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Slovakia

COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT

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Slovakia

Country Financial Accountability Assessment

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Executive summary

1. In financial management terms Slovakia is poised between an over-controlled and secretive past, and a future which requires a wider distribution of powers matched by far greater transparency and public accountability. Familiarity with former systems, conservatism and risk aversion pull in one direction; the need for change pulls in another. Does Slovakia have the vision, courage and skills to confront the challenges? The answer is: not yet, but maybe soon.

2. The private sector inheritance is one of technical competence (detailed charts of accounts; good book-keeping skills; a well-disciplined system; and a comprehensive approach). Its weaknesses are

- lack of users of accounting information in the sense of the lack of people needing to make economic decisions (buy, sell, invest, liquidate) on the basis of financial reports
- financial statements which comply with formal requirements but which are not relevant to decision-making, either by management or by external parties
- financial statements which do not comply with international norms
- an audit profession which is not yet fully familiar with its role in giving audit opinions on financial statements
- lack of connection between the financial statements of enterprises and the needs of the capital market

3. The Slovak agreement on accession to the European Union, effective early 1995, is a major motivating influence for reform. To become a member, Slovakia has to comply with the principles of the *Acquis Communautaire*. It has established an advisory and co-ordination body for this purpose and is seriously engaged in making the necessary changes.

4. Promising developments are occurring bringing Slovakia closer to EU requirements. The MF's role in seeing that the chart of accounts converges progressively with international accounting standards, is critical. The slow emergence of an effective capital market means that financial accountability is relatively under-developed. Once the aftermath of the banking crisis has been dealt with, improved corporate governance and a more dynamic capital market will be seen as priorities as will corporate financial reporting. The major challenge is for accounting, auditing and financial reporting to be ready to play their roles when this point is reached.

5. Slovakia's credit rating in financial markets has improved in recent years. In March 2000 when Government issued EUR500 million worth of 10 year eurobonds, Slovakia was rated at *Ba1* by Moodys and *BB+* by Standard and Poors. A further upgrade of these

ratings would further reduce the cost of capital. Improved financial accountability and reduced corruption would help to bring this about. Thus there is a substantial benefit in bringing about the reforms with which this paper is concerned.

6. For the state proper, basic systems have been established: a well-defined budget process; reliable systems of accounting and budgetary control and systems of audit and control. Improvements are needed such as a more flexible and responsive government accounting system resulting in meaningful audited financial statements being presented to the National Council; an external auditor with more advanced skills, the duty to attest the accuracy and reliability of the financial statements which it audits and the obligation to report on significant financial management matters directly to the Slovak people. Sources of financial management risk exist in the areas of state guarantees and extra-budgetary funds. The misuse of funds continues to be a general problem which must be brought under control. Clearly there are differences between the systems as designed and their working in practice. Such problems would be greatly diminished by greater transparency, which implies the need to understand principles of public accountability and to apply them with vigor throughout Slovakia.[1] Given the above weaknesses, the risks of funds not reaching their intended destinations appear moderately high. Corruption has not yet been brought under control. Furthermore the budget suffers from unpredictability because improvident past policies suddenly have major impacts on today's decisions. A means of anticipating such factors is badly needed. Financial management reforms should be pursued as part of a more general program for improved governance and public expenditure management with emphasis on accountability, transparency and more effective use of public resources.

7. Self-governing local entities were established with considerable independence. The challenge is to create the correct financial management regime under which these entities can work, one in which the state is not an every day player but a regulator and a remote monitor which sets the rules of the game and checks whether they are followed, intervening infrequently in very significant cases where corrective action is needed.

8. Improved financial control and accountability do not just happen. They have to be planned and so do the conditions for their success. New legal forms and institutions are a good start but attitudes also have to change. It is at this level that Slovakia faces the greatest challenge which is to gain support for a new management model for both public and private sectors. A medium term expenditure framework offers a possible means of pursuing a program of expenditure management and budgetary reforms.

9. Several additional financial management actions are required in the public sector:

- to ratify the European convention on money laundering

- to set up a public procurement office and to establish procurement monitoring procedures

[1] Government of Slovakia might decide to complete the IMF's fiscal transparency questionnaire as a way of gaining greater understanding of the status of its fiscal transparency arrangements and of the issues which need to be addressed in this area.

- to complete the legislative framework for internal and external financial control

- to strengthen the NKU and to extend its audit mandate to cover public funds in general including certain extra budgetary funds

- to publish consolidated financial management data relating to general government

10. Slovakia will also have to meet the *Maastricht* criteria: government debt no greater than 60%, and the budget deficit no more than 3% of GDP. While the nominal budget deficit was around 2%, it has grown and is now probably as much as 5% due to quasi-fiscal transactions (contingent liabilities arising from guarantees; the cost of rescuing the country's largest banks, deficits of certain public funds etc.).

Glossary

EBF	Extra Budgetary Fund
EU	European Union
EUR	Euro (unit of currency)
GDP	Gross Domestic Product
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IMF	International Monetary Fund
ISA	International Standards on Auditing
MF	Ministry of Finance
NBS	National Bank of Slovakia
NKU	Supreme Audit Office
OECD	Organization for Economic Cooperation and Development
SAI	Supreme Audit Institution
SIGMA	Support for Improvements in Governance and Management (OECD)
SK	Slovak unit of currency
TSA	Treasury Single Account
WTO	World Trade Organization

Slovakia

Country Financial Accountability Assessment [2]

1. Introduction

1.1 Slovak financial accountability systems are strongly influenced by the Communist past but must meet the needs of a European future. Fortunately, Slovakia has the benefit of laws and institutions pre-dating communism, easing the transition from one system to the other. Past influences are still strong: centralization, strong controls and a uniform system of accounting based on a chart of accounts. In future Slovakia will need improved public financial management, fiscal decentralization, a more competitive economy, an effective capital market and harmonization of standards with those of the European Union. A good start has been made on many fronts. But there is still tension between the culture of control and a more flexible policy based on standards, quality performance, accountability and competition.

1.2 Accountability is the need to give answers with respect to responsibilities conferred (for instance about duties to be carried out; assets to be managed; resources used). It applies within organizations where it is part of normal hierarchical relationships and ways of doing business. More important in the current context is external accountability between an entity (for example an entire government; a government entity; a company) and the outside world.

1.3 Managers of public and private entities are in a position of trust because they manage other people's money. The principle of public accountability treats them as agents and requires them to make public disclosures of key information on management, ownership performance and financial status of the entities which they manage. The aim is to inform the outside world on their financial stewardship, provide relevant information to the capital market and reduce opportunities for managers to milk their organizations by ensuring a degree of transparency. Accountability also requires independent verification of the information disclosed and of compliance with norms (the job of the professional auditor). Adopting principles of public accountability shines a light in dark corners. It empowers the public by making key information available on how entities are managed and therefore effectively limits the discretion of managers to abuse their positions of trust and provides them with a powerful incentive to be good managers.

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[2] A country financial accountability assessment (CFAA) considers the strength of financial accountability processes in both the public and private sectors. The aim is to assess whether existing processes are strong enough to ensure that funds are spent for their intended purposes. A CFAA is an assessment and not an audit and it is carried out by Bank staff with the help of officials of the country concerned. Therefore its findings do not provide a complete assurance concerning the status of financial accountability processes. However it provides a well-informed and objective assessment, a diagnosis of problems, advice on their resolution and a rough indication of the level of financial accountability risk in the country concerned. This CFAA was written by Peter Dean as part of a team led by Jean-Jacques Dethier responsible for preparing a Public Sector Reform Loan for Slovakia.

1.4 Corruption is defined as the abuse of public resources for private gain. Transparency International assesses Slovakia at 3.7 on a scale between 1 and 10 on its perceptions of corruption index. A score of ten implies a corruption-free environment. A score of 3.7 places Slovakia 53rd in the list of 99 countries for which scores are available. The Slovak Republic compares with selected countries in the same region as follows:

Country	*Rank*	*Score*
Hungary	31	5.2
Poland	44	4.2
Slovak Republic	53	3.7
Bulgaria	63	3.3
Ukraine	75	2.6
Russia	82	2.4

1.5 The local chapter of Transparency International has carried out a series of surveys of corruption and has produced a 106 page report on corruption in Slovakia. Amongst the findings are:

- Corruption affects almost all population groups and accompanies the Slovak citizen on every step and every serious occasion. Corruption is not solely connected with big deals, big business or high politics.

