Policy brief

Guidelines for PIFC-compliant financial inspection

Guidance for SIGMA partners

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List of Abbreviations and Acronyms

AFCOS	Anti-fraud co-ordination service
CHU	Central Harmonisation Unit
EU	European Union
EC	European Commission
FMC	Financial management and control
MoF	Ministry of Finance
OLAF	European Anti-Fraud Office
PIFC	Public internal financial control
PFM	Public financial management
SAI	Supreme Audit Institution

Introduction

This document presents a set of guidelines for financial inspection that is compliant with public internal financial control. The Guidelines are intended to help administrations in their efforts to consolidate the financial inspection function, which in all aspects is complementary to but does not replace the internal audit function and respects the principle of managerial responsibility.

The Guidelines are addressed to the senior management of ministries of finance in European Union (EU) candidate countries and potential candidates, with the main stakeholders in the areas of financial inspection, internal audit, central harmonisation units and bodies responsible for public financial management (PFM) reform.

Other areas of PFM could also benefit from co-operation and co-ordination with the financial inspection function, such as external audit or institutions with a role in fighting fraud and corruption. Therefore, this document could be relevant for supreme audit institutions, law enforcement bodies, anti-fraud co-ordination services[1] (AFCOS) or other public control or inspection bodies, such as the technical inspection services in ministries other than the ministry of finance or public procurement institutions in their administrative control and investigation functions.

Why financial inspection guidelines?

Financial inspection is an *ex post* activity for controlling the regularity of transactions and other activities with financial consequences performed within the entities in which the inspection takes place.

In the event that irregularities are uncovered or any damages are caused to the assets of the organisations and entities under the financial inspection mandate and if there are relevant legal grounds, corrective actions can be taken and those responsible may be liable administratively. In the past, financial inspection was the only *ex post* internal[2] control of the budget execution and the safeguarding of public assets in EU candidate countries.

The concept of public internal financial control (PIFC), introduced in 2002 by the European Commission (EC) Directorate-General for Budget in the Chapter of the accession negotiations related to financial control[3], is based on the adoption of internationally-recognised frameworks and standards, as well as EU good practice. It consists of three pillars: financial management and control (FMC) based on the concept of managerial accountability; internal audit in line with international standards; and, central harmonisation units (CHUs) in ministries of finance that are the key drivers of PIFC reform.

Managerial accountability requires holding managers accountable for achieving results and making them responsible for implementing effective internal control systems; internal controls are not based on external mechanisms to the management processes but are embedded in the FMC system. However, a lack of

[1] As established in Article 3, paragraph 4 of Regulation (EU, Euratom) 883/2013, of the European Parliament and the Council, 11 September 2013, on the investigations by the European Office of Fight against Fraud (OLAF).

[2] Control that is internal to the government administration.

[3] Current Chapter 32, Chapter 28 of the *acquis* in the enlargement negotiations for the acceding countries in 2004 and 2007.

progress in implementing modern managerial accountability and FMC in the 2004 accession countries was observed, meaning the EC did not call for the abolishment of financial inspection and accepted its continuation as a second line of defence.

The view was that if the three pillars were well developed, there should be no need for a central *ex post* control such as financial inspection. Indeed, as mentioned above, controls would be embedded in the FMC system and internal audit would determine possible deficiencies regarding these controls. Moreover, the supreme audit institutions (SAIs) would carry out *ex post* financial, compliance and performance audits on the functioning of the FMC and internal audit system. However, this has not materialised in practice.

As the EC acknowledged that financial inspection would still have a role in the financial control environment of candidate countries and would continue to exist in these countries after 2005, the question arose of how financial inspection would have added value for the development of PIFC and would not hinder the development of internal audit and managerial accountability. As internal audit activities in candidate countries appeared in practice to be financial inspection activities, the EC required a clear delineation of roles and responsibilities between the financial inspection and internal audit functions. After presenting its initial views on a set of basic principles for financial inspection in 2011[4] (Annex II), SIGMA has regularly supported EU candidate countries and potential candidates in establishing and developing a financial inspection function in line with these principles.

Once the PIFC concept was introduced in the enlargement negotiations, SIGMA supported the further development of PIFC-compliant financial inspection in several EU candidate countries and potential candidates, assessing the state of affairs of PIFC several times against SIGMA's Principles of public administration[5]. In this context, SIGMA decided to update the 2011 Basics of Financial Inspection on the basis of its experience and on what could realistically be implemented in EU candidate countries and potential candidates.

Management and control, internal audit and financial inspection

PIFC is preventive in nature, aiming at ensuring that managers in public entities execute their budgets in an effective and compliant manner to achieve their objectives. The responsibilities of managers include the obligation to establish systems that impede as much as possible the occurrence of corruption and fraud, but this role does not usually include investigating instances of possible financial irregularity and fraud.

