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Albania

COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT

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CURRENCY

Currency Unit = Albanian Lek (ALL)
US\$ 1 = ALL 140.7 (as of 02/28/2002)

GOVERNMENT FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

BoA	Bank of Albania
CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
CoM	Council of Ministers
CY	Calendar Year
EC	European Commission
EFP	Economic, Finance, and Privatization
EU-TACIS	European Union – Technical Assistance for Commonwealth of Independent States
DFID	Department for International Development
FMR	Financial Monitoring Reports
FY	Fiscal Year
GDIA	General Director Internal Audit
GDP	Gross Domestic Product
GFS	Government Finance Statistics
GPRS	Growth and Poverty Reduction Strategy
HSC	High State Control
IEKA	Instituti i Eksperteve Kontable to Autorizuar
IFC	International Finance Corporation
IMF	International Monetary Fund
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IDA	International Development Association
IFAC	International Federation of Accountants
IIA	Institute of Internal Auditors
INTOSAI	International Organization of Supreme Audit Institutions
IOSCO	International Organization of Securities Commission
ISA	International Standards on Auditing
MoF	Ministry of Finance
MTEF	Medium Term Expenditure Framework
NAS	National Accounting Standards
NSC	National Securities Commission
OECD	Organization for Economic Cooperation and Development
PEIR	Public Expenditure and Institutional Review

PMR	Project Monitoring Reports
PRGF	Poverty Reduction and Growth Facility
SAI	Supreme Audit Institution
SDR	Standard Drawing Rights
SOE	State Owned Enterprise
USAID	United States Agency for International Development

Albania : Country Financial Accountability Assessment

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ALBANIA
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PREFACE

This report was prepared on the basis of the findings of a series of World Bank missions to Albania from September 2001 to November 2001 by a Task Team comprised of Sanjay Vani, Task Team Leader and Sandro Zanus Michiei, (ECCAL). Michael Gascoyne (ECSPF) contributed the section on the Private Sector Accounting and Auditing. The Government and private sector counterparts were actively involved in the entire process. Written comments received from the Government on the draft report have been incorporated in the final report.

The report is based on the results of interviews and discussions with public and private institutions and on detailed analysis of the laws, documents and other information collected. Government and private sector counterparts lent their full and proactive support to the CFAA mission and engaged with the Bank's team in a comprehensive dialogue. The Bank is grateful to the Government of Albania for this cooperation.

Purpose of the Report

A CFAA considers the strength of the financial accountability framework in both the public and private sectors. The aim is to assess whether the existing framework, as designed and practiced, is sufficient to ensure proper use of country's own resources and those provided by the Bank and other institutions.

One of the CFAA's main purposes is to assess the risks posed by the financial accountability framework for the implementation of Bank programs and the use of Bank funds, and to propose suitable measures to manage these risks. The CFAA also supports a dialogue with the borrower country and development partners on financial accountability matters, and assists in the design of programs to build financial management capacity.

The CFAA is a diagnostic exercise covering the financial management systems of both public and private sectors of a country. It is not an audit, and it does not provide assurance that all funds are being used for intended purposes. However, it provides a well-informed and objective assessment of the strengths and weaknesses of financial management systems, a diagnosis of problems and advice on their resolution, and an indication of the level of financial accountability risk in the country concerned.

Each CFAA is expected to cover specific core content. Although financial accountability encompasses a wide range of activities in the private and public sectors of an economy, for the purpose of CFAA, the following are the core contents of the CFAA:

- Transparent and Accountable Budgeting

- Public Sector Accounting and Financial Reporting
- Public Sector Internal Control System
- Public Sector Auditing
- Legislative Scrutiny of Public Sector Financial Management
- Private Sector Financial Accounting and Auditing Practices

The executive arm of the Government has an obligation of safekeeping and proper use of public resources entrusted by its constituents, and provision of a credible legal/regulatory framework to promote good financial governance in both private and public sectors of the economy. The institutional and legal/regulatory regime constitutes the public financial accountability framework in a country. The financial accountability framework should provide reasonable assurance to interested private sector parties that financial operations are conducted properly and that investments are managed with due care and are protected from the risk of fraud and misuse.

The Bank's interest in the CFAA lies mainly in providing inputs for managing fiduciary risks. The Bank's fiduciary responsibilities to its shareholders and the borrowing Government's fiduciary responsibilities to its citizens are closely related. If the borrowing Government meets its fiduciary responsibilities to the citizens, the Bank's fiduciary responsibilities are automatically met. It is therefore necessary for a country to develop a proper financial accountability framework, in design as well as in practice. The CFAA, therefore, must not only focus on the existing systemic weaknesses giving rise to fiduciary risks, but also to present advice on developmental needs.

Acknowledgements

The mission members wish to acknowledge the extensive cooperation and assistance received from officials and staff of the Government, state agencies, and private sector institutions interviewed. Chrik Poortman, Country Director and Regional Coordinator for South East Europe, Eugen Scanteie, Resident Representative, and Luisa Masutti, Country Officer for Albania, offered invaluable assistance and information in carrying out the CFAA. Elda Hafizi, and Odeta Bullo Team Assistants in the Bank's Tirana Office, provided support with logistic arrangements for the mission. Anila Kuka and Ana Hirata assisted in the report production. Genc Ruli, Institute of Contemporary Studies, Tirana assisted the mission in the data collection work. John Hegarty, ECA Regional Financial Management Adviser, and peer reviewers David Shand (OCSFM), and Nicola Smithers (PRMPS) offered invaluable comments and provided other important inputs to the task. Richard Carroll, Consultant, assisted with the editing and formatting of the report.

Executive Summary

1. After 44 years of communist rule, Albania established a multiparty democracy in 1990. The transition has proven difficult as successive governments tried to deal with severe unemployment, the collapse of a fraudulent nationwide investment scheme (the pyramid scheme), and massive refugee influxes from neighboring Kosovo. The economy continues to be bolstered by remittances of some 20% of the labor force that works abroad. These remittances supplement GDP and help offset the large foreign trade deficit. The recent structural reforms undertaken by the Government coupled with sound macroeconomic management have eased the inflationary pressures and reduced fiscal deficits. The GDP growth rates for the past two years have exceed 7%.
2. Albania has adopted a parliamentary form of government and has made remarkable progress in just over a decade since the end of the communist rule in establishing a legal and institutional framework for accountability arrangements. The Constitution and various laws clearly spell out the roles and responsibilities of the government, the Parliament, and the watchdog bodies such as the High State Control, and the People's Advocate (the Ombudsman). Albania has also taken proactive steps in enacting laws and regulations in areas where gaps are identified in the legal framework. Albania has also been actively pursuing reforms in the budgetary area. In 1998, it enacted a very well structured Organic Law on Budget. In 2000, Albania adopted the Medium Term Expenditure Framework (MTEF) approach to budgeting that aims to improve the linkage between policy planning and allocation of resources.
3. With its significant progress in establishing a legal and institutional base, and strong commitment to reforms, Albania is in a good position to develop a sound fiduciary infrastructure. There are, however, several issues that need to be addressed. The main issues that emerge are:
 - weak capacity in several institutions;
 - weak internal controls including inadequate cash management and weak internal audit function; and
 - absence of a solid legal basis for internal audit in the public sector.
4. In the area of private sector accounting and auditing, the major issues are:
 - need to differentiate between the banks, insurance companies, listed companies, non-listed companies, and other entities for determining applicable accounting standards; and
 - weak audit capacity and lack of experience in implementing ISA

Recommendations

5. A first step in dealing with these issues is to constitute a high-level working group to create a detailed action plan. Many of the actions will focus on capacity building in several key institutions. The action plan will require substantial technical assistance to implement. The most important areas for action are presented below.
6. **Enact the Law on Public Sector Internal Audit.** A Law on Public Sector Internal Audit is currently being discussed within the Government for tabling before the Parliament. This law would help establish a solid legal basis for internal audit in the public sector.
7. **Strengthen internal controls including internal controls in the treasury. Strengthen treasury cash management function, more specifically by establishing daily reconciliation of district treasury payment requests with the reimbursement by the Bank of Albania to the agent banks, and by daily reconciliation between revenue collections transferred by the agent banks with the taxpayer filled payment forms.** Internal controls is one area that has not received as much attention in Albania as it deserves. This report provides details regarding major risks present in the current treasury operations particularly in respect of reimbursement to the paying banks and transfer of collections from the collecting Banks. The recent audit reports of HSC indicate significant non-compliance with laws and several instances of waste and abuse of resources. The Government has realized the importance of strong internal controls in reducing waste and abuse of public resources, and, with inputs from the Bank, it is in the process of tabling legislation on Public Sector Internal Audit in the Parliament. Once again the challenge would be to build a strong internal audit function in the Government.
8. **Strengthen internal audit capacity by establishing effective internal audit structures in the line ministries, preparing rules and methodology for conducting internal audits in the public sector, and providing extensive training to the internal audit staff. In addition, strengthen capacity of HSC by pursuing twinning arrangements with a well-established SAI in the region.** The High State Control (HSC), the Supreme Audit Institution (SAI) in Albania, has been established by the Constitution, and has broad scope of audit without any undue restrictions either in the scope or the agencies to be audited. HSC has the necessary operational freedom to determine the structure and staffing including salaries, and the annual work program. The internal regulations on functioning of HSC are to a large extent based on INTOSAI documents. The HSC has adopted INTOSAI audit standards and submits the audit reports to the Parliament. However, full implementation of these audit standards would require extensive training to the audit staff. HSC would benefit by entering into twinning arrangements with another well-established SAI in

the region, which would enable the HSC staff to learn latest audit techniques as well as recent advances in Government auditing.

9. **Build capacity in the Accounting Department (MoF) to prepare consolidated financial statements for the Government.** Government accounting is performed by two different organizations – by the Treasury and by the line ministries. The Treasury follows cash-basis of accounting, where as the line ministries have adopted a modified accrual basis of accounting and prepare yearly financial statements including a Balance Sheet. The Government has established an Accounting Department to prepare accrual based consolidated financial statements. The challenge in this area is to strengthen the Accounting Department by providing technical assistance in methodology for preparing consolidated financial statements. Currently, cash-based financial statements compiled by the Treasury are presented in the Parliament. Accounting in the treasury and line ministries is done manually. Albania, with the assistance from the Bank, is in the process of modernizing treasury operations. In the medium term, Albania should also consider implementing a computerized integrated financial management system at the budget institution level.
10. **Strengthen internal audit capacity within SII and introduce computerized pension and accounting systems in districts.** The Social Insurance Institute (SII) handles enormous resources (approximately 35% of the State budget) and has fairly autonomous structure. There is an urgent need to strengthen the accounting and internal audit functions in the SII. Considering the huge number of pension and other payments handled by it, computerization of accounting at the district level and creating a secured central pension database should receive highest priority.
11. **Strengthen the Parliamentary commission on Economic, Finance, and Privatization (EFP) to provide effective oversight over the executive arm of the Government by building research and analytical capacity and by providing exposure to internal best practices in the legislative scrutiny.** The Constitution provides for legislative oversight over the executive in several ways. The Parliament has a committee to perform a detailed review of budget proposals, budget execution reports prepared by the Government, and the audit reports submitted by HSC. This Parliamentary committee lacks capacity and technical skills to carry out its functions effectively. As with the executive branch, there is a need to strengthen the capacity of the parliamentary committee by providing exposure to international best practices and technical resources to carry out analysis and research.
12. **Improve audit capacity in dealing with Bank-funded projects.** The fiduciary risks in Bank-financed projects are contained by requiring creation of separate PIUs that have separate accounting, reporting, and auditing systems than the normal Government accounting and reporting systems. The Bank

requires the project financial statements to be audited by international audit firms acceptable to the Bank. Having regular supervision of project financial management aspects by the field-based FMS and Disbursement Assistant further contains the fiduciary risks. PIUs in Albania have been using standard accounting software thus obviating the need to develop accounting software for each project. Due to scarcity of skilled accounting professionals in Albania, recruitment of the PIU accountant is difficult, and the PIU often ends up hiring a person with only bookkeeping background who is trained in project financial management. The review of audit reports indicates inadequate understanding of Bank policies and procedures, particularly regarding procurement and disbursement, on the part of auditors. The Bank should conduct formal training for auditors in Bank policies and procedures. Considering the infant stage of the accounting and auditing profession in Albania, the Bank should also conduct a formal review of the capacity of the audit firms to audit Bank financed projects.