- All types of corruption, clientelism (patronage) and criminality occur often or very often in Slovakia (this answer was given by 51-80% of the respondents to the TI survey).

- In the opinion of business community representatives, corruption is most widespread at ministries and other central state administrative bodies, followed by customs authorities, and less so (but still significant) at district and regional government offices, courts, tax authorities, municipalities and employment offices.

1.6 A national program to fight corruption was launched by the Prime Minister in February 2000. Its many components include better access to information and improved transparency in public administration; reducing discretionary power in decision-making; improving transparency of financial transactions; reforming political party financing; improving financial audit and control mechanisms; and introducing a declaration of assets from by public officials.[3] Clearly, improved financial management and accountability are key to the program's success.

[3] Law no. 46 of 1999 provides for the disclosure of expenses by political candidates. Political parties are required to produce annual reports for Parliament but the contributors and their contributions are non-transparent and the financial statements of political parties need not be audited.

2. Private sector

2.1 Legal framework

2.11 The legal framework is provided by the Act on Accounting (No. 563/1991) as amended in 1999; by the Act concerning Auditors and the Slovak Chamber of Auditors (No.73/1992) which is currently in process of amendment; and by the Commercial Code (No.513/1991 as amended in 1999).

2.12 The Act on Accounting prepared on the basis of the 4th and 7th directives of the EU sets out the basic framework:

- legal entities and individuals carrying on a business must keep accounting records and supporting documents

- accounting entities (joint stock and limited liability companies) are to maintain complete, well-supported and accurate accounting records in order to be able to present a true and fair view of the transactions of the entity

- they must prepare annual financial statements for the calendar year and use the accrual basis of accounting (subject to special provisions for small entities which are allowed to prepare single entry accounts on the cash basis).

- the financial statements are to comprise an income statement and balance sheet, are to use the national language and are to be expressed in units of the national currency

- entities using double entry book-keeping are encouraged to prepare their own charts of accounts. But financial statements are to be consistent with statutory charts of accounts published by Ministry of Finance

- the financial statements are to be audited and filed with the commercial court or an economic chamber[4]

2.13 The Act deals extensively with accounting records (the books of accounts to be used) and with accounting documents, their archiving and retention) and briefly with issues such as currency translation and consolidation.

2.14 Valuation of assets is at cost. However allowance is to be made for loss and deterioration. Regular inventory-taking is required for all assets. Valuations are to be reduced to net realizable value where this is less than cost. Internally generated inventory is to be valued at cost; securities and equity interests at their purchase prices and intangibles are to be written off over five years. Accounting valuation rules are generally

[4] However the filing requirement relates to a narrow subset of accounting information with the result that there is no public access to the full annual financial statements.

conservative. However, in practice, downward adjustment for loss and deterioration of assets is not as systematic as it would be if International Accounting Standards were strictly followed. As a result, international accounting firms resident in Slovakia report that at the moment of taking over audits from national firms, considerable over-valuation of entities' assets is discovered. Presently the commercial banks are audited almost exclusively by Big Five firms. Over-valuation of assets is still thought to be widespread in that sector (estimates of over-valuation approach US$2 billion). Significant over-valuation of assets greatly diminishes the usefulness of financial statements.

2.15 From the above it is clear that Slovakia's accounting standards do not comply with International Accounting Standards (IAS). But they have been developed against an IAS background and continue to converge with IAS. In 1999, the Department of Accounting Methodology of the Ministry of Finance made changes to the Act on Accounting and methodological guidance notes. This represented a step towards compliance with IAS. The formats of corporate financial statements and classification of assets and liabilities are very close to the obligations of EU`s 4th Directive and of IAS and Notes to the Financial Statements are in full compliance with EU`s 4th Directive, the IAS Framework and IAS 1. The major differences between national and international standards are found in the following areas: leasing, deferred tax, unrealized gains (not recognized), format of the financial statements (e.g. classification of assets and liabilities).

2.16 A particular problem is evident in Slovak accounting. Form often dominates substance. The major use of commercial accounts is the calculation of business tax liability. The writing off of bad debts and obsolete inventory does not qualify as an expense in calculating taxable profit. Therefore despite the accounting requirement to write down assets to realizable value where this is less than cost, this is not always done. This can result in financial statements in which assets and therefore equity are over-stated. Financial statements prepared in this way, carry little informational or analytical value either for internal management or for external accountability purposes.

2.2 Accounting methodology

2.21 All accounting norms are set by the Department of Accounting Methodology of the Ministry of Finance under the Act on Accounting (1991). This is done via the issue of charts of accounts and methodological guidance notes on how to use them. There are seven charts of accounts: for entrepreneurial entities, budgetary entities, banks, insurance companies, small non-profit organizations, the National Property Fund and the Exim Bank.

2.22 The charts of accounts share a common numerical structure thus facilitating consolidation. The chart of accounts has nine main classes of accounts:

1. Intangible and tangible assets (including fixed assets, inventory and accumulated depreciation)
2. Financial accounts (cash, near cash, short term investments and short term borrowing)
3. Settlements (receivables, payables, prepayments)
4. Capital and long term liabilities

5. Expenses (including taxation accounts)

6. Revenues

7. Closing and off-balance sheet accounts (including the profit and loss account)

8. and 9. Internal accounting of the entity

2.23 Each class is further divided into account heads. Account heads are further divided into detailed accounts. Thus as far as is humanly possible, the charts of accounts provide for all foreseeable possible accounting transactions and events. However as business becomes more sophisticated, more information categories are needed. If the current set of accounts does not adequately describe a particular transaction, entities can create new account heads or detailed accounts consistent with the established chart.

2.24 Disclosure and audit requirements are determined by the Commercial Code, the Act on Accounting and the Act on Securities (No. 600/1992 as amended in 1999) with the following results:

- joint stock companies must have their financial statements audited and must make them public.
- entities whose individual regulations require it, must publish audited financial statements.
- in addition, all companies must publish audited financial statements if their annual turnover exceeds SK40 million or if their business assets exceed SK20 million.
- companies for which an audit is required must submit their financial statements to the Companies' Registry.
- small and medium-sized entities are to produce simplified financial statements according to simplified formats prescribed by MF, bringing Slovakia into compliance with the EU's 4th directive.
- publicly traded companies (including all companies privatized in the first wave of voucher privatization) are required to publish financial statements every half year, in compliance with International Accounting Standards (IAS).

In practice, publicly listed companies frequently present financial statements which are not in compliance with IAS.

2.25 Detailed notes accompany the charts of accounts. These specify the exact use of each account: its permissible content; *de minimis* rules which may apply; valuation rules; disallowed items; methods of calculating key figures; sample double entry entries showing accounts to debit and credit; and closing entries. The pros and cons of the chart of accounts approach to accounting are well-known:

Pros: consolidation of information is facilitated (between entities and between sectors); thus more uniform and more complete aggregate information is possible than in systems which allow heterogeneous account classifications; accountants have very detailed instructions which minimize issues of personal choice, resulting in a disciplined approach to recording accounting information, accounting skills are easily transferable throughout the economy and reliable book-keeping is achieved.

Cons: the result may be mechanistic book-keeping which complies with the law but may not result in useful information for market decisions; form may dominate substance and tax issues may dominate the information provided; accounting methodology cannot keep pace with the needs of the business environment; accountants equate good accounting with compliance with regulations and financial statements do not provide the most useful information for business decisions.

2.26 Slovakia shares in both pros and cons: it has built a well-documented accounting system and created a well-informed and disciplined book-keeping workforce. On the other hand, accounting has not achieved its optimum role as a business language, financial statements do not always convey useful information, Slovakia lags in the adoption of International Accounting Standards and the link between reliable accounting and the capital market is yet to be made.

