



REPUBLIC OF CROATIA
Government of the Republic of Croatia
Ministry of Finance

**INDEPENDENT DEVELOPMENT STRATEGY OF
PUBLIC INTERNAL FINANCIAL CONTROL (PIFC)
IN THE REPUBLIC OF CROATIA**

for Local and Regional Self-government Units

Developed in co-operation with experts of CARDS 2004 Project "Strengthening the Public Internal Financial Control Structure in the Republic of Croatia"

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LIST OF ABBREVIATIONS AND ACRONYMS

AFCOS	Anti Fraud Co-ordinating Structures
CARDS	Community Assistance for Reconstruction, Development and Stabilisation
CFCU	Central Finance and Contracting Unit
CHU	Central Harmonisation Unit
COSO	Committee of Sponsoring Organisations of the Treadway Commission
CODEF	Central State Office for the Development Strategy and the European Union Funds Co-ordination
EC	European Commission
EU	European Union
FMC	Financial Management and Control
IA	Internal Audit
IIA	Institute of Internal Auditors
INTOSAI	International Organization of Supreme Audit Institutions
IPA	Instrument for Pre-accession Assistance
ISPA	Instrument for Structural Policies Pre-Accession
NAO	National Authorising Officer
NF	National fund
OLAF	<i>Organisation de Lutte Anti Fraude</i>
PHARE	Programme of Community Aid to the Countries of Central and Eastern Europe
PIFC	Public Internal Financial Control
SAB	State Administration Bodies
SAPARD	Special Accession Programme for Agriculture and Rural Development
SIGMA	Support for Improvement in Governance and Management

1. Summary

On 15 June 2005, the Government of the Republic of Croatia passed the Development Strategy of Public Internal Financial Control (PIFC) in the Republic of Croatia. The Strategy identified the activities and tasks to be performed within the framework of the internal financial control system. Since the activities and tasks referred to in the Strategy were mainly completed and given the fact that a new Public Internal Financial Control Law¹ was passed in late 2006, a need for updating and supplementing the existing Strategy to fit in the new activities and tasks arose. Therefore, on 5 April 2007, the Government of the Republic of Croatia passed the Action Plan for the Establishment and Development of the Public Internal Financial Control System in the Republic of Croatia by end-2008 (hereinafter referred to as the Action Plan).

The said Strategy and the Action Plan determine all what has to be done in relation to internal financial controls at the government level.

Since the internal financial control system should also be established and developed at local levels, there is a need to also pass this system's establishment and development strategy for local levels. This stems from the provisions contained in the Public Internal Financial Control Law (hereinafter referred to as the Law) and provisions found in the Negotiation Position of the Republic of Croatia for the Intergovernmental Conference on the Republic of Croatia's Accession to the European Union for Chapter 32 – Financial Control, dated December 2006.

For these reasons, it was decided to proceed with the production of the Development Strategy of Public Internal Financial Control in the Republic of Croatia for Local and Regional Self-government Units, providing for the activities and tasks which must be achieved until end-2010.

The purpose of the policy paper on internal financial control is to set forth key elements on the current state-of-play and on the development of a strategy aimed at establishing and developing a comprehensive and efficient internal financial control at local levels, i.e. with the local and regional self-government units in the Republic of Croatia.

Internal financial control will be continuously developing on both central government and local levels in keeping with the requirements of the European Union, international standards and best practices as found in the European Union.

Additionally, this policy paper defines the activities of the Ministry of Finance's Central Harmonisation Unit relative to the internal financial controls establishment and development. The Ministry of Finance will be in charge of updating and supplementing the policy paper in line with the development and the requirements of local and regional self-government units.

Based on this policy paper, regional self-government units may pass development strategies of internal financial control for their respective territories (counties), taking account of the needs and activities of each local unit belonging to the respective territory.

¹ Republic of Croatia's Official Gazette *Narodne novine* 141/06

This policy paper provides a description of the current state-of-play, i.e. the legislative and institutional frameworks and of the activities undertaken in respect of Public Internal Financial Control in the Republic of Croatia.

There are separate explanations of the current state-of-play for central government and local levels, i.e. the paper contains a description of the overall control environment within which the system is being established and developed. The paper contains a thorough description of both internal financial control system's components, i.e. Financial Management and Control and Internal Audit with their respective relevant features.

The weaknesses of the existing system were also described, as well as the activities to be undertaken in the establishment of Financial Management and Control and Internal Audit in local and regional self-government units.

The policy paper indicates the scope of competence and tasks of the Central Harmonisation Unit and of the Public Internal Financial Control Council, as well as the assignments falling under the scope of the State Audit Office.

Additionally, the document provides a short overview on the pre-accession aid funds aimed at preparing the Republic of Croatia's accession to the European Union, whereas the document closes with a timeframe for the activities pertinent to the development of the internal financial control system at local level by end-2010.

2. Introduction

The Public Internal Financial Control system (hereinafter referred to as PIFC) encompasses a portion of the *acquis communautaire* principles established by the European Union as an integral and consolidated system of internal financial control for achieving sound management of public resources, irrespectively of their sources.

Just like other candidate countries, the Republic of Croatia was also recommended to adhere to the said principles and to apply all measures necessary for the alignment and development of the regulatory determinants as a vehicle for its alignment with the European Union's *acquis communautaire* and best practice.

The process of alignment with *acquis communautaire* pertaining to internal financial control runs within the framework of Chapter 32 – Financial Control. In addition to internal financial control, this chapter also deals with external audit and the safeguarding of financial interests of the European Union and with the protection of the Euro against counterfeiting.

In respect of Chapter 32 – Financial Control, on 20 April 2004 the European Union published a document titled "Opinion on Croatia's Application for Membership of the European Union", making the following conclusion:

"Croatia needs to develop general policies and a coherent legislative framework in this field. Administrative capacities, including functionally independent internal audit units in State institutions, have to be established or reinforced and relevant staff trained. The State Audit Office has the legal and organisational basis to develop further into an appropriate external audit body but needs to be strengthened.

"In the area of control over EU funds, efficient mechanism for monitoring, controlling and auditing of EU funds will need to be developed. In addition, Croatia's administrative capacity to give effective and equivalent protection to the EC's financial interests will need to be ensured.

"Provided Croatia makes further efforts to reorganise and strengthen its public internal financial control, external audit and anti-fraud capacities, it should be able to meet EU requirements in this field in the medium term."

Chapter 32 – Financial Control was opened on 26 June 2007 and the European Union's Council passed the common negotiation position, indicating a total of five benchmarks to be met for the closure of this chapter.

One of the benchmarks pertains to the system of internal financial controls, which obliges us to adopt and implement all regulations providing for this field. Since this stands as an obligation of ours as per the Law, this benchmark will be implemented on an ongoing basis and there should be no obstacles with regards to the closure of the chapter in the relevant field.

In the European countries, Public Internal Financial Control is commonly known as PIFC:

P – Public – pertaining to the public sector;

- I – Internal** – an organisationally internal system;
- F – Financial** – pertaining to the financial and all other resources alike;
- C – Control** – pertaining to all types of controls.

The public internal financial control system is a comprehensive system of financial and other controls put in place by the User of Budget Heads and aimed at achieving successful management and accomplishment of the User of Budget's assignments.

The system of internal financial controls which has to be established and developed in the Republic of Croatia's public sector comprises the following elements:

- **Financial Management and Control;**
- **Internal Audit; and**
- **Co-ordination and harmonisation of the overall system of internal financial controls carried out through the Central Harmonisation Unit, i.e. the Ministry of Finance's Department for Harmonisation of Internal Audit and Financial Control (hereinafter referred to as the Central Harmonisation Unit).**

Covering Financial Management and Control and Internal Audit, the principles underlying the internal financial control system do not pertain to national funds only, but rather to the European Union's funds as well in order to fully protect both one's own financial interests, as well as those of the European Union.

It has to be noted here that the internationally recognised standards and the European Union's best practice in this field will be employed in the establishment and development of this system.

The Government of the Republic of Croatia adopted the first Development Strategy of Public Internal Financial Control in 2004, whereas in June 2005 it adopted an improved and expanded Development Strategy of Public Internal Financial Control (PIFC) in the Republic of Croatia (hereinafter referred to as the Strategy), which is relevant for the central government level. The Strategy went about defining the activities to be undertaken in this field, and the set activities were fulfilled. For this reason, on 5 April 2007, the Government of the Republic of Croatia has passed the new Action Plan for the Establishment and Development of Public Internal Financial Control System in the Republic of Croatia until end-2008. The Action Plan determines activities, their holders and the deadlines within which the planned activities are to be undertaken.

Since the Action Plan and the Strategy pertained to central government only, it was necessary to bring forth a new Strategy, which would define duties and activities relative to the establishment of this system at local levels as well. This also stems from the provisions contained in the Law, prescribing the obligations in terms of establishing and developing Financial Management and Control, including a functionally independent Internal Audit with users of budget, both centrally and locally.

During the course of the local level strategy making, one must take account of the European Charter of Local Self-Government² and of the Conclusion on the Acceptance of and Adherence to the Principles and Institutes (provisions) of the European Charter of Local Self-

² *Narodne novine*, International Agreements 19/97 and 2/07

Government³ which specifically emphasises autonomy and independence of local self-government.

Consequently, the passage of this Strategy will also lay down rights and duties of the Ministry of Finance's Central Harmonisation Unit in relation to local self-government and in respect of establishing and developing the systems of internal controls, without interfering with their independence.

In order for the Strategy to meet all required criteria, the Minister of Finance appointed a working group for its passage. In addition to the representatives of central government authority, the working group membership includes representatives of local and regional self-government, who will play a significant role in the Strategy passage procedure. In addition to the representatives of local and regional self-government and of the Ministry of Finance, the working group includes representatives from the State Audit Office, the City of Zagreb – Republic of Croatia's capital and the largest city and the representatives of CARDS 2004 Project "Strengthening the Public Internal Financial Control Structure in the Republic of Croatia" (hereinafter referred to as CARDS 2004 Project).

Similarly, during the passage procedure the Strategy was forwarded to all counties (20) and county centres (20), which had an opportunity to express their opinions, i.e. to provide comments and suggestions for the purposes of this document.

During the course of procedure, all ministries and other interested state bodies directly linked with this field also provided their comments and suggestions to the Strategy.

The purpose of this Strategy is to set forth key elements on the current state-of-play and on development strategy for the establishment and development of an integral and efficient internal financial control at local levels, i.e. for the decentralised public sector functions in the Republic of Croatia.

2.1. Current State-of-Play

With the passage of the Public Internal Financial Control Law in December 2006, the Ministry of Finance became a body in charge of co-ordination of the establishment and development of this system. The Ministry of Finance's Central Harmonisation Unit is in charge of implementing this co-ordination.

However, even before the passage of the Law, the Ministry of Finance already commenced the Public Internal Financial Control system development efforts. This was done on the basis of the provisions contained in the Law on Organisation and Scope of Competence of Central State Administration Bodies⁴ and the Decree on Internal Organisation of the Ministry of Finance⁵ and in keeping with the European Union practice and with assistance and financial support provided by the European Union via two projects, including CARDS 2002 "Development of PIFC and Internal Audit" and CARDS 2004 "Strengthening the Public Internal Financial Control Structure in the Republic of Croatia".

3 *Narodne novine*, International Agreements 1/93

4 *Narodne novine* 199/03, 30/04, 136/04, 22/05 and 44/06

5 *Narodne novine* 43/05, 114/05, 14/06 and 138/06

The Ministry of Finance has been providing co-ordination of the overall system establishment process since 2005. With the view of providing support to the establishment of the system, it makes methodological instructions and guidelines available, brings forth implementing regulations, assists in institutional building and carries out training for internal auditors and people involved in financial management and control.

In addition to the role of the Ministry of Finance's Central Harmonisation Unit in the establishment of this system, it is necessary to highlight the importance of the user of budget heads, i.e. the ministers and other officials, who bear the responsibility for the use and management of public funds and for decision-making in public administration.

While a user of budget head may delegate his/her authorities and responsibilities for the establishment, development and implementation of this system to other persons, the ultimate accountability for attaining operability of the internal financial control system always rests with the responsible ministers, heads of other government institutions and other managers.

Therefore, it is necessary to keep raising heads' awareness of the need for introducing the internal financial control system and its functioning in the public sector. If the heads grow to appreciate and understand the need for establishing this system and if they attach certain value and significance to internal controls, all other employees also will appreciate the necessity for and indispensability of internal controls and will respond by conscientiously observing the set controls.

2.1.1. Legal Framework for Introducing Internal Financial Controls

The passage of the Law led to meeting one of the core requirements of the European Commission set for this field. However, even before the Law was passed, the Republic of Croatia already established a regulatory framework necessary for the establishment and development of this system.

Before the new Law was passed, the legal framework for the establishment of this system was found in the Budget Law⁶, especially when it comes to internal audit. This Law prescribed that users of budget were obliged to establish internal audit, as well as the core internal audit tasks.

The Budget Law set forth that the Minister of Finance would pass the Internal Audit Rulebook to prescribe the conditions and criteria for the performance of internal audit affairs and to provide for its establishment. This was completed in August 2004.

