

DRAFT

REPUBLIC OF BULGARIA
MINISTRY OF FINANCE

POLICY PAPER¹
ON
PUBLIC INTERNAL FINANCIAL CONTROL
IN THE
REPUBLIC OF BULGARIA

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¹ Update of the PIFC Policy Paper as of 19 September 2002

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LIST OF ABBREVIATIONS

| | | | |
|--------------|---|-------|---|
| PIFC | Public Internal Financial Control | NF | National Fund |
| FMC | Financial Management and Control | IA | Internal Audit |
| CHU | Central Harmonisation Unit | NAO | National Audit Office |
| FM/C systems | Financial Management and Control Systems | MoF | Ministry of Finance |
| EC | European Commission | DIA | Delegated Internal Auditor |
| EU | European Union | FMCA | Financial Management and Control Act |
| PIFC Act | Public Internal Financial Control Act | IAAPS | Internal Audit Act in the Public Sector |
| PIFCA | Public Internal Financial Control Agency | PFIA | Public Financial Inspection Act |
| RIPIFC Act | Regulation on the Implementation of Public Internal Financial Control Act | NSSI | National Social Security Institute |
| CFCU | Central Financing and Contracting Unit | NHIF | National Health Insurance Fund |

1. EXECUTIVE SUMMARY

In the process of its extension the European Union adopted the principles for sound financial management of the public funds, regardless if they come from an internal or international financing. It has been recommended these principles also to be laid down in the legislation of the member states and the candidates for accession. In compliance with the undertaken commitments in the negotiation process, the Republic of Bulgaria adopted and aims at establishing a comprehensive system for public internal financial control and completely applying the achievements of *acquis* in the field of financial control. The necessity has been realized for undertaking new initiatives and actions for observing the commitments under Chapter 28 “Financial Control”, the proposals of DG Budget of the European Commission, the recommendations of the SIGMA Final Report dated from 26 April 2005, as well as the requirements for the Extended Decentralized Implementation System (EDIS) for accreditation in order the sound financial management of the public funds of the Republic of Bulgaria to be guaranteed. In this regard actions for updating the Policy Paper on the Public Internal Financial Control as of 2002 have been undertaken.

The current updated Policy Paper describes the status of the PIFC system and the control environment in the Republic of Bulgaria and further develops the Strategy for the Development of PIFC, adopted by a decision of the Council of Minister on 16 June 2005. It has been elaborated on the basis of the SIGMA independent assessment of the Peer Review May/June 2004 and it is in compliance with the recommendations given in the Final Report as of 26 May 2005, as well as with the recommendations of DG Budget of the European Commission for the future development of PIFC.

There are three major directions, in which the PIFC model in the Republic of Bulgaria has to be developed:

- Strengthening the financial management and control by a normative regulation of the managerial accountability in the public sector.

- Establishing an independent internal audit in the organizations spending public funds, which shall provide an objective assessment on the FM/C Systems and give recommendations for their improvement.
- Establishing a Central Harmonisation Unit to the Minister of Finance, this shall coordinate and harmonize the FM/C Systems and the internal audit in the public sector.

In order to fulfill these requirements, the Bulgarian government took the initiative to make legislative amendments, elaborating and submitting to the National Assembly of the Republic of Bulgaria for adoption three new drafts of acts:

1. Financial Management and Control Act
2. Internal Audit Act in the Public Sector
3. Public Financial Inspection Act.

By the means of the new acts the functions shall be clarified and the responsibilities of the managers of the organizations in the public sector, of the internal auditors and of the state financial inspectors, shall be differentiated, aiming to improve the control environment and to achieve sound financial management of the public funds in the Republic of Bulgaria as well as of the EU funds.

The Republic of Bulgaria has good traditions in the field of control. When the Public Internal Financial Control Act entered into force on 1 January 2001, the foundation of the managerial accountability and of the internal audit was laid in the Republic of Bulgaria. The Act imposed a centralized model of PIFC and defined a leading role of the PIFC Agency in this area. In 2002 the Council on PIFC was established, that took the responsibility for the control and coordination of all measures connected with PIFC. After the closure of Chapter 28 “Financial Control” in 2002, considerable amendments occurred in the field of financial management, control and internal audit in an international aspect as well as in the European Union, which led to major changes in the management of the organizations in the public sector. The managing team, responsible for PIFC in the Republic of Bulgaria, went through a graduating development of the

vision regarding the PIFC elements, provoked by the continuous dialogue with DG Budget of the European Commission and with SIGMA. The new drafts of regulations on the Structural and Cohesion Funds and the resulting from those changes in the financial management and control also provoked the reconsideration of the approach regarding the PIFC system.

Owing to the changes, the priority tasks of the Bulgarian government and in particular of the Minister of Finance are the following:

1. Adoption of the drafts of the Financial Management and Control Act, of the Internal Audit Act in the Public Sector and of the Financial Inspection Act by the National Assembly and their entering into force as of 1 January 2006.
2. Establishment and endorsement of a strong Central Harmonisation Unit to the Minister of Finance with two directions – financial management and control and internal audit. The undertaking of the coordination and harmonization of internal control and internal audit in the public sector by the newly formed “Internal Control” Directorate at the Ministry of Finance and strengthening its administrative capacity.
3. A wide popularization of the new acts and training of the managers from the public sector in the field of managerial accountability, internal control and internal audit.
4. Transferring to the Minister of Finance the direct responsibility for internal audit functions by separating the internal audit from the Public Internal Financial Control Agency, which shall keep the financial inspection functions.
5. Decentralizing internal audit on the basis of a phased programme beginning with selected pilot organisations. The defined pilot organisations are the Ministry of Regional Development and Public Works, the Ministry of Labour and Social Policy, the Ministry of Transport and Communication, the Ministry of Environment and Water, the Road Executive Agency.
6. Establishment of favorable conditions for the introduction of the decentralized internal audit, after the Internal Audit Act in the Public Sector enters into force, by the means of establishing internal audit units and the appointment of heads of internal audit and internal auditors at the organizations in the public sector, using the administrative capacity of internal auditors of the PIFC Agency.

7. Taking effective measures to transform the Public Internal Financial Control Agency into a Public Financial Inspection Agency as well as assessing its potential role as an independent Winding-Up Body for certifying projects/programmes, financed by the Structural and Cohesion Funds.

8. Defining the Audit Authority under Art. 61 of the draft of the Regulation on the General Provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund as of 14 July 2004 (COM (2004) 492 final).

9. Reporting quarterly to the Council of Ministers and annually to the Parliament on the processes related to the changes in PIFC.

The elaboration and introduction of the changes in the PIFC system need the significant assistance and coordination between the organisations and the teams responsible for that.

The key participants in that process will be:

- The managers of the organizations in the public sector – they are responsible for the internal control as they establish adequate financial management and control systems and monitor their effective functioning in the organization. They have to give example for morality, belonging and to contribute to the favorable control environment in the organizations, which they manage.
- The internal auditors – they play an important role for the assessment of the financial management and control systems while contributing to the maintenance of their effectiveness in a satisfactory degree.
- The remaining members of the staff – the internal control creates responsibility for the whole staff and this has to be thoroughly recorded in the job description of each employee. They are resources of information, which is used by the internal control system, or perform duties necessary for the control execution.
- The Minister of Finance – as a responsible person for the establishment and organization of the comprehensive financial management and control systems as well as for the development and implementation of the internal audit in the public sector. For the implementation of these tasks the Minister of Finance is supported by the CHU/IA and the CHU/FMC.

