutions have established divisions for internal control which carry out ex post control in terms of respecting the laws, sub laws and internal normative enactments within their competences as well as control of financial operations. Controles are mainly directed to discovering possible errors, deviations or irregularities after performing the activities .

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By passing the systemic Law on Budget in 2001, inspection supervision over the usage of budget funds (budget inspection) was seized and a central function of internal audit was established in the Ministry of Finance.

4.4 Internal Audit

The activities on the development of internal audit in the public sector started by adoption of the Budget Law in 2001 which proscribed an obligation of the Ministry of Finance to carry out an audit in the part of: accounting documents, receipts, contracted obligations and expenses with the spending units, extra budgetary funds and municipalities. At the end of 2003 an internal audit sector was formed within the Ministry of Finance which, as a centralized internal audit performs the works of internal audit with all budget users. This sector has 8 auditors employed. This law did not proscribe an obligation of the founding of a functionally independent unit of internal audit within other institutions of the public sector.

The development and implementation of the internal audit sector within the Ministry of Finance, which included preparation of the basic documents for internal audit and training of auditors of the Ministry of Finance, was technically supported by USAID/Bearing Point during 2004 and 2005.

The following enactments were adopted in 2004 :

- Instructions on manner and procedure of work of internal audit (Official Gazette of RM 53/04);
- Internal audit manual;
- Internal audit charter.

The instructions proscribed a manner and procedure of work of internal audit to be performed by the internal audit sector in the Ministry of Finance.

The manual for internal audit used by the internal auditors of the Ministry of Finance, defines in detail the requests and procedures of internal audit, illustrates a general approach to internal audit and describes the way in which methodology is related to the relevant standards and instructions for auditing and it also presents the key issues to be considered in applying methodology.

The Internal audit charter defines: the purpose, authorization, role, obligations, tasks and reporting requirements of the Internal audit sector of the Ministry of Finance.

Pursuant to the Budget Law, the works of the internal audit relate to: work assessment and functioning of internal audit; control of the law application in material-financial operation and lawful usage of funds; assessment of efficiency, economy and effectiveness of the operation, authorized spending of budget funds and checking the accuracy of the accounting records, establishment of cooperation with external audit and reporting on the execution of the annual auditing plan.

The audit works are carried out based on the annual audit plan endorsed by the Minister of Finance on the proposal of the deputy minister for internal audit. The annual audit plans are made based on the strategic audit plan covering a period of three years. Internal audit of the Ministry of Finance submits to the Minister of Finance and to the audited subjects its reports on the audits carried out. The findings of an internal audit are internal documents intended for the elimination of irregularities which affect the work of certain institutions and which may result in unlawful or inefficient usage of the budget funds. Also, these findings have a preventive role to eliminate irregularities and to improve the efficiency of the work of the spending unit, aimed at alerting the person in charge to take necessary actions in order to improve efficiency and lawful functioning of the system.

The audits carried out by the Internal Audit Sector of the Ministry of Finance covered the process of execution of expenses and receipts, depending on the subject of the audit stated by the annual audit plans for each subject to control. This included an assessment of work and functioning of internal controls in terms of application of the proscribed rules and procedures, analysis of the budget funds usage process, starting from an initial approval of purchasing of goods and services, approval of funds and expenses and checking of the accuracy and completeness of the accounting records on expenses and receipts.

5. Development of the PIFC system in Montenegro

The development of a comprehensive system of internal financial control in the overall public sector, which will enable establishment of the firm financial management for managing the public funds (both national and foreign) will have priority in Montenegro. In this context, all important aspects of managerial accountability, financial management and control, internal audit and a central harmonization unit should be worked out. This will include preparation of a firm legal base, establishment of centralized bodies and adequate administrative capacities, documentation and education, which includes training of all employees being involved in this process. The timeframe for implementation of the overall PIFC system in the public sector in Montenegro would be 5-7 years. The activities on development and implementation of the PIFC system will be determined in the Action Plan and the reports on annual progress of the Action Plan will be submitted to the Government of RM annually.