To implement this type of activity, some countries have established a financial inspection function, designed as an *ex post* function focusing on the legality and regularity of individual operations. In administrations where internal audit is not fully developed, this function complements the responsibility of senior managers and ensures that individual cases of mismanagement and negligence are dealt with promptly and effectively.

Where both internal audit and financial inspection exist, the PIFC system should ensure that the functions complement each other. This means that differences in objectives, methodologies and characteristics of each should be respected to guarantee their complementarity, that the roles should be clearly defined and understood, including by senior management and by the institutions responsible for each of the functions, and that, if there is a shift of their roles, it should not be an immediate change but a gradual transition between the two.

[4] Basics of Financial Inspection, presented in the Second Regional Conference on Public Internal Financial Control, held on 21-23 September 2011.

[5] SIGMA prepared Baseline Measurement Reports in 2015 and Monitoring Reports in 2016, 2017, 2019 and 2021, in all EU candidate countries and potential candidates (with the exception of Bosnia and Herzegovina in 2019 and Türkiye in 2021). https://www.sigmaweb.org/publications/monitoring-reports.htm

In a PIFC-compliant system, financial inspection is an *ex post* function that focuses on individual cases that have taken place and where specific suspicion of wrongdoing is identified or reported. The main objective is to investigate irregularities and fraud, with the final aim to correct and sanction. It is not to actively seek cases to investigate. Internal audit is also an *ex post* activity, but looks to the future, the main objective being to support management to improve the organisation, providing independent assurance that its risk management, governance and internal control processes are operating effectively.

Regarding the organisation of both functions, financial inspection is always a centralised function, placed within and reporting to the ministry of finance, while internal audit in many countries (including all EU candidate countries and potential candidates) is decentralised in each institution, reporting to the head of the organisation.

Financial inspection examines and investigates specific financial transactions, from the point of view of their regularity and can have the power to impose sanctions as a result of its investigations. The purpose of internal audit is to assess the organisation as a whole, including systems and all types of operations and transactions; it also checks compliance, but the focus is good management and good governance in the organisation. Sanctions cannot be imposed in view of the results of the audits.

Finally, internal audit is a proactive function and its methodology is based on risk assessment for the purpose of planning. Financial inspection is generally a reactive activity, although procedures and tools for establishing investigative priorities in order to manage the workload can be used in order to focus on significant cases.

Table 1. Comparison between the financial inspection and the internal audit function

	FINANCIAL INSPECTION	**INTERNAL AUDIT**
Objective	Investigate and assess irregularities and fraud	Providing for independent assurance that an organisation's risk management, governance and internal control processes are operating effectively.
Final aim	*Ex post* activity, looking at the past. Final aim is to correct	*Ex post* activity, looking at the future. Final aim is to support management to improve the organisation
Checks	Compliance	Good governance
Organisation	• Outside the organisation (MoF) • Centralised	• Inside the organisation • Decentralised
Characteristics	Generally reactive	Proactive
Focus on	• Individual cases • Specific financial transactions	• Systems (assessment, recommendations for improvement) • All operations and transactions
Planning	Procedures and methodologies for better targeted and more efficient use of resources on investigation priorities	Risk assessment for planning
Reporting	Reports to a central organisation	Reports to the head of the organisation

Sanctioning powers	Yes, prescribe corrective actions and possibly administrative sanction	No sanctioning powers

The financial inspection function in EU candidate countries

In order to support administrations in the transition to a fully functioning PIFC system, SIGMA reviewed the implementation of the 2011 Basics of Financial Inspection in EU candidate countries and compared it with the situation in EU Member States that acceded the EU after 2004. The aim was to update these principles on the basis of SIGMA's experience and on what could realistically be implemented in EU candidate countries and potential candidates, as well as to draft these Guidelines. This section provides a summary of the results of the review. More detailed results are included in Annex I of this document.

In practice, most of the requirements of the 2011 Basics are met by the administrations reviewed. However, some important requirements that influence the relationship between financial inspection with internal audit are not fully complied with.

a) The scope of financial inspection and implicitly the nature of the results of financial inspection, i.e. 'the *ex post* control function of financial inspection should check cases of serious mismanagement, suspected professional misconduct irregularities, suspicions of fraud and corruption' is not complied with. This implies that the traditional way of inspecting is still common practice.
b) There are still administrations with decentralised financial inspection.
c) It is not clear if all administrations have procedures and methodologies for selecting cases for financial inspection.
d) It is not guaranteed that the relevant public authorities take action on the results of the financial inspection.
e) Co-operation with functional national and international partners is not well-developed.

The main conclusion is, therefore, that financial inspection often overlaps with internal audit and does not necessarily support the development of managerial accountability.