The reform of the PFC system will help the managers of the organizations in the public sector. They are given opportunity to develop adequate and effective systems for financial management and control, providing reasonable assurance for the achievement of the objectives of the organization. Their managing accountability will be strengthened. The internal auditors have to support the managers of the organizations in the process of identifying, assessing and managing risks, which threaten the achievement of objectives, to assess the FM/C systems adequacy and effectiveness and to give recommendations for the improvement of the organizations' activities. The public financial inspection shall be a guarantee for the legitimate and transparent spending of the public funds

The implementation of measures and the coordination of activities will continue to be performed by the steering group formed with the Strategy for the Development of PIFC. The group, in which the deputy Ministers of Finance are members, shall coordinate the activities for the accomplishment of priorities and measures of the Policy Paper and shall harmonize its decisions with the Council on Public Internal Financial Control.

Fulfilling the outlined measures, the Republic of Bulgaria shall create conditions for obtaining a positive evaluation by the European Commission, for a duly access to the Structural and Cohesion Funds and for achieving sound financial management of the public funds.

The positive assessment of the reform started in the PIFC system from the EU Annual report for 2005, Chapter 28 "Financial control" is recognition for the efforts made by the Ministry of Finance.

To make "...continuous efforts to ensure the relevance of the new legal framework to the reforms in this sector, notably the separation between financial inspection and internal audit, the decentralisation of internal audit, and the operational capacity of the Internal Control Directorate in the Ministry of Finance responsible for harmonisation of Financial Management and Control as well as Internal Audit throughout the public sector" is still a priority for Bulgaria. In this relation are the measures given under point 7 of the Policy Paper on PIFC in the Republic of Bulgaria.

2. INTRODUCTION

The present document is an updated version of the Policy Paper on Public Internal Financial Control in the Republic of Bulgaria, adopted by the Council of Minister on 19 September 2002. It completes the Strategy for the Development of PIFC in the Republic of Bulgaria adopted by the Council of Minister on 16 June 2005.

The purpose of this document is to define the framework of the contemporary, adequate and effective system on PIFC, including the financial management and control, internal audit, central coordination and harmonization and the public financial inspection as well as to cooperate for sound financial management of the public funds in the Republic of Bulgaria.

The definition for the PIFC system and its main elements are stipulated below in Chapter 3. The current PIFC status in the Republic of Bulgaria is described in Chapter 4. The gap analysis and the weaknesses in the PIFC system established by the European Commission are reflected in Chapter 5. The recommendations regarding the PIFC system, including the recommendations from the Regular Report for 2004 of the EC, are indicated in Chapter 6. The proposals for improving the existing PIFC system and the action plan are described in Chapter 7. The conclusions of the Policy Paper are set in Chapter 8.

The PIFC principles, described in the present Policy Paper, are applicable to the Bulgarian as well as to the European funds and are based on the internationally agreed standards for internal control and audit and on the good European practices. They will be laid down in the Financial Management and Control Act, the Internal Audit Act in the Public Sector as well as in the Public Financial Inspection Act, which replace the current Public Internal Financial Control Act. The new legislation shall lead to structural changes both in the Ministry of Finance and the PIFC Agency, as well as in all organizations in the public sector, where internal audit units are to be established.

All important and essential recommendations, given to the Republic of Bulgaria in the preparation process for its accession to the EU from 2002 to September 2005, have been

reflected in the updated Policy Paper on PIFC. The requirements under Chapter 28 “Financial control”, the proposals of DG Budget of the European Commission, the recommendations from the Regular Reports of the EC, the SIGMA Final Report as of 26 April 2005, the EDIS requirements for accreditation, the requirement for financial management and control standards as well as for sound management of the public funds in the Republic of Bulgaria, are complied and reflected in the elaboration of this document.

The Minister of Finance is responsible for the elaboration and coordination of the updated Policy Paper on PIFC. The initial version of the document has been prepared by a group at expert level and after that it was widely considered and discussed.

3. PIFC FRAMEWORK

The Public Internal Financial Control is the comprehensive system for control, performed by the government or by delegated organizations in order to guarantee that the sound financial management and control of the organizations, spending public funds, observe the principles for sound financial management.

PIFC is an aggregation of three main elements: the financial management and control systems /the managerial accountability/, independent internal audit and central harmonization unit to the Minister of Finance.

3.1. FINANCIAL MANAGEMENT AND CONTROL

The expressions FMC, FM/C Systems, internal control, control systems are used as synonyms. The FMC is a comprehensive process that is integrated in the activities of the organization, and performed by the management and staff. This process aims at reaching reasonable assurance that the objectives of the organization are achieved by:

- a) Compliance with the acts, secondary legislation and internal acts and contracts;
- b) Reliability and comprehensiveness of the financial and operational information;
- c) Effectiveness and efficiency of operations;

- d) Safeguarding of the assets and information.

The financial management and control in the organizations from the public sector is performed by:

- a) Establishing an efficient and effective control environment;
- b) Risk management;
- c) Implementation of proper control activities;
- d) Management of information and communication;
- e) Provision of supervision on the control activities of the organizations in the public sector and provision of a system for their improvement.

The managerial accountability is the obligation of the managers of the organizations from the public sector to observe and apply the principles of sound financial management and legitimacy in the management of the public funds.

The ex-ante financial control is a set of control activities, necessary for the managerial decision taking, related to the proper budgeting and spending of the budget funds with the public procurement, contacts and etc.

The ex-post financial control checks whether the statutory provisions are completely applied, it checks the proper spending of funds /by financial inspectors/ in compliance with the requirements of the normative acts.

Certification – regarding the funds received under the pre-accession program of the EU, an audit is performed for: provision of a certificate /certification/ of the annual accounts of the relevant program/project; elaboration of an annual audit report on the adequacy of the management and the control systems of the spenders as well as a check for the availability and correctness of the co-financing amounts on behalf of the Republic of Bulgaria.

3.2. INTERNAL AUDIT

The internal audit is an independent and objective activity for providing assurance and consulting activity, designed to add value and improve the organisation's operations. The internal audit shall assist the organisation to achieve its goals through the implementation of systematic and disciplinary approach for assessment and improvement the effectiveness of the processes of risk management, control and management.

The difference between the internal audit and FMC shall be clearly defined and comprehensible. FMC is a responsibility of the management. The internal audit shall make an objective assessment and shall report to the management of the organization for the adequacy and the effectiveness of FMC in the organization and shall provide recommendations for its improvement.

3.3. CENTRAL HARMONISATION UNIT ON FMC AND CENTRAL HARMONISATION UNIT ON IA

The purpose of such units is to assist the Minister of Finance in introducing and ensuring the effective financial management and control and independent internal audit in the public sector, including the adherence to the good European practices and audit standards.

The Harmonization units are responsible for the elaboration of clear standards and frames for the implementation of FMC and internal audit in the public sector. The units shall support the qualitative development of the internal control and popularize its qualities through seminars, conferences, working groups and etc. These units shall make on the spot checks whether the internal control and audit standards are observed without any deviations.

The strengthening of the CHU/FMC and the CHU/IA shall lead to the improvement of the efficiency of the PIFC systems.

4. DESCRIPTION OF THE CONTROL ENVIRONMENT IN THE REPUBLIC OF BULGARIA

4.1. THE NATIONAL ASSEMBLY AND THE NATIONAL AUDIT OFFICE

The National Assembly is responsible for the democratic control of the policies of the Government and, in the context of this Policy Paper, of how the Government performs sound financial management of the public funds. The National Assembly through the NAO, as an independent Supreme Audit Institution, receives an external assessment of whether the public sector organisations have established adequate financial management and control systems. The NAO is a constitutional audit body and functions independently from the executive, legislative and judicial power. The NAO performs audits (external in relation to the government systems) and reports on its findings and recommendations to the National Assembly for further discussions.

