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# **Screening report Montenegro**

## **Chapter 32 – Financial control**

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Bilateral meeting: 19 June 2013

## I. CHAPTER CONTENT

This chapter contains two main policy areas, namely (a) public internal financial control (PIFC) and external audit (EA) and (b) the protection of the EU's financial interests and the protection of the euro against counterfeiting. There is no EU legislation requiring transposition into national law or directly applicable legislation in the field of PIFC and EA. Instead, the candidate country is expected to adopt internationally agreed internal control standards and EU good practices across the entire public sector as well as the external audit standards as defined by the International Organisation of Supreme Audit Institutions (INTOSAI).

As concerns **PIFC**, it is an integral part of national public finance management. It is a comprehensive concept relating to the entire public budget, in particular central government income and expenditure, including foreign funds. The PIFC concept is based on three principles: 1) decentralised managerial accountability underpinned by financial management and control (FMC) systems, 2) functionally independent internal audit and 3) centralised harmonisation of methodologies and standards relating to FMC and internal audit. The candidate country undertakes to implement PIFC across the entire public sector. The candidate country is expected to adopt and implement a PIFC Policy Paper and action plan and a PIFC legal framework as well as to set up and maintain the necessary national structures and administrative capacity for implementation of PIFC.

Regarding **external audit**, the candidate country is expected to comply with the standards of the International Organisation of Supreme Audit Institutions (INTOSAI), in particular its Lima and Mexico Declarations, which foresee functional, institutional and financial independence of the SAIs as well as implementation of both financial and performance audits in line with the INTOSAI standards.

With regard to the second policy area, Article 325 of the TFEU requires Member States to take the same measures to counter fraud affecting the financial interests of the Union as they take to counter fraud affecting national financial interests, including coordination of their actions through close and regular cooperation between the competent authorities and the Commission. **The protection of the EU's financial interests** covers both the criminal law protection through alignment of national legislation with the Convention on the Protection of the EU's Financial Interests (PFI Convention) and its three protocols and operational cooperation between the competent authorities of the Member States and the Commission. Member States must have the capacity to cooperate effectively with the European Commission and to communicate all suspected cases of irregularities and fraud. Member States are also obliged to assist and co-operate in on-the-spot checks carried out by Commission services. Some of this *acquis* applies directly to Member States and thus does not need to be transposed. In order to facilitate the required cooperation by future Member States, the candidate country is requested to nominate a national anti-fraud coordination service (AFCOS) as a single contact point for the Commission prior to accession.

As concerns the non-penal aspects of the **protection of the euro against counterfeiting**, the Geneva Convention for the Suppression of Counterfeiting Currency outlines the principles which have been further detailed in the relevant *acquis*.

This includes among others the prohibition of metals or tokens similar to euro coins, procedures for gathering, storing and exchange of information on counterfeits, obligation for financial institutions to check authenticity, withdraw counterfeits and transmit them for analysis as well as cooperation at national and international level.

## **II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY**

This part summarises the information provided by Montenegro and the discussion at the screening meetings. Montenegro indicated that it can accept the relevant standards and *acquis* regarding this Chapter.

### **II.a. Public internal financial control (PIFC) and external audit**

Montenegro stated that the first PIFC strategy was adopted by the Government in December 2007, providing the basis for PIFC development in Montenegro. The revised PIFC strategy with an action plan for the period 2013-17 was adopted in June 2012. In addition, the Public Administration Reform strategy of Montenegro for the period 2011-2016 covers PIFC development.

PIFC is regulated by the 2008 Law on Public Internal Financial Control System (last amended in 2012) and the 2012 Budget Law. Implementing legislation on both Financial Management and Control (FMC) and internal audit is also in place. This includes: instructions on setting up FMC in budget users; methodology of reviewing the quality of FMC in the public sector; guidelines on the development of internal rules and procedures for FMC; instructions on reporting on FMC; FMC manual; guidelines on establishment of internal audit in the public sector; internal audit method and procedure; internal audit manual; code of ethics for internal auditors; instructions on reporting on internal audit; methodology for reviewing the quality of internal auditors in the public sector as well as an internal audit certification scheme.

