

28 September 2006

Screening report

Croatia

Chapter 32 – Financial control

Date of screening meetings:

Explanatory meeting: 18 May 2006

Bilateral meeting: 29 June 2006

I. CHAPTER CONTENT

This chapter contains four main policy areas, namely public internal financial control (PIFC), external audit (EA), the protection of the EU's financial interests and the protection of the Euro against counterfeiting.

With regard to the first two areas, there is no Community legislation requiring transposition into national law. Rather, the screening concerns the commitment of the candidate country to adopt international control and internal audit standards and EU best practice. For this purpose, the candidate country should discuss with the Commission and adopt a PIFC Policy Paper with a short and long term action plan having realistic deadlines.

PIFC is a comprehensive concept to support the candidate country in upgrading its internal control systems. PIFC and EA essentially relate to the entire public budget, in particular central government income and expenditure, including foreign funds. However, the more specific rules for managing and controlling EU funds are treated under the relevant other accession negotiation chapters.

The PIFC concept is based on three principles, 1) managerial accountability carried by sound financial management and control (FMC) systems, 2) decentralised and functionally independent internal audit (IA) and 3) centralised harmonisation of the FMC and IA systems.

Regarding **external audit**, the candidate country is expected to apply the norms defined by the International Organisation of Supreme Audit Institutions – INTOSAI, in particular its Lima Declaration, which foresees supreme audit institutions that are functionally, institutionally and financially independent.

The other relevant policy area under this chapter concerns the **protection of EU financial interests**. First, it comprises operational cooperation of Member States, which must have the capacity to cooperate effectively with the European Commission and to communicate all suspected cases of irregularities and fraud. They must ensure the protection of EU funds at an (at least) equivalent level to the protection of national funds. Member States are also obliged to assist and co-operate on-the-spot checks carried out by EC services. While some of this *acquis* applies directly to Member States and thus does not need to be transposed, effective co-operation and coordination structures and capacities in the candidate country need to be set up. In order to facilitate the required cooperation by future Member States, the nomination of national anti-fraud cooperation services – AFCOS – as a single contact point with OLAF is considered very useful.

Furthermore, this part of the chapter also includes the convention on the protection of the EU's financial interests ("PIF-Convention") and its three protocols, including the harmonisation of penal law and the reinforcement of cooperation.

Finally, this part of the chapter comprises the non-penal aspects of the **protection of the Euro against counterfeiting** (first pillar aspects), such as the prohibition of metals or tokens similar to Euro coins, the obligation for financial institutions to withdraw counterfeit notes and coins and effective anti-counterfeiting bodies and procedures.

II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY

This part summarises the information provided by Croatia and the discussion at the screening meeting. Croatia indicated that it can accept the relevant standards and *acquis* regarding Internal Financial control.

II.a. Public Internal Financial Control (PIFC) and External Audit

The Government of the Republic of Croatia passed the first **PIFC** Strategy in September 2004 providing the main PIFC development guidelines. With the overall PIFC system development and previous experience in mind, Croatia decided to elaborate and improve the existing Strategy. Thus, the Government of the Republic of Croatia passed, in June 2005, a new Development Strategy of PIFC. The strategy aims at ensuring a harmonisation with international internal control and internal audit standards and EU best practices, effective, economic and efficient collection and utilisation of public resources in line with policies and objectives of the government, as well as accountability and fiscal transparency. The strategy is comprehensive and covers all public budgets and funds including EU funds. In particular it explains PIFC and discusses managerial accountability, financial management and control (FMC), functional independence of internal audit (IA), the role of Central Harmonisation Units (CHU) and describes the existing institutional and legal framework. It also concludes that there is a need for further development of PIFC in particular in the field of FMC and IA. It provides for an action plan including a timetable for aligning the existing PIFC system with the requirements under Chapter 32.