The NAO Act is based on internationally agreed audit principles and regulates the NAO powers. The NAO performs audits of all budgets in the state sector: the state budget, the budget of the National Social Security Institute, the budget of the National Health Insurance Fund and the municipal budgets. The NAO activity covers also the EU funds and programmes, including also their management up to the final beneficiaries. The NAO performs audits on the use of the budget and other state funds in respect of the principles of legitimacy, effectiveness, efficiency and economy in terms of the external control. The EU considers, that with the starting and the implementation of the new NAO Act, the activities of the NAO are in compliance with the external audit requirements, included in the accession criteria.

In relation to the comprehensive monitoring of the PIFCA system, the EC recommends a peer review of the activity of the NAO.

4.2. THE GOVERNMENT AND ITS STRUCTURES

The Organic Budget Law regulates the establishment, adoption, implementation and reporting of the state budget, for which the Ministry of Finance is responsible. The spenders of budget appropriations are defined by the Council of Ministers. According to

the PIFC Act they bear full responsibility for the establishment, maintenance and functioning of sound FM/C Systems. The state budget defines and allocates funds for the implementation of public functions and policy decisions in compliance with the principles of legitimacy, regularity, expedience, economy and transparency.

The Government determines the criteria for the functioning and the reliability of the public internal financial control systems within the framework of the budget on national and lower level. The Government has chosen an internal financial control system in which the responsibility for financial management and control in spending the budget funds rests with the budget spenders. In short, the spender of budget appropriations is responsible for sound financial management.

The ex-ante control is also a responsibility and function of the spender/manager and is performed by a financial controller or a person responsible for the function on ex-ante control. The managers of the organisations have the obligation to ensure the implementation of the ex-ante control function in their subordinate spenders and structures.

The PIFC Agency performs centralised internal audit. In order to perform effectively the internal audit activity, the PIFC Agency has delegated internal auditors in all bigger budget spenders under the republican and local budgets. Numerous methods and manuals with the purpose of assisting and harmonizing the internal audit activity have been developed.

The internal auditor shall assess independently the state of play of the FM/C Systems being established by the manager of the organisation, shall report directly his/her findings to that manager and shall provide him/her with recommendations, which have to be followed up in order to improve the effectiveness of the FM/C Systems.

4.2.1. The Ministry of Finance

4.2.1.1. “Internal Control” Directorate

In the implementation of the Strategy for development of the PIFC in the Republic of Bulgaria as of 16 June 2005, the Minister of Finance has made a proposal for

amendments of the Regulations on the structure of the Ministry of Finance and the PIFC Agency. With a Decree № 198 as of 12 September 2005 of the Council of Ministers of the Republic of Bulgaria an “Internal Audit” Directorate has been established as of 1 September 2005 within the structure of the Ministry of Finance. The main functions of the newly established Directorate are as follows:

- To develop and popularize strategies and methodologies, to coordinate and harmonize the implementation of the Bulgarian legislation in the area of internal control as regards the financial management and control and the internal audit;
- To elaborate, update and improve the methodology by issuing regulations, instructions, guidelines, standards, manuals and standard working documents in the control area;
- To monitor systematically and to assess the effectiveness of the implementation of the internal control;
- To coordinate the establishment of professional skills in the area of internal control;
- To elaborate a consolidated annual report for the state of the internal control in the public sector in the Republic of Bulgaria, which is presented by the Minister of Finance to the Council of Ministers;
- To perform its activities through the implementation of different functions for financial management and control and internal audit, which are performed jointly and with a view to their specificity;
- To establish and maintain good relations with the NAO;
- To report for its activities directly to the Minister of Finance.

The newly established Directorate shall be strengthened as a Central Harmonisation Unit. It shall undertake all the functions on harmonisation of the financial management and control and internal audit, performed so far respectively by the “Methodology of the budget control” Department – acting as CHU/FMC and by the “Harmonisation and methodology of the audit activity” Directorate of the PIFC Agency – acting as CHU/IA.

4.2.1.2. “Treasury” System

The Minister of Finance performs the functions of a State Treasury through management and control of the implementation of the consolidated fiscal programme by the means of the Single Account System.

A State Treasurer is appointed at the Ministry of Finance, who manages, coordinates and controls the functioning and the management activity of the State Treasury as: coordinating the fulfilment of the functions of the Ministry on the implementation of the state budget; executing control for the implementation of the assigned tasks.

The organisation, monitoring and analysis of the current implementation of the state budget accepted by the National Assembly is performed by a “State Treasury” Directorate at the Ministry, which is responsible also for the elaboration of unified budget classification, chart of accounts, accounting standards and guidelines for accountability on cash and accrual basis for the budget enterprises, as well as the principles, procedures and rules of functioning of the Single Account System and the System for electronic budget payments (SEBRA), as well as the bank servicing of the budget enterprises;

A detailed description of the Bulgarian “Treasury” system is made in Annex 2.

In implementation of the SIGMA recommendations from the Peer Review with the amendments in the Regulation on the Structure of the Ministry of Finance /in force as of 06 February 2004/ a “Methodology of the Budget Control” Department has been created at the “State Treasury” Directorate performing the function of Central Harmonisation Unit on financial management and control in the period as of February 2004 to 1 September 2005.

A Draft Concept for further development of the financial management and control is elaborated as a key element for establishment of internal control in the organisations of the public sector in Republic of Bulgaria for the period 2005-2008. The Concept is submitted to the Council of Ministers for information, to the report of the Minister of Finance, on the basis of which the Strategy for development of the PIFC is adopted.

4.2.1.3. The Public Internal Financial Control Agency - described in details in item 4.3.

4.2.1.4. Customs Control Authorities

The Customs control is exercised by the Customs administration organised in the Customs Agency under the Minister of Finance. Its principle tasks are: performing customs supervision and control over import, export and transit of goods for, from and through the Republic of Bulgaria; collection of customs duties; prevention and discovery of customs and currency infringements and crimes and of illicit traffic of narcotic substances and precursors; exposing administrative infringements and imposing administrative penalties; applying tariff measures and trade policy measures; executing of ex-post control over goods and documents in connection with import, export and transit.

4.2.1.5. Tax Control Authorities

The status and functions of the Tax Administration are regulated in Art 231 of the Tax Procedure Code (TPC).

According to the Law of the National Revenue Agency (promulgated, SG, №112 as of 29 November 2002, amended, № 114 as of 30 December 2003) a National Revenue Agency is created as a specialised public authority under the Minister of Finance for establishing, ensuring and collecting public receivables. The main functions and powers of the Agency are as follows: serving the taxpayers; providing for the printing and free of charge dissemination of tax and other declarations, containing guidelines for their filling; establishing public receivables for taxes and statutory social security contributions on the grounds and amount; securing and collecting by force the public receivables; keeping register of the tax subjects; establishing administrative infringements and imposing administrative penalties according to the tax laws, as well as according to the laws, regulating the statutory social security contributions; collecting the voluntary payments of the public receivables and etc.

4.2.1.6. Control of the National Fund, the Central Financing and Contracting Unit, Implementing Agencies

The National Fund is established at the Ministry of Finance as a Central Treasury Authority, responsible for the management of funds under the EU programmes. The Central Financing and Contracting Unit and a limited number of Implementing Agencies /PHARE, ISPA and SAPARD/ are also established in 1998.

The National Fund is a key structure in the overall co-ordination of the EU funding. It is responsible for the project formulation, grant applications, opening of bank accounts, ensuring the flow of EU funds, national co-financing, fund transfers to the Implementing Agencies, monitoring, assessment and financial control, including SAPARD Agency.

The National Fund guarantees and ensures transparency and economic effectiveness of the management of the funds provided by the EU. The NF is under the responsibility of the National Authorising Officer, who provides for the overall financial management and reporting for the use of funds. The NF manages also the national co-financing funds for joint EU-Bulgarian projects and programmes. The funds, managed by the NF are fully incorporated in the consolidated fiscal programme of the Government.

