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ACRONYMNS AND ABBREVIATIONS

AAA	Association of Accountants and Auditors	MOFE	Ministry of Finance and Economy of Serbia Republic
BI	Budget Inspectorate	MSA	Mutual Service Agency (Montenegro and Federal)
BIAS	Budget Inspection and Audit Service in Serbia	MSU	Administration for Mutual Services (Serbia)
BRA	Bank Rehabilitation Agency (Serbia)	NAS	National Accounting Standard
CBM	Central Bank of Montenegro	NATO	The North Atlantic Treaty Organization
COSO	Committee of Sponsoring Organizations (Integrated Framework for Internal Control)	NBY	National Bank of Yugoslavia
CPAR	Country Procurement Assessment Report	NGO	Non Governmental Organization
CPE	Continuing Professional Education	OBL	Organic Budget Law
DFID	Department for International Development (UK)	OECD	Organization for Economic Cooperation and Development
DM	German Mark (also DEM)	OSCE	Organization for the Security and Cooperation in Europe
DSU	Direct Spending Unit	PAC	Public Accounts Committee
EAR	European Agency for Reconstruction	PACT	UNDP Programme for Accountability and Transparency
EBRD	European Bank for Reconstruction and Development	PEIR	Public Expenditure and Institutional Review
EC	European Commission	PIU	Project Implementation Unit
EP	Elektroprivreda (Power company)	PO	Payable Order
ERTP	Economic Recovery and Transition Program	PSC	Public Sector Committee
ESI	European Stability Initiative	RM	Republic on Montenegro
EU	European Union		
FARAH	Financial Accounting, Reporting and Auditing Handbook (WB)	SAC	Structural Adjustment Credit
FMIS	Financial Management Information System	SAI	Supreme Audit Institution
FMS	Financial Management Specialist	SBA	Stand-by Arrangement
FRY	Federal Republic of Yugoslavia	SDK	Community Bookkeeping Service
GDP	Gross Domestic Product	SFRY	Socialist Federal Republic of Yugoslavia
GFS	General Finance Statistics	SIDA	Swedish International Development Cooperation Agency
IA	Internal Audit	SNAO	Swedish National Audit Office
IAPC	International Auditing Practices Committee	SPAI	Stability Pact Anti-Corruption Initiative
IAS	International Accounting Standards	TCA	Treasury Consolidated Account
IASB	International Accounting Standards Board	TGL	Treasury General Ledger
IBRD	International Bank for Reconstruction and Development	TI	Transparency International
IC	International Community	TSA	Treasury Single Account
ICG	International Crisis Group	TSS	Transitional Support Strategy
IDA	International Development Association	UNDP	United Nations Development Program
IDP	Internal Displaced Person	UNMIK	United Nations Mission in Kosovo
IFAC	International Federation of Accountants	USAID	United States Agency for International Development
IFI	International Financing Institution	UST	United States Treasury
IMF	International Monetary Fund	VAT	Value Added Tax
INTOSAI	International Organization of Supreme Audit Institutions	WG	Working Group
ISA	International Standards on Auditing	YAAA	Yugoslavian Association of Accountants and Auditors
ISU	Indirect Spending Unit	YUD	Yugoslavia Dinar
LBS	Law on the Budget System	ZOP	Agency for Accounts and Payment (Payment Bureau)
MOF	Ministry of Finance (Federal and Montenegro)		
MOFs	Ministries of Finance (Federal, Serbia and Montenegro)		

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PREFACE

This report was prepared on the basis of the findings of a series of World Bank missions to the Federal Republic of Yugoslavia (FRY) from July 2001 to October 2001, by a Task Team comprised of Siew Chai Ting, Team Leader and Senior Financial Management Specialist; Roberto Tarallo, LCR Manager, Financial Management (former Senior Financial Management Specialist in ECA); Milica Vukadinovic, Research Assistant; and Julie Lynn of the UK National Audit Office (NAO), a consultant to the Department for International Development (DFID), working on external auditing. A World Bank mission, consisted of PEIR and CFAA teams, visited the FRY in November 2002, to disseminate the findings of the FRY PEIR and FRY CFAA. In both Republics, the Ministries of Finance have taken strong ownership of the dissemination events.

The Country Financial Accountability Assessment (CFAA) task was part of joint effort combining the CFAA and the Country Procurement Assessment Report (CPAR) led by Shaun Moss, Team Leader. The CFAA mission also worked closely with the task team for the Public Expenditure and Institutional Review (PEIR), led by Sergei Shatalov, Team Leader and Senior Economist; and with the Serbia Structural Adjustment Credit (SAC) team, led by Ardo Hansson, Team Leader and Senior Country Economist.

The report was prepared in close collaboration with government counterparts in the FRY, and also benefited from information provided by the donor community in the FRY. Counterparts from government and private sector institutions lent their full and proactive support to the CFAA mission and engaged with the Bank's team in a comprehensive dialogue about the issues identified by the assessment. The team would like to thank the Federal government, and the governments of the Republic of Serbia and the Republic of Montenegro, including Ministries of Finance, (especially Ms. Gordana Lazarevic of the Federal MOF, Head of Department for IFIs; Dr. Milan Dabovic, Deputy Minister of Finance of the Republic of Montenegro; and Professor Dejan Popovic, Deputy Minister of Finance of the Republic of Serbia), Ministries of Education, the National Bank of Yugoslavia, the Central Bank of Montenegro, state agencies, and private sector institutions, for their excellent cooperation.

Purpose of the CFAA

This CFAA was prepared against a background of institutional and political uncertainty for the purpose of providing greater assurance to the FRY governments, the Bank, and the donor community, about the use of their financial resources. The improved standards of financial management and transparency of public finance flows recommended in this report are essential for achieving adequate socio-political stability and international support to the economic reconstruction and development programs of the FRY governments. The purpose of the CFAA is to assess the risk that financial resources in the FRY may be used for the purposes other than those intended or with insufficient regard for economy and efficiency, by comparing the financial management standards and practices of agencies using (or regulating the use of) funds against international or "best practice" standard. The risk assessment covers two dimensions: the risk to public funds (public financial accountability), and the risk to funds lent by the World Bank (fiduciary dimension).

Assessment of risk to public funds requires an assessment of the internal controls exercised by the executive on itself, and the external scrutiny exercised by oversight agencies. In the context of a country's separation of powers and overall governance environment, in fact, the executive arm of the government has an obligation to the public, and other stakeholders, for safekeeping and

proper use of public resources entrusted by its constituents, and for providing a credible legal/regulatory framework to promote good governance and financial management in both private and public sectors of the economy. The institutional and legal/regulatory regime that seeks to provide this assurance constitutes the public financial accountability framework in a country.

Assessment of risk to the Bank requires an assessment of the risks that the country's financial accountability framework poses for the implementation of Bank programs and the use of Bank funds, accompanied by a proposal of suitable measures to manage these risks. It also supports dialogue with the borrower country and development partners on financial accountability matters, and assists in the design of programs to build financial management capacity. A CFAA is not an audit, nor does it provide assurance that all funds are being used for intended purposes. However, it provides a well-informed and objective assessment of the strengths and weaknesses of financial management systems, a diagnosis of problems and advice on their resolution, and an indication of the level of financial accountability risk.

Report Cut-off Date

The report is an assessment of the status of the FRY's financial accountability at June 2002. Relevant updates to the report that reflect the impact and outcomes of reforms now underway will be considered as opportunity permits and, in any case, no later than twenty four months from the publication of this CFAA.

Scope of CFAA

This first CFAA for the FRY focuses on the most critical issues in the near to medium term. In this context, the CFAA concentrates on public sector accountability and on fiduciary arrangements for Bank-financed projects, with a limited review of private sector accounting and auditing arrangements that focuses on those issues that might affect the fiduciary safeguards and arrangements.

The FRY CFAA covers the following areas:

- Public sector: budget management (section 2)
- Public sector: payments, cash management and treasury (section 3)
- Public sector: accounting and reporting (section 4)
- Public sector: financial controls, internal and external audit (section 5)
- Financial and private sectors: banking, accounting, and fiduciary considerations (section 6)
- Risk assessment and management (section 6)

The CFAA was prepared using the methodology prescribed in the CFAA Guidelines issued by the Financial Management Sector Board. The CFAA analyses and conclusions are based on (a) questionnaires prepared by participants; (b) interviews with senior government officials and different donor organizations in the FRY; (c) review of existing or proposed legislation; and (d) review of publications and reports. The CFAA team received and reviewed public sector questionnaires prepared by the Federal Ministry of Finance, Serbian Ministry of Finance and Economy, Serbian Ministry of Education, and Montenegrin Ministry of Finance. The CFAA team also received and reviewed private sector questionnaires prepared by the Federal Ministry of Finance and the Association of Accountants and Auditors in Montenegro.

The CFAA team sought objectively to establish appropriate benchmarks for progress. Montenegro, for example, was moving ahead of the Federal and Serbian governments in a number of areas, and it could be used as a reference for suitable standards in some cases. The CFAA has considered standards and benchmarks applicable to both the Federal and republic levels, while recognizing that some parties may have further to do in attaining those standards than others.

Relationship with Other Bank Work on FRY

The World Bank's Transitional Support Strategy (TSS) for the FRY identifies a critical need for the Bank to develop analytical work after ten years of absence from Yugoslavia. As the TSS states, the Bank is focusing in FY02 on three core pieces of economic and sector work, (i) a public expenditure and institutional review, together with country financial accountability and procurement assessments; (ii) a private sector development strategy; and (iii) a poverty-focused household survey. The TSS considers the Country Procurement Assessment Report (CPAR) and the CFAA report essential to further development of both Bank's project-related activities and its economic policy dialogue with the FRY governments. Given the recent renewal of relations between the Bank and the FRY, these reports represent a first step forward in these complex areas.

Both the CPAR and the CFAA cover the Federal government, the Republic of Serbia, and the Republic of Montenegro (RM), but exclude Kosovo, a province of Serbia, which is currently under UN administration. The Federal government is the main counterpart, as it is the sovereign borrower and member of the World Bank. However, many procurement and financial accountability functions are managed at the level of the two republics.

The CPAR and CFAA teams prepared separate reports, closely coordinating their work and identifying the links connecting each report to the other and to the PEIR. The CFAA used inputs produced by the team preparing the first Serbia Structural Adjustment Credit (SAC-I), and provided inputs to the conditionality for SAC-I.

Acknowledgements

Messrs. Timothy Gilbo, Country Officer for the FRY; Rory O'Sullivan, Country Manager for the FRY; and Mmes Nancy Cooke, Lead Country Officer for the FRY; Mary Sheehan, former Principal Country Officer for the FRY; and Elaine Patterson, previous Deputy Country Manager for the FRY, offered invaluable assistance and information in advance of and during the mission. Messrs. Tony Hegarty, AFR Manager, Financial Management (AFTQK); Gerardo Corrochano, Lead Financial Analyst (ECSPF); and Anand Rajaram, Senior Economist (PRMPS); who acted as peer reviewers for the study, offered invaluable comments and provided other important inputs to the task. Messrs. John Hegarty, ECA Manager, Financial Management, for excellent review and comments, and Ms. Suzanne Snell, Consultant, assisted with the editing of the report. Ms. Milica Vukadinovic, Research Assistant, provided support with logistic arrangements for the mission.

**FEDERAL REPUBLIC OF YUGOSLAVIA
COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT**

EXECUTIVE SUMMARY

Introduction

1. After ten years of World Bank absence from Serbia and Montenegro, this first CFAA is an important and integral part of the World Bank's analytical activities as presented in the Transitional Support Strategy (TSS) for the FRY. This CFAA was prepared against a background of institutional and political uncertainty in order to provide greater assurance to the FRY governments, the Bank, and the donor community about the use of financial resources. The improved standards of financial management and transparency of public finance flows recommended in this report are essential for achieving adequate support to the reconstruction, economic stabilization and development programs of the FRY governments.

2. This first assessment of financial accountability in the FRY covers two dimensions: the risk to public funds (public financial accountability), and the risk to Bank funds (fiduciary considerations). The assessment of public financial accountability covers all areas of public financial management in the FRY: (i) budget management (including payments, cash management and treasury); (ii) accounting, reporting and, financial controls; and (iii) internal and external audit. The fiduciary considerations cover (i) a review of the Central Bank in its Deposit Account holder capacity for adjustment-type operations; (ii) a review of the acceptability of local commercial banks to operate Special Accounts for investment-type operations; (iii) an assessment of local audit firms' capacity and suitability to audit Bank-assisted-projects; and (iv) a review of institutional arrangements applicable to financial management for the implementation of Bank-financed investment projects.

Public Sector Accountability - Key Findings and Recommendations

3. This CFAA reveals that the public sector financial accountability was weak during the last decade and needs development and strengthening. The new governments that were elected in late 2000 have commenced a process of major reform. The Federal, Serbian and Montenegrin governments have demonstrated strong determination to implement the reforms; but there are concerns about the capacity in the three governments, especially the heavy reliance on foreign consultants in implementing key reforms. Additional uncertainty is added by the fundamental constitutional changes which are underway. Because of the uncertainty, the CFAA team intends to remain in close contact with the authorities as the reforms progress, and the team will update the assessment within a relatively short period. In the meantime, the CFAA team will ensure that the fiduciary arrangements for both investment and adjustment operations respond to the weaknesses and uncertainties that exist. The CFAA suggests that the most serious areas of weaknesses and recommendations associated with them should become top priorities of the governments in the FRY, and these are listed below.

Budget Planning and Preparation (Section 2.2)

4. The quality of planning and budget preparation during the past decade was generally poor in the FRY. Multi-year financial planning is not developed, and a disaggregated multi-year perspective on revenues and expenditures is lacking. The budget consists of a limited number of very aggregate budget lines (positions) which provide only a broad level of information and are generally inadequate for meaningful budgeting. Budgets are incomplete and do not include (i) all

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revenues and sources of funds; (ii) all expenditures and uses of funds; and (iii) all public and enterprise debts. Insufficient time was allocated to the preparation of the budget, and its consideration and approval by Parliament. The reliability of the budget preparation has already improved in Montenegro, and as a result of the reform measures recently introduced, Serbia's budget has become more meaningful. The new budget system laws in Serbia and Montenegro could, in the short term, further improve the budget process.

5. To enhance economic policy analysis and forecasting, **the CFAA recommends that** the Serbian Ministry of Finance and Economy (MOFE) and the Montenegrin Ministry of Finance (MOF) establish a strong fiscal analysis unit, to provide services such as rigorous forecasts, revenue estimation and tracking. **The CFAA recommends that** all levels of government establish clear and inclusive definitions of general government expenditure and implement an all-inclusive consolidated budget framework. **The CFAA recommends that** the Federal government increase the time allocated for budget planning and the budget cycle and for the scrutiny and debate of the budget, in harmony with the new republican budget laws and in accordance with OECD Fiscal Transparency Guidelines.

Priority - Budget Execution (Section 2.3)

6. During the past decade, there were effective cash controls but overall budget management was ineffective. At present, not all ministries comply with the requirement to submit a spending plan, nor are all submitted plans necessarily consolidated to give a spending plan for the government as a whole. The view of budget execution presently employed in the FRY is a narrow one: the block distribution of funds from the main budget account based on limited analysis, rather than the release of funds when required for actual spending. The supporting reporting system focuses on tracking these transfers of funds rather than measuring the expenditure undertaken with these funds. By focusing on cash controls, the present system is inherently weak because it cannot control for past commitments coming due, making efficient cash management virtually non-existent. Budget execution should improve when the new treasury systems will be implemented and fully functioning, hopefully in late 2002 for Montenegro and late 2003 for Serbia. The Montenegrin MOF has already implemented a treasury interim accounting system since late 2001.

7. To strengthen fiscal discipline, **the CFAA recommends that** reliable tracking of expenditures be introduced in all ministries. **The CFAA also recommends** the introduction of commitment accounting, which would allow optimization of cash management and tracking of arrears. The Serbian MOFE and the Montenegrin MOF should establish an accurate inventory of arrears and a commitment control system based on the new treasury system to prevent and/or control the creation of new arrears.

Cash Management (Section 3.2)

8. Cash management is weak and inefficient. Cash flows are monitored on a daily basis in both the Federal MOF, the Serbian MOFE, and the Montenegrin MOF, to ensure the availability of funds to meet major regular payments, with other transfer requests considered each day and priority requests approved. This daily triage can imply that urgent items early in a week can displace more important items later in the week.

9. In the medium term, the new budget laws would enable the Montenegrin MOF and Serbian MOFE to improve cash management through the establishment of a Treasury Single Account (TSA). However, there is an urgent need to strengthen the cash management system without waiting for the implementation of a new treasury system, so that the governments know their true cash projections. **The CFAA recommends that** the Federal MOF, Serbian MOFE, and

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the Montenegrin MOF, introduce an effective cash management system (based on realistic revenue and expenditure schedules) to replace the present cash release mechanisms at all levels of government. In particular, each MOF should introduce a weekly triage replacing the daily triage for non-scheduled payments. **The CFAA also recommends that** a new cash management function be established within the newly formed Treasury department to implement improved cash management procedures.

Priority - Transition to a Modern Treasury System (Section 3.4)

10. A modern treasury system plays a fundamental role in enhancing public financial accountability by providing comprehensive, timely and reliable information on budget transactions that supports effective management of government expenditure. A good treasury system includes the following components: (i) enabling legislation, policies and procedures; (ii) consolidation of all government accounts into a unified account (treasury single account); (iii) a treasury general ledger system; and (iv) appropriate institutional arrangements. Currently there is no treasury system at any government level. There is a pressing need to establish a treasury system, to be completed by the time the Payment Bureaux (ZOPs) will be fully restructured, to ensure that government revenues are available to meet expenditures.

11. In Montenegro, the Treasury Single Account (TSA) has been opened but does not yet include all revenue. In addition, the treasury interim accounting system currently in use is not yet capable of producing accurate monthly budget execution reports. A comprehensive, permanent computerized system will be developed with the financial support of the European Union beginning in mid-2002 but full implementation will take until 2003. In Serbia, the government is establishing a new treasury system, in accordance with the new budget law. The Serbian MOFE has completed the new organizational structure, a qualified treasurer has been appointed, and the new positions will be filled following staff approval. The European Agency for Reconstruction (EAR) will provide support for the establishment of a treasury function in the MOFE, for the introduction of a new treasury system/general ledger, with an expected completion date in late 2003. In the meantime, the Serbian MOFE continues to experience difficulties in producing regular and high-quality budget execution reports, as the Mutual Services Agency (MSA) has not modified its software for the new chart of accounts. The MOFE is developing a budget tracking system, using an MS Excel spreadsheet system, in order to produce meaningful budget execution reports.

12. **The CFAA recommends that** the Federal and republican governments implement a full treasury system, including the adoption of Treasury Single Account (TSA). The TSA should be established before the new financial management information system (FMIS) is finalized. The CFAA recommends that the interim treasury system be completed by the Montenegrin MOF as quickly as possible for better cash management and commitment control, as well as improved quality of budget execution reports. **The CFAA recommends that**, until the completion of the new treasury system in late 2003, an interim treasury/general ledger be implemented by the Serbian MOFE to improve its cash management and commitment control, and to provide accurate and reliable budget reports; it also recommends that the revision of its organization structure to accommodate new treasury functions be also finalized. The Federal MOF should establish a formal treasury function, including commitment control, cash management, and debt management units.

Accounting Systems (Section 4.3)

13. Presently the MOF does not have a full picture of all financial transactions, because the ZOP and the MSA, which had clear but limited reporting responsibilities to the line ministries, are precluded from full reporting to the MOF. Bookkeeping is cash-based with some rudimentary

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elements of commitment tracking. Furthermore, the present system suffers from the lack of a centralized accounting function that is able to provide standardized policies, procedures and methodologies on sound accounting and high-quality reporting.

14. **The CFAA recommends** the restructuring and strengthening of government accounting systems in the three governments, including requiring the ZOP and MSA to provide full reporting to the MOF. The Serbian MOFE and the Montenegrin MOF should establish an accounting policy and methodology function within their Treasury Department to carry out the necessary methodological strategic thinking and to prepare the detailed accounting policies and procedures necessary for the implementation of the new budget law and required accounting standards. The CFAA also recommends that the Serbian MOFE and the Montenegrin MOF create a new centralized accounting function within their Treasury Department, whose functions would include (a) an accounting unit that would deal directly with the financial management units of the Direct Spending Units (DSUs), and process their commitment and payment requests; (b) another accounting unit that would prepare accounts, manage the ledger system, and provide access to regular daily information to other users in each MOF, in particular Budget Departments; (c) a payroll office for DSU salaries; and (d) coordination of the reports generated by the ZOP and MSA.

Budget Reporting (Section 4.4)

15. The reports on budget execution during the past decade were incomplete, limited in coverage, and late. As a result, they did not provide useful or relevant information for decision-making or budget management purposes. If consolidated reports are made on the transactions of Direct Spending Units, the reports would still give an incomplete picture of budget execution, since they exclude expenditures of the accounts of Indirect Spending Units (ISUs). Budget reporting capabilities are also limited because the Budget Departments may check that funds transferred to DSUs for the purpose of funding ISUs are executed by the DSUs, but they have no way to monitor the end use of funds by the ISUs. Budget reports are prepared only at midyear, and no consolidated budget reports are prepared.