The first step in the development of the system is **drafting the law on the PIFC system** with provisions referring to the budget users on the state and local levels and to extra budgetary funds as well. This law will set out the framework to generally govern the public internal financial control and will cover managerial accountability, financial management and control and internal audit in the public sector of Montenegro also including methodology, standards, relationships and responsibilities and competences of the Ministry of Finance and other bodies involved in carrying out of the public internal financial controls. The deadline for passing the law is 2008. More detailed secondary legislation will follow.

5.1. Development of managerial accountability concept

Pursuant to this concept, the managers of the institutions will be responsible for the establishment, implementation and development of a firm system of financial management and control in their institutions, also including the development of rules for efficient, effective and economic use of the funds available. A manager of an institution may also delegate these authorizations and responsibilities to other persons and in case of delegation of responsibilities, the manager of the institutions will be responsible for the efficiency of the established system of internal management and control and also for the selection of the person to whom authorizations will be delegated.

5.2. Development of effective FMC system

Development of an effective financial management and control system will start after the enactment of the law on the public internal financial control system which is to be continuously developed and improved by future reforms in the area of the public finance (implementation of the program budgeting, development of capital budget, introduction of a middle term planning, bookkeeping of transactions based on cash or modified cash base that includes keeping of records on property and obligations etc.).

For successful functioning of the FMC, it is compulsory to apply the principle of division of duties. After entry into force of the law, the amendments to the Rulebook on internal organization and systematization will be adopted in order to establish appropriate organizational structure and to give necessary authorizations to the managing persons in the institutions. Namely, by changes and amendments to the Rulebook, the duties shall be divided between more people, to provide effective controls and to reduce operation risks, the occurrence of errors or incorrect actions and to delegate responsibilities. .

The institutions of the public sector will be in charge of preparing and implementing within the time period set up by the Minister of Finance: written procedures in the form of internal enactments (rulebooks) by which they will define basic operation processes and show diagrams of business flow processes and will give instructions with detailed descriptions of business operations which will serve as a base for detailed job descriptions in the sub laws on organization and systematization. Based on these enactments, the assessments of risks that may endanger accomplishment of set up operation goals will be made. On the basis of possible risk analysis, internal controls will be founded proportional to the amount of risk. A head of the spending unit will take decision on ex ante, ongoing and ex post controls taking into account the needs, type of operation and risk analysis results in a due course.

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To be successful in implementing the PIFC system in Montenegro, it is necessary to organize appropriate training for the persons in all institutions on both state and local levels, who will be in charge of establishment and development of this system.

In the first phase, the PIFC system will be presented to the managers of all institutions of the public sector.

In the second phase, the training will be provided for the managers of sectors, those employed in financial-accounting services and afterwards, for other relevant staff on the state level.

In the third phase, the training will be organized for the heads of sectors, the persons employed in financial-accounting services and afterwards to other relevant staff on the local level.

For the successful enforcement of this decision, it is necessary to provide technical support (Twinning project) of foreign consultants who have a broad experience in this area.

5.3. Development of decentralized internal audit

Considering that independent internal audit is one of the elements of the PIFC, institutions of the public sector will be obliged to establish functionally internal audit units which will carry out an independent, professional and systematic assessments by management established the FMC system. This will include auditing of all functions and processes of operation and controls established with the budget users, proposal of measures, and giving of recommendations on the FMC system improvements, monitoring of activities on elimination of the problems observed, shortfalls and omissions in operation, as well as giving advices to management in the area of risk assessment and management.

Internal auditor is free to chose the type of audit depending on a goal which is to be acheived by an audit. After completing of audit, internal auditor discusses about his findings and recommendations with the responsible head of organization whose activities were subject to auditing, in order to provide a good communication and cooperation in enforcement of recommendations. The final report is submitted to head of organization who is, at the same time, responsible for enforcement of recommendations.

The Internal audit units within the institutions in the public sector will be reporting to managers directly to provide for objective assessments of the established FMC system. Organizational positioning of the internal audit units will be very important in order to make them independent in their work, so that by their organization, they will not be a part of any operation process or organisation, and will report on their work exclusively to the manager of the institution. They will be functionally independent so that managers whose activities are subject to auditing cannot negatively influence their work.