Often, financial inspection does not just focus on cases of serious mismanagement, suspected professional misconduct, irregularities or suspicions of fraud and corruption. The traditional way of inspecting is still common practice, and financial inspection also investigates cases of weaknesses in FMC systems, which should be the managers' responsibility; these weaknesses should be primarily uncovered in the first instance by the monitoring function of senior managers (and reported in their statements of internal control) or sub-ordinated units.

Financial inspections have been oriented traditionally towards compliance or transaction/operations, but are now refocusing on riskier areas. Financial inspection has in the past played an important role in monitoring the proper use of budgetary funds; however, with the development of internal audit, there is a significant trend towards reviewing and modernising the financial inspection function.

The traditional way of inspecting is thus limiting the role of managers in establishing systems to prevent and detect this type of case. Any interference with the development of managerial accountability should be avoided; financial inspection cannot replace the responsibility of managers to ensure that their organisation operates at all times within the law to deliver services efficiently and effectively, establishing systems and mechanisms that limit the risks and reduce the occurrence of irregularities and fraud. It is the responsibility of management to establish preventive control measures such as the implementation of procedures that limit the possibility of irregularities, fraud and corruption to a minimum, or the early detection of cases of irregularities, fraud and corruption, and to make sure that cases of mismanagement are dealt with promptly and effectively.

In the framework of their monitoring role, senior managers could decide, depending on the seriousness of the misuse or abuse, to refer it to the appropriate authorities for action (including financial inspection) as soon as evidence emerges that this has indeed occurred.

There should also be a clear separation between financial inspection and internal audit. There can be overlaps when there is not a distinct separation and a clear definition of roles and responsibilities. Managers are not always aware of the main purpose of internal audit and therefore can regard it as another form of financial inspection. Findings that are mainly procedural should normally be reported by internal auditors, and not be investigated by the financial inspection institution.

As mentioned previously, managers should have a primary role in detecting weaknesses in FMC systems and procedures and in taking the necessary measures to correct or avoid future errors. On the next line of defence, internal audit should also have a prominent role here, when assessing internal control in the audited entities. If financial inspection is focusing on the weaknesses of FMC processes, the full development of the internal audit function is being hampered.

As regards organisation of financial inspection, in some countries it is not a centralised function of the ministry of finance but has delegated or regional offices, competing with internal audit and creating a risk that there is a lack of focus on serious mismanagement issues.

Finally, financial inspection should be carried out in co-operation with managers and with internal audit. The cases investigated can provide additional information for risk management and for internal audit risk assessment. As mentioned before, serious cases detected in the framework of management and internal control processes, as well as findings of internal audit, can be referred to financial inspection for further investigation. The obligations of public officials towards investigative bodies are legally regulated in candidate countries, but co-operation between financial inspection, management and internal audit is not well developed and national legislation does not require it.

Guidelines for financial inspection

Financial inspection is an *ex post* control function. In practice the powers, mandate, scope and tasks of financial inspection functions in EU candidate countries and potential candidates where financial inspection is operational[6] differ.

These Guidelines are intended to establish a series of principles generally applicable to financial inspection. They take into account the legislation of the countries reviewed for this paper (see Annex I) and what could realistically be implemented in EU candidate countries and potential candidates.

The way in which the Guidelines are implemented will depend on the local regulatory framework for administrative investigations.

1. The *ex post* control function of financial inspection should only check cases of serious mismanagement, suspected professional misconduct, irregularities[7], suspicions of fraud[8] and corruption[9]

The financial inspection function should include dealing with cases of serious mismanagement and suspected professional misconduct, irregularities, suspicions of fraud and corruption in institutions covered or funded by the state budget, including private beneficiaries of grants and subventions. In principle, the financial inspection function itself should not search for these cases but investigate identified cases brought to the attention of the financial inspection by other stakeholders in the financial system. As a rule, financial inspection should be less concerned with minor, local cases, which should be dealt with by the managers of the entities themselves, with the support of their own management and control systems.

The terms of reference for each specific inspection should be approved by the head of the financial inspection to ensure that the inspection stays within the recommended scope.

[6] Albania, Bosnia and Herzegovina, Kosovo[*], Montenegro, the Republic of North Macedonia, Serbia and Türkiye.

[*] This designation is without prejudice to positions on status, and is in line with United Nations Security Council Resolution 1244/99 and the Advisory Opinion of the International Court of Justice on Kosovo's declaration of independence.

[7] The definition of the term irregularity corresponds to national legislation when it affects national funds, but it generally refers to non-compliance or misapplication of laws and regulations, arising to the actions or omissions of an institution, which has or could have a detrimental effect on budget funds and funds from other sources. In the EU legislation, an irregularity constitutes any infringement of regulatory and/or contractual provisions as defined in article 1, paragraph 2 of the C regulation on the protection of the Communities' financial interests (2988/95).