16. The Federal MOF has no plans to introduce a new financial management system to improve financial accounting and reporting. In Montenegro and also in Serbia, the new Budget Laws should enhance budget reporting, as the Montenegrin MOF and Serbian MOFE will determine accounting procedures, the formats and timing of reporting, the timetable for preparation and submission of infra-annual and final accounts of governments, and their contents.

17. **The CFAA recommends** that timely and accurate reporting on budget execution be prepared by the governments and presented to the legislatures for discussion on a regular basis, at least quarterly. To achieve this, the Serbian MOFE and the Montenegrin MOF should introduce more meaningful budget execution reports, including (a) a monthly summary report providing expenditure breakdowns to the subcategory level for all transactions; (b) a quarterly report providing details of items and selected sub-items of spending; (c) a monthly report on flows and closing balances; and (d) monthly reports on revenues. **The CFAA recommends** that each level of government be made accountable for comprehensive and reliable budget reporting, including presentation of monthly, half-yearly, and annual consolidated budget execution reports to the three Parliaments.

Priority - Financial Controls (Section 5.1)

18. The financial control functions within the public sector consist of checks and balances through policies and procedures adopted to assist management in ensuring the orderly conduct of the public institutions, the prevention and detection of fraud and error, the accuracy and

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completeness of the accounting records, and timely preparation of reliable financial information. The existing financial control functions have been weak during the last decade and need development and strengthening. Elements of financial control have been carried out by the ZOPs, by internal controllers within some line ministries, by the Mutual Services Agency, and by the MOFs. These controls were limited to basic documentary checks of the accounting and reporting of spending units. However, these functions are not conducted systematically nor as part of any overall managerial control to prevent abuse within an organization. Weaknesses within the control system included a lack of up-to-date information on the financial position in line ministries; little or no follow-up to ensure that funds were spent as intended; insufficient segregation of duties over transactions; failure to maintain accurate assets registers; scattered and incomplete accounting records and supporting documentation; poor reporting mechanisms and an audit trail which needs improvement. In conclusion, there is little or no follow-up through the Ministry of Finance directly on whether funds were used as intended.

19. In Serbia, the Organic Budget Law (OBL) foresees many changes to the system of internal control and audit. When fully implemented, it will allow Serbia to move towards a modern Public Internal Financial Control System. The Serbian MOFE has a small budget inspectorate to take forward the introduction of internal audit, but has yet to define a strategy for the implementation of the internal control environment that is needed to accompany the introduction of the Budget Law. The European Agency for Reconstruction (EAR) will provide support to the Serbian MOFE and Montenegrin MOF for the implementation of effective Public Internal Financial Control and the establishment of modern, risk-based Internal Audit functions. Currently, there is no plan to enhance financial controls in the Federal government.

20. **The CFAA recommends that** ex-ante procedures to check the legality and amounts of transactions at the expenditure's commitment stage be reinforced to avoid overspending, and that ex-post controls be introduced to verify the correctness and appropriateness of transactions, and their proper recording. The Federal and republican MOFs should establish and institutionalize internal controls, by strengthening existing policies, procedures, rules and internal regulations across spending units and in all phases of public finance management (covering budget planning, preparation, execution, and reporting), supported by compliance checks by the budget inspectorates or internal audit departments.

Priority - Internal Audit (Section 5.2)

21. Internal audit is regarded as one of the primary tools of any organization to ensure effective and efficient operations, timely, reliable and relevant reports, compliance with applicable laws and regulations, and the safeguarding of assets. There is currently no Internal Audit (IA) function in the Western sense operating in FRY. The closest parallel is the work done by the Budget Inspectorates (BIs), which only carry out compliance work, to check whether internal control procedures are being properly followed. The BIs are not equipped to cope with the need to ensure sufficient checks and balances in the system and prevent abuses. The BIs have an inadequate mandate, are insufficiently staffed, and are poorly equipped to carry out their duties efficiently and effectively. While the Serbian BI carried out an impressive inspection of public spending in Budget Year 2000, the Montenegrin and Federal BIs have not played any significant role.

22. In Serbia and Montenegro, the new budget system laws allow for the establishment of internal audit functions at the MOF level. Both republics are waiting for the arrival of expert consultants to take the process forward.

23. **The CFAA recommends that** modern internal auditing functions be introduced in all three governments, building on the experience of the existing Budget Inspectorates. As a priority,

the CFAA recommends that an action plan setting out milestones for developing Internal Audit Departments be developed. As a first step, **the CFAA recommends that** each of the Federal and republican governments appoint an internal audit head, at least at Assistant Minister level, who should report directly to the Minister of Finance and should not have any other operational responsibilities within the MOF or any bodies falling within internal audit's remit.

Priority - External Audit (Section 5.3)

24. Supreme Audit Institutions (SAIs) are national agencies responsible for auditing government revenue and spending. The primary purpose of SAI is to independently oversee the management of public funds and the quality and credibility of government's reported financial data. There is currently no Supreme Audit Institution (SAI) in FRY, at either the Federal or republican level, with responsibility for carrying out external, ex-post audit in the public sector. The absence of an SAI, reporting independently to the Parliament, reduces the counter-balancing effect of the legislature or judiciary over the executive. A functioning external audit is a prerequisite for EU accession, and presently there is no audit law that meets, to any extent, the requirements of the EU.

25. In Serbia, the National Assembly, with assistance from the United Nations Development Program (UNDP), and Program for Accountability and Transparency (PACT), established in 2001 a Working Group to consider the way forward for the creation and establishment of an SAI. This Working Group visited the SAIs of Slovenia, Germany, and France, but it did not include a pure Westminster SAI model in its study tour activities. The EAR will provide support to the National Assembly of the Republic of Serbia for the establishment and development of an SAI that meets international and European Union auditing standards.

26. In consideration of the Federal level's uncertain prospects, there is currently no plan for the development of external audit of Federal institutions, and no donor has yet shown interest in providing technical assistance for the establishment of a Federal SAI. In Montenegro, little progress has been made to date towards setting up an SAI, due to limited understanding within the public sector about audit issues, limited infrastructure (in particular technical capacity) to undertake the development of an SAI, and the higher priority which has been assigned to other reform areas. Germany has agreed to provide technical assistance (to commence in 2002) to Montenegro for the establishment of an SAI.

27. **The CFAA recommends that** Federal and Montenegrin governments establish a task force, led by parliamentarians, that would review main types of SAI models to ensure that the most suitable model is chosen, and immediately establish a provisional broad timetable to take forward the development of an SAI. **The CFAA recommends that** the provisions of the laws adopted to establish SAIs be in compliance with the broad principles espoused by the International Organization of Supreme Audit Institutions (INTOSAI) in the Lima Declaration of 1977, as republished in 1998. Until the establishment of functioning SAIs, the CFAA recommends that the Montenegrin government continue, and the Federal and Serbian governments commence, the audit of Direct and Indirect Spending Units, extra-budgetary funds, and public enterprises by suitably qualified independent auditors.

Fiduciary Considerations – Key Findings and Recommendations

28. The report outlines the key risk management measures that should be implemented by the Federal and republican governments, and the opportune mitigation strategies to be adopted by the Bank, in conducting investment lending and adjustment operations. The primary responsibility for fiduciary risk management remains with the three FRY governments, with significant support from the World Bank and other development partners. The CFAA evaluated the fiduciary aspects

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of the Bank's lending program, and made certain recommendations on the key fiduciary areas listed below.

Priority - Safeguards for Adjustment Operations (Section 6.3.2)

29. The review of the National Bank of Yugoslavia (NBY) in its deposit account holder capacity indicated that the FRY has appropriate capacity to manage the Bank's credits, and to understand the flow of funds, and has recently issued well-documented instructions on recording obligations of the FRY for entries into capital of the World Bank. There are no apparent difficulties in transferring IDA Credit funds through the NBY to the government Budget Account for the Republic of Serbia (in Dinar) and to the government Budget Account for the Republic of Montenegro (in Euro) in the Central Bank of Montenegro (CBM). However there is the related risk of attachment of foreign currency assets of the NBY by creditors and other former constituents of the Socialist Federal Republic of Yugoslavia (SFRY). Consequently, the fiduciary arrangements have been agreed with the borrowers in the recently approved Structural Adjustment Credit (SAC) in Serbia and also in the Montenegro SAC, which was negotiated in May 2002. The key characteristics of both SACs include ring fencing both the deposit account and the correspondent bank account into which the credit proceeds are paid, and requiring an audit of both accounts. The Bank requires that SAC funds be held at the Deutsche Bundesbank (or at any other financial institution ensuring extra-territoriality) rather than at NBY's correspondent banks abroad. The role of the NBY in adjustment operations for Montenegro has also been clarified.

Investment Operations: Assessment of Commercial Banks (Section 6.3.3)

30. Based on the assessment of commercial banks, **the CFAA concluded that**, at present, only three commercial banks in Serbia could be considered acceptable to operate Special Accounts for investment-type operations. Based on the desk-review assessment, **the CFAA finds that** there are currently no banks in Montenegro that can be regarded as acceptable to operate Special Accounts. The CFAA recommends that all banks held to be suitably qualified in the view of NBY (Group A banks in Serbia) and Central Bank of Montenegro (CBM) in Montenegro be reassessed in due course by the World Bank for inclusion in a revised list of banks acceptable to operate Special Accounts for investment-type operations.

Assessment of Private Firms to Audit Bank-assisted Projects (Section 6.3.4)

31. Based on its assessment of audit firms in Yugoslavia, **the CFAA team concluded that**, at present, only two audit firms are acceptable to the Bank and are therefore pre-qualified to participate in bidding for auditing World Bank-financed projects. The CFAA team also concluded that two other audit firms would be conditionally pre-qualified, subject to meeting certain conditions. None of the audit firms reviewed has recent experience with World Bank projects. **The CFAA recommends that** the selected auditors be subject to careful monitoring and evaluation by the Bank in conducting their first audits, to ensure compliance with the Bank's requirements and guidelines. **The CFAA also recommends that** a global tender approach be adopted in FRY, leading to the appointment of one auditor for the whole country project portfolio. The selection of a global auditor would be effective for a period of two annual audits, with an annual renewal clause subject to performance evaluation.

Future Action

32. Because of the fast pace of reforms and development programs, as well as the fluidity in constitutional and governance arrangements, **the CFAA recommends that** the Bank remain in continuous dialogue with the three levels of government as the new arrangements take shape in

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detail, to update its recommendations in light of changing circumstances and revise its country-specific fiduciary safeguards as warranted. The CFAA proposes to undertake a new assessment once the situation has stabilized, probably in about twenty four months, and in any case before the end of calendar year 2004.

1. COUNTRY CONTEXT

1.1 A Democracy in Transition

1. Until the early 1990s, the former Socialist Federal Republic of Yugoslavia (SFRY) consisted of the federation of Bosnia, Croatia, Macedonia, Montenegro, Serbia and Slovenia. In the early 1990s, following the breakup of the SFRY, five republics were established: Slovenia, Croatia, Bosnia-Herzegovina, the Former Yugoslav Republic (FYR) of Macedonia, and the Federal Republic of Yugoslavia (FRY). The SFRY ceased to be a member of the World Bank Group in February 1993.

2. The FRY was constituted in April 1992 as a federation of the Republics of Serbia and Montenegro and consists of three levels of governments: Federal, Serbian, and Montenegrin. The Republic of Serbia is by far the larger of the two constituent republics, with 94 percent of FRY's population of 10.5 million and a similar share of its GDP. The Republic of Serbia includes the autonomous provinces of Kosovo and Vojvodina (see IBRD Map No. 31506). After the war in Kosovo, this province was placed under the UN administration by UN Security Council Resolution 1244 (June 1999), which established a transitional authority: the United Nations Mission to Kosovo (UNMIK).

3. The decade since its founding has been one of regional conflict and international isolation, characterized by authoritarianism and substantial mismanagement of public resources. Federal elections in October 2000, and Serbian Parliamentary elections in December 2000, brought to office reform-oriented governments with a mandate to bring about greater democracy, modernization and integration with the international economy.

4. The initial CFAA mission took place about a year after the 2000 elections. The CFAA team found the country in transition, not only to a market and a post-conflict economy, but also to evolving conception of statehood. Considerable progress has been made in establishing democratic governance and in reintegrating the country into the international community. The FRY has been re-admitted to the United Nations (UN), the Organization for Security and Cooperation (OSCE), and the various international financial institutions, including the International Monetary Fund (IMF), the World Bank (WB), the European Bank for Reconstruction and Development (EBRD), and European Investment Bank (EIB). On July 23, 2001, a European Union (EU) FRY Consultative Task Force was inaugurated as the first step towards reaching a Stabilization and Association Agreement with the EU. The FRY is a participant in the EU's Stabilization and Association Process which aims to create, over time, democracy, peace, stability and prosperity in the Balkans.

5. Both the Federal government and the republican governments of Serbia and Montenegro have made substantial progress on their economic reform agendas over the past year. In Serbia, progress since elections in December 2000 has been extensive, with major liberalization of prices, foreign trade and foreign exchange; tax reform; improved privatization and bank restructuring regimes; enhanced transparency in the budget process; and reductions in the gray economy and smuggling. Although in Montenegro reforms began earlier, supported by donor technical and financial assistance, implementation in some areas has been less rapid, in part because of more serious capacity constraints. All three governments face the daunting task of rebuilding an economy while implementing a tough reform agenda. The renewed commitment to reform in the FRY is substantial, but counterbalanced by uncertainty and risks.

1.2 Constitutional Changes

6. Foremost among these risks is the future of the FRY. FRY's Federal structure is highly decentralized and fluid. The Federal Constitution grants the republics any powers not vested in the Federation, including most revenue-raising and most economic and social functions. It reserves as the main Federal responsibilities foreign relations, foreign trade, defense, monetary/exchange rate policy, and customs.

7. The Government of Montenegro has taken over most of the responsibilities for economic management in its territory, foreign relations, currency and customs, and has largely cut fiscal links with the Federal government and the government of the Republic of Serbia.¹ Well before the Federal elections in October 2000, and Serbian elections in December 2000, that brought to office the first Federal and Serbian reform-oriented governments, Montenegro had already elected a reformist government that was moving to separate itself from the rest of the FRY with the strong support of the international community. In 1998, Federal authorities ceased transfers of funds to cover pension costs of ex-Federal employees and the pension subsidies in Montenegro, while Montenegro took control of its revenue sources and to stop transferring revenues from custom duties to the Federal budget. Montenegro introduced German Mark (DM) in 1999 as a parallel currency with the YU Dinar with the justification of combating inflation induced by uncontrollable money supply from the National Bank of Yugoslavia. The DM became the only legal tender a year later, and was then succeeded by the Euro in January 2002. Montenegro also took control of its borders and customs administration and set up a council to establish monetary and foreign currency policy. Belgrade countered by temporarily imposing a trade blockage against Montenegro and terminating electronic payments between the two republics through the centralized payments system. Montenegro established its own central bank, the Central Bank of Montenegro (CBM) in November 2000. The trade blockade has been lifted and NBY has since moved to reestablish payment systems between Serbia and Montenegro.

8. The Federal and Serbian governments established mechanisms for joint preparation of new legislation and policy discussions, and in August 2001, the Federal government adopted "The Initial Grounds for the Joint Platform on Constitutional Restructuring of the FRY." A political dialogue was ongoing between Montenegro and Serbia to determine the nature of their constitutional relationship.

1.3 Governing Structures

9. Apart from the constitutional issues, there are two major obstacles to the proper functioning of existing governing structures: (i) significant duplication of functions in the Federal and Serbian governments, amounting to about 20 percent of the 2001 Federal budget;² and (ii) lack of harmony between the Federal and Serbian Constitutions. The Serbian Constitution was adopted on September 28, 1990, at a time of state and political crises in the former SFRY, and that Constitution was not subsequently made concordant with the 1992 Constitution governing Federal institutions.

10. The FRY is a parliamentary democracy, consisting of the legislative body, the Federal Assembly, and the judicial branches, including the Federal Supreme Court and Federal Public Prosecutor. The Assembly is bicameral and consists of a Chamber of Citizens (deputies elected in the member republics in direct elections, by secret ballot, provided that in the member republics no fewer than 30 Federal deputies can be elected), and a Chamber of the Republics (consisting of

¹ This paragraph is based on section 3 of ESI Report: Sovereignty, Europe and The Future of Serbia and Montenegro, A Proposal for International Mediation, February 12, 2001.

² Based on a Survey of Replication of Functions in Federal and Republic Bodies and Levels of Funds for Financing, jointly prepared by the Federal MOF/Serbian MOFE.

20 Federal deputies from each member republic). The Parliament decides, among other things, about joining international institutions and passes the Federal budget, approves the Federal balance sheet, ratifies international treaties within the competence of the FRY, and elects and dismisses Federal-level executives, including the governor of the NBY. The NBY is an independent entity and the sole issuing institution of the monetary system of the FRY, responsible for monetary policy, exchange rate stability, and for financial discipline and performance of other operations prescribed by Federal laws.

11. Both the Republic of Serbia (capital in Belgrade), and the Republic of Montenegro (capital in Podgorica), are unitary republics headed by a directly elected president, with a single assembly (National Assembly), and a directly elected president. Each republican government consists of a prime minister, deputy prime ministers, and ministries. The National Assemblies are the representative and legislative bodies of the republics. The National Assemblies pass all laws of the land, ratify international treaties falling within the competencies of the republics, appoint the Prime Minister, ministers, and justices of all courts, adopt the budget, and perform other duties as established by the Constitution. The differences between the two republics are that (1) Montenegro's Constitution (October 12, 1992) provides for decisions related to changes in constitutional status or to an alteration of borders to be subject to citizen referendum; and (2) since its move to de facto independence, Montenegro conducts its own foreign policy, and carries out other powers that in Serbia's case are exercised by the Federal government.

1.4 A New Union: Serbia and Montenegro

12. With EU mediation, Serbia and Montenegro signed an agreement in Belgrade on March 14, 2002, "The Basis for the Settlement of Relations between Serbia and Montenegro", which allows for the creation of the new state union of Serbia and Montenegro. The name Federal Republic of Yugoslavia would no longer be used. This agreement was submitted and approved by the Federal parliament, as well as the parliaments of the two constituent republics. Now, a constitutional commission, comprised of representatives from the three parliaments, is preparing a constitutional charter for the new state union. The new charter would then be submitted to the three parliaments for approval. If approved, the constitutions of Serbia and Montenegro would have to be amended or replaced by new constitutions no later than December 31, 2002, in order to bring them into compliance with the charter.

13. Under the agreement, the new union would have common institutions such as a presidency, a Parliament, Council of Ministers and Court. The unicameral Parliament would be elected once the Constitutional Charter is adopted, and the President would be elected by the Parliament. The Council of Ministers would comprise five departments: foreign affairs, defense, international economic relations, internal economic relations, and human and minority rights. The Court would have constitutional and administrative functions and would also be responsible for harmonizing court practice. As a result, an important outcome of the agreement would be the possibility for reduction of administrative costs, because the sizeable Federal apparatus, which was being financed by Serbia alone, could be reduced. Most Federal and Serbian republican institutes and directorates would merge.

14. The March 2002 agreement provides for one country with two independent economies, currencies (the Euro and Dinar), separate banking systems, separate customs tariffs and customs services, separate fiscal rates and fiscal services. However, the Agreement refers to an unrestricted operation of a common market between the two states, with a free flow of people, goods, services and capital between them. The differences in the economic systems between the two states, in particular trade and customs, are to be overcome through the harmonization of the two systems with the EU economic system. In addition, the two member states have the right to

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reconsider the agreement after three years and may then institute proceedings for a change of state status, that is, withdrawal from the state union or its termination.

15. As the FRY CFAA is being finalized, the Federal, Serbian and Montenegrin Parliaments have ratified the agreement. However, the Constitutional Charter has not yet been promulgated, the shape of the new common institutions is not finalized, and the merger of the Federal and Serbian institutions has not commenced. This report was prepared starting five months prior to the March 2002 agreement. Although we report the CFAA findings would not change as a result of the new Constitutional Charter, the Bank will follow development closely and discuss implications, if any.

16. The March 14, 2002 Agreement will deeply change the composition of the public expenditure systems of Serbia and Montenegro, and particularly the role of the Federal government. Nonetheless, some issues regarding the Federal structure are relevant. First, whatever new structure emerges is likely to be built upon current Federal structures and processes, and thus the review of Federal budget management is still highly relevant. Second, some problems or issues that emerge from the Federal review will remain relevant for the new Union structure, however constituted. Moreover, even if a wholly new Ministry of Finance is created at the national level, the analysis provides a review of the weaknesses of past practices, and can serve as a guide to establishing a new process.

2. PUBLIC SECTOR BUDGET MANAGEMENT

2.1 Legal Framework

17. The organic laws that govern public finance management are included in the Law Regarding the Funding of the FRY for the Federation, the Law on Public Revenue and Public Expenditure in Serbia, the new Budget Law (2002) in Serbia, and the new Budget Law (2001) in Montenegro. There are few standard operating guidelines (by-laws) or other basic internal regulations to guide the budget preparation process in Serbia or at the Federal level. Existing law in Montenegro does include such regulations and new ones will be approved to match the new budget law.