The establishment of the internal audit units will depend on criteria that will be proscribed by the Minister of Finance. The criteria to be taken into account when establishing the units may be as follows: financial resources available, degree of risk exposure of the budget user, number of programs, organizational structure and number of employees, specific quality of operation of a budget user.

The establishment of internal audit with the budget users will be carried out in one of the following ways:

- a) by the establishment of an independent unit within the budget organisation which will report directly to the manager of the institution.
- b) By the establishment of a common unit for internal audit on the proposal of a group of budget users - to be previously approved by the Minister of Finance;
- c) By an agreement made with the parent body or other authority or local government unit, on carrying out of internal audit, with previous consent of the Minister of Finance.

In the budget users in which the forming of internal audit units are not justified, internal audit would be carried out in one of the above stated manners (under items b and c).

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The development of decentralized internal audit in the RM will begin after the Government of the RM adopts the development strategy of public internal financial control .

After adoption of the PIFC law, which will specify obligations of funding internal audit with budget users, a number of a larger budget users on the state level will be determined (exp. Ministry of Finance, Ministry of Education and Science, Ministry of Health, Labour and Social Welfare, Ministry of Culture, Sports and Media, Pension and Disability insurance fund of the Republic, Health Fund of the Republic) in which **pilot exercises** of decentralized internal audit will take place. Thus, the managers of those institutions will determine employees who will be involved in internal audit and will inform either the Ministry of Finance or the CHU .

Further development of internal audit with the budget users will follow in phases:

Phase I will include training of internal auditors of larger budget users on the state level which, based on the law and secondary legislation will have established independent internal audit units. In this phase, these subjects will make amendments to the rulebook on organization and systematization and establish appropriate units for internal audit also assigning the employees who will be involved in the training program for internal audit.

Phase II will include training of the internal auditors with other budget users on the state level that will have established an internal unit based on one of the ways referred to in point 5.3.

In **phase III** the internal auditors involved in the local self-government will be trained.

For successful implementation of decentralized internal audit through all the above stages, it is necessary to obtain expert assistance which will include strengthening of administration capacities of the CHU and the Ministry of Finance and training of employees engaged as internal auditors with all budget users which are obliged to establish independent internal audit units.

5.4. Establishment of Central Harmonisation Unit

The third component of the public internal financial control (PIFC) is the request for establishment of a central harmonization unit for financial management and control (FMC) and internal audit (IA) methodologies.

Considering that by the Decree on amendments to the decree on organization and manner of work of the public administration, which was issued at the end of 2006, the Ministry of Finance has been made responsible for the development of the systems of internal financial controls in the public sector in accordance with international standards, the amendments to the Rule book on internal organization and systematization of the Ministry of Finance will be adopted by the second quarter of 2008, by which the Sector for internal audit of the Ministry of Finance will be transformed into the Sector for Public Internal Financial Control as a central harmonization unit consisting of two departments: the Department for Harmonization of Financial Management and Control and the Department for Harmonization of Internal Audit. This sector will be in charge of performing activities of the development of centralized coordination and harmonization of the public internal financial control (FMC and IA).

Department for harmonization of financial management and control will be in charge of the: adoption, development and adjustment of methodology for financial management and internal control in the public sector in compliance with EU best practice; preparation and development of a manual for financial management and internal control; giving advice and instructions relating to implementation of recommendations of internal audit; training of managers and officers who are responsible for financial management and control; preparation of consolidated annual report on the activities related to the FMC in the public sector, for submission to the Government of RM .

Department for harmonization of internal audit will be responsible for: announcements of standards and development of methodology of work of internal audit, evaluation of the standards applied, organization of training for internal auditors, collection, analysis and consolidation of the strategic and annual plans of the internal audit units, preparation of consolidated Annual report on

the activities of internal audit units based on analysis of internal audit findings and material recommendations of the budget users, which is to be submitted to the Government of RM.

