

# Extent of Financial Management and Control and Internal Audit in Local Governments and Local Public Enterprises

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## 1. INTRODUCTION

Financial management and control (FMC) and internal audit (IA) were first introduced into the Serbian public sector with the 2008 National Programme for European Integrations. The Stabilisation and Association Agreement with the European Union (EU), which Serbia signed in 2013, mandated the introduction of these processes and functions. Chapter 32, Financial Control, was the first negotiating chapter in the EU accession process to include issues of FMC and IA.

The introduction of these functions into Serbia's public sector is closely linked with EU accession. In the second half of 2017, the Government of Serbia (GoS) adopted the [Public Internal Financial Control Development Strategy, 2017-2020](#) ('the PIFC Strategy'). Its implementation is a major part of the EU accession process, given that Chapter 32 comprises PIFC issues. The PIFC Strategy is part of overall efforts to reform public administration, and aims at ensuring good governance by incorporating standard FMC and IA practices into day-to-day activities.

The PIFC Strategy is underpinned by appropriate regulations, above all the Budget System Law and statutory instruments based on this piece of legislation.

The GoS has lent additional backing to these processes by integrating them into another strategic document, the [Public Financial Management Reform Programme, 2016-2020](#).

The Ministry of Finance (MoF) Central Harmonisation Unit (CHU) is the entity tasked with implementing and monitoring efforts to introduce FMC and IA. The MoF makes PIFC policy, whilst the CHU is charged with putting it into practice.

Under the [Budget System Law](#), all beneficiaries of public funds<sup>1</sup> (BPFs) are required to establish FMC and IA by one of the modes set out in legislation, and to report to the CHU annually on the status of FMC and IA in their organisations. This law, however, did not prescribe any time limits for these functions to be introduced, which has resulted in divergent practice.

The European Commission's [Serbia 2018 Report](#) noted that the country had made some progress in this regard and that recommendations made by the Commission in 2016 had been partially implemented. The Commission went on to claim that implementation of internal control remained generally weak and that internal audit practice in the public sector was still developing, as well as that high-level political support would remain instrumental for the implementation of PIFC reforms at all levels of the administration and in state-owned companies.

According to the latest publicly available data published in the most recent PIFC Strategy, IA has been introduced at all ministries, the three mandatory social insurance funds, numerous BPFs at the national level, and few BPFs at the level of local governments (LGs).

This study focuses on FMC and IA in LGs and public enterprises owned by LGs (local public enterprises, or LPEs).

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<sup>1</sup> The Budget System Law defines 'beneficiaries of public funds' as direct budget beneficiaries (authorities and organisations established by the Republic of Serbia and authorities and services established by local governments) and indirect budget beneficiaries (judicial authorities; budget funds; local community councils; public enterprises; funds and directorates established by local governments funded from public revenues for purposes governed by specific legislation; and institutions established by the Republic of Serbia or local governments).

## 2. PURPOSE

There are currently no systematically collected or accurate data about the number of LGs and LPEs that have introduced FMC procedures and IA functions. There is also no information about the reasons for the absence of these arrangements in LGs and LPEs and/or their quality. In view of the importance of this information, the Local Public Finance Reform Project (RELOF, [www.lokalnefinansije.rs](http://www.lokalnefinansije.rs)), supported by the CHU, resolved to perform research to assess the current state of play in LGs and a sample of selected LPEs. The purpose of the research was to arrive at an accurate and impartial picture of the current extent of FMC and IA in LGs and LPEs.

Since a comprehensive overview of the current state of play is the initial precondition for supporting the introduction and/or enhancement of these arrangements, this wide-ranging research aimed at collecting all information relevant to the current status of FMC and IA in LGs and selected LPEs. The MoF CHU will benefit from the findings as a starting point for planning future activities, as will the LGs themselves. In addition, the data will inform continuing activities of RELOF, whose upcoming second phase (2019-2022) will include extensive support for LGs in their efforts to introduce and/or enhance these arrangements.

## 3. METHODOLOGY

The nature of the topic meant that the research had to be both qualitative and quantitative, whilst a questionnaire was chosen as the most appropriate research instrument. As it was imperative to cover all LGs and selected LPEs throughout Serbia within the limited time available, RELOF felt a survey would be the most efficient option. Statistical analysis was used for quantitative research, whilst narrative analysis was employed for qualitative data. To achieve the objectives of the research, RELOF undertook a series of activities which are described in more detail below.

### 3.1 Survey

The survey comprised a number of steps as outlined in this section.

**Development of questionnaire.** Creating a survey questionnaire was the first step. The LG questionnaire covered FMC and IA, whilst the LPE section included questions related to oversight. The questionnaire was designed to be as simple as possible and so allow respondents to complete it as quickly as practicable.

The initial questionnaire was developed by RELOF experts and was then forwarded to the CHU for consultation before being finalised.

The design of the questionnaire followed a number of basic principles:

- The structure was kept clear: as there were multiple topics, they were dealt with one by one;
- It was easy to understand: was written in plain language and technical terminology was avoided; and
- The questions were clear and unambiguous.

The questionnaire is given below as Annex 1 to this Report.

**Preparation of respondent database.** After all questions were formulated, a detailed base of LGs was prepared and a sample of LPEs was constructed. This database contained contacts of officers tasked with completing the questionnaire at each LG or LPE, depending on their respective organisational structures, which aided the collection of reliable responses.

**Dissemination of questionnaire.** The questionnaire was first e-mailed to LGs established under the Law on Territorial Organisation of the Republic of Serbia, excluding Kosovo and Metohija, urban municipalities (of which there are 30) and the City of Belgrade, for a total of 144 addresses. The questionnaire was also sent out to LPEs from our sample (280 LPEs in total; the goal was to receive feedback from up to 150 local public enterprises).

RELOF took a number of steps to ensure as many respondents as possible completed the questionnaire, namely:

- 1) After the questionnaire was e-mailed, the RELOF Team telephoned the prospective respondents to confirm they had received the e-mail and provide any additional explanations where necessary;
- 2) The RELOF Team telephoned the respondents two days later to remind them to complete the questionnaire;
- 3) Where necessary, the RELOF Team telephoned the respondents a third time to remind them of the final deadline for returning completed questionnaires.

Finally, to ensure as many LGs and LPEs provided feedback, RELOF printed hard copies of the questionnaire and mailed them, accompanied by cover letters, to all prospective respondents.