2.27 Clearly, to abandon the chart of accounts at this stage would be disastrous. Rather it is necessary to build upon it: to adapt it progressively to conform with International Accounting Standards and with the European Union's 4th Directive; to improve the formats permitted for financial statements; to insist on the application of valuation rules requiring assets to be valued at the lower of cost or net realizable value; and to pave the way for the preparation of the financial statements of large corporate entities primarily for management and accountability purposes, rather than for tax purposes.

2. 3 Auditing

2.31 Auditing is regulated by the Act on Auditors and the Slovak Chamber of Auditors (No.73/1992) which is currently in process of amendment. This Act, as its name implies, is less about auditing than about auditors and their professional institute. The auditor is to verify that:

- the financial statements faithfully represent the state of affairs and results of the entity
- accounting is complete and correct and is supported by relevant documents
- relevant legislation has been followed

2.32 The auditor is to keep records on the course of the audit and at the end of the audit to report to the audited entity in writing on the above matters.

2.33 More or less standard provisions exist for the audited entity to provide information needed for the auditor to perform the audit; for the auditor to maintain confidentiality and to act independently and impartially (circumstances which would prevent an auditor from being independent are listed); for the auditor to be paid for audit services based on a contract with the client.

2.34 Auditors report to the audited entity.[5] In the private sector this means to the shareholders, partners (in limited liabilities companies) or entrepreneurs (natural persons). Auditors of joint stock companies are often appointed on the suggestion of the supervisory board of the company, after which a service contract is drawn up by management. The auditor's opinion is disclosed in the annual report of the audited entity, which according to the Act on Accounting is submitted to the Register Court not later than in three months after the general meeting at which the accounts were considered, or at the latest by the end of the year which succeeds the fiscal year under consideration.

2.35 The main activities of the Chamber of Auditors as mentioned in the Act are:

- represent, protect and enforce the legitimate interests of auditors in the Slovak Republic
- issue certificates of competence, decrees and licenses entitling people to act as auditors
- keep registers of auditors and assistant auditors
- ensure the execution of the audit act and the professionalism of the audit profession
- issue national audit standards in line with international audit standards
- guide auditors' activities in line with binding legislation and national audit standards
- create a positive environment for professional training
- comment on draft legislation that relates to the activities of auditors and business people and to co-operate with Ministry of Finance in creating generally binding legislation about accounting and auditing

2.36 The Chamber issues its own by-laws and sets its own membership fees etc. It has its own code of ethics and admits both natural and legal persons as auditors. However only a natural person can sign an audit report. To qualify a candidate must have: the capacity to carry out legal acts, a clean criminal record, successfully completed a university education specializing in economics, not less than five years relevant professional experience including at least three as an assistant to an auditor and passed

[5] This is what the Act on Auditors says; hopefully in practice auditors report to the shareholders.

the professional exam. The professional exam is set by the exam commission of the Chamber, the members of which are appointed/dismissed by the Ministry of Finance. Otherwise the Chamber is independent of government.

2.37 Proposed amendments to the Act on Auditors have been made to reflect the requirements of the 8th directive of the EU. They are as follows:

- to make the Chamber of Auditors responsible for quality control of audits
- to eliminate the requirement for mandatory rotation of auditors after three years
- to ensure that audits are conducted in the name of natural persons and not corporate entities
- to make it easier for those holding foreign accounting qualifications to be recognized as auditors
- to require the Chamber to provide high quality training for auditors
- to require the Chamber to publish at least annually a list of its members with relevant details of each

2.38 The Chamber is making important strides in the auditing field. It is aligning Slovakia's norms with International Standards of Auditing (ISA) and has published a set of auditing standards extremely close to ISA. At the practical level this may take time to show results, as practitioners adjust to a new and relatively unfamiliar regime. It also supports convergence between national and International Accounting Standards and is a candidate for IFAC membership.

2.39 A technical problem arises because of the interaction between the end of the financial year (31 December) and a single payment date for the corporate income tax (following 31 March). It has the effect of compressing the closing of accounts, their audit and tax preparation into one short period. Clearly some relaxation of these rules (perhaps involving a sliding schedule of tax payment dates) would help. Revenue losses would not be substantial because existing procedures provide for pre-collection of tax based on the results of the previous year.

2.4 Accounting profession

2.41 The accounting profession is fragmented in Slovakia. It is composed of at least four groups: members of the Chamber of Auditors (exclusively Slovak nationals at present: about 850 members); qualified and unqualified staff of the Big Five (both Slovak and foreign: about 500 both qualified and part-qualified staff; a few nationals who are employed by the Big Five are also members of the Chamber); accountants who belong to the Union of Accountants; and control staff working in the public sector (in NKU, Ministry of Finance, line ministries etc.). Such divisions occur frequently in other countries. Nevertheless the Slovak accounting profession is weaker as a result. In particular the Chamber of Auditors has been something of a closed shop which has damaged the development of the profession. [6] Amending the audit law will help, but actions speak louder than words and the basic criterion for success is a more integrated

[6] At the time of writing only one non-Slovak national is a member of the Chamber.

auditing profession with membership of foreign auditors actually encouraged (for instance fully qualified professionals already admitted under foreign jurisdictions (both nationals and foreigners) could be given reciprocal membership rights, maybe subject to passing exams in Slovak company law and taxation. Whatever reciprocal arrangements are made, the audit syllabus should be published with a supporting bibliography for students and the training arrangements broadened to counter any suggestion of a closed profession.

2.42 Local audit firms can be owned by non-Slovak residents. Under the recent amendments to the Act on Auditors, a legal person can be listed in the chamber's register if:

- the audit work is done by auditors listed in the Chamber's register.
- the majority of voting rights is held by auditors listed in the Chamber's register or in a similar register maintained in another member country of OECD
- the majority of members of the company are auditors listed in the chamber's register.

2.43 Some of the best young Slovak professionals are not members of the Chamber, but would like to be. These are people who hold recognized international accounting qualifications, and who now have to work for three years as an audit assistant and pass the national exams before they can become members. Strict requirements are contrary to the national interest. Working towards a more integrated auditing profession will equip Slovakia with professionals more capable of operating in competitive markets, more able to serve the needs of the country and more closely aligned with international norms.

2.44 The future of the accounting and auditing profession depends upon the creation of relevant skills. Therefore education and training are important. Slovakia shares the tradition of many other European countries where the only accounting courses are contained within the economics syllabus. The tradition is a respected one, but needs to be supplemented by new courses which concentrate more heavily on accounting as such (and closely related subjects). Such a course is now being planned at Matej Bel University, Banska Bystrica in co-operation with McGill University.

2.45 Meaningful development will only be possible if the focus of accounting in Slovakia changes. At present the intellectual basis of accounting and related studies is somewhat undervalued, resulting in a procedural approach to the subject. Slovakia's tradition of book-keeping using charts of accounts now has to be the launching pad for a move to a new financial management based on market needs and international standards.

2.46 Slovakia's accounting reforms may be significantly influenced by its EU aspirations. For some time it appeared that EU accounting requirements would diverge from those of IASC, thus complicating the policy choices of countries preparing for EU membership. However in June 2000 an EU *communique* announced a new strategy for European financial reporting designed to establish uniform standards in conformity with

IAS. The EU expects to make detailed proposals before the end of 2000. These are likely to require all EU companies listed on a regulated market to prepare consolidated accounts in accordance with IAS. This is expected to become effective as an EU requirement by the year 2005. Thus the policy choices confronting EU candidates are about to become simpler: complying with IAS will become a priority. This will ensure compliance with EU directives in so far as accounting standards are concerned. However EU directives will remain important to the extent that they specify reporting formats and set down criteria for accounting disclosures of companies in various size categories.

2.5 Corporate governance

2.51 Corporate governance is under-developed in Slovakia, mirroring the country's recent Communist past. Shares are not held widely and companies tend to be controlled by small groups of shareholders, particularly by previous managers. Publicly quoted companies are few and the concept of making disclosures in the public interest, quite new. There is no equivalent of the Securities and Exchange Commission[7] responsible for monitoring and regulating the capital market. The Stock Exchange plays a very limited role. Thus the capital market is under-developed. This and the crisis in the banking sector (see below) mean that the demand for accounting information and auditing services is quite weak, except as regards companies and banks which are bankrupt and therefore in need of restructuring.