2.1.1 Federal Budget Legislation

18. The existing Federal budget laws have many good features, such as stressing the gross principle in final accounting and aiming for a more complete coverage of government operations by including off-budget activities of budgetary institutions, but they are not harmonized with the functioning of a market economy. The key areas requiring strengthening include:

- Enhancement of the laws' general provisions, including scope of coverage by the laws; defining all terms used in the laws³; and specifying that all government revenues are to flow into a single government fund.
- Clear specification of the different budget stages, delineating the budget preparation, presentation and approval stages. The budget should be placed in a macroeconomic framework with corresponding fiscal projections; the budget preparation process should be detailed, including the issuance of a budget circular specifying budget parameters and targets, the timing of the budget process in relation to the start of the fiscal year, the budget submission by ministries, and the assessment by the MOF; the budget timetable should be clearly described; the content of budget documents to be submitted should be prescribed; and the budget should detail revenue and expenditure, and a deficit limit should be specified.
- Provision for the implementation of the Treasury, an organizational unit which would be responsible for all financial assets and liabilities of ministries and government agencies.
- Adequate discussion of government cash management and banking arrangements, including specifying that all moneys owned by the government should be paid into a Treasury bank account, facilitating the introduction of active cash management and control functions by the MOF; and requiring MOF approval for the opening of bank accounts.
- Requirement that a limit be set on debts and guarantees in the annual budget, and empowerment of the Federal government to loan to lower levels of government.
- Introduction of appropriate accounting standards in budget institutions, local authorities and financial reporting for special funds, together with provisions for dealing with unspent appropriations.
- Strengthening and assigning internal audit functions to the MOF
- Introduction and definition of the role of the Supreme Audit Institutions (SAI).

³Including: local authorities, special funds, fiscal year, revenues and receipts, expenditure and other payments, scope of services provided by each level of government, surplus/deficit, and financing by the central and local governments.

2.1.2 Serbia's New Budget Law

19. The Republic of Serbia has begun to make significant progress towards introducing a sound budget framework and strengthening budget procedures. In February 2002 a new Law on the Budget System (LBS) was adopted by the parliament, replacing the 1991 Law on Public Revenue and Expenditure. The new Law reflects current good international practice, emphasizing a number of important principles and changes. First, it reiterates the need for the budgetary process to be inclusive of all public revenues and expenditures, including those of local governments and the Social Funds. Second, it also sets the budget calendar, according to which preparations of the budget for the following year will begin on April 30. Government should adopt the budget by November 1 and send it to the Legislature for approval. It specifically identifies in the budget calendar the development of a strategic budget framework to be approved by the Government prior to the detailed preparation of the annual budget. Third, it will introduce the institution of a treasury system at the level of the republic central government, autonomous province of Vojvodina, and local governments. The new Treasury, yet to be established, will include all budget beneficiaries' income. Fourth, it would allow Serbian MOFE and local finance departments to carry out multi-year financial planning by providing a linkage between the overall government budget framework and strategic government economic policies. Finally, the OBL introduces internal and external auditing, clear delineation of budget stages, and clear responsibilities for the minister of finance in budget execution.

2.1.3 Montenegro's New Budget Law

20. Montenegro initiated a fast-paced reform of budgetary processes and institutions in 1998, inspired by the Montenegrin drive to full fiscal autonomy and the cessation of inter-budgetary flows between it and the rest of the Federation. The Montenegrin Parliament adopted a new organic Budget Law in August 2001 that reflects international good practice. It replaces the current Law on Public Expenditures and supercedes related articles in other laws that deal with the budget and other government financial activities.

21. The new law forms the foundation for enabling legislation that will drive the implementation of fiscal reform. It sets out the parameters and requirements for the formulation of the annual Budget Law and execution of the resulting budget appropriations and allocations, strengthens the role of the Ministry of Finance in public expenditure management, and provides a legal basis for the establishment of a Treasury system. The Montenegrin MOF has already issued necessary regulations as specified in the Law, such as Treasury Directions, Budget Instructions based on IMF Government Finance Statistics (GFS) classifications, annual Budget Circulars, and periodic Treasury Instructions. With the support of a U.S. Treasury Adviser, line ministries have made reasonable progress in implementation and seem to have few problems with handling the new budget preparation instructions.

22. Compliance with the provisions of the new Budget Law is required within 12 months from the day of enactment of the new law. During this period, budget and treasury regulations will be approved, and until these regulations are approved, the existing regulations will be used. Extra-budgetary funds and municipalities are required to comply with the new Budget Law within 18 months of the enactment of the new law.

2.1.4 Recommendation

23. **The CFAA recommends that** the Federal government introduce an organic budget law, in accordance with the international best practice and harmonized with the new budget laws in Serbia and Montenegro. The key areas requiring enhancement include (a) coverage of all budget institutions; (b) specification of the different budget stages, including appropriate budget

timetable, detailing the budget preparation process, and prescribing the contents of the budget documents; (c) clarification of the responsibilities of the minister of finance in prescribing regulations and procedures on budget execution, including budget instructions and more frequent allocations of cash and more frequent reporting of revenues and expenditures; (d) introduction of treasury functions; (e) consolidation of cash balances; and (f) introduction of internal audit and external audit functions. [Short Term]

2.2 Budget Planning and Preparation

2.2.1 Financial Planning

24. Multi-year financial planning is at present not yet fully developed in both Federal and republican governments, and budget formulation remains weak. A disaggregated multi-year perspective on revenues and spending is lacking. There is insufficient linkage between government policies and budgetary resource allocations. In Montenegro, the Prime Minister's Office has developed an aggregated fiscal framework for the current and two subsequent years, which reflects some of the key fiscal policies and programs. Still missing are external debt service assignment and the impact of fiscal decentralization, and there is still no disaggregated multi-year perspective on revenues and spending.

2.2.2 Budget Coverage

25. At all levels of government, the budget consists of a limited number of very aggregate budget lines (positions) which provide only a broad level of information. Typically this analysis for an individual ministry is restricted to three to six economic resource lines (positions), which is generally inadequate for meaningful budgeting. The budget serves rather as a means of setting limits for budget users, who then have a relative free hand in execution within these limits.

26. Budgets do not include neither (i) all revenues and sources of funds (grants, donations received by foreign governments; only budgetary support is included, in terms of financing gap); nor (ii) all expenditures and uses of funds (including off-budget items and own revenues). In addition, good practice requires that contingent liabilities of the government, such as debts and arrears of social funds, local government and public enterprises are included in the budget annex.

2.2.3 Procedures and Timetable

27. In the present budget timetable, there is inadequate parliamentary time for scrutiny of the Federal or republican budget before it is passed; nor are there functioning parliamentary finance or budget committees to review and analyze the proposed budget before it goes to the Parliament for discussion and adoption. The government's annual budget has normally been presented in December for the fiscal year starting January 1. The 2001 budget was not presented until January 2001 due to political transition in the country and the 2002 Federal and republican budgets were approved in late December 2001.

28. There are no well-developed or consistent guidelines for the initiation of Federal budget submissions, reallocations of budget funds during the implementation phase, or other formal communication and control routines between the Federal MOF and the spending units. Given the uncertain political situation in the country, the Federal budget preparation process for 2002 budget had not even begun as of October 1, 2001 (it should normally start in early September), and subsequently it decided to use the Serbian instructions for its 2002 budget. No agreement had been reached at state level defining the functions of the Federal government, and the Federal MOF was having difficulty obtaining accurate and consistent macroeconomic data (such as GDP figures), needed for financial planning.

Public Sector Budget Management

29. The new laws on budget system in Serbia and Montenegro set out a new budget calendar for the Republics. An important feature of new budget law is that it allows substantially more time for the preparation of budget proposals by line agencies (2 months), for the review of budget requests by the MOF and preparation of the draft Budget (2½ months), and for consideration and approval of the Budget by Cabinet and Parliament (2 months). Implementation of this new timetable should help to emphasize the role of the Budget as a key instrument to the realization of government policies and programs. Table 1 presents the budget calendar for Serbia and Montenegro.

Table 1: The Budget Calendar

Date	Activity
April 30	Preparation of a budget memorandum, including a strategic framework of resource ceilings.
May 15	Medium-term macro-fiscal framework is adopted by the government. Budget Memorandum includes review of fiscal implications of government policies and strategies.
June 1	Circulation of budget instructions
Aug. 1	Submission of budget proposals by the direct spending units (DSUs) and social fund administration to the Montenegrin MOF/Serbia MoFE.
Oct 1	Updating of the budget memorandum and finalization of budget proposals by the Montenegrin MOF and Serbian MoFE
Nov. 1	Adoption of the proposed budgets by the republican Parliaments.
Dec. 15	Republican Assembly approves Republic Budget.

30. In Serbia, the Government that was elected in late 2000 has begun to address many budget issues. Even prior to passage of the new budget law in February 2002, modified and simplified procedures were adopted for the preparation of the 2002 Budget. These involved the introduction of a more detailed budget classification based on the IMF's GFS classification, and a requirement for budget submissions to be accompanied by a supporting explanation and justification. Ministries were also asked to separately identify in their budget submissions the funding requirements for: (i) continuing existing levels of activity; (ii) on-going activities which could not be covered within existing budget allocations; (iii) planned capital expenditures; and (iv) new programs. The new procedures resulted in improvement in the quality of budget proposals submitted by line ministries.

31. However, whereas the new budget format and information could have been used to more rationally allocate resources to budget users, the budget office relied on past practices of modifying economic classification elements from last years' budget until the 2002 budget targets were reached. This resulted in approved spending levels that did not match the new classification, could not be bridged to requests from budget users, and made it difficult to execute the budget and monitor compliance.

32. The preparation of budget proposal for 2002 in Montenegro, based on the new budget law, has been successful. There have been intensive training and liaison with line ministries and direct budget users in the formulation of the 2002 budget proposal. The reliability of the budget has improved significantly, with the implementation of the new Budget Law and the new Treasury system (including budget instructions, budget circulars, treasury instructions) in Montenegro in late 2001. With the assistance of a U.S. Treasury (UST) adviser, the Montenegrin MOF has made impressive progress on budget preparation and this technical assistance is continuing.

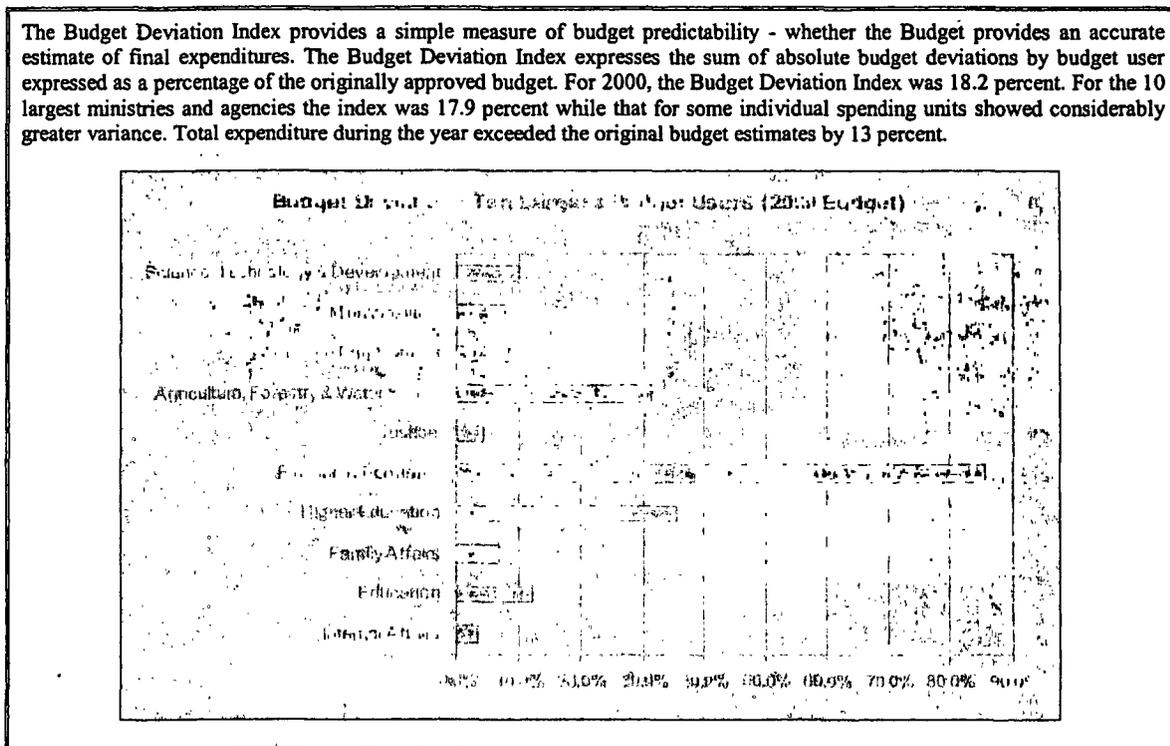
2.2.4 Lack of Link Between Policy and Budget Process

33. In the past decade, the budget process fails to make explicit resource allocations to the major areas of public service delivery. As a result, there has been little incentive for line ministries to review service provision, in order to match it to the availability of funds. Given no

indicative resource ceilings at the outset of budget preparation, line ministries and agencies submit budget requests that often exceed the available financing by two or three times. The line ministries have every incentive to inflate budget requests in the hope of maximizing the subsequent settlement, and little incentive to review service provision in order to match it to the likely availability of funds. In the past, the lack of forward budget planning meant that in-year spending reductions were handled in an *ad hoc* fashion, negating much of the work done during the initial budget preparation process, and with no tradeoffs considered across functions, policy commitments, or results. The subsequent cutbacks of funding requests during the finalization of the budget negated much of the initial preparation of the budget, and resulted in the real budget being finalized with the preparation of the annual spending plan following approval of the budget by Parliament.

34. The variability between approved and actual budgets by functional or administrative classifications gives some sense of the lack of link between policy and budget process. Table 2 illustrates budget volatility for fiscal year 2000. For 2000, individual direct budget users expenditure varied between 10.5 percent and 277 percent of budget. Eight were below 80 percent, 12 were above 120 percent. On a functional classification basis, for 2001, average variation between approved and actual expenditures was 30 percent, ranging from 239 percent above budget to 22 percent below. This significant variability can be attributed to poor budget formulation, including absence of multi-year planning, as well as budget execution systems operating on a cash rationing basis unrelated to budget priorities.⁴

Table 2: Budget Deviation Index



Source: MoFE, Republic of Serbia

35. Weaknesses in the budget process are also reflected in institutional deficiencies. The three MOFs currently have a limited role in economic policy analysis and forecasting. Current

⁴ FRY: Public Expenditure and Institutional Review (Volume One: Main Report)

staffing levels and capacities in the three MOFs are inadequate both for macroeconomic and fiscal analysis and for the appraisal of sector expenditure plans. Policy and programming capacities within line ministries are similarly poorly developed and there is little linkage between these functions and the preparation of line ministry budgets. One example of the minimal capacity for analysis of the expenditure implications of policy decisions is the double-digit deviation in percentage between planned and collected revenues from turnover tax and payroll tax in Montenegro, which make up about 80 percent of total budget revenues. In 2000, the budget anticipated an income of DM 149 million in payroll taxes, but received only DM 88 million (see table 3).

Table 3: Montenegro: Planned and collected turnover and payroll taxes, 1996 – 2000
(in million DM)

Year	Turnover tax revenues			Payroll tax revenues		
	Plan	Executed	Deviation	Plan	Executed	Deviation
1996	128.6	137.6	+6.9 %	126.6	106.8	-15.6 %
1997	208.2	149.5	-28.2 %	209.2	180.6	-13.7 %
1998	171.6	122.1	-28.8 %	156.4	138.0	-11.8 %
1999	128.0	147.5	+15.2 %	105.8	69.4	-34.4 %
2000	170.4	193.2	+13.4 %	149.0	87.6	-41.2 %

Source: *Monet*, Nr. 5, April 2001, p. 22-24.

36. The Governments that were elected in late 2000 and early 2001 have begun to address these issues. Considerable progress has been made in restoring the aggregate fiscal discipline and predictability that are essential pre-requisites to sound budget management. However, the reform of budget formulation is still at an early stage, and significant challenges remain in: (i) establishing a framework of policies and priorities to guide the allocation of public expenditure resources; (ii) specifying the planned performance (outputs and outcomes) of budgetary expenditure; (iii) determining revised standards and norms for public service delivery; and (iv) developing capacities for monitoring budgetary performance.

2.2.5 Recommendations

37. To enhance economic policy analysis and forecasting, **the CFAA recommends that each MOF establish a strong fiscal analysis unit to provide services such as rigorous forecasts, and revenue estimation and tracking on a monthly basis, including overall consolidated non-financial public sector accounts and major off-budget social funds. To improve revenue forecasting, the Fiscal Analysis Unit should work closely with the Public Revenue Authority. [Short Term]**

38. To enhance financial planning, **the CFAA recommends that each MOF develop a strategic budget framework, in four main stages: (a) design the medium-term macro-fiscal framework (short term), (b) conduct an analysis of cross-cutting issues, such as the budgetary impact of planned revenue policy measures, debt servicing, the balance between wage and non-wage allocations, and government decentralization (short-term); (c) prepare sector expenditure strategies; and (d) formulate sector expenditure plans. This strategic framework should result in the following improvements in the estimates for future budgets: (a) the new ceilings for line ministries would shift the focus of the budgeting exercise from maximizing ministry allocations towards achieving an appropriate distribution of resources; (b) a common functional classification would reflect the strategic program areas; (c) evaluation of budget requests by individual line item allocations would shift towards ensuring that expenditure allocations as a whole are consistent with the realization of planned outputs. [Short/Medium Term]**

39. **The CFAA recommends that** the Federal and republican governments establish clear and inclusive definitions of general government expenditure. Each of the Federal and republican MOFs would implement an all-inclusive consolidated budget framework, comprising central government, local governments, all extra-budgetary funds, own-generated revenues for line ministries, public debt, donor contribution, and direct/indirect transfers to/from public-owned enterprises and the governments. **[Short Term]**

40. To provide greater transparency, **the CFAA recommends that** the Federal government increase the time allocated for budget planning and the budget cycle. **The CFAA also recommends that** the Federal Parliament consider increasing the time allocated for the scrutiny and debate of the budget, in accordance with OECD Fiscal Transparency Guidelines. **[Short/Medium Term]**

2.3 Budget Execution

41. The main actors are the Ministries of Finance (MOF in the Federal government and in Montenegro and MOFE in Serbia), the Mutual Services Agencies (MSA in the Federal government and in Montenegro and Mutual Services Unit or MSU in Serbia), which administer the accounts of most government bodies, and the Payment Bureaux (ZOPs), which collect revenues and transfer funds. The roles of the MSAs/MSU and ZOPs are covered in detail in section 3.

2.3.1 Current Budget Execution Process

42. During the past decade, there was effective cash control but overall budget management was ineffective. Although all three governments require the budget institutions to prepare detailed spending plans at the beginning of the fiscal year broken down by month, and these are received and examined by each MOF, such plans are not consolidated to give a spending plan for the government as a whole. Furthermore, not all ministries comply with the requirement to submit a spending plan, nor are all the submitted plans necessarily communicated to the Mutual Services Agencies (MSAs) that must process payments.

43. The view of budget execution presently employed in the FRY is a narrow one: the distribution of funds from the main budget account, rather than releasing funds when required for actual spending. The execution of the budget in practice entails the transfer of funds from each MOF to the accounts of individual ministries and administrative units. The main control in all three governments has been from the main budget account to the accounts of the ministries and other direct budget users or spending units (DSUs), which in turn control transfers to indirect budget holders or spending units (ISUs). A similar process applies to the expenditure of the Health, Pensions, and Labor Market Funds; under the control of the relevant fund, each of which is responsible for its own accounting and budget execution control. These entities should then report back on individual items of expenditure. In practice, this does not always occur, and there are no effective means of monitoring expenditure across different government agencies. The limits on the government's ability to control unplanned expenditures and align commitments with available resources work to increase unplanned outlays. For example, the Montenegrin MOF has not had enough influence to control cash inflows into the social funds, but has been left with accumulated deficits/arrears.

44. There is a disconnect between revenues and expenditure management: transfers to meet expenditure are under the control of each MOF, but revenues are not. There is no systematic forecasting process or reconciliation of revenues and expenditures. There is still little accountability for budget execution: governments appear to decide expenditures without reference to the planned budget, and there is little link between expenditure and revenue

collection. As a result, it is expected that there will be significant variances between actual and budgeted revenues and expenditure for 2001 at all levels of government.

2.3.2 Revenue Management

45. The Federal government's fiscal competencies are restricted. The Federal government's own sources of revenue are limited to customs and administrative fees, and the Federal government regulates only the tariff system and policy, taxation system elements such as customs policies, and the system of Federal administrative and court fees. The largest portion of the Federal revenue base (as percent of total revenues) is its portion of the sales tax, collected by the ZOP, formally subordinated to the NBY (a Federal institution). Montenegro has not transferred any revenues to the Federation since 1998, including the customs duties collected at its borders.