This approach proved exceptionally successful: as many as 128 LGs and 144 LPEs returned completed questionnaires.

**Development of results database.** The responses to the questionnaire were input into a pre-prepared database pending further statistical processing. The responses were additionally checked at this stage, with some LGs and LPEs contacted once more to clarify vague and/or ambiguous responses.

### 3.2 Data analysis

The data were analysed using appropriate statistical techniques. This analysis provided insight into the current state of play; the results are presented below. Ultimately, to create a robust foundation for future activities, the findings of the research were presented at a Conference in Zaltibor, Serbia, that gathered all the relevant stakeholders.

### 3.3 Presentation of quantitative results

After the research was completed, a Conference was held for all LGs that took part in the process, CHU representatives, and other stakeholders. A conference for LPEs is planned under Phase II of RELOF and will be organised in collaboration with the Ministry of Economy (MoE).

The main goals of the Conference were to:

- 1) Present the quantitative findings so as to allow participants to understand the current extent of FMC and IA;
- 2) Collect information for the qualitative section of the research in focus groups; the objective here was to establish key challenges in implementing these functions and the best practices for their introduction;
- 3) Initiate policy dialogue on improvements to FMC and IA at LGs; and
- 4) Initiate the development of a network of LG staff directly tasked with FMC and IA to enhance peer learning.

The Conference presented the results and main conclusions of the quantitative segment of the research. Detailed findings are given in Section 4 below.

### 3.4 Collection of qualitative information

Four focus groups were created at the conference to facilitate qualitative data collection. The purpose of the groups was to use discussions and exchange of experiences and arguments to define the best approach to overcoming challenges to effective implementation of FMC and IA at LGs.

The focus groups were moderated by RELOF experts and discussed a pre-defined set of topics. The moderators presented the conclusions of each focus group during a plenary session, at which the participants were able to ask additional questions.

The views of the focus groups and principal conclusions of the conference will be described in detail below.

## 4. RESEARCH FINDINGS

### 4.1 Demographics

A total of 128 LGs took part in the research exercise, which was performed from 1 November to 1 December 2018.

**Table 1. Overview of LGs surveyed**

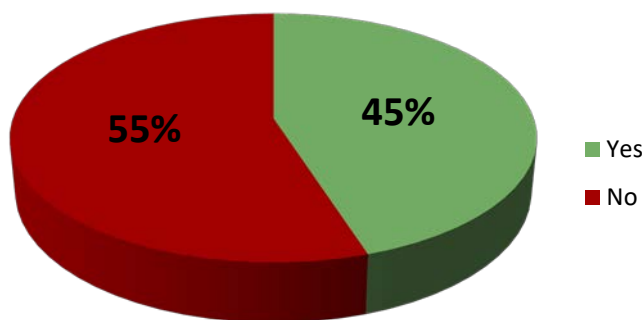
LGs by type	LGs surveyed	Total no. of LGs in Serbia (excl. Kosovo)	% of LGs responding to questionnaire
1	2	3	4(2/3)
Cities	23	28	82%
Municipalities	105	117	89%
Total	128	145	88%

Local governments and LPEs proved exceptionally responsive and ready to co-operate in the course of the research.

### 4.2 Financial management and control

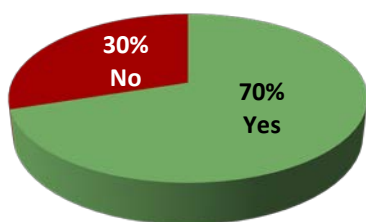
The PIFC Strategy aims at ensuring that FMC and IA are comprehensively integrated into the Serbian public sector governance system. The Budget System Law defines FMC as a system of policies, procedures, and activities established, maintained, and regularly updated by the manager of the organisation in question. Application of the concept of managerial accountability depends on the establishment and maintenance of this FMC system; as noted above, all beneficiaries of public funds are required to establish FMC systems. The current situation at the surveyed LGs is described below.

A total of 128 LGs took part in the research. Of these, 58 (45%) had FMC in place, whilst 70 (55%) did not.

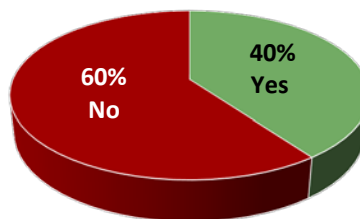


**Figure 1. Presence of FMC in LGs**

Cities have proven much quicker to introduce FMC (16 cities have these arrangements in place, 70% of all cities surveyed). By contrast, only 40% of all municipalities have established FMC (40 of the 105 LGs that took part in the research have introduced FMC systems).