The National Fund is subject to both external audit, performed by the NAO and to internal audit performed by the PIFC Agency. Auditors/controllers nominated by the European Commission are also entitled to check the activities of the NF, the CFCU and the Implementing Agencies.

The actual management of projects, (co-) financed by the EU is carried out by the Implementing Agencies for PHARE, ISPA and SAPARD. The Implementing Agencies are managed by a Programme Authorising Officer (under Phare) or Sector Authorising Officer (under ISPA) who are responsible for the proper financial, administrative and technical management of the projects, including the conduct of tendering and contracting procedures as well as for the monitoring of projects implementation. The progress towards the Extended Decentralised Implementation System (EDIS) of funds management aims at giving to the Implementing Agencies more responsibilities related to the financial management and control.

4.2.2. Public Fund Control Authorities

4.2.2.1. Control Authorities of the National Social Security Institute

The Control authorities of the NSSI execute control (inspections and financial checks) both on the revenue and expenditure of the state social insurance, on the revenue from the supplementary mandatory pension insurance and the health insurance. Thus, they discover losses, which may be caused by non-payment of insurance contributions or by improperly made expenditure. The authorities concerned work in accordance with the Plan for Improvement the Insurance Contribution of the NSSI.

Joint checks are performed also in accordance with an Agreement for joint activities between NSSI, the Ministry of Labour and Social Policy, the Employment Agency, the General Labour Inspection Implementation Agency and the Police National Service Directorate. Information exchange also takes place. The PIFCA and the NAO perform control over the activities of NSSI and its Regional Offices.

4.2.2.2. Control of the National Health Insurance Fund

The control over the health insurance activities is regulated in Section X “Control, Expertise and Disputes” of the Health Insurance Act.

The financial control under 73a under the Health Insurance Act over the revenues of the National Health Insurance Fund from the health-insurance payments and the outstanding interests is performed by the control authorities of the State Social Security Institute under the terms of the Social Insurance Code.

Officials from the Regional Health Insurance Fund – financial inspectors and doctors-controllers, perform the direct control over the expenditure for health insurance. They shall check the accounting documents of the medical care performers and the legitimacy of the incurred expenditure.

The PIFC Agency checks the disbursement of budget funds and observing the procedures under the Public Procurement Law.

The National Audit Office performs the control over the budget execution of the National Health Insurance Fund.

4.2.3. Control over the Activities of the Municipalities

The financial activities of the municipalities shall be also included into the scope of the PIFC Agency. The Agency regularly gathers information through system-based audit, analyses the implementation of the guidelines and elaborates recommendations, based on the findings in the audit reports. In 2005, into the 70 highest budget-spending municipalities, teams of internal auditors were delegated, who apart from the performance of internal audit in the municipalities, monitor also the functioning of the FM/C Systems. The audit in the other municipalities shall be performed by auditors on specific financial control tasks in compliance with the annual plan for the audit activities of the PIFC Agency.

The risk areas in the municipalities have been defined on the basis of analysis of the previous audits' results. A special attention is paid on the of acquiring, managing and accounting of municipal property, the revenues from privatised municipal trade companies and their transfer to funds and accounts, disbursement of aid grants and the recovery of the unused funds, legitimate collection and disbursement of funds under the extra budgetary funds and accounts, meeting the requirements of the Public Procurement Law and the unpaid expenses.

The municipalities are financed by their own resources and by state budget subsidies. With the Council of Ministers Decree N: 399 from 13 June 2002, a Concept and a Programme for financial decentralisation was accepted. The increase of the financial independence of the municipalities is implemented with the amendments of the Law on the Local Self-governance and Local Administration, Law on Municipal Budgets, Law on the Local Taxes and Charges, Law on the Corporate Revenues Taxation, Law on the Municipal Property and the adoption of the Law on Municipal Debt /in force as of 1 June 2005/

The financial independence of the municipalities will be further strengthened with the development of local self-governance.

4.2.4. Inspectorate

According to the Law on the Administration, inspectorates have been established within the Ministries. The main task of the inspectorates is, via checks, to ensure the observing of the legislation and the internal acts in the course of performing the activities of the Ministries. The specific functions of the inspectorates are regulated with the Regulations on the Structure of the respective Ministries.

The control, performed by the inspectorates, is in a high degree overlapped with the control activities of the PIFC Agency.

4.3 DESCRIPTION OF THE CURRENT SITUATION OF THE PUBLIC INTERNAL FINANCIAL CONTROL AGENCY IN BULGARIA

The current situation of the PIFC Agency can be examined in the following aspects: legal framework in force, objectives, scope, internal audit, including audit over EU funds, as well as inspection/checks.

4.3.1. Legal framework in force

PIFC Act

The current Public Internal Financial Control Act was adopted by the National Assembly of the Republic of Bulgaria on 27 October 2000 and entered into force as of 1 January 2001. The PIFC Act was promulgated in the State Gazette N: 92 from 10 November 2000, entered into force as of 1 January 2001, supplemented N: 28 from 19 March 2002, amended and supplemented N: 101 from 29 October 2002, entered into force as of 1 January 2003, amended N: 31 from 4 April 2003. The main amendments entered into force as of 1 January 2003 and are related with the terms and procedures for performance of ex-ante control and introducing the financial controller as a person, performing the ex-ante control in the organisations stipulated by the Act.

Secondary PIFC legislation

The Regulation on the Implementation of the PIFC Act was adopted by the Council of Ministers on 5th April 2001. The Regulation on the Implementation was adopted by the Decree of the Council of Ministers N: 103 from 24 April 2001, promulgated State Gazette N: 44 from 8 May 2001, amended and supplemented N: 43 from 13 May 2005, amended N: 49 from 27 May 2003, entered into force as of 27 May 2003. It contains detailed provisions of the PIFC Act for the implementation of the public internal financial control.

Regulation on the Structure of the PIFC Agency

With Decree N: 14 as of 22 January 2004, the Council of Ministers adopted a new Regulation on the Structure of the PIFC Agency, following the necessity of considerable changes in the structure of the Agency and assigning new functions of its administrative units. A specialised Directorate for methodology and harmonisation of the audit activities has been established in performance of DG Budget's recommendation for the establishment of a similar unit. The current Department for control over the spenders of EU funds has been transformed into a Directorate. Thus, the PIFC Agency strengthened its administrative capacity for performing audit over funds under the EU pre-accession funds and programmes. The "Informational Technology and Communication" Directorate has been established, responsible for the development of the informational systems and communication within the PIFC Agency. The functions for the establishment of a favourable environment for training and increasing the qualification of the PIFC Agency's staff have been assigned to the "Human Recourses, Financial and Administrative-Legal Activities" Directorate. In order to optimise the activities of the PIFC Agency's Regional structures, the number of the Regional Directorates was reduced from 28 to 9.

Internal acts

In December 2002 the Director of the PIFC Agency approved the Code of Ethics and the Charter for the Internal Auditors of the PIFC Agency. In August 2003 the Director of the

PIFC Agency approved the Manual on Internal Audit. Under the “bridging” project, the SIGMA experts consulted the working group for elaboration of updated version of the Manual on Internal Audit that was presented in March 2005.

An Agreement for co-operation among the PIFC Agency, the National Audit Office and the newly established Public Procurement Agency in the field control over the public procurements was signed. The Agreement was signed at the beginning of 2005.