As foreseen in the PIFC strategy action plan, Croatia is developing a PIFC framework law defining requirements for the expected PIFC system, training of persons involved in financial management and control as well as in functionally independent internal audit, reporting requirements on PIFC to the Government as well as the actions to be taken in cases of irregularities and fraud. In addition, the Ministry of Finance has already passed implementing regulations such as a code of ethics, a charter, a rulebook and a manual for internal audit. Internal audit are formally established in 12 out of 13 Ministries. Furthermore, a programme for professional training and taking exams for qualification of certified public sector internal auditors has been adopted. Training and certification of internal auditors are on-going within the functional responsibility of the CHU. These aspects still need to be scrutinised. In the field of FMC, Croatia foresees to develop implementing regulations such as a rulebook, risk management methodology, and a FMC manual and a training programme for management and other persons involved in FMC.

Croatia has committed itself to take into account comments by DG Budget of the European Commission before primary and secondary PIFC legislation is finalised, in line with the 2004 Memorandum of Understanding on the administrative Co-operation between the Ministry of Finance and DG Budget. To this end, all PIFC related policy papers, acts or draft legislation or regulations will be sent to the DG Budget for comments, allowing for sufficient time for scrutiny.

Regarding **external audit**, the State Audit Office (SAO), a member of INTOSAI, adopted a Strategic Development Plan (SDP) 2003 – 2007 in the beginning of 2003. The SDP was based upon the conclusions from the 2000/2001 self-assessment and SIGMA's 2002/03 recommendations following an independent external evaluation. The SDP contains elements to harmonise and approximate the work methodology used by the SAO to generally accepted standards and best European Standards. It regulates aspects such as legal framework, audit methodology, the audit cycle, support processes, human resource structure and external relations and considers the Lima declaration, the INTOSAI Auditing Standards, and the European Implementing Guidelines for INTOSAI Auditing Standards as well as the Prague declaration.

A State Audit Act was adopted by the Croatian Government in July 2003 and its latest amendment dates from 2004 in accordance with the conclusions from the self-assessment

and SIGMA's recommendations. The State Audit Act provides for functional, operational independence of the SAO but there is no legal basis in the Constitution. The Financial independence of the SAO has been strengthened by a new Act affecting certified state auditors' salaries. However, Croatia plans to improve the financial independence of the SAO, since its budget is included in the State budget prepared by the Ministry of Finance. Taking further steps towards achieving full financial independence is a part of the SAO's strategy.

The State Audit Act provides for the SAO to perform financial audits and performance audits and obliges it to report its audits to the Parliament. INTOSAI Auditing Standards have been translated to Croatian and published in the Official Gazette. Moreover, the SAO has also translated the European Guidelines of INTOSAI standards. In addition, it has also drawn up a Code of Professional Ethics for State Auditors. Draft manuals for both financial audit and performance audits have been developed and training is being undertaken. Pilot financial audits and pilot performance audits are now also being undertaken.

II.b. Protection of EU Financial Interests and Protection of the Euro

Article 280 TEU requires Member States to fight protect the **Community's financial interests** in the same way as national financial interests. Croatia has yet to formally align its legislation to this requirement. The same applies for the immediate communication of irregularities and fraud in the Common Agricultural Policy, Structural Funds and Cohesion Fund.

Regarding cooperation for on-the-spot checks by EU investigators, Croatia stated that it intends to fully support such activities. However, no formal rules are yet in place, which ensure that EC inspectors as well as information and evidence produce by them are treated like national ones. The same applies for the obligation to safeguard evidence, to actively cooperate with and participate in EC inspection missions, and to support such missions, if requested, vis-à-vis economic operators.

Croatian penal law already punishes the principal offences of fraud, corruption and money laundering. Liability of heads of business as well as legal persons for criminal acts, including against the EU's financial interests is equally established. Currently, there are no plans for further alignment.

Within the system of decentralised implementation of EU pre-accession funds, Croatia is subject to provisions requiring the National Authorising Officer to regular communicate on suspected irregularities and fraud. A whistle-blowing system is in place which protects those officials who report suspected wrongdoings in the administration. Croatia stated that it plans to establish a central office to treat and coordinate suspected cases of irregularities and fraud, which would serve as a contact point (AFCOS) for the Commission's Anti-Fraud Office.