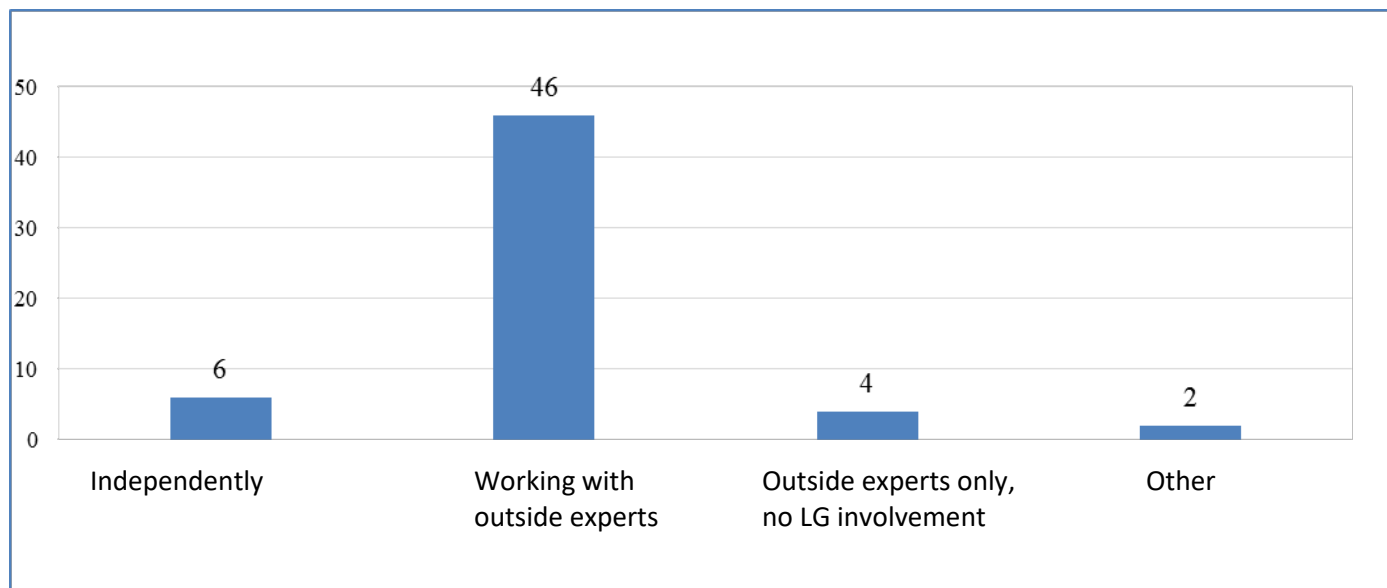


**Figure 2. Presence of FMC in cities**



**Figure 3. Presence of FMC in municipalities**

Few LGs introduced FMC independently; most relied on assistance from and collaboration with external experts. Again, few LGs had their procedures developed independently by external experts. In these cases, the arrangements have by and large proven unworkable as they were accompanied neither by implementing decisions nor training to explain the purpose, importance, and mode of implementation. Here reports for the CHU are also produced by the external experts and only forwarded to the central government by the LG.



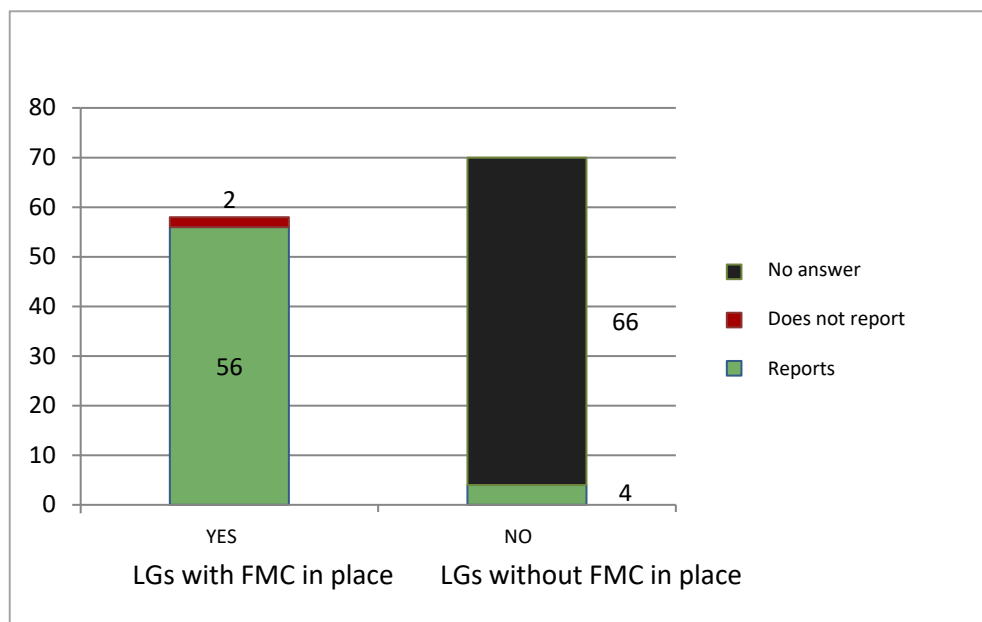
**Figure 4. Approaches to FMC implementation by LGs**

Local governments faced various challenges when introducing FMC. In addition to a set of issues common to all, such as a lack of internal resources (expert staff or funds needed to retain outside expertise), other problems encountered by LGs also included:

- Lack of awareness by managers and staff of the importance of and need for FMC;
- Failure to enact a decision to appoint FMC Manager and FMC Working Party;
- Lack of interest amongst most staff in introducing the system;
- Staff insufficiently trained to develop procedures and assess risk; and
- Staff overload due to hiring freeze and consequent inability to fill all positions. In this context, developing procedures was seen as just one more onerous task.



Beneficiaries of public funds are required<sup>2</sup> to notify the MoF, via the CHU, of the presence of FMC and IA in their organisations for the purpose of consolidated annual reporting on the state of these functions across the public sector. As such, this study also took into account information related to these reporting practices.



**Figure 5. Reporting to CHU**

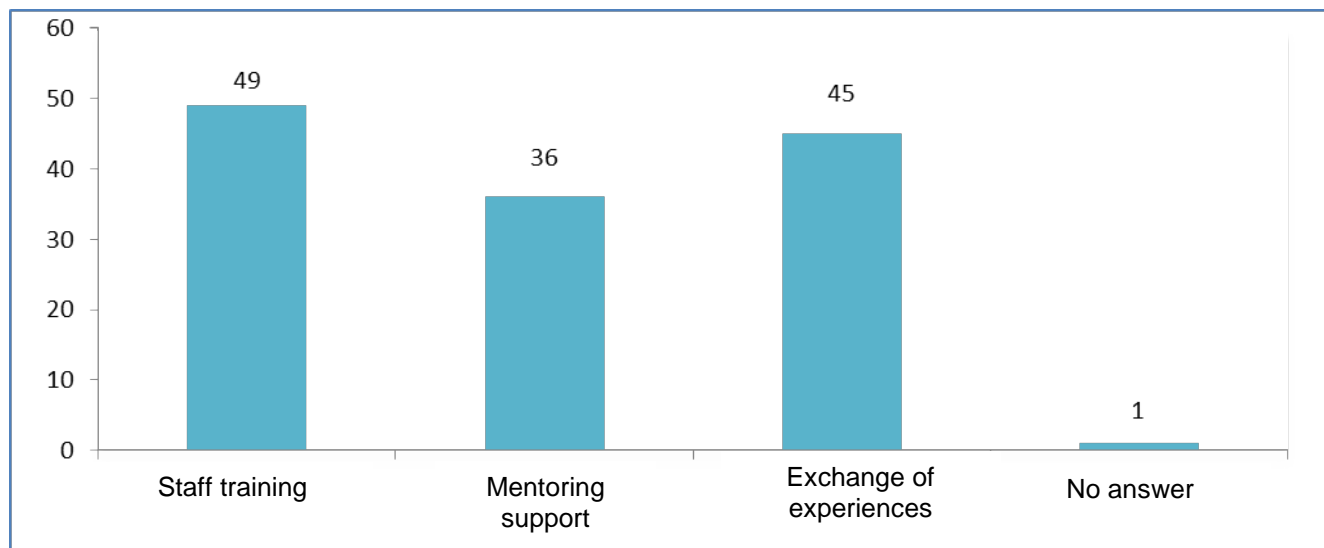
Of the total number of LGs with FMC in place (58), 97% (56) reported regularly submitting reports to the CHU. By contrast, only 4% (3 LGs) with no FMC claimed to do so, with the remaining 96% (67 LGs) did not respond, in the belief that they were under no obligation to produce reports before introducing FMC.