[8] Fraud includes any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means, Association Of Certified Fraud Examiners.

[9] Corruption is the abuse of entrusted power for private gain, Transparency International.

2. Financial inspection should only check compliance with laws, regulations, rules and national and international agreements

Financial inspection should check the regularity of public sector activities, i.e. adherence to formal criteria such as relevant laws, regulations, rules and agreements and not on the propriety, i.e. observance of the general principles governing sound financial management. Financial inspection is an *ex post* check with a focus on the correction of past irregularities and mismanagement to ensure legality and regularity, it does not focus on making recommendations for the future to support management, this is a function of internal audit. Assessing propriety is an internal audit related activity rather than a financial inspection related activity[10].

In general, financial inspection should check the legality of transactions related to budget, accounting and assets and liabilities. All documentation related to the inspections should be checked at the premises of the inspected entity. This should be the minimum position. However, the scope of the financial inspection could be broader, the powers of the financial inspection function could also include:

- cross checks of transactions in the books of the third parties that are involved in the transactions or received grants and subventions.
- the obligation of commercial banks to submit information on bank accounts to the financial inspectors.

The need to extend the powers of financial inspection institutions will depend on the set-up and powers of law enforcement institutions (e.g., existence of Economic Police) or other administration services (e.g., fiscal investigation services).

3. Financial inspection should cover the entire state budget

Public sector is a broad concept. Financial inspection institutions should have the mandate to follow the correct use of the state budget in all public institutions, including

- state budget/municipal budget/regional budgets, including EU funds
- state-owned and municipal enterprises
- commercial companies with at least 50% of ownership by state or municipality
- entities funded by state-owned and municipal enterprises and commercial companies
- guarantees by state or municipality
- aid programmes of state/municipality/state-owned and municipal enterprises.

The authority to inspect (*ex post*) the awarding and implementation of public procurement of EU contracts and grants until the final beneficiary could be added with a view to the future accession of the EU candidate countries and potential candidates.

4. Financial inspection should be a reactive control activity

The financial inspection should only work on the basis of complaints and alerts of mismanagement, suspected professional misconduct, irregularities, alerts or suspicion, of fraud and corruption. Appropriate

[10] Compliance auditing by supreme audit institutions includes both aspects, regularity and/ or propriety (ISSAI 4000, clause 24).

channels and procedures should be in place for the submission of requests and should allow for an immediate reaction of the financial inspection. Examples of entities that can submit requests for financial inspection are:

- the head of state
- the prime minister’s office
- the council of ministers
- the minister of finance or particular structural units of the ministry of finance
- state authorities (including ministries), natural persons and legal entities
- internal audit units
- the public procurement agency
- the supreme audit institution
- the prosecutor's office
- AFCOS
- EU institutions, EC services and the European Anti-fraud Office (OLAF)
- employees in the public or private sector (‘whistle-blowers’)
- informants (anonymous individuals or otherwise) highlighting irregularities such as elements of financial mismanagement, suspected fraud, theft, destruction of property, abuse of power or corruption.

5. Financial inspection should be a centralised, professional control function

Financial inspection should be a centralised function which guarantees better objective, impartial and professional results than a de-centralised financial inspection function.

The financial inspection function can be located within the ministry of finance or prime minister’s office. Financial inspection activities are closely related to the mandate and tasks of the ministry of finance. However, the location of the financial inspection function in the ministry of finance has the disadvantage that serious suspicions of mismanagement by top officials of the ministry could be hard to investigate by the financial inspection institution, because the head of the financial inspection institution may be overruled by their superiors within the ministry of finance.

Another option is to locate the financial inspection institution in the prime minister’s office, where the financial inspection function would have more power. The disadvantage of this option is that the financial inspection function would not have a close connection with ministry of finance institutions. A third option is to locate the financial inspection function in the ministry of finance, but that it should report to the prime minister or to the council of ministers, thus reinforcing its independence and ensuring the possibility to investigate top officials of the ministry of finance while keeping the advantage of the connection to the ministry.

The financial inspection function should have a legal basis that regulates, for example, the degree of functional independence, powers, competences and procedures for operating and reporting.

A critical mass of professional and especially legal expertise is essential and should be guaranteed by training or possibly licensing. External experts from private and public entities could be contracted, if needed.

6. Financial inspections should use tools to prioritise subjects for inspection

As the mandate of financial inspection is broad and in general the resources of financial inspection functions are too limited to meet all requests for inspections, financial inspection institutions should prioritise requests for inspections on the basis of the risks and the amounts at stake. These risks should be recorded in a database to be developed by the financial inspection institution and should focus on suspected cases of serious mismanagement or negligence by officials of institutions funded by the state budget.