46. Public revenue systems in FRY do not include two very important tax forms that underlie the budgets of the majority of European countries, including those in transition: global individual income tax, and value added tax (VAT). Although an income tax was approved in Serbia in 1991, its application was deferred from one year to the next and in 1998, it was rescinded for good. Specific kinds of individual income are subject to specific taxation in Montenegro and Serbia, but both republics lack a global income tax⁵. Sales are taxed based on a single-stage tax on retail sales and a cumulative multi-stage tax on services. The VAT was approved by a Federal law in 1999, but the commencement of its application has been postponed three times so far, and is now expected in mid-2003.

47. In Serbia, many exceptions and special programs granted tax exemptions to certain companies or branches of the economy, thus violating the principle of taxation equality. Some exceptions had negative net effects on the economy, as in the case of the tax on re-registration of vehicles coming from Montenegro. Special facilities for privileged taxpayers included selective payment of obligatory taxes and contributions, payment of net salaries/wages before payment of taxes and contributions, and halving the sales tax rate on certain domestic products. This privileged taxation regime was often recorded in the form of decrees and court rulings, as well as instructions conveyed by telephone. The shortfall due to favoritism shifted the burden of financing public expenditures onto other sources, in particular, salary and wage taxes amounting to about 1.05 Dinars on one Dinar of net salary/wage, and general sales tax as high as 31 percent. Another result was to disrupt tax discipline, so that hardly 50 percent of public revenue was collected by regular procedure, while the rest was collected through administrative controls and forced collections.

2.3.3 Expenditure Management

48. The present system of expenditure control is limited by the narrow view of budget execution presently employed in the FRY- the block distribution of funds from the main MOF account to the accounts of the primary budget holders or direct spending units (DSUs), rather than releasing funds when required for actual spending. Subsequently, the DSUs transfer funds to the accounts of the subordinate budget users, or indirect spending units (ISUs), via a control/transit account set up by the MOF. The underlying principle is one-block transfers of funds, with limited breakdown according to the type of institution and of spending. The supporting reporting system, therefore, focuses on tracking these transfers of funds rather than classifying the expenditure undertaken with these funds. As a result, there is an incomplete picture of budget execution, and reporting on expenditure is limited.

49. By focusing on cash controls, the present system is inherently weak because it cannot control for past commitments coming due, and even efficient cash management (aimed at

⁵ Along with Albania, Bosnia and Herzegovina, and Lithuania.

optimizing the flow of funds within the system) is virtually non-existent. To exercise real control over spending, controls must be applied at the commitment stage—the first stage of the spending process—to determine the future demand for cash expenditures. Without controls on commitments, any unexpected commitment falling due, or any shortfall in expected revenues is translated into the creation of arrears or the need to restrict other types of cash release, leading to undue disruption and deterioration in government services.

50. Over 70 percent of the Federal budget is allocated for defense, lacking the basic elements of transparency and accountability. Some steps have been taken to integrate defense expenditure system into the overall FRY public expenditure management (PEM) system⁶. Specifically, in August 2001, the finance department was transferred from the control of the Chiefs of Staff to the civilian Ministry of Defense.

2.3.4 Parliamentary Oversight

51. FRY governments, at all levels, are not effectively held accountable by the legislature for their use of public resources. Parliaments exercise little or no control over public finances primarily because the parliamentary committee system is largely ineffective. The Public Accounts Committees (or Parliamentary Budget/Finance Committees) have been established but are not yet functional. In Serbia and Montenegro, the chairmen have been appointed but the committees have neither a proper structure and resources (staff, adequate office space, equipment), nor a clear mandate.

2.3.5 Budget Execution in Serbia

52. In Serbia, the system of budget execution involves the Budget Department of the MOFE, which releases funds on a day-to-day basis, according to resource availability, from the main budget account to the accounts of line ministries; the ministries in turn distribute these funds to the accounts of their subordinate spending units. The payment priorities of making payments are typically determined by government decision on advice from the MOFE, on the basis of the type of institution and the type of spending.

53. The MOFE receives timely reports on revenue collections from the Payment Bureau that collects them, but makes no revenue forecasts. The MOFE also receives information on movements in the main budget account, and since it prepares its own payment orders according to budget line items, it also receives more detailed information on the movement of funds out of the line ministries' accounts, and the remaining balances. However, it has no further information on how these monies are spent, except through quarterly reports by direct spending units (DSUs) on their expenditures, based on aggregated budget lines. While key payment dates are known (for example, for wages), there is no forecasting of expenditures, so the amounts of large payments falling due for large contracts are not known in advance.

54. Without the forward planning of cash flows, the MOFE, faced with revenue shortfalls or higher than expected obligations, can only react rather than being a proactive manager of its cash flows. As a result, the release of funds has degenerated into a cash rationing system. To reverse this pattern, stronger commitment controls are being introduced and a medium-term strategy for expenditure management is under preparation.

55. The Government took a step towards creating a single treasury account by closing most ministry accounts. Supported by an IMF program,⁷ Serbia made a decision to close the ministries'

⁶ Please refer to PEIR for more information.

⁷ Annex B of Appendix IV for the FRY Standby Agreement April 2001 to March 2002 – Item 4 of the Fiscal Sector in Structural Benchmarks requires Serbia to take the following action: "Improvement of cash management and fiscal

Direct Spending Unit (DSU) bank accounts (of which there were 81), along with the Indirect Spending Unit (ISU) accounts, beginning September 30, 2001. All payments formerly made from the numerous DSU accounts would now be made directly from the main budget account. The Serbian MOFE has started abolishing DSU accounts according to the planned schedule, but some of the major ministries still have not switched to the new system, and a few ministries (such as Ministry of Interior, Public Revenue Administration, and Ministry of Education) are still outside the control of the MOFE. However the closure of these accounts has led to temporary weakening of control of the budget account in Serbia because neither the Serbian MOFE nor the MSA has the capacity to manage the high volume of payment orders and there is no mechanism available in the Payment Bureau to authorize transfers in bulk.

2.3.6 Budget Execution in Montenegro

56. Revenues and expenditures are unpredictable for most spending units. Government ministries, social funds, public agencies and municipal administrations do not know whether in a given fiscal year they will actually receive what is allocated to them in the annual budget. This is a particular problem for municipalities, which depend on centrally collected (and widely fluctuating) income transferred from the central government for more than half of their revenues.⁸ As a result, there is no multi-year financial planning at the municipal level and almost no capital investment in municipal infrastructure.

57. The four social funds responsible for the pension system, the health system, employment programs and development, are also unable to predict their revenues and expenditures. In 2000 the pension fund accumulated DEM 20 million in arrears, bringing total arrears to DM 46 million.⁹ Unpredictability is aggravated by spontaneous policy decisions, such as those to increase the minimum wage from DM 50 to DM 80 in October 2000 and to DM 90 effective on January 1, 2002, which led to public sector salary increases in the same proportion¹⁰. Cascading increases are likely to affect all social benefits, and they will have major implications for the pension system in particular, which will lead to further bloating the accumulated arrears.

58. Budget execution in Montenegro should improve significantly when the new Budget Law and the new Treasury system are fully implemented. There will then be regular allocations and systematic reallocation of budget funds by the Minister of Finance. Under the new budget law, in fact, the Montenegrin Cabinet and MOF may approve reallocation of budget appropriations but only up to 5 per cent of approved budget.

2.3.7 Budget Results: Resource Gaps

59. By focusing on cash controls, the present system has an inherent weakness in that it is not able to control for past commitments coming due. The result is the buildup of large arrears.

60. Generally, the Federal Government maintained a balanced budget, matching revenues with expenses in 4 of the past 5 years. The exception was 2000, when significant arrears emerged. At the end of December 2000, the stock of arrears of the Federal government was estimated at

reporting by eliminating primary budget managers' expenditure accounts and own accounts of direct spending units (637 accounts and their 850 subaccounts) and by creating ledger accounts within account 630 [main MOF account]".

⁸ Local revenues consist of communal taxes and fees, building site charges and administrative taxes. Transferred revenues include 50 percent of property taxes, the tax on real estate transactions, the tax on inheritance and gifts, and 70 percent of residence tax. The municipal share of personal income tax varies according to the size and wealth of the municipalities, with the formula set by central authorities.

⁹ *Monet*, Nr. 5, April 2001, p. 33.

¹⁰ *Monet*, No. 4, January 2001, p. 14.

Dinar 7.063 billion¹¹. The system was able to maintain aggregate spending limits on average, but in-year downsizing without a Treasury and a commitment control system assured generation of arrears. For 2001, a net surplus was generated, and some of the arrears for 2000 were paid. Table 4 presents Federal outturn relative to the approved budget¹².

Table 4: Federal Budget Outturn Relative to Approved Budget, 2001
(YUD million)

	Budget	Actual	Deviation
Total Revenues	48,024	49,401	3%
Total Expenditures	45,874	47,811	4%
Deficit/Surplus	2,150	1,590	-26%

Source: FMoF, World Bank staff estimates.

61. In terms of aggregate fiscal discipline, the Republic of Serbia's PEM system has had mixed results. Big—though hidden—deficits existed, amounting to as much as 13 percent of the gross domestic product (GDP) in 2000. At the end of December 2000, the stock of arrears of the Serbian government is estimated at Dinar 32.522 billion¹³. They took the form of losses run by public enterprises (EPS, NIS and others), arrears in payments to suppliers and pension and social transfers payments, unpaid debts to foreign creditors, and unpaid foreign exchange savings. As shown in Table 5, for 2001, the Republic Budget was brought in very close to plan, and would have been brought in just below plan except for net lending to insolvent banks which increased expenditures during the year, and partly at the expense of extra budgetary arrears¹⁴.

Table 5: Republic of Serbia 2001 Consolidated Budget Expenditures, Approved Versus Actual Spending (YUD million)

Item	Budget	Actual	Ratio
Republic Budget	129,369	132,339	1.02
Local Government	27,989	31,396	1.12
Pension Funds	72,874	79,399	1.09
Health Fund	38,513	39,459	1.02
Total	274,102	286,468	1.04

Source: Republic of Serbia MoFE.

62. Montenegro also faces a serious fiscal imbalance. The consolidated budget deficit was over 10% of GDP¹⁵ for calendar year 2000. The deficit was approximately DM 140 million in cash terms and about DM 200 million in accrual terms due to a significant buildup of arrears in wages, salaries, pension and health fund obligations. There has been a significant expenditure overrun in 2001 as well, owing to large wage increases and associated increases in social transfer payments, higher than envisaged spending on subsidies, and lending to enterprises. Budget transfers to the social security funds were lower than planned, leading to further arrears accumulation for both the health and labor funds. Arrears, which were supposed to diminish, are actually increasing.

¹¹ FRY - Letter of Intent of the government of the FRY to IMF, Revised Memorandum of Economic and Financial Policies, Technical Memorandum of Understanding, September 4, 2001, Annex C

¹² FRY: Public Expenditure and Institutional Review (Volume One: Main Report)

¹³ FRY - Letter of Intent of the government of the FRY to IMF, Revised Memorandum of Economic and Financial Policies, Technical Memorandum of Understanding, September 4, 2001, Annex C

¹⁴ FRY: Public Expenditure and Institutional Review (Volume One: Main Report)

¹⁵ "Montenegro Economic Trends," *Monet*, Number 5, April 2001, p.31.

63. The cost of supporting the state administration and public companies, which together employ some 60 percent of Montenegro's official workforce, absorbs two-thirds of the Montenegrin budget, and is met only through massive and (until now) largely unconditional foreign assistance. The fiscal sustainability of Montenegro appears to be excessively dependent on aid flows. Recently, lower than anticipated foreign financing left a financing gap which was filled in large part by borrowing from the domestic payments and clearing system (effectively the Central Bank of Montenegro). Based on revised revenue and expenditure estimates, and the latest projection of foreign grants (DM 92 million), the consolidated general government of Montenegro is estimated to have a financing gap of about DM 20 million in 2001.

2.3.8 Recommendations

64. To strengthen capacity for budget execution in direct spending units, **the CFAA recommends** that all direct spending units prepare quarterly financial plans satisfactory to each MOF. **[Short Term]**

65. To strengthen fiscal discipline, **the CFAA recommends that** reliable tracking of expenditures (including establishing an accurate inventory of arrears) be introduced in all ministries.. **[Short Term]**.

66. **The CFAA recommends** the introduction of commitment accounting, which would allow optimization of cash management and tracking of arrears. Each MOF should establish a commitment control system (based on the new treasury system) to prevent and/or control the creation of new arrears. Over the medium term, a switch to a modified accrual accounting system could be considered. **[Short Term]**.

67. To ensure proper and transparent accountability to the legislature, **the CFAA recommends that** the parliamentary oversight committees at the Federal and republican levels be strengthened. In particular, **the CFAA recommends that** budget oversight functions be separated from other legislative oversight functions, with the objective of having the annual budget proposal reviewed and the implementation of the approved budget periodically analyzed. **[Medium Term]**.

3. PUBLIC SECTOR: PAYMENTS, CASH MANAGEMENT AND TREASURY

68. In the current legacy payment and cash management systems that handle public expenditure in FRY, the main actors are the Mutual Service Agencies (MSAs, MSU in Serbia), which process payments, the Payment Bureaux (ZOPs), which transfer funds and act as the governments' bankers, and the finance ministries, which monitor and manage cash flow. New treasury systems are being established in Serbia and Montenegro but will not be fully functional for another year or two. In the interim, improved cash management can greatly improve management of public funds.

69. A modern treasury system plays a fundamental role in enhancing public financial accountability by providing comprehensive, timely and reliable information on budget transactions and thus help to manage government expenditure effectively. A good treasury system includes the following components: (i) enabling legislation, policies and procedures; (ii) consolidation of all government accounts into a unified account (treasury single account); (iii) a treasury general ledger system; and (iv) appropriate institutional arrangements.

3.1 Mutual Service Agencies (MSA/MSU)

70. The Mutual Services Agencies administer the accounts (processing and authorizing payments and maintaining detailed account records) of most government bodies in all three governments. There are three MSAs in FRY: one at the Federal level, and one each in Serbia and Montenegro. At the Federal level, the MSA manages 44 Federal bodies, including most ministries, institutes, and agencies), except for the Ministry of Interior, Ministry of the Defense and Army (the latter account for 70 percent of budget expenditure), Federal Customs Administration, and some small institutes. The Serbian Mutual Services Unit (MSU) administers the accounts of all Serbian bodies (most ministries, institutes and agencies) except for nine organizations (including the Ministry of Interior, Public Revenue Administration and some small institutions).

71. The MSA receives notification of invoices to be paid by spending units and records these in each spending unit's ledger. MSA staffs establish that the payment is within the approved budget and that the cash to cover the payment is available in the spending unit's account. Where a spending plan has been submitted to MSA, the budget check is made against the detailed expenditure item, when this analysis is available, otherwise against the resource line in the budget. Subject to these checks, a payment order is prepared and sent to ZOP. The ledger for each spending unit is continuously updated and summary reports are issued to spending units on request. A daily report on expenditure is produced for each budget holder by the MSA. The MSAs also produce a monthly report, which compares expenditure to budget and payments and hence allows the identification of arrears.

72. The current accounting processing is cash-based with some rudimentary elements of commitment tracking. Line ministries send requests for payment to the MSA accompanied by an invoice from the supplier. The payment request, which sets out payment amount, supplier details and availability of funds, is signed by, or more usually on behalf of, the minister (or head of the spending unit). Payment requests are in a fairly standard format, but not on a prescribed or pre-numbered form controlled by the MSA.

73. Before processing the payment request, the MSA verifies the payment by checking the correctness of the invoice calculations, checking that the invoice total equals the amount in the payment request from the Ministry, and checking that the request has been duly signed by an authorized signatory. The MSA also checks whether the spending unit has enough funds allocated

for expenditure of this type, and whether the cash is actually available for payment in the spending unit's account. The MSA maintains an account for each spending unit, records the invoices due for payment, payments made, and balances available. If there are insufficient funds available, the MSA requires the spending unit to replenish the funds. Each MOF is informed of these shortfalls and payment action is suspended (i.e. no payable order is issued).

74. The MSA records the details of the invoices received for payment in the individual suppliers' ledger accounts. The MSA holds a ledger for each supplier that records details of all invoices received, payments made, and balances outstanding. Once the invoices are recorded in the suppliers' ledgers, the manager ticks the priorities of who will be paid that day, based on funds available for particular expenditure categories in individual ministries. The MSA prepares the Payable Order (PO), which is sent to ZOP to execute the payment.

75. When the MSA gets daily confirmation from ZOP of all the payments made, it checks these against the POs it has forwarded to ZOP for accuracy and completeness. The details on the statements from ZOP are entered into the MSA accounting system (i.e. into the individual accounts for ministries and suppliers). Statements of account balances are not automatically supplied to line ministries, but only if the ministries make a specific request, and most do so. The MSAs also maintain a ledger by category of expenditure and can prepare reports breaking down expenditure by particular type (position). However, the three governments do not receive complete report, as there is no consolidated government-wide expenditure data.

76. Requests to MOF for transfers to a ministry account are made in two ways. The MSA may submit a request for a transfer to make payroll payments. For other invoiced payments, the invoices are first sent to MSA, where they are entered into the database and a summary is sent to the ministry. Based on this summary, the ministry then submits a transfer request directly to MOF. The use of funds transferred from MOF is restricted to the resource identified by a particular position in the budget, and the cash so transferred can be used flexibly within that resource category. There is no automatic control on this limitation via the ZOP account and its implementation depends on the actions of MSA. On occasions, this control is breached on the instructions of the relevant ministry.

77. The MSA is not seen as a part of central control system but a unit providing a standardized financial accounting services to individual budget users in accordance with budget user's individual requirements. It does not therefore report directly to the MOF on budget execution.

3.2 Cash Management

3.2.1 Inadequate Cash Management System

78. Cash flow is monitored on a daily basis in MOF. Revenue cash flows are not under the control of MOF (since they are managed by a separate Public Revenue Administration), but expenditures, and the cash transfers to meet payments, are. The funds distributed from the main MOF account to the primary budget managers' or DSU accounts, and subsequently to their subordinate budget users' or ISU accounts, pass through subaccounts (transit accounts) set up as control accounts by the MOF to monitor the on-transfer of funds from DSU accounts to ISU accounts. The system is, however, quite limited for budget analysis and control purposes, as it represents one single block of transfers of funds, with limited breakdown according to the type of institution and type of spending, the so-called budget position number.

79. A schedule is prepared each month of the dates of salary, pension, and other regular payments. Each day a table is produced showing revenues and expenditures and net lending/borrowing for each month of the current year and each day of the current month. This

provides a basis for considering and determining the requests for cash transfers, but there is no systematic process of forecasting and reconciling revenues and expenditures.

80. The objective of cash management, in practice, is to ensure the availability of funds to meet major, regular payments. As a result, other transfer requests are considered each day and priority requests are approved accordingly. This daily triage can imply that urgent items early in a week can displace more important items later in the week. Ideally such prioritization should take place on a systematic basis, with an estimated requirement for the month being submitted in advance and commitments being controlled, in order to contain expenditure within the forecast revenue availability. As things stand, therefore, it would be an improvement if the daily triage for non-scheduled payments were replaced by a weekly triage.

3.2.2 Establishment of Treasury Single Account

81. In Montenegro and Serbia, the new budget laws would enable the Montenegrin MOF and the Serbian MOFE to improve cash management and introduce systematic controls over receipts and expenditures through the establishment of a Treasury Single Account (TSA). This TSA unifies all government accounts, comprising all funds represented in the government budget. It operates like a fund managed by the Treasury using a single bank account. All transactions of the TSA are to be recorded in the Treasury General Ledger (TGL), and no expenditure shall be made from the TSA except where appropriated by the annual government Budget Law.

3.2.3 Recommendations

82. There remains an urgent need to strengthen the cash management system (particularly reconciliation procedures) without waiting for the implementation of new treasury system, so that the governments know their true cash projections. **The CFAA recommends that each MOF introduces an effective cash management system (based on realistic revenue and expenditure schedules) to replace the present cash release system at all levels of government. In particular, each MOF should introduce a weekly triage replacing the daily triage for non-scheduled payments. An effective cash management system should also include (a) monitoring cash flows into and out of the Treasury Single Account, and the daily balances of the account; (b) preparing cash flow forecasts and updating spending plans based on information from the DSUs and revenue authorities; (c) determining the spending limits of DSUs on a weekly/monthly basis; (d) managing government deposits and advising on short-term financing needs; and (e) liaising with the NBY/CBM on borrowing arrangements and cash flow fluctuations. [Short/Medium Term]**

83. **The CFAA also recommends that a cash and debt management function be established within the newly formed Treasury department to implement improved cash management procedures. [Short Term]**

3.3 Payment Bureaux (ZOPs)

3.3.1 Yugoslav Legacy

84. The Payment Bureau (ZOP or Zavod za Obračun i Plaćanja), or the Clearing and Payments Service, was created in the SFRY during the 1950s, to manage socially-owned resources through full control of the financial sector. The ZOP had a monopoly over providing payment services. However, its activities went well beyond providing financial transfers (for private and public sector payments). The ZOP also collected and distributed taxes and customs revenues, provided treasury and accounting services to both public and private sectors, and was the primary source of statistical data for the country. There are now two ZOPs in FRY: the ZOP

in Belgrade, part of the NBY, serving the Federal and Serbian governments; and the ZOP in Podgorica, part of the CBM, serving Montenegro.