**Significantly, the study revealed that as many as 95% of all LGs (55) claimed to be highly interested in enhancing existing FMC arrangements. Conversely, all respondent LGs that currently lack FMC arrangements (70) reported being interested in introducing this function with the assistance of outside experts.**

This readiness and desire to enhance/introduce FMC at LGs will serve as a robust foundation for future RELOF support to selected LGs.

Local governments reported being the most interested in training for existing staff and exchange of experiences with other LGs (through what is termed ‘peer to peer learning’), whilst mentoring was preferred by fewer LGs. It ought to be noted that many LGs opted for more than one mode of support.

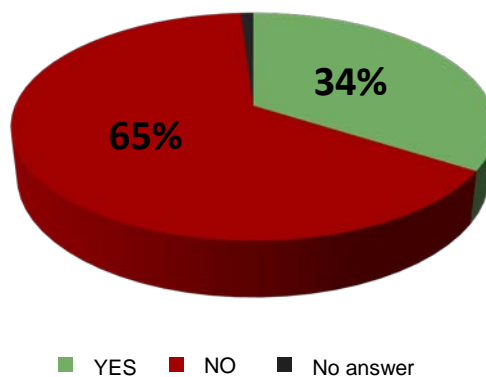
<sup>2</sup> Arts. 81 and 82, Budget System Law (*Official Gazette of the Republic of Serbia*, Nos. 54/09, 73/10, 101/10, 101/11, 93/12, 62/13, 63/13 – Correction, 108/13, 142/14, 68/15 – Other Law, and 103/15).



**Figure 6. Desired support in introducing FMC**

### 4.3 Internal audit

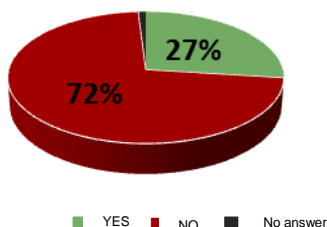
According to the Budget System Law,<sup>3</sup> the PIFC system is made up of the CHU, FMC, and internal audit (IA). This piece of legislation mandates the introduction of internal audit by all LGs. Criteria for introducing IA are set out in the [Regulation on common criteria for organisation and standards and methodological guidelines for conducting internal audit in the public sector](#) (Serbian) enacted by the Minister of Finance in 2011. The manager of each beneficiary of public funds is responsible for establishing IA and ensuring it is able to operate appropriately. However, the Budget System Law does not envisage any time limits for introducing IA, which has led to inconsistencies in practice. The key challenge to the effective implementation of IA and the ability of internal auditors to do their jobs properly is for top managers to embrace this function and understand its utility. A total of 44 LGs who took part in the survey (34%) had IA in place, whilst 84 LGs (65%) did not.



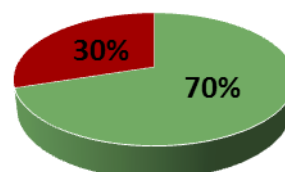
**Figure 7. Presence of IA in LGs**

<sup>3</sup> Art. 80, Budget System Law (*Official Gazette of the Republic of Serbia*, Nos. 54/09, 73/10, 101/10, 101/11, 93/12, 62/13, 63/13 – Correction, 108/13, 142/14, 68/15 – Other Law, and 103/15).

The findings revealed that IA had been introduced by 16 respondent cities (70%), as against only 28 municipalities (27%).

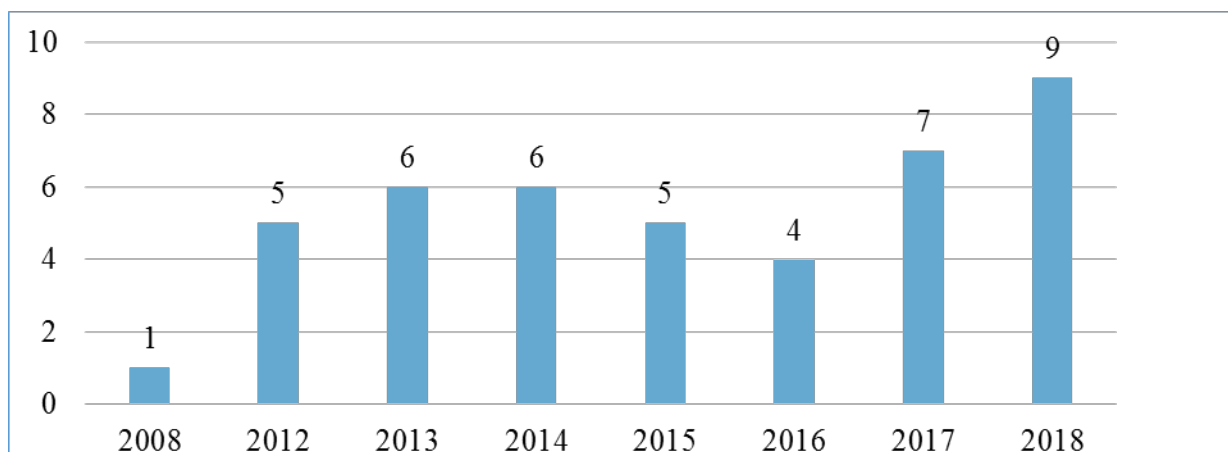


**Figure 8. Presence of IA in municipalities**



**Figure 9. Presence of IA in cities**

Article 2(1)(51g) of the Budget System Law defines internal audit as ‘an activity that provides independent objective assurance and advisory activity with a view to enhancing operations of an organisation and assists in the attainment of the objectives of the organisation’. Although the survey has found that the IA function in LGs is still in its infancy, it is encouraging to see that all LGs lacking internal audit are interested in introducing it, whilst 100% of LGs with IA in place would like to see enhancements to its operation.