Resources should be applied effectively and not overlap with internal audit, the SAI or prosecutors' work. In any event, financial inspection should be cautious in inspecting suspicions of fraud and corruption. Law enforcement institutions should be contacted at an early stage of the inspection in order to avoid making procedural mistakes, which could lead to the case being declared inadmissible by the court.

7. Financial inspectors should have unlimited access to premises and documentation of the inspected entity

Financial inspectors should have unlimited access to premises and documentation of the inspected entities. In the event, financial inspectors do not have access, the financial inspection regulations should define that access will be guaranteed by executive management (e.g., via the minister of the interior) or the individual responsible and/or the management of the inspected entity shall be personally held liable, or the entity have its budget cut.

8. Financial inspection should have the possibility to hold wrongdoers liable administratively

The financial inspection should be authorised to hold inspected entities accountable for violating laws and regulations but may only impose administrative penalties. It should not have law enforcement powers or authority. The financial inspection institution should have several instruments available. Depending on the nature of the violation, the financial inspection institution may request the correction of irregularities or that the loss be refunded.

The financial inspection institution should request that the inspected entity and/or the entity to which the inspected entity is subordinated take (remedial) action, but should not have powers to force the inspected entities to do so, as this is a management responsibility.

In the event that the management of the inspected entity does not co-operate with the financial inspectors or does not follow up on the request of the financial inspection institution to take action, the financial inspection institution may start a misdemeanour procedure, which includes the possibility of appealing, either against the entity or the responsible official. In the event of suspicion of a criminal offence, the financial inspection institution should contact the prosecutor's office.

9. Financial inspection should report to the entity inspected and to the institution responsible for that entity

Inspected entities should have the opportunity to comment on draft financial inspection reports, which include proposals for eliminating violations of laws and regulations and, if appropriate, proposals for disciplinary measures to be taken against those violating laws and regulations[11]. The head of the financial inspection institution should be responsible for dealing with the comments on the financial inspection reports, but they should inform their superior (e.g., the minister of finance) of the results of the financial inspection.

Reports should be sent to the head of the entity inspected. In the event the financial inspection report concerns violations of laws or regulations by the head of the inspected entity, the draft financial inspection report should be submitted to the head of the entity to which the inspected entity is subordinated. This principle should equally apply to higher echelons. If the head of the main entity or other senior official is involved in the financial inspection, the financial inspection institution should report to the minister; if the minister is involved, the financial inspection institution should report to the prime minister.

The financial inspection drafts and publishes an annual report with data on the results of the financial inspections. To increase the impact of financial inspection work, the annual report of the financial inspection institution should be discussed at government level, preferably together with the CHU, which is responsible for reporting on the development of PIFC. Based on this reporting, the government should define an action plan. To foster transparency of financial inspection activities, summaries of the individual financial inspection reports (anonymised) and the annual report should be published on the financial inspection website.

10. Financial inspection should routinely follow up on requests to address violations of laws or regulations

Financial inspection institutions should follow up on their requests to address violations of laws or regulations. Inspected entities should report to the financial inspection institutions on the measures taken to eliminate violations. The financial inspection institutions should set up and maintain a database with different categories of findings, which could be used for defining the risk-based programming of requests for financial inspection, as well as the follow-up activities; these should include checking if the management of inspected entities and higher echelons carried out remedial actions correctly and if cases reported to prosecutors' offices led to prosecutions or convictions.

11. Financial inspection should co-operate with functional national and international partners

Financial inspection should not work in isolation. Both the audit and financial inspection functions can mutually benefit from each other. As mentioned above, the audit and financial inspection functions are complementary. The internal audit institution could signal to the financial inspection institution violations of laws and regulations or mismanagement, which are worth investigating in further detail. Where internal audit stops, the financial inspection could start its work. The results of financial inspections could be a source for the risk-analysis of audit institutions.

Public procurement institutions with a legal mandate for administrative control or investigation could also provide input to financial inspection institutions, reporting cases of legal non-compliance or mismanagement.

Law enforcement institutions are also important for financial inspection. Financial inspection institutions should be professionally equipped to identify criminal offences and to assist law enforcement institutions

[11] In some countries the draft findings are called 'minutes' or 'acts'. In this discussion paper, 'draft financial inspection report' had the same meaning as 'minutes' or 'acts'.

in successfully prosecuting wrongdoers. Professional working relations between law enforcement bodies and financial inspection should be regulated in a memorandum of understanding.

In relation to irregularities with EU funds, the AFCOS should be the contact point for financial inspection. The financial inspection institutions should report any irregularities found that relate to the spending of EU fund to the AFCOS.

With a view to the future accession of the EU candidate countries and potential candidates to the EU, the financial inspection institutions should closely co-operate with the EU fund management of the country, the EC and the European Court of Auditors. However, the financial inspection institutions can only be of help to those EU institutions if they have the authority to inspect EU funding to the final beneficiary, which could be a citizen.