The “Harmonisation and Methodology of the Audit Activities” Directorate has elaborated the following unified methodology for the activities of the internal auditors within the system of the PIFC Agency: Manual for audit the activities on the human resources management; Methods for performing of checks over the procedures during the officers’ official trips; Methods for performing of financial-economic analysis of trade companies with state or municipal participation; Methodical guidelines for performing of control in the field of public procurement, during the checks under Art. 57, para 4 under the Public Procurement Law; Guidance of the newly appointed auditor, Risk management – guidance for the internal auditors, Methods for audit the activities of the inspectorates, Guidance for performance of specific checks of the municipal activities, made by the specialised units of the municipalities, as well as templates of working documents for specific audits, templates of an audit plan, audit report and etc. A questionnaire for self-assessment of the internal control has been elaborated and tested in the pilot ministries.

4.3.2. Scope of the PIFC Act

The Public Internal Financial Control, performed by the PIFC Agency, is in compliance with the PIFC Act and includes the financial activities of spenders of budget appropriations under republican budget and spenders of funds under EU programmes. It also includes the authorities, administering revenues in the state budget, spenders of extra-budgetary accounts and funds, according to the State Budget Law of the Republic of Bulgaria for the respective year; spenders of budget appropriations under the municipal budgets and funds; the State Social Security and the National Health Insurance Fund. The PIFC Agency also controls the financial activities of the legal entities with a blocking quota state or municipal equity in the capital, including when they are in

insolvency proceeding, as well as legal entities whose obligations have been guaranteed with state or municipal property.

The Public Internal Financial Control includes also the activities of the persons funded with funds under republican and municipal budgets, as well as under EU programmes.

On the ground of Art. 8, para 1, item 6 under the PIFC Act, the PIFC Agency provides guidance and recommendations to the spenders of budget appropriations for the establishment of the Financial Management and Control Systems. Performing the obligation of the PIFC Agency for unification of the matter on establishment and functioning of the Financial Management and Control Systems, the updated Guidelines N: 2 for the establishment and functioning of the Financial Management and Control Systems have been elaborated and approved by the Director of the PIFC Agency on 27 June 2003. They reflect the changes in the Financial Management and Control Systems, as a result of the amendments of the PIFC Act and the Regulation on the Implementation of the PIFC Act related to the introduction of the financial controllers for exercising the ex-ante control. The Guidelines have been elaborated and sent to the spenders prior to the transfer of the function on methodology and harmonisation of the Financial Management and Control Systems from the PIFC Agency to the Ministry of Finance.

In order to eliminate the conflict between the provision of Guidelines for the establishment and functioning of the Financial Management and Control Systems and the control over their implementation, in 2003 within the PIFC Agency a functional unit responsible for the guidelines, related to Financial Management and Control Systems, was established.

Following the SIGMA recommendation, the responsibility for provision of guidelines, related to the functioning of the Financial Management and Control Systems, was transferred to the “Methodology of the Budget Control” Department under the Ministry of Finance for the period from February 2004 till 1 September 2005.

4.3.3. Internal Audit

The internal audit in all Ministries, big municipalities and spenders of EU funds is performed by delegated internal auditors /DIA/ and in the other organisations – by auditors on specific financial control tasks, on the basis of an annual plan for the audit activities of the PIFC Agency. The delegated internal auditors perform their activities as functional units for internal audit and in compliance with the forthcoming legal changes they will be in the basis of the decentralised internal audit model.

The delegated internal auditors perform their activities on the basis of an order issued by the Director of the PIFC Agency, including the organisation, where the auditors have been delegated to perform their activities and the period for delegation. The specific audit engagements are defined in the annual plan for the activities of the delegated internal auditors, approved by the Director of the PIFC Agency. In 2005 180 internal auditors were delegated at 110 organisations.

The performance of specific audit engagements is made in compliance with the updated version of the Manual on Internal Audit, elaborated in compliance with the requirements of the International Internal Audit Standards.

The internal audit on specific financial-control tasks is performed on the basis of an order, issued by the Director of the PIFC Agency or an order, issued by the Director of the respective Regional Directorate of the PIFC Agency.

The internal auditors are civil servants and are subordinated to the Director of the PIFC Agency. In comparison with the organisations, which they audit, the internal auditors are functionally and organisationally independent.

Planning and reporting the activities of the PIFC Agency

The PIFC Agency performs its audit activities on the basis of an annual plan, approved by the Director of the PIFC Agency. The annual plan for the audit activities of the PIFC Agency is elaborated on the basis of criteria for assessment of the organisations, included within the scope of the PIFC Act and in compliance with the available resources –

number of internal auditors and number of working days. On the basis of risk assessment and provision of resources of each audit team, a respective annual planning of the audit activities of the delegated internal auditors and planning of each specific financial-control task shall be made.

The ad-hoc audits shall be made upon proposals made by the Council of Ministers and the Minister of Finance, as well as upon the judgement of the PIFC Agency.

At the end of each quarter period and every year, the Regional Directorate submits to the Central Office of the PIFC Agency analysis and reports on the activities, performed during the respective reporting period. The report shall be elaborated in compliance with the preliminary defined benchmarks. A base for the elaboration of the report is the information, gathered by the separate audits in the “Phoenix” information system.

The Agency presents an annual report on the results of its activities via the Minister of Finance to the Council of Ministers. The Agency summarises and reports to the European Commission the results of its activities, related to the EU funds.

4.3.4. Inspection/Checks

For the time being, within the PIFC Act, there is no differentiation between the functions on internal audit and the function for the establishment of administrative irregularities /inspections/. The internal auditors of the Agency simultaneously perform these two functions during the performance of internal audit. The mixture of these two functions will be solved after the adoption of two separated acts –Internal Audit Act in the Public Sector and Public Financial Inspection Act.

The PIFC Act contains provisions concerning the imposing of administrative measures. In cases of data, indicating commitment of crime, the Prosecutor’s Office shall be informed.

On the basis of the report, written guidelines for correcting the established irregularities shall be given, as well as proposals to the competent authorities to repeal illegal acts,

issued by the managers of the auditees and proposals for seeking property and disciplinary liability.

The deficit deed shall be drawn in cases of deliberately caused damages, provided in the Law and availability of prerequisites related to the occurring of property liability. This act shall be sent to the Court for giving its opinion concerning the property liability or shall be sent to the Prosecutor's Office in cases of data indicating commitment of crime.

In cases, when administrative irregularities have been established, an act shall be drawn up and procedures for imposing administrative penalties start.

4.3.5. Audit of Spenders under the European Union Funds

The PIFC Agency performs audit of the functional units related to the absorption of the European funds /PHARE, ISPA/.

ISPA Programme

The audit under ISPA Programme shall be performed by the delegated internal auditors to the Implementing Agency in the Road Executive Agency, Ministry of Regional Development and Public Works, Ministry of Transport and Communication and the Ministry of Environment and Water in compliance with the objectives and tasks, laid down in the annual plan under the ISPA Programme.

PHARE Programme

The audit under PHARE Programme shall be performed by the delegated internal auditors to the Implementing Agency under PHARE Programme at the Ministry of Regional Development and Public Works, Ministry Labour and Social Policy and the "Central Financing and Contracting Unit" Directorate at the Ministry of Finance.

Certification

On the basis of the Multi-Annual Financing Agreement, the Minister of Finance has determined the PIFC Agency as a certifying body for the annual accounts of the SAPARD Programmes. This activity of the PIFC Agency is in compliance with the

current PIFC Act. The PIFC Agency reports to the European Commission for the certifications performed.

5. GAP ANALYSIS IN THE PIFC SYSTEM IN THE REPUBLIC OF BULGARIA

In the framework of the Final Report /26 April 2005/ from the Second phase of the Peer Review, performed in May/June 2004, the SIGMA experts analyzed the current PIFC system in the light of the accession requirements, international standards and trends in the development of the PIFC. The SIGMA experts have provided a number of essential recommendations. In their assessment in the light of the specified trends, the Government has to cope with the following main gaps and challenges in the next two years:

1. The current initiatives for amendments and supplements of important laws, e.g. the Law on the Administration, Organic Budget Law and the PIFC Act do not introduce such regulation for managerial accountability. This concept has to take the key place in the frameworks of the harmonized legal regulation of the public administration. In this sense it shall be necessary to consider for introducing of two separate PIFC Laws, which should be implemented in the public sector; the first one – concerning the internal control that has to arrange different aspects of managerial accountability and the other one – concerning the internal audit.