The CHU will be in charge of preparing training program for both, the FMC and internal audit. In the starting phase, training would be conducted by foreign experts through twinning project, and latter on, the possibility of involving outside institutions would be considered (universities and professional associations in the area of accounting and auditing).

5.5. Management and control of EU funds.

In addition to the core purposes of the EU pre-accession funds (namely IPA) it is equally important to prepare the candidate and potential candidate countries for the management of the EU support by the time of their accession. The basic philosophy in the management of the EU funds is coherent with the general principles of sound financial management and therefore the framework of PIFC provides for important structures and rules for ensuring transparent and accountable financial management.

In the context of the EU funds management, it is expected from the potential candidate countries to prepare their structures and administration for decentralised management of IPA. Among the first decisions in the process is to designate the structures foreseen in the IPA regulation³:

NIPAC (National IPA coordinator) with appropriate service - NIPAC has a key role in programming coordination, appropriation of program funds, determination of priorities, monitoring and evaluation;

Certified Accrediting Officer (CAO) and the **Audit Authority**. The CAO has a role in accrediting the National Fund and the National Authorising Officer. The Audit Authority has a role in monitoring and auditing of the management and control systems of IPA;

National fund, led by the National Authorising Officer (NAO) - national coordinator of the financial management of EU assistance. National Fund is the unit through which EU finances will be channelled to beneficiary country;

Implementing Agency for IPA components (e.g. Central Financing and Contracting Unit), led by Programme Authorizing Officer – PAO, who is in charge of tendering, contracting and financial control and payments, especially for capacity building programs (Component 1 of IPA);

Senior Programme Officers - SPO who is in charge of management and implementation of the more technical project activities within the line ministries (incl. determining assistance needed, making of term of reference, monitoring of implementation).

Based on the inter-ministerial discussions it is likely that both the National Fund and the Central Financing and Contracting Unit (Implementing Agency for IPA component 1) will be established in the Ministry of Finance. The internal auditors in the department for central internal audit in the Ministry of Finance will be trained and authorized to carry out audits also in the case of programmes financed under IPA. It is likely that the functions of the Audit Authority will be carried out by the Ministry of Finance. During the preparations for IPA, it is important to decide and elaborate detailed procedures for carrying out audits over the IPA programmes (including the cooperation procedures between the Audit Authority and the internal audit departments in ministries). The development of the system of internal audit in the government of Montenegro will support also the development of audit capacities for IPA.

Concerning the management and control of the EU (IPA) funds, the Republic of Montenegro will apply the same principles and standards in the system of financial management and control and internal audit to all budgetary funds. The decentralised management of IPA funds will become one of the “testing grounds” for the initiatives foreseen in the PIFC strategy.

The Rulebook on internal organization and systematization of the Ministry of Finance will be subject to amendments to reflect changes arising from the use of the EU funds e.g. to allow for

³ Council Regulation (EC) No 1085/2006 of establishing an Instrument for Pre-Accession Assistance

establishment of the relevant structures as foreseen in the IPA regulation (the National Fund, the Central Financing and Contracting Unit, the Audit Authority).

More importantly, the preparations for the decentralised implementation system (DIS) mean that for the management of IPA programmes, clear and detailed procedures, templates and checklists shall be prepared in all key control areas. In this area, it is also important to ensure a good control environment beginning with a management philosophy that supports the principles of sound financial management⁴.

5.6 Development of controls/ procedures relating to fraud and irregularities

One of the development goals of the public internal control system should be the prevention of fraud and serious irregularities. Thus the law needs to provide that Heads of organisations shall report to Ministry of Finance and other appropriate authorities on the measures undertaken to prevent, monitor and take actions against the risk of fraud, serious irregularities and corruption, in respect of both the EU and national budgets, and to introduce rules and procedures for preventing, detecting, reviewing, reporting and documenting all such occurrences and also for appointment of persons who will be in charge of irregularities and who will obtain information on irregularities and on suspicions of frauds and autonomously take activities against such occurrences.