Last, but not least, the SAI is also important. The results of financial inspection could be a source for the risk-analysis of the SAI. A memorandum of understanding between the SAI and the financial inspection institution may strengthen the relationship.

Financial inspection should neither overlap with internal audit, nor hinder its development

The roles of financial inspection and internal audit should be clearly defined in a way that ensures there are no overlaps in the activities of both functions and that the internal audit function can be fully developed. Financial inspection should not investigate weaknesses in FMC systems; these should be analysed by internal audit in the framework of their analysis of the internal control systems or when auditing governance in the organisation. Financial inspection should not analyse organisations as a whole, but check specific operations or budget transactions, with objectives such as:

- verify that budgetary funds are used legally, purposefully and in a timely way,
- verify if legislation is applied appropriately, directly, or indirectly,
- *ex post* financial inspection on budget transactions or accounting operations,
- *ex post* financial inspection for checking the regularity of transactions.

The financial inspection should not make recommendations on good management or governance or propose improvements in the organisations. This is the role of internal audit. The financial inspection should only propose measures to correct or eliminate violations of laws and regulations, and to repair damage.

The financial inspection should not have delegated or regional offices; this would create a risk of lack of focus on serious mismanagement issues and financial inspection activities could potentially intrude on the competences of internal audit.

Finally, the financial inspection institution should co-operate with the internal audit institution by contributing information that may inform the risk assessment carried out by the internal audit institution.

Annex I. Results of the review of existing financial inspections in EU candidate countries

Introduction

This annex is intended to serve as background information for the Guidelines for PIFC Compliant Financial Inspection. It follows the structure of the Guidelines.

For the preparation of the Guidelines, SIGMA analysed the legislation on financial inspection in a group of seven countries, including both EU Member States and EU candidate countries[12]. Information on countries that became EU Member States in 2004, 2007 and 2011 was included in the review for reasons of comparison but was not cross-checked with the countries reviewed[13].

Regarding EU candidate countries, Albania, Bosnia and Herzegovina, Montenegro, the Republic of North Macedonia, Serbia and Türkiye have established financial inspection functions. The potential candidate Kosovo does not have a financial inspection function.

This Annex is also based on SIGMA experiences in EU candidate countries and in Member States that acceded the EU in 2004, 2007 and 2011, and what could realistically be implemented in EU candidate countries and potential candidates.

The result of a SIGMA peer review on the development of PIFC in the then candidate country Bulgaria in 2005 showed the need for a realistic approach towards the development of PIFC. Internal audit was introduced in the Ministry of Finance of Bulgaria, but it was centralised and part of the Financial Inspection Agency. This Agency had 1200 staff, mainly financial inspectors. Introducing decentralised internal audit would have meant an extensive process and would not have functioned according to international standards overnight. Therefore, the EC recognised that financial inspection was still needed as long as internal audit was not well established and developed. The financial inspection function in Bulgaria still exists and has around 200 staff.

The Bulgarian experience and that of Portugal showed that an ‘instant change’ was not possible as may have been assumed. The Portuguese experience demonstrated that managing the change from financial inspection to internal audit needed much more attention than expected. Clear definitions of roles and responsibilities of both the financial inspection and internal audit functions were essential. Portugal had to prepare a programme to redirect the financial inspection function, which focused on how to move from a single financial inspection function to an environment with financial inspection and internal audit functions.

[12] Albania, Bulgaria, Croatia, Hungary, the Republic of North Macedonia, Serbia, Slovenia.

[13] With the exception of Slovenia, SIGMA received response on a draft version of the Guidelines and annex from the Director of the Budget Supervision Department.

Awareness raising among managers was needed too: senior and line managers regarded internal audit as another form of financial inspection.

Results of the analysis regarding the application of the principles included in the Guidelines

1. *The ex post control function of financial inspection should only check cases of serious mismanagement, suspected professional misconduct, irregularities, suspicions of fraud and corruption.*

Guideline 1 is not observed in practice. None of the reviewed administrations focuses only on cases of serious mismanagement, suspected professional misconduct irregularities and suspicions of fraud and corruption. SIGMA experience was that cases investigated by financial inspection are in fact cases of weaknesses in FMC, which in the first instance should be uncovered by the monitoring function of ministries or sub-ordinated units and internal audit.

Examples of FMC weaknesses are issues such as an excess of borrowing to fund unauthorised investment or to finance unauthorised current expenditure, guarantees beyond the level that has been authorised by the ministry of finance, or misuse of central funds intended to support central government policies and in practice used for local purposes. Funds not being spent in accordance with the budget indicates a failure of the treasury control system rather than an indication that a more in-depth investigation is required. If the head of a budget user submits a statement of internal control annually and the CHU of the ministry of finance feels that such a certificate has been improperly given because there is evidence of significant financial management weaknesses, only then should the CHU refer this to the budget supervision directorate, which should undertake an investigation.