13. **Enact a new law on accounting clearly differentiating between banks, insurance companies, listed companies, non-listed companies, and other entities for determining applicable accounting standards.** Most, if not all, Albanian commercial entities fall within the EU definition of “small enterprises” and hence would have only limited external reporting requirements (primarily taxation reporting). The current Law on Accounting, enacted in 1993, is expected to be revised soon to properly differentiate the accounting and reporting requirements for different kinds of companies such as banks, insurance companies, listed companies, and small and medium enterprises. In addition, it is expected that the law would clarify the standard setting authorities. The Trade Companies Law requires annual audit of joint stock companies meeting certain threshold. It is estimated that only around 1,000 of the 35,000 companies currently meet the threshold. There are about 120 registered auditors in Albania. “Instituti I Eksperteve Kontable to Autorizuar” (IEKA) is the association for all auditors that administers a set of professional examinations before admitting a person as a member. IEKA seeks to maintain the professional standards of its members through an annual peer review process. IEKA plans to adopt the International Standards on Auditing (ISA) once the translation is completed.
14. Additional measures that would strengthen Albania’s fiduciary capacity include:
 - implementation of the treasury automation project being financed under the Public Administration Reform Project;
 - uniform and integrated accounting and reporting software in budget spending units that will use the same database as the treasury and adhere to the one transaction – one data entry – one record principle;
 - computerization of employee payroll by creating centralized and secure employee database;

- strengthening skills of the line ministry staff to undertake programmatic budgeting, now adopted by the Government, by conducting extensive training programs;
- specifying clear-cut criteria for selection of capital projects, including specifying technical, economic, financial, environment, and social criteria; and
- introducing budget evaluation function for proper evaluation of budget outcomes, thus enabling the results to be factored into the in the capital budgeting process and also increasing the accountability of project managers.

ALBANIA COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT

1. Country and Economic Background

1. In 1990 Albania ended 44 years of communist rule and established a multiparty democracy. The transition has proven difficult as successive governments tried to deal with severe unemployment, the collapse of a fraudulent nationwide investment scheme, and massive refugee influxes from neighboring Kosovo. The collapse of financial pyramid schemes¹ in early 1997 - which had attracted deposits from a substantial portion of Albania's population - triggered severe social unrest which led to more than 1,500 deaths, widespread destruction of property, and an 8% drop in GDP. The economy continues to be bolstered by remittances of some 20% of the labor force that works abroad. These remittances supplement GDP and help offset the large foreign trade deficit. The recent structural reforms undertaken by the Government coupled with sound macroeconomic management have resulted in easing the inflationary pressures and reduced fiscal deficits. The GDP growth rates for the year 2000 and 2001 are expected to exceed 7%.

2. Albania has adopted a parliamentary form of Government. The Constitution, approved in the November 1998 referendum, mandates unicameral Parliament. The President appoints the Prime Minister on the proposal of the party or coalition of parties that has a majority of seats in the Parliament. The Council of Ministers (CoM) determines the principal policies of the country and is accountable to the Parliament. The Parliament has the right to ask the Prime Minister and any member of the CoM for written information or to appear in the Parliament for questioning. The term of the Parliament is 4 years. A 3/5th majority in the Parliament elects the President for a term of 5 years. The President has a no executive role.

3. Albania is divided into 12 regions. The Constitution, which was adopted in 1998, has eliminated the role of districts in the local self-Government. Local self-Government now centers around region. Within regions, communes (in rural areas) and municipalities (in cities) are basic units of local Government. The executive organ of a municipality or a commune is the mayor, who is elected directly by the people. Communes and municipalities have their own budget and they have a right to levy local taxes. The representative organ of the region is the regional council. Communes and municipalities delegate members to the regional council in proportion to their population. The mayors of communes and municipalities are always members of the regional council. The regional council makes regional policies that are in harmony with the State policies. The regional council has the right to issue ordinances and decisions

¹ Pyramid schemes work on the principle that money paid in by later investors is used to pay artificially high returns to earlier investors. The scheme finally collapses when the interest and principal due to the old investors exceeds the money that the scheme is able to attract from new investors.

that are binding on the communes and municipalities in the region. At the region, the Government as its representative appoints a Prefect, who is the Chief Administrator. This CFAA covers the assessment of financial accountability at the central Government level.

4. The 1999-2001 Country Assistance Strategy (CAS)² emphasizes governance and institution building as the central focus of Bank's strategy in Albania. Albania has prepared a Growth and Poverty Reduction Strategy Paper (GPRS) through a broad-based participatory approach. The Bank assisted Albania in this process.
5. In July 2001 the International Monetary Fund (IMF) completed the final review of Albania's third annual arrangement under the Poverty Reduction and Growth Facility (PRGF) and authorized Albania to draw the final credit tranche of SDR 4.7 million (about US\$6 million) from the IMF. The IMF had previously approved the PRGF arrangement in May 1998 for SDR 45 million (about \$56 million). During the recent Article IV consultation with Albania, the IMF commended the authorities for pursuing a prudent fiscal policy, and urged further structural reforms and improvements in governance.
6. The Bank carried out a Public Expenditure and Institutional Review (PEIR) and Country Procurement Assessment (CPA) and the respective reports were issued in April 2001 and January 2001. This report draws upon the important findings and recommendations contained in PEIR and CPA reports.

2. Legal and Institutional Framework

7. Albania has made remarkable progress in just over a decade since the end of the communist rule in establishing a legal and institutional framework for accountability arrangements. The Constitution and various laws clearly spell out the roles and responsibilities of the Government, the Parliament, and the watchdog bodies such as the High State Control, and the People's Advocate (the ombudsman). Albania has also taken proactive steps in enacting laws and regulations in areas where gaps are identified in the legal framework; for example, a Law on Public Sector Internal Audit is currently being discussed within the Government for tabling before the Parliament.
8. The Constitution approved in the 1998 referendum establishes the role of High State Control (HSC) as the Supreme Audit Institution (SAI) in the country and provides independence from the executive. The Constitution has also established an institution of People's Advocate to develop a culture of good governance in the country. In order to provide transparency, the Constitution has specified that the working of the Parliament and committees of Parliament shall be open to public.

² Albania : Country Assistance Strategy

9. Albania has enacted separate laws on budget preparation and execution, working of the HSC and People's Advocate, on accounting and auditing in the private sector. A schematic diagram depicting institutions of financial accountability is given in Annex 1.

3. Budgetary Controls

10. As a unitary country, Albania has one consolidated budget, submitted to the Parliament for approval. The budget is a consolidation of the central Government budget and local Government budgets, the latter consisting of budgets of the regions, communes and municipalities, which number about 400.
11. The Organic Budget Law (enacted on July 29th, 1998) governs the budgetary process. Formally, the consolidated budget is enacted as the annual budget law that is approved by the Parliament and signed by the President. The annual budget is a public document and is required to be published in the official gazette.

Medium Term Expenditure Framework

12. Albania has adopted a Medium Term Expenditure Framework (MTEF) to improve the linkage between policy planning and the allocation of resources. The first MTEF was prepared for the period 2001 to 2003 and the second for the period 2002 to 2004. Preparation of the 2002 – 2004 MTEF took place within the framework of the Growth and Poverty Reduction Strategy (GPRS). The GPRS priorities have provided the strategic direction for the allocation of budgetary resources under the MTEF³. DFID-financed consultants have been providing technical assistance to Albania in preparing the MTEF. Although, a few senior officers in the Budget Department have gained good understanding of the MTEF process, the majority of the staff in the budget department and line ministries has yet to understand the concepts and processes involved in the MTEF. The Government has proposed to DFID that the third MTEF consultancy contract should include a significant portion towards training and education of staff in the line ministries and finance ministry, and of Parliamentarians.
13. The three-year MTEF covers both investment spending and recurrent expenditures. The MTEF aims to
 - promote fiscal discipline by ensuring public expenditures are planned within a realistic macroeconomic and fiscal framework,
 - facilitate the strategic prioritization of expenditures by linking more explicitly Government policies to expenditure plans,

³ The strategic priorities identified for the 2002-2004 MTEF are : increase the share of GDP allocated to health and education sectors, maintain spending on social protection, maintain high level of investment in public infrastructure.

- bring greater predictability to the budgeting process.
14. The sector expenditure strategies require an analysis on the role of the State in each sector. The MTEF sets out proposed resource ceilings for each line ministry for the three year period reflecting the sectoral priorities. These ceilings provide the framework for the preparation and evaluation of annual line ministry budgets.
 15. As the Organic Budget Law was enacted in 1998, and the MTEF was introduced in 2000, there is no mention of the MTEF in the Budget Law, only that budget institutions are required to estimate revenues and expenditures for the two years beyond the budget year. The MTEF process determines the sectoral expenditure ceilings, which forms the basis of annual budget preparation. Therefore, it is essential that MTEF is institutionalized and specifically included in the Organic Budget Law. In 2001 the Government presented estimates for the next three years along with the annual budget to the Parliament. However, considering the important role of MTEF in providing strategic direction to the Government in setting the sectoral policies and expenditure ceilings and also in view of the four-year term of the Parliament, it is advisable to consult the Parliament during the MTEF process and ensure presentation of full MTEF to the Parliament.

Budget Preparation and Approval

16. The responsibility for preparing the consolidated budget is with the Budget Department of the Ministry of Finance (MoF). The budget preparation work begins with the formulation of the macroeconomic framework, which defines the resources the Government will have for the next budget year. Although, Albania has made considerable progress in fiscal forecasting⁴, Albania relies substantially on IMF assistance in the preparation of the macro-economic framework. Based on the forecast of resource availability expenditure aggregates are determined including expenditure ceilings for sectors. The MTEF sectoral allocation forms the basis for this exercise. MoF proposes the expenditure ceilings in consultations with the budget institutions before being approved by the CoM.
17. The next stage in the budget cycle is the issuance of annual budget guidelines by the MoF, not later than July 10 of the preceding budget year. The guidelines in addition to providing procedures and timetable include expenditure ceilings for recurrent and investment expenditures for each budget institution. The budget institutions, however, do not specify expenditure ceilings while asking the lower levels (district / regions) to prepare their budget proposals. The guidelines ask the budget institutions to prepare two budget proposals under two resource availability scenarios. The budget institutions, in spite of the indication of expenditure ceilings, tend to send inflated budget proposals to

⁴ Albania : Public Expenditure and Institutional Review (Report No. 21857-ALB) dated April 16, 2001.

MoF in the hope of getting a larger allocation. The Ministry of Local Government coordinates budget requests from local governments. The preparation of recurrent expenditure budgets is still incremental in nature without consideration of service delivery standards and insufficient regard to the policy and program objectives. The budget institutions get less than 7 weeks to prepare their budget proposals. This lack of sufficient time could prove to be problematic as and when the budget institutions actually move away from the incremental approach to budgeting.

18. In the next stage, the proposals received from various budget institutions, not later than September 1st of the preceding budget year, are reviewed and discussed to bring the demands within realistic constraints. In the event of disagreement between the MoF and budget institution, the Finance Minister is required to prepare a report to the Prime Minister detailing both views. The Prime Minister has the authority to take the final decision. The central Budget Department consolidates the budget proposals into a draft annual budget law. The draft annual budget law is first reviewed and approved by the Economic Policy Committee⁵ of the Government and later by the CoM before being submitted to the Parliament no later than November 20th of the preceding budget year. The MoF is required to provide analysis of expected impact on state budget revenues and expenditures in respect of any new laws or amendments submitted to the Parliament. The Minister of Finance presents the draft annual budget to the Parliament on behalf of the CoM.
19. The Parliament's Economic, Finance, and Privatization Commission reviews the draft annual budget law. The Commission presents its findings and recommendations to the Parliament. The Constitution effectively restricts the ability of the Parliament to suggest major changes in the draft annual budget, excepting inter-sectoral allocations, as Article 82 requires that an amendment increasing the expenditure level or reducing revenues is first required to be provided to the CoM thirty days before its introduction in the Parliament. In addition, the Organic Budget Law states that any proposals to increase expenditure levels shall be accompanied by measures to increase revenues or decrease other budgeted expenditures (Article 20).
20. If the draft annual budget is not approved by December 31st preceding the budget year, CoM is authorized to approve and implement a three-month budget with the restriction that expenditures of budget institutions for each month should not exceed 1/12th of actual expenditure for the previous year and not include any expenditure items not included in the previous budget.
21. The Organic Law on Budget gives authority to the Government, without requiring Parliament's approval, to reallocate expenditures with the approval of CoM, provided the reallocation does not exceed ten percent of the total

⁵ EPC is a high level ministerial body headed by the Prime Minister with representation from main ministries. EPC is involved right from the discussion on macroeconomic framework.

approved appropriation. If the revenue shortfall exceeds 10 percent of the total approved appropriation, then a formal budget amendment, proposed by the CoM, is required to be approved by the Parliament.