In addition, on 2 September 2004, the first Development Strategy of Public Internal Financial Control (PIFC) was passed, which stood as the first regulatory framework for the establishment of all activities from this field. These activities were achieved, as follows:

- The Development Strategy of Public Internal Financial Control (PIFC) was updated and improved, and the Government of the Republic of Croatia has passed it as at 15 June 2005;

⁶ *Narodne novine* 96/03

- On 5 April 2007, the Government of the Republic of Croatia has passed the Action Plan for the establishment of this system, indicating the activities to be undertaken by end-2008, since the activities from the 2005 Strategy were completed;
- In December 2005, the Minister of Finance brought forth the Budget Users' Internal Audit Rulebook⁷;
- The Internal Auditors' Manual was produced during the course of 2004 and updated and improved in mid-2005 to include the "European Union Funds Auditing" and "Risk Management" sections as its integral parts;
- Produced jointly with the CARDS 2004 Project experts, the Financial Management and Control Manual was passed in June 2007 and distributed to all ministries and government bodies. This manual is also available on the Ministry of Finance's website as a tool for all interested in this field;
- In May 2005, the Government of the Republic of Croatia passed the Ministry of Finance's Central Finance and Contracting Unit and the National Fund Internal Audit Capacity Action Plan for carrying out audits of the pre-accession funds;
- The Professional Code of Ethics was passed in August 2005;
- A template Internal Auditors' Charter also was produced in 2005 and distributed to all users of budget in order to provide for relationship between internal auditors and user of budget heads in a harmonised fashion;
- In August 2005, the Minister of Finance passed the Programme for Professional Training and Passing the Exam for Acquiring the Profession of a Certified Public Internal Auditor and the Instruction of the Check of Knowledge and Abilities and the Passage of Exam for Acquiring the Profession of a Certified Public Internal Auditor;
- In March 2007, the Minister of Finance passed the new Programme and Instruction, also pertaining to professional training of internal auditors;
- In March 2007, the Minister of Finance passed the Financial Management and Control Training Programme;
- In January 2006, the 2006-2007 Internal Auditors' Training Plan was passed, planning the training of internal auditors candidates at both central and local levels;
- In December 2005, the Government of the Republic of Croatia appointed the Internal Audit Council at a proposal of the Minister of Finance for the purpose of directing the establishment and strengthening the development of the internal financial control system;
- The Internal Financial Control Council, replacing the Internal Audit Council, was appointed by the Government of the Republic of Croatia as at 9 March 2007, also at the Minister of Finance's proposal⁸;

⁷ *Narodne novine* 150/05

⁸ Council Appointment Decision published in *Narodne novine* 27/07

- The Internal Audit Council discussed the Consolidated Republic of Croatia Public Internal Financial Control Report for 2005, and the Government of the Republic of Croatia adopted it in April 2006;
- The Internal Financial Control Council discussed the Consolidated Republic of Croatia Public Internal Financial Control Report for 2006 as at 10 May 2007 and the Government of the Republic of Croatia adopted it as at 16 May 2007, coupled with reaching certain conclusions which were forwarded to all competent bodies.

Internal financial control in the Republic of Croatia is founded upon abundant regulatory groundwork and most of the provisions contained in the said regulations and enactments equally pertain to both central and local government levels.

2.1.2. Institutional Framework for the Internal Financial Control Establishment

a) at central government level

The internal financial control systems in the Republic of Croatia have been established within the framework of various institutions in state administration bodies. There, financial controls cover procedures falling under the respective scopes of individual government bodies. The main institutions within which financial and other forms of controls are being exercised include the following:

- Croatian Parliament;
- Government of the Republic of Croatia;
- State Audit Office;
- Ministries and other state administration bodies;
- Ministry of Finance (which includes the operation of the Customs Administration, the Tax Administration, the Financial Police, the Budget Supervision Division in the State Treasury);
- Public Procurement Office;
- Commission for Control of Public Procurement Procedures;
- Government Office for Internal Audit;
- Central State Office for Government Asset Management;
- State Inspectorate;
- Extra-budgetary institutes, i.e. funds (pension, health, employment) and other.

Various organisational forms lodging the controlling and inspection systems may be found in the said institutions and state administration bodies.

One of the assignments the Central Harmonisation Unit should have would refer to checking and the alignment of the legal regulations providing for the controlling functions, in order to avoid overlapping of individual controlling and inspection remits with that of internal audit.

These institutional forms, i.e. the institutions and government bodies were described in detail in the Strategy pertaining to the central government level, for which reason there will be no repetition of their activities' description in this local level Strategy.

b) at local level

Local and regional self-government stands as one of the main cornerstones of any democratic system. One of the democratic principles common to all European Union member-states refer to the right of the citizens to take part in locally important public matters. This right may be exercised most directly manner at local level, where the existence of local units enables and achieves efficient and effective management close to the citizenry.

A stronger local self-government represents a strong contribution in building the EU member-states on the principles of democracy and decentralised authority.

The local self-government implies the right of and the possibility for local units to define and manage public matters within the legally provided framework, while retaining their own responsibility and acting in the interest of their respective citizenries.

The local and regional self-government system was laid down in the Constitution of the Republic of Croatia as of 22 December 1990.⁹ The Constitution of the Republic of Croatia, the acceptance of the principles contained in the European Local Self-Government Charter and the Law on Local and Regional Self-Government¹⁰ created the legal framework for the development of local and regional self-government and their greater independence in the Republic of Croatia.

The Law mentioned above provides for local self-government units (municipalities and cities) and regional self-government units (counties), as well as for their respective scopes of competence and organisation, manner in which their bodies operate, supervision over their enactments and work and other issues of importance for their work.

Organisation and scope of work of local and regional self-government units' bodies was provided for by the Statute, as laid down in the said Law. In the performance of local matters, the local self-government units' bodies act autonomously, i.e. they operate in keeping with the Law and the Statute and are subject only to the supervision of legality carried out by authorised government bodies.

Some state administration dealings may be legally delegated to become an integral part of the scope of work of local self-government units' bodies. In the performance of such dealings, local self-government units' bodies act as the state administration bodies' subordinates.

The Republic of Croatia has a total of 20 counties, 126 cities, 429 municipalities and the City of Zagreb as a separate and unique territorial and administrative unit, whose organisation was laid down in a separate Law on the City of Zagreb.

The counties, cities and municipalities are legal persons. These units have been established by the Law on the Areas of Counties, Cities and Municipalities in the Republic of Croatia¹¹ and may be founded, terminated and altered solely through a law, i.e. they cannot be altered or terminated through a bylaw or another enactment.

9 *Narodne novine* 56/90

10 *Narodne novine* 33/01, 60/01 – statutory interpretation and 129/05

11 *Narodne novine* 86/06

Municipalities, cities and counties have their respective Statutes which provide more thoroughly for the self-governance scope of a municipality, a city or a county, coupled with their characteristic, public acknowledgements, organisation, authorities and the manner of bodies' work, the manner of performing affairs, forms of consultations with citizens, carrying out referenda on issues falling under their scopes, the community self-government, organisation and work of public services, forms of co-operation between local or regional self-government units, and other issues of importance for exercising rights and discharging duties.

The municipal councils, city councils and county assemblies act as the representative bodies of the citizens and of local and regional self-government units' bodies. They pass enactments falling under the scope of competence of the respective local and regional self-government units, and carry out other matters in keeping with the Law and the Statute of the given local or regional self-government unit. The executive bodies of local self-government units include the Municipality Head and the Municipality Government in case of a municipality and the Mayor and the City Government in case of a city, whereas the executive bodies of regional self-government units are the County Prefect and the Prefecture.

Administrative departments and services were put in place for the performance of matters falling under the self-governance scope of local and regional self-government units, as well as for the performance of state administration matters delegated to these units.

Counties

A county is a regional self-government unit. Its territory represents a natural, historical, transport, economic, social and self-governance whole. The counties are established to carry out matters of regional interest.

Counties perform matters of regional importance, especially those referring to:

- Economic development;
- Transport and transport infrastructure;
- Education;
- Public health;
- Physical and urban planning;
- Public roads maintenance;
- Planning and developing a network of educational, health, social and cultural institutions;
- Issuing building and location permits, other enactments relative to land development and to the implementation of physical planning documents for the county territory outside the limits of a large city territory; and
- Other matters in keeping with special laws.

The county territories were defined by a list of municipalities and cities constituting the respective county territories, i.e. the counties comprise several municipalities and cities as legal persons completely autonomous in relation to the counties they territorially belong to.

Additionally, the counties partially perform matters falling under the scope of state administration. These matters have been delegated to the counties on the basis of special laws. They also run some matters from the self-governance scopes of municipalities and cities,

which matters were delegated to a county on the basis of a decision made by the representative body of the given local self-government unit (municipality or city).

Cities and Municipalities

A city is a local self-government unit which seats a county administration and any settlement with population greater than 10,000 and representing an urban, historical, natural, economical and social whole.

In its composition as a local self-government unit, a city may also include the adjacent suburban settlements. This is the case when the latter make an economical and social whole together with the urban settlement and are linked with it through daily commuting and the locally important daily needs of the citizens.

A municipality is a local self-government unit, which is essentially being founded for a territory comprising several inhabited settlements representing a natural, economical and social whole and which are interconnected through common interests of the citizens.

In their self-governance scopes, cities and municipalities perform matters of local significance, pertaining to:

- Settlement layout and housing;
- Physical and urban planning;
- Communal activities;
- Child care;
- Social welfare;
- Primary health care;
- Upbringing and elementary education;
- Culture, recreation and sports;
- Consumer protection;
- Protection and improvement of the environment;
- Fire fighting and civil defence;
- Transportation in the given area; and
- Other matters in keeping with special laws.

Special laws provide for individual activities that cities and municipalities must organise and those matters that a local self-government unit may perform, providing it ensured the necessary conditions.

Large cities are local self-government units, which at the same time stand as economical, financial, cultural, health, transportation and scientific centres of development of the broader environment and which have the population greater than 35,000. In addition to the matters from their respective scopes, large cities and those cities which seat county administrations may perform matters falling under the scope of counties.

The state administration matters performed in local self-government units and regional self-government units are being provided for by the law. The costs of performing the state administration matters transferred to the bodies of local and regional self-government units

are being covered from the State Budget. The Law providing for the work of state administration more thoroughly sets forth the rights and duties of local and regional self-government units' bodies in carrying out the state administration matters.

The City of Zagreb

The Law on the City of Zagreb¹² and the Law on Local and Regional Self-Government provide for the status, scope and organisation of the City of Zagreb. Pursuant to the Law, the Statute of the City of Zagreb¹³ provides for the self-governance scope of competence, characteristics, public acknowledgments, organisation, authorities and manner of work of its bodies, forms of direct decision-making by citizens, co-operation with other local and regional self-government units and other matters of importance for exercising the rights and discharging the duties of the City of Zagreb.

The City of Zagreb's organisation includes, as follows:

1. **The City of Zagreb Assembly** as the representative body of the citizens of the City of Zagreb;
2. **Executive bodies of the City of Zagreb** comprising the Mayor of the City of Zagreb and the City of Zagreb Government. The Mayor acts on behalf of and represents the City of Zagreb and is the holder of the executive matters in the City of Zagreb;
3. **Administrative bodies** performing the matters falling under the self-governance scope of the City of Zagreb and the state administration matters. The administrative bodies are managed by the Heads of the City Offices. For the matters falling under the City of Zagreb self-governance scope, they report to the Mayor and the City Government. For the state administration matters, they report to the Mayor who in relation to them bears the authorities of a State Administration Office's Chief in a regional self-government unit;
4. **Community self-government**, i.e. city neighbourhoods and community committees.

The City of Zagreb performs matters falling under both city and county scopes of competence.

The city administrative bodies of the City of Zagreb have duties same to those of the state administration bodies', in keeping with the law providing for the state administration system. They carry out matters falling under the state administration scope of competence with the given regional self-government unit, as well as other state administration matters as laid down in the Law.

Within the framework of its self-governance scope, the City of Zagreb ensures the performance of public services by founding city institutions and city companies to meet the everyday needs of the citizens in the fields of communal/utility, social, economic and other activities in accordance with the law.

12 *Narodne novine* 62/01

13 Official Journal of the City of Zagreb 19/99, 19/01, 20/01 – official version, 10/04, 18/05, 2/06 and 18/06

2.1.3. Financing the Local and Regional Self-Government Units

Financing of local and regional self-government units was provided for by the Law on Financing the Local and Regional Self-Government Units.¹⁴

Local and regional self-government units have their own revenues, which they manage freely within the framework of their self-governance scope. Municipalities, cities and counties which assumed financing of the decentralised functions are being provided with financial resources through the allowance of additional shares in personal income tax and from the state budget (equalisation grants).

The revenues of local and regional self-government units should be commensurate with the matters performed by their respective bodies on the basis of the law.

Units' revenues shall be:

1. Municipal, city and county taxes, surtax, fees, contributions and charges;
2. Revenues from property owned and proprietary rights;
3. Revenues generated from companies and other legal persons owned by the given unit, i.e. those in which the unit holds business interests or shares;
4. Revenues from concession fees, as granted by their representative bodies;
5. Fines and seized economic benefits for violations that they themselves prescribe in accordance with the law;
6. Portions of joint taxes shared with the Republic of Croatia;
7. Aids and grants provided by the Republic of Croatia, as planned in the State Budget;
8. Other revenues prescribed by the law.

County taxes are: inheritance and gifts tax, tax on motor vehicles, boats and vessels tax and tax on gaming slot machines.

Municipal or city taxes:

1. Income tax surtax;
2. Consumption tax;
3. Tax on leisure houses;
4. Tax on uncultivated arable agricultural lands;
5. Tax on unused entrepreneurial property;
6. Tax on undeveloped construction lands;
7. Company name tax;
8. Public surfaces utilisation tax.

Furthermore, counties, municipalities and cities are being financed from the joint tax resources, i.e. the taxes whose fiscal revenue is being shared between the state, municipality, city and county in accordance with the legal regulations in force. These include personal income and conveyance taxes.

¹⁴ *Narodne novine* 117/93, 33/00, 73/00, 127/00, 59/01, 107/01, 117/01, 150/02, 147/03 and 132/06.

2.1.4. Central Government Supervision and Protection of Local and Regional Self-Government

For the purpose of protecting constitutionality and legality, as well as of protecting the citizens' rights, the central government exercises supervision over the legality of work and the enactments of the local and regional self-government units' bodies.

The supervision of the legality of work and enactments of local and regional self-government units is being carried out in the manner and following the procedure as prescribed by the law providing for the state administration system. Supervision of legality of general enactments passed by the representative bodies of counties, cities and municipalities is being discharged by the state administration bodies seated in the respective counties and the competent central state administration bodies, each within their respective remits and in keeping with special laws.

In the performance of the state administration matters transferred to the local and regional self-government units' bodies, a competent ministry may issue orders to a municipality head, a mayor and a county prefect. Should a municipality head, a mayor or a county prefect fail to observe the orders as issued by the competent ministry, the Government of the Republic of Croatia may withdraw the authority for the performance of the transferred state administration matters from the said local and regional self-government units,.

In addition to the aforesaid types of supervision, the Republic of Croatia also has budget supervision in place.

Budget supervision of local and regional self-government units and their respective budgetary and extra-budgetary users is a procedure revolving around supervising the legality in the use of budgetary resources. In respect of the directly or indirectly allocated resources from the state budget, the budget supervision of local and regional self-government units and their respective budgetary and extra-budgetary users is a procedure revolving around supervising the legality, purposefulness and timeliness in the use of budgetary resources. Budget supervision is being performed to check the regularity in the use of budgetary resource, as well as the application of laws and other regulations. The inspection of regularity in the use of budget resources implies seeing whether or not budgetary resources are being used in an amount, for the purposes and within the timeframe as laid down in the budgets of the respective local and regional self-government units.