**Figure 10. Introduction of IA in LGs by year**

There are various reasons why this function is yet to be introduced, with the most common ones being:

- Public sector hiring freeze: existing staff are unable to take on IA duties in addition to existing responsibilities;
- Length of time required to train Internal Auditors;
- There is a lack of staff with appropriate expertise; and
- Internal Auditor positions are not attractive, the salary cannot compete with private sector pay.

Local governments reported being the most interested in training for existing staff and mentoring support, whilst exchange of experiences with other LGs (through what is termed ‘peer to peer learning’) was preferred by fewer LGs. It ought to be noted that many LGs opted for more than one mode of support.

A cross-assessment of the 128 respondent LGs concluded that 25 had both FMC and IA arrangements in place, whilst 51 had neither.

FMC in place	IA in place	
	Yes	No
Yes	25	33
No	19	51

*Figure 11. Cross-assessment of IA and FMC in LGs*

In the upcoming period, RELOF will pay close attention to supporting LGs without either FMC or IA, and will endeavour to ensure that these LGs introduce at least one of the two systems as quickly as possible. The introduction of at least one of these functions by most of the 51 LGs identified as having neither will serve as a clear signal that LGs are committed to enhancing their decision-making about the use of public funds. In addition, having one function in place will significantly facilitate the introduction of the other. Fostering the exchange of experiences between LGs in this group and motivating them will be a key priority for RELOF in the next stage of support for local authorities.

Finally, appropriate attention will also be paid to enhancing these functions at LGs that have already introduced them. These local authorities will be encouraged to share their valuable experiences with their peers to motivate them, thereby improving the outlook for Serbia as a whole.

## 5. CURRENT EXTENT OF FMC AND IA IN LPEs

### 5.1 General considerations

The FMC and IA survey looked at 144 LPEs, out of a total of 280 that received the questionnaire. The survey took place from 1 November to 1 December 2018 on a sample of LPEs in various sectors, of differing sizes, and based in a variety of locations.

The overall impression is that LPEs that took part in the survey were predominantly interested in the introduction or enhancement of these functions.

### 5.2 Financial management and control

Pursuant to Article 81 of the Budget System Law, all beneficiaries of public funds – LPEs included – are required to introduce FMC. The current state of play amongst the respondent LPEs is shown below.

A total of 41% of respondent LPEs had FMC in place, as against 58% that did not.

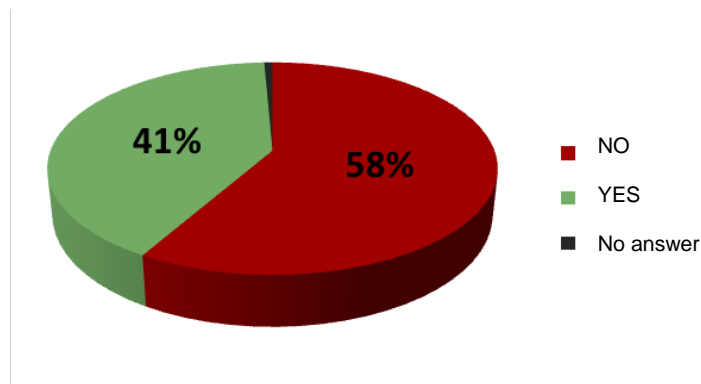
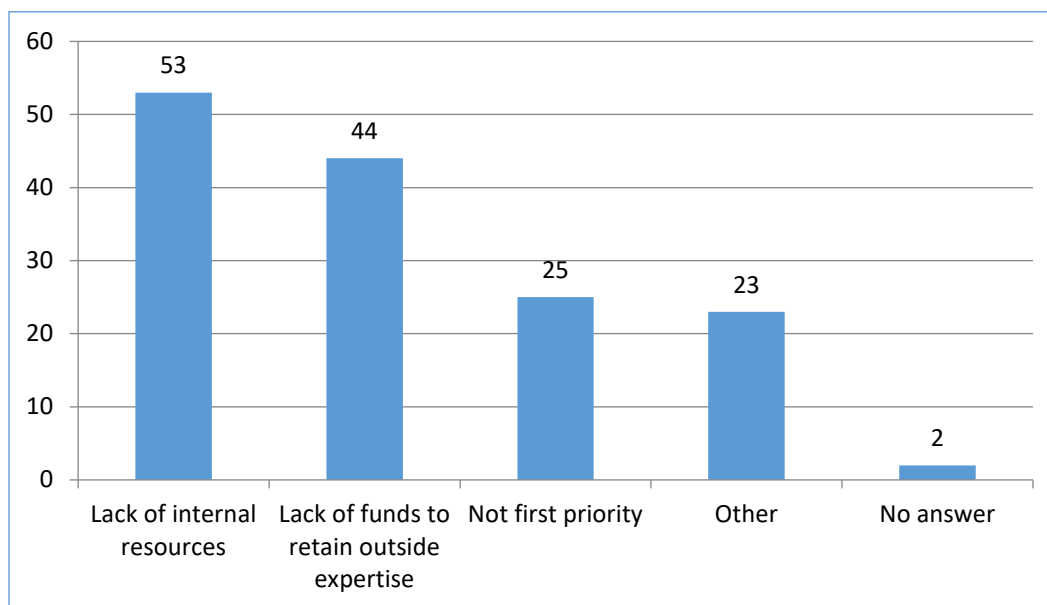


Figure 12. Presence of FMC in LPEs

Similarly to LGs, LPEs also faced numerous challenges in implementing FMC. The key issues are shown in the chart below.



**Figure 13. Reported reasons for the absence of FMC in LPEs**

Apart from the issues listed above that were reported by all LPEs surveyed, such as the lack of internal resources (e.g. trained staff) or funds to retain outside expertise, many LPEs also claimed to have experienced the following problems when introducing FMC:

- Lack of awareness amongst managers and staff of the benefits of FMC (some LPEs seem to believe it would reduce efficiency);
- Operational issues due to lengthy account freezes;
- Under-educated staff and lack of interest amongst most employees to introduce FMC;
- Frequent changes to general managers and attendant alterations to staffing arrangements;
- Restrictions imposed by the Government order suspending hiring, Law on the Maximum Number of Employees in the Public Sector,<sup>4</sup> and Article 27e of the Budget System Law.