2.52 Protection for minority shareholders is said to be weak. Current arrangements are that all major corporate decisions must be made by at least two-thirds of shareholders; and the Slovak Commercial Code enables the owners of at least 10% of a corporation's capital stock to call for an emergency shareholder meeting or to place an issue on the agenda of the general meeting of shareholders. Despite such provisions, foreign investors perceive inadequate minority shareholder protection as a disincentive to equity investment. Similar observations are made about the bankruptcy law.

2.53 All companies must be registered, before conducting business in the Slovak Republic. Slovakia's system of business registration relies on a network of eight regional courts. Each register is kept by a regional court. However, there is no centralized reporting process. The Slovak registration system is burdened with heavy reporting requirements, a lengthy approval process, complicated and arcane approval methods, corruption, and a court registration system that cannot handle the caseload. Investors both foreign and domestic make the accusation that by maintaining an overly complicated, non-transparent registration process, Slovakia is deliberately slowing down the process for foreign investors.

2.6 Banking supervision

2.61 NBS monitors the performance of commercial banks using both on-site and off-site examinations. Off-site procedures require commercial banks to report monthly on 70 selected indicators. In addition, they are to provide prudential reports to NBS covering

[7] Such a body is about to be established following recent legislation. However the Slovak stock market remains narrow, illiquid and therefor relatively unimportant as a source of finance or as a signaling device.

capital adequacy, liquidity, credit exposure, and foreign exchange exposure on their loan portfolios.[8] The content of these reports and their submission are governed by Bank instructions.

2.62 Articles 21 to 24 of the Banking Act 1992 (as amended) establish the basic rules for accounting and auditing of banks. Bank's accounts are to follow the methodological guidance issued by Ministry of Finance. With respect to financial statements NBS requires that all banks follow IAS 30 ("Disclosures in the financial statements of banks and of other similar financial institutions"). In addition those with foreign licenses must also comply with the rest of IASs. Banks make quarterly financial reports but only those that are listed make their results public.

2.63 The banking sector has gone through a deep crisis with many banks potentially or actually insolvent due to past lending policies. Many of the companies receiving bank loans are themselves insolvent and are therefore unable to service their borrowings. The full cost of stabilizing the banking sector is estimated at over SK100 million. This would be spread over several years. Some bad loans have been transferred to separate institutions which have been able to collect some of the sums involved. As part of the planned remedies major state banks are to be privatized and the services of J.P. Morgan have been retained for this purpose.

2.64 In the meantime commercial banks are unable to fulfil their economic role as providers of credit. Bank loans are either unavailable or excessively priced.

2.65 NBS is also responsible for certain aspects of the control of money laundering. It issues instructions to the commercial banks on how to apply the Acts of 1994 (no. 249) and 1996 (no. 58) passed to combat money laundering: which transactions should be considered as suspicious, how to spot unusual transactions, how banks should report to the tax authorities and financial police etc.

3. State sector

3.1 Legal and institutional framework

3.11 The legal framework is provided by the Act on Budgetary Rules (1995 and as subsequently amended); by the annual budget; and by the Act on the NKU (1992). The main players are the Ministry of Finance, National Bank of Slovakia which acts as the government's bank, budgetary entities, extra-budgetary funds, municipalities and the NKU (Supreme Audit Office).

3.2 Government budgeting

3.21 The budget is administered by the Ministry of Finance (MF). The act on budgetary rules requires budget entities to prepare draft budgets of expenditures and revenues and to submit them to MF. This provides the basis for the Government's draft budget which

[8] Articles 11 to 15 of the Banking Act 1992 as subsequently amended, establish the powers of NBS in these areas.

must be submitted to the National Council (legislative assembly) by October 15. The budget and accounting year coincides with the calendar year. The National Council is to enact the budget in time for the new budget year. Special funding arrangements exist if it is late in doing this. Such an eventuality has not recently occurred.

3.22 The budget is divided into chapters, each chapter being administered by a ministry or other major public body. The limit established for a chapter cannot be exceeded. A chapter administrator may make transfers within a chapter provided no mandatory limits are exceeded. Each chapter provides specific authority and limits for incurring expenditure. Thus direct comparison can be made between authorized and actual expenditure. Budgetary organizations must use the sums granted to them during the budget year; unused surpluses lapse, except in the case of budgetary funds and municipalities which may carry unused balances forward. Specific chapters are established for the state treasury and state debt. Service charges on state debts are in one of the few chapters which may be exceeded if budgeted funds prove inadequate.

3.23 A well-defined budget calendar exists

- January-March: budgetary strategy; setting limits for aggregate revenue and expenditure and for the planned deficit
- April: distribution of the budget call circular
- Mid-July: budgetary organizations and others must submit their draft budgets
- Mid-October: Government submits draft budget to Parliament
- By end December the budget must be enacted by the National Council
- Eighteen months later (six months after the end of the completed financial year) the state final account must be presented to the legislature

3.24 In approving the budget, the government approves the estimated revenues and the limits for expenditures for the year, the budget surplus or deficit; the means of financing it; the borrowing limit for the year and the extent to which the government may issue loan and other guarantees.

3.25 The level of new state guarantees issued, is regulated by each annual budget act. In the past guarantees were given recklessly without adequate thought to the consequences. More recently the situation has been brought under stricter control. Nevertheless the cost of having to honor past guarantees has risen from SK1.8 billion in 1996, to SK4.1 billion in 1999. The exact scheduling of future payments under loans guaranteed by the state is shown in the annual budget document. Eighty per cent of guarantees made are for state-owned entities. The size of the State's contingent liabilities arising from guarantees issued, depends predominantly upon the viability of these enterprises: some are profitable (in telecoms, and gas); some are not (in water construction, nuclear power, railways, electricity). In 1999 the cost of honouring guarantees cost the state budget a sum equivalent to almost 2% of budgeted expenditure. It should be noted that the Roads Fund

has borrowed funds directly from the capital market and is in receipt of state guarantees. It borrows at rates significantly higher than those paid by the State.

3.26 The budget is implemented by budgetary organizations and semi-budgetary organizations (those with some own revenues who also receive budget subventions). The head of a budgetary organization is responsible for keeping expenditure within budget limits. Expenditure and revenue are recorded using classifications regulated by MF. Quarterly reports are made to MF.

3.27 Budgetary control is made possible by quarterly credit limits set for all budgetary organizations and administered by NBS. Budget entities in the state sector must bank with NBS. Besides carrying out payments for them (which is a normal banking function), NBS also carries out budgetary control. It does this by means of separate accounts for about 6,000 subsidiary spending units which are part of the Treasury Single Account (TSA). Quarterly limits are set by spending agencies within the totals authorized by the budget. These are communicated to NBS. Such limits are authorized by both the spending unit and by their supervising bodies and are authenticated by NBS. In deciding on payments NBS has to determine: (a) whether the requested payment is within the limit set for the spending unit and (b) whether the aggregate balance on the TSA is sufficient to make the payment. The fact that NBS cannot lend money to the government, results in occasional failure to honor the state's payment instructions (when the answer is to question two is "no"). If the answer to both questions is "yes", the payment is made. The fact that most payments are effected electronically means that the risks inherent in cash transactions are minimized.

3.28 After the completion of the budget year, MF draws up the draft state final account and the government presents it to the National Council which debates and accepts it, provided it is satisfied with its accuracy.

3.3 Extra-budgetary funds [9]

3.31 Twelve large EBFs exist. They are of significant size: together their expenditures are about 3% of GDP, the subsidies which they receive about 1%, and their combined deficits about 0.3%. Annex two identifies the twelve funds and provides summary data on their financial results. The existence of large extra-budgetary funds diminishes the comprehensiveness of the budget and the effectiveness of its controls. Several of these funds in fact have deficits but this is not apparent in the annual budget document which shows their income statements as if they balance. This would not be the case if conventional accounting principles were applied to them. If receipts from privatization and from borrowing were shown as capital items, their deficits would be more obvious. Given that some are dependent on privatization proceeds, there is the prospect of larger subsidies in future if this source of finance declines. More important, giving these funds access to separate sources of finance militates against a meaningful allocation of total resources via the budget and creates parallel decision-making structures and possible inconsistencies.