Budget supervision is being carried out by the Budget Supervision Inspectors employed in the Ministry of Finance's Budget Supervision Division.

3. Public Internal Financial Control

The Public Internal Financial Control Law provides for the system of internal financial controls encompassing Financial Management and Control, Internal Audit and a central unit in charge of co-ordination and harmonisation of the Public Internal Financial Control system in the Republic of Croatia.

The Law sets forth the methodology, standards, relationships and the responsibilities and authorities of the Ministry of Finance and other bodies in the implementation of the Public Internal Financial Control system.

The adopted Law will lead to a full alignment of the Croatian legislation with the European Union's *acquis communautaire* in the field of Public Internal Financial Control.

The Public Internal Financial Control (PIFC) system is a comprehensive system of financial and other controls put in place by the user of budget head and aimed at achieving successful management and the achievement of the user of budget tasks.

Pursuant to the Law, the Public Internal Financial Control system comprises:

- a) **Financial Management and Control (FMC);**
- b) **Internal Audit.**

The Ministry of Finance is in charge of co-ordination of the establishment and development of the Public Internal Financial Control system. Acting as the Central Harmonisation Unit, the Department for Harmonisation of Internal Audit and Financial Control is tasked with the implementation of such a co-ordination.

The User of Budget Head and a person with delegated authority and responsibility are responsible for the establishment, development and implementation of the internal financial control system.

Irrespective of the fact that some authorities and responsibilities have been transferred to other persons, the user of budget head is accountable for the establishment, development and implementation of the internal financial control system.

3.1. Financial Management and Control (FMC)

Financial Management and Control represents a comprehensive system of internal controls put in place by and resting under the responsibility of the user of budget heads. By managing risks, the system provides a reasonable assurance that the budgetary and other resources will be used regularly, ethically, economically, effectively and efficiently during the course of objectives achievement.

This system encompasses all business transactions, especially those related to revenues/receipts, expenses/expenditure, tendering procedures and contracting, recovery of wrongly paid amounts, assets and liabilities. The institution heads and all employees are involved in implementing the internal control system.

Financial Management and Control is being introduced for the purpose of improving financial management and decision-making processes towards the achievement of general objectives, such as:

- a) Carrying out operations in a regular, ethical, economical, efficient and effective manner;
- b) Compliance of operations with laws, regulations, policies, plans and procedures;
- c) Safeguarding of assets and other resources against loss due to mismanagement, unjustified spending and use and against irregularities and fraud;
- d) Strengthening accountability for the successful achievement of tasks;
- e) Timely financial reporting and business results monitoring.

Financial management and control is being implemented in all organisational units and at all levels of a user of budget, whereas the system covers all funds of the user of budget, including the European Union's funds.

It must be pointed out that all users of budget are under obligation to introduce this system, irrespective of their size and the number of employees. Since all users of budget spend the taxpayer monies, they are responsible for the manner in which they use the funds and for the results achieved through such a spending.

3.1.1. Managerial Accountability for the Collection and Use of Public Resources and the Responsibility of the Heads for the Financial Management and Control System Establishment

Pursuant to the provisions contained in Article 7 of the Law, the user of budget head is responsible for:

- a) Establishment of an adequate, efficient and effective system of financial management and control;
- b) Production and implementation of strategic and other plans, as well as of programmes for the achievement of the User of Budget goals and objectives;
- c) Legal, purposeful, efficient, economical and effective disposition of budgetary and other funds;
- d) Definition and achievement of objectives of the organisation, risk management and introducing proper and efficient internal controls in accordance with the provisions of this Law and the international internal control standards;
- e) Establishment of reporting lines in accordance with the transferred authorities and responsibilities;
- f) Competency of all staff concerning the performance of tasks in accordance with financial management and control.

In accordance with other laws, especially the Budget Law, the instructions and guidelines issued by the Ministry of Finance, and in keeping with the principles of sound financial management, user of budget heads and other officials in charge of FMC implementation are responsible for the revenue collection, liabilities settlement and execution of all expenses.

The user of budget head is responsible for the establishment of an adequate, efficient and effective FMC system, as well as for its implementation. The head is also responsible for the implementation of Financial Management and Control via the application of the interrelated components of this system.

The Financial Management and Control components have been defined in line with the INTOSAI guidelines for the public sector internal control standards, as developed by the Public Internal Control Standards Committee of the International Organisation of Supreme Audit Institutions. There represent *acquis communautaire* in this field (Chapter 32 – Financial Control) and have been founded upon COSO¹⁵ model. The internal control standards were structured so as to include five components, i.e. control environment, risk assessment and management, control activities, information and communication, and monitoring and review.

- Control environment stands as the very foundation of the entire internal control system. It ensures discipline and organisation, as well as the climate influencing the overall quality of internal control. It influences strategy making and objective setting, as well as the organisation of control activities. Control environment creates the tone to the organisation, bearing influence to control conscience with the employees. Elements of control environment include personal and professional integrity and ethical values of employees; management and operating style, organisational structure, including the assignment of authorities and responsibilities; human resource management rules and practice; competency of employees.

- Risk management is an overall process aimed at identifying, evaluating and monitoring risks, taking account of the user of budget objectives, coupled with taking necessary actions towards the mitigation of risk. Risk assessment includes risk identification, valuation of risks, risk ranking and the development of risk responses, i.e. putting controls in place. The user of budget head is responsible for the passage of a risk management strategy to annually update risks significant for the operations overall.

- Control activities are founded upon rules and procedures being introduced and implemented to make sure that the objectives would be achieved, i.e. risks managed. They encompass procedures of approval, procedures of delegation of authorities and responsibilities, segregation of duties, double signature system, rules ensuring the safeguarding of assets and information, procedures for complete, accurate, regular and up-to-date recording of all business transactions, human resource management procedures, etc. To be efficient, control activities should be adequate, consistent in their operation according to plans and at all times, cost-effective, comprehensive, reasonable and interrelated with general objectives of the user. The control activities are being carried out organisation-wide, at all levels and in all functions of the user.

- Efficient information and communication is necessary to run and control the operations. Heads should make sure that there is adequate, reliable and timely communication in place relative to internal and external events. Ability to make adequate decisions depends on the quality of information, which implies that information should be adequate, timely, valid, accurate and available.

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- Given that internal control is a dynamic process, which must constantly adapt to risks and changes that the User faces, *monitoring and review* of the system is necessary to ensure its alignment with the changing objectives, environment, resources and risks. The FMC system is being monitored to evaluate its functioning via on-going monitoring, self-assessment and internal audit.

The internal control components (standards) are a recommendable approach to the development of internal control in the state administration and provide the basics against which internal controls may be assessed. The manner of implementation will depend on the specific properties of a user of budget, the risks and head's decision. Each user should design its own system of internal controls, depending on the needs and the environment in which it operates.

On the basis of enactments on internal organisation and manner of work, the head may delegate his/her authorities to other persons. Although the delegation of authorities also implies the delegation of the responsibility, one should notice that the delegation of authorities and responsibilities does not exclude the head's accountability.

In addition to the Head, the persons listed hereunder are in charge of the establishment, implementation and development of financial management and control:

- **Financial Management and Control Head;**
- **Financial Management and Control Co-ordinator.**

The Financial Management and Control Head is responsible for the establishment, implementation and development of financial management and control with a given user. Pursuant to the provisions contained in Article 8 of the Law, with the consent of the User of Budget Head, the Financial Management and Control Head is obliged to develop a plan for the establishment of financial management and control within a six-month period from the effective date of the Law, i.e. until 4 July 2007. If an FMC Head was not appointed, this is the responsibility of the user of budget head. The plan should contain an overview of activities necessary for the implementation of Financial Management and Control, the deadlines for the execution of the activities and persons responsible for carrying out individual activities.

Taking account of the needs and specific properties of operations of the Users of Budget, the User of Budget Head may appoint a Financial Management and Control Co-ordinator or establish a Financial Management and Control Unit. While the Co-ordinator operationally carries out and co-ordinates the establishment and development of Financial Management and Control in the User of Budget, he/she is not involved in the performance of control activities.

Similarly, the User of Budget Head decides on the forms of ex-ante and ex-post controls.

Pursuant to the provisions contained in Article 12 of the Law, after a risk analysis has been carried out, the Head of User of Budget may additionally establish an ex-ante financial control function to be executed by a financial controller for those business processes or transactions exposed to a higher level of risk. **Financial controller** is a person in charge of checking the legality, economy, efficiency and effectiveness of a business transaction before a

final decision has been made, a contract entered into or any other business transaction executed.

In addition, the User of Budget head may also appoint persons to perform ex-post controls, i.e. controls which are being performed after a business transaction has been completed for the purpose of detecting irregular, non-earmarked or inefficient business transactions and events. Ex-post control may not be performed by a person responsible for or involved in the performance of ex-ante control.

The appointment of a financial and an ex-post controller is only one of the forms of controls. The User of Budget Head decides on their appointment, taking the needs and specific features of the User of Budget into consideration.

3.1.2. Training of Persons in Charge of the Financial Management and Control Establishment

Persons in charge of the establishment of this system are obliged to undergo a training organised and delivered by the Ministry of Finance's Central Harmonisation Unit, i.e. the Division for Methodology and Co-ordination of Financial Management and Internal Control.

Jointly with CARDS 2004 Project, s Financial Management and Control Training Strategy was developed, envisaging the delivery of two types of seminars, i.e. the Awareness Raising Seminar and the Seminar on the Financial Management and Control Establishment and Development.

The Awareness Raising Seminar – the Importance of the Internal Financial Control System – is intended for the institution heads, i.e. for the top managerial level and is essential for a successful implementation of the system of financial management and control in the public sector.

The seminars on the financial management and control establishment and development are intended for persons in charge of the implementation and development of financial management and control.

The purpose of training is to make the trainees aware of the system and the activities to be undertaken in order to get the system established and developed, aiming at improving financial management and decision-making for the purpose of achieving the User of Budget's objectives and performing its affairs in a regular, ethical, economical, efficient and effective fashion.

Training is being delivered in accordance with the Financial Management and Control Professional Training Programme passed by the Minister of Finance in March 2007. The training programme comprises four basic modules in the following fields:

1. Introduction to Financial Management and Control;
2. Risk Management;
3. Internal Controls;
4. Establishment and Development of Financial Management and Control – practical implementation.

In addition to the basic modules, the persons in charge of the establishment and development of financial management and control may get further professional improvement through certain optional modules to be organised by the Central Harmonisation Unit.

Since there are many units at local levels obliged to establish financial management and control (20 counties and the City of Zagreb, 126 cities and 429 municipalities and 2,074 users¹⁶ owned by local and regional self-government units), training will be delivered locally during the period of two years.

The plan is to start with training of persons in charge of the establishment of this system at local level in late 2008 and to continue during the course of 2009 and 2010. Until then, it is expected that all activities necessary for the establishment of financial management and control in local and regional self-government units would be completed.

The training based on the aforementioned modules will encompass representatives (Financial Management and Control Heads) of the counties, cities and larger local level users of budget.

In order to identify the best ways for the establishment of this system in the light of specific properties of local and regional self-government units, the Central Harmonisation Unit plans on starting with the establishment of this system by organising training in one county, city and municipality each, which will be pilot-projects. In co-operation with the pilot-units, the plan is to produce a list and description of business processes, a risk register and a plan of the establishment of the necessary controls customised to the local level users.

After the pilot-projects have been carried out, the plan is to deliver training in individual county centres, which will be used to deliver training for the appointed Financial Management and Control Heads in counties, as well as for the Heads appointed on behalf of the cities and larger users owned by individual counties or cities.

During the training, the Central Harmonisation Unit's Division for Methodology and Co-ordination of Financial Management and Internal Control will also be undertaking ongoing activities aimed at raising awareness of the system of financial management and control in bodies of the respective local and regional self-government.

3.2. Internal Audit

Internal audit is an independent activity which assesses the systems of internal controls, gives an independent and objective professional opinion and advice for the improvement of operations; it helps the user of budget achieve its objectives by bringing in a systematic and disciplined approach to the evaluation and improvement of effectiveness of the risk management, control and governance processes. In principle, it is performed through systems auditing, compliance auditing, performance auditing, financial auditing and IT systems auditing.

¹⁶ Data pertaining to the 2007 Users of Budget List published on the Ministry of Finance's website.

Internal audit provides support to the user of budget in the achievement of its objectives by:

1. Producing strategic and annual internal audit plans based on an objective risk assessment and by carrying out individual internal audits in keeping with the adopted plans;
2. Assessing the adequacy and the effectiveness of the system of financial management and control in respect of:
 - a) identification, assessment and management of risk;
 - b) compliance with laws and other regulations;
 - c) reliability and comprehensiveness of financial and other information;
 - d) efficiency, effectiveness and economy of operations;
 - e) safeguarding of assets and information;
 - f) performance of assignments and the achievement of objectives.
3. Making recommendations for the improvement of operations.

Internal audit units are organisationally put in place on the basis of the provisions contained in the Law and the Budget Users' Internal Audit Rulebook and are located at the highest organisational level. Those users of budget which aren't obliged to put their own internal audit units in place may appoint an internal auditor in line with the Law and the Budget Users' Internal Audit Rulebook. Internal regulations provide for direct responsibility of an internal auditor before the user of budget head.

While carrying out audits, internal auditors have full, free and unlimited right of access to the overall documentation, data and information stored at any data carrier, as well as to the heads, staff and tangible assets. Internal auditors are obliged to observe the principles of secrecy of data and information made available to them during the course of an internal audit, unless prescribed otherwise by law.

Internal auditors perform the matters from their scope of competence in keeping with:

- Internationally recognised internal auditing standards;
- Laws, other regulations and guidelines providing for the field of internal audit in the Republic of Croatia;
- Development Strategy of Public Internal Financial Control in the Republic of Croatia; and
- Best practice of the European Union member-states.

In their work, internal auditors are obliged to adhere to the Internal Auditors' Manual, the Internal Auditors' Charter and the Internal Auditors' Professional Code of Ethics.