Given the difficulties encountered to date by beneficiaries of public funds in implementing FMC, regardless of whether or not they were actually able to introduce these arrangements, it was encouraging to see that as many as 94% of LPEs expressed interest in introducing these systems, with another 83% wishing to enhance their existing arrangements.

<sup>4</sup> *Official Gazette of the Republic of Serbia*, Nos. 68/2015, 81/2016 – Constitutional Court Ruling, and 95/2018.

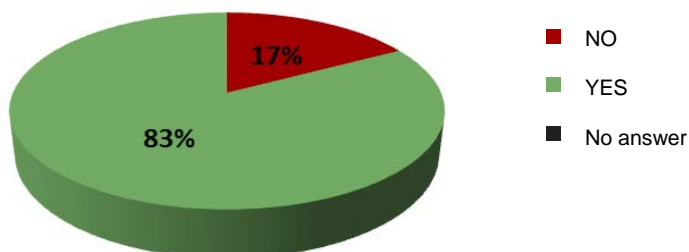


Figure 14. LPE interest in enhancing FMC

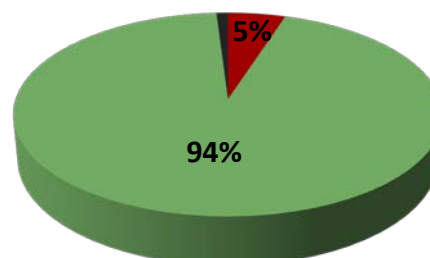


Figure 15. LPE interest in introducing FMC

These findings show that similarly to their LG counterparts, many LPE staff understand and acknowledge the importance of FMC and the need for its introduction.

### 5.3 Internal audit

As beneficiaries of public funds, LPEs are also required to set up IA in addition to FMC. This study has shown that LPEs are lagging behind LGs in terms of introducing an internal audit. As few as 17% of those polled reported having set up IA, 80% claimed they did not have this function in place, whilst the remaining 3% did not answer the question.

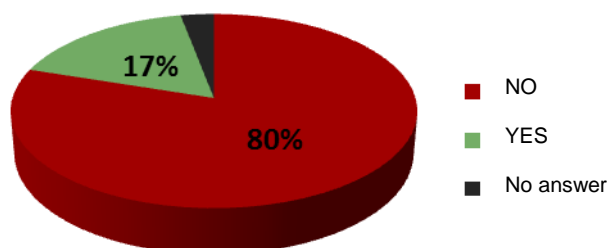


Figure 16. Presence of IA in LPEs

The conclusion here is that internal audit is still in its infancy in LPEs. There are many reasons for this, but some are shared by all LPEs.

The most commonly cited reasons for failing to introduce IA are:

- Public sector hiring freeze: lack of trained staff and funds;
- Parent LGs are expected to introduce joint IA;
- Lack of priority accorded to IA; and
- Lack of interest amongst management and staff in introducing IA.

A smaller proportion of LPEs than LGs seem to be willing to introduce or enhance IA. A total of 73% of the 144 LPEs that took part in the survey reported interest in enhancing the internal audit function, whilst 74% expressed the desire to introduce IA.

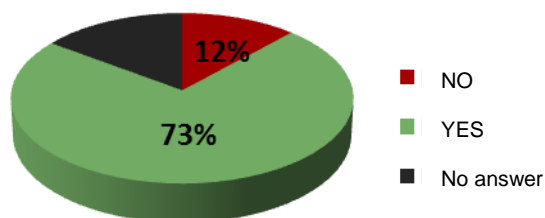


Figure 17. LPE interest in enhancing IA

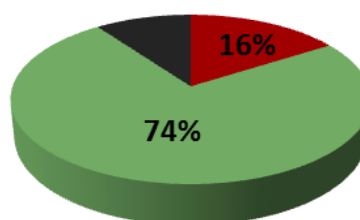


Figure 18. LPE interest in introducing IA

It ought to be noted that fewer LPEs reported being interested in introducing this function independently: **rather, they seem to prefer their parent LGs to address this issue by setting up some form of joint IA.** In addition, a minority of LPEs claimed to introduce IA was not a statutory requirement for them.



## 6. STATE OF PLAY WITH REGARD TO FMC AND IA IN LGS

As noted above, the findings of the research were shared with the participants of a Conference held at the Hotel Mona in Zlatibor on 11 and 12 December 2018. The first day of the conference saw the presentation of the results and key conclusions, based on an analysis of responses to the questionnaire. Focus groups were then established to allow the exchange of experiences and stimulate LG representatives to review the presence of FMC and IA. The focus groups also permitted attendees to pinpoint the causes of the current situation with regard of FMC and internal audit and propose possible solutions for overcoming challenges in implementation, leading ultimately to the roll-out of FMC and IA at all LGs.

To promote participation and focus on the specific issues, the participants were divided into eight focus groups (four each for FMC and IA, respectively) as follows:

- Cities with FMC/IA in place;
- Municipalities with FMC/IA in place;
- Cities without FMC/IA in place; and
- Municipalities without FMC/IA in place.

The focus groups endeavoured to assess the quality of FMC and IA in local authorities that have introduced them. In addition, the participants also discussed the reasons behind the absence of these functions in LGs that are yet to establish these functions as mandated by law.

### 6.1 LGs with FMC in place

Some LGs that have introduced FMC has done so with the aid of outside consultants. The LGs that set up FMC with the help of RELOF noted they were highly satisfied with how the system was implemented. They reported having undergone the requisite training, with outside consultants greatly facilitating the entire process. It was also noted that external experts helped design the required documents, but that the majority of work was ultimately undertaken by LG staff. All focus group participants agreed that this approach was the only appropriate mode of introducing the system. This group of LGs felt that management support was key for initiating the introduction of FMC, with staff quickly assuming full responsibility for implementation. The municipality of Šid, which put FMC in place in 2017, also cited favourable experiences with outside consultants.

Other LGs were less positive about both the introduction and operation of FMC to date. Many noted they introduced these arrangements only to meet the statutory requirement, whilst the system remained dormant in practice. Staff seemed less involved in the introduction: LG employees did not directly participate in setting up the systems, which were developed in the main by outside experts. This approach meant the effectiveness of the system was questionable. Procedures/processes developed in this way often remained poorly aligned with the processes and needs of the LG in question and, as such, impossible to implement. Moreover, in many cases, no training was delivered to explain the purpose, significance, and mode of operation of the FMC function.