[9] Based on Slovak Republic: Reforming extra-budgetary funds, paper prepared for Government of Slovakia by Csaba Laszlo, April 2000.

3.32 At present the reasons for paying subsidies to these entities is not clear. They are not openly accountable for their use of resources and the achievement of their objectives. They are not obliged to produce annual reports including audited accounts on their activities. There is therefore an element of non-transparency which may invite the misuse of funds and certainly obscures how state funds are in fact being used. The National Property Fund receives the proceeds from privatization and repays government bonds but is not part of the detailed budget. Some EBFs borrow money. They do so at interest rates higher than apply to the state's borrowings. Their activities and borrowings are not explicitly guaranteed by the state (except in the case of the Road Fund) but there is clearly an implicit guarantee. This adds an element of risk to state finances particularly if EBFs borrow in foreign currencies. How such loans would be repaid is clearly a question mark. Such borrowing should be subject to strict ceilings and state government control; better still EBFs should not be able to borrow except from the state.

3.33 EBFs can carry over budget surpluses and deposit their funds in commercial bank accounts. Some use the National Bank of Slovakia but their accounts are not aggregated with the rest of the state's accounts for cash management purposes (Treasury Single Account). Moreover there is doubt about their financial management capacities: some have inadequate systems of internal control, accounting and internal audit being carried out by the same people.

3.34 Clearly EBFs present budgetary and control problems. Winding them up would be the most convenient solution. If they remain in existence, their borrowing powers should be strictly controlled or eliminated and a suitable regime established by the State: modern accounting principles (accrual-based as these entities hold assets and have entered into liabilities); a requirement for annual audit of financial statements and for annual reports containing audited financial statements; all borrowings to be approved in advance by MF and the status of indebtedness to be regularly reported; and special disclosure of key facts about large transactions (suitable limits defining a large transaction would have to be established).

3.4 Government accounting and reporting

3.41 The Department of Accounting Methodology of the Ministry of Finance prescribes a chart of accounts for budgetary entities. Government ministries, departments and their subordinate offices must conform with this. A special chart of accounts applies to the health, social and pension funds. But generally the whole of the public sector (including local self-governing units) follows the same system. The health, social and pension funds are not subject to the common accounting classification system applicable to budgetary entities.

3.42 Government accounting occurs at the level of revenue collection agencies and of spending units. Each budgetary organization is an accounting entity, sometimes with its own software, which produces its own financial statements. These statements are not audited. Every quarter budgetary organizations submit accounts to the Data Center (Ministry of Finance) for aggregation. By this means it is possible to produce quarterly financial statements and the annual state final account (annual financial statement of

revenues and expenditures on the cash basis for the state budget sector). The state final account compares actual expenditures with those originally budgeted as adjusted by any amendments subsequently made by Parliament and any within year adjustments made by Ministry of Finance.

3.43 There are three tiers as far as government accounting is concerned: accounting units (about 6,000) which record transactions; ministries and other administrative bodies which carry out monthly consolidations of the data coming from their accounting units; and the Ministry of Finance which sets accounting standards and consolidates accounting information coming from ministries. While all state entities follow government accounting standards, their accounting units may use non-standard software. To this extent aggregation of data by the Data Center is made more difficult. This, and the three tier aggregation of data, cause reporting delays

3.44 The basis of accounting in the state budget sector is cash. Commitments are not recorded. But information is recorded on receivables, other assets and liabilities. This information is not reported in the state final account which is a cash statement. The state final account is audited in the general sense that NKU carries out audits and has a duty to report to the National Council on the final account. But annual audits are not comprehensive and there is no attestation of accuracy of this account. In the past NKU has identified inaccuracies in the account which were subsequently rectified.

3.45 There is separation of responsibilities within accounting units: authorization and prior control are separated from accounting, and the operation of bank accounts requires two authorized signatories. Accounting systems are supported by physical inventory-taking. Asset accounts are adjusted where inventory-taking identifies losses.

3.46 Payments are made by National Bank of Slovakia (NBS) on behalf of spending units. Similarly collections are deposited by revenue collection agencies. Some of these may first be deposited in commercial bank accounts (e.g. customs revenues). NBS maintains a treasury single account (TSA) for government into which flow the state's revenues and out of which come most of its payments.

3.47 This system has three main advantages:

- aggregation of cash balances in the TSA means that the state's liquid resources can be managed centrally to the extent that they are held in the TSA
- strong budgetary control of expenditure is achieved, again to the extent that it is covered by the TSA
- delegation of financial management responsibilities to revenue collection agencies and spending units is achieved

3.48 It has compensating disadvantages:

- information on expenditures arrives at Ministry of Finance late and incomplete

- lack of information on expenditure commitments[10] impedes cash management

- the information reported by NBS does not respond in full to the information needs of Ministry of Finance

- some of the monetary flows do not go through the TSA e.g. those of several extra budgetary funds; likewise some cash balances are held outside TLS and a large part of revenues is first deposited in commercial banks

3.5 Establishing a treasury system

3.51 The proposed treasury system is described in "Strategy of Building the Treasury System to 2002", Ministry of Finance. Thorough analysis of the issues is provided in "Slovak Republic: Improving Fiscal Management", IMF, January 2000. The conclusions reached are consistent with those of the IMF.

3.52 The reasons for wishing to establish a new treasury system are mostly the conventional ones (for example, better management of public finances, better support for medium term budget policies, better liquidity management, better budget execution and more precise and more timely reporting and better management of government assets and liabilities). The reform is set in the context of preparations for joining the European Union and the need to conform with the Maastricht criteria on the budget deficit and indebtedness.

3.53 The arguments for a deep treasury system reform are not strong in Slovakia as most of the claimed advantages either have already been achieved, or could now be achieved by means other than those proposed. Budgetary control is strong in the current, NBS-dominated system. The characteristic weakness is not the system of control, but the fact that some state institutions are outside the NBS net. The responsibility for accounting and financial management is currently correctly located at the level of the spending units. To the extent that a treasury system attempts to move the focus of control to Ministry of Finance, the result will be a reversion to a system of over-centralized control from which Slovakia has only recently (and luckily) escaped. Finally the Treasury Single Account at NBS ensures consolidated cash management (to the extent that state institutions are obliged to use it).

3.54 The arguments for a new treasury system which stand up to scrutiny are as follows:

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[10] Commitment accounting is a standard feature of government accounting systems in many countries. By this means the amount of available budget resources of a budget-funded agency is reduced at the time each new commitment is recorded. This gives advance warning of expected cash expenditures and therefore supports cash management.

- currently fiscal information coming from spending units arrives late and in inconvenient form for fiscal analysis (problems of classification, data recording and data consolidation and reporting)

- lack of an integrated financial information system bringing together Ministry of Finance, line ministries, spending units, National Bank of Slovakia and NKU creates problems of untimely, unshared and inaccurate information. There is no doubt that a more efficient system could be created with advantages for all participants

- lack of data on expected spending and expected revenues make reliable forecasting, and therefore cash management, difficult. The lack of commitment accounting is part of the problem

3.55 These arguments by themselves are sufficiently strong to justify a new treasury system. However, there is a danger that reform will result in unnecessary or even harmful changes over and above what is needed. Micro management of expenditure by Ministry of Finance is a danger. Nothing in its strategy paper suggests that it wishes spending agencies to manage their own resources. Treasury systems which assume detailed central controls over line ministry transactions are unrealistic in that capacity rarely exists to enforce such controls. In practice, systems based on detailed central controls are unlikely to be successful because good financial management starts with spending agencies and cannot occur without their full participation. Treasury systems should therefore be designed as a service to spending ministries and units, so that they derive from it distinct advantages such as:

- improved budget formulation because of the availability of better tools

- easier consolidation of budget proposals; more convenient "flexing" of budget proposals

- improved accounting (more accurate and timely records; closer monitoring of each stage of a transaction; more convenient consolidation of data)

- better reporting (more timely, more complete, less costly to do)

- direct on-line communication of data with other participants in the budget and accounting processes

3.56 The lack of an orientation to the needs of ministries and spending units and the heavy concentration on Ministry of Finance needs, is an obvious weakness of the present treasury proposal.

