



GOOD GOVERNANCE

POSITION PAPER ON THE DRAFT LAW ON PUBLIC INTERNAL CONTROL IN THE CZECH REPUBLIC

All rights are reserved. Published by the Centrum of Excellence for Good Governance, z.s. in accordance with copyright law, no part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without prior permission of the publisher.

Lukáš Wagenknecht
Email: WAGENKNECHT.LUK@GMAIL.COM
Chairman of the Association

22nd December 2016

Prague 2016

CONTENTS

EXECUTIVE SUMMARY.....	4
LIST OF ABOVE AND BELOW USED ABBREVIATIONS.....	4
OVERVIEW OF THE MAIN DEFICIENCIES OF THE DRAFT LAW ON PUBLIC INTERNAL CONTROL.....	5
OVERVIEW OF THE CURRENT CZECH LEGISLATION ON PUBLIC INTERNAL CONTROL	6
CRITICAL OVERVIEW OF THE DRAFT LAW ON PUBLIC INTERNAL CONTROL.....	7
MINISTRY OF FINANCE IS RESPONSIBLE FOR EXTERNAL AUDIT OF REGIONS AND MUNICIPALITIES .	8
THE DRAFT COMES UP WITH A VERY INSUFFICIENT DEFINITON OF CONFLICT OF INTEREST	8
KEEPING THE EXISTING NON-TRANSPARENT SYSTEM OF WAIVER OF FINES FOR COMMITTED BREACHES OF BUDGETARY RULES.....	9

EXECUTIVE SUMMARY

At Monday's meeting of the Czech government (19 December 2016), the Minister of Finance submitted the draft law on public internal control (government draft no. 607/16) which on the same day was approved by the Government ("the draft law"). The draft law shall replace current legislation (Financial Control Act no. 312/2001 in force as of 01/01/2002) that designs the legal framework of the public internal control in the Czech Republic.

According to the Czech Ministry of Finance the draft law should:

- Increase protection of public funds
- Give More flexibility to approval procedures
- Avoid duplicity of controls
- increase quality of public finance management
- strengthen internal audit function

These goals may, at the first glance, look laudable but in fact, the draft law goes against these goals. The purpose of this paper is to analyse the draft law and to highlight its main deficiencies which, if the draft law is adopted, will considerably dilute the effectiveness of the internal control in public institutions in the Czech Republic.

The legislation that builds strong internal control is essential in the fight against fraud and corruption. Strong internal control also helps to build the trust with citizens. The EU-28 Public Internal Control Network¹ set out that Effective Public Internal Control should be designed in line with the following overall principles:

- Good public governance in the public interest is the context, the purpose and the driver of PIC
- PIC is focused on performance
- PIC is based on COSO and INTOSAI
- The accountability triangle is a cornerstone of PIC
- PIC is organised according to three lines of defence
- PIC requires a functionally independent internal audit function
- PIC is harmonised at an appropriate level
- PIC adopts a continuous improvement perspective²

CONCLUSION: On the basis of the arguments which follow, it is concluded that the draft law is not based on the principles of Effective Public Internal Control established by the EU-28 Public Internal Control Network. By contrast, the draft law goes against these principles and creates control environment that is vulnerable to misuse, fraud and corruption.

LIST OF ABOVE AND BELOW USED ABBREVIATIONS

PIC	Public Internal Control
PIFC	Public Internal Financial Control (Model developed by European Commission)

¹ Network operated in partnership between the Commission and the Member States featuring a peer-to-peer sharing of good PIC practices

² For more details regarding these principles, see Annex.

IPPF	International Professional Practise Framework for Internal Audit
COSO	Integrated Framework for Internal Control developed by Committee of Sponsoring Organizations of the Treadway Commission
INTOSAI	Auditing Standards developed by The International Organization of Supreme Audit Institutions

OVERVIEW OF THE MAIN DEFICIENCIES OF THE DRAFT LAW ON PUBLIC INTERNAL CONTROL

On the basis of the analysis Good Governance came to conclusion that the draft law does not make the control environment in the Czech Republic any better compared to the current situation. To the contrary, the new draft would make public internal control weaker in relation to the existing applicable legislation (under the Act no. 312/2001, on financial control, in force as of 2001). The draft law undermines the control environment in the Czech Republic for the following reasons:

- The draft law destabilises the current system of public internal control built on PIFC model.³ Internal control is not anymore based on the COSO model. Internal audit function is not compliant with the International Professional Practise Framework (IPPF) for internal audit. The Public internal control is not harmonised at an appropriate level.
- The draft law reduces the accountability and responsibility of the top manager of each organization for establishing an effective overall internal control environment within that organization.
- The draft law changes the definition of internal control. It defines internal control in general terms only as a vehicle to ensure that public funds are managed efficiently, effectively and economically. This is a very vague and insufficient definition. Public internal control should be oriented to objectives, outcomes and outputs which shall be achieved in a legal, appropriate, ethical and financially responsible way. The draft law focuses merely on financially responsible way but omits focusing on performance and adherence to laws and regulations to which the organization is subject.
- The draft law is not mandatory for public universities. It means that public universities would have no obligation to establish an effective internal control system.
- The draft law does not solve overlaps of different types of internal controls and inspections. The principle of single audit is absolutely omitted. One audit body cannot rely on the work of the other bodies because the methodology is not aligned with International Standards and therefore it cannot be unified.
- The draft law does not describe the relationship between internal and external auditors. The draft law does not fix current internal control deficiency that the public accounting systems are not subject to regular independent audits.⁴
- The draft law introduces a new inspection function within the Ministry of Finance. It is unclear to whom the inspectors under the draft law will report and what will happen with their inspections reports – will they be followed and implemented or will these reports be shredded? Beyond that, there is a risk that inspection findings could serve to the Minister of Finance in a political struggle with

³ Model PIFC (Public Internal Financial Control) developed by European Commission

⁴ In the Czech Republic, the financial statements of public institutions are not subject to regular independent audit. Supreme Audit Institution or any other External Auditor does not give an opinion on financial statements.

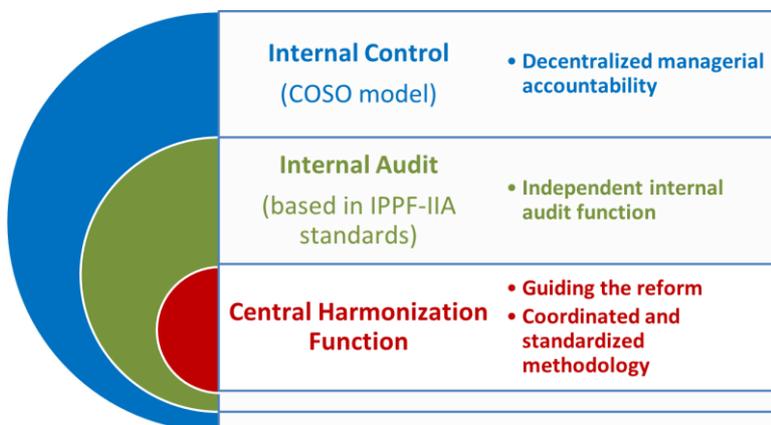
his political opponents. Furthermore, this inspection function overlaps with the powers of the Supreme Audit Institution.

- The draft law introduces audit committees but does not describe their role and responsibilities nor the relationship with internal audit. The draft law does not specify qualification requirements for audit committee members. The audit committees could be very helpful in safeguarding the independence of the internal audit when performing internal controls and risk management. However, without specified responsibilities these audit committees represent only an additional administrative burden.

OVERVIEW OF THE CURRENT CZECH LEGISLATION ON PUBLIC INTERNAL CONTROL

The backbone of current legislation on public internal control is the Financial Control Act from 2001. The Act is based on PIFC model. The Czech Republic had to adopt this model to fulfil the Chapter 28 (Financial Control) in order to become a Member State of the EU. The PIFC model requires that:

- strong financial management and control systems and procedures covering, among others, managerial accountability and ex-ante control procedures is established. This means that management must devise a system which at the same time
 - (i) prevents and detects breaches of internal controls
 - (ii) has an adequate internal and external audit arrangements to provide independent assurance that internal control systems have operated effectively, and
 - (iii) mitigates risks to a level acceptable to all stakeholders);
- an effective internal audit exists within institutions responsible for implementation of budget rules;
- a central harmonisation and co-ordination function for both financial management and control and internal audit is in place, preferably located in the Ministry of Finance (this is intended to provide consistency in the quality of internal control systems within the public sector, as well as providing a focal point for the dissemination of best practice and developing new and enhanced guidance).



The current Financial Control Act is mandatory for all public organizations including public universities. Besides the Financial Control Act there are other laws that design different types of controls and inspections. However, these other laws are not standardized, overlap and blur the control environment. A new draft law that would make control environment better and aligned with International Standards is needed. Yet, as has been outlined in the outset, the existing draft law does not achieve these goals, and in reality, even weakens the already insufficient system of public internal controls.