22. The Law provides for a reserve fund to meet unforeseen expenditures. The maximum limit for appropriation to the reserve fund is three percent of total appropriations. The Law further stipulates that only after the CoM has approved the proposal of the Finance Minister, actual expenditures could be made. The Finance Minister is required to prepare and submit periodic reports on use of reserve fund to the Parliament. In view of audit objections raised in the audit report for the year 2000 and for better transparency, it is important that MoF strengthens the process of approval and presentation of periodic reports to the Parliament.
23. Loan guarantees often entail public expenditure priorities that are established by the recipient rather than the Government. For the budgetary process to become a transparent and integrated exercise it is essential that Government loan guarantees which represent contingent burdens on the budgetary resources be integrated within the budget document itself. Loan guarantees should receive the same executive and legislative scrutiny as other budgetary outlays. Albania has made some progress in this direction recently by establishing a ceiling for guarantees in the annual budget law. Within the ceiling established by the annual budget law the Finance Minister is authorized to issue the guarantees on behalf of the Government.

Capital Budgeting

24. Until 2000, capital budgeting (investment projects) was the responsibility of the Ministry of Economic Cooperation and Trade. However, beginning 2001 the MoF took over the task of compiling the capital budget. The budget institutions review, select, and compile the investment project proposals received from lower level offices (region / district) for submission to MoF. Based on the ceilings earlier indicated and negotiations with the line ministries, MoF finalizes the capital expenditure projects. The line ministries are required to estimate the total cost of multi-year projects with annual breakdowns of estimated expenditures (Article 19.6).
25. Preparation of a sound capital investment program is essential for rationalizing and increasing long-term efficiency of public expenditures. However, there are no clear-cut criteria for the selection of capital projects that specifies the technical, economic, financial, environment, and social criteria. First priority is given to ongoing projects close to completion, and second, to donor-funded projects. This approach could lead to misallocation, as not all unfinished projects, particularly projects where initial cost-benefit analysis was not undertaken, are worth finishing.

26. Although, bringing it within the purview of MoF has strengthened the capital budgeting process, the capital investment proposals do not yet incorporate estimates of recurrent expenditures associated with investment projects. As a result, the implied future liability of such recurrent expenditures on the three-year budget estimates is not considered. Moreover, the decision making process that selects the capital projects is also influenced by the amount of recurrent expenditures associated with the project, and the absence of such information could lead to sub-optimal decisions.

Budget Classification

27. The old budgetary classification system was changed in 2001 by incorporating a detailed economic classification scheme within the existing functional classification scheme⁶. The earlier economic classification – in use until 2000 – was restricted to only ten categories of expenditures without any detailed sub-categories. As a result, reconciliation with the chart of accounts was difficult. Although, the economic classification has been changed in accordance with the Manual on Government Finance Statistics, 1986 (GFS)⁷ issued by the IMF, the existing functional classification is a mixture of administrative and functional classifications. As recommended in the Public Expenditure and Institutional Review (PEIR) report, the functional classification is expected to be revised by the Government in 2002 to accurately reflect Government's main functions, programs, and activities and to better align the mandates of the ministries with programs.

Budget Implementation

28. The individual projects that constitute the capital expenditure budget of the Government undergo frequent amendments during the course of the year. For example, for the year 2001, in the health ministry an amendment resulting in inclusion of certain new projects and deleting approved projects was carried out at the start of the budget year in January itself. Such amendments are routinely proposed during the year by the line ministries for MoF approval. Sometimes amendments are necessary because the original proposals and contract amounts differ, or the projects are not progressing as per schedule at times due to

⁶ Economic Classification identifies the types of expense incurred by Government for discharging economic responsibilities of the Government. For example, compensation to employees, subsidies, grants etc. The Functional Classification provides information on the purpose for which an expense was incurred. For example, expenses incurred on education or environment protection. Functional Classification should not be confused with the administrative organizational structure of the Government. In situations where functional classification is not aligned properly with the ministries in the Government, it could lead to dispersed accountabilities as more than one line ministry may be responsible for implementing the same program or function.

⁷ A revised GFS Manual issued by the IMF in December 2001 has introduced accrual accounting and balance sheets. Currently, only few countries are capable of meeting the standards promulgated in the revised manual. For more information, please see <http://www.imf.org/external/pubs/ft/gfs/manual/index.htm>

procurement procedures of donors, or emergency situations occur. Although such amendments do not change the overall spending ceilings or the balance between capital and recurrent expenditures, they occasionally result in changing the allocation between sub-programs such as between primary health and secondary health or shifting resources from one district to another.

29. As the treasury is responsible for making all the payments, there is a direct control exercised by the MoF to ensure that the payment requests sent by the budget spending units are within the approved budget allocations. Although this system assists in avoiding payments in excess of appropriations, it is unable to control commitments made by the budget institutions in excess of approved appropriations.

Budget Monitoring and Evaluation

30. Budget evaluation in Albania is primarily focused on collecting regular accounting reports on budget execution and ensuring compliance with spending limitations. The controls are mainly input-oriented rather than outcome-oriented. Periodic evaluation of budget outcomes and integrating the findings into the next year's budget formulation are key ingredients for improving the overall efficiency of public expenditures and increasing the accountability of program managers. Budget evaluation is also essential to programmatic budgeting, which emphasizes the allocation of funds by programs and the measurement of outcomes and performance of budget institutions.
31. For budget evaluation to be effective, the budget process will need to incorporate measurable monitoring indicators in the budgetary process. Budget evaluation is normally carried out at two stages. First, all budget institutions carry a self-evaluation of their programs and monitor progress on the performance indicators on an ongoing basis. Second, selective budget evaluation is carried out by an independent entity (internal auditor or external auditor) upon completion of a program. With increased decentralization it is equally important to institutionalize proper budget evaluation arrangements at the regional and commune / municipality levels.

Recent reforms

32. The most significant improvements in the budget process in the recent past include:
 - Adoption of MTEF,
 - Adoption of economic classification of budget based on IMF-GFS classification (1986),
 - Improved reporting on fiscal aggregates and budget implementation
 - Incorporation of extra-budgetary funds (such as Social Insurance Institute) into the budget, which substantially improves comprehensiveness of

management of public finance. The budget also includes the profits/losses of the state owned enterprises.

4. Accounting and Reporting

33. Government accounting in Albania is performed by two different organizations. The line ministries (spending units) follow a modified accrual basis of accounting (i.e. they do not account for depreciation) and maintain their own accounting records in prescribed formats using a double entry system of accounting. The main purpose of accounting at the line ministries is to keep track of expenses vis-à-vis budget provisions although to a certain extent it does duplicate the accounting done at the Treasury. The Treasury follows a cash basis of accounting and maintains records of all revenues and payments. The financial statements prepared by the treasury are submitted to the CoM and the Parliament. Demonstrating compliance with the approved budget is an important component of public accountability. The Government fiscal year begins on January 1 and ends on December 31.
34. The Government plans to produce an accrual based consolidated financial statement for the Government⁸ and accordingly has recently (FY 2000) established an Accounting Department within the MoF to compile the accrual-based financial statements prepared by the line ministries. The line ministries submit the annual financial statements to the Accounting Department. However, proper consolidated financial statements that net out transfers have not yet been prepared. Nor is any reconciliation carried out between the accounting reports and the treasury reports at the consolidated level. There is lack of clarity over the role of the Accounting department, which also serves as the licensing authority for the private sector accountants. More importantly, there is a need for technical assistance to guide the Accounting Department in preparing the methodology and procedures in consolidating the financial statements. In the long run, it will be appropriate to review the provisions of the Organic Budget Law to explore the possibility of requiring submission of such consolidated financial statements to the CoM and the Parliament as mandatory requirements. These statements provide a better picture of the finances of the State, because financial performance is currently measured and presented in terms of entries in the budget, without regard to other important sources of financial information such as liabilities incurred.

Accounting rules and procedures

35. The Organic Budget Law clearly specifies that the ministers are responsible for proper accounting and internal inspection of revenue and expenditure transactions of budget institutions under their control. The Law also requires

⁸ The treasury would continue to compile cash-based budget statements for submission to the Parliament as the budget approved by the Parliament continues to be prepared on cash basis (and therefore the 1986 GFS classification continues to be relevant).

the Minister of Finance to issue instructions, each fiscal year, to budget institutions regarding accounts closing and preparation of cash based annual receipt and payment accounts. The preparation of cash-based annual receipt and payment accounts are required to be reconciled with the treasury records. It further states that heads of individual budget institutions are duty bound to prepare annual accounts for the preceding year by 1st of March of the following year.

36. The line ministry head offices are required to review the annual accounts budget institutions under their control and prepare consolidated financial statements. The consolidated line ministry financial statements are required to be submitted to MoF by 31st March each year. Analysis of submissions for the fiscal year 2000 indicates that most of the line ministries had submitted the annual financial statements by May 15th, 2001 – only the Election Commission had not submitted the financial statements.
37. The Minister of Finance is responsible for preparing a final annual statement of accounts (cash-basis) of the State budget by 15th of May each year. The final accounts compiled by the MoF are based on the treasury statements. The contents of the final statement of accounts shall be in conformity with the classification used in the State budget. In addition, the annual Statement of Accounts shall include:
 - beginning and year-end balance in the Consolidated Fund
 - explanation for major discrepancies
 - details of all Government borrowings
 - details of all guarantees issued during the year
 - details of expenditures incurred out of the reserve fund
38. The Minister of Finance is required to present a final Statement of Accounts to the CoM and the Parliament before 30th of June. The Organic Law does not explicitly states the sequence of submission to the CoM and the Parliament but, in practice, the final accounts are first submitted to the CoM and then to the Parliament.
39. The Organic Budget Law empowers the Minister of Finance to issue standard accounting procedures and reporting requirements for the budget institutions, special and extra-budgetary funds, and local governments. Accordingly, the MoF issued a detailed accrual based Accounting Plan in 1998, which was later modified in January 2001. The purpose of issuing an accrual-based Accounting Plan is to facilitate financial management particularly management of liabilities. This requirement imposes an additional burden on the budget institutions that continue to maintain cash-based budget classification accounts, which are required to be reconciled with the treasury records. However, full asset accounting particularly valuation of assets created or acquired in the past is yet to be implemented.

40. The Accounting Plan and the guidelines envisage double-entry system of accounting following modified accrual basis. The Accounting Plan has the following structure : Class 1 – Equity, Loans, and Long term liabilities, Class 2 – Fixed Assets, Class 3 – Stock and Work-in-Process, Class 4 –Current Assets and Liabilities, Class 5 – Cash and Bank, Class 6 – Expenditure Account, Class 7 – Revenue Account, Class 8 – Annual Profit/Loss Account.

Accounting and Reporting by line ministries

41. The Organic Budget Law requires each budget institution to establish a finance office headed by a finance officer, who reports directly to the head of the budget institution. The finance officer is responsible for maintaining accounting records and documents, and is required to observe principles of economy, efficiency, and sound financial management in carrying out his duties. Finance officers are also required to maintain register of commitments entered into by the budget institution in accordance with the directions issued by the MoF.
42. The line ministries maintain records of their transactions. Some line ministries maintain decentralized offices in districts. These ministries include: Agriculture and Food, Culture, Youth and Sports, Education and Science, Health, Labor and Social Affairs. Their directorates work separately from the structures of districts, performing functions of the ministries within the respective territories. Although the directorates are physically integrated in the district offices, they are in fact part of the respective ministries. These directorates maintain books of accounts.
43. Each budget spending unit of a line ministry has an accounting office that verifies bills before forwarding them to the Treasury for payment, keeps records, and prepares reports related to budget execution. The accounting staffs in the budget spending units are well experienced in bookkeeping and reporting but lack training in management accounting and reporting. The accounting staff will need extensive training in management accounting and reporting to carry out the MoF's ambitious plan to prepare an accrual-based financial statements that facilitates analysis of debtors and creditors, and management accounting.
44. A few budget spending units use computers more for report preparation than for bookkeeping and accounting. However, neither the hardware nor software is standardized. There is no provision for management accounting data that could provide useful information on costing and performance accounting to the managers. Implementation of integrated software that keeps track of budget provisions, commitments, liabilities, and actual expenses would not only speed up the preparation of financial reports but also facilitate better controls over commitments and budget allocations. It will also enable the budget spending units to provide electronic data to the line ministry head offices and thus reduce delays (see paragraph 32 above) in preparing timely consolidated information.