Many LGs that recently introduced FMC were unable to say with any certainty how satisfied they were with the processes and procedures they implemented. Nevertheless, the following reasons were cited as the causes of delays in introducing and implementing FMC:

- Lack of support from management and political and other leaders due to poor awareness and inadequate knowledge of the importance and function of the FMC system;

- Poor awareness of staff, little understanding of the importance of FMC, fear of change, and avoidance of responsibilities prescribed for each position in the system;
- Absence of staff due to attrition and compounded by the hiring freeze in the public sector. The lack of people at some LGs leads to positions remaining unfilled, with the knock-on effect of defeating the purpose of some aspects of FMC (such as its checks and balances) as the same individual is responsible for both taking an action and controlling it; and
- LGs do not have sufficient internal capacity to introduce this system on their own, but there is also a lack of qualified external consultants to assist them in this regard.

## 6.2 LGs without FMC in place

A key reason reported for the absence of FMC is the poor understanding by the management of the significance of the system, even where senior officers are formally in its favour. Another commonly cited issue is the lack of funds to hire external experts to support the introduction. In addition, LGs frequently complain about their chronic lack of staff, resulting in an excessive workload for existing employees that would only be made worse if FMC were to be introduced.

In addition to the issues noted above, LGs that have to date failed to introduce FMC reported a number of other challenges:

- Current FMC legislation was said to be inappropriate. Although LGs are required by statute to introduce FMC, there is no time limit nor penalties for not doing so. This group of local authorities felt the law ought to be amended;
- The Ministry of Finance ought to put more pressure on LGs to introduce FMC, cite best practices (where the system works), and better promote the significance of the system (in meetings and conferences, as well as through leaflets and other promotional materials).

## 6.3 LGs with IA in place

The LGs surveyed introduced IA between 2012 and 2018. Most cities have single dedicated Internal Auditors, whilst a minority have IA units in place with two or more Internal Auditor staff.

This group was dissatisfied with the current situation, although they had put IA in place. The LGs noted there was still a great deal of misunderstanding of the role, function, and responsibilities of internal auditors, as well as that there were different expectations of IA that were often at odds with its intended function.

A number of other challenges to existing IA were also mentioned:

- In the vast majority of cases, the designated Internal Auditors were not certified due to the lengthy waiting time for mentoring, a precondition for certification;
- Uncertified Internal Auditors were insecure when performing their duties and needed training that covered much more than mere technical knowledge of the matters at hand;
- For internal audit reports to carry sufficient weight, the Internal Auditor needed to have support from the management;

- Current IA legislation was said to be inappropriate: there was no single method of establishing IA (i.e. whether it involved a single Internal Auditor, a unit, or a joint internal audit arrangement); there were also no regulations governing where the Internal Auditor ought to be formally placed inside the organisation;
- There were no clearly defined time limits for introduction or sanctions for LGs that fail to set up IA;
- There were no vertical linkages between internal auditors and the CHU, which has been recognised as the key institution to integrate them and harmonise their work, promote the profession, and assist in ensuring LG managers recognise the significance of IA.

#### 6.4 LGs without IA in place

The first and foremost reported reason for failing to introduce IA is the lack of knowledge and awareness of the importance of the internal audit function. This has led to complete disinterest amongst managers and staff for appointing internal auditors, even in situations where the initial preconditions had been put in place. Moreover, avoidance of this requirement was caused by unfounded fears of what internal auditors represented: this function was often wrongly equated with that of an 'internal controller' or 'budget inspector'. All of these challenges have meant that internal audit has remained low on the list of priorities for LG managers, with most feeling other issues outweighed IA.

Local governments that took part in this focus group listed a number of additional constraints to introducing IA:

- Lack of staff and issues with existing employees. The public sector hiring freeze made it impossible to fill positions that would be left vacant if existing staff were appointed as Internal Auditors;
- Poor staff structure by age and qualifications, which, coupled with the hiring freeze, exposed some employees to excessive workloads and prevented their re-assignment to the internal audit function;
- As FMC and IA were part of the same system, introducing IA at LGs with no FMC would have questionable value. Many LGs that lack IA also lack FMC; and
- In some LGs, managers have initiated and supported the introduction of IA, however Internal Auditor pay is low compared to the private sector, and the workload is disproportional to the remuneration. Some internal candidates have withdrawn from the running for IA due to hostility from co-workers.

These LGs also noted that IA had only recently become a priority, which has led to a faster pace of introduction. The officials also voiced concerns as to form outweighing function due to this acceleration: some newly-introduced services could prove ineffective if their creation was not accompanied by broader improvements in how LGs operated.

Last but not least, the group stated it was important to address the need for internal audit at smaller LGs. The feeling was that the best solution here was to set up some type of joint internal audit, which would require amendments to legislation to be workable in practice.

## 7. KEY RECOMMENDATIONS FOR IMPROVING FMC AND IA in LGS

The second day of the conference was devoted to focus groups which aimed at defining recommendations and next steps for improving the state of play and effectiveness of FMC and IA. The key causes of the current difficulties with both systems largely matched, which was only to be expected since FMC and IA are part of a single system of internal controls. Similarly, the key recommendations are also to a large extent identical. As such, the proposals are grouped below into eight recommendations for enhancing the system.

### ***RECOMMENDATION #1: Raise awareness and enhance knowledge and understanding of the significance and utility of FMC and IA for decision-making and LG management.***

All eight focus groups noted the lack of understanding of the significance and utility of FMC and IA on the part of managers, which indicates that any improvements must begin with improving the awareness of senior LG officials. Successful implementation of FMC and IA requires that these processes are initiated and subsequently continuously supported by the mayor and head of the local administration.

The Ministry of Finance can play a key role in enhancing awareness, as can the CHU, Ministry of Public Administration and Local Government, the State Audit Institution (SAI), and donor-funded projects such as RELOF. The best option for educating this target group would be to organise meetings with each ministry, conferences, roundtables, and training sessions involving multiple LGs that would allow each of them to share their experiences in this process.