With regard to the **protection of the Euro against counterfeiting**, Croatian law provides for a definition of such acts referring to both notes and coins. The Croatian National Bank has been appointed with respect to technical analysis and central collection and processing of information on counterfeit Kuna banknotes and coins. The technical analysis of counterfeit Euro is carried out by a specialised centre within the ministry of the interior. The criminal police directorate within the ministry of the interior centralises all information relating to counterfeits and informs Europol and Interpol. The CNB plans to prescribe, until the end of 2006, the obligation for all financial institutions to withdraw suspected

counterfeits from circulation and procedures for such cases. Cooperation with the Member States, the Commission and the ECB takes place in terms of exchange of information (via Interpol, Europol and the European Commission's Pericles programme). Croatia recognises the need for legislation to provide for communication or transmission of counterfeits to the ECB.

Regarding counterfeit and sale of medals and tokens similar to Euro coins, Croatia plans to pass relevant legislation until the end of 2006.

III. ASSESSMENT OF THE DEGREE OF ALIGNMENT AND IMPLEMENTING CAPACITY

As regards the relevant international standards and the *acquis* under this chapter, Croatia has achieved a satisfactory level of alignment. A comprehensive strategy paper has been adopted and primary legislation is being developed. Croatia is aware of the need for further development and implementation, which can be achieved in the medium term.

III.a. Public Internal Financial Control (PIFC) and External Audit

The strategy for development of the PIFC system and the Strategic Development Plan for the State Audit Office are comprehensive and aim at upgrading the PIFC system and external audit towards meeting EU requirements. These documents are of dynamic nature and may need to be updated based upon experience having in mind also that implementation deadlines for actions might be prolonged. Croatia is therefore requested to provide the European Commission with updates of action plans including actions to be taken, deliverables, owners and expected completion time on a regular basis.

The development and adoption of the PIFC framework law is important in order to provide a clear and authoritative basis for upgrading the internal control system. Once the new law is adopted, the internal audit implementing regulations already passed by the Ministry of Finance needs to be revised for consistency with the new law. The capacity of the Central Harmonisation Units for internal audit and financial management and control will have to be kept at levels in such a way that they can carry out their responsibilities adequately and timely. Training and certification of internal auditors needs to continue. In particular, the focus needs to be on development of implementing regulations for financial management and control and on related training of management and staff.

Croatia has been accredited for the Decentralized Implementation System of Community assistance in February 2006. The implementation of the system will be monitored closely.

In the field of **external audit**, the Commission welcomes Croatia's commitment to provide the State Audit Office with a legal basis in the constitution in order to strengthen the State Audit Office's position and independence. Croatia also needs to strengthen the State Audit Office's financial independence by introducing in its legislation that it can submit its draft budget directly to the Parliament for its deliberation and decision. The audit manuals needs to be adopted taking into account the relevant standards and training of staff should continue.

III.b. Protection of EU Financial Interests and Protection of the Euro

Croatia must still take the necessary decisions to nominate and establish the instruments ensuring the coordination and cooperation with OLAF for the fight against fraud in the field of the protection of the EU Financial Interests. Constructive discussions on the establishment

of an AFCOS have taken place with OLAF and Croatia has committed itself to take such decision shortly.

In order to comply with the requirements of the **PIF-Convention** and its protocols, Croatia's criminal law identifies certain offences. However, Croatia must still undertake further efforts to align its provisions with the Convention and the Protocols:

- The penal law protection against the misappropriation of funds should be completed.
- The existing fraud and corruption provisions should be assessed as to whether a further amendment of national law is required in the light of Croatian jurisprudence.
- The jurisdiction granted to Croatian courts should also be aligned in detail with the requirements of the PIF-Convention and its protocols.

With respect to the **protection of the Euro against counterfeiting** Croatia needs to designate national analysis centres for coins and notes where all suspected counterfeits will be transmitted for identification. An adequate level of police capacity appears to be in place.

Croatia should provide specific sanctions for credit institutions failing to withdraw counterfeits from circulation and hand them over to the competent national authorities. Moreover, there should be a provision for sanctions against medals and tokens similar to Euro coins.