Findings on violations of the public procurement acts can be mainly procedural, for example not tendering when required, not observing terms for publication of notices or late reporting on the appointment of the members of the award commission. These issues should normally be reported by internal auditors. Other examples of violations are not applying a 10% salary reduction, recruitment of staff in face of embargo, or expenditures of a municipal hospital disregarding rules on salaries and business trips.

In summary, evidence of deliberate misuse or abuse of funds should come initially from the monitoring processes and the appropriate ministry should then decide whether or not the misuse or abuse was that serious that it should be referred to the financial inspection for further investigation.

In addition to previous possible areas of misuse of funds, irregular procurement arrangements could occur leading to waste of resources or even fraudulent or corrupt behaviour. The process of procedural appeal over procurement depends on local public procurement legislation. The question that arises is whether a contractor should have the possibility to raise the issue directly with the budget supervision department or only indirectly following an appeal to either the public organisation concerned or the line ministry with overall responsibility for a particular category of public organisations. From the accountability perspective, the indirect process would be more appropriate.

2. *Financial inspection should only check compliance with laws, regulations, rules and national and international agreements.*

Legal provisions on financial inspection in the reviewed administrations show a wide range of tasks but observe the objective of guideline number 2, i.e. to check compliance with laws, regulations, rules and national and international agreements. The tasks concentrate on checking budget transactions, with objectives such as:

- verify budgetary funds are used legally, purposefully and in a timely way as determined in the budget,

- verify if legislation is applied appropriately, directly or indirectly,
- *ex post* financial inspection on budget transactions or accounting operations
- *ex post* financial inspection for checking regularity of transactions and other FMC activities.

However, most countries also include provisions for proposing corrective measures to be taken such as actions to stop irregularities/establishing violations and indicators of fraud and the identification of measures to repair damage. Other tasks mentioned are:

- detecting fraud and irregularities affecting EU financial interest (1 country),
- discovering damages to property of entities within mandate (3 countries),
- *ex post* financial inspection on awarding and implementation of procurement contracts (2 countries),
- in the event of violations against law: proposals to return funds or to eliminate irregularities, start misdemeanour procedures or inform prosecutors office (5 countries),
- AFCOS function (1 country).

3. *Financial inspection should cover the entire state budget*

The mandate of financial inspection institutions of the reviewed countries differs. However, financial inspection laws and rulebooks have in common that the mandate covers the institutions and programmes mentioned in guideline 3. It is not clear if public-private partnerships and concessions are included in these mandates; they are not explicitly mentioned in legislation.

The financial inspection functions of all reviewed countries are entitled to inspect state budget, local government budget; funds allocated to legal entities and state-owned and local-owned enterprises; and guarantees given to state, regional and local governments. Most countries are also mandated to inspect extra-budgetary funds; commercial companies with blocking quota in capital; aid programmes to state and local entities and state and local-owned enterprises; and property liability. Three countries are allowed to inspect regional government budget and two EU Member States to inspect funds submitted to civil persons.

4. *Financial inspection should be a reactive control activity*

The reviewed candidate countries observe guideline 4 and work on the basis of complaints and signals coming from sources mentioned in the Guidelines. The reviewed 2004 EU Member States, however, still work on the basis of a programme.

5. *Financial inspection should be a centralised, professional control function*

Guideline 5 is partly observed. The financial inspection function in the reviewed countries is centralised in the ministry of finance except for one candidate country and one Member State: there are regional offices although those offices are steered and supervised by the main financial inspection department in the ministry of finance. The decentralisation of the financial inspection function has the risk for lack of objectivity, impartiality and non-professional results and lack of focus on serious mismanagement issues.

One candidate country requires that financial inspectors have a license. The financial inspection law of another candidate country opens the possibility to engaging public administration employees or external experts in the cases of lack of human resources and lack of specialities for covering specific areas of financial inspection.

The number of financial inspection staff in the Western Balkan candidate countries is small, varying from 6 to 20 staff members.

6. Financial inspections should use tools to prioritise subjects for inspection

In practice, only one EU Member State and one candidate country of the reviewed countries uses a risk-based approach for selecting subjects for inspection; the financial inspection laws of the other reviewed countries refer to a methodology to be developed in secondary legislation.

7. Financial inspectors should have unlimited access to premises and documentation of the inspected entity

Guideline 7 is fully observed. All financial inspection institutions reviewed have unlimited access to premises and documentation of the inspected entities. In one Member State financial inspection also has powers to ensure access to premises and documentation for the EC if this access is denied to representatives of the EC when visiting an institution.