According to Montenegro, FMC is regulated in a manner that aims to strengthen budget users' internal financial control arrangements by assigning middle managers the responsibility for developing internal controls. FMC managers have been appointed in 82 budget users both at central and local level and they are responsible for the establishment, implementation and development of FMC. So far, around 30 budget users have established relevant action plans and over 40 have recorded internal control procedures. At the same time, however, there has not been delegation of decision-making responsibilities to middle management, as the heads of budget users are solely responsible for authorisations of changes in the system. Risk management, which is a managerial activity, is not yet systematically implemented. Montenegro informed that a new Law on Budget and Fiscal Responsibility is under preparation. The new law aims to introduce medium-term budget planning, to improve managerial accountability, to introduce new fiscal rules as well as to set up a centralised budget inspection function in order to address a perceived lack of financial discipline within budget users.

The internal audit function is regulated in a manner that requires the 30 biggest budget users at central and local level to set up an internal audit unit. Smaller budget users can perform internal audit by a unit of another budget user on a basis of an agreement and after a prior approval of the Ministry of Finance. So far, 39 internal audit units have been set up, including 26 at central level and 13 at local level.

Out of them, 31 internal audit units have been staffed (23 at central level, 8 at local level). However, the large majority of them (20) has only one internal auditor. Montenegro has currently around 50 internal auditors in total. The training of internal auditors is managed by the Central Harmonisation Unit (CHU), including a national certification scheme. Montenegro indicated that an international certification by the Chartered Institute of Public Finance and Accountancy (CIPFA) programme has also started at the end of 2012.

The CHU is located in the Ministry of Finance. It is headed by an Assistant Minister and it has two sections, one for FMC and the other for internal audit. Out of eight allocated posts six are filled. The CHU is responsible for the preparation of the PIFC legal framework, the training and certification of internal auditors, the training on FMC, the preparation of an annual consolidated report on PIFC to the Government, the cooperation with professional bodies, the quality review of FMC and internal audit as well as the keeping of registers on internal audit units, charters and FMC managers.

With regard to **external audit**, Montenegro's State Audit Institution (SAI) was established with the SAI law in 2004. It is a member of the INTOSAI since 2007. Independence of the SAI is anchored in the Constitution. The Law on Audit of EU Funds from February 2012 provides for the full separation of the SAI from the Audit Authority, which is part of the executive and responsible for auditing of EU pre-accession funds.

The SAI law provides for a sufficiently broad mandate for the SAI to audit budget execution. The amendments to the SAI law in 2012 enlarged the audit scope of the SAI to cover also the financing of political parties. The SAI law guarantees both operational and functional independence of the SAI in the discharge of its functions. As concerns financial independence, the SAI law stipulates that the SAI will submit its draft budget directly to the Parliament. However, the financial independence of the SAI is in practice limited, because the Ministry of Finance, which receives the proposed draft budget from the Parliament, has the possibility to adjust the SAI budget directly. Montenegro confirmed that the proposed amendments to the SAI law aim to achieve the SAI's full financial independence.

According to the SAI law, the SAI is governed by a Senate, which has five members. The Parliament appoints the members on the basis of requirements defined in the SAI law. Parliament also appoints a President among the members for a period of nine years. Otherwise, the office of a member of the Senate is permanent. Each member is responsible for managing one of the sectors within the SAI. Montenegro informed that the SAI has initiated an amendment to the Constitution, which would ensure functional immunity of the members of the Senate. According to Montenegro, a Senate position has remained unfilled for the past few years.