85. As an institution, the ZOP made a valuable contribution in a centrally planned economic environment. Given its prerogatives, its monopoly over execution of payment transactions provided the backbone for its power and control over public finance and the country overall economic system through the numerous functions it performed. The reported use of ZOP power was crucial for political control over most large enterprises, and was used as a source of cash resources by the dominant political elite. Its non-transparent practices (including lack of external audits) were, in fact, largely perceived as the primary channel for diversion of funds within the system.

86. At the same time, the operational procedures of the ZOP also created negative incentives for business development and the associated day-to-day activities. Its monopoly over all payment transactions precluded banks from providing banking services for their customers that are considered normal in a free market environment, and hence inhibited banks from developing customer relationships. As a consequence, the financial services sector was severely constrained and the development of a competitive financial intermediation process was retarded. The ZOP's ultimate control over the allocation and distribution of financial resources created a severe constraint to the development of a competitive financial intermediation process and a main deterrent to potential foreign investors.

3.3.2 Government Banking Arrangements

87. Government banking arrangements in FRY are similar to those observed in the other ex-SFRY republics. In Serbia, the NBY, including ZOP which became part of NBY in 1996, serves as the Federal and Serbian republican governments' banker. In Montenegro, the Central Bank of Montenegro assumes direct management of the payment system and has no relationship with the Federal ZOP (payment system for the FRY). Montenegro operates a monopoly payments system through its own ZOP. The Montenegrin Ministry of Finance has entered into an agreement with the CBM regarding the conduct of banking services on behalf of the government.

88. The ZOP accounts of the MOFs, as well as the DSU accounts, are held with the NBY or the CBM, although special purpose accounts have also been opened in commercial banks. Indirect spending units (ISUs) have their accounts in commercial banks, normally as sight deposits underpinning the ZOP giro accounts. A few legal entities hold foreign currency accounts and term deposit accounts, which are not covered by the ZOP system, though this is not in accordance with existing legislation.

89. There were some 14,000 legal government entities in the FRY, of which an estimated 90 percent are situated in Serbia and the rest in Montenegro. The legal entities in Serbia had an estimated 87,000 giro accounts, of which around 58,000 were revenue collection accounts. The proliferation of giro accounts, many of which are likely to have sight deposits in banks outside NBY, represents a very complex problem to overcome if efficient cash management is to be achieved.

3.3.3 Payment Bureaux Reform

90. The future of the Payment Bureaux (ZOPs) is an important consideration in the reform of public accountability in Yugoslavia. The introduction of modern financial management and control tools for the public sector while gradually eliminating the ZOP system is a prerequisite to the development of a sound public expenditure management system. The CFAA does not cover the reforms of the ZOPs; however these are regarded as instrumental for the successful

implementation of the proposed reforms in government financial management necessary to provide effective and efficient budget execution.

91. The Serbian ZOP has been under transformation since 1998 following the passage of the Law on Transformation of the ZOP. The law was to be implemented by January 1, 2000, but orderly completion of the transformation is still ongoing. The key issue, in fact, is to ensure smooth transformation of all activities currently undertaken by the ZOP, including clearing house, gyro-accounts, tax administration, statistics, and other registrar functions. The Serbian MOFE has started abolishing the DSUs' accounts according to the planned schedule in accordance with an agreement with the IMF, but some of the major ministries still have not switched to the new system, and a few entities, such as the Ministry of Interior, Public Revenues Administration, and Ministry of Education have retained their own accounts.

92. All payments formerly made from the numerous DSU accounts will now be made directly from the main budget account.¹⁶ However, it would not be possible for the ZOP staff currently having the authority to make transfers from the main budget account to cope with this vastly increased number of individual documents to sign, and there is no mechanism available in ZOP to authorize transfers in bulk. For salaries alone, ZOP receives 6,000 orders twice a month from MSA. In addition to these, it is estimated that some 300 orders are prepared each day. The ISU accounts in the Ministry of Education, for instance, are transfer accounts from which payments are made to the 2,000 budget holders within the sector. The salary payments alone give rise to some 4,000 payments per month and other payments are said to exceed 500 per month. One alternative to transferring this payment function to the ZOP in the short term would be to allow the units currently authorized to sign DSU and ISU transfers to be authorized to sign main budget account transfers.

93. The ZOP treats government accounts as any other accounts, not explicitly differentiating expenditures outside the government sector from transfers within the government sector. The reports provided by the ZOP, in fact, are prepared according to banking practices, rather than on a budgetary basis, i.e. using relevant classifications and formats. While government expenditure should be in accordance with the approved budget, the ZOP giro system does not allow a budget accounting system, but simply cash recording. In operating its giro accounts, the ZOP supports a multitude of budgetary institutions' accounts, resulting in a fragmentation of government cash resources, since all expenditure authorizations must be accompanied by cash. These features are inappropriate for modern budget management, efficient cash management and adequate financial control.

3.3.4 Recommendations

94. **The CFAA recommends that** Serbia devise new arrangements for making payments on the closure of DSU accounts, including implementation of an action plan to systematically close the DSU accounts for those ministries that are still operating their own accounts, preparing an inventory of giro accounts of all budget users, and establishing policies and procedures to better manage these accounts. **[Short Term]**

¹⁶ For example, in the case of education expenditure, when authorizing payment orders, the MSA section heads and the Finance Section of the Ministry of Education will establish the availability of funds to meet the payment from the amount of funds in the DSU of the relevant ministry. The Serbian MOFE will now need to provide MSA and the Ministry of Education with a daily list of the amounts that can be charged in respect of each budget holder to the main budget account.

3.4 Transition to a Treasury System

95. There is a pressing need to establish a treasury system, to be completed by the time the Payment Bureaux are fully restructured, in order to ensure that government revenues are available to meet expenditures. However, the creation of a treasury system should not be viewed merely as replacing the services of the Payment Bureaux, but as a mean of introducing other important and necessary reforms in government financial management, such as the introduction of a Treasury General Ledger (TGL).

96. The challenge faced in introducing a treasury system in FRY is twofold: to gradually take over the payment processing functions of the ZOPs, and simultaneously to introduce other necessary reforms in government financial management. Rapid change should be discouraged, since the ZOPs are crucial for maintaining tax compliance and high revenue collection levels and for controlling and reporting on public spending. In Montenegro, a medium-term plan to replace the ZOP with a system operated by commercial banks has been adopted, but will not be put in place until the banks are ready to operate the system. Montenegrin tax authorities have adopted alternative tax recording, withholding and collection capabilities are in place, and the CBM can adequately enforce bank prudential requirements.

3.4.1 Montenegro's New Treasury

97. In accordance with the new budget law, the Montenegrin government is establishing a new centralized treasury system, including detailed reporting and control procedures and the corresponding implementation of an effective Information Technology (IT) system. The organizational and functional structure of the Treasury has been agreed by the Ministry of Finance and approved by the government. The new organizational structure will be introduced gradually as new functions and activities are adopted. In the short term, a service area for payments and accounting will be established. The Assistant Minister for Government Treasury (Head of Treasury) has been approved by Parliament. The Treasury has offices and equipment in the Montenegrin MOF building, but faces problems with hiring, as few MSA staff are willing to move to the newly established Treasury.¹⁷

98. The core of this system is the Treasury General Ledger. Other functions such as debt management and cash management will be introduced later. A Treasury Interim Ledger System is in place, designed to be a first step in the modernization of accounting practices. It will allow the Treasury to process and to account for all government payments, which will arrive on paper at a central Treasury office in Podgorica. The General Ledger in the new treasury system currently includes entries only for the DSUs. Large DSUs (e.g. Ministry of Education) have sub-ledgers that cover IDUs (such as schools), which will not automatically have sub-accounts. IDUs will be allowed to open accounts outside the Treasury only if authorized by the Montenegro MOF. As a result, at least for the 2002 budget year, the new treasury system will not include two large ministries: Interior and Education, together with social funds, local governments, or the DSUs' own funds. The Montenegrin MOF expects that the university system and the Supreme Court will also remain outside the system.

99. The Treasury Single Account (TSA) has been opened and is ready for operation. In this rollout phase, not all revenues would be flowing through the TSA. In addition, the treasury interim accounting system currently in use is not yet capable of producing accurate monthly budget execution reports. Until ZOP reorganization is complete, there will always be the question of the completeness of revenues collected by ZOP (particularly taxes, social charges, and pension contributions). The TSA will cover about 40 percent of total republican budget spending and include most major line ministries (but not Ministry of Justice, Ministry of Interior, or large parts

¹⁷ USAID and EAR: An Introduction to the Government Treasury Presentation.

of the Ministry of Education). Both salaries and purchases of line ministries will be covered, including goods and services. There will be a need to extend formal contracts to purchases now done informally (e.g. electricity). In December 2001, a draft timetable was worked out for the extension of the Treasury system to line ministries not covered, social funds, and local governments.

100. The Treasury interim accounting system, supported by the USAID, has already been implemented in two agencies on a pilot basis and preparation for the implementation of salary/payroll payments is underway. The Treasury Interim Ledger System is designed for interim operations; it is expected to last up to a year and is not intended as a long-term solution. Within this interim period, the system will operate in a controlled environment and will not require significant extensions or functionality upgrade. From a functional setting, the system implements the same core procedures envisaged in the long-term solution, to the extent possible. In particular, the Chart of Accounts should not require redesign when the long-term solution is implemented. Although the interim treasury system has been established since late 2001 and is producing monthly reports, the quality of these reports is still weak and inadequate. It will take several months to improve the standards of reporting. A comprehensive, permanent computerized system will be established with EAR support. The development phase of the project is planned to finish by July 2002, and implementation will last well into 2003.

3.4.2 Serbia's New Treasury

101. In accordance with the new budget law, the Serbian government will establish a new treasury system, including detailed reporting and control procedures. The draft of the future organization structure (including the new Treasury Department) of the Serbian MOFE is ready. A suitably qualified treasurer, at assistant minister level, has been appointed. The new organizational structure will be introduced gradually as new functions and activities are adopted. Job descriptions, including treasury, budget and macro-economic divisions, have been finalized and positions will be advertised in late 2002 after approval by the Serbian government. The finance section of the MSA already provides payment processing to most of the DSUs. However, despite the recent reforms in the new budget classification, the MOFE is having major problems with the budget execution reports: monthly reports have not been prepared, and quarterly reports are presently not available. This is because the MSA has not modified its software for the new chart of accounts enabling full use of the new budget classification. Presently the MOFE is developing a budget tracking system, using an MS Excel spreadsheet system, to produce limited budget execution reports.

102. The MOFE is currently developing a number of regulations or by-laws for the establishment of the new treasury system, including accounting regulations, rulebooks on chart of accounts and interim reporting and final reports, and other necessary regulations.

103. Given the limited resources available to the MOFE, the implementation of a full treasury/general ledger system cannot be implemented without considerable technical assistance. EAR is considering technical support for a project covering the establishment of a treasury function in the MOFE, which will commence in mid-2002 for the delivery of new general ledger/treasury system in late 2003. Until a full treasury system is established, it is critical that the MOFE develop an interim treasury/general ledger which would enable the preparation of timely, accurate and reliable budget execution reports.

3.4.3 Federal Treasury Option

104. The Federal MOF has no plans for introducing a treasury system. The Federal government has no medium-term fiscal framework, no treasury system, and no system of commitment controls.

105. Given the relatively small size of the Federal government and the limited resources within the public sector, and taking into account the latest reorganization of the Federal government in late 2001 and plans for substantial decentralization of government operations, establishing a full-fledged separate treasury system for the Federal institutions could be difficult. Nevertheless, the Federal government should review its options for the establishment of a formal treasury function, including commitment control, cash management, and debt management units.

3.4.4 Recommendations

106. **The CFAA recommends that** each of the three governments implement a full treasury system, including the adoption of Treasury Single Account (TSA), to the operation of all spending units and also all social funds. The TSA should be established before the new financial management information system (FMIS) is finalized. **The CFAA recommends that**, to better control spending, an outline plan of treasury information flows (including all budgetary entities) be prepared, while treasury systems are being planned and developed. The establishment of a functioning treasury system should include (i) the adoption of the necessary enabling legislation, (ii) the consolidation of all government accounts into a unified single account or Treasury Single Account (TSA), (iii) the implementation of a new financial management information system (FMIS), and (iv) the introduction of a Treasury General Ledger (TGL) that will record all stages of revenues and expenditures and general suitable reports for budget management, replacing the simple ZOP cash release system presently in operation. This should be complemented by the necessary institutional structure and capacity building for the respective governments to establish adequate cash management and proper accounting and reporting functions. **[Short Term]**

107. **The CFAA recommends that**, until the completion of the new treasury system in late 2003, an interim treasury/general ledger be implemented by the Serbian MOFE to improve its cash management and commitment control, and to provide accurate and reliable budget reports, and that the revision of its organizational structure to accommodate new treasury functions also be finalized. **[Short Term]**

4. PUBLIC SECTOR ACCOUNTING AND REPORTING

4.1 Budget Classifications

4.1.1 Adoption of GFS Classification

108. In Montenegro, the new Law on the Budget System (LBS) is being implemented. The Montenegrin MOF has successfully formulated the 2002 budget based on the new GFS methodology, and provided extensive training to the line ministries in the new procedures introduced by the LBS.

109. In Serbia, a new budget classification system, consistent with the IMF GFS classification was introduced with the 2002 budget, even though the new budget law was not adopted until February 2002. Compared with previous years, the new classifications represent a significant improvement, offering a greater level of detail for both revenues and expenditures, and allowing more meaningful tracking and analyses on fiscal aggregates composition and budget process outcomes. Such additional analysis would also provide more systematic and meaningful accounting and reporting. The Serbian MOFE is currently amending its 2002 budget, passed in December 2001, to provide for a better budget allocation process using the new and more detailed chart of accounts (which will comply with IMF GFS classifications) and to provide for the transfer of funds to Vojvodina, (in particular education and cultural expenditures, which are granted greater autonomy).

110. The Federal government decided, in the fall of 2001, to adopt Serbia's budget methodology for its 2002 budget, including GFS classifications. As a result, the Federal budget should be very similar, in structure and content, to the Serbian budget.

4.1.2 Recommendations

111. **The CFAA recommends** that the Federal MOF continue with the revised, GFS-compliant budget classification used in 2002, providing a better analytical base for spending decisions. Because of current low capacity, the GFS system of economic/functional classifications should be adapted for a cash basis accounting system, with appropriate modifications to track commitments and arrears. **[Short Term]**

4.2 Accounting Standards

4.2.1 NAS and IAS

112. The 1997 Law on Accounting authorizes the Yugoslavian Association of Accountants and Auditors (AAA) to set accounting and auditing standards, and prescribes government accounting compliance with the National Accounting Standards (NAS), set at the end of 1980s under the former SFRY. Some subsequent additions and amendments have been made, with the intention of harmonizing the NAS with International Accounting Standards (IAS). Many IAS have been translated into Serbian and published, but not a complete set. Furthermore, working practices are not always aligned with published standards.

113. At present, the chart of accounts is laid down by Federal law. The Serbian MOFE had expressed concern that the new budget classification system would be in violation of the Federal Accounting Law, which governs this area. The Federal MOF indicated that the Accounting Law would be amended to allow the necessary variations, thus permitting the use of the new classification system. The Montenegrin government is presently drafting, with the assistance of

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USAID, a new law on accounting and auditing that will regulate accounting and auditing for enterprises, but the new law will not regulate governmental budgetary organizations.

114. IAS-based accounting standards are clearly too demanding for the current capacity of FRY's public sector institutions. In more general terms, it could be argued that IAS, which are generally applied in the commercial sector, and which were written to promote consistency and comparability in financial reporting across different countries, may not be the right solution for public sector accounting. A different standard-setting body of the IFAC, the Public Sector Committee (PSC), is actually in charge of issuing standards which apply to general purpose financial reporting by governments, budgetary institutions and other government agencies. The PSC's draft on financial reporting under the cash basis of accounting is more adequate and justifiable, given current systems and practices in the FRY.

4.2.2 Recommendations

115. **The CFAA recommends that** the three MOFs review the appropriateness of the use of NAS (which are being harmonized with IAS) in government accounting and reporting. The CFAA considers that the IAS is totally inappropriate for the government sector, that the accrual-basis IPSAS would also be excessive, and that the governments adopt cash based accounting, with modification for commitment tracking, in compliance with the IFAC-PSC Exposure Draft 9 "Financial Reporting Under the Cash Basis of Accounting". In implementing the new standard, each MOF should adopt a rulebook that regulates accounting and reporting applied to public sector institutions (in particular structure, formats and classifications). **[Short/Medium Term]**

116. **The CFAA recommends that** immediate action be taken by the Federal MOF to introduce changes to the provisions in the Federal accounting law allowing accounts to be kept in accordance with the new GFS-related structure. **[Short Term]**

4.3 Accounting Systems

4.3.1 Current System Using MSAs

117. The Mutual Services Agencies (MSAs) administer the accounts of most direct budget holders (ministries, institutes, and other agencies; see section 3.1). Despite the supposed adoption of the NAS, pure cash bookkeeping is still in place, with limited commitment tracking. The MSAs perform bookkeeping functions for each DSU's budget lines, including processing of payment orders for salaries, purchase of goods and services, and investment costs. It also prepares aggregate payment orders for the first stage of transfers to the ISUs, i.e. the transfer from primary DSU accounts to the DSU's sub-accounts (transit accounts). The financial management units of the DSU, on the other hand, prepare the payment orders out of the sub-accounts to the individual accounts of the ISUs, which it takes directly to ZOP without passing through the MSA. The DSU maintains the books for the transactions that it makes out of the sub-accounts, while the MSA maintains the books and associated source documentation for the transactions that it handles. Hence the recording of budget transactions lacks integrity and creates no adequate audit trail, due to the absence of a centralized accounting system.

118. The software in use is a package developed in 1997, using an Oracle platform. The package requires some modifications, particularly to the reporting component, but the majority of the programmers involved in its initial development have left, and the remainder are required for system maintenance. Furthermore, the system suffers from the lack of a centralized accounting unit and of an accounting methodology function, in the absence of which, there are no standardized policies or procedures on budget execution accounting and reporting.

4.3.2 Recommendations

119. **The CFAA recommends** the restructuring of government accounting systems in the three governments. Each MOF should establish an accounting policy and methodology function within its Treasury Department to carry out the necessary strategic thinking and to prepare the detailed accounting policies and procedures necessary for the implementation of the new budget law and accounting standards. **[Short Term]**

120. **The CFAA recommends that** each MOF create a new centralized accounting function (or a new Accounting Services Department for Montenegro) within its Treasury Department, whose functions would include (a) a front-office accounting unit that would deal directly with the financial management units of DSUs, processing their commitment and payment requests; (b) a back-office accounting unit that would prepare accounts, manage the ledger system and provide access to regular daily information to the other users in the MOF; (c) a payroll office for DSU salaries; and (d) coordination of the reports generated by the MSA and the ZOP. **[Short Term]**

4.4 Budget Reporting

4.4.1 Current Practices

121. There are no reliable, regular reports on budget execution. Serbia's 1991 Law on Public Revenues and Expenditures requires that the "Budget Balance Sheet", including a report on the execution of the Budget, be submitted to the Government by February 28 of the following year. The absence of quarterly and half-yearly reports on Budget implementation was identified as a weakness by the Parliamentary Economic and Finance Commission.

122. However, when prepared, reports are of poor quality, incomplete, and often late and therefore do not provide useful or relevant information for decision-making or budget management purposes (e.g. analysis of trends). Budget reports are prepared only at midyear, and consolidated budget reports are not prepared. The issue, therefore, is the extent, timeliness and reliability of financial information about government operations, including budget allocations, financial performance targets of public agencies and their actual financial performance, public procurement and contracting.

123. The MSA prepares reports monthly, or on demand (for each DSU on the movement on its primary account), which are also copied to the Budget Department in the MOF. However these reports are not consolidated into a report for all primary accounts to get an overall picture of budget execution at this level. If consolidated reports were made on the transactions of the DSUs, the reports would still give an incomplete picture of budget execution, since they exclude spending out of the accounts of Indirect Spending Units (ISUs). In this system, the lower-level units, ISUs, may also be legal entities governed by different laws, and with different financial regulations and reporting requirements. It is often unclear which of these spending units should be reporting back to the MOF and which should be consolidated. There is a need to carefully define government operations, and assign these lower level units either to government or to the enterprise sector.

124. Reporting of spending is limited. The MOFs have information on their transfers to the DSU accounts, as well as their own direct expenditures. They have the information of the transfers to DSUs from the Payment Bureaux (ZOPs), but no subsequent information on direct spending of the DSUs from their own accounts, or of the expenditure incurred from the ISU accounts. Under this arrangement, the Budget Department may check that funds transferred to DSUs for the purpose of funding ISUs are executed by the DSUs, but it has no way to monitor the end use of funds by the ISUs. Through the daily reports supplied by the Payment Bureaux, the Budget Departments are able to monitor DSU use of direct funds, though again, only on an

aggregate basis. Therefore, budget execution reporting is deficient, especially on the expenditure side, with no reliable infra-annual breakdown of total government expenditure.