Internal Auditors' Manual prescribes the methodology of work and of carrying out internal audits. For the purpose of standardising the manner in which internal audits are being carried out, the Central Harmonisation Unit of the Ministry of Finance produces and updates the Manual, with the approval of the Minister of Finance. The internal audit units of individual users of budget may produce their own annexes to the Internal Auditors' Manual to meet the specificities in their operation. These annexes to the Manual need to be supplied to the Central Harmonisation Unit of the Ministry of Finance for approval.

The Internal Auditors' Charter sets forth rights and duties of internal auditors in their dealings with an auditee. The User of Budget Head passes the Charter on the basis of a template prepared by the Ministry of Finance's Central Harmonisation Unit. In addition to the

User of Budget Head, the internal audit unit head also signs the Charter. The Charter should be submitted to the Ministry of Finance's Central Harmonisation Unit for the purpose of establishing and maintaining a register of the internal auditors' charters. Before the commencement of each internal audit, auditors are obliged to hand out a copy of the Internal Auditors' Charter to the authorised person of the auditee.

Internal Auditors' Professional Code of Ethics sets forth principles and rules that auditors should observe during the performance of internal audit matters. The Code was passed by the Minister of Finance in August 2005.

Planning of internal audit in local and regional self-government units is being performed in line with the provisions contained in the Law, the Budget Users' Internal Audit Rulebook and the Internal Auditors' Manual. Planning of internal audit in local and regional self-government units is being carried out equally as in the central government bodies.

Internal audit is performed in accordance with:

- a) Strategic Plan for a three-year period;
- b) Annual Plan;
- c) Individual Audit Engagement Plan.

The internal audit unit head produces the strategic and annual plans for the performance of internal audits, as well as amendments to them. The User of Budget head endorses the plan. Should the User of Budget Head refuse to approve the inclusion of individual audits into the strategic or annual plans, the internal audit unit head is obliged to inform the Ministry of Finance's Central Harmonisation Unit on this issue in writing.

The strategic plan is being brought forth until the end of the current year for the following three years, whereas the annual internal audit plan is being passed until the end of the current year for the following year.

3.2.1. Independence of Internal Audit Units and of Internal Auditors

Functional independence of an internal audit unit is achieved through its independence of other organisational structures existing within a user of budget, through planning of its work, carrying out audits and reporting.

Internal audit units are organisationally put in place at the highest level. Organisationally and functionally, it is directly and solely responsible to and linked with the user of budget head. This simultaneously leads to its independence from other organisational structures.

Performing a professional job, internal auditors apply a methodology in the performance of internal auditing matters. The methodology is founded upon international internal auditing standards. Additionally, auditors apply principles and rules as found in the Internal Auditors' Professional Code of Ethics. Accurate and regular application of standards and the methodology is an important factor to functional independence. Similarly, the Charter contributes to internal auditors' independence, since it prescribes rights and duties of internal auditors and of entities subject to auditing.

Neither internal auditors nor internal audit units may be involved in the execution of direct functions of a user of budget.

Independence of internal auditors is also associated with the audit planning process, be it strategic or annual internal audit plans. By planning their activities, internal auditors are becoming independent in respect of anything that might influence the performance of audits.

Independence of internal auditors is achieved through their independent work, whereas a contributing factor to their independence is the fact that auditors may not be dismissed or transferred to another position for expressing the factual status and making certain recommendations. Before any disciplinary measures are taken, a transfer or dismissal of internal auditors completed, the user of budget head is obliged to inform the Ministry of Finance's Central Harmonisation Unit on the matter and to enclose all necessary documentation.

3.2.2. Public Internal Auditors' Professional Training and Certification

The Law prescribes requirements to be met by an internal auditor, as follows:

- a) University degree;
- b) Requirements as prescribed for the civil service admission;
- c) Minister of Finance's certification for the performance of public internal auditing matters, acquired as per the training programme and the instruction passed by the Minister of Finance.

According to the provisions of the Law, internal auditors may be those auditors who acquired certifications as certified auditors (private sector auditors), those who are certified internal auditors from another professional institution and those holding a certified government internal auditor certificate. However, before obtaining a Minister of Finance's certification for the performance of internal audit matters, those auditors first must undergo a check of their knowledge, i.e. they are passing an exam in line with the training programme passed by the Minister of Finance.

The Central Harmonisation Unit is in charge of organising internal auditors' training at both central and local government levels (hereinafter referred to as the public sector). The training is being delivered in keeping with the Professional Training Programme for Obtaining the Profession of a Certified Public Sector Internal Auditor and in line with the Instruction on the Check of Knowledge and Abilities and the Passage of the Exam for the Profession of a Certified Public Sector Internal Auditor, passed by the Minister of Finance in March 2007. For the purpose of maintaining and constant improvement of public sector internal auditors' training, the Central Harmonisation Unit regularly monitors the developments in international internal auditing standards (IIA), internal auditors' training programmes from other countries and the international best practice.

The internal auditors' training comprises both theoretical and practical training. The theoretical training consists of a total of seven modules (totalling seven weeks worth of training) and the passage of an exam. On the other hand, the practical training consists of carrying out two practical audits under mentorship. The certified public sector internal auditors' training is equal for both persons coming from central government bodies and those coming from local and regional self-government units.

Theoretical training comprises the following seven mandatory modules:

1. Introduction to Internal Audit;
2. Public Internal Financial Control System;
3. Internal Audit Work Methodology;
4. Audit Skills and Techniques;
5. Accounting and Financial Operations Analysis;
6. Auditing Information Technology and the Application of Information Technology in Auditing;
7. Application of the Internal Audit Work Methodology on a Practical Example.

To date, the internal auditors' training system lacked a module which would employ a case study to apply the prescribed internal auditing methodology, which would result in having the trainees possessing greater level of knowledge in the application of the methodology in practical auditing. For this reason, a practical auditing module is being introduced, which will provide the applicant internal auditors a practical example reflecting the overall auditing methodology.

Upon the completion of theoretical and practical training and the passage of the exam, internal auditors are granted a "Public Sector Internal Auditor's Certification". The certification is a testimony that auditors have been trained to apply professional standards and the methodology produced for performing internal audits in public institutions. Certification is being granted on the basis of an evidenced evaluation of professional skills and experience in public internal auditing.

After internal auditors have completed the professional training programme, they are trained to carry out systems audits, compliance audits, i.e. they have obtained basic knowledge on the methodology necessary to perform internal audits. Additional professional development of internal auditors towards the performance of other types of audits will be carried out through the delivery of additional training in optional modules.

Among other, the following optional modules were envisaged:

1. Auditing European Union Funded Programmes and Projects;
2. Performance Auditing;
3. Financial Audits;
4. IT Systems Audit;
5. Risk Assessment and Strategic Planning;
6. Internal Audit Work Quality Assessment.

According to data closing as at 30 June 2007, the training process for obtaining the Minister of Finance's certification included a total of 196 persons, of which 129 persons from central government bodies and 67 persons from local and regional self-government units.

Until end-2007, the plan is to pass the new 2008-2010 Internal Auditors' Training Plan to cover applicants who will undergo internal auditors' training at both central and local levels.

International experts trained the local teams – trainers for the delivery of training. Certified internal auditors may be the trainers. The training is currently being delivered by the trainers – internal auditors from the Central Harmonisation Units and those coming from other state administration bodies. These trainers convey their theoretical and practical knowledge to the future internal auditors. To date, a total of 26 trainers-internal auditors were trained, and their paramount task is to convey the theoretical knowledge and to link it with actual practice.

3.2.3. Audit Committee

The users of budget who are obliged to put internal audit in place may also establish an Audit Committee, with the following remit:

- Monitoring the efficiency of the internal financial control system, internal audit and risk management system;
- Evaluating the Strategic and Annual Internal Audit Plans;
- Monitoring the Internal Auditing Methodology application;
- Monitoring the application of the Internal Auditors' Professional Code of Ethics and the Internal Auditors' Charter;
- Discussing the Annual Report on Performed Audits and Internal Audit Activities;
- Follow up of the implementation of internal audit recommendations as per agreed action plans and the implementation of State Audit Office's recommendations.

3.3. Interrelation between Financial Management and Control and Internal Audit

The User of Budget head and a person with delegated authorities and responsibilities are responsible for the establishment, implementation and development of internal financial control system, i.e. both financial management and control and internal audit.

Each user of budget is obliged to establish financial management and control, which falls under the remit of the head and a person with delegated authorities and responsibilities (Financial Management and Control Head).

Through financial management and control establishment and its further development, management will *inter alia*:

- Identify vision, mission, objectives general to the institution and those specific to all of its organisational units;
- Plan for the expected results for the achievement of the set objectives;
- Arrange business processes and prescribe working procedures for them with adequate audit trails in order to have the operations performed in a regular, economical, efficient and effective fashion;
- Develop a risk management strategy and manage the risks, which includes the definition of business objectives of processes, identification of risks, assessment of risks, identifying the risk tolerance level, design of risk response – controls;
- Execute tasks as prescribed in working procedures in keeping with the plan and adopted policies, using a safe information and communication systems during the course;
- Organise internal controls in a way for them to provide a reasonable level of assurance that the planned objectives would be achieved;
- Monitor the financial management and control system and keep developing it;

- Co-operate with internal audit in the performance of systems audits and other types of audits with the view of objective definition of findings, which serve as the groundwork to auditors for expressing their professional opinion on the established controls and making recommendations for the internal controls improvement;
- Develop action plans for the implementation of internal audit recommendations as expressed in audit reports upon the completion of audits, and will implement them within the agreed deadlines.

As a functionally independent activity, internal audit oversees the system of internal controls put in place by management. By providing advisory service, it helps management in the establishment and development of the financial management and control system and in the operations improvement.

In advisory terms, internal audit helps management manage risks by:

- Evaluating the risk management strategy passed by management and by giving advice for improvement;
- Agreeing with management on the review of the identified business processes and by providing advisory assistance in documenting business processes (production of audit trails);
- Agreeing with management on business objectives belonging to the identified business processes;
- Providing advice in identifying a uniform approach to business process risk evaluation.

Internal audit develops strategic and annual internal auditing plans on the basis of an independent risk assessment. The head of institution endorses the strategic and annual internal audit plans. Should some elements between risk assessment done by management and that done by internal audit significantly differ, agreement on the matter should take place. Individual internal audits are being carried out on the basis of priorities agreed between management and internal audit.

After the completion of an audit assignment on a business process, internal audit use the audit report to give its professional opinion on internal controls put in place in the audited business process, it alerts to weaknesses in the established controls, i.e. to risks which might remain in place in case of a failure to implement recommendations expressed in the audit report. Recommendations are aimed at improving the economy, efficiency and effectiveness of internal control, i.e. of financial management and control, and ultimately lead to the improvement of institution's operations.

Management is responsible for the implementation of the recommendations presented in an audit report, whereas internal audit has an obligation to follow up the implementation and to report accordingly.

Performance audit aims at performing internal audits of the economy, efficiency and effectiveness of operations, as well as of performance measurement and quality assessment. If a performance audit has shown that an institution has been performing successfully, one may regard that top management recognises and appreciates the concept of successful performance (efficiency) and that it is committed to such management that leads to good performance. This situation would comply with the concept of sound financial management and control, which

means that organisational resources have been put to best use in order to achieve the set and measurable goals and objectives of the organisation.

It is necessary to stress that internal auditors must maintain their independence. An internal audit unit or an internal auditor may not be involved in the execution of direct functions of the user of budget, the implementation of a process or controls that they themselves will later on assess and audit.

4. Description of the Current Situation and the Weaknesses of Internal Financial Control in Local and Regional Self-Government Units in the Republic of Croatia

4.1. Financial Management and Control

Financial Management and Control encompass the overall user's operations, i.e. all business processes, especially those related to revenues/receipts, expenses/expenditure, tendering procedures and contracting, recovery of wrongly paid amounts, assets and liabilities. The system of internal controls is implemented by institution heads and all employees.

All users of budget are obliged to establish financial management and control, including all local and regional self-government units and users of their respective budgets, regardless of their size and the number of employees.

The financial management and control establishment includes the following:

- Organisational setup, i.e. the appointment of persons in charge of financial management and control and potentially the establishment of a financial management and control unit;
- Development of a plan of activities to be undertaken towards the establishment of this system, which includes listing and describing business processes, risk assessment and the passage of a risk management strategy and the establishment of control activities as a response to risk assessment.

Worth emphasising is the fact that Republic of Croatia has already partially implemented internal controls, although this was not a prescribed legal obligation before the Law was passed.

A series of regulations provide for the collection and spending of public revenue and all other types of public resources, i.e. the expenditure side.

The Budget Law¹⁷ provides for budget planning, development, passage and execution, asset and debt management, public debt management, borrowing and guarantees of the government and local and regional self-government units, public sector budgetary relations, accounting, internal and budget supervision. The passage of the Decision on a Unit's Budget Execution for the current year being made on the basis of the Budget Law provides for the budget revenues and receipts, as well as expenses and expenditure structures, i.e. their execution, financial and non-financial asset management, scope of borrowing and guarantees, use of earmarked revenues, rights and duties of users of budget resources, authorities of city/municipality/county governments and institution heads in budget execution, i.e. the authorities and responsibilities of administrative bodies and managers, postponement of the regulations application and other issues pertinent to budget execution, such as: users of budget, implementing documents of the special budget section, contract conclusion obligations, public procurement procedures.

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Pursuant to the Budget Law, the units are obliged to keep budget accounting and to produce financial reports, which are being submitted to the Ministry of Finance and the State Audit Office.

The Public Procurement Law¹⁸ and the Small Value Goods, Works and Services Procurement Procedure Decree¹⁹ define procurement procedures to be implemented, depending on the value of goods, works or services planned for procurement.

The Rulebook on Local and Regional Self-Government Units' Borrowing Procedure and the Issuance of Guarantees of Local and Regional Self-Government Units²⁰ prescribes the procedure, terms and conditions and mandatory contents to be included in a request for obtaining consent for borrowing on the part of a local and a regional self-government unit (hereinafter referred to as municipality, city, county) and for the issuance of county guarantees for investments (projects), as well as the manner of reporting on borrowing, giving consent for borrowing and guarantees issuance.

The supervision over the user of budget funds is being carried out by a representative body of a local self-government unit autonomously or in the manner provided for in the Statute. Such supervision is also exercised by the State Audit Office, which is obliged to carry out audits of local and regional self-government units' financial reports and operations for each budget year.