⁴ For further details please see the Roadmap for the decentralised implementation system for IPA programmes in the Republic of Montenegro (being developed by the Secretariat for European Integration)

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6. Action plan for implementation of the Strategy

R.br.	Description of activities	Competence	Deadline
A) COMMON ACTIVITIES			
1.	Drafting of the Law on public internal financial controls which will cover managerial accountability, financial management and control and internal audit in the public sector of Montenegro also including methodology, standards, relationships and responsibilities, reporting and the competences of the Ministry of Finance and other authorities in conducting public internal financial control system .	Ministry of Finance/ to request expert support of SIGMA	January-September 2008.
2.	Amendments to the Rulebook on internal organisation and systematization of the Ministry of Finance by which the existing Sector for Internal audit will be transformed into the Sector for Public internal financial control (Centralized harmonization unit with two departments) and independent department for internal audit of MoF will be established.	Ministry of Finance	January-June 2008.
3.	Drawing up secondary legislation relating to application of the Law on Public Internal Financial Control System.	Ministry of Finance - CHU – possible request of SIGMA support	January-June 2009.
B) ACTIVITIES RELATED TO INTERNAL AUDIT			
1.	Development of manual on carrying out of internal audit.	Ministry of Finance-CHU/ possible SIGMA input - to be requested (Twinning project)	January-June 2009
2.	Drawing up the Charter on internal audit by which auditors competences, rights and obligations to be imposed over each internal audit unit and auditors, will be determined. The charter will emphasise and ensure functional independence of the internal auditors and mutual relationships between an auditing subject and internal audit unit.	Ministry of Finance-CHU/ require expert support (Twinning project)	January -June 2009.
3.	Amending the Rulebook on internal organisation and systematization of budget users on the state level and establishment of internal audit units	Budget users on the state level with CHU support	June 2009-June 2010.
4.	Amendments to the Rulebook on internal organization and systematization with budget users on the local level and the establishment of internal audit units	local self-government authorities	January-December 2010.
5.	Creation of a training program for education of internal auditors	Ministry of Finance/CHU and requesting of expert support (Twinning project)	January-May 2009
6.	<ul style="list-style-type: none"> - Pilot exercises of internal audit with selected budget users on the state level - Training of internal auditors of the budget users on the state level who will be covered by development Phase I - Training of internal auditors of the budget users on the state level who will be covered by the 	Ministry of Finance-CHU/ expert assistance to be requested (twinning project)	<p>June-December, 2009</p> <p>June-December 2010</p> <p>December 2010-June 2011</p>

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	<p>development phase II</p> <ul style="list-style-type: none"> - Training of internal auditors of the budget users on the local level - Continuous training of internal auditors of all budget users on the state and local levels and drawing up of curricula for internal audit certification 		<p>June 2011-June 2012</p> <p>Starting from 2013</p>
C) ACTIVITIES RELATED TO MANAGERIAL ACCOUNTABILITY AND FINANCIAL MANAGEMENT AND CONTROL			
1.	Amending the Rulebook on internal organisation and systematization of budget users for establishment of adequate managerial accountability/FMC	All budget users on both state and local level with CHU support	June 2009-June 2010
2.	Development of the manual for managerial accountability/ financial management and control.	Ministry of Finance-CHU/ an expert support should be requested	June –December, 2009
3.	<p>Preparation of the written procedures for the existing operational processes</p> <ul style="list-style-type: none"> -with selected pilot institutions - all budget users 	Budget users with CHU support - to request expert support (Twinning project)	<p>January-June 2010</p> <p>From June 2010 to be continued</p>
4.	Development of training program for training of managers and employees in charge of FMC with the budget users.	Ministry of Finance-CHU asking for expert support (Twinning project)	September-December 2009
5.	<p>Training for managerial accountability and financial management and control:</p> <ul style="list-style-type: none"> - managers and employees on the state level; - managers and employees on the local level - continuous training 	Ministry of Finance-CHU- to request expert support (Twinning project)	<p>From January 2010</p> <p>From January 2011</p> <p>From 2012</p>