45. Budget spending units prepare a monthly receipt and payment report (cash-basis) that is reconciled with the treasury records before being submitted to the respective head office. Each budget spending unit also prepares a yearly accrual-based financial report and submits it to the line ministry head office. The yearly financial report comprises balance sheet, receipt and payment statement, and other schedules. MoF has also asked the budget spending units to prepare eight-monthly financial statements so as to facilitate timely preparation of the annual financial statements. The line ministry head office consolidates the financial statements and submits them to the Accounting Department within MoF. As mentioned earlier, the Accounting Department has yet to develop proper methodology and procedures in consolidating the financial statements of all line ministries for preparing a consolidated financial statement for the Government.

Treasury Accounting

46. The Treasury is an integral part of the MoF. The Treasury maintains accounts on cash basis and records transactions as when treasury receives money or makes payment on behalf of a budget spending unit. Most of the operations in the treasury offices are handled manually. There is no recording of commitments in the treasury ledgers. The treasury produces periodic reports on the performance of revenues, expenditures, and fiscal deficit. The reports prepared by the treasury form the annual financial statements of the Government.
47. The treasury carries out all the budgetary payments in Albania. The state owned Savings Bank handles all the payments on behalf of the treasury (except in Elbasan and Durres districts where National Commercial Bank has won the contract for handling Government payments). The treasury has a central department located in Tirana and 36 district treasury offices in the districts. A proper system of cash management is lacking as there is no concept of cash allocations on a periodic basis before making the payments on requests received from the line ministries. This is partly due to the fact that the Savings Bank makes the payment on an “overdraft” basis thus obviating the treasury having to find adequate cash before releasing the payments. For financing a cash shortfall, the treasury issues Treasury bills that are exclusively subscribed by the Savings Bank.
48. The treasury branch offices maintain Expense Register and Bank Register for recording expenses by budget classification and payments made from the Bank account respectively. In the Expense Register a separate folio is maintained for each budget classification and sub-classification. As mentioned earlier, most of the accounting and reporting in the treasury branches is done manually which at times delays preparation of reports and is prone to errors given the large number of transactions. The treasury staff spends most of their time in clerical

activities as a result not much time is left for cash management or on control activities. The on-going World Bank supported Public Administration Reform Project (Cr.3328-ALB) is financing strengthening of the treasury functions including automation of the treasury accounting and reporting functions. The project aims to introduce networked treasury database and centralized treasury ledger. The project is expected to be completed in the last quarter of CY2003. Although the treasury computerization would provide information in respect of commitments made by the budget institutions, it will not eliminate duplication in accounting at the budget institution level. A broader Integrated Financial Management Information System that integrates accounting at the budget institutions and treasury levels would not only eliminate duplication in accounting but also would ensure integrity of the accounting data and provide quicker information to the decision makers.

Revenue Accounting

49. The tax and custom revenues are collected in separate transit accounts in approved commercial banks. The revenues collected at the end of the day are required to be transferred by the collecting banks to the treasury account with the Bank of Albania. The treasury maintains a Register of Revenues where tax and non-tax revenues are recorded on a monthly basis whereas daily collections are recorded in the Bank Register that has an account for each bank that collects the taxes and customs duties. Entries in the Bank Register are made on the basis of bank documents received daily from the collecting banks. The tax and customs department prepare a monthly summary of taxes and custom duties collected and send it to the respective treasury offices for month-end reconciliation and for incorporating entries in the Revenue Register as per budget classification. The treasury branch reconciles the monthly totals as per budget classification prepared by the tax office with the figures registered in the Bank Register maintained by the treasury.
50. The tax directorate and customs department has district offices. The district tax and custom offices, based on copies of bank documents and individual tax payment form (filled in by the tax-payer and deposited with the collecting bank), record receipts individually and as per budget classification structure. At the month-end, the tax office prepares a summary of taxes and customs duties collected as per budget classification structure and sends it to the treasury branch office.
51. The treasury branches send an analytical report containing revenues collected as per the budget classification every month to the central treasury office before 7th of the following month.

Public access to financial statements

52. The Constitution stipulates that “organs of central and local Government must make their revenues and expenses public”⁹. The Organic Budget Law stipulates that the annual State Budget and any amendments to the budget should be published in the official gazette. The Government also publishes “Fiscal Statistics of the Government” each year that includes month-wise information on actual revenue and expenditure details as per functional and economic classification in the Budget document, macroeconomic indicators, domestic and external debt etc. It is, however, not certain as to what extent the civil society is able to access and use this information to hold the Government accountable.

5. Internal Controls

53. INTOSAI¹⁰ has defined internal control as a management tool used to provide reasonable assurance that management’s objectives are being achieved. Thus responsibility for adequate and effective internal controls rests with management, and the head of each Government organization must ensure that a proper and effective internal control structure is in place¹¹. The purposes of an internal control system are to identify the risks faced by management, develop internal systems to mitigate these risks, and establish an internal audit process to ensure that the control systems are in fact addressing the risks and that all risks are covered by these systems. Thus internal audit is an essential component of a well-functioning internal control system.
54. The internal control framework comprises controls exercised by the budget department, the treasury, internal audit units within the line ministries and the central internal financial control department. In addition, the Supreme Audit Institution (SAI) of the country (viz. High State Control) carries out an independent external audit of the budget execution. Each budget institution is required to have a finance office that is responsible for first level controls in the budget institution. The finance officer ensures completeness of documentation, availability of budget allocation, and compliance with departmental rules. The treasury exercises the following ex-ante controls over the expenditures : verification of the documents submitted by the budget institution to ascertain correctness and completeness, availability of budget appropriation, cross-verification with the receipts (taxes deducted at source and it’s subsequent deposit). It is important to remember that even a well-designed system of

⁹ The Constitution of Albania, Article 157

¹⁰ http://www.intosai.org/3_INTCOe.html

¹¹ The Organization for Economic Cooperation and Development (OECD) has identified a number of components that must be included for effective internal control: (1) Accounting & reporting controls, governing the accounting and reporting of transactions, (2) Physical asset controls, to protect state assets (includes procurement controls), (3) Process controls, to ensure all actions are authorized, (4) Performance monitoring, for economy, efficiency and effectiveness, and (5) Financial controls over financial, administrative and budgetary activities.

internal controls can be circumvented by employee collusion and management fraud.

55. The heads of departments are recruited according to the Civil Service Act, passed in November 1999, which stipulates that for every vacancy, a competitive examination will determine a shortlist of three candidates, out of which the minister or head of the department will select the incumbent. These provisions have greatly improved the transparency in the appointment at senior positions and strengthened the control framework in the public administration. Employees are barred from becoming members of the political organizations.
56. Employee salaries and social insurance contributions account for approximately 20% of the total budget expenditures (and roughly 25% of the recurrent expenditures – see Table 5.1). The district treasury office receives the employee count for each budget spending unit at the beginning of each year. The district treasury office checks the accuracy of the employee payroll prepared by the budget spending unit by comparing it with the previous month's statements and the cap on employee number noted at the beginning of each year in the treasury register. The SAI audit reports have not observed any serious issues of weaknesses in this area. However, considering the significant budget resources spent on employee costs and, more importantly, as wages are paid in cash and not by bank transfer, it would be beneficial to create a computerized secured employee database and payroll system to eliminate the risks of excessive payments and leakages on account of ghost employee payments. The possibility of making salary payments by direct transfer to the employee bank account should also be explored.
57. Internal controls at the Treasury and the budget spending unit levels are documented in various rules, regulations, and decrees. Internal controls typically focus on identifying and reporting non-compliance in the payment process. Written rules are excessive in some areas and incomplete in others, which leads to an incomprehensive system of internal controls. For example, the treasury has detailed rules as to how to verify the payment requests received from the budget institutions. However, rules are incomplete regarding reconciliation at the central treasury level as has been explained in the following paragraphs. Frequently excessive effort is spent on insignificant and small payments, leaving insufficient resources for controlling large and vulnerable payments. Financial risk assessment to determine the focus of attention is practically non-existent as illustrated in the following paragraphs.
58. The district treasury offices (DTO) receive invoices and bills from the district line ministry offices for authorization and payment. After processing the bills, the DTO sends the payment vouchers to the paying Bank. The state owned Savings Bank handles all the payments on behalf of the treasury (except in Elbasan district where FEFAD bank has won the contract for handling Government payments). The district branch of the Savings Bank makes the

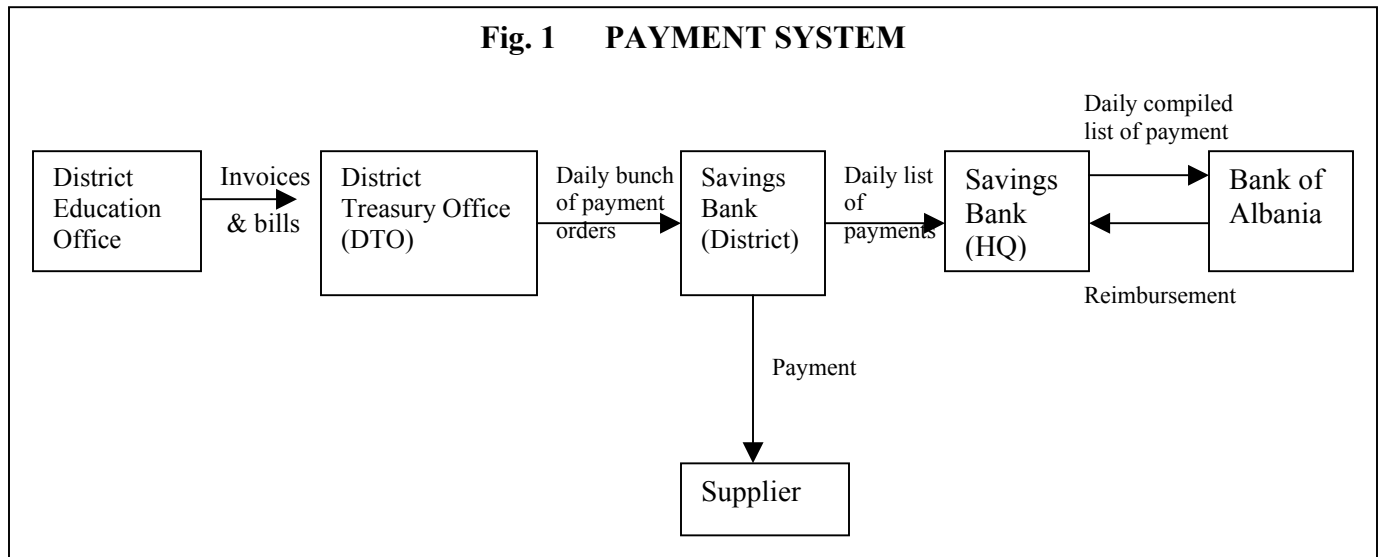
payment, and prepares and forwards a list of all payments made to the Savings Bank head office in Tirana. The Savings Bank head office, after consolidating the payment lists received from the district branches, forwards the consolidated reimbursement request to the Bank of Albania on a daily basis. On the basis of the reimbursement request received from the Savings Bank head office, the Bank of Albania reimburses the Savings Bank. An independent mechanism to

Table 5.1 : State Budget Revenues and Expenditures (Actuals)