The SAI has adopted a strategic development plan for the institution for the period 2012-17, following a peer review by Member State experts. The strategic goals for the SAI are amendments to the legal framework, improvement of audit quality, capacity building of the SAI, upgrading of the SAI's information system and improvement of the SAI's communication policies. Montenegro confirmed that its key strategic goal is to improve the institutional capacity of the SAI by increasing both the number and the professional capacity of its audit staff. The SAI has currently only around 35 auditors employed in comparison to over 60 audit positions foreseen in its internal organisation and systematisation, as approved by its Senate in May 2013.

Montenegro stated that the SAI law provides a mandate for the SAI to perform both financial and performance audits. The proposed amendments to the SAI law will require the SAI to perform audits in line with the INTOSAI international audit standards (ISSAI). The SAI has both financial and performance audit manuals in place since 2012. The SAI has implemented the 2012 audit programme with 14 audits. Performance audit work is however at a very early stage. Since 2009, the SAI has performed five performance audits.

## **II.b. Protection of the EU's financial interests and the protection of the euro against counterfeiting**

The legal framework in the area of protection of the EU's financial interests is provided for by the Montenegrin Criminal Code, the Criminal Procedural Code, the Law on Liability of Legal Persons for Criminal Offences and the Law on International Legal Assistance in Criminal Matters. Montenegro's legislation prescribes criminal penalties for the principle offences of fraud, passive and active corruption and money laundering, including in serious cases deprivation of liberty and extradition. The liability of heads of businesses and liability of legal persons as well as the conditions for the confiscation of objects or material benefit are prescribed as well.

Regarding on-the-spot checks, Montenegro stated that it fully supports the cooperation with European Commission investigators. However, Montenegro acknowledged that the current legal framework does not yet have in place specific provisions ensuring the obligation to safeguard evidence as well as the cooperation and participation in Commission inspection missions. Montenegro also confirmed that the Criminal Code is in the process of being amended and that the definition of bribe and sanctioning of foreign officials will be introduced in line with the PFI Convention and its protocols.

Montenegro has set up a national anti-fraud coordination service (AFCOS) for the cooperation with the European Commission's Anti-Fraud Office (OLAF) within the Ministry of Finance. It is an independent office under the direct authority of the Minister. The office has so far only one employee. Montenegro announced that the Ministry foresees to recruit a further employee. Besides cooperating with the Commission, AFCOS is coordinating the work of administrative, investigative and judicial institutions, which are part of the national AFCOS network. In the context of ongoing preparations for the decentralised management of Instrument for Pre-Accession (IPA) funds by Montenegro, the Decree on the decentralised management of the Instrument for Pre-Accession from July 2011 tasks the designated IPA structures to define in specific manuals the procedures on reporting of irregularities. Montenegro informed that it is in the process of updating the Government decision adopted in October 2009 on the establishment of the AFCOS system in Montenegro. Montenegro stated that a further Government decision is foreseen for the appointment of representatives of the institutions involved in the AFCOS network by the end of 2013. Also, a national strategy for the protection of the EU's financial interests is planned to be developed and adopted in the course of 2014.

With regard to the protection of the euro against counterfeiting, Montenegro has not ratified the Geneva Convention for the Suppression of Counterfeiting Currency. Montenegro stated that its legislation is already to a large extent harmonised with the relevant EU legislation for the protection of the euro.

The Montenegrin legislation defines counterfeiting, competent national authorities, procedures for gathering, storing and exchange of information of counterfeits as well as an obligation for financial institutions and cash handlers to check the authenticity of euro notes and coins and withdraw and transmit suspected counterfeits for analysis. Reporting on counterfeits is compulsory for anybody who comes in contact with counterfeits. A failure to report is treated as a criminal offense.

No specific legislation is yet in place that would prohibit medals and tokens similar to euro coins based on design, size and shape. Montenegro confirmed that relevant implementing legislation on medals and tokens based on the Law on the Central Bank of Montenegro is going to be developed in the course of 2013. Montenegro also stated that further alignment in this area will be reached with the forthcoming new Payment System Law and the new Credit Institution Law.