3.57 As argued above, most of the claimed advantages of the new treasury system are things which can be achieved without a new treasury system but which should be done anyway to improve Slovakia's systems of public finance:

- centralization of public revenues and ensuring timely deposit and transfer of collections to the consolidated fund

- bringing extra-budgetary funds into the budget and requiring them to bank with NBS

- preventing state entities from borrowing money other than via Ministry of Finance

- improved management of the state's financial investments

3.58 The issue of how to treat municipalities is topical given the proposed decentralization to self-governing units. The arguments favoring their inclusion in the treasury system are as follows:

- public sector entities receiving large amounts of state funds should be obliged to use the treasury system

- the resultant consolidation of public cash resources enables effective liquidity management

- leaving the cash resources of local government units outside the treasury system exposes them to risk

The arguments in the opposite direction are as follows:

- self-governing units are not State entities and should not be controlled by State entities, except in the general sense of the State setting up a suitable accountability system and monitoring compliance with that system

- local governments in other countries are rarely obliged to use the central government treasury; they have the right to carry cash balances forwards from one period to another, to bank it in commercial banks and to earn interest on surplus balances in savings accounts

- local entities should decide on their own banking arrangements; this means that they may choose to bank with the treasury if the service provided is better than that provided by commercial banks

3.59 It is now unlikely that the treasury system will be expanded to cover local governments.

3.6 Procurement [11]

3.61 Slovakia was the first country in Central and Eastern Europe to pass a public procurement act (1994), and to establish a procurement system based on the principles of transparency, competition, economy and efficiency. However, procurement is still vulnerable to corruption and abuse. The 1998 audit report from NKU identified disregard of procurement rules as the most frequent violation of the law.

3.62 This conclusion is supported by the Slovak Anti-Monopoly Department, which indicates a substantial increase in anti-competitive practices (e.g. price fixing, bid-rigging, collusion among bidders, under-invoicing, etc.) and the Government's inability to successfully prosecute the violators due to weaknesses in the legal system. Among the factors contributing to the deterioration include lack of guidelines about the use of various non-public tendering procedures; lack of separate standard bidding documents and contract formats for goods, works, and consultant services; poor and unclear technical specifications; ambiguous and subjective evaluation systems; lack of expertise among the evaluation commissions; poorly written contracts; and, last but not least, the low salaries of procurement staff.

3.63 The Transparency International report identifies the following causes of procurement abuses:

- insufficient political will to enforce adherence to formal rules;
- out-of-date, unclear, uncertain or ambiguous language used in the wording of formal rules;
- low discipline shown by procurement officers;
- insufficient control;
- the fact that the respective rules are still relatively unknown;
- frequent changes of personnel;
- bad working conditions and possibilities available for procurement officers.

3.64 SIGMA (Support for Improvements in Governance and Management in Central and Eastern Europe) is active in this area. It indicates that countries seeking EU membership must establish and maintain procurement systems that meet standards of transparency and of open and fair competition and that public procurement systems should be protected

[11] The paragraphs on procurement are based on the country report of Transparency International on combating corruption; a report of a World Bank mission which conducted surveys on perceptions and experiences of corruption in Slovakia during 2000 and the World Bank's Draft Country Procurement Assessment Report (2000).

against waste, abuse, fraud and corruption. SIGMA standards for a properly maintained public procurement system [12] require such a system to:

- Continue to achieve good value for money in public expenditure
- Adapt to changes in a country's public administration and territorial system
- Be able to meet international obligations under WTO and EU rules
- Remain open, fair and transparent
- Be effective in providing an impartial complaints service
- Address problems of fraud and corruption through effective mechanisms for prevention and detection
- Take account of information on international best practices such as benchmarking

3.65 Bank staff are currently advising Government on how to come closer to such criteria.

3.7 Government audit

3.71 External audit of the state sector is carried out by the Supreme Audit Office (NKU). NKU is described in chapter three of the Constitution (1992) as an independent body which audits budgetary funds, state property, property rights and state income. It is to submit its reports on the results of its audits to the National Council of the Slovak Republic (legislature) at least once a year and anyway whenever requested by the National Council.

3.72 NKU was established in 1993 under an Act of January of that year. The act expands somewhat on the constitutional provisions. NKU is to audit

- management of the resources of the State budget
- management and disposal of state property
- disposal of property rights and claims of the Republic
- imposition and collection of taxes, fees, fines etc being the revenues of the state budget
- performance of obligations and exercise of rights by the state in its financial and economic activities

[12] From Sigma Policy Brief number 3 on Public Procurement.

3.73 The independence of NKU arises from the Constitution and from the independence of its president and vice presidents who are elected by the National Council for five year terms (renewable once). The election cycle is normally four years long. Therefore there is no direct linkage between NKU appointments and the result of national elections. However it is recognized that these appointments are political, even if in practice the appointees act apolitically. The National Council may only terminate these positions in certain unlikely cases (e.g. the incumbents are sentenced for committing a deliberate criminal act or they assume functions incompatible with the positions which they occupy). The degree of independence granted is relatively modest by international standards. Elsewhere terms of office are often longer, remuneration is protected and termination actions of the legislature require more than a simple majority vote. In Slovakia the president of NKU has the right to take part in debates of the National Council.

3.74 The types of audit to be carried out by NKU concern compliance, economy and the use of funds for their intended purposes. In practice the main emphasis is on compliance which also covers intended purpose.

3.75 The entities subject to audit are ministries and central organs of the state and their subordinate offices and entities established by these bodies; funds, communities and legal persons which manage or dispose of state property; legal persons in which the state is owner (or part-owner) and natural persons if they use state funds.

3.76 NKU reports to the National Council once a year on its audit findings. It does this via the legislative committee on finance, budget and currency. This committee is made up of 12 members, eight from the current coalition and the other four from the opposition. Specifically NKU gives its opinion on the state final account (the annual account of budget execution after the end of the year) and if requested by the National Council, on the proposed budget before it is passed. Relationships between the NKU and the legislative committee are good. However they now need to be deepened and broadened. The Committee should encourage NKU to publish annual reports for the benefit of the Slovak people without first debating, and therefore delaying the publication of NKU findings.

3.77 Auditors are employed by NKU to carry out audits. They must be persons of integrity who are impartial and have relevant auditing skills. They must inform audited entities of the objective of the audit at its outset; proceed on the basis of facts; elaborate audit findings in minutes and allow auditees access to the minutes for the purpose of rebuttal; include the auditee's rebuttal in the minutes; discuss the minutes with auditees and leave a copy of the final minutes with the auditee. All members of NKU are to keep confidential the information gained as a result of audits. A code of ethics exists for NKU staff.

3.78 Auditors are granted access to physical locations, records, documents as required for the purposes of carrying out the audit. Auditees are obliged to collaborate with the auditors; create conditions which enable audits to be carried out properly and provide

written or oral evidence as required by the auditor. NKU can impose fines of up to SK10,000 on those who refuse to provide access.

3.79 If NKU identifies defects as a result of carrying out audits, the defects are first reported to the audited entity for remedial action; then to the relevant ministries and other relevant central organs if no action has occurred. These bodies are to report back on remedial actions taken. In the event that remedies are still not forthcoming, the government is to be informed with further appeal to the National Council.