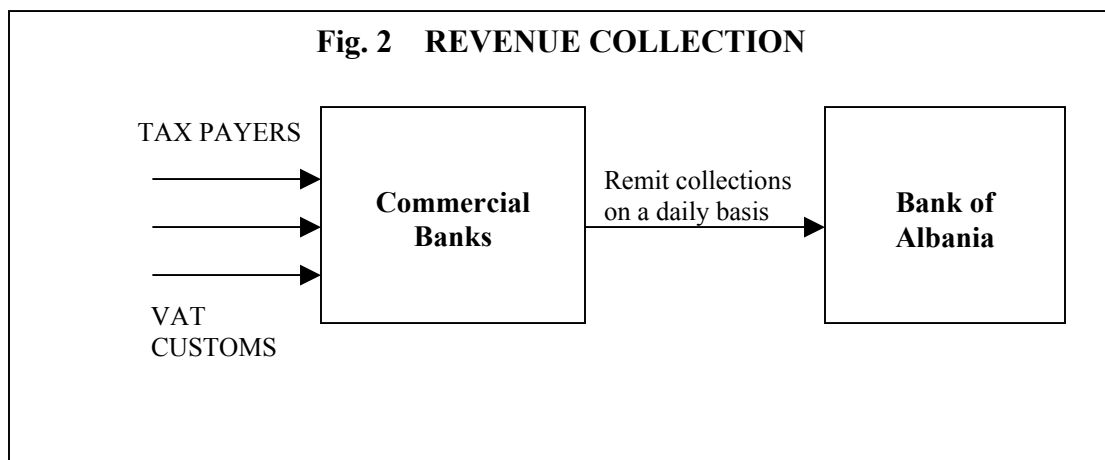
	<i>(in millions of lek)</i>	
	2000	1999
Revenues:		
Tax Revenues	84,060	65,401
Social Insurance Contributions (incl. Health)	20,053	18,165
Non-tax revenue	16,524	23,940
Total Revenue	120,637	107,506
Expenditures :		
Current Expenditures		
Personnel	33,240	31,183
Operations and Maintenance	19,299	20,072
Subsidies	5,242	2,704
Social Insurance (incl. Health)	37,388	33,895
Other expenditures	8,580	8,320
Interest	29,573	34,937
Total Current Expenditures	133,322	131,111
Cost of Bank restructuring	1,025	461
Surplus / (Deficit)	(13,710)	(24,066)
Capital Expenditures	36,274	34,120
Total Surplus / (Deficit)	(49,984)	(58,186)
Financed by:		
Privatization receipts	8,932	906
Domestic borrowings	21,028	27,022
Foreign borrowings	20,024	30,258

(Source : Fiscal Statistics of Government)

reconcile the list of payments provided by the Savings Bank and the payments approved by the treasury on a daily basis is lacking, and the Bank of Albania makes the reimbursement to the Savings Bank directly. Reconciliation is done only on month-end balances. This procedure has several risks as there is a possibility of over-reporting of payments by the paying bank so as to utilize the float during the month generated by excessive reporting of expenses and adjusting the difference at the month-end for month-end balance reconciliation (see Figure 1).



59. A similar risk exists in the revenue collection mechanism. The tax revenues (the major revenue earner is customs duty, which is expected to contribute about \$362 millions, 38% out of the total revenue of \$961 millions in 2001) are collected by specified commercial banks. The commercial banks are required to transfer the collections on a daily basis to the Bank of Albania. There are no checks and balances to verify whether the banks in actual practice transfer the collections on a timely basis. As with expenditures, there is a risk that the banks could use the float by under-reporting or late reporting the collections and adjusting the difference before the month-end balance reconciliation (See Figure 2).



60. An independent mechanism to verify the payments and revenues on a daily basis to ensure receipt of full tax revenues on timely basis and to avoid the float in the payment system is urgently required. In view of the privatization of the Savings Bank, which would result in transferring all payment functions to private sector banks, the treasury needs to develop a long-term strategy for treasury management including strong control mechanisms for the payment system. It is important that treasury receives expert guidance on these issues on a continuous basis from a resident treasury adviser rather than on an ad-hoc basis. In the short-term, it is recommend that the treasury should implement the following measures to strengthen internal controls in the treasury:
- the central treasury office should obtain daily payment data from district treasury offices (which is also forwarded to the paying banks) and reconcile the reimbursement made by the Bank of Albania to the paying banks. Alternatively, the Bank of Albania should not release the reimbursement to the paying banks unless and until advised by the central treasury office, which should collate the daily payment data received from district treasury offices and issue reimbursement instruction to the Bank of Albania.
 - Each district tax office should reconcile on a daily basis the tax collections as reported by the receiving banks with the copies of individual tax payment forms received from the receiving banks to reconcile the date of tax payment by the tax-payer and the date of receipt in the treasury account.
61. The Law on Procurement, enacted in 1996, is a comprehensive legislative instrument for the conduct of public procurement¹². However, despite the fact that the law establishes open tendering system as the main preferred method of public procurement, packages are often broken down into smaller-value contracts to avoid open tendering. The Law has established the Public Procurement Agency (PPA), reporting to CoM, as the central organ for coordination and development of the public procurement system. Although the CPAR concludes that the PPA's organizational design is at par with the international best practice, PPA's effectiveness is greatly undermined by inadequate resources, relatively high staff turnover, and political interference. Furthermore, due to poor enforcement, the budget institutions have little incentive in following the provisions contained in the Law on Procurement. The CPAR also recommends improving dissemination of information on bidding opportunities and bid processes so as to bring in more transparency. Many of these issues are also flagged in the annual audit report for the year 2000 prepared by the HSC. The audit report also highlights lack of proper knowledge about the procurement framework in the country, mainly at the local level.

¹² Albania : Country Procurement Assessment Report dated January 2001

62. All contracts for capital projects are selected and awarded at the line ministry head office level, whereas purchases for recurrent expenses are handled at the local budget spending unit level. Due to this centralization of capital purchases, monitoring of the procurement process has been made easier.

Structure of the Internal Financial Control Department

63. The Organic Budget Law grants the right of inspection of accounting records of budget institutions, special funds, and local authorities to the MoF. The Finance Minister is authorized to determine the inspection procedures and such inspections can be conducted periodically and or on surprise basis.
64. Currently, all line ministries have their own internal audit units. In some line ministries the internal audit is more of a small section within the operations department rather than working as a separate unit reporting to the line Minister. The internal auditors mainly carry out compliance work on ex-post basis. The internal audit units develop their own audit programs and prepare audit reports after completion of each audit for presentation to the head of the department. In important cases, the report is also sent to the line minister.
65. In May 2000, a central internal financial control department was set up within the MoF¹³. This department is headed by a Director and has a staff of 22. This function is evolving and is expected to provide oversight over the internal audit units within the line ministries. Currently, it carries out internal audit within the finance ministry including customs and tax departments and entities under the control of the MoF.

Issues in internal auditing

66. Internal audit in Albania is still in the formative stage. The internal audit units in line ministries lack proper recruitment policies, and structured training and professional development opportunities. The internal audit units work as part of the operations department and do not report directly to the line minister thus compromising their independence in conducting internal audit work and in preparing reports.
67. The internal audit department within MoF lacks the authority to supplement the internal audit work in line ministries where inadequate capacity or skills or issues of independence are noticed. The internal audit department in MoF lacks authority to provide any oversight over the quality of audit work conducted within line ministries. There is no law on internal audit that clearly defines the roles and responsibilities of the central internal audit within MoF and decentralized internal audit units in line ministries. Without a law on internal audit, the central internal audit lacks capability to enforce acceptable audit standards to be implemented by line ministry internal audit units.

¹³ Decree # 217 of the Council of Ministers dated May 5, 2000 on Financial Control

68. The internal audit work carried out in Albania basically consists of compliance testing. Performance audits or value for money audits or internal control reviews that would assist the management in improving their performance and strengthening the control framework are not carried out. It is not suggested here that the internal audit should immediately move in the direction of performance audit as the performance measurement systems are not in place. However, creating limited capacity within the internal audit function to carry out selective performance audit, at the request of line managers, is essential. The emphasis on compliance testing is mainly due to lack of technical skills on the part of the internal audit staff. Moreover, the demand for such reviews is also lacking as line ministry managers and line ministers have little understanding of the usefulness of such reviews. Another important factor having an impact on the efficacy of the internal audit work is the absence of any clear legal requirements that would necessitate line ministries to maintain sound internal control framework within their ministries and be held accountable for it, though the Organic Budget Law has a vague reference to the responsibility of line ministers for “internal inspections”. A clear legal requirement would influence the line managers to pay more attention to the internal control issues and consequently require them to strengthen internal audit units within their ministries as one of the functions of internal audit is to continuously assess the internal controls and make recommendations for improving it.
69. Effective internal controls are key management tools that help managers discharge their responsibilities for the efficient and legal use of public resources. The two most recent audit reports of HSC indicate several instances of non-compliance with laws and fraud/corruption across a wide number of ministries. Implementation of effective internal controls can remedy these problems. These controls include processes that control how resources are managed, ascertaining compliance with the decisions of the Government, and monitoring the execution of Government programs.
70. Normal procedures failed to detect the instances of abuse and waste, which means that not only is the current regime of internal control less than fully effective, but also that management has no means of detecting and resolving these issues as a regular part of their management responsibilities. External auditors cannot be the main detectors of problems, it must be an internal capacity. The external auditor’s reports are tabled directly in Parliament, and there is no opportunity for the Government to remedy problems before such instances become public knowledge.
71. There is a growing interest by the Parliament and the media in the reports of the HSC, which will be increasingly problematic for the Government. The opposition and the media tend to amplify the errors reported by the HSC, and can create a climate of public suspicion of the Government’s ability to manage public resources. However, the Government has to demonstrate that it is making

credible progress in this area to avoid mounting public criticism following the release of each HSC audit report.

Recommendations on the Draft Law on Internal Audit

72. The Government is about to table a legislation to establish a more structured internal audit regime across the Government. The CFAA team has been working closely with the Government counterparts and has been providing advise to them in preparing a sound law on internal audit in the public sector. The main recommendations revolve around the following key concepts.
73. The internal audit department, headed by General Director of Internal Audit (GDIA) and reporting to the Finance Minister, should have the following responsibilities:
- **Standard setter:** Develop internal audit standards and enforce their implementation
 - **Recruitment:** Develop recruitment policy including entry and promotion criteria and recruit internal audit staff for all internal audit positions across the Government.
 - **Training:** Develop and deliver structured training programs including continuous education programs.
 - **Quality assurance:** Develop quality assurance mechanisms to ensure high quality of internal audit work.
 - **Internal audit work:** carry out internal audit within MoF and agencies controlled by MoF, carry out internal audit work in line ministries when the line ministry internal audit units lack capacity or when issues of significant importance are noticed that require specialized skills
74. Each line ministry should be responsible for and held accountable for maintaining an adequate internal control framework within their ministries. Each line ministry should establish internal audit units/directorates, headed by a director and reporting directly to the line minister. The line ministry internal auditors should provide their audit plans to GDIA for information, after the line minister approves them. The line ministry internal audit department should be responsible for conducting internal audit within the line ministry and submitting internal audit reports to the line minister with a copy to the GDIA. The GDIA should be responsible for making available a pool of qualified and trained internal auditors to the line minister who should have the authority to choose a particular candidate from the pool. The internal audit staff, though recruited and trained by GDIA, should functionally as well as administratively report to the line minister. The GDIA should ensure quality of internal audit by proper

recruitment, training, setting audit standards, and by review of internal audit reports prepared by line ministry internal audit units. As mentioned earlier, the GDIA should have the authority to conduct internal audit within line ministries in specific circumstances.

75. Each line minister should prepare an annual assurance letter addressed to the Finance Minister indicating maintenance of effective internal control framework within his or her ministries. This would ensure the accountability of the line minister to maintain an effective internal control framework in his/her ministry and strengthen the decentralized internal audit structure. Similarly, the Finance Minister should submit an annual assurance letter to the Council of Ministers indicating maintenance of effective internal control framework is in place because the Finance Minister has the overall responsibility for ensuring proper internal controls.
76. The Minister of Finance should prepare annually and table with the Council of Ministers a Government-wide summary and analysis of key internal audit findings and recommendations. This analysis would enhance the ministers' understanding of the state of management and provide positive incentives for ministries to correct any reported deficiencies.
77. The Finance Minister should also establish an Internal Audit Committee to advise on matters of internal audit including review of internal audit reports to ensure high quality. The committee should comprise reputed members of the audit profession, professors in economics or audit or public finance, and legal experts.