125. At present the Federal and republican MOFs account for the execution of the budget by providing information on the release of funds, but they do not provide information on actual expenditures incurred by the first line budget users (DSUs) and their subordinated institutions (ISUs). The reports concentrate on compliance with the annual budget law with respect to release of authorized appropriations, and do not attempt to reconcile expenditure releases with actual authorizations. Although general ledgers exist at the institution level, all commitments and other subsidiary information must be retrieved manually. Moreover, while the present system accounts for budget releases, it does not bring together amounts authorized for expenditure with commitments made against that authorization, and actual expenditures. Presently, the budget accounts positions are not integrated into the accounting system so that managers can immediately know the relationship between actual expenditures and authorized amounts. In summary, the current accounting systems are unable to provide relevant information on the amount actually spent, on one hand, and the amount authorized to be spent, on the other hand. Likewise, the accounting system cannot provide information on the revenues actually collected and the budget plan for the collection of that type of revenue.

126. Finally, no one institution is responsible for comprehensive budget reporting. The ZOPs (within the NBY and CBM) prepare annual and semi-annual consolidated budget execution reports for the republican Parliaments, based on the returns received from the MSAs and ministries who prepare their own accounts. However, the ZOPs are only responsible for the consolidated budget execution reports, and not the overall budget process.

4.4.2 Planned Reforms

127. Owing to the uncertain prospects of the Federal government, the Federal MOF has no plans to introduce reforms in its financial management systems for better financial accounting and reporting. The Serbian MOFE has introduced many fiscal reforms and there is a plan to further enhance the existing system of public finance and reorganize government administration, which will be conducive to better financial management. In Serbia, as well as in Montenegro, the new Budget Laws should enhance budget reporting, as the Montenegrin MOF and the Serbian MOFE will determine accounting procedures as well the structure and timing of reporting to be generated from the Treasury General Ledger (TGL), together with other specific reporting requirements from spending units, and the timetable and the contents for preparation and submission of government final account. The new budget laws specify more frequent in-year reporting, and reporting frequency is increasing. The new laws require regular reporting on expenditures, commitments, cash payments from the budget, suspensions of program spending (if over 45 days), and other reports that will provide a comprehensive picture during the year of the evolution of public finances.

4.4.3 Recommendations

128. **The CFAA recommends that** timely and accurate reporting on budget execution be prepared by the governments and presented to the legislatures for discussion on a regular basis, at least quarterly. Timely and accurate budget reporting helps to identify financing gaps and make budget revisions more transparent, and promotes efficient budget management. To achieve this, each MOF should introduce more meaningful budget execution reports, including (a) a monthly summary report providing expenditure breakdown to the subcategory level for all transactions, (b) a quarterly report providing details of items and selected sub-items of spending, (c) a monthly report on cash flows and closing balances, and (d) monthly reports on revenues. **[Short Term]**

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129. **The CFAA recommends that each MOF be made accountable for comprehensive and reliable budget reporting, including monthly, half-yearly, and annual consolidated budget execution reports for the three Parliaments. [Medium Term]**

5. PUBLIC SECTOR: FINANCIAL CONTROL, INTERNAL AND EXTERNAL AUDIT

5.1 Financial Controls

130. The financial control functions within the public sector consist of checks and balances (including policies and procedures) adopted to assist management in ensuring the orderly and efficient conduct of the public institutions, the prevention and detection of fraud and error, the accuracy and completeness of accounting records, and the timely preparation of reliable financial information. Sound internal controls are critical to public financial accountability.

5.1.1 Current Internal Control Environment

131. The quality of financial planning, budgeting, internal controls (including budgetary control) and financial reporting are generally poor in the FRY. Historically, the ZOP was the key element of internal control for both the public sector and the socially owned sector, and was in charge of the financial administration and quasi-audit functions of budgetary operations, extending to economic transactions of various other economic subjects (such as business entities and individual taxpayers). Traditionally, basic elements of financial control have been carried out by internal controllers within some line ministries, the Mutual Services Agency (MSA), and the MOF, even if limited to basic documentary checks of accounting records and financial reports of spending units. However, these functions were not conducted systematically nor as part of the overall managerial controls within an organization, but rather focused on individual investigations to uncover abuses or misconduct of public officials in the use of property and economic resources.

132. These traditional controls lacked substance and were not part of a coherent system to ensure transparent public finance management, to prevent breaching rules and regulations, and to provide oversight of financial transactions, and to ensure complete, accurate and meaningful reporting. Major weaknesses of the traditional control environment included a lack of up-to-date information on the true financial position of line ministries; little or no follow-up to ensure that funds were spent as intended; insufficient segregation of duties over transactions; failure to maintain accurate asset registers; scattered and incomplete accounting records and supporting documentation; poor reporting mechanisms and an audit trail which needs improvement. In conclusion, there is little or no follow-up through the Ministry of Finance directly on whether funds were used as intended.

5.1.2 Reform of Internal Controls

133. In Serbia, the Organic Budget Law (OBL) foresees many changes to the system of internal control and audit that, when fully implemented, they will allow Serbia to move towards a modern public internal financial control system. The Serbian MOFE is responsible for overseeing this process and providing guidance to line ministries. Little has so far been done to develop the detailed policies and control systems necessary to implement the OBL. The Serbian MOFE has a small budget inspectorate to take forward the introduction of internal audit functions, but has yet to define a strategy for the implementation of the internal control system that is needed to accompany the introduction of the Budget Law. EAR is considering providing support to the MOFE for the implementation of an effective control framework, and the establishment of modern internal audit functions throughout the government sector that meet international standards and European Union requirements. This back-loaded program is to be implemented in

two phases, with limited funds allocated to the first phase and stop/go reviews in Fall 2002 to assess preliminary results.

134. In Montenegro, many changes to the system of internal controls and audit should begin soon, since the new Budget Law, passed on August 9, 2001, is being applied starting with the budget for year 2002. The Budget Law is supported by detailed Treasury Regulations that set out much of the groundwork for enhanced financial controls. An assistant minister, formerly from the Mutual Services Agency, was appointed to head the Treasury on September 28, 2001, and expert advice will continue during 2002 to assist with implementation, rollout of the new IT systems, and training of staff.

135. There is no plan to enhance financial controls in the Federal government, as there is no proposal for a new Federal budget law.

5.1.3 Recommendation

136. **The CFAA recommends that** ex-ante procedures to check the legality and amounts of transactions at the expenditure's commitment stage (e.g. their correspondence to the budget appropriations approved by the Parliaments) be reinforced to avoid overspending, and that ex-post controls be introduced to verify the correctness and appropriateness of transactions and their correct recording. The Federal and republican MOFs should establish and institutionalize internal controls, by strengthening existing policies, procedures, rules and internal regulations across spending units and in all phases of the public finance management (covering budget planning, preparation, execution and reporting), supported by compliance checks by the budget inspectorates or internal audit departments. **[Short Term]**

5.2 Internal Audit

137. Internal audit is regarded as one of the primary tools of any organization to ensure effective and efficient operations; timely, reliable, and relevant reports; compliance with applicable laws, regulations, and safeguards of assets.

138. There is currently no Internal Audit (IA) function in the Western sense operating in FRY. The closest parallel is the work done by the Budget Inspectorates (BIs), which carry out compliance work, to check whether internal control procedures are being properly followed. The BIs term this work "external control", because the BIs are external to the line ministries: the Serbian BI is internal to the executive branch of government but external to the individual budget institutions. The Federal Budget Inspectorate is not independent, as it reports to the MOF and has never carried out inspections of the MOF.

5.2.1 Role of Budget Inspectorates

139. The Budget Inspectorates (BIs) perform their functions in accordance with relevant legislation,¹⁸ reporting directly to the Ministers of Finance, and carry out their activities in accordance with an approved annual work plan. The BIs' main function is to control the execution of revenues and expenditure. They also perform compliance work to check whether internal control procedures are being properly followed. The BIs' "control activities" fall somewhere between internal controls and internal auditing. These activities are mainly carried out through inspections consisting of documentary reviews and physical check of assets and inventories, performed throughout budgetary institutions. This work is equivalent to basic

¹⁸ Articles 37 and 38 of the Law Regarding the Funding of FRY and other laws and decree of the federal government, Articles 83 to 88 of the Law on Public Revenues and Public Expenditures and other laws and decree of the Serbian government, and Law on Public Expenditures and other laws and decree of the Montenegrin government.

compliance auditing, but does not extend to evaluating the overall control environment, assessing risk areas, or making recommendations for system improvements. Additionally, performance audit issues relating to the economy, efficiency and effectiveness of operations are not considered.

140. The BIs are not equipped to cope with the need to ensure sufficient checks and balances in the system, and to prevent, rather than uncover, abuses. Their work is not planned and conducted as part of an overall systematic managerial control to prevent and/or minimize misuse of public property and resources. The MOF BIs have an inadequate mandate (e.g. they cannot inspect sensitive areas, including military expenditures, which account for 70 percent of total Federal budget, or republican Ministries of Interior, which have their own inspectors), are insufficiently staffed, and are poorly equipped to carry out their duties efficiently and effectively. There are currently only seven inspectors in the Federal MOF, five in the Serbian MOFE, and one in the Montenegrin MOF; the Federal and Montenegrin BIs have played no significant role. There has been no indication from the Federal MOF of any intention to build modern internal audit capabilities.

5.2.2 Inspection of Serbia's 2000 Budget

141. The Serbian BI was established in 1973. It barely functioned during the 1990s, but was reportedly being used to carry out politically motivated inspections of local municipalities, controlled by government opponents. By 2000, the BI had only five inspectors. These trends have recently begun to be reversed, as the Serbian government completed an impressive inspection of public spending for the year 2000 budget. The new government, formed after the December 2001 elections, has revitalized the BI to some extent, requiring it to carry out a series of inspections in 29 ministries and government agencies, over expenditure made by the previous government. In order to perform this task, the BI's limited staff resources were supplemented by an ad hoc team of some 35 additional inspectors, drawn from the Financial Police of the Public Revenues Administration and the ZOP.

142. While this effort demonstrates the Serbian government's commitment to increased accountability of public spending, its capacity in this area remains limited. The work done by the BI during 2001 has been useful in establishing some sense of the extent of abuses and misuse of public funds within the previous system, and in setting a benchmark, against which, the new government can assess its own performance. However, inspectors have largely focused on investigations to uncover and punish individual misconduct by public officials. Similarly, the Financial Police, who also investigate financial frauds, focus on individual cases. The task force that carried out the inspection of Budget 2000 remains ad hoc, drawing from other public finance and law enforcement agencies. Spending ministries and social funds have equally modest or lower inspection capacity.

5.2.3 Reform of Internal Audit in Serbia

143. The OBL provides for the establishment of a Budgetary Inspection and Audit Service (BIAS), and equivalent bodies at the local level, which reflects the devolution of budgeting and treasury functions to local governments. The central BIAS will be able to carry out inspections and audits over direct and indirect spending units, organizations for compulsory social insurance, public enterprises founded by the government; enterprises in which the republic has direct or indirect control over capital or management, and legal entities in which public funds comprise more than 50 percent of total revenue. Similarly, Local Budgetary Inspection and Audit Services will be responsible for carrying out inspections and audits of direct and indirect spending units of local autonomous budgets, public enterprises founded by local governments, enterprises in which

the local governments have direct or indirect control over capital or management, and legal entities in which funds from local budgets comprise more than 50 percent of total revenue.

144. The central BIAS will draw upon the staff and resources of the existing BI within the Serbian MOFE, but will have a more extensive remit, incorporating all normal internal audit functions. The OBL will allow the central BIAS, and its local equivalents, to carry out compliance audits, assessment of internal control systems, and performance audits. They will also be able to advise management on the reliability of internal controls and audit implications relating to the introduction of new systems, procedures or business processes, and will have a liaison role with external audit.

145. The OBL sets out all the requisite rights and responsibilities of the BIAS and local equivalents. Once passed, the OBL will establish the legal framework within which comprehensive internal audit functions can be carried out in the Republic of Serbia. More detailed operational policies and methodologies are required to operationalize the BIAS, and significantly more resources will be needed for it to adequately perform its work. The existing BI has limited human resources, and they are poorly equipped and not yet adequately trained to carry out the full range of BIAS duties efficiently and effectively. Staff will need extended support to gradually take up their new responsibilities.

146. By focusing first on training staff at the central and local BIAS levels, a pool of expertise can be developed, building on the experience of the existing BI, maximizing the impact of the limited resources available, and allowing staff to develop the new skills needed to meet the new responsibilities. Moving in this direction will involve staff training and systems upgrades. Considerable technical assistance will therefore be needed to build the necessary skills and develop the required methodology. In due course, BIAS staff could move to individual line ministries to take the lead in establishing Internal Audit Departments within them, moving towards a functional-type internal audit model. This option should be kept under review, although realistically it may not be viable for several years.

147. The Swedish International Development Agency (SIDA) fielded an internal audit expert for four weeks in October 2001 to advise on the OBL and undertake feasibility work to facilitate longer-term bilateral support for the development of internal audit (IA) in Serbia.

5.2.4 Reform of Internal Audit in Montenegro

148. The new Budget Law requires that an internal audit function be created at the Montenegrin MOF level, with a remit to audit the inflows, commitments, and outflows of all spending units, extra-budgetary funds and municipalities. Detailed guidance on how internal audit will operate is to be prescribed by the Minister of Finance. Support for the development of IA in Montenegro will be provided by an EAR-funded advisor.

149. No staff have yet been allocated within the Ministry of Finance to do IA inception work. The Minister will need to appoint both a senior person, preferably at Assistant Minister level, to be the Head of Internal Audit, and to recruit staff to work in the Internal Audit Unit. None of these personnel should be involved in any operational role within the Montenegrin MOF or other ministries, so that they can carry out their roles with the requisite level of independence. Office space and equipment are also required to allow the IA unit to begin functioning.

150. The functions of IA set out in the Montenegrin Budget Law are aligned with international best practice: (a) provide regular assessments of the adequacy and effectiveness of the government's decision-making processes, and the control framework; (b) report significant internal control issues and improve the control processes and information system, in order to minimize risk in the decision-making process; (c) review efficiency of the utilization of existing

services and propose a more efficient way of providing these services; (d) liaise with external audit; and (e) provide information periodically on the status of execution of the annual audit plan.

151. The details of how the new IA Department will fulfill its role, and how it will approach the range of audit functions required, are still to be developed. Detailed operational policies and methodologies are required to operationalize internal audit, and a training program needs to be developed. Given the limited previous experience of internal audit anywhere within Montenegro, it is unlikely that many experienced or qualified staff will be available to the IA Department, and those joining the new IA Department will need extended support to gradually take up their new responsibilities.

152. The new Budget Law does not set out the rights and responsibilities of the IA Department in any detail, and the Treasury Directions provide only a little more clarification, i.e., that all audited bodies are required to make available to IA all documentation relating to financial tasks and activities. Additional guidance through detailed regulations is needed in several critical structural areas that would establish the legal framework for IA work:

- the relationship of the IA Department to the Minister of Finance and to audited bodies;
- the independence of the Head of IA and IA staff from operational responsibilities;
- the freedom of IA to plan its own work program;
- the financing and resourcing of IA;
- reporting arrangements;
- confidentiality of audit work; and
- quality assurance mechanisms.

5.2.5 Recommendations

153. **The CFAA recommends that** modern internal auditing functions be implemented in all three governments, building on the experience of the existing Budget Inspectorates. The limited resources available within the public sector, in terms of both financing and suitably qualified staff, imply that comprehensive internal audit functions can be achieved only through an incremental approach, starting the process with the three MOFs and then gradually expanding to line ministries and other public institutions. This would imply the setup of a small, independent, centralized and highly professional internal audit department within the three MOFs, working across the various governmental institutions. In the longer term, it may be desirable to set up internal audit departments within individual line ministries or other spending units, at least for those with larger budgets. **[Short/Medium Term]**

154. As a priority, **the CFAA recommends that** an action plan setting out milestones for developing Internal Audit Departments be developed in all three governments. The plans should clearly establish a program for recruiting staff, establishing office facilities, developing IA methodologies and working procedures, and carrying out training for staff. **[Short Term]**

155. As a first step, **the CFAA recommends that** each of the Federal and republican governments appoint an internal audit head, at least Assistant Minister level, who reports directly to the Minister of Finance and who should not have any other operational responsibilities within the MOF or any bodies falling within internal audit's remit. **[Short Term]**

156. To provide overall independence, **the CFAA recommends that** Federal and republican governments ensure that adequate and sustainable financing is made available to enable the internal audit departments to become established and able to carry out their responsibilities, based on annual work plans. **[Short/Medium Term]**

5.3 External Audit

157. Supreme Audit Institutions (SAIs) are national agencies responsible for auditing government revenue and spending. The primary purpose of an SAI is to independently oversee the management of public funds and the quality and credibility of government's reported financial data. Both internal and external audits help to strengthen the control environment in public sector institutions.

158. There is currently no SAI in FRY, at either the Federal or republic levels, with responsibility for carrying out independent, external, ex-post audit in the public sector. No independent external audit has been carried out on government accounts and final budget accounts have never been audited by independent auditors, except for the 2000 final budget execution report for Montenegro which was audited by private auditors. The absence of an SAI, reporting independently to the Parliament, or operating as part of the judicial process, reduces the counter-balancing effect of the legislature or judiciary over the executive. A functioning external audit is a prerequisite for EU accession.

159. There is also a need to increase awareness within public sector bodies about the SAIs' role and responsibilities, and conversely the obligations that public bodies have to the SAI. A lack of understanding of the role, mandate and importance of the SAIs is to be expected. This understanding needs to be developed among audited bodies and the wider public community in Serbia and Montenegro, including the media and public, in order to enhance the impact of its work.

5.3.1 Plans for an SAI in Serbia

160. Serbia's OBL includes a requirement that an external audit report on the government financial statements be provided annually to the National Assembly. In the interim, Serbia's National Assembly is required to appoint suitably qualified auditors to carry out this task. The Serbian government and Parliament are aware of the deficiency and limited initial work has been undertaken towards the establishment of an SAI. The government has expressed its commitment to making Serbia a leader in good public sector financial management, catching up on advances made in other countries in South Eastern Europe, such as Hungary and Slovenia.¹⁹ Preliminary work to take forward the development of an SAI began in 2001, but there is a long way to go before an external audit function is established in the public sector. The government introduced Law on the Audit of Public Revenues in 2002, but much remains to be done to bring such a law into effect.

161. To date, the National Assembly has established a Working Group²⁰ to consider the way forward for the creation and establishment of an SAI for Serbia, with the assistance from the UNDP Programme for Accountability and Transparency (PACT). This Working Group (WG) has visited the SAIs of Slovenia, Germany, and France, to gather information about the role and responsibilities of SAIs elsewhere, and to consider what changes might be needed to the legal framework (including the Constitution) to ensure that an independent and effective SAI can be created. However the working group has not included a review of the Anglo-Saxon model in its study tour activities (although Slovenia has adopted elements of this model), and thus would not have considered the advantages and disadvantages of all SAI models, particularly in regard to financial audits (attestation of financial statements).

¹⁹ MOFE report on reforms in the first six and half months of 2001.

²⁰ The Vice President of the National Assembly and the Vice Chair of the Budget and Finance Committee, plus a Deputy Minister of Finance and Economy, and a representative of the Ministry of Justice.

162. A decision on the model to adopt was originally intended to be taken in September 2001, but this will not be possible until all visits have been completed and findings presented to the Serbian National Assembly and government. The group was due to present results of its study tours to a workshop in November 2001, but it has been delayed further.

163. The WG plans to consider the most appropriate legal framework and organizational structure for the establishment of an SAI in Serbia, with the assistance of another UNDP program, establishment of a Supreme Audit Institution commenced in early 2002. The new UNDP program aims at preparing the ground for a future SAI, especially the choice of SAI model and also the finalization of legal framework for the future SAI. The WG also considers that an SAI is likely to require some 200 staff to be able to operate effectively. It envisages that recruits will be selected from Payments Bureau staff who will become available as it winds down by the end of 2002, and from the staff of banks that have recently collapsed.

164. Once a decision has been made on the model to be adopted, intensive work, supported by an external advisor with experience of the relevant model, will be required to draft the necessary legislation. EAR will provide support to the National Assembly for both the creation and establishment and development of an SAI that meets international best practice. This project is to be implemented in two phases, with limited funds allocated to the first phase and stop/go reviews in Fall 2002. The government hopes to complete the first phase (creation of SAI) by late 2002, including appointment of officials and staff of the SAI, provision of the necessary premises and equipment for the new institution, and establishment of a staff training program and detailed working procedures. These implementation processes will also require external financial and technical support. Subject to meeting this demanding schedule, the SAI will begin operations in 2003.

165. **The CFAA fully supports** the establishment of an SAI as an essential component of public financial accountability, governance and transparency, especially in view of Serbia's desire to achieve EU membership. Every effort should be made to meet the timetable set out by the Serbian MOFE for establishing the SAI and making it operational by 2003. Whatever model is chosen, the provisions of the Law should comply with the broad principles espoused by the International Organization of Supreme Audit Institutions (INTOSAI) in the Lima Declaration of 1977, and republished in 1998. In particular, the SAI status, prerogatives, and duties, should be firmly anchored to the Constitution²¹, and its independence from the Executive should be enshrined in the legislation.