CRITICAL OVERVIEW OF THE DRAFT LAW ON PUBLIC INTERNAL CONTROL

Recently released draft law is neither aligned with PIFC model nor with International Standards for audit. By contrast, is the draft law undermines the first two pillars of the current system of internal control based on PIFC model and abolishes the third pillar (Central Harmonization Function).

Undermining the first pillar of PIFC – narrowed goals of internal control and no managerial accountability

The draft law sets objective of internal control as to ensure that public funds are managed efficiently, effectively and economically. This is a very vague and insufficient objective. The draft law focuses only on one category: this category is effectiveness and efficiency of the organization's operations. But the objective of the internal control is to fulfil not only the objectives of effectiveness and efficiency of the organization's operations but also of safeguarding of assets against loss, timeliness and transparent reporting, adherence to laws and other regulations.

The draft law omits to mention the goal of safeguarding of assets against loss as well as the goal reporting and compliance objectives. In the current legislation all these aspects are covered.

The current legislation also says that it is the responsibility of the Top Manager of each organization to establish an effective overall internal control environment within that organization. The new draft law is very vague in this respect and it says that an organization shall establish internal control system without any managerial accountability. Yet, it is the accountability structure which is the basis for a solid internal control system.

Undermining the second pillar of PIFC – new definition of internal audit that is not in conformance with IPPF

That current legislation defines internal audit as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization to accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. The current legislation also stipulates that internal audit shall be in conformance with International Professional Practise Framework for Internal Audit (IPPF).

The draft law brings new definition of internal audit without any link to IPPF. Moreover, the draft law narrowed internal audit function just to four specific categories:

- Evaluation of compliance with laws and regulations,
- Evaluation of effectiveness and efficiency of controls,
- Evaluation of effectiveness and efficiency of operations,
- Evaluation of the IT risks.

It is necessary to stress that the role of internal audit shall be broader. It is not only an assurance activity but also a consulting activity. Moreover the internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes. Also, it must assess and make appropriate recommendations to improve the organization's governance processes for:

- Making strategic and operational decisions
- Overseeing risk management and control
- Promoting appropriate ethics and values within the organization
- Ensuring effective organizational performance management and accountability
- Communicating risk and control information to appropriate areas of the organization
- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management

These essential functions of internal audit are omitted. The draft law changes the role of internal audit and transforms internal audit into an inspection function.

Abolishing of the third pillar of PIFC – harmonization function is missing

The current legislation describes central harmonisation and co-ordination function, which is located at the Ministry of Finance. The central harmonization unit is the focal point for the dissemination of best practice and developing new and enhanced guidance.

The new draft completely abolishes central harmonisation and co-ordination function.

MINISTRY OF FINANCE IS RESPONSIBLE FOR EXTERNAL AUDIT OF REGIONS AND MUNICIPALITIES

The draft does not fix the current internal control deficiency consisting in the fact that the Ministry of Finance is responsible for external audit⁵ of regions and municipalities. The judgment of auditors from the Ministry of Finance can be biased because they are not independent (they are subordinated and accountable to the Minister of Finance). Above that, there is a risk that audit findings could serve to the Minister of Finance in a political struggle with his political opponents from regions and municipalities. It is obvious that external audit of regions and municipalities should be in scope of the Supreme Audit Institution which is administratively and functionally independent.

THE DRAFT COMES UP WITH A VERY INSUFFICIENT DEFINITION OF CONFLICT OF INTEREST

The Ministry of Finance (its current Minister is in a serious conflict of interests because he is at the same time owner of one of the largest company in Czech Republic - Agrofert⁶) leaves a legal possibility that a person in conflict of interest can make a decision with financial impact but must not prioritize his own interest. A person even does not have to disclose any conflict of interest that may arise: the provision relating to the conflict of interest formulated in this way in the draft law definitely does not contribute to the fight against fraud corruption.

⁵ Audit is not in conformance with INTOSAI. It is rather kind of inspection.

⁶ <http://byznys.ihned.cz/c1-65309470-agrofert-vydelal-8-6-miliardy-korun-k-rekordnimu-zisku-babisove-firme-pomohly-hlavne-nemecke-a-slovenske-chemicky>

KEEPING THE EXISTING NON-TRANSPARENT SYSTEM OF