Internal Audit Standards and Procedures

78. GDIA should adopt one of the internationally acceptable audit standards – the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors (IIA) and, to the extent applicable, the International Standards on Auditing (ISA) issued by the International Federation of Accountants (IFAC), and Audit Standards issued by the International Organization of Supreme Audit Institutions (INTOSAI). In addition, GDIA should develop internal audit manuals, and Code of Conduct for internal auditors.

6. Social Insurance Institute

79. The Social Insurance Institute (SII) administers the pension and social security (e.g. unemployment insurance, employment disability / accident insurance, maternity benefits) operations. The law has also entrusted SII with the responsibility of collecting health insurance contributions and transferring them to the Health Insurance Institute. The SII, though financially dependent on the Government, has an autonomous structure. Its tripartite Administrative Council

comprises representatives from the Government, trade unions, and employers. The Budget Director in MoF, as a representative of MoF, is a member of the Administrative Council of the SII. The MoF representative on the Council generally chairs the sub-committee that conducts an annual review and inspection in SII.

80. The SII has a large budget that is equivalent of about 35% of the state budget. The SII budget is included in the state budget as a separate line item (see table 6.1 for the summary of receipts and payments).

Table 6.1 : Receipts and Payments	
<i>(in million leks)</i>	
2000	
Receipts:	
Contributions	18,034
Others	464
Total Receipts	18,498
Payments :	
Pension	21,587
Insurance Payments	6,666
Total Payments	28,253
Surplus / (Deficit)	(9,755)
Administration Expenses	632
Capital Expenditures	54
Total Surplus / (Deficit)	(10,441)
Financed by:	
Government Subsidy	10,212

(Source : Annual Report of the Board)

81. SII has 36 Bank accounts, one each for district branch office, and does not have to depend on the treasury. The branches utilize the contributions received from employers and employees for making payments, and the surplus funds are transferred twice a month to the head office. In case of a shortfall, headquarters (HQ) transfers funds to the branch office. Each branch has an accountant who maintains accounts and records. The accounting is done manually. The branches prepare monthly accounts and send them to the Regional Offices. The 12 Regional Offices prepare a monthly Cash Statement and a four-monthly

Balance Sheet and Income and Expenditure Account and submits them to HQ. As the SII serves a large of beneficiaries (exceeding 400,000 beneficiaries), maintaining pension records on a manual basis is not only cumbersome and laborious but is prone to errors and abuse. SII has begun the computerization process under donor-funded projects. However, SII needs to do much more by establishing a centralized secured database for ensuring integrity of the data and improving controls.

82. SII has its own internal audit department, headed by a director, which has a staff of 12 in the head office and one each in the regions and branches. The main objectives of internal audit are to verify the compliance with rules and regulations, check whether expenditures are as per approved plan, and whether accounting is performed as per rules and regulations. The Director of Internal Audit reports directly to the Director General. Each branch prepares a monthly report, which is sent to the regional office for review and consolidation. Each region in turn prepares a monthly summary and sends it to the HQ before 10th of the following month. The HQ-based internal audit staff also carries out periodic inspections in branches and regions. As is the case with internal audit in line ministries, there is a need to upgrade the skills of internal auditors by providing training in risk-based audit methodology particularly in view of the fact that SII is a decentralized organization and serves a large number of pensioners and employees in the country.
83. SII is audited by HSC every year. The audit report on SII accounts is included in the annual audit report of the HSC submitted to the Parliament. The audit report for the year 2000 highlights the evasion of payment of contributions by agricultural laborers and privates sector firms. In addition to the audit by HSC, a sub-committee of the Administration Council of SII also conducts an annual review and inspection in SII. Considering peculiar nature of operations of SII, it is advisable that an international firm that has expertise in pension and insurance audit, at least once in five years, audit SII accounts. Such an audit would help SII in strengthening the accounting and control framework in SII.
84. Except for a small reserve fund that could meet less than three months liabilities, SII has not created any reserve fund out of which pensions could be paid, and it pays monthly pensions out of monthly contributions received.

7. External Audit

85. The Constitution has established the High State Control (HSC – Kontrolli Larte I Shtetit), as the Supreme Audit Institution (SAI) to carry out external audit¹⁴ of

¹⁴ The Lima Declaration adopted by INTOSAI states the purpose of audit as follows : “The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is

public finances. The Law on State Supreme Audit Institution¹⁵ enacted in December 1997, amended in April 2000, governs the working of the HSC. The April 2000 amendment changed the three member Board model to a monocratic model headed by a Chairman, a designation retained even after dismantling of the three member Board.

86. The law, in accordance with the INTOSAI standards¹⁶, defines audit to include legality, regularity, and performance; and provides a broad scope of audit to cover audit of state property and implementation of State budget. HSC has the right to audit entities in which the state either owns more than one-half of the quotas or shares, or guarantees their debts, credits and obligations¹⁷. HSC also has a right to audit private organizations that receive funds from the State or via the State budget.
87. The objectives of HSC as stated in the law are to ensure “proper and effective use of public funds, the development of sound financial management, and the audit of orderly execution of administrative activities.” Another objective clearly stipulated in the law is to provide information to the public authorities and public through publication of an objective report.

Structure and working of the High State Control

88. The law stipulates that financial resources for HSC shall be provided as a separate chapter in the annual state budget. The draft budget is required to be provided by HSC to the Economic, Financial, and Privatization Committee of the Parliament, who in turn presents it in the Parliament.
89. However, in practice, in the absence of a strong and effective Parliamentary committee, HSC is dependent upon MoF for sufficient budget allocations every year. The Chairman of HSC on many occasions seeks a meeting with the Finance Minister to pursue HSC budget proposals. This situation, where HSC is at the mercy of MoF to receive adequate budget for its activities, may be compromising the independence of HSC.
90. The Constitution states that the Chairman of HSC should be appointed and dismissed by the Parliament on the proposal of the President. It should be noted here that the Chairman, though appointed and dismissed by the

to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent--or at least render more difficult--such breaches.”
http://www.intosai.org/2_LIMADe.html

¹⁵ Law on the State Supreme Audit Institution, # 8270 dated December 23, 1997 and as amended on April 10, 2000.

¹⁶ See INTOSAI Audit Standards http://www.intosai.org/2_CodEth_AudStand2001_E.pdf

¹⁷ The Constitution of Albania Article 163

Parliament, is not an officer of the Parliament. HSC is a separate institution created by the Constitution. The Chairman remains in office for seven years, with the right of reelection. There is an informal understanding between the parties that the opposition parties would nominate the Chairman to be then proposed by the President. The Law requires Chairman to be a university graduate in finance or economics or law and possess a minimum of ten years of experience. The Chairman is barred from accepting any duties with or without remuneration in public and private bodies, and membership in any political party. He is required to take the oath of office in the Parliament. The current Chairman worked in the MoF prior to his current appointment. The Law also clearly defines the circumstances in which the Chairman can be removed from office, e.g. upon conviction for a criminal offense, absence from work for more than six months, mental or physical incapacitation, or accepting duties that are incompatible with the duties of the Chairman.

91. The Chairman has full authority to determine the structure and staffing of HSC, the salary structure, annual work program, and duties and responsibilities of directors. The Law has adequate provisions to ensure the functional and organizational independence of HSC, so as to enable it to accomplish the task of audit objectively and effectively.
92. HSC has a staff complement of 140. It has an independent cadre of staff and the staff is not on loan or deputation from the line ministries or other agencies. The law also empowers HSC to appoint experts on a temporary basis. It has 6 departments, which are headed by Directors who are appointed by the Chairman. HSC operates from the central office in Tirana and six regional offices. Considering fairly recent origins of HSC and the evolving nature of the accounting and auditing education in the country, HSC would benefit by entering into twinning arrangements with another well-established SAI that would enable the HSC staff to learn latest techniques in risk-based auditing and recent advances in Government auditing. The HSC did not receive any substantive technical assistance in the past.
93. The General Secretary, appointed by the Chairman, supervises day-to-day working of the HSC. For coordinating the work amongst different departments within HSC, it has established a Cabinet, which is headed by a Chief who reports to the General Secretary. The heads of department within HSC are members of the Cabinet. The role of the General Secretary and the Chief of Cabinet is akin to that of the Chief Executive and Chief Operating Officer respectively. The Cabinet is responsible for preparing audit plans, preparing periodical audit bulletins and annual audit report, organizing training programs, reviewing complaints received by the Chairman and following up on responses.
94. The internal working of the HSC is governed by the “Internal Regulations on the Functioning of the State Supreme Audit Institution” issued in March 2001.

The regulations, to a very large extent, are based on the INTOSAI documents and standards, which is commendable.

HSC Audit Reports

95. The Constitution requires HSC to submit the following reports to the Parliament:
- a report on the implementation of the annual State budget;
 - opinion on the report of the CoM on the expenses of the previous financial year;
 - an annual report on its activities; and
 - report on the results of audits / reviews specially requested by the Parliament.
96. It is interesting to note that the HSC is required to provide an opinion not only on the annual financial statements but also on the report prepared by the CoM on the previous year's budget implementation¹⁸. In addition, the Law authorizes the Chairman to report to the Parliament on matters of importance any time during the year. HSC is also authorized to present reports or documents to the CoM on matters of State and public interest. By specifying the Parliament as the primary recipient of the audit reports, the Constitution and the Law has clearly established the reporting relationships for HSC.
97. Although the Law requires HSC to follow audit standards promulgated by INTOSAI, thus ensuring adoption of acceptable international standards in the conduct of audit, the actual implementation of these standards is yet to be satisfactory for reasons mentioned earlier. The auditors in HSC need substantial training and on-the-job experience in implementing these standards fully. Twinning arrangements with a well established SAI in the region could provide the necessary training and experience to the auditors in HSC.
98. Most of the audit work is performed in the field. There does not appear to be any cases in which auditors were denied information that they had requested. At the end of the field audit, a provisional audit report is prepared and submitted to the head of the department, who gets one month to respond. The auditors, based on the response received, finalize the audit report. The head of the audit department within HSC reviews the finalized audit report before submission to the Chairman for signature and transmission to the head of the line department.
99. The HSC generally has been submitting audit reports on the State budget execution to the Parliament in the last quarter of the following year. Neither the audit report nor the annual activity report provides an executive summary (each report exceeds 125 pages) and it is difficult to discern major issues amidst the vast amount of detailed factual information. The format and presentation of the

¹⁸ The report of the CoM provides analytical information on the budget execution during the year.

audit report and the annual activity report could be greatly improved by providing an executive summary and stating issues and conclusions. It will also be important that HSC identifies the root causes of the reported weaknesses. In addition, the reports should also state the purpose, scope of the audit, and auditing standards followed in the conduct of the audit.

100. As a result of the report submitted by HSC for the year 2000¹⁹, the following personnel actions were taken:

No. of line ministry staff reprimanded	81
Suspension of promotion	16
Transfer to a lower grade	37
Removal from Civil Service	13
Removal from Office	21
Imposition of penalty	84

(Source : Report on the Activity of the HSC for the year 2000)

101. The audit reports are in the public domain. HSC also publishes quarterly audit bulletins that provide a summary of the work carried out by the HSC. The audit reports are also made available on the HSC web site²⁰.
102. Although HSC has adequate staff and adopted the international audit standards, as stressed earlier, HSC needs to train and develop professional skills of its auditors. In view of this, the audit of Bank-financed projects should continue to be carried out by international audit firms until HSC develops the necessary capacity and skills base.

8. Legislative Oversight Over the Executive

103. The Constitution has provided for legislative oversight over the executive in several ways, for example, by requiring Parliament²¹ to approve the annual budget and the annual report of the CoM on budget execution, and to review the annual audit report submitted by HSC. The Parliament also approves the appointment of the Chairman of HSC. The plenary sessions of the Parliament are open both to the public and the media.
104. Another significant provision in the Albanian Constitution concerns the establishment of Peoples Advocate (or ombudsman) which is supposed to defend not only human rights but also develop a culture of good governance. It protects legitimate interests of individuals from unlawful or improper action or failure to act by the organs of public administration. The Peoples Advocate is appointed by the Parliament by 3/5th majority for a period of five years. The

¹⁹ Report on the Activity of the State Supreme Audit for the year 2000, Table 5

²⁰ HSC website <http://members.albaniaonline.net/klsh/englishh.htm>

²¹ Parliament website <http://www.parlament.al/english/eng-ver.html>

first ombudsman was appointed in February 2000. It is too early to assess the ombudsman's performance in developing a culture of good governance.