3.80 The above legal relationships and provisions are sound, if rather basic in nature. Some of the practical difficulties which limit the effectiveness of external audit in the Slovak public sector are as follows:

- lack of mandate to audit extra budgetary funds (National Property Fund, Health Insurance Agency, Social Insurance Agency, National Labor Office, certain companies in which the state participates as owner) [13]

- lack of mandatory requirement for Ministry of Finance to follow up with line ministries on defects identified at audit and to report to the legislature on the status of remedial actions taken

- lack of financial independence of NKU; therefore lack of sufficient resources to employ the number of well-qualified professionals needed to do the job

- lack of a legal requirement for NKU to report to the Slovak people on significant findings and matters arising from audits

- lack of adoption of modern, comprehensive audit standards

3.81 Because of inadequate institutional linkages and resources as described above, NKU finds itself quite isolated and often unable to achieve the remedial action that is the ultimate reward of audit. It is currently trying to build stronger relationships with Ministry of Finance and to address its own funding problems. Perhaps the single most important issue is the lack of a public report to the Slovak people. At present NKU reports through a legislative committee and its findings may be made public only after consideration by parliament. A public report addressed directly to the people would give NKU more authority and the Slovak people better accountability. The other major issue is the lack of adequate follow-up on audit findings. Various bodies are responsible for follow up: the auditee concerned, the Ministry of Finance and the Parliamentary Committee on Finance, Budget and Currency. But frequently nobody takes a lead and NKU is left with findings but no adequate remedial action. Until such issues are resolved the value of audit (stemming losses, ending bad practices and stamping out illegal actions) is largely unrealized with consequent loss of public resources and economic opportunities.

[13] Audit of the armed forces is carried out by the Office of the Government.

3.82 It seems likely that NKU will address the above issues primarily in the context of Slovakia's application to become a member of the European Union. At a meeting in Warsaw in March 1998 a working group composed of the presidents of the European Court of Auditors and of Supreme Audit Institutions (SAIs) of central and eastern Europe established convergence criteria for the SAIs of countries preparing for membership of the European Union. The recommendations of the working group appear in annex one below. Assessing NKU against these criteria reveals the following aspects requiring remedial attention:

- lack of financial independence (2)
- restricted audit mandate (3)
- need to develop performance audit (4)
- lack of timely, public report of audit findings (5)
- incomplete adoption of international audit standards (6)
- issues regarding training and quality of staff (7, 9 and 10)
- lack of focus on the internal control systems of auditees (11)

3.83 There are three levels of control other than that of NKU: the Ministry of Finance which employs 12 controllers; the territorial financial control administration which inspects the regional and provincial offices and entities of the state and employs about 70 people; and the Office of the Government where about 30 controllers are located. The latter carry out special duties such as the audit of the military, checking compliance with government resolutions, and answering complaints and petitions. They may also audit the usage of state budget funds. In addition, each ministry has its own control staff. Clearly given these facts, controllers are not numerous in relation to the size of population, but they are fragmented and therefore require co-ordination for an optimum result. Of all the control bodies only one can levy penalties: the Ministry of Finance. It cancels from the relevant appropriation, funds which have been misused or lost.

3.84 Modern concepts of internal control have not made much headway in the Slovak public sector. These locate the prime responsibility for internal control with the management of the entity concerned. It has the responsibility of ensuring that the entity is properly managed and sets up control systems for this purpose. These controls protect the entity's assets, ensure correct accounting and regulate all aspects of the entity's internal arrangements, enabling the entity to achieve its objectives. Management also establishes internal audit as a semi-independent function within the organization to inform management on the extent that controls are working and the risks to the entity if they are not. The idea that in the first instance the entity is responsible for its own control has not yet penetrated far in the Slovak public sector or at least it has become lost in the sort of control which is directed primarily at fault-finding rather than assessing the adequacy of systems. Currently external controls are carried out by NKU and MF. The proposed treasury system assumes central control of accounting transactions carried out by budget entities. If Slovakia wishes to achieve strong public financial management it

has to locate essential controls at the entity level. The job of supervisory control or external audit then becomes an evaluation of whether internal control systems established by management are adequate and working properly.

3.9 Risks

In Slovakia the weakest aspects of public financial accountability are as follows:

- the NKU does not give an audit opinion on the reliability of the government's annual financial statements and does not have the duty to report significant audit findings directly to the public.

- extra-budgetary funds and state guarantees are not properly controlled.

- weak follow up and remedial action on significant audit findings.

- defective procurement practices.

- weak accountability arrangements for local government units.

- an administrative culture which tolerates corrupt actions.

4. Local government sector

4.1 Local government finance

4.11 Local self-governing entities were set up soon after independence and were granted a legal status independent of the state. Currently there are 2,881 such entities and some are very small indeed. Their total expenditure is dwarfed by that of the central government. The latter maintains 8 regional offices and 79 district offices and thus at present is strongly represented at the regional and local levels.

4.12 A basic accountability framework exists with the state playing a minimal role. If the state provides ear-marked funds to self-governing units, the state requires full accountability and may carry out audits and inspections to see that the money was used properly for its intended purpose. Otherwise, self-governing entities rely on their own accountability arrangements. While local entities must account according to state norms, they are separate legal entities which prepare their own budgets, have their own sources of revenue, maintain bank accounts with commercial banks, prepare their own finnacial statements, borrow money as needed, carry forward unused resources beyond the end of the budget year and invest any surplus they may have.

4.13 A form of internal audit is carried out by a controller who is voted into office by the elected council and then paid from the budget of the self-governing unit. The controller is appointed for life and has a status independent of the mayor. The controller's reports go directly to the elected council. He reports on the budget which is made public in draft form 14 days before it is debated. He also reports on the annual final account. Beyond

this, each self-governing unit is subject to annual audit by an independent auditor. Thus the existing system of financial control is relatively complete.

4.14 Local governments have their own very small revenue resources, notably from the real estate tax. In addition they take a share of certain state taxes. They cannot vary the rate of the real estate tax. Real estate registers are not always complete. More significantly valuations are more or less meaningless. An additional problem arises where the state has leased land to farmers. The State Land Fund collects the money and pays it to the Ministry of Agriculture, thus diminishing the possible revenues of local governments.

4.15 Other reported problems include:

- unpredictable flow of funds from the state to self-governing units, making financial management difficult
- lack of laws restricting the borrowing powers of self-governing units
- some self-governing units have become over-indebted, have funded non-viable construction projects and/or are in financial crisis
- controllers appointed for life are certainly independent, but may present other disadvantages as part of a modern accountability system

4.16 There are three main challenges for Slovakia: (1) to ensure that local self governing units have the freedom to manage their finances responsibly, (2) to activate community interest so that they are held accountable and (3) to ensure that in these matters the State plays a minimal but meaningful role. Each issue is briefly discussed in the next three paragraphs.

4.17 Managing finances responsibly implies the need for:

- specific legislation defining the financial powers and responsibilities of local self-governing entities, in particular covering revenue raising, budgeting, accounting, reporting and auditing. Much of this framework already exists.
- manuals, guidelines and training explaining how the legislation is to be followed.
- controls that are consistent with the spirit of decentralization.

4.18 Meaningful local participation implies the need for:

- local self-governing units to be open and transparent in their financial dealings (for instance local budgets and annual financial statements to be made public, as they are at present).

- local self-governing units to be audited by independent auditors (as occurs at present).

- local people to be involved in the above issues either individually or collectively.

4.19 Local self-governing entities cannot be entirely independent. They use public money and therefore have a duty to be open about how they use it. They must be subject to independent audit; the audit findings must be made public; and such audits must be comprehensive (applicable to the entire local entity not just restricted to the funds transferred from central government). These arguments apply now and will be even stronger once local self-governing units become much larger spenders of public money.

4.2 Decentralization

4.21 Decentralization is needed in Slovakia. But it may prove disappointing if expectations for it are too high. It is said that it will increase transparency and efficiency, and reduce corruption and public expenditures.[14] Reducing expenditures would be a novel result. By itself, decentralization increases expenditures, first because funds are managed by smaller units (diseconomies of scale) and second because of duplication of administrative structures. If greater democracy and participation are also objectives, cost savings are even less likely. This is not to say that decentralization could not be an excuse for reducing expenditures; only that by itself it is more likely to increase expenditures.

4.22 Furthermore, decentralization merely changes the location of corruption, the amounts involved and the identity of the perpetrators and the beneficiaries. To have an impact on the level of corruption, decentralization would also have to impact the causes of corruption such as weak controls, lack of transparency, incentives to cheat, lack of public interest in honest administration and low likelihood of being penalized. We would not expect decentralization by itself to reduce corruption unless it changes behaviour.