166. The SAI will need to develop the necessary skills to perform financial audits, or certification of financial statements. Skills adequacy and experience of staff is an important issue, given the lack of a workforce with a professional auditing background within the Serbian public sector. As for the development of internal audit functions, human capacity within the SAI will need to be built up gradually. A logical starting point could be legality or regularity audits, reviewing the propriety of financial management against legal requirements, which is similar to inspection and control work traditionally performed by control bodies such as the ZOP.

167. The availability of adequate financing for the SAI's activities is also an important issue. Adequate and sustainable financing needs to be made available for SAI activities, with financing tied to an annual work plan, and including the necessary investments in infrastructure and information technology. The formal institutionalization of working relations between the SAI and the National Assembly will also be required to ensure that appropriate consideration is given to the SAI's reports, and that their recommendations are acted on. The legal basis for permanent

²¹ Work is underway to prepare a new constitutional law, offering a good opportunity to establish a strong link between the SAI, as a key Republican institution, and the Constitution.

legislative oversight of the SAI will need to be established, and this could be realized through the creation of dedicated Audit Committee in the National Assembly.

5.3.2 Limited Progress in Montenegro

168. There is no Supreme Audit Institution (SAI) in Montenegro with responsibility for carrying out independent, external, ex-post audit in the public sector. Lack of progress to date towards setting up an SAI is due to limited knowledge within the public sector about audit issues, limited human and technical capacity, and the higher priority which has been given to other areas, notably establishing the Treasury system and introducing internal audit arrangements. Montenegro's government took the initiative to have its 2000 final budget report audited by a private audit firm, but this audit is limited in scope, covering budget expenditure only. This initiative should be continued and extended to cover both revenue and expenditure. Independent and suitably qualified private auditors should be appointed on competitive basis.

169. **The CFAA fully supports** the establishment of an SAI, as an essential component of public financial accountability, governance, and transparency within Montenegro, and recommends that the government of Montenegro immediately establish a provisional broad timetable to take forward the development of an SAI. This could leave the detailed work until a consultant is recruited, but as a minimum, it should set milestones for a Montenegrin working group to be set up, an external expert to be in place; the date the preferred audit model option would be presented to Parliament; the date Parliament would approve the audit model; and a timeframe for drafting legislation to set up the SAI.

170. Representatives from Parliament, rather than the government, should take the lead, although government officials may also be involved in a working group or task force. Given the heavy demands on the time of Members of Parliament, secretarial and logistical support to the working group could probably best be met from government, or possibly with donor-funded resources. Germany (GTZ) has agreed to provide technical assistance (to commence in 2002) to the Montenegrin MOF for the establishment and development of a sound and modern supreme audit institution. The working group should consider all the main SAI models before reaching a decision on which is most suitable for Montenegro. Approval for such a decision should be reserved to the Parliament. Due account should also be taken of the model adopted by Serbia. If the Federal structure continues, it would not be desirable to have different audit models operating in its constituent members.

5.3.3 Interim Arrangements for Montenegro and Federal Government

171. In consideration of the Federal level's uncertain prospects, there is currently no plan for the development of external audit of Federal institutions, and no donor has yet shown interest in providing technical assistance for the establishment of a Federal SAI. Given the small size of the Federal and Montenegro governments, limited accounting and auditing expertise within the public sector, and plans for substantial decentralization of government operations, establishing separate and independent external audit units in the Federal government and Montenegro could be difficult. One way to overcome these problems would be to create a reduced-scope SAI (a small council or commission) that would not carry out audits directly but rather outsource these, retaining quality control prerogatives and taking responsibility for independently reporting to the Parliament on how public resources have been used.

172. In the case of a commission, which could be appropriate at the Federal level, it would not carry out audits itself, but would procure the relevant expertise from the private sector. It would be responsible for setting terms of reference, finding suitably qualified and independent auditors to deliver the work, as well as overseeing and ensuring the quality of their work.

173. In the case of Montenegro, the SAI itself could be a relatively small body, which would not carry out audits directly but would procure audit services from the private sector, or even public auditors from another state. The SAI would retain responsibility for the audit opinion, and would have to exercise strong quality assurance controls over contractors undertaking work on its behalf. This type of approach has been successfully implemented in New Zealand. If private auditors are chosen, they should be independent and suitably qualified and appointed on a competitive basis.

5.3.4 Recommendations

174. **The CFAA recommends that** Montenegro government establish a task force, led by parliamentarians but with secretarial and logistical support from the government, that would review the main types of SAI models to ensure that the most suitable model is chosen. Each government should immediately establish a provisional broad timetable to take forward the development of an SAI. **[Short Term]**

175. **The CFAA recommends** the establishment of independent external audit institutions reporting to parliament. The independent external audit institutions will help to address chronic weaknesses in public sector governance and financial accountability, by increasing the transparency of financial transactions, the personal accountability of public officials and, ultimately, the efficiency of public administration as a whole **[Medium Term]**. The provisions of the laws adopted to establish SAIs should comply with the broad principles espoused by the International Organization of Supreme Audit Institutions (INTOSAI) in the Lima Declaration of 1977 and republished in 1998. **[Short Term]**

176. Formal working relations between the three SAIs and the three Parliaments should be established, to ensure that appropriate consideration is given to the SAIs' reports and that their recommendations are acted on, through the creation of dedicated Audit Committees in the three Parliaments with this responsibility. **[Short/Medium Term]**

177. Until the establishment of functioning SAIs, **the CFAA recommends that** the Montenegrin government continue, and the Federal and Serbian governments commence, the audit of direct and indirect spending units, extra-budgetary funds, and public enterprises by suitably qualified independent auditors. The appointment of external (private) auditors should be done on a competitive basis, with the independence of the auditor from any government influence and the technical competencies of audit staff being key selection criteria. **[Short Term]**

178. To provide overall independence, **the CFAA recommends that** the Federal and republican Parliaments ensure that adequate and sustainable financing is made available for SAI activities, with financing tied to an annual work plan and including the necessary investments in infrastructure and information technology. **[Medium Term]**

5.4 Consequences of Weak Control and Audit

179. A consequence of the weak control environment and weak audit function in Serbia and Montenegro was the high level political official corruption, misuse of public funds, and incidence of financial crime. Based on a public opinion survey on corruption²², citizens of Serbia believed that the phenomenon of corruption was extremely widespread and one of the most serious problems facing the Serbian society. However, there were widespread expectations that the scope of corruption would significantly be decreased. Montenegro also has a high level of perception of

²² Extract from the Corruptions in Serbia By Center for Liberal Democratic Studies, 2001

corruption, corruption being a pervasive and widespread phenomenon in almost all institutions²³. Both republics have taken action to combat corruption as part of economic and public sector reform.

5.4.1 Corruption, Financial Crimes, and Misuse of Government Funds

180. A recent Serbian MOFE Budget Inspectorate report, covering the period from February 1, 2000 to January 25, 2001, found evidence of numerous irregularities in the management of resources and identified misuse of budget funds amounting to some 2.7 billion Dinar, and illegal use of a further 1.1 billion Dinar.²⁴ As a result of the report, some 50 officials, including 15 ex-ministers, are currently facing legal action. Aside from the quantified financial irregularities identified in the report, the major structural weaknesses noted by the inspectors were a lack of financial discipline in the enforcement of legal regulations; substantial amounts of revenues and expenditures executed outside the budget system, making the overall position on income and expenditure impossible to determine; an absence of documentation relating to assets; and uncontrolled, unsanctioned dealings with banks and commercial enterprises. The BI does not have the resources to go back into the affairs of earlier years, but a similar situation probably existed for most of the 1990s in Serbia.

5.4.2 Effects of Corruption and Financial Crimes

181. The consequences of corruption and financial crimes, and their economic and social effects, were, and continue to be, exceptionally serious for the FRY. The most dangerous result has been that laws and regulations were passed and implemented to favor private rather than public interests. Politically and economically powerful business people influenced the legal framework and the economic system ('state capture'), and had diverted public resources to their private needs (maximizing rents and personal wealth).

182. Another effect of corruption is higher transactions costs, which directly decrease social welfare. According to research done by the Center of International Private Enterprise²⁵, significant transactions costs exist, as evidenced by the large amount of work time that private entrepreneurs spend dealing with corruption (for instance, being obliged to pay bribes to obtain a business license), and they discourage foreign investment. Resources absorbed by corruption cannot be used to generate new value or to increase total welfare.

183. Corruption also has a negative impact on the poor. Since the poor must spend a greater portion of their limited resources to obtain basic and minimum necessities, corruption reduces that income and makes the poor even poorer, widening economic inequalities.

184. Corruption encourages the growth of the gray economy. The gray economy in FRY still takes the form not only of unregistered employment and conduct of business, but also of illegal trafficking of excisable products, particularly oil products, cigarettes and alcoholic beverages, for which more than 50 percent of demand was satisfied through illegal channels. These activities developed during the 1990s, when the combined effect of low salaries, high unemployment, and impediments to normal trade during sanctions created both a need and an opportunity for informal sector activity. The greatest relative importance of the gray economy was at the time of hyperinflation in 1993, when it accounted for more than one-third of economic activity and more than half of registered social product (54 percent). Current estimates indicate that the gray

²³ Extract from the concluding consideration of the survey on Corruption "Opinions and Attitudes of Montenegro Citizens", by The Center for Transition – The Group for Transparency in Montenegro, dated November 2000.

²⁴ June 2001, report by MOFE Financial Inspection and Compensations Department (No. 401-00-41-17/2001-09)

²⁵ Corruption in Serbia by Center of International Private Enterprise, 2001.

economy accounts for up to 70 percent of total economic activity, but is only partially registered.²⁶

5.4.3 Anti-corruption Efforts

185. The Serbian Government is implementing a multi-pronged strategy in combating corruption. One of the first statements issued by the new Serbian Prime Minister in 2001, was that Serbia would join various international organizations in order to deal successfully with corruption and organized crime. Both Serbia and Montenegro have now joined the Stability Pact for South Eastern Europe (SPA) and established institutions to fight corruption. Montenegro has passed the first of several required pieces of legislation, and legislation is under preparation in Serbia.

186. The five basic principles of the Serbian government's strategy for fighting corruption are (i) creating an institutional framework; (ii) reforming state administration; (iii) economic reform; (iv) increased participation by civil society; and (v) establishment of a political environment enabling the fight against corruption. To date, a number of significant steps have been taken²⁷:

- The Working Group of the Ministry of Justice and Local Government made draft Amendments to the Criminal Code of Serbia in March 2001.
- The Anti-Corruption Unit was formed to be the headquarters of the anti-corruption initiatives in Serbia, and was strategically located within the MOFE. This office coordinates all anti-corruption initiatives.
- The government recently established the Independent Council for The Fight Against Corruption and Crime, and will appoint a coordinator to the Stability Pact Anti-Corruption Initiative (SPAI).
- The government formed a high-level Committee For The Fight Against Corruption, whose role is to steer the anti-corruption action of the administration and whose task is to investigate the most severe economic crimes of the past decade.
- Up to 26 anti-corruption teams were established, made up of representatives of the Ministry of Interior and State Prosecution Office.
- A special governmental body, the Working Group for Preparation of the Law on Local Government, was established.
- The government has established inter-ministerial coordination for fighting crimes and corruption. It will set priority tasks and inform public on the implementation of anti-corruption actions.
- The government will discuss and adopt six anti-corruption laws, including laws on changes and amendments to the penal codes on games of chance, tobacco, tax administration, public procurement, budget system, and the final account.

187. The Republic of Montenegro has also initiated significant efforts to combat corruption. In February 2000, Montenegro, along with other countries in the region, accepted the SPAI Compact and Action Plan at the Sarajevo Working Table III meeting. In February 2001, it established a separate government agency, the Anti-Corruption Initiative Agency, which has responsibility for preparing draft laws and sub-legal regulations; adopting international documents and standards and monitoring their implementation; defining an anti-corruption strategy; promoting transparency and integrity in business transactions, and monitoring the privatization process; undertaking public awareness and prevention activities; and co-coordinating activities of both governmental and non-governmental sector, aimed at curbing of corruption.

188. Over the summer of 2001, Montenegro made significant strides. Two important pieces of legislation were passed: the Public Procurement Act and the Organic Budget Law. The

²⁶ Corruption in Serbia, Center for Liberal Democratic Studies.

²⁷ Transition in Serbia: Serbian Government's Strategy for Fighting Corruption, Website of Serbian Government

government is now working on a draft Code of Conduct for Civil Servants, a Conflict of Interest Law, Freedom of Information Act, and an Illicit Enrichment Law, to be finalized by December 2001. A new anti-money laundering was also adopted, which establishes an Anti-Money-Laundering Commission. A Law on the Financing of Political Parties is also being drafted.

189. Progress in collaborative partnerships with civil society can also be seen in the agreement reached by the Montenegrin government and the NGO sector to establish a common cross-cutting Committee for Anti-Corruption to review the National Strategy for Anti-Corruption and to work on new legislation. The committee's work is ongoing and is to be submitted to Parliament in the second quarter of 2002.

190. The Federal Assembly adopted an anti-Money Laundering Law in September 2001. The Law will come into effect in July 2002. The FRY is a party to the 1998 UN Drug Convention and the UN Convention against Transnational Organized Crime. Enactment of the Money Laundering Prevention Law was a significant act on the part of the FRY.

5.4.4 Recommendations

191. The measure of success in anti-corruption efforts is not the adoption of strategies or passing of laws, but actual implementation of the strategies and seeing the impact in economic terms (the reduction of administrative barriers), and in political terms (greater transparency). **The CFAA recommends that** the FRY governments adopt effective strategies to implement the relevant legislation and anti-corruption programs, including: (a) in Serbia, strengthening of the newly established special Commission for Fighting against Corruption and strengthening of the Council for Fighting Corruption and Crime; (b) in Montenegro, strengthening of the newly established Committee for Anti-Corruption and the recently established Anti-Corruption Initiative Agency (February 2001), and streamlining of the national Strategy for Anti-Corruption; (c) membership in international or regional anti-money-laundering organizations; (d) publication of decisions involving use of public finances (including procurement decisions) in the Official Gazette and, possibly, the media; and (e) strengthening of collaborative partnerships with civil society, including greater consultation, participation and scrutiny in a common cross-cutting anti-corruption programs and legislations by NGOs. **[Short/Medium Term]**

6. FINANCIAL AND PRIVATE SECTORS AND FIDUCIARY CONSIDERATIONS

6.1 Financial Sector

192. FRY's banking sector is characterized by a large number of small banks and a high concentration of balance sums in banks, which are now bankrupt. Banks' level of capitalization is inadequate, and their clientele creditworthiness is low. As a result, there is a large number of insolvent banks in both Serbia and Montenegro. An estimated 50 percent of the loan portfolio of Serbia's banks is non-performing (80 percent concentrated in the biggest four banks). Many banks have seen their foreign currency deposits frozen under the Milosevic regime. More recently, there has been a marked reduction in lending activity, due to the drastic contraction of transactions in Dinars and the lack of public confidence. The low confidence is a legacy of the freezing of foreign currency deposits and several pyramid scheme scandals in 1992-93. The fall in deposits and lending activity, and high operational costs, make questionable the survival of a large number of banks.

6.1.1 Banking Laws

193. The Yugoslav banking system ceased to be a classical mono-banking system in the late 1950s. The first attempt to modernize financial intermediation, in the sense of establishing a modern two-tier commercial and central banking system was the adoption of the Law on Banks and Other Financial Organizations in 1989. The basic provision of the current Banking Law, enacted in mid-1993, were taken over from the 1989 Law on Banks. The Law allows the establishment and/or the transformation of banks with a specific ownership structure. Banks are defined as universal banking organizations that may also develop investment banking operations, in addition to commercial banking. Since then, bank founders may be private juridical and natural persons from the country, as well as from abroad. The 1989 Law, for the first time, introduced standards relating to supervision, obligatory capital for bank establishment, rules for activity startup (i.e. criteria necessary to found a bank and maintain the license), and prudential requirements (e.g. limits for the largest individual loan and guarantee, solvency, minimal capital adequacy).

194. The NBY is legally vested with central bank responsibilities for the FRY (including Montenegro and Kosovo), but in practice it exercises these functions only within the Republic of Serbia, for which it is both the government's depository and fiscal agent. The NBY is vested with banking supervisory functions (although the Federal MOF still has a department in charge of financial sector oversight), as well as the right to licensing and delicensing. Since Montenegro has adopted the Euro as its legal tender, the CBM does not exercise monetary policy/issuance functions, but it is responsible for the banking regulatory framework, banking supervision, as well as the Government's depository and fiscal agent.

6.1.2 Ownership and Financial Condition

195. The banking laws enabled the reorganization and modernization of the banking system, but commercial banks are intrinsically fragile and still not well developed, in comparison with international practices and trends. In fact, about 80 percent of the banking sector in the FRY is owned by enterprises under social ownership (so-called "old" banks), with truly private ownership accounting only for the remaining 20 percent (so-called "new" banks). The sector is still protected, through numerous barriers-at-entry: relatively few licenses have been issued to foreign banks, which also face restrictions on retail banking. The largest "old" bank, Beogradska

Banka, accounts for 37 percent of total capital of the sector. The 30 largest banks, accounting for 70 percent of total banking system assets, are insolvent. Moreover, the banks' reported capital is probably overstated, owing in part to the common practice of reporting as income accrued interest from non-performing loans. Of the "old" banks, some may be subject to a rehabilitation program, but most will probably be closed down. While the larger state (or socially-owned) "old" banks are virtually bankrupt, the "new" banks that are solvent tend to be very small. These small private banks have limited capacity to provide loans in any significant number or volume.

6.1.3 Banking Sector Reform in Serbia²⁸

196. Under the leadership of the NBY, the authorities took decisive steps to assess the conditions of troubled banks and effectively launched the implementation of a comprehensive banking sector reform program. Since the beginning of 2001, the FRY authorities have progressed from stock-taking, to planning, and then to launching the most significant parts of an ambitious financial sector reform program. While the authorities launched the liquidation of a number of small and almost completely inactive banks since mid-2001, particular emphasis was given to a detailed analysis of the costs of resolving the four largest banks. The authorities took bold steps in early 2002 that have resulted in the closure of these largest four state banks. The determination and speed of reform in the financial sector have yielded impressive results. By the first quarter of 2002, nearly one year after the planning stage of the program started, the FRY authorities have: (i) initiated liquidation proceedings for the four largest banks in Serbia and for 19 small to medium-sized insolvent banks - together representing 61 percent of the assets of the banking system; (ii) issued rehabilitation decrees putting five banks under the administration of the BRA for assessing their restructuring and privatization, or liquidation; (iii) placed one bank under the administration of NBY's Problem Bank Unit; and (iv) given four solvent but undercapitalized banks until end-2002 to meet minimum capital standards.

197. Resolution efforts are also being accompanied by improvements in the regulatory and supervisory framework of the banking system and an aggressive program of institution building at the Bank Rehabilitation Agency (BRA). In mid-2001, under the leadership of the NBY, the legal framework for bank resolution was modified to make the BRA the mandatory receiver for bank liquidations. Substantial institution building has taken place both at the NBY and the BRA, supported by a well structured donor technical assistance program and by a Technical Assistance grant from the Bank²⁹.

198. In the medium term the authorities intend to complete the restructuring and privatization of the banking system, and further strengthen the institutional capacity and governance of the institutions responsible for the banking sector. The Bank, through the PFSAC operation has supported (i) ongoing reforms aimed at the closure and liquidation of insolvent banks; and (ii) ongoing reforms aimed at improving the regulatory framework of bank resolution³⁰.

²⁸ Extracts from the Private and Financial Sector Adjustment Credit (PFSAC), approved by the Board in May 2002.

²⁹ The Bank's Financial Sector TA Grant is currently under implementation. The project aims primarily at supporting the BRA to carry forward the liquidation and divestiture of all insolvent banks selected for restructuring.

³⁰ Specifically, the PFSAC supports the withdrawal of the four largest banks' licenses and entry of the banks into bankruptcy, followed by the appointment of the BRA as its bankruptcy administrator. In addition, the credit will support the completion of the resolution of additional 24 small and medium-sized banks found to be insolvent that are presently under BRA/NBY control pending a decision regarding their resolution. The credit will also support NBY's program for four small solvent banks that are pending compliance with new minimum capital requirements. Finally, the operation supports additional efforts to enhance the regulatory framework of bank resolution, including the already implemented decision to allow the BRA to act as the court-appointed bankruptcy trustee for banks.

6.1.4 Banking Sector Reform in Montenegro

199. The CBM has conducted an extensive on-site examination of all Montenegrin banks to determine the capitalization, liquidity and solvency conditions of the financial sector. A team of CBM staff and international experts spent considerable time in all 11 commercial banks (excluding Serbian or Yugoslavia registered banks) examining their financial conditions. Attention has been focused on the resolution of serious liquidity and capital deficiency issues facing the Republic of Montenegro's largest bank, Montenegrobanka, which accounts for about 50 percent of the total banking sector's assets. The bank has been placed under interim administration since April 2001; experts appointed by the CBM have been assigned to determine the precise conditions of Montenegrobanka, and to take actions to protect its depositors and ensure proper management of the bank until a decision is made concerning its future.