105. The Organic Budget Law requires the CoM to inform the Parliament of any changes in the budget resulting from new economic circumstances in July of each year (Article 32), and requires the Finance Minister to present the final accounts of revenues and expenditures to the Parliament for examination and approval by 30th June each year. These provisions ensure proper legislative scrutiny over the executive actions.
106. After each general election, the Parliament constitutes an Economic, Finance, and Privatization (EFP) Commission to conduct detailed review of the budget proposals and budget execution reports. The Chairman of the commission is a member of the majority party whereas the Deputy Chairman is from the minority party. Nine other members of the Commission are nominated by the Parliament based on the strength of each party in the Parliament. For the Commission to be most effective, it is important that its members view their work as both important and not politically partisan in nature. One important step is in the selection of members with careful attention to how they would approach the work. The leadership of the Commission is also vitally important. It appears to be helpful if the Chair is a senior and respected member of a party that is not affiliated with the Government.
107. The EFP Commission relies on the analytical reports prepared by the MoF, it has no research or professional staff of its own to conduct analysis and research. Without independent supporting research data, the discussions in the Commission would degenerate into political rhetoric rather than substantive. Fortunately, in November 2001 the Commission hired an Economics professor on a short-term basis to provide research inputs. An important aspect of the Commission proceedings is that they are open to the media. The Commission presents its report on the Government budget proposals in the plenary session of the Parliament.
108. The Commission is also charged with the responsibility of providing oversight over the budget execution. In this regard, the Commission is empowered to summon a minister or the head of a department to review the budget implementation. The Commission also coordinates with HSC. The Commission presents its annual report on the budget execution to the Parliament. Capacity within the Commission to provide oversight over budget execution is limited, as it has no specialized staff to review the line ministry reports and the HSC audit reports. There are no established procedures for the Government to formally respond to the recommendations of the Parliament. Good governance requires capacity and effectiveness in both the executive and legislative branches of Government. The Commission should be provided with sufficient resources and training, and access to expertise that they might require for

enhancing effectiveness. The Commission has expressed keen interest in learning and adapting international best practices.

9. **Anti-Corruption Measures**

109. The report prepared by the CoM “Combating Corruption in Albania : A Comprehensive Reform Program”, though dated August 1998 but still applicable, is candid in admitting that corruption is widespread in Albania and that it has great costs for social and economic development. A recent report (February 2001) on “Legal Assessment of Corruption in Albania”, prepared by Institute of Contemporary Studies, concludes that Albania has a legislative framework to fight corruption, but it suffers from poor implementation and enforcement due to very weak institutions implementing the laws. For example, according to surveys, the general public perceives the office of the Prosecutor and the tribunals as corrupt organizations.
110. The Bank has been supporting the Government in implementing an anti-corruption program. The revised Anti-Corruption Plan Matrix, adopted by the Government in July 2000, has more than 130 measures in five areas : institutional reform, strengthening legislation, financial management, promoting transparency, and creating public awareness. The Government has created an Anti-Corruption Monitoring Group (ACMG) to closely monitor the progress in implementation. The Bank-financed freestanding Legal and Judicial Reform Project is implementing several policy reforms and institution building measures. The Public Administration Reform Project is supporting reforms aimed at improving the targeting, transparency, and effectiveness of public expenditures. In addition, the Bank is also providing support through non-lending activities in the Government’s anticorruption strategy. The Council of Europe is also providing assistance to the Government through its Stability Pact Anti-corruption Initiative (SPAI).

10. **Fiduciary Arrangements in Bank Financed Projects**

111. Since Albania became a member of the World Bank in 1991, all lending to the country has been on IDA terms and includes a total of 43 credits with a total commitment of over USD 565 million²². There are 21 projects currently under implementation with commitments ranging from USD 5 million to USD 30 million. With only few exceptions, all projects are managed by stand-alone Project Implementing Units (PIU) within the implementing Ministry or the revenue earning entities. The PIU staff are hired by the line ministry on a contractual basis for the duration of the project. A director, responsible for the implementation of the project and reporting directly to the line Minister, heads each PIU. The core staff in each PIU includes an accountant and procurement officer who are selected directly by the project director.

²² As of 30 November 2001

112. Due to the scarcity of skilled accounting professionals, recruitment of accountant for the project is a difficult, and the PIU often ends up hiring a person with some bookkeeping background who is then provided with initial training in project financial management. Many of the accountants also undergo periodic training in financial management.
113. Although all projects in Albania prepare Project Management Reports (PMR), introduced by the Loan Administration Change Initiative (LACI) in 1998, the method of disbursement is still transaction-based and no project has yet adopted the PMR-based disbursement method. PIUs in Albania have been using standard accounting software that is capable of producing PMRs thus obviating the development of accounting software for each project. The software is flexible enough to prepare reports required under the Albanian legislation and produce the new Financial Monitoring Reports (FMR) introduced by the Bank in December 2001. The standardized software provides a clear audit trail and also facilitates exchange of experience and cross-fertilization among implementing entities. The accounting is based on the double entry method using cash basis.
114. The policies and procedures are documented in the Accounting Manual for each project. Due to the limited size of the project, with the exception of the Albanian Development Fund (ADF), no PIU has established an internal audit function.
115. The field-based Financial Management Specialist assisted by the Disbursement Assistant carries out Bank supervision of the projects at least once a year. The supervision covers review of financial management and disbursement arrangements, consistent application of policies and procedures described in the project's Accounting Manual, and follow-up of recommendations provided by the auditor in the management letter. The Bank supervision, in the last couple of years, did not detect any substantial financial management issue in the Bank-financed projects.
116. A single international firm audits bank-financed projects, except projects implemented by revenue earning entities. The appointment is on an annual basis. For revenue-earning projects, the respective revenue earning entities appoint the auditors.
117. Until FY 2000, the cost of annual project audit was financed under the credit. However, beginning in FY 2001 the Government will be paying the audit fees from its own budget. The auditor is selected amongst a list of three international audit firms who have established their offices in Tirana. International audit firms carry out the audit of Bank-financed projects since the local audit profession is still in the early stage of development and the local professional association of auditors has yet to adopt the International Standards on Auditing (ISA).

118. The audit reports submitted for non-revenue earning Bank-financed projects, in the last couple of years (1999 and 2000), did not raise any significant issues regarding accounting, reporting or internal controls. However, all audit reports for projects implemented by revenue-earning entities were qualified. The qualifications in the audit report underscore the inadequate financial management arrangements in the entities as reflected in the inability of the auditor to obtain adequate information on the company's assets and liabilities, inappropriate accounting policies adopted by the entity, and inadequate accounting records maintained by the company.
119. In the last couple of years, the audit reports were submitted to the Bank after the due date of June 30. The delay was due to late appointment of auditor and delay in carrying out the audit, as the capacity among international audit firms is still low. However, with the MoF appointing the auditors under a single contract, it is expected that the appointment would be on time and the auditors would get sufficient time to plan their audits.
120. Although the Bank has not yet carried out a formal assessment of audit firms, the review of audit reports indicates that the auditors do not have full understanding of the Bank's financial management, disbursement and procurement requirements. As a result, the audit reports do not provide full assurance that all the transactions are executed in accordance with the legal agreements and Bank policies. The Bank would need to provide formal training in Bank policies and procedures to the audit firms so as to enable them to better assess compliance with the Bank requirements. In addition, the Bank should carry out a structured formal assessment of the capacity of audit firms to carry out audit of Bank-financed projects.

11. Private Sector Accounting and Reporting

Business Environment

121. An extremely poor country by European standards, Albania is making the difficult transition to a more open-market economy. The majority of businesses have now been transferred to the private sector, with the State retaining interests in only a handful of strategic enterprises (power, telecom etc.) and the Savings Bank (privatization of the Savings Bank is a condition of the proposed Financial Sector Adjustment Credit). However, the formal private sector has been slow to recover from the 1997 crisis and a large proportion of economic activity is cash based and transacted through the informal sector. Some estimates put the size of the grey economy at around 50% of GDP. The Albanian economy is dominated by the agricultural sector that employs 58% (761,000 people) of the labor force. The enterprise sector employs only 11% (148,000 people) of the workforce. Most, if not all, Albanian commercial entities fall within the EU definition of "small enterprises" and hence would

have only limited external reporting requirements (primarily taxation reporting).

Analysis of Enterprise Sector by Revenue

Turnover in million leks	Turnover \$'000	Number of enterprises	Average number of employees
< 4	28	28,384	47,399
4 - 20	28 - 138	5,758	27,017
20 - 50	138 - 345	957	15,503
50 - 100	345 - 690	304	9,259
100 - 200	690 - 1,380	148	10,791
> 200	> 1,380	127	38,034
Total		35,678	148,003

Source: INSTAT annual structural survey of economic enterprises 1999

122. Albania has enacted legislation to facilitate the public trading of corporate securities but currently no stock exchange exists. With the collapse of pyramid investment schemes fresh in the minds of the Albanian public, it would be essential that any company listing its securities adhere to the highest standards of corporate governance including the regular disclosure of relevant, reliable and timely financial information. The European Union is proposing that, from 2005, all listed companies be required to publish financial statements prepared in accordance with IAS. Though Albania is not currently an EU accession candidate, it would be in Albania's interest to adopt what is likely to become the de facto accounting standard for all European (EU and non-EU) listed companies.
123. Albania has 13 banks. The majority of banks are either partly or fully owned by foreign investors and many have benefited from technical assistance provided by the parent bank. The most notable exception is the State owned Savings Bank, which accounts for 61% of the assets and 71% of the deposits of the financial sector.
124. The insurance industry is dominated by INSIG, a State owned company providing primarily property insurance products. Another two, privately owned, insurers are operating in Albania.

Accounting

125. The current Law on Accounting was published in 1993, shortly after the country embarked on its transition from a centrally planned to a market oriented economy. It requires all joint stock companies, all banks and those limited

liability companies with a turnover exceeding 50 million lek (USD 345,000) or more than 10 employees to maintain their accounts on the accruals basis.

126. The accounting law was drafted with the assistance from the EU Phare program and many of the basic concepts underlying the law will be familiar to an international audience:
- historical cost accounting;
 - accrual accounting and the matching concept;
 - consistency of accounting policies and presentation between periods;
 - assumption of the going concern basis;
 - materiality; and
 - no offsetting of assets and liabilities or income and expenses.
127. All companies must adopt an accounting system in compliance with the accounting plans issued by the Council of Ministers. For the private sector, there are currently two such accounting plans:
- Accounting plan for banks; and
 - Accounting plan for all other entities
128. The annual financial statements comprise the balance sheet, income statement and notes to the accounts. The notes describe the accounting policies adopted by the company and may give more detailed analyses of certain balance sheet or income statement items. With the vast majority of companies being closely held, the financial statements are produced primarily for tax reporting purposes.
129. For banks, the situation is a little less clear; while the Accounting Law states that the Council of Ministers determines the accounting systems for all commercial entities (including banks), the Banking Law states that the form and content of the financial statements of banks shall be determined by the Bank of Albania (BoA). The BoA has determined that banks shall prepare their financial statements in accordance with IAS, giving rise to some minor conflicts between its rules and the Accounting Law. In practice, the banks have followed the instructions of the BoA but there is a potential for confusion and the BoA and the Government should work together to harmonize the Accounting Law and the BoA regulations in this regard.
130. There are currently no special accounting rules or disclosure requirements for insurance companies. It is unlikely that the general accounting principles applicable to trading companies will, in this environment, give sufficient guidance to insurance companies regarding the recognition of earnings and the accumulation of loss reserves.
131. The annual financial statements are required to be signed by a company director and an approved accountant; the MOF is the body responsible for approving

accountants. To become an approved accountant, a person must either; (i) possess a bachelors degree in accounting and finance and have at least 3 years practical experience; or (ii) possess a bachelors degree (any subject), have at least 3 years practical experience and have passed an examination set by the MOF.