### ***RECOMMENDATION #2: Raise awareness and enhance knowledge and understanding of the significance of FMC and IA on the part of staff***

All focus groups reported that lack of interest on the part of staff, at least in the early stages of this process, resulted in poor implementation of FMC and/or IA. In some cases, the staff even actively resisted the introduction of these functions.

Training is required early in the process to overcome these challenges. It was also noted that training ought to be reinforced later in the course of implementation to deepen staff knowledge and understanding and permit them to engage more actively in this process. Staff particularly needed to be involved in the development of the FMC system. The best option for achieving these objectives would be for relevant trainers to deliver training at each LG and so reach the greatest numbers of staff.

In addition, the need for mentoring support was also cited as particularly relevant, especially for IA, given that the vast majority of Internal Auditors have not undergone mentoring as part of the CHU's official certification programme. It was also important for staff to be able to exchange experiences directly with their peers in other LGs through joint training, roundtables, and conferences.

### ***RECOMMENDATION #3: Introduce FMC and IA at indirect budget beneficiaries***

In most LGs, FMC and/or IA cover only the city/municipal administration and a limited number of LPEs. For FMC to appropriately serve the entire LG, in the next stage of implementation it must also extend to indirect budget beneficiaries. The methodology for introducing FMC at indirect budget beneficiaries ought to be the same as for LGs, but must also include training for managers and all staff and mentoring by outside consultants for the development, establishment, and implementation of the FMC system. Local governments that have set up IA functions will also be able to perform this function for their indirect budget beneficiaries through some sort of joint IA arrangements, and this is especially true for smaller communities.

***RECOMMENDATION #4: Introduce quality control and performance audit for existing FMC and IA systems***

All focus groups reported that, in most LGs, FMC and IA were at an early stage of implementation. At this point it is not possible to realistically assess the extent to which these systems are appropriate and fit for purpose for each individual LG. Nevertheless, the participants were unanimous in claiming it was necessary to introduce quality control and performance audit arrangements for FMC and IA systems at each LG.

***RECOMMENDATION #5: Develop new models of internal audit***

The participants agreed that the current requirement, whereby each LG, regardless of size, is required to introduce IA separately, is not suitable for all local authorities and ought to be adjusted. It is not imperative – indeed, it is often not even possible – for small LGs to set up internal audit on their own, so a model must be found that will fit their needs and capacities. This initiative may also involve amending the legal framework; changes will require consultations and open discussion of the issue that must involve the relevant institutions at the national level.

***RECOMMENDATION #6: Develop a system to certify Internal Auditors more quickly***

All LGs cited the certification process as a key reason for delays in introducing IA. As the hiring freeze in the public sector will remain in effect throughout 2019, an alternative must be found.

It was also noted that one option for improving the IA function and promoting development of internal auditors was to forge closer ties with the CHU, with regular training sessions, conferences, and roundtables devoted to the issue. Exchange of experiences and networking between internal auditors may also prove beneficial to the IA function in general.

***RECOMMENDATION #7: Enhance co-operation between the central and local levels to explore options for introducing IA in local governments***

Given the importance of introducing IA in all budget beneficiaries and the challenges faced by LGs, communication and co-operation between the central and the local level must be enhanced. Improved dialogue would greatly contribute to addressing issues encountered in introducing IA in local governments.

The study identified the issue of LGs being unable to hire internal auditors as having been successfully overcome through dialogue with the CHU and clarification provided by this body. The CHU has made it clear to participating LGs that the Government of Serbia was willing to allow the hiring of internal auditors and supportive of this function. Internal auditors can be chosen from amongst existing staff if they meet the proper requirements, and may also be recruited from outside the organisation.

Practice to date has shown that LGs' applications for the central government to allow hiring have failed due to inappropriate justification. According to the CHU, the applications were rejected chiefly because they did not focus only on the recruitment of internal auditors, but also included other requests that made them unacceptable.

The CHU recommended that LGs changed their approach when seeking consent to recruit internal auditors: these applications should focus only on the individual position in question and avoid asking for permission to hire additional staff. The participating LGs recommended organising informative meetings, seminars, or roundtables to raise awareness amongst LGs of how best to get their applications accepted.

### ***RECOMMENDATION #8: Enhance the statutory framework governing this area***

The Budget System Law and statutory instruments enacted pursuant to it regulate PIFC, and, as such, both FMC and IA as well. The LGs surveyed felt that the existing regulatory framework was not completely appropriate.

Suggestions for enhancing regulations include most notably the need to introduce time limits for establishing FMC and IA; define minimum standards for FMC; change how internal auditors are certified (especially as regards mentoring).

The LGs represented on the focus groups recommended launching improvements to the statutory framework as quickly as practicable, claiming that the process would be lengthy and require continuous dialogue between the local and the national level.

## **8. CONCLUSION**

This study is significant particularly for its systematisation of data on the presence (or absence) of FMC and IA in LGs and LPEs in Serbia. Apart from outlining the state of play at 128 LGs and 144 LPEs, the findings have allowed identification of reasons that have led to the current state of affairs. Consultations and discussions with the CHU and SAI have resulted in the definition of steps needed to ensure improvements. The study also determined the types of support that were the most acceptable and desired by LGs and LPEs.

The conference allowed an exchange of positive experiences and examples of best practice between many LGs, and also permitted them to highlight what they felt were omissions in meeting their statutory requirements. One such example was the introduction of FMC by outside consultants with no local staff involvement or the introduction of these arrangements without appropriate training for staff. As outlined above, this approach has led to many LGs introducing this system as a mere box-ticking exercise without proper functionality.

The conference was also valuable as it allowed LGs to resolve the dilemmas they faced in their day-to-day operations in direct contact with the CHU. It was emphasised that the Government was willing to approve the hiring of new auditors provided that applications were worded appropriately. The CHU also clarified that uncertified internal auditors were still required to perform this duty as soon as they were appointed even without first being certified. It should be noted that the participants called for the CHU to do more to raise the profile of the internal auditor profession, especially for Internal Auditors yet to be certified, whose suggestions are often rejected by their organisations' managers.

Although the study did confirm that the implementation of FMC and IA at LGs and LPEs was still at an early stage, it is highly encouraging to see that all LGs and most LPEs are interested in either introducing or enhancing FMC and/or IA. More importantly, respondent LGs reported being interested in setting up these functions so they operated appropriately and reliably: in that context, the support offered by RELOF to a number of LGs in the future was seen as both necessary and welcome.