In respect of the organisational setup of financial management and control at local levels, and in keeping with the obligations stemming from the provisions of the Law, the users have appointed persons in charge of financial management and control. This primarily pertains to the appointment of the Financial Management and Control Heads. Most frequently, these persons in counties are the heads of the finance administrative department, whereas in cities these are the city finance office heads.

The smaller users of budget with only a few employees expectedly will not appoint financial management and control head, but the institution head would rather undertake the necessary activities in order to put this system in place.

It is necessary to point out that some local and regional self-government units have ISO certificates in their possession. Before they obtained the certificate, they had to list and describe their business processes. Still, the course of some business processes was not prescribed and this is something yet to be done in order to ensure their running in keeping with the principles of legality, economy, efficiency and effectiveness. The existing system of internal controls was not put in place taking account of the objectives a unit wishes to achieve and the risks influencing the achievement of such objectives. In addition, the existing controls in particular cases are oriented towards meeting the principles of legality and regularity, but not to achieving economy, efficiency and effectiveness.

Some counties, such as the Istria County and Split-Dalmatia County have also started with introducing the quality management system according to the requests of international norm HRN EN ISO 9001:2000, which forms the background for the effective and efficient organisation's business operations. For the introduction of the quality management system, it

18 *Narodne novine* 117/01, 197/03 and 92/05

19 *Narodne novine* 14/02

20 *Narodne novine* 55/04

is necessary to produce the quality management system documentation which covers, inter alia, a map of processes and documented procedures as well as to improve continuously the effectiveness and efficiency of processes for the purpose of achieving the objectives of the organisation. The purpose of the quality management system introduction is to create the controlled conditions in the business operations in which the services or goods are provided and aiming at higher level of efficiency and effectiveness, and business performance, higher level of customer satisfaction with provided services and employee satisfaction, and reduction of costs. Therefore, the introduction of Financial Management and Control in public sector contains all that is covered by the international norms, but as well in addition risk management and set up of controls, and monitoring of the overall system.

After the passage of the Law, the Central Harmonisation Unit organised several seminars for the local-level institution heads in order to present them the provisions of the Law and the obligations the users have under this Law.

In co-operation with CARDS 2004 Project, the Financial Management and Control Manual was produced, incorporating the most modern knowledge from the field of financial management and control and providing a detailed indication of the actions and procedures to be implemented in order to effectively establish this complex and modern system with all users of budget.

During the course of 2006 and 2007, a series of "awareness raising" seminars for institution heads were organised. These were intended for the top managerial levels at local level (in Zagreb, Opatija, Pula, Slavonski Brod, Sisak, Novigrad, Split, Delnice, Rijeka, Osijek, Split, Zadar, Varaždin and Čakovec).

The Central Harmonisation Unit developed a proposed plan for the financial management and control establishment and development with set deadlines for the establishment of the system until 2010 for the local levels, in order to help the appointed financial management and control heads consider and recognise the activities necessary for the establishment of this system. This would also help them pass the said Plan to meet the legal requirements.

4.1.1. Necessary User of Budget Activities for the Establishment of Financial Management and Control at Local Level

With the passage of the Public Internal Financial Control Law, the Republic of Croatia began the process aimed at changing and aligning the existing public finance system to match the requirements of modern operations and those of the European Union. The Financial Management and Control establishment process first covered the central government level (ministries, state administration bodies) and the City of Zagreb. In accordance with the further efforts invested in the process of changing and aligning the public finance system with the new financial management and control system, it is necessary to also cover the local and regional self-government, as an important segment of public finance.

The activities listed hereunder should be undertaken to introduce and develop financial management and control:

- by producing audit trails, to:
 - identify all existing business processes and activities, as well as the established

- controls;
- identify the main risks and controls necessary to reduce the adverse impact of those risks;
- identify whether or not the existing controls actually are the necessary ones;
- identify the gaps and to establish the missing and eliminate the unnecessary controls;
- by passing organisation decrees and rulebooks to:
 - provide a detailed job descriptions for all officials, civil servants and employees, with an indication of their respective responsibilities;
 - delegate certain responsibilities to lower levels;
- by carrying out audits of systems of internal controls to:
 - evaluate the efficiency of controls against control objectives;
 - make recommendations for the improvement of the system of internal controls, i.e. of the financial management and control system.

The financial management and control establishment is a complex process and there are no uniform organisational solutions that would apply to all users of budget. They depend on the size and specific properties of a user, its business processes, risks and other elements.

The establishment of the system covers the organisational setup and the passage of the system establishment and development plan, coupled with the implementation of the planned activities.

The organisational setup includes:

- the appointment of persons tasked with carrying out matters towards the establishment of the system (Financial Management and Control Head, Financial Management and Control Co-ordinator, Working Group) and
- establishment of a Financial Management and Control Unit (division or section).

The Financial Management and Control Head or the User of Budget Head in case the former was not appointed, is obliged to pass the financial management and control establishment and development plan within the period of six months from the effective date of the law, i.e. until 4 July 2007.

Listing and describing the business processes running in local and regional self-government units belong to the more significant activities to plan for.

The listing of business processes will be done for each organisational unit on the basis of instructions and guidelines provided by the respective financial management and control heads or a person who underwent the training. The business processes description will detail the manner in which business process are being executed. The business processes description will also make an indication of the controls being carried out during the course of the business process, as well as of the persons carrying out individual control activities. Furthermore, the description or documentation of business processes will enable employees to know specifically what authorities and responsibilities they have. A book (map) of business processes of local and regional self-government units will result from the list and description of business processes, which will result in obtaining an audit trail for each business processes. Risk management is an integral part of the financial management and control system. Therefore, risk assessment efforts will cover the overall operations and will lead to the establishment of adequate risk management measures, mainly the controls. The risk

assessment will serve as the foundation for the production of a risk register and for the passage of a risk management strategy, which falls under the responsibility of the institution head.

The need for further control activities, which may be put in place as ex-ante and ex-post controls, will subsequently be considered. In addition to those controls that are "embedded" in the business processes, the User of Budget Head may decide to appoint a person, a financial controller, who would carry out ex-ante controls for those business processes or transactions which are exposed to a greater level of risk or are of greater significance for the local and regional self-government bodies' budgets.

Moreover, the User of Budget Head may decide to also appoint persons to carry out ex-post controls, i.e. the controls that are being carried out after the completion of a business transaction and aimed at detecting the irregular, the non-earmarked or inefficient business transactions and events. Ex-post control may not be performed by a person responsible for or involved in the performance of ex-ante control. Ex-post control is being carried out after an activity was completed and is oriented towards the detection of potential errors, discrepancies or irregularities, and leads to the reviewing of a process or possible sanctions.

After a decision on introducing additional control activities has been made, the financial management and control head will pass the plan for putting the additional control in place, whereby he/she will anticipate actions to be undertaken in order to put the needed controls in place or to eliminate the potentially unnecessary controls.

The User of Budget Head files reports with the Ministry of Finance's Central Harmonisation Unit on the functioning, effectiveness and efficiency of financial management and control.

The financial management and control head has an obligation to draft annual reports on the activities relative to the financial management and control establishment and development. After the User of Budget Head has approved it, the report is submitted to the Central Harmonisation Unit until 31 January of the current year for the previous year.

All persons involved in financial management and control will have to be trained on an ongoing basis, in order to acquire knowledge necessary for this system's establishment and development. The User of Budget heads and Financial Management and Control Heads in local and regional self-governments will be responsible for employees' training.

4.2. Internal Audit

The Republic of Croatia has a decentralised internal audit establishment and performance model in place. Users of Budget are setting up their internal auditing functions in line with the Law and in keeping with the provisions and criteria set forth in the Budget Users' Internal Audit Rulebook. Internal audit reports directly to the User of Budget Head. According to the Law, the Central Harmonisation Unit is in charge of co-ordination of internal audit establishment with Users of Budget at both central and local government levels.

Pursuant to Article 17 of the Law, those Users of Budget under obligation of establishing internal audit may choose to put internal audit in place in one of the following manners:

- establishment of an internal audit unit or the appointment of an internal auditor on the basis of their own judgment of suitability thereof;
- establishment of a joint internal audit unit, at the proposal of several Users of Budget, with prior consent given by the Minister of Finance;
- agreement on performing internal audit work with a competent ministry/institution and a local and regional self-government unit, with prior consent given by the Minister of Finance.

The Budget Users' Internal Audit Rulebook laid down the criteria whereby users of budget are obliged to establish their own internal audit units if they employ in excess of 100 staff for government bodies, i.e. in excess of 50 staff for bodies of local and regional self-government units or if their annual expenses and expenditure account for more than HRK 30,000,000.00.

Notwithstanding the said criteria, the entities listed hereunder are obliged to establish their internal audit units:

- City of Zagreb;
- Large cities with population greater than 35,000;
- Counties;
- County centres and
- Local and regional self-government units, i.e. the cities with the transferred financing of decentralised elementary education functions.

According to the criteria laid down in the Rulebook, from the a total of 576 existing local and regional self-government units, 83 local units are under obligation of establishing their own internal audit units.

The Rulebook on the Users of Budget Internal Audit, which will be passed by the end of 2007 will define different requirements to a certain extent on the basis of which the Internal Audit Units will be established. Namely, the obligation for establishing the Internal Audit Units will have the users of budget that will meet both aforesaid requirements, which implies having annual expenses and expenditure more than HRK 30,000,000.00. and employing more than the prescribed number of employees. In that manner, a number of the Local Government and Self-Government Units which are obliged to establish the Internal Audit Unit, will be reduced to approximately 50 units, but for all others the obligation to introduce internal audit will furthermore remain. This implies internal audit being performed in one of the manners prescribed by the Law. This may be by establishing a joint internal audit unit for more users of budget, i.e. local units or by concluding the agreement with another competent institution, as set forth in the Law but with the previous consent of the Minister of Finance. The Law prescribes that internal audit has to be established within one year following the effective date of the Law, that is 4 January 2008.

The establishment of internal audit function with users of budget commenced during the course of 2005, first in the ministries and state administration bodies, to continue during the course of 2006 and 2007 in the remaining state administration bodies but also in local and regional self-government units subject to the legal obligation of putting internal audit in place.

Internal audit in the City of Zagreb was established within the City Control Office. In terms of internal auditing, the City Control Office's scope of competence pertains to internal auditing of the processes in the city administrative bodies, the City bodies, the community self-government bodies, national minorities' councils and representatives, the co-operation with the Central Harmonisation Unit and other matters assigned under their remit.

A total of 47 different local and regional self-government units commenced the process of establishing their internal audit functions by referring one or several staff to training for obtaining the Minister of Finance's internal auditing certification. Not all of those local units which referred their staff to training process have established internal audit through their internal regulations. The completion of this activity is expected during the course of 2007.

In addition to internal auditing, a number of the appointed internal auditors in local and regional self-government units also engage in other executive matters, a practice which should be abandoned immediately. Internal auditors should solely perform internal auditing matters.

General objectives of internal audit have been defined in the purpose and role of internal audit as set forth in the Law. The purpose and role of internal audit in local and regional self-government units are identical to the purpose and role of internal audit in the central government bodies.

However, the user of budget heads in both central government bodies and in local and regional self-government units in practice still have different understanding of the role and purpose of internal audit. Some user of budget heads still believe that the purpose and role of internal audit primarily has to do with the preventative or ex-post check of individual transactions (which is the role of inspection).

A number of institution heads grasp the difference between inspection and internal audit and recognise the actual purpose and role of internal audit. These institution heads are providing their support to internal auditors and use internal audit as a management tool to manage business even more successfully. Therefore, it is necessary to raise awareness of the users of budget heads concerning the establishment of an adequate, efficient and effective system of internal controls.

In establishing their respective internal audit functions, almost all central government level users of budget and a number of users of budget of local and regional self-government units adhere to the provisions of the Law and the Rulebook. However, a smaller number of the local and regional self-government units' users of budget failed to observe the legal provisions while appointing internal auditors on the basis of their internal regulations. Namely, while the Law stipulates that an internal auditor should report directly to the user of budget head, some units have organisationally positioned the internal auditor in the County Prefect's/Mayor's Cabinet. This cabinet is not operationally managed by the respective user of budget head, and the internal regulations do not define direct reporting line towards the user of budget head. Therefore, the enactments which provide for local units' organisation should organisationally position internal audit immediately next to the user of budget head, with direct reporting to the head.

4.2.1. Necessary User of Budget Activities for the Establishment of Internal Audit at Local Level

The 2003 Budget Law prescribed that users of state budget and budgets of local and regional self-government units are under obligation of establishing internal audit functions. During 2003 and 2004, however, this was not done. Encouraged by the Central Harmonisation Unit and having a possibility to train candidates for internal auditors, the internal audit establishment and development process with users of budget commenced in 2005.

During 2006, the further training of public internal auditors and the establishment of new internal audit units marked the continuation in the process of internal audit establishment and development with users of budget at both central and local government levels.

The Republic of Croatia has a decentralised internal audit organisation model in place, which means that each user of budget is under obligation of establishing internal audit, directly reporting to the User of Budget Head. This is based on the Public Internal Financial Control Law and the criteria as prescribed in the Budget Users' Internal Audit Rulebook.

Users of Budget are obliged to establish internal audit in one of the ways prescribed by the Law.

Through their respective internal regulations, each user of budget is responsible to define the internal organisation and the number of necessary internal auditors, depending on the number of employees, the business processes through which they are achieving their objectives and depending on budgetary and other resources made available to them.

Based on the said, those users of budget subject to obligation of establishing internal audit are using their internal organisation decrees to provide for the position and scope of competence of their respective internal audit units, i.e. they are appointing an internal auditor who reports directly to the User of Budget Head, thereby highlighting the independence of internal auditors. The enactments providing for internal arrangements present the descriptions and lists of internal audit unit heads' and internal auditors' jobs, coupled with the definition of the necessary number of such staff.

With the view of raising awareness of user of budget heads concerning the need for and obligation of establishing internal audit, the Central Harmonisation Unit as a co-ordinating body will keep delivering presentations, seminars and workshops.

According to the Public Internal Financial Control Law, the Central Harmonisation Unit is obliged to keep the register on internal audit units and the register on internal auditors, whereas users of budget are obliged to regularly and orderly supply data on the establishment of units and establishment of internal audit altogether.

Pursuant to the Law, only persons having a Minister of Finance's certification in their possession may perform internal audit in keeping with the methodology as prescribed by the Central Harmonisation Unit.