2. The high level supervision is necessary and the Government has to decide whether the responsible for PIFC or other authority has to direct and supervise the development processes. The responsible for PIFC or other authority has to take the direct management for further development of the PIFC system. The framework established by the Commission of the Financing Organizations /COSO/ is useful for the establishment and conceptualization of the internal audit standards and it is necessary, the Government to examine this framework as an appropriate future tool for elaboration of an integrated control framework, which to be a part of the public governance.

3. It is possible to improve the transparency and reliability in the reporting of the state budget before the National Assembly. The information set in the annual reports, which shall be submit to the Commission on Budget and Finance, has to be discussed.

4. The National Assembly has to undertake more active position at addressing actual questions and asking to the Minister of Finance on issues related to the PIFC policy.

5. In order to improve the reporting on behalf of the Government before the National Assembly the opportunity for introducing annual statement regarding the quality and activity of PIFC should be consider. The Minister of Finance on behalf of the Government, separately and in addition to the Financial Report should submit such statement. For facilitating the task of the Minister of Finance, it is necessary to think about the elaboration of annual reports for the management, which to express the assurance that the spenders have introduced effective systems for control and supervision. In this relation, it is necessary to underline the responsible role and functions of the respective positions in the Act.

6. Wide discussion among the professional environment, inside or outside of the PIFC system, of the opportunities for establishment and higher professionalism in the control and audit environment of the public administration could also contribute to the development of the PIFC in Bulgaria.

7. Together with the strengthening of the managerial accountability at the Central government level, the same consequences need to be reflected at the local administration as well. In this respect the possibility for cooperation with the National Association of Municipalities should be examined.

8. The Bulgarian administration lags behind the timetable for preparation of the managing of EU funds. The Implementing Agencies on pre-accession EU funds under ISPA and Phare programs still not fully meet the requirements under the Extended Decentralized Implementation system /EDIS/. For example some of the agencies have not elaborated guidelines and opportunities for follow- up audit yet. Except for the managing

of the pre-accession funds, there is a necessity of further development of structural and control requirements, which are necessary for the future Structural funds and Cohesion Fund to the time of accession.

9. One of the most important main participants for the successful implementation of the financial management and control in the public sector in Bulgaria is CHU on FMC, which has been a part of the “State Treasury” Directorate at the Ministry of Finance since February 2004. The Minister of Finance shall give permanent strong support to this direction and for this purpose it is necessary to consider the possibility for differentiation of its work at a separate Directorate.

10. In general, at the all levels and in all fields of the state and local management, the staff training in the PIFC area is and should be a high priority. In particular, the training of managers is necessary to guarantee that they fully understand the concept for managerial accountability and to give them the opportunity in positive way to approve it among officers, for whom it is needed. The training is also necessary for the elaboration of measures for risk management and implementation.

11. To guarantee that the activity of internal auditors fully suit the international agreed standards it will be necessary to ensure their present training.

6. RECOMMENDATIONS

6.1 RECOMMENDATIONS FROM THE COMMISSION 2004 REGULAR REPORT ON THE REPUBLIC OF BULGARIA'S PIFC SYSTEM

In the Regular Report is written: “Particular attention should be paid to ensuring the protection of the financial interests of the European Communities. The timely development of a national anti-fraud strategy and the strengthening of the council coordinating the fight against infringements affecting EC financial interests would go a long way to ensure that the current gaps in administrative capacity are filled. Further efforts are necessary to strengthening managerial accountability as well as to further strengthening the administrative capacity to implement sound financial control systems.”

The annual report says: “Further efforts are needed to guarantee the correspondence between the new legal framework and the reforms in this sector, namely the separation of financial inspection from the internal audit, the decentralization of the internal audit and the working capacity of the directorate “Internal control” at the Ministry of Finance, accountable for the harmonization of the FMC and for the internal audit in the entire public sector.

6.2. SIGMA RECOMMENDATIONS

The essential recommendations from the SIGMA Regular Report are the following:

- A new meaning of the existing concept for performing the internal audit by delegated auditors to be given and internal audit units in the structure of the organizations in the public sector to be established.
- As a result, the PIFC Agency has to be transformed into an Agency for Public Financial Inspection. It is important to introduce an administrative function on financial inspection, which to be horizontally entrusted to a control authority, having a high degree of independence from separate ministers, in the view of the fact that the Inspectorates, even in the light of their new increased responsibilities, report to the ministers.
- In accordance with the transformation of the PIFC Agency into an Agency for Public Financial Inspection, the CHU/Internal audit has to be transferred to the Minister of Finance and to be unified with CHU/FMC in one Directorate in order a strong, qualified coordination service with well-qualified experts to be established.
- At all levels in the administration a clear limit of vertically subordination between the internal audit /its scope includes all activities and processes in the organization/ and investigation /Public Financial Inspection and Inspectorate/ should be built.

- After the introduction of the internal audit to the spenders, the role of financial controller and inspectorate on managerial disposal has to be reevaluated for providing the most efficient performing of the necessary control and audit tasks. In this relation three alternatives are possible: bundling of the Inspectorate in the framework of internal audit; transformation of the Inspectorate in a functional direction, responsible for inspections on ministerial/managerial level, which to be subordinated to the management and to perform follow-up actions concerning administrative and financial violations, as well as removing the unnecessary, after the introduction of the managerial accountability, functions of financial controllers.
- Taking decisions for development of the PIFC system in Bulgaria should be the highest priority for the Bulgarian Government for introducing all necessary changes with a view to meet the EU requirements.

7. ACTION PLAN – PROPOSALS TO IMPROVE THE EXISTING PIFC SYSTEM

| PERFORMANCE MEASURES | Responsible institutions and implementation deadline |
|---|--|
| 1. The adoption of the Financial Management and Control Act, which shall regulate the managerial accountability and the framework of financial management and control on the basis of the COSO model. | Ministry of Finance, Council of Ministers, National Assembly Deadline 31.12.2005 |
| 2. The adoption of the Internal Audit Act in the Public Sector, which shall regulate the establishment of independent internal audit at the organizations in the public sector in accordance with the International Internal Audit Standards. | Ministry of Finance, Council of Ministers, National Assembly Deadline 31.12.2005 |

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| <p>3. The adoption of the Public Financial Inspection Act, which shall regulate the order and way for seeking the administrative penalty liability and property liability, when violations at the budget, financial-economy or accounting legislation have been established.</p> | <p>Ministry of Finance, Council of Ministers, National Assembly Deadline 31.12.2005</p> |
| <p>4. The undertaking of the coordination and harmonization of internal control and internal audit in the public sector by the newly formed “Internal Control” Directorate</p> <p>The establishment and endorsement of a strong Central Harmonization Unit with two directions – financial management and control and internal audit and strengthening its administrative capacity. The appointment of the Director of the Directorate with appropriate knowledge and experience in the area of contemporary control and audit.</p> | <p>Ministry of Finance Deadline 30.09.2005</p> |
| <p>5. A wide popularization of the new acts and training of the managers from the public sector in the field of managerial accountability, financial management and control and internal audit.</p> | <p>Ministry of Finance Deadline 30.04.2006</p> |
| <p>6. Transferring to the Minister of Finance the direct responsibility for internal audit functions in the public sector by separating the internal audit from the functions on the Public Internal Control Agency, which shall keep the financial inspection function.</p> | <p>Ministry of Finance PIFCA Deadline 30.04.2006</p> |