8. Financial inspection should have the possibility to hold wrongdoers liable administratively

In practice, guideline 8 is fully observed. The financial inspection legislation of the reviewed countries includes misdemeanour provisions; the amounts related to these provisions, however, are relatively low.

Suspicions of criminal offences are reported to the public prosecutor's office, but in two candidate countries, financial inspection can initiate a criminal justice procedure. In most countries financial inspection can start a misdemeanour procedure; one EU Member State even informs the regional tax office when starting this procedure. In the event of violations against laws and regulations, financial inspection in most countries proposes to return funds or to eliminate irregularities or to block accounts (one candidate country). When the inspected entities do not react on the proposed actions to be taken, financial inspection can impose sanctions, which vary from blocking budget or bank accounts to imposing penalties or suspending funds.

9. Financial inspection should report to the entity inspected and to the institution responsible for that entity

In practice, guideline 9 is partly observed. Financial inspection legislation of the reviewed countries regulates that draft reports have to be sent to the inspected entity, to the higher level and to the MoF or prime minister's office. In one EU Member State the draft financial inspection reports are also sent to the internal audit department, state treasury and SAI. Annual reports are sent to the state and local governments for information.

However, the government does not define an action plan in any of the countries. The financial inspection institutions in only three countries send the annual report to the parliament. All countries inform citizens on the activities by means of the ministry of finance website, but it is not clear if all of them publish the individual financial inspection reports and annual reports[14].

10. Financial inspection should routinely follow up on requests to address violations of laws or regulations

Guideline 10 is partially complied with in practical terms. The reviewed countries carry out follow-up activities although the intensity depends on the resources available. In one candidate country, inspectors have the right to be informed by the competent court about the decisions adopted in relation to the measures taken based on the inspection activities.

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[14] The English version of the websites has mostly brief information. The financial inspection institutions of Bulgaria and Serbia publish quarterly annual reports on their websites.

11. Financial inspection should co-operate with functional national and international partners.

Guideline 11 is not observed. None of the laws of the reviewed countries have clauses on co-operation with internal audit. Only one EU Member State has specific clauses in its financial inspection law on co-operation with law enforcement bodies and the SAI. In one candidate country, AFCOS is part of the financial inspection function.

Annex II. Basics of financial inspection[15]

1. Financial inspection should be subordinated to the ministry of finance.
2. Financial inspection should cover the whole public sector.
3. Financial inspection should have the power to follow funds into the private sector.
4. Financial inspection should only be concerned with compliance.
5. Financial inspection should only focus on potential risks of fraud, corruption or major financial abuse (such as the bankruptcy of a municipality).
6. The action should be determined by complaints about activities where those complaints suggest possible fraud, corruption or major financial mismanagement.
7. Requests for financial inspection should be addressed to the minister of finance, who should decide whether to carry out a financial inspection.
8. Financial inspection should only investigate to the point where prosecutors should take over in potential cases of fraud or corruption.
9. Financial inspection reports should be submitted to the minister of finance for final decision about action.
10. Financial inspection may propose penalties and should make recommendations for system improvements (including to internal audit).
11. Financial inspection should ideally have an intelligence data base with actual and major risks.

[15] As presented at the Second Regional Conference on Public Internal Financial Control, held by SIGMA on 21-23 September 2011.

The SIGMA Programme

SIGMA (Support for Improvement in Governance and Management) is a joint initiative of the OECD and the European Union (EU), principally financed by the EU. SIGMA has been working with partner countries on strengthening public governance systems and public administration capacities since 1992.
In partnership with the European Commission (EC) Directorate-General for Neighbourhood and Enlargement Negotiations (DG NEAR), we currently work with:

- Albania, Bosnia and Herzegovina, Kosovo*, the Republic of Moldova, Montenegro, the Republic of North Macedonia, Serbia, Türkiye and Ukraine as EU candidate countries and potential candidates; and
- Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Jordan, Lebanon, Morocco, Palestinian Authority[1] and Tunisia as EU Neighbourhood countries.

SIGMA provides assistance in six key areas:

1. strategic framework of public administration reform
2. policy development and co-ordination
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SIGMA reviews and gives feedback on:

- governance systems and institutions
- legal frameworks
- reform strategies and action plans
- progress in reform implementation.

SIGMA provides:

- advice on the design and prioritisation of reforms
- methodologies and tools to support implementation
- recommendations for improving laws and administrative arrangements
- opportunities to share good practice from a wide range of countries, including regional events
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* This designation is without prejudice to positions on status, and is in line with United Nations Security Council Resolution 1244/99 and the Advisory Opinion of the International Court of Justice on Kosovo's declaration of independence.

[1] Footnote by the European External Action Service and the European Commission: this designation shall not be construed as recognition of a State of Palestine and is without prejudice to the individual positions of the European Union Member States on this issue.