200. The government of Montenegro and the CBM are working toward the adoption of a sound management and stabilization strategy for the banking sector, as well as the establishment of rigorous oversight of commercial bank operations. The Montenegrin republican Parliament passed new laws on the central bank and commercial banks which are broadly consistent with international standards (that is, they establish stringent licensing standards, tight financial reporting requirements, and sound financial performance criteria). The government has amended the banking legislation to clarify and strengthen the supervisory authorities of the CBM. Owing to capacity constraints, it will take time for the CBM to develop and carry out these functions on a par with international standards. The Council of the CBM has passed several regulations enabling the central bank to start up its activities, including responsibility for the payment system in Montenegro. Overall, the CBM has moved from the creation to establishment of a central bank, in a relatively short period.

6.2 Private Sector Accounting and Auditing

201. As in other transition countries, existing audit and accountancy firms in the FRY, including local members of international networks, are quite young. Most of the firms belonging to the latter group have around five years of experience, except for the local Deloitte & Touche office, which was established in 1991. Most local accounting firms are owned by former members of the Community Bookkeeping Service or SDK, the previous government audit organization, and most are very small.

202. All legal entities with an obligation to have their financial statements audited are required to submit the auditor's opinion to the NBY's Payment Bureau. The ZOP has an obligation to enable interested third parties to examine audited financial statements. It should be noted that business entities have no obligation to publish a full annual report providing financial information to third parties (auditor's opinion, financial statements and notes to the financial statements), if they do not wish to do so.

6.2.1 Private Sector Accounting Standards

203. Financial audits are performed in accordance with auditing standards and regulations set by the Yugoslavian Association of Accountants and Auditors (YAAA). The only existing auditing standards are the International Standards on Auditing (ISA). Provisions related to the content of audit reports and audit opinions are identical to the requirements of ISA.

204. Financial reporting is regulated by the Federal Law on Accounting. The accounting standards referred to in the Law on Accounting are specifically identified. However, the Law on Accounting authorizes the YAAA to set accounting and auditing standards. National Accounting Standards (NAS) were set at the end of 1980s under the SFRY. Some subsequent additions and amendments have been made with the intention of harmonizing the NAS with International

Accounting Standards (IAS). The YAAA, as member of the International Federation of Accountants (IFAC), has decided to support the application of IAS in FRY. As a result, many IAS have been translated and published by the YAAA, but not a complete set.

205. Although attempts have been made to harmonize the accounting regulations and existing NAS with IAS, there are certain departures:

- The NAS require revaluation of non-monetary assets and capital by applying revaluation coefficients based on retail price indices. This policy is similar to that required by IAS 29, Financial Reporting in Hyperinflationary Economies. An adjustment of a previous year's figures for assets and liabilities denominated in foreign currencies that is stated at the exchange rates in effect at the balance sheet date and adjusted for inflation in the current year based on officially published retail price indices, would not produce values that could be compared with other current year amounts in the balance sheet, unless the inflation rate was exactly matched by the change in foreign exchange rates. However, NAS does not require these figures to be restated in terms of the measuring unit current at the balance sheet date. Because IAS 29 does not allow application of different adjustment criteria, it is not practical to apply IAS 29 in the FRY nor, therefore, to prepare financial statements in accordance with IAS.
- FRY taxation policy is based on Yugoslav tax regulations, and differs from IAS 12, Income Taxes, in that Yugoslav tax regulations do not recognize temporary differences in income taxes. Accordingly, no deferred tax assets or liabilities are recognized.
- Due to undeveloped financial markets, the fair value of financial assets and liabilities is not determined in accordance with IAS 32 and IAS 39, Financial Instruments.
- The regulations relating to impairment of assets in some respects differ from the requirements of IAS 36, Impairment of Assets.
- The NAS require revaluation of non-monetary assets (fixed assets) by applying revaluation coefficients based on retail price indices without conducting a proper valuation of assets. This policy is not in compliance with IASs 16, Property, Plant and Equipment; and 36, Impairment of Assets.
- Furthermore, actual practices are reportedly quite different from the accounting treatment recommended in published standards.

6.2.2 Auditing and Accounting Profession

206. Technically speaking, the accounting and auditing professions in the FRY are regulated by the current Federal Law on Accounting (1997), the Federal Law on Audit of Financial Statements, and the Federal Law on Auditing (1996). In practice, these laws are only being implemented in the Republic of Serbia. Under the Law on Auditing, an audit may be performed by an auditing firm that employs at least one certified auditor and two other auditors. The Federal MOF issues auditor, and certified auditor certificates. A candidate who has two years of experience in an audit firm, and has successfully passed the first tier of exams organized by the Federal MOF, is entitled to receive a certificate bestowing the title of auditor. Such a practitioner who as two additional years of experience, and who has successfully passed the second tier of exams organized by the Federal MOF, is entitled to receive a certificate bestowing the title of certified auditor. An authorized accountant, as described by the Law on Accounting, has a right to obtain the title of auditor upon request, with no testing requirement. Continuing professional education (CPE) is not mentioned in the laws.

207. The professions of accountant and auditor are supervised by the Federal MOF. However, this monitoring activity is being carried out solely on the basis of a review of annual reports filed by the four accountancy and auditing associations, the Yugoslav Association of Accountants and Auditors (YAAA), the Serbian AAA, the Montenegrin AAA, and a fourth association at the

Federal level. This type of oversight is insufficient to ensure adequate control, by the regulator, over the professionalism and the quality of the work carried out by audit firms. All four AAAs have delegated authority to carry out training and examinations of accountants as prescribed by the law, but without adequate quality assurance and control mechanisms by the Federal MOF over their training program, testing materials and curricula.

6.2.3 New Private Sector Accounting Legislation

208. The Federal MOF is currently drafting new laws on accounting and auditing. The current proposal would delegate authority to license auditors to the accounting and auditing associations. Should these associations also retain their present publishing, training, testing and continuing professional education (CPE) activities, this proposal would create serious conflicts of interest, by reason of the concentration of regulatory functions and profit-bearing business activities within the same associations.

209. In Montenegro, the Law on Accounting and Auditing was approved by the Parliament on February 1, 2002. The new law would mandate (i) the generalized adoption of IAS (for both tax returns and financial reporting purposes); (ii) the adoption of International Standards on Auditing (ISA); and (iii) the establishment of an independent Accounting Standards Board that would be charged with issuing accounting and auditing guidelines, as well as with licensing professional auditors. In the law, it is proposed that all banks, all companies privatized by shares or vouchers, all listed companies, and all other companies with turnover in excess of DEM 2 million, comply with the new reporting requirement under IAS. However, at the present level of development of the accountancy profession and business needs, no enterprise in Montenegro could comply fully with IAS. USAID has provided technical assistance in the preparation of the draft legislation and would also provide hands-on training to practitioners and assistance to enterprises in the conversion process, which would be based on the adoption of an IAS-compliant chart of accounts.

210. The CFAA team offered comments on the draft Accounting and Auditing Law to ensure that it follows, as much as possible, international trends (for instance, providing for simplified financial reporting and audit requirements for micro-enterprises, and for specific, reduced-scope IAS reporting requirements for small and medium enterprises) and represents an adequate vehicle to foster private sector development. However, the final text that was adopted by the Montenegrin Parliament still falls short of recognized international best practice in several key areas. The **CFAA recommends** an alignment of the new accounting and auditing law to international trends and best practice. To that end, the CFAA team will work with the Montenegrin government to prepare a country action plan deriving from the CFAA findings and recommendations, along with amendments to the law.

6.3 Fiduciary Considerations

211. The former SFRY ceased to be a member of the World Bank Group in February 1993. In October 2000, the FRY asked the World Bank to open a dialogue on membership and resolution of its substantial (\$1.7 billion) arrears. After fulfilling the stipulated conditions, on May 8, 2001, FRY joined the World Bank after a nearly decade-long hiatus. At the same time, the WB's Board of Executive Directors endorsed a Transitional Support Strategy (TSS), dated June 26, 2001. The TSS sets out a plan to resolve FRY's IBRD arrears, and establishes temporary International Development Association (IDA) eligibility for the FRY on an exceptional basis. Up to \$540 million in IDA resources are allocated over the FY02-FY04 period, with actual lending to be determined based on policy performance.

212. The program of proposed WB support foresees up to 80 percent of commitments in the form of adjustment credits supporting critical policy reforms in two core areas: (i) improving fiscal sustainability, including strengthening of public expenditure management, reform of the social sectors, and control of quasi-fiscal deficits; and (ii) transition reforms in private and financial sector development to stimulate growth. Because significant resources will be provided, the governments should demonstrate that public funds are being spent in the most transparent and efficient way, and that scarce resources are not being captured by privileged or connected groups. A suitable model of governance and strong financial accountability will also be required to ensure that the fiduciary concerns of the Bank and donors are adequately addressed.

6.3.1 Fiduciary Requirements for Bank-Assisted Projects

213. The CFAA mission reviewed the proposed fiduciary arrangements in Bank-assisted projects. These included: (i) a review of the central bank, NBY, in its capacity as deposit account-holder for adjustment-type operations³¹; (ii) a review of the acceptability of local commercial banks and branches of foreign banks to operate Special Accounts for investment-type operations; (iii) an assessment of local audit firms' capacity and suitability to audit Bank-assisted projects; and (iv) a review of institutional arrangements for financial management during implementation of Bank-financed investment projects.

6.3.2 Safeguards for Adjustment Operations

214. In order to review the suitability of the front-end accountability mechanisms for funds received under adjustment-type operations, the CFAA mission obtained information relating to the transfer of funds under the Structural Adjustment Credit (SAC), involving NBY, CBM, Montenegro's MOF and Serbia's MOFE.

215. The CFAA team discussed the flow of funds for adjustment operations with representatives of the NBY, including the Vice Governor and the Assistant General Director for Accounting and Financial Matters. The NBY has appropriate capacity to manage the Bank's credits, understands the flow of funds, and has recently issued instructions on recording obligations of FRY for entries into capital of the World Bank, which is well documented.

216. Based on discussions that took place during the mission, there are no apparent difficulties in transferring IDA Credit funds, through the NBY, to the government Budget Account for the Republic of Serbia (in Dinar) or to the government Budget Account for the Republic of Montenegro (in Euro). The government account for the Republic of Serbia is maintained by the NBY, and the government account for Republic of Montenegro is maintained by the CBM. The CFAA review confirmed that proposed arrangements for receipt of funds from IDA and transfer of funds to IDA for debt service could be carried out in accordance with the authorized instructions from the respective government offices, and adequately reflected in the NBY accounting records.

217. However there is the related risk of attachment of foreign currency assets of the NBY by creditors and other former constituents of the SFRY. Consequently, the fiduciary arrangements have been agreed with the borrowers in the recently approved Structural Adjustment Credit (SAC) in Serbia and also in the Montenegro SAC, which was successfully negotiated in May

³¹ Based on the division of labor between the Fund and the Bank, a Safeguards Assessment of the NBY has been carried out by the IMF. The purpose of the Safeguards Assessments is to identify vulnerabilities in a central bank's control, accounting, reporting, auditing systems and legal structure that may impair the integrity of central bank operations. Safeguards Assessment represent an *ex ante* mechanism to help prevent the possible misuse of IMF/Bank resources and misreporting of information.

2002. The key characteristics of both SACs include ring fencing both the deposit account and the correspondent bank account into which the credit proceeds are paid, and requiring an audit of both bank accounts. The Bank also requires that SAC funds be held at the Deutsche Bundesbank (or at any other financial institution ensuring extra-territoriality) rather than at NBY's correspondent banks abroad.

218. The role of the NBY in adjustment operations for Montenegro has also been clarified. It was agreed that the passage of funds would be made in accordance with a law to be passed by the FRY and a counter guarantee law to be passed by the Republic of Montenegro. The parties agreed that a provision prohibiting the use of funds for local expenditures would apply with respect of funds to be made available by the NBY to the Republic of Montenegro.³²

6.3.3 Investment Operations: Assessment of Commercial Banks

219. It is the governments' responsibility to choose commercial banks that are acceptable to the World Bank to operate Special Accounts for Bank-assisted projects.

220. A few banks in Serbia are liquid and adequately capitalized. At the start of the CFAA mission, the NBY had not completed its initial review and categorization of individual banks according to their financial condition. Because of the generally weak conditions of the Serbian banking sector, and lack of a proper categorization of domestic commercial banks by the NBY, the CFAA mission carried out a limited review of three commercial banks. Based on this assessment (comprising key criteria such as adequate capitalization, experienced management and proper organization, good business plan and commercial strategies), **the CFAA mission concluded** that all three commercial banks reviewed can be considered acceptable to operate Special Accounts for investment-type operations. Since the three banks were already carrying out operations in Dinars (or soon would be), project accounts (functioning in local currency) are also to be opened and maintained within those banks. **The CFAA also recommends** that the World Bank Loan Department closely oversee the number of special accounts, as well as their relative size and balance within each bank, to avoid concentration of funds within a single credit institution.

221. In Montenegro, the CFAA team abstained from independently reviewing individual commercial banks, pending the reassessment and relicensing of all banks by the CBM. This process, initially scheduled to be completed in mid-November 2001, is still underway. The CFAA team was able to review the reports prepared by the CBM to determine whether there could be sound banks in Montenegro; however, both CBM management and international banking advisers to the CBM indicated that, it is unlikely that any local commercial bank could be currently acceptable to operate Special Accounts.

222. This opinion is endorsed by the CFAA, due to the relatively newness of the banking system (both CBM and domestic commercial banks) and also the lack of suitable foreign-owned, locally licensed, banks. Since the local commercial banks are not considered eligible, there are several options for Special Accounts, including: (a) using a branch of a commercial bank which has been considered acceptable to the Bank; or (b) opening Special Accounts in an acceptable overseas bank, with separate project accounts for local currency expenditures opened in the best Montenegrin commercial banks, as rated by the CBM, on condition that the balance on those accounts be maintained at all times within a pre-defined ceiling to be determined on a case-to-case basis. According to the Governor of CBM, option (b) would be the preferred option as long as no bank in Montenegro is considered acceptable.

³² Fiduciary arrangements which were agreed during the negotiation of Montenegro SAC, according to the Agreed Minutes of Negotiations for Montenegro SAC.

223. Pending the reorganization and consolidation of the banking system, the CFAA **recommends that** all banks assessed as suitably qualified banks in the view of the NBY (Group A banks in Serbia) and the CBM, be in due course reassessed by the World Bank for inclusion in a revised list of banks acceptable to operate Special Accounts for investment-type operations. It is the responsibility of the borrower to identify suitably qualified banks, and of the Bank to perform an assessment of their eligibility.

6.3.4 Assessment of Private Auditing Firms

224. In accordance with the World Bank's legal agreements, the borrower (the FRY) is required to appoint auditors acceptable to the Bank, to audit project financial statements, Special Accounts, other disbursement schedules, as well as implementing organization/beneficiary financial statements, as applicable for investment operations, and deposit accounts for adjustment operations. Audits are required to cover both non-revenue earning projects and those supporting revenue-earning legal entities, such as enterprises and autonomous agencies that benefit from and/or manage project funds. Once an auditor has been pre-qualified to audit non-revenue projects, the auditor could be also eligible (not automatically, since there may be circumstances where the Bank would require additional strengths, such as industry expertise) to audit revenue-earning legal entities.

225. As there is currently no Supreme Audit Institution (SAI) in the country, the CFAA mission completed a pre-qualification exercise to evaluate national private sector audit firms for inclusion in the list of firms authorized to participate in the bidding process for audit services relating to World Bank-financed projects. International Accounting Standards (IAS) and International Standards on Auditing (ISA) were used as the benchmarks in the CFAA's assessment of audit firms since: (i) Bank guidelines prescribe that all revenue-earning legal entities required to submit audited financial statements to the World Bank must comply with IAS; and (ii) knowledge of IAS is a good proxy for general firm competence.

226. There are 26 firms registered by the Federal MOF, many of which fulfill just the minimum staffing requirements for being licensed, i.e. one certified auditor and two independent auditors. Based on the information provided to the CFAA team by the Federal MOF, it appeared that only firms associated with the international accounting firm networks were likely to have the necessary infrastructure and capacity to participate in bids for auditing World Bank-financed projects.

227. Based on its assessment of audit firms in Yugoslavia, **the CFAA team concluded** that only two audit firms, among the five which submitted expressions of interest, are acceptable to the Bank and are therefore pre-qualified to participate in bidding for the audit of World Bank-financed projects. The CFAA team also concluded that two other audit firms would be (conditionally) pre-qualified, subject to meeting certain conditions. One firm failed to meet the necessary standards and therefore is not pre-qualified.

228. None of the audit firms reviewed has recent experience with World Bank projects. In conducting the first audits, **the CFAA recommends** that the selected auditors be subject to careful monitoring and evaluation by the World Bank, to ensure compliance with World Bank requirements and guidelines. The first audited financial statements would be carefully reviewed and assessed by the World Bank, to ensure that they comply with the required standards and meet the expected performance.

229. The CFAA team believes there are significant benefits to using a single global auditor for all Bank-assisted projects. These benefits include better oversight of auditors, significant economies of scale, particularly standardization of audit methodology and audit reports, and most likely cheaper audits. **The CFAA recommends that** a global tender approach be adopted in the

FRY, leading to the appointment of one global auditor for the whole country project portfolio. The selection of a global auditor would be effective for a period of two annual audits, with an annual renewal clause subject to performance evaluation. **The CFAA also recommends** that the Bank re-assess national audit firms after two annual audits for inclusion in a revised list of firms authorized to participate in bidding for the audit of World Bank-financed projects.

6.3.5 Financial Management in Bank-Assisted Projects

230. The CFAA team discussed alternative fiduciary arrangements for financial management, disbursements and internal audit in Bank-assisted projects with the counterpart team, other senior government officials at all levels of government, and the Yugoslavia Country Team in the Bank. There are three options for institutional arrangements for project implementation.

- (i) One centralized agency within the Federal government, for instance, under the Federal MOF, responsible for all implementation activities for all projects in each republic;
- (ii) One implementation agency for each project in each republic (traditional PIU model), located within the relevant line ministries or project beneficiaries; and
- (iii) Same as option (ii), except that financial management, disbursement fiduciary functions, and appropriate oversight and control activities, would be carried out by one centralized, specialized unit in each republic. Key issues associated with this option are the financing of the centralized unit, its location, and the allocation of costs to each project, the optimal staffing, and the legal framework of such unit.

231. Both republics have been using second option (one implementation agency for each project in each republic, located within the relevant line ministries or project beneficiaries) in the investment projects which have been approved or negotiated since re-joining the membership of the World Bank. This arrangement is acceptable to the Bank, and the Bank has provided training on financial management and disbursements to the projects staff in March 2002.

6.4 Fiduciary Risk Assessment and Management

6.4.1 Risk Assessment

232. The CFAA is an assessment of the risks that funds entering the public sector finance pool in the FRY may not be used for legitimate purposes (as defined by the country legislation and by the Bank Articles of Agreement, Operational Policies and Procedures). In view of the new borrower status of the FRY, this assessment is conducted by comparing the financial management standards and practices of agencies using public funds against benchmarks derived by best practice operations within the Bank's overall portfolio.

233. This CFAA reveals that there are a number of risks in the management of public funds in the FRY. The risks to the public funds include: (a) poor public sector financial management in the past; (b) unfinished reforms - the new governments that were elected have commenced a process of major reform which is well designed, but it is still too early to say if the reforms will be totally successful; (c) capacity constraints in all three governments, in particular in Montenegro, in implementing key reforms; (d) fundamental constitutional changes which are underway; (e) weak banking sectors; (f) weak audit capacity; (g) poor implementation capacity in line ministries; (h) central banking risks - the risk of attachment of foreign currency assets of the NBY by creditors and other former constituents of the SFRY; and (i) the lack of recent Bank implementation experience within the FRY.

6.4.2 Risk Management

234. The primary responsibility for fiduciary risk management remains with the three FRY governments, with significant support from the World Bank and other development partners. Fiduciary risk may be reduced by well-designed programs and appropriate decisions in the course of project execution, and by monitoring and evaluation, as well as enforcement of fiduciary requirements in the course of implementation or supervision.

235. Since re-joining the membership of the Bank, the FRY have put in place a number of risk mitigation measures, including: (a) the use of a small number of pre-screened banks and auditors; (b) the establishment of appropriate institutional and implementation arrangements (ring fencing) for financial management, disbursement and procurements in Bank-assisted projects; (c) the provision of training on financial management, disbursement and procurement to the borrower's project staff; (d) special ring-fencing of deposit accounts and correspondent bank accounts for adjustment operations; and (e) audit arrangements for every adjustment loan.

236. The Bank has stationed an accredited Financial Management Specialist to the country to assist with follow-up and to ensure proper supervision of projects under implementation. Because of the fast pace of reforms and development programs, as well as the fluidity in constitutional and governance arrangement, **the CFAA recommends that the Bank remain in continuous dialogue with the three levels of government as the new arrangements take shape in detail, to update its recommendations in light of changing circumstances and to revise its country-specific fiduciary safeguards as warranted.** The CFAA proposes to undertake a new assessment once the situation has stabilized, probably in about twenty four months and in any case before the end of calendar year 2004.

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