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|---|--|
| <p>7. Decentralizing internal audit on the basis of a phased programme beginning with selected pilot organisations. The defined pilot organisations are the Ministry of Regional Development and Public Works, the Ministry of Labour and Social Policy, the Ministry of Transport and Communication, the Ministry of Environment and Water, the Road Executive Agency</p> | <p style="text-align: center;">Ministry of Finance PIFCA Deadline 30.09.2005</p> |
| <p>8. The establishment of favorable conditions for the introduction of decentralized internal audit, after the Internal Audit Act in the Public Sector enters into force, by the means of establishing internal audit units and the appointment of heads of internal audit and internal auditors at the organizations in the public sector, using the administrative capacity of internal auditors of the PIFC Agency.</p> | <p style="text-align: center;">Ministry of Finance PIFCA Deadline 30.04.2005</p> |
| <p>9. Undertaking of effective measures to transform the Public Internal Financial Control Agency into a Public Financial Inspection Agency.</p> | <p style="text-align: center;">PIFCA After 01.01.2006</p> |
| <p>10. Defining the Audit Authority under Art. 61 of the draft of the Regulation on the General Provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund as of 14 July 2004 (COM (2004) 492 final).</p> | <p style="text-align: center;">Ministry of Finance Deadline 31.12.2005</p> |
| <p>11. Reporting quarterly to the Council of Ministers and annually to the Parliament on the processes related to the changes in Public Internal Financial Control.</p> | <p style="text-align: center;">Ministry of Finance</p> |

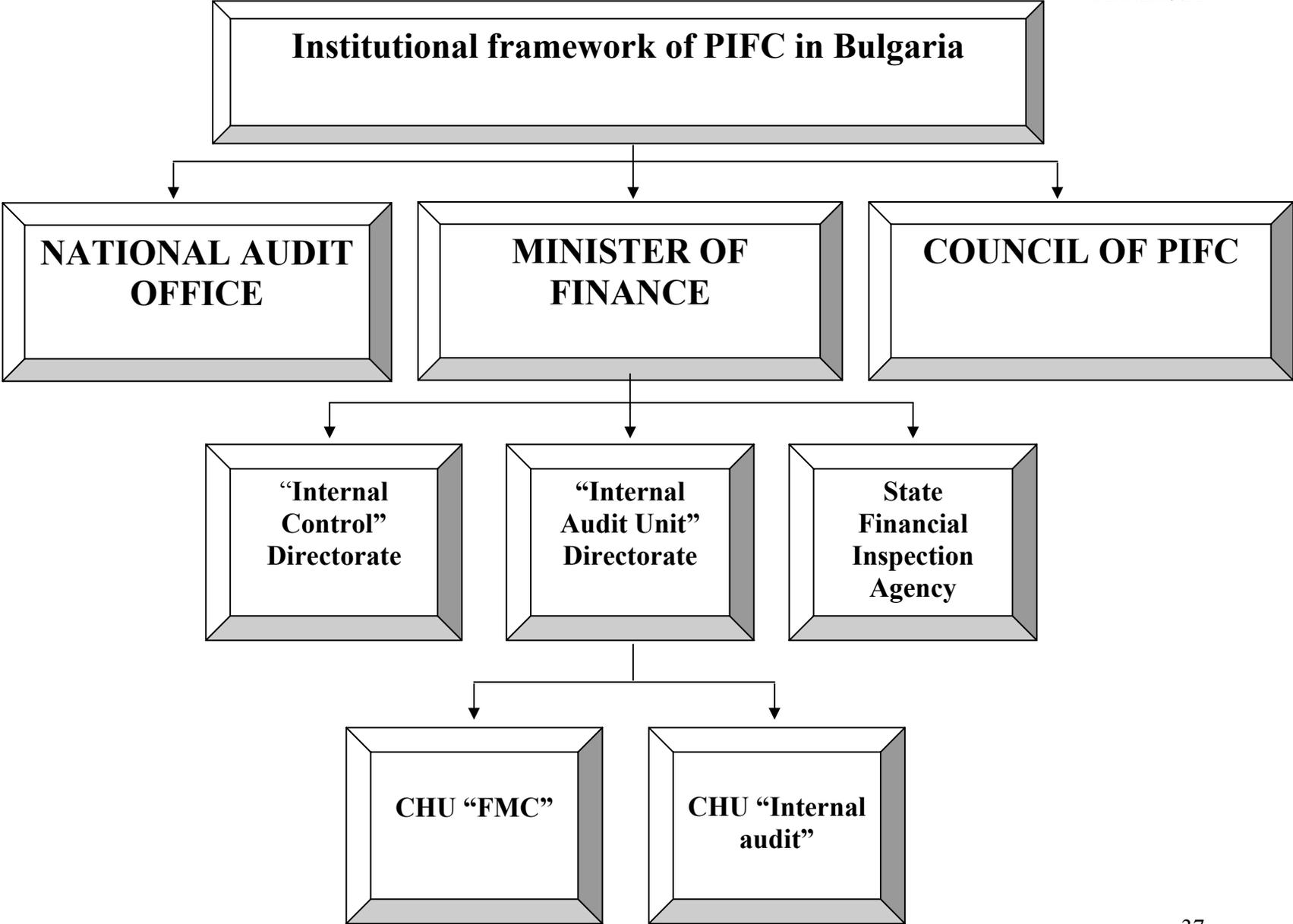
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| <p>12. Updating the structure of the Steering Group on Deputy Ministers' level, responsible for the performance of the changes, which shall coordinate all developments with the PIFC Council</p> | <p style="text-align: center;">Ministry of Finance</p> <p style="text-align: center;">Deadline 30.10.2005</p> |
| <p>13. As result of the PIFCA structural changes, proceeded from the change of the internal audit model /from centralized to decentralized/ in order to plan the reallocation of the financial resources from the budget of PIFCA to the budget organizations, as follows:</p> <p>a/ on the first level budget spenders under republican budget, where auditors from PIFCA will be transferred;</p> <p>b/ on municipalities budgets, where auditors from PIFCA will be transferred</p> | <p style="text-align: center;">Ministry of Finance</p> <p style="text-align: center;">Deadline 30.10.2005</p> |
| <p>14. To elaborate strategic and annual plan for the activity of the directorate "Internal control" at the Ministries of Finance.</p> | <p style="text-align: center;">Ministry of Finance</p> <p style="text-align: center;">Deadline 30.04.2006</p> |
| <p>15. To elaborate secondary legislation in the FMC and internal audit sphere after the adoption of PFMCA and PSIAA</p> | <p style="text-align: center;">Ministry of Finance</p> <p style="text-align: center;">Deadline 30.11.2006</p> |
| <p>16. To prepare analysis for the IT providence needed for the FMC and Internal Audit activities.</p> | <p style="text-align: center;">Ministry of Finance</p> <p style="text-align: center;">Deadline 31.05.2006</p> |