A User of Budget Head will refer one or several persons from his institution to training process for obtaining the Minister of Finance's certification. This depends on the

number of employees, the business processes through which they are achieving their objectives and on budgetary and other resources made available to them. The Central Harmonisation Unit will organise the delivery of theoretical training, while practical training on the one hand will be performed with the help of the Central Harmonisation Unit's mentors and the mentors from some central government bodies, and with the help of the certified internal auditors coming from local and regional self-government units, on the other.

After the appointment of an internal audit unit head, i.e. the appointment of an internal auditor, it is necessary to pass the Internal Auditors' Charter. This process requires consent from the Central Harmonisation Unit of the Ministry of Finance. The Charter should be signed by the internal audit unit head or an appointed internal auditor and the User of Budget Head.

The User of Budget's internal audit will carry out an independent risk assessment for all business processes of the User of Budget and produce the Strategic and Annual Internal Audit Plans. The User of Budget Head endorses these plans until the year-end for the forthcoming period.

Internal auditors will perform individual audits on the basis of the Annual Internal Audits Plan. Upon the completion of each audit, auditors produce audit reports to be submitted to the institution head. In its audit report, internal audit expresses its professional opinion on internal financial controls in the audited field and makes recommendations for the improvement of internal controls. The institution heads will decide whether or not recommendations will be accepted and will produce an action plan to be carried out by management of the user of budget. Internal audit does not get involved in the recommendations implementation, but makes a follow-up and reports on the implementation to the User of Budget Head.

After the year's end, the internal audit unit head or the appointed internal auditor drafts an annual report on the internal audit activities for the reporting year. After the User of Budget endorses the report, it is submitted to the Central Harmonisation Unit by 31 January.

5. Central Co-ordination and Harmonisation System

The Central Harmonisation Unit (Department for Harmonisation of Internal Audit and Financial Control) was established in the Ministry of Finance through the passage of the Ministry of Finance's Internal Organisation Decree²¹ in April 2005. It comprises two divisions, as follows:

- Division for Methodology and Co-ordination of Internal Audit and
- Division for Methodology and Co-ordination of Financial Management and Internal Controls.

The divisions' scopes of competence chiefly pertain to the establishment, co-ordination and development of public internal financial control system in the Republic of Croatia and to the establishment and development of methodology and standards of work of internal audit and of financial management and the system of internal controls in line with the international standards and the European Union best practice. The core task also has to do with training of

21 *Narodne novine* 43/05, 114/05 and 14/06

internal auditors and persons in charge of the establishment and development of financial management and control.

The Central Harmonisation Unit is headed by an Assistant Minister, who was tasked with management of matters falling under the scope of the Central Harmonisation Unit.

Pursuant to the provisions contained in Article 35 of the Law, the Ministry of Finance's Central Harmonisation Unit is in charge of:

- a) Preparing laws and bylaws from the field of financial management and control, as well as of internal audit;
- b) Development of methodology and work standards for financial management and control, as well as for internal audit;
- c) Organising training of persons responsible for and involved in financial management and control, as well as internal audit;
- d) Coordinating the establishment and development of the public internal financial control system;
- e) Providing opinion on transfer and dismissal of Internal Auditors;
- f) Keeping and maintaining the register of internal audit units, the register of internal auditors' charters, the register of certified auditors and the register of persons involved in financial management and control;
- g) Quality control of the public internal financial control system;
- h) Establishing and maintaining a website containing data on the activities of the Central Harmonisation Unit within the Ministry of Finance, training and acquisition of certification for the profession of a certified internal auditor.

In addition to the above, the Central Harmonisation Unit within the Ministry of Finance produces consolidated annual reports on the internal financial control system and on its work on the basis of annual reports supplied by users of budget (central and local government level) concerning the activities relative to the establishment and development of financial management and control, and on the performed internal audits and the internal audit activities.

After the Public Internal Financial Control Council has discussed the consolidated report, the Minister of Finance approves and submits it to the Government of the Republic of Croatia.

The previous year's report should be submitted until end-April of the current year. The consolidated report contains aggregate and important data on financial management and control, more significant findings and recommendations provided by internal audit, and more significant activities undertaken by user of budget heads for the purpose of improving the internal financial control system.

To make the production of the consolidated annual report possible, the Minister of Finance passed the Instruction on the Production of the Annual Public Internal Financial Control System Report²² to ensure the application of a uniform report production methodology for both financial management and control and internal audit fields.

²² *Narodne novine* 8/07

5.1. Methodology and Standards Co-ordination and Harmonisation

The Central Harmonisation Unit is responsible for the development and implementation of the Financial Management and Control and Internal Auditing methodology and standards. Special attention is being paid to the development of procedures and audit trails for financial management and control and to the development of the Financial Management and Control Manual, the Internal Auditors' Manual, the Internal Auditors' Charter template and the Internal Auditors' Professional Code of Ethics. Additionally, this unit provides methodological guidelines in respect of financial management and control and internal audit. Aiming at completing the said tasks efficiently, the Central Harmonisation Unit regularly monitors the development of the international internal auditing standards (IIA)²³, the development of the international financial management and control models (COSO) and other relevant standards.

The Ministry of Finance's Central Harmonisation Unit performs quality control of the financial management and control and internal audit systems. The aim is to adequately monitor the implementation of recommendations and agreement on them with users of budget subject to the Law and for the purpose of collecting information needed for the improvement of the work methodology and standards.

The Central Harmonisation Unit also evaluates the activities performed by internal audit units and those in the field of financial management and control, oversees the execution of the identified requirements and analyses the functions of internal audit units and of financial management and control in the central government bodies and in the local and regional self-government units alike.

The core assignment of the Central Harmonisation Unit also focuses on training of persons in charge of the financial management and control establishment and of internal auditors, a topic described in a separate section of this Strategy.

5.2. Planned Activities of the Central Harmonisation Unit for the Establishment of Internal Financial Controls in Local and Regional Self-Government Units

In addition to the Law passed, the Financial Management and Control Manual and the Training Programme, the Central Harmonisation Unit will also produce other necessary bylaws from the field of financial management and control (the Financial Management and Control Rulebook) and will issue the necessary guidelines and instructions to make the establishment of this system possible for all users of budget. Amongst other, this refers to the development of instructions on listing and describing business processes, risk management instructions, business processes listing and describing examples (audit trail drafting), examples of the financial management and control system establishment plan, risk register and the risk management strategy.

In the field of internal audit, a new Internal Audit Rulebook will be passed. Also, the Internal Auditors' Manual will be improved, i.e. all implementing regulations required by the Law will be brought forth.

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Furthermore, the plan is to establish co-operation with the competent ministries and professional associations (e.g. the Association of Employers in Health, the Elementary and Secondary School Head Masters' Association, the Croatian Counties' Association, the Association of Cities and Municipalities) in order to find best system establishment solutions for individual activities (health, education, judiciary) at local levels.

The Central Harmonisation Unit's activities will also be oriented towards further strengthening of accountability of institution heads and other persons involved in financial management and control and in internal auditing. The purpose behind these efforts has to do with raising awareness of the need of establishing the system of internal financial control with all users of budget to enable as good financial and other management of public resources as possible.

Furthermore, an ongoing professional improvement, skills upgrade and awareness raising efforts are envisaged, as well as the exchange of experiences between the central and local government levels through conferences, seminars and workshops. The exchange of experiences will enable not only better local development and improvement of the system, but also will serve as a feedback vehicle to inform of the need of making changes to the methodology and further development of the internal financial control system.

The Central Harmonisation Unit will provide advisory assistance to local and regional self-government units in finding best solutions in respect of roles of persons who will be in charge of the system establishment. This advisory role will involve giving opinion on various organisational solutions in the light of specific properties found at local levels. In addition, it will give advice on listing and describing business processes, risk assessment and management and on internal control self-assessment.

A total of 2,650 local level users of budget are obliged to establish the financial management and control system. The persons in charge of this system establishment must undergo training organised by the Central Harmonisation Unit.

For the purpose of developing the internal auditors' profession and improving the quality of their training, the Central Harmonisation Unit will produce a document on the long-term development of public internal auditors' training system and will be delivering continuous internal auditors' training in line with this document.

Similarly, it will keep organising annual seminars for all public internal auditors. Special annual seminars will be organised for the purpose of developing specific sets of knowledge to cater for the needs of internal auditors in regional self-government units.

In co-operation with the counties, the Central Harmonisation Unit will organise training centres or regional training venues to deliver training on internal financial control.

These regional venues or training centres are planned for the cities of:

- Zagreb,
- Split,
- Rijeka,
- Pula,
- Osijek.

The regional training venues will serve to deliver training for persons in charge of financial management and control with users of budget who are geographically closest to the given regional training venue. Rijeka or Pula will be defined as training centres depending on the number of persons who are gravitating toward these cities.

Additionally, these regional training venues and other cities and local and regional self-government units alike will see activity of mentors who will practically train local level internal auditors, who are involved in the training process to acquire a public sector certified internal auditor's certification. The mentors would be in charge of leading mentorship with first internal audits.

Apart from this, options for organising train-the-trainers courses will be considered. In co-operation with the Central Harmonisation Unit's trainers, these trainers could deliver training on the internal financial control system in local and regional self-government units.

The sustainability of training of internal auditors but also of the persons involved in Financial Management and Control will be achieved by the further increase of the Central Harmonisation Unit staff, and its organisational and human resource strengthening. As well, it will be necessary to take into consideration in the forthcoming period the establishment and development of the internal auditors' training in cooperation with the Croatian Institute of Internal Auditors which was set up in the Republic of Croatia in 2006. Particularly, it will be possible when the first internal auditors in the Republic of Croatia acquire the certificates of certified internal auditors of the U.S.A. Institute of Internal Auditors (IIA). Following this, the Croatian Institute of Internal Auditors will proceed with the further internal auditors' training process together with the Central Harmonisation Unit of the Ministry of Finance.

Related to the establishment of training, there is a possibility to cooperate also with the Association of Accounting and Financial Employees, and the Internal Auditors' Department (Section) functions within it. However, these forms of cooperation will need to be previously agreed and confirmed by written agreements.

In late January 2008, the local level users of budget will for the first time file their reports to the Central Harmonisation Unit on the activities undertaken for the establishment of the internal financial control system. It is expected that the Central Harmonisation Unit will provide its assistance for the purpose of producing these annual reports in a uniform fashion.

The Central Harmonisation Unit is in charge of keeping and maintaining a register of persons involved in financial management and control. Therefore, all of those users of budget who already appointed persons in charge of the establishment of this system are obliged to supply their respective decisions on these appointments to the Central Harmonisation Unit.

The Central Harmonisation Unit is in charge of keeping the registers on internal audit units and on internal auditors. When supplying their annual reports, users of budget also must submit data on the setup of the units and the establishment of internal audit overall.

The establishment of financial management and control and internal audit in local and regional self-government units will require a far greater scope of work of the Central Harmonisation Unit as compared to what is being done right now. Since the Central

Harmonisation Unit employs a staff of nine, there will be a need to plan for an increase in the number of professional staff in the Central Harmonisation Unit.

5.3. Co-operation between the Central Harmonisation Unit and Other Bodies

The Central Harmonisation Unit co-operates with users of budget and other institutions, as well as with organisations whose scopes of competence are related to auditing (commercial audit, state audit, internal audit).

This co-operation is essential for improving the internal financial control system.

The Strategy and the Rulebook set forth that co-operation with the State Audit Office is needed to determine a common approach to the most important auditing issues, while keeping the autonomy and independence of both state and internal auditors in mind.

Pursuant to the provisions of the Public Internal Financial Control Law, internal auditors are obliged to co-operate with state auditors and provide them with all data pertaining to the content of the completed internal audits. The co-operation with the State Audit Office may also pertain to the internal audits planning process, in order to avoid duplicating some auditing work.

Joint training of internal and state auditors is one of the most important forms of co-operation, which will keep developing during the course of years. As early as at the beginning of 2006, the Ministry of Finance's internal auditors were involved in the process of training the state auditors on auditing the pre-accession funds.

This training was organised within the framework of a twinning project between the State Audit Office and the representatives of the National Audit Office of Great Britain.

A joint seminar also was organised including the participation of the state audit representatives and internal auditors in order to familiarise auditors with the methodology and manner of work of both state and internal auditors. Such workshops and seminars will be taking place in the future as well in order to achieve ever better training and linkage between the two professions.

The Central Harmonisation Unit is involved in the activities of the Croatian Institute of Internal Auditors, a branch of the International Institute of Internal Auditors. In June 2006, the constituent assembly of the Institute took place, when the Statute was adopted and members of the Institute's bodies were elected.

Furthermore, co-operation was established with the Croatian Association of Accountants and Financial Experts, i.e. with its Internal Auditors' Section. This section gathers internal auditors from all institutions once a year for a joint seminar.

In addition to the said concerning the establishment and development of financial management and control, there is a plan to establish co-operation with professional associations (e.g. the Association of Employers in Health, the Elementary and Secondary School Head Masters' Association, the Croatian Counties' Association, the Association of Cities and Municipalities) in order to find best system establishment solutions for individual activities (health, education).

In the light of all said, the Central Harmonisation Unit will try and establish any type of co-operation which would help accelerate and improve quality of the building and further development of the internal financial control system at both central and local government levels.

6. Public Internal Financial Control Council

The provisions contained in Article 34 of the Law prescribe the authorities of the Public Internal Financial Control Council. Until the passage of this Law, only the Internal Audit Council was in place, dealing with the internal auditing issues and drawing on the PIFC Development Strategy for the definition of its authorities. The Law sets forth that the new Council would consider the matters falling under the scope of financial management and control, in addition to those relative to internal auditing. Thus, the Government of the Republic of Croatia appointed the Public Internal Financial Control Council (hereinafter referred to as the Council) as at 9 March 2007 at the proposal of the Minister of Finance, and dismissed the then Internal Audit Council.²⁴

The Council consists of some twenty members and is presided over by the Minister of Finance. Among others, members of the Council include the Auditor General, several ministers, several Financial Management and Control Heads who are also senior officials in various ministries, several internal audit unit heads, a representative of the City of Zagreb, a representative from the Zagreb's Faculty of Economics, the Chairman of the Croatian Institute of Internal Auditors and the Head of the Ministry of Finance's Central Harmonisation Unit.

The Council was founded for the purpose of developing financial management and control and of internal audit. The Council is the Minister of Finance's advisory body and has no executive responsibilities.