4.23 The Transparency International report on Slovakia notes that in spite of reforms state control of Slovak municipalities has not been eliminated. As a result, self-government bodies are subjected to political interference by state bodies, which leads to a climate favourable to hidden corruption, patronage and bribery. In addition, the system of controlling management of financial resources is not working satisfactorily. The fact that the remuneration of the main controller is open to political influence represents a considerable deficiency. Objectivity and impartiality in performing controlling activities are thus significantly threatened. Moreover, filling this position is rather problematic especially in small municipalities where there is a lack of people having the required qualification and skills. This is true also for other specialized municipal positions. It happens quite often that a person is assigned to this position only in a formal sense, leading to control failures.

[14] "The concept of decentralization and modernization of public administration", Government Office of the Slovak Republic, March 2000.

4.24 The Transparency International report goes on to observe that current legislation gives the people the possibility of participation in public issues. Nevertheless, experience shows that at the local level representative democracy increasingly overwhelms participative democracy. As a result the gap grows between common people and their elected representatives. Despite popular dissatisfaction with the performance of municipal bodies most local voters do not participate in the affairs of their municipalities. Participation in public meetings is usually low. People are either unaware or skeptical about the possible effects of their own participation. The reasons are: lack of information and transparency on the one hand, and lack of interest on the other. Only rarely are cases of corruption detected and proved, and if they are, public communication about them is insufficient. Accordingly, there is also an absence of public condemnation.

4.25 From the point of view of the State, decentralization therefore implies a risk that resources transferred to local units will be misused (control and accountability being weaker at local levels). The natural reaction is a search for strict central controls. If successful, this will negate the fundamental objectives of decentralization. The trick is therefore to create a system of remote control: one in which local self-governing units are both responsible and accountable and in which central government has a predominantly monitoring role.

4.26 The basic reason for decentralization is to achieve greater local participation in decisions about local uses of funds, (thus a diminution in state influence on local matters). Therefore, wherever possible, policy should be directed at achieving proper public accountability without putting State bodies in a position of supervisory control. This means that local entities must:

- be governed by sound financial management principles set centrally
- be publicly accountable as discussed above
- have a choice as to where they maintain bank accounts
- keep their own accounting records and process their own transactions
- be audited by independent auditors, (either by NKU or by professional firms of auditors)

4.27 This leaves the State with the following responsibilities:

- establishing the financial management and accounting framework in which local governments are to operate
- ensuring, when state funds are provided to local bodies for specific uses, that the purposes intended were in fact achieved
- setting limits to the borrowing powers of local bodies and establishing a reporting framework to ensure compliance

- monitoring compliance with public accountability requirements (public budgets and financial statements and independent audits) via receipt of the relevant documents

- exercising reserve powers in the case of a local body seriously failing to meet its public accountability obligations (this would include taking the local body into temporary state receivership in the most serious cases)

It is clear from the above that the state still has much to do, even though it stops short of controlling local government entities directly.

4.28 Decentralization implies a far greater flow of funds through self-governing entities. There is tension between representatives of the state who feel that these entities lack the capacity to manage the larger flows effectively and representatives of the entities who argue that the self governing entities have good financial management and accountability; indeed some say that they are better at these things than the state itself.

4.29 Following decentralization, there would be 12 regional offices[15] and they would be self-governing. Several state responsibilities (notably large parts of health care and education) would be transferred to self governing units. At the same time resources would be transferred from the state to the local government sector with a notional aim of achieving a division of public expenditure of the order of State (55%) and local (45%). This compares with the current split, which is estimated at 88%-12%.

4.30 To transfer funds to local governments on the scale envisaged in the decentralization reform the ideal solution is the transfer of defined taxing powers in addition to those already at the disposal of local governments. In addition a system of revenue-sharing will be required. However, a simple tax sharing scheme would favor local governments which are rich (have large tax bases), and prejudice local governments which are poor (have small tax bases). Therefore an equalization transfer would also be made. The aim of such a transfer would not be to achieve complete equalization but to ensure basic levels of social provision particularly in needy local government areas. It would be based on indicators such as numbers of population, numbers of children of school age, incidence of poverty, numbers of the elderly etc.

4.31 In deciding on the accountability regime appropriate for self-governing units the following general principles apply:

- as self-governing units dispose of public funds (tax revenues from their residents and transfers of state funds), they should be publicly accountable for these funds

[15] The current decentralization proposals have not yet gained legislative support.

- full accountability means caring for public funds and managing them on behalf of the people transparently according to proper standards and known principles

- budgets and annual financial statements are public documents

- local government entities are subject to independent audit by relevant professionals

- their borrowing must be monitored against ceilings established by the State

4.32 Some of the above is achieved under existing legislation. The same principles will be relevant to self-governing entities after the decentralization which is currently planned. Of course some adaptation may be necessary for very small government units.

Annex 1

Eleven recommendations for Supreme Audit Institutions (SAIs) in central and eastern European countries [16]

The SAI should:

1. have a solid, stable and applicable legal base, laid down in the Constitution and the laws, complemented by regulations, rules and procedures.

2. have the functional, organizational and financial independence required to fulfil its tasks objectively and effectively.

3. have the powers and means clearly stated in the Constitution and the laws to audit all public resources and operations (including EU resources) regardless of whether they are reflected in the national budget and regardless of who receives or manages these public resources and operations.

4. undertake the full scope of government external auditing, covering both regularity and performance audits.

5. be able to report freely and without restriction on the results of its work. Reports may be submitted to parliament and made public.[17]

6. adapt to suit local conditions and formally adopt, promulgate and disseminate audit standards... *(omission)*[18]... Audit standards should be applied on a consistent and reliable basis to the work of the SAI to ensure that audit work is of an acceptable quality and competence... *(omission)*.

7. ensure that its human and financial resources are used in the most efficient way to secure effective exercise of its mandate. To this end SAI management will need to develop and institute appropriate policies and measures to help guarantee that the SAI is competently organized to deliver high quality and effective audit work.

8. develop its internal organization as a supportive structure for the proper conduct of work related to the requirements of the pre-accession period.

9. ensure that its staff are competent, capable and committed to help guarantee that effective audit work is produced in conformity with international standards and good European practices.

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[16] At a meeting in Warsaw in March 1998 a working group composed of the presidents of SAIs of central and eastern European countries and of the European Court of Auditors established the above convergence criteria for countries preparing for membership of the European Union.

[17] This criterion appears to be too permissive. Best practice requires SAIs to report both to parliament and the public.

[18] Omissions are for the sake of brevity.

10. develop the technical and professional proficiency of its staff through education and training.

11. focus on the development of high quality, effective management (internal) control systems in audited entities.

Extra-budgetary funds

The table below is taken from "Slovak Republic: reforming extra-budgetary funds" by Csaba Laszlo, April 2000.

Revenues and Expenditures of EBFs (2000) in Million SK

Name of EBF	Own revenues	Loans	Subsidies	Total revenues	Expenditures			Balance
					Current	Capital	Total	
Market Regulation in Agriculture	807,7	600,0	440,0	1847,7	1846,7	1,0	1847,7	0,0
Improving Forest Management	42,0		360,0	402,0	400,1	1,8	401,9	0,1
Land	693,1			693,1	593,0	100,1	693,1	0,0
Water	384,0		150,0	534,0	192,8	336,2	529,0	5,0
Land management and Food	1233,7			1233,7	1033,4	0,3	1033,7	200,0
Nuclear	2937,8		60,0	2997,8	313,2	855,2	1168,4	1829,4
Road	1845,3	8300,0	7300,0	18870,0	9013,1	9856,9	18870,0	0,0
Housing Development	343		2700,0	3043,0	2418,3	624,7	3043,0	0,0
Environment	421,8		140,0	561,8	80,9	480,9	561,8	0,0
Physical Culture	400,0		16,2	416,2	416,2		416,2	0,0
Pro Slovakia	2,3		72,0	74,3	74,3		74,3	0,0
Health	74,8		20,7	95,5	13,9	81,1	95,0	0,5
Total	9185,5	8900,0	11258,9	30769,1	16395,9	12338,2	28734,1	2035,0
						Source: MOF		