8. CONCLUSIONS

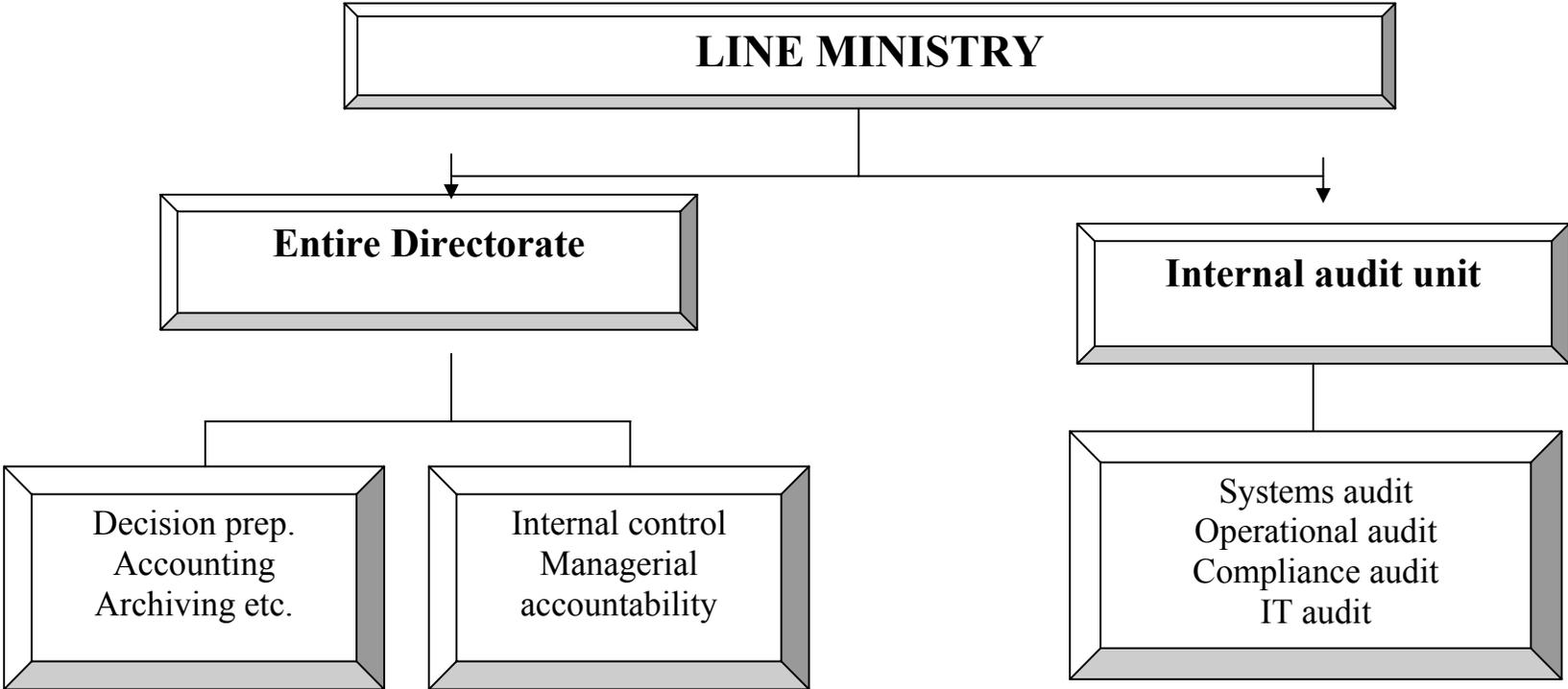
With the adoption and entering into force of the new laws - Financial Management and Control Act in the Public Sector, Internal Audit Act in the Public Sector and Public Financial Inspection Act, the principles for sound financial management of the public resources will be regulated and the control environment in the Republic of Bulgaria will be improved and the differentiation of the responsibilities of the managers of the organizations in the public sector, internal auditors and state financial inspectors will be achieved.

The fulfillment of the Action Plan in p.7 of the Document has an exceptional importance for achieving the strong and adequate management and control system and internal audit in accordance with the International Standards and the best European practices. This fulfillment is obligatory for the Republic of Bulgaria in order to be guaranteed that:

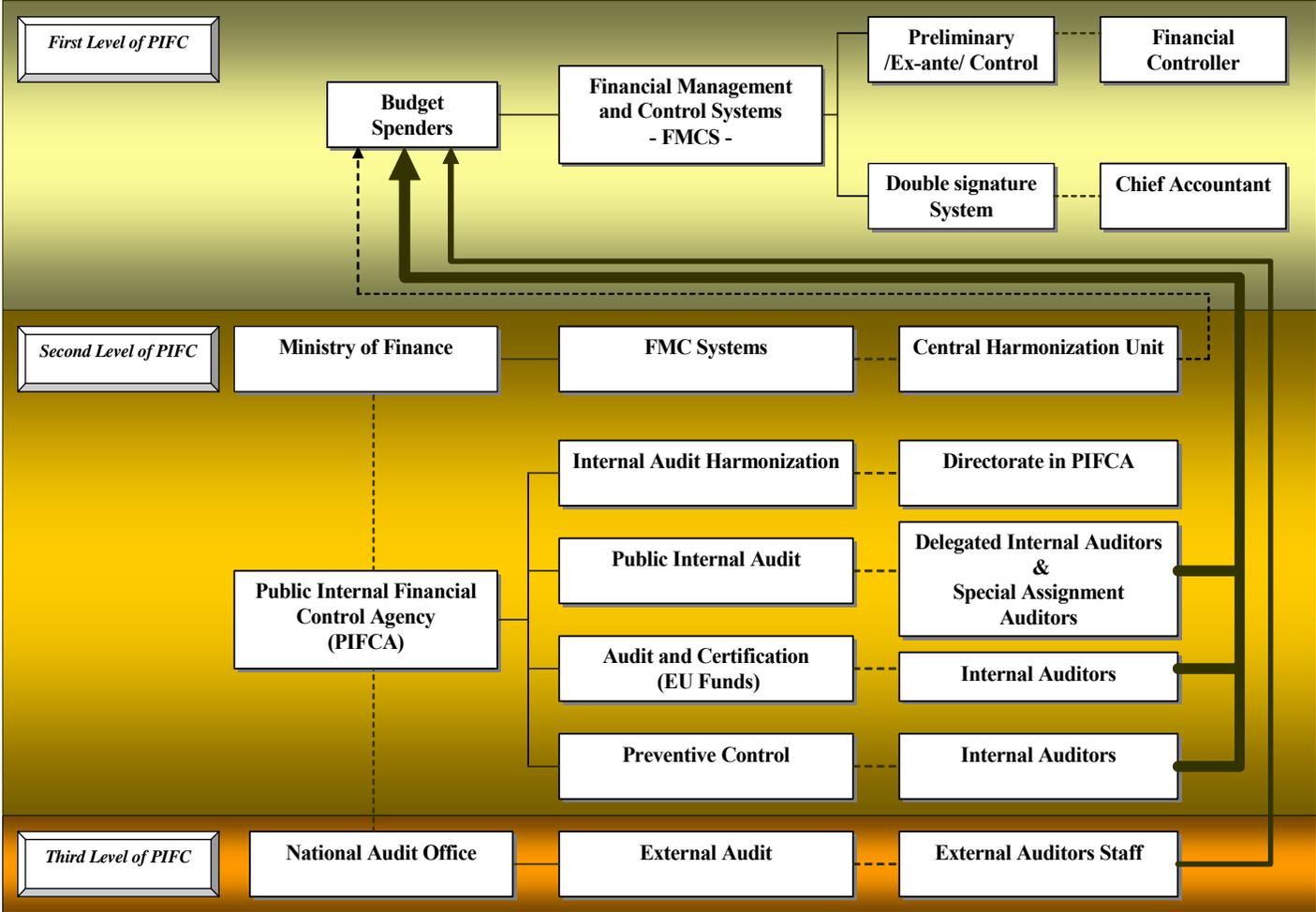
- Positive assessment on behalf of the European Commission during the monitoring missions and elaboration of the reports;
- Receiving a timely access to the Structural and Cohesion Funds.
- Fulfillment of the engagements undertaking at the time of negotiations for accession to the European Union under Chapter 28 “Financial Control”.
- Responsibility for sound financial management and transparency at the disposal of public funds.



PIFC: Institutional Framework In Line Ministries



ANNEX №3



ANNEX №4