As concerns national structures for the protection of the euro, the Central Bank of Montenegro is responsible for the technical analysis and the central collection and processing of information on counterfeit euro banknotes and coins. The Central Bank has cooperation agreements in place with the European Technical and Scientific Centre of the European Commission (euro coins) since 2008 and the European Central Bank (euro banknotes) since 2009. The Police Administration acts as the national central office and coordinates national law enforcement agencies and informs and cooperates with Europol and Interpol. Montenegro also participates in the Pericles programme.

### **III. ASSESSMENT OF THE DEGREE OF ALIGNMENT AND IMPLEMENTING CAPACITY**

As regards the relevant international standards and the *acquis* under this chapter, Montenegro's level of alignment is at a satisfactory level. Montenegro still needs to take steps in order to complete legislative alignment in the area of the protection of the euro against counterfeiting as well as to guarantee sufficient implementation capacity in the area of PIFC and external audit.

#### **III.a. Public internal financial control (PIFC) and external audit**

Montenegro has in place both the PIFC strategy framework, i.e. the new PIFC strategy and its action plan for the period 2013-17, as well as the legal framework. However, the PIFC strategy is weak as regards the implementation of managerial accountability. The strategy does not address how bottlenecks in the public administration, such as a lack of sound delegation from top to middle management, could be overcome. There is therefore a need to address PIFC comprehensively as part of Montenegro's public administration reform process. Montenegro is requested to provide the European Commission with updates of action plans in this respect on a regular basis.

Implementation of FMC is still focused primarily on the legality and regularity of financial transactions with less explicit emphasis on economy, efficiency and effectiveness. Risk management is not applied yet systematically in practice and will need to be further developed. As concerns the planned new centralised financial inspection function, it will need to be compatible with PIFC requirements, including full separation from the internal audit.

The internal audit function has been set up primarily on a decentralised basis. The staffing levels in internal audit units remain however very low, and a large majority of the units have only one auditor. This may potentially endanger both the quality and independence of internal audit.

The Central Harmonisation Unit (CHU) has been functioning for a number of years, and it is implementing its tasks satisfactorily. Sufficient administrative capacity needs to be maintained, especially as a considerable amount of CHU resources are still used for training activities.

With regard to external audit, the SAI's independence is anchored in the Constitution. Whereas the SAI's operational and functional independence is guaranteed in the SAI law, its financial independence is not yet satisfactory in practice. The envisaged changes to the SAI law should contribute to the strengthening of the SAI's financial independence by allowing the Parliament to directly negotiate and approve adjustments to the SAI budget. One of the positions in the Senate has remained unfilled for several years. This has slowed down institutional development of the SAI.

The key focus of the SAI's strategic development plan for the period 2012-17 is on improving internal organisation, audit quality and institutional capacity. The SAI needs to gradually increase both the number and professional capacity of its audit staff. The current audit capacity of the SAI is still very limited, and operational independence could be adversely affected by the fact that the SAI is tasked to audit the financing of political parties since 2012. The SAI has the required financial and performance audit manuals in place. Performance audit work needs to be further developed, as only a few performance audits have been implemented so far. Montenegro is encouraged to ensure a formal mechanism for review and reaction to SAI's audit reports by the Parliament.

### **III.b. Protection of the EU's financial interests and the protection of the euro against counterfeiting**

Montenegro's legal framework is already harmonised with the relevant parts of the PFI Convention and its three protocols. Montenegro needs to ensure sufficient operational capacity for AFCOS so that it can efficiently coordinate all relevant actors in the AFCOS network. Montenegro will need to guarantee efficient cooperation with the European Commission as concerns on-the-spot checks by Commission investigators as well as the safeguarding of evidence.

With regard to the protection of the euro against counterfeiting, Montenegro's legal framework is already harmonised with the *acquis* except for the prohibition of medals and tokens similar to euro coins based on design, size and shape. Montenegro also needs to implement the relevant parts of the Geneva Convention for the Suppression of Counterfeiting Currency. Montenegro has set up the required administrative structures and has sufficient implementation capacity for technical analysis and classification of counterfeited euro notes and coins.