132. Under the auspices of the Financial Sector Adjustment Credit (FSAC), a new law on accounting is currently being drafted. This law is part of a wider review of the corporate governance environment in Albania. It is our understanding that the new law will clearly differentiate between banks, insurance companies, listed companies and other public trust entities, which will be required to implement IAS in full, and other corporate bodies which will be subject to a much simpler accounting and reporting regime. Currently, there is no official translation of IAS into the Albanian language. This might impede the introduction of IAS for banks, insurance companies etc. and therefore, consideration should be given to commissioning an official translation.
133. The Law on Accounting established National Accounting Council under the Ministry of Finance. The Council, which is supported by a small secretariat, comprises 9 members from the MoF, academia, the accounting profession and business. The Council is responsible for drafting the detailed accounting standards (instructions) and for advising on the implementation of the standards

Accountancy Training

134. The main center for academic accountancy training is the Economics Faculty of the University of Tirana. The university offers a four-year undergraduate economics program with the option to major in either accounting or finance after the second year. Students majoring in accounting study the following accountancy related topics as part of their course:
 - Principals of finance
 - Financial analysis
 - Internal auditing
 - Cost and management accounting
 - Enterprise sector accounting
 - Public sector accounting
 - Bank accounting
135. The students also receive some practical training in the use of accounting software and spreadsheets packages but there is a chronic shortage of computers in the university and therefore students have little opportunity to gain hands-on experience. Further, much of the written materials available within the university are old and in short supply. The university graduates 200 – 240 students each year, divided fairly evenly between those majoring in accounting and those majoring in finance. In addition to the undergraduate

courses, the university offers an MBA program (in conjunction with the University of Nebraska) and a Diploma course (distance learning program) in accounting and finance.

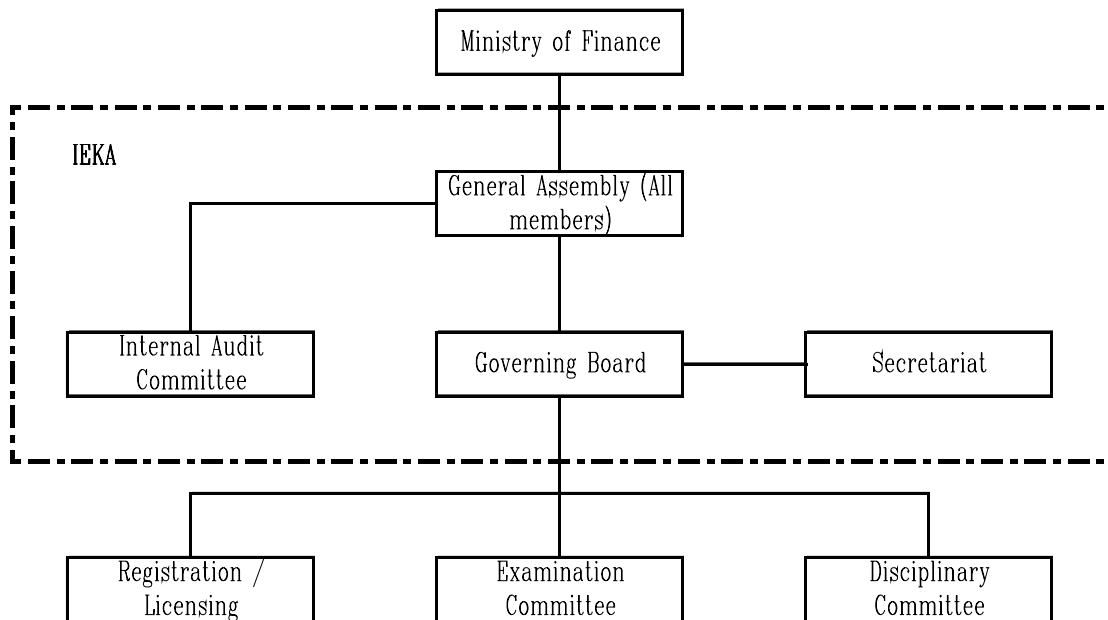
Auditing

136. The Trade Companies Law stipulates that annual audits, performed by independent external auditors, are required for all joint stock companies and for limited liability companies which meet two of the following three criteria:
- Total assets > 6 million Lek (USD 43,000)
 - Turnover > 12 million Lek (USD 46,000)
 - More than 10 employees
137. It is estimated that only around 1,000 of the Albania's 35,000 companies meet two of the above criteria.
138. By a decree of the CoM, the "Instituti I Eksperteve Kontable to Autorizuar" (IEKA), is the professional association for all auditors in Albania. IEKA has 120 members, who perform the approximately 1,000 statutory audits that are required each year. In order to become a member of IEKA, a candidate must:
- Be at least 25 years of age;
 - Have at least 3 years of professional experience;
 - Have no criminal record; and
 - Pass 5 professional examinations.
139. IEKA, which is an associate member of the International Federation of Accountants (IFAC) and a member of the South Eastern European Partnership on Accounting Development (SEEPAD), has received assistance from the Institute of Chartered Accountants in Scotland (ICAS) to establish a professional education and testing program. Candidates for membership of IEKA must pass the following written examinations:
- Accounting and financial analysis;
 - Auditing and professional standards;
 - Law;
 - Business management and MIS; and
 - Taxation.
140. Auditing companies may also register as members of IEKA; generally the company must be 75% owned and controlled by auditors who are themselves member of IEKA. Acknowledging that auditing practices in Albania are in the early stages of development and that many auditors do not have the experience to properly audit complex financial institutions, IEKA has also made provision

for foreign firms, which audit most of Albania’s banks, to obtain membership; currently Deloitte and Touché Albania and KPMG Milan are IEKA members.

- 141. Though funded primarily through membership fees, IEKA is not a Self Regulatory Organization (SRO); it is subject to oversight by the MoF. Initial drafts of the new accounting law included provisions establishing IEKA as an SRO. Given the difficulty of the local business environment and the well-publicized failure of SROs to properly regulate some of the large international auditing firms, it would be premature for the MoF to relinquish its oversight function. The structure of IEKA is depicted in the Chart 1.
- 142. IEKA seeks to maintain professional standards of its members through an annual peer review process. Fifteen auditors, formed into 5 teams, review the audit working papers of 30 members and interview the auditor and his staff. IEKA’s audit methodology was prepared by ICAS (based on International Standards on Auditing) and it is against this benchmark that an auditor’s work is measured. Since the review program commenced in 1998/99, 7 auditors have been censured and 5 have been suspended from practice for 1-2 years.
- 143. IEKA is currently translating the International Standards on Auditing into Albanian. When this is complete, the institute will adopt the Standards as their own.

Chart 1 : Structure of IEKA



IEKA members form only a minority on each of these committees

12. Recommendations

144. This CFAA has identified the following major issues in public financial accountability:
- weak capacity in several institutions;
 - weak internal controls including inadequate cash management and weak internal audit function;
 - absence of a solid legal basis for internal audit in the public sector;
145. In the area of private sector accounting and auditing, the major issues are:
- need to differentiate between the banks, insurance companies, listed companies, non-listed companies, and other entities for determining applicable accounting standards;
 - weak audit capacity and lack of experience in implementing ISA
146. The recommendations of the CFAA are grouped into areas that require priority attention and other systemic improvements over the medium and long term.

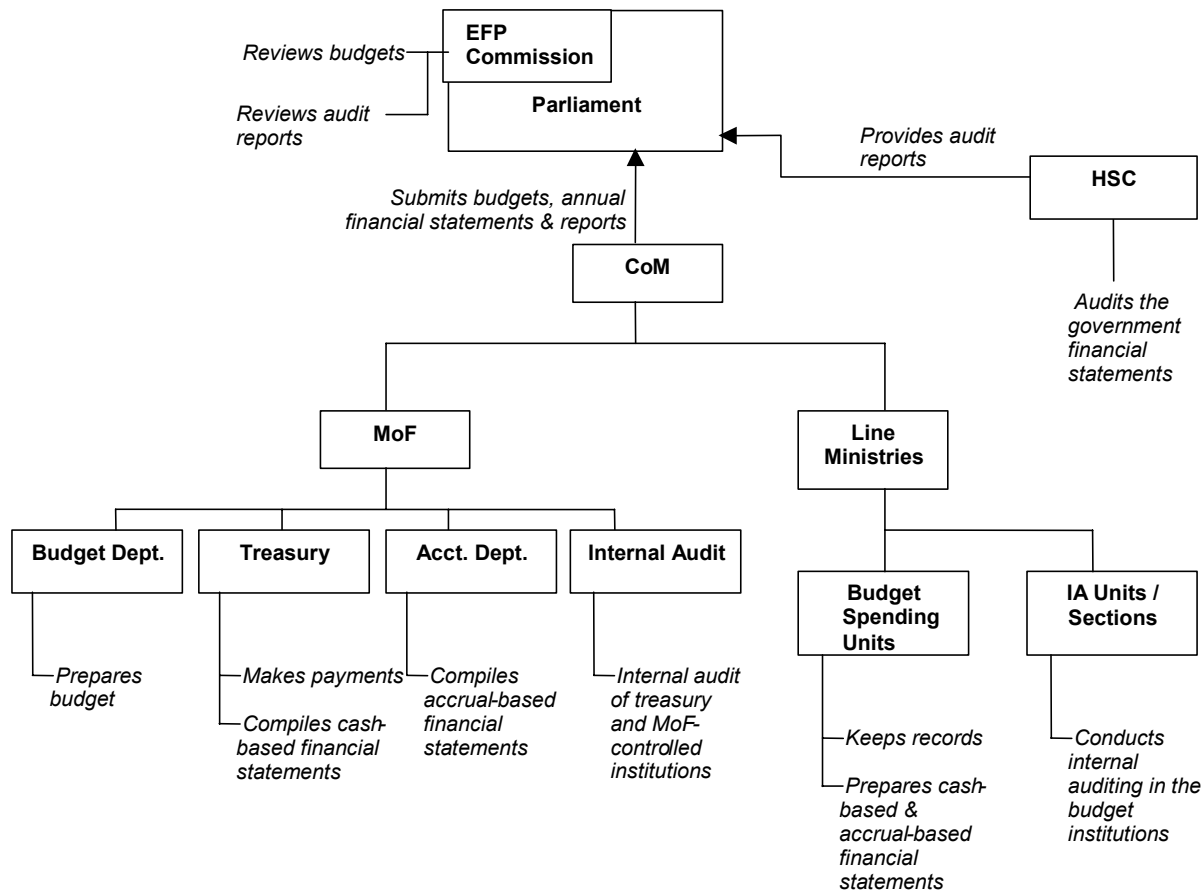
Key Recommendations

- strengthen internal controls including internal controls in the treasury, strengthen treasury cash management function, more specifically by establishing daily reconciliation of district treasury payment requests with the reimbursement by the Bank of Albania to the agent banks, and by daily reconciliation between revenue collections transferred by the agent banks with the taxpayer filled payment forms;
- enact the Law on Public Sector Internal Audit;
- build internal audit capacity – establish effective internal audit structures in the line ministries, prepare rules and methodology for conducting internal audit in the public sector, provide extensive training to the internal audit staff;
- build capacity in the Accounting Department (MoF) to prepare consolidated financial statements for the Government;
- strengthen capacity of HSC – consider twinning arrangements with a well-established SAI in the region; and
- enact a new law on accounting clearly differentiating between the between banks, insurance companies, listed companies, non-listed companies, and other entities for determining applicable accounting standards.

Systemic Improvements

- commence implementation of the treasury automation project;
- introduce uniform and integrated accounting and reporting software in budget spending units that is using the same database as the treasury and adhering to the one transaction – one data entry – one record principle;
- computerize employee payroll by creating centralized and secure employee database;
- strengthen internal audit capacity within SII and introduce computerized pension and accounting systems in districts;
- strengthen the skills of the line ministry staff to undertake programmatic budgeting, now adopted by the Government, by conducting extensive training programs;
- develop clear-cut criteria for selection of capital projects, including specifying technical, economic, financial, environment, and social criteria;
- extend computerization to the district level in SII and create a secured central pension database;
- introduce budget evaluation function for proper evaluation of budget outcomes, thus enabling the results to be factored into the in the capital budgeting process and increasing the accountability of project managers;
- strengthen the Parliamentary commission on Economic, Finance, and Privatization (EFP) to provide effective oversight of the executive arm of the Government by building research and analytical capacity and by providing exposure to internal best practices in the legislative scrutiny; and
- Officially translate IAS and ISA into Albanian.

Schematic Diagram of Fiduciary Institutions



EFP = Economic, Finance, and Privatization (EFP) Commission - a committee of the Parliament.

CoM = Council of Ministers, headed by the Prime Minister

MoF = Ministry of Finance

HSC = High State Control, the Supreme Audit Institution of Albania

IA Units = Internal Audit Units