According to the Law, the Council's activities focus on:

- a) Improvement of risk management and self-assessment of internal control undertaken by the Users of Budget Heads;
- b) Follow-up of the activities taken by the Users of Budget Heads, following their risk assessment and internal control self- assessment;
- c) Follow-up of recommendations, by the Users of Budget Heads, which were given by internal audit and the State Audit Office;
- d) Safeguarding of functional independence and the development of internal audit;
- e) Providing recommendations for the development of financial management and control, and internal audit;
- f) Evaluation of the justification of reasons for the dismissal and/or transfer of the Internal Audit Units' Heads;
- g) Providing advice and opinion, if judged appropriate, on the Consolidated Annual Public Internal Financial Control Report (managerial accountability, financial management and control, internal audit) before its endorsement by the Minister of Finance and subsequent submission to the Government of the Republic of Croatia.

Should the Council establish that there are some open issues arising out of its work, it shall inform the Government of Croatia on these issues for the purpose of taking adequate actions.

This should make the work of the Ministry of Finance's Central Harmonisation Unit easier, since the Council will inform the Government of the Republic of Croatia of some difficulties in the development and implementation of internal financial control system. This would lead to arriving at certain conclusions aimed at taking measures for the improvement of

²⁴ The dismissal and appointment resolutions published in *Narodne novine* 27/07.

the situation. Of course, the users of budget heads would first be alerted as to what measures and actions should be taken in order to put a legally prescribed system in place.

The first Council's meeting took place on 10 May 2007 to discuss the Consolidated 2006 Republic of Croatia's Public Internal Financial Control Report. The Council extended its commendations on the results achieved in this field, detected some difficulties in relation with the development of this system and arrived at certain conclusions, which were proposed for the passage to the Government of the Republic of Croatia.

In the future period, the Council's work should be oriented towards the internal financial control activities and problem areas arising at local levels. The local level representatives would be adequately informed of the matter for the purpose of taking measures from their scopes of competence towards the improvement of the system.

7. State Audit

The State Audit Office is an autonomous and independent state body reporting exclusively to the Croatian Parliament for its work. In the organisational sense, it is established via the Central State Audit Office in Zagreb and 20 regional offices in the counties' centres.

According to the provisions of Article 1 of the State Audit Office, audits cover auditing of government income and expense, financial reports and financial transactions of government sector units, local and regional self-government units, legal entities funded fully or partly by the budget, public enterprises, companies and other legal persons in which the Republic of Croatia, i.e. local and regional self-government units have majority stock ownership, i.e. majority share ownership and the use of the European Union funds and funds from other international organisations or institutions for funding public needs.

The government sector units cover all legal, executive and judicial power bodies, as well as all agencies, institutions and other entities at the level of the Republic of Croatia and local and regional self-government units, funded by the state budget or the budget of local and regional self-government units.

As a mandatory requirement, audits must be carried out once a year for the State Budget, the funds at the level of the Republic and for the budgets of local and regional self-government units.

Audits of government sector units, local and regional self-government units, public enterprises, companies and other legal persons in which the Republic of Croatia or the local and regional self-government units hold majority stock ownership, i.e. share ownership as well as audits of other entities are carried out on the basis of the annual programme of the State Audit Office.

Certified state auditors perform audits. They are independent, competent persons employed in the State Audit Office, possessing a chartered state auditor's certificate and meeting other conditions set forth in the State Audit Office.

The audit is, according to the State Audit Law, defined as the examination of documents, papers, reports, systems of internal control and internal audit of accounting and financial procedures and other records to determine whether the financial reports present a true financial position and the results of financial activities, in keeping with the accepted accounting principles and the accounting standards.

The audit is also a procedure of examining financial transactions representing government income and expense in terms of the legal use of resources. The audit covers as well making an assessment of the effectiveness and the economy in the performance of an activity and making an assessment of the efficiency in the achievement of objectives belonging to a programme.

Audits are being carried out in compliance with provisions of the State Audit Law, auditing standards of the International Organisation of Supreme Audit Institutions - INTOSAI and other legal acts and rules of profession.

The State Audit Office is obliged to annually submit a report on its work and on the performed audits to the Croatian Parliament.

The Croatian Parliament holds a public discussion on the State Audit Office's reports and findings, and all citizens are informed on this discussion via electronic media, newspapers and other public communication means. In such a way, the Members of the Croatian Parliament and the broad public, i.e. the taxpayer, are made familiar with the operations of the users of budget at central government level and of all local and regional self-government units, as well as with the manner in which all public resources have been used. The state audit reports are available at the State Audit Office's website.

8. Pre-accession Aid Funds for Preparing the Republic of Croatia's Accession to the European Union

As a candidate country for membership of the European Union, the Republic of Croatia has a possibility to utilise the EU pre-accession funds (PHARE, ISPA and SAPARD), including the CARDS programme intended for providing assistance to the countries of southeast Europe. The pre-accession funds are programmes of financial and technical assistance to candidate countries, helping the Republic of Croatia and the countries of middle and Eastern Europe and other candidate countries in their preparation for the full membership of the European Union. These programmes are fully or partially funded by the European Union. These resources are intended not only for the development and strengthening the economy, but also for building the institutional capacity and its alignment with the capacities existing in the EU, including:

CARDS – a technical-financial assistance programme oriented towards the development of institutional and legal frameworks, sustainable economic and social development, promotion of regional and cross-border co-operation between the member-states and the EU membership candidate countries;

PHARE – a programme for providing support in the alignment of the legal framework with the *acquis communautaire* of the EU and for providing assistance in building and strengthening the institutions necessary in the European integration process;

ISPA – a programme for financial assistance to projects in the fields of transport infrastructure and environmental protection;

SAPARD – a programme for providing assistance in the implementation of the *acquis communautaire* in the fields of common agricultural policy and rural development.

The legal framework indicated hereunder provides for management and implementation of the EU programmes in the Republic of Croatia, as well as the authorities of bodies in charge of managing the programmes:

- Law on the System of the European Union Programmes Implementation and the System of Implementation of Projects Funded from the Loan and Grants Funds from other Foreign Sources²⁵
- Decree on CARDS, PHARE, ISPA and SAPARD Programmes Management²⁶
- Decree on the Scope and Content of the Responsibilities and Authorities of Bodies in Charge of Managing the Pre-Accession Aid Instrument²⁷

In January 2007, the European Union introduced a new funding instrument to assist potential Union member-states, as well as to those already having the status of a candidate. The purpose of the Instrument for Pre-accession Assistance (IPA) is to help in alignment with the *acquis communautaire* and convergence to the European Union standards.

IPA replaced the pre-accession programmes effective to date (PHARE, ISPA and SAPARD) and CARDS programme, thereby becoming a single financing instrument for the period 2007-2013.

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The IPA programme represents an integrated aid programme in the pre-accession period, and consists of five components:

1. Transition Assistance and Institution Building;
2. Cross-Border Co-operation;
3. Regional Development (transport, environmental protection, regional competitiveness);
4. Human Resources Development;
5. Rural Development.

The **Central State Office for Development Strategy and Co-ordination of the European Union Funds (CODEF)** is responsible for the overall IPA programme co-ordination, especially for the matters dealing with the preparation, oversight and appraisal. The CODEF is headed by the **National IPA Co-ordinator**, appointed by the Government of the Republic of Croatia.

The overall financial management of the IPA programme falls under the scope of competence of the **National Authorising Officer for IPA Programme** (hereinafter referred to as the National Authorising Officer), i.e. the **National Fund Department** (hereinafter referred to as the National Fund) of the Ministry of Finance.

The Government of the Republic of Croatia determined the institutions responsible for the implementation of individual European Union programmes or parts of such programmes in line with the internationally assumed obligations of the Republic of Croatia, the Decree on the Scope and Content of the Responsibilities and Authorities of Bodies in Charge of Managing the Pre-Accession Aid Instrument.²⁸

The **National Fund** was founded by the Government of the Republic of Croatia as a separate unit in the State Treasury of the Ministry of Finance for the purpose of efficient financial management of the European Union's pre-accession funds, in line with the internationally assumed obligations of the Republic of Croatia.

All funds approved for use from the pre-accession programmes will be received through the National Fund, and such funds will be used by and referred to the end beneficiaries, i.e. the programme implementation agencies in keeping with the European Union rules. The core objective of the National Fund has to do with management of the European Union funds and the establishment of fiscal discipline through their efficient and prudent use.

Objectives to be set through this Fund have to do with a clear and legal process of the implementation of the said programmes, financing the expenses in line with the European Commission's requirements, responsible and efficient use of the aid funds, comprehensiveness of information on the asset value increase and on the achieved results, coupled with improvements in strategic decision-making.

The **National Authorising Officer (NAO)** appointed by the Government of the Republic of Croatia at a proposal of the Minister of Finance is responsible for the work of the National Fund, whereas his most important role pertains to the responsibility for the overall

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financial management of the European Union's pre-accession funds and to his obligation of ensuring the observance of the rules, regulations and procedures of the European Union dealing with procurement, reporting and financial management, and to catering for the establishment and the development of an adequate reporting system and project information system. NAO is under obligation to establish and manage the procedures for interlinking between the National Fund and the implementing agencies and to exercise control over the agencies and end beneficiaries.

Importantly, the National EU Programmes Co-ordinator and the National Authorising Officer are obliged to submit reports on the status of the European Union programmes in the Republic of Croatia. These reports are submitted to the Government of the Republic of Croatia every six months, each referring to the previous semi-annual period.

The Government of the Republic of Croatia appointed the Minister of Finance **Competent Accrediting Officer**, and his task is to issue, monitor, suspend or withdraw the accreditations granted to the National Authorising Officer and the National Fund.

The **Central Finance and Contracting Unit (CFCU)** was established as the Department for Financing EU Assistance Programmes and Projects within the Ministry of Finance, with the sole responsibility of executing payments, accounting, contractual administration and financial reporting on the services rendered, goods delivered and works executed within the framework of the decentralised EC aid implementing system in the Republic of Croatia.

The Central Finance and Contracting Unit ensures reporting in line with the rules, regulations and procedures of the European Union, pertaining to the procurement of services, goods and works and for the efficiency of the reporting and project information system.

The matters dealing with the implementation of projects from the CARDS, PHARE and ISPA programmes are handled by the Central Finance and Contracting Unit of the Ministry of Finance as an implementing agency. It was accredited to that end in February 2006.

The matters dealing with the implementation of projects from the SAPARD programme are handled by the Ministry of Agriculture, Forestry and Water Management, i.e. the Directorate for Market and Structural Support in Agriculture, functioning as the SAPARD Agency.

The competent central government bodies and the bodies of local and regional self-government, i.e. the beneficiaries of the EU pre-accession funds are responsible for the preparation of sectoral annexes in the programming process and for the technical implementation of the European Union aid programmes. These will comprise Project Implementation Units (PIUs), whose primary assignment has to do with the project implementation and monitoring. Before starting the implementation and management of the EU funds, all implementing agencies must get accredited, i.e. they have to put an internal control system in place covering the responsibilities assigned to them in the system, coupled with an obligation of establishing internal audit.

External audit and review of the earmarked spending of the EU pre-accession funds for the CARDS, PHARE and ISPA programmes falls under the responsibility of the State

Audit Office. External audit of the SAPARD programme is performed by the Independent Division for Verification of SAPARD Programme of the Ministry of Finance. The State Audit Office and the Independent Division for Verification of SAPARD Programme of the Ministry of Finance will be performing these audits until the completion of the CARDS, PHARE, ISPA and SAPARD programmes.

In building the institutions in charge of auditing the European Union funds, changes are being introduced to meet the EU requirements. Until end-2007, institutional changes are expected in respect of organisation of external audit of the European Union funds. It was proposed that external audit of the IPA programme be carried out by the Croatian Agency for Auditing Funds of the European Union Programmes Implementation or the Independent Service for Auditing the European Union Programmes System, both from the Ministry of Finance.

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* *

The role of **internal audit** is to give independent assurance on systems and processes, make recommendations and give advice for their improvement and the achievement of the best possible level of efficiency of operations. Internal audit was designed to add value and improve an organisation's operations. It helps the organisation achieve its objectives by bringing in a systematic, disciplined approach to the evaluation and improvement of the efficiency of the risk management, control and governance processes. It alerts to irregularities and non-compliance with legal and other regulations and caters for the accuracy and purposefulness of all activities encompassed by auditing procedures.

As a comprehensive system of internal controls put in place by users of budget heads and falling under their responsibility, **Financial Management and Control** provides reasonable assurance that the budgetary and other resources will be used regularly, ethically, economically, effectively and efficiently during the course of objectives achievement, which means in agreement with laws and other regulations, while safeguarding the resources against loss, abuse and damage.

Moreover, for the implementation of the EU programmes, it is necessary to put in place a sound **control environment and control activities** in all bodies, beneficiaries of the EU funds. The said encompasses a series of policies and procedures designed to assess risks for the purpose of objectives achievement. This can be achieved via the establishment of quality ex-ante and ex-post controls, as well as through systems reviews.

Therefore, a functionally operational internal audit and a developed financial management and control jointly make an integral part of an organisation for the use of pre-accession funds, i.e. they create organisational entities/bodies tasked with programming, receipt, distribution and earmarked spending of the pre-accession funds, both centrally and locally.

These matters were also prescribed in the provisions of the Public Internal Financial Control Law in respect of the public authority bodies, i.e. those users of budget who manage the European Union funds. The Law prescribes that financial management and control cover all resources, including the European Union funds. On the other hand, internal audit contributes to the protection of the European Union's financial interests by providing its professional opinion stemming from audits carried out in the field of the EU funds. The Law

prescribes that those users of budget who use the EU funds must establish internal audit, irrespective of the applicability of the set criteria.

Pursuant to Article 32 of this Law, Internal Audit Units of those Users of Budget authorised for the implementation of the European Union funded programmes and projects shall perform internal audit of administration, and internal audit of financial and technical-management systems. Internal audits shall be carried out with the Users of Budget or another institution authorised for the implementation of programmes and projects fully or in part funded by the European Union, including all other participants who received funds for programmes and projects of the European Union.

While performing EU funds audits, internal auditors take account of both laws and regulations of the Republic of Croatia and those applicable in the EU, bearing all their subsequent changes in mind.

With its accession to the European Union, a possibility will open up for the Republic of Croatia to use the cohesion and structural EU funds intended for the member-states.

For these reasons, accredited institutions with the respective systems of internal controls stand as an absolute necessity.

9. Irregularities and Fraud

In late 2006, the Irregularities and Fraud Prevention Section (Anti Fraud Co-ordinating Structures, AFCOS) – the national central contact point for co-operation with OLAF (EC's Anti Fraud DG) – was established within the State Treasury's Budget Supervision Division of the Ministry of Finance.

All member-states have such a structure in place, whose role is to provide assistance and support to OLAF and the member-states in an efficient fight against fraud and irregularities.

In December 2006, the Decree on Amendments to the Ministry of Finance's Internal Organisation Decree²⁹ was passed to establish the Irregularities and Fraud Prevention Section in the State Treasury's Budget Supervision Division.

This Decree identified the scope of the Section which became the central national body or the AFCOS (Anti Fraud Co-Ordination Structures) in charge of co-operation with OLAF (*Office European de Lutte Anti-Fraude*). This organisational solution is also in line with the European Commission's Anti Fraud Regulation.

In keeping with the said Decree, the Section co-ordinates the legislative, administrative and operational activities aimed at protecting the financial interests of the European Union; it co-operates directly with the European Commission's Anti Fraud Directorate-General (OLAF); it exchanges information on irregularities and fraud with the European Commission's Anti Fraud Directorate-General; it takes part in their direct inspections and investigations; exchanges information with other public authority bodies in cases of suspected irregularities and fraud in the use of the European Union's funds; it files relevant charges to the competent bodies of the Republic of Croatia and monitors the course of the investigative procedures; it co-operates with the relevant bodies in the production and implementation of the National Anti Fraud Strategy; in co-operation with the European Commission's Anti Fraud Directorate-General, it develops the professional training programmes for the employees of institutions involved in the protection of financial interests of the European Union and provides organisational support in their implementation.

The amendments to the Ministry of Finance Internal Arrangements Rulebook as of 6 February 2007 determined the optimal number of employees of the Section, their jobs description and the required professional conditions for individual jobs. Currently, the Section is in its final staffing stage.

In end-January 2007, the Minister of Finance passed the AFCOS Croatia Action Plan, identifying the activities and the deadlines for a more expedient and more efficient operability of the AFCOS.

The provisions contained in Article 36 of the Law set forth that the User of Budget Head shall be obliged to appoint an Irregularities Officer who shall receive the notifications on irregularities and suspected cases of fraud or to autonomously take actions against irregularities and fraud. Upon the receipt of a notification on an irregularity or suspicion of fraud, the User of Budget Head or the Irregularities Officer shall take adequate measures and

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inform the State Attorney of the Republic of Croatia in case of national funds and the Irregularities and Fraud Prevention Section in case of the EU funds, and within 15 days shall inform in writing the person who alerted to an irregularity or fraud as to the measures taken.

The procedures in cases of irregularities and fraud in relation to competent bodies of the Republic of Croatia and the European Union and other relevant issues shall be provided for in special regulations.

10. Conclusion

Through the achievement of objectives in line with the Public Internal Financial Control Law and this Strategy and with the proposed activities for the development of the internal financial control system and the activities of CARDS 2004 Project "Strengthening the Public Internal Financial Control Structure in the Republic of Croatia", the Central Harmonisation Unit of the Ministry of Finance will jointly with the Project experts keep strengthening its institutional capacity in this field and will keep providing support to local and regional self-government units in their efforts towards the introduction and implementation of the internal financial control system.

The activities will chiefly be oriented towards the further strengthening of the user of budget heads' accountability and of the persons in charge of this system's establishment, for the purpose of raising awareness of the absolute necessity for establishing internal financial control to enable better management of public resources.

As a co-ordinating body, the Central Harmonisation Unit of the Ministry of Finance will focus its activities on training internal auditors and persons in charge of financial management and internal controls in local and regional self-government units, in order to start with the establishment and development of this system at local levels.

In order to implement all what was indicated in this Strategy, it is necessary to apply all the principles and arrangements as provided for by the Public Internal Financial Control Law. Therefore, the Central Harmonisation Unit is obliged to:

- Carry out all the necessary activities concerning the establishment and development of the internal financial control system at both central and local levels;
- Continuously perform the activities relating to raising awareness of the user of budget heads concerning the need for establishing and developing this system;
- Permanently improve the quality of training and of work methodology for internal auditors and persons in charge of financial management and control towards quality performance of their tasks;
- Hire an adequate number of professional staff to discharge duties stemming from the Law at both central and local levels.

Therefore, this Strategy points out the tasks ahead of the Ministry of Finance's Central Harmonisation Unit. On the other hand, local and regional self-government units will implement the internal financial control system in keeping with the legal provisions and their possibilities until end-2010.

In these activities, the Central Harmonisation Unit will receive assistance and support from CARDS 2004 Project's experts and the experts of the European Commission, who will provide all the necessary help and advice for further development of internal financial control system at local levels.

11. Timeframe of Activities Relating to the Internal Financial Control System Development in Local and Regional Self-Government Units Until 2010

Description of Activities	Persons/Entities in Charge	Deadline or Period of Work
A) JOINT ACTIVITIES		
<ul style="list-style-type: none"> Keep carrying out promotional activities in local and regional self-government units concerning the Law and raising awareness of managerial accountability in the establishment of the internal financial control system 	<ul style="list-style-type: none"> Central Harmonisation Unit CARDS 2004 	Ongoing
<ul style="list-style-type: none"> Produce annual reports on: <ul style="list-style-type: none"> the Financial Management and Control system the performed audits and internal audit activities 	<ul style="list-style-type: none"> Local and Regional Self-Government Units 	31 January, every year
<ul style="list-style-type: none"> Produce the annual report on the internal financial control system on the basis of annual reports submitted by users of budget on the activities relative to the establishment and development of financial management, and on the basis of annual reports on the performed internal audits and internal audit activities of local and regional self-government units, as well as on the work of the Central Harmonisation Unit 	<ul style="list-style-type: none"> Central Harmonisation Unit Public Internal Financial Control Council Minister of Finance Government of the Republic of Croatia 	30 April, every year
<ul style="list-style-type: none"> Organise a seminar for user of budget heads at central and local government levels on the establishment of the internal financial control system and managerial accountability 	<ul style="list-style-type: none"> Central Harmonisation Unit EU's DG Budget 	September 2007
<ul style="list-style-type: none"> Keep and maintain registers of internal audit units, internal auditors' charters, the register of certified auditors and persons involved in financial management and control of local and regional self-government units 	<ul style="list-style-type: none"> Central Harmonisation Unit 	Ongoing
<ul style="list-style-type: none"> Check of the compliance of legal and other regulations related to control functions, with the regulations prescribing the internal financial control system 	<ul style="list-style-type: none"> Central Harmonization Unit 	Continuously
B) FINANCIAL MANAGEMENT AND CONTROL (FMC) ACTIVITIES		

<ul style="list-style-type: none"> • Pass the Financial Management and Control Rulebook 	<ul style="list-style-type: none"> • Minister of Finance at the proposal of Central Harmonisation Unit and CARDS 2004 Project Team 	By 31 December 2007
<ul style="list-style-type: none"> • Establish and regulate (where still required) adequate FMC structures in each user of budget <p>Appoint financial management and control head and other persons in charge of FMC establishment</p>	<ul style="list-style-type: none"> • Users of budget with the help from the Central Harmonisation Unit • Users of budget 	By end-2007
<ul style="list-style-type: none"> • Organise regular meetings with the users of budget representatives, consult them on the proposed regulations and continuously provide instructions, guidance and advice, as needed 	<ul style="list-style-type: none"> • Central Harmonisation Unit 	Ongoing
<ul style="list-style-type: none"> • Develop a Risk Management Methodology 	<ul style="list-style-type: none"> • Central Harmonisation Unit 	By 30 June 2008
<ul style="list-style-type: none"> • Production of written procedures for the existing business processes or audit trails 	<ul style="list-style-type: none"> • Central Harmonisation Unit • Users of budget 	By 31 December 2010
<ul style="list-style-type: none"> • Pass a training plan for persons involved in FMC at local level 	<ul style="list-style-type: none"> • Central Harmonisation Unit 	By 30 June 2007
<ul style="list-style-type: none"> • Deliver training for persons in charge of FMC establishment and development in line with the Training Plan 	<ul style="list-style-type: none"> • Central Harmonisation Unit 	By 31 December 2010
C) INTERNAL AUDIT ACTIVITIES		
<ul style="list-style-type: none"> • Pass a new Users of Budget Internal Audit Rulebook to provide for the performance of internal audit, as well as the criteria for the establishment of internal audit with users of budget, whose content will be aligned with the Public Internal Financial Control Law 	<ul style="list-style-type: none"> • Minister of Finance at the proposal of Central Harmonisation Unit and CARDS 2004 Project Team 	By 31 December 2007
<ul style="list-style-type: none"> • Pass a new Internal Auditors' Professional Code of Ethics, whose content will be aligned with the Public Internal Financial Control Law 	<ul style="list-style-type: none"> • Minister of Finance at the proposal of Central Harmonisation Unit 	By 31 December 2007
<ul style="list-style-type: none"> • Pass a new Internal Auditors' Charter template, whose content will be aligned with the Public Internal Financial Control Law 	<ul style="list-style-type: none"> • Minister of Finance at the proposal of Central Harmonisation Unit 	By 31 December 2007
<ul style="list-style-type: none"> • Pass the Internal Auditors' Charter in line with the template charter 	<ul style="list-style-type: none"> • Users of budget 	Ongoing

<ul style="list-style-type: none"> Update the Internal Auditors' Manual towards the internal auditors' work methodology improvement, whose content will be aligned with the Public Internal Financial Control Law 	<ul style="list-style-type: none"> Minister of Finance at the proposal of Central Harmonisation Unit and CARDS 2004 Project Team 	By 31 December 2007
<ul style="list-style-type: none"> Produce materials for additional professional improvement and training of internal auditors for optional modules 	<ul style="list-style-type: none"> Central Harmonisation Unit with assistance of CARDS 2004 Project Team 	By 31 December 2007
<ul style="list-style-type: none"> Pass a local and regional self-government units' internal auditors' training plan for the period 2008-2010 	<ul style="list-style-type: none"> Central Harmonisation Unit 	By 31 December 2007
<ul style="list-style-type: none"> Deliver internal auditors' training in line with the local and regional self-government units' internal auditors' training plan 	<ul style="list-style-type: none"> Central Harmonisation Unit 	Ongoing by 31 December 2008
<ul style="list-style-type: none"> Carry out mentorship during the performance of initial practical audits in local and regional self-government units 	<ul style="list-style-type: none"> Central Harmonisation Unit CARDS 2004 Mentors, certified internal auditors from SAB and LRSGU 	Ongoing
<ul style="list-style-type: none"> Establish and regulate (where still required) adequate establishment of internal audit in each local and regional self-government unit in line with the prescribed criteria and appoint heads and internal auditors 	<ul style="list-style-type: none"> Local and regional self-government unit Central Harmonisation Unit 	By 31 December 2007
<ul style="list-style-type: none"> Organise regular meetings with the local and regional self-government units' representatives, consult them on the proposed regulations and continuously provide instructions, guidance and advice, as needed 	<ul style="list-style-type: none"> Central Harmonisation Unit Ministries/SAB Local and regional self-government unit 	Ongoing
<ul style="list-style-type: none"> Organise the annual public sector internal auditors' seminar 	<ul style="list-style-type: none"> Central Harmonisation Unit Local and regional self-government unit 	October 2007 October 2008 October 2009 October 2010

Annex 1 – Legal Framework for Financial Management and Control at Local Level

The operations of local and regional self-government bodies are regulated by the following regulations:

- Law on the Areas of Counties, Cities and Municipalities in the Republic of Croatia (*Narodne novine* 86/06);
- Law on Local and Regional Self-Government (*Narodne novine* 33/01, 60/01 and 129/05);
- Budget Law (*Narodne novine* 96/03);
- Law on Financing Local and Regional Self-Government Units (*Narodne novine* 117/93, 33/00, 73/00, 127/00, 59/01, 107/01, 117/01, 150/02, 147/03 and 132/06);
- Communal Governance Law (*Narodne novine* 26/03 – official version, 82/04, 110/04 and 178/04);
- Concessions Law (*Narodne novine* 89/92);
- Fire Fighting Law (*Narodne novine* 139/04 – official version and 174/04);
- State Budget Execution Law;
- Public Internal Financial Control Law (*Narodne novine* 141/06);
- Budget Accounting and Chart-of-Accounts Rulebook (*Narodne novine* 119/01, 74/02, 3/04 and 27/05);
- Budget Accounting Financial Reporting Rulebook (*Narodne novine* 27/05 and 2/07);
- Budget Supervision Rulebook (*Narodne novine* 42/04 and 6/06);
- Instruction on Economical and Functional Classifications of Expenses/Expenditure and Revenues and Receipts (*Narodne novine* 140/02);
- Public Procurement Law (*Narodne novine* 117/01, 197/03 and 92/05);
- Small Value Goods, Works and Services Procurement Procedure Decree (*Narodne novine* 14/02);
- Public Procurement Notices and Records Decree (*Narodne novine* 14/02, 18/02 and 122/05);
- Decree on the Manner for Calculation of the Equalisation Grants Amounts for the Decentralised Local and Regional Self-Government Units' Functions for 2007;
- Decision on the Conditions and Manner for Cash Payments (*Narodne novine* 36/02);
- Decision on the Criteria and Measures for the Definition of Balance Sheet Entitlements for Financing the Minimum Public Needs Financial Standard in Elementary Education for 2007;
- Decision on the Criteria and Measures for the Definition of Balance Sheet Entitlements for Financing the Minimum Public Needs Financial Standard for Secondary Schools and Student Dormitories for 2007;
- Decision on Minimum Financial Standards for Material and Financial Expenses of the Social Welfare Centres and Wood Heating Housing Allowances 2007;
- Decision on Minimum Financial Standards for the Decentralised Functions for Health Institutions for 2007;
- Decision on Minimum Financial Standards for the Decentralised Financing of Homes for the Aged and the Disabled Persons for 2007;
- Decision on Minimum Financial Standards for the Decentralised Financing of the Regular Public Fire Brigades' Activities for 2007; and
- Special regulations providing for rights and duties within individual activities.

Annex 2

Organisation Chart of the
Department for Harmonisation of Internal Audit and Financial Control
(Central Harmonisation Unit) within the Ministry of Finance
as at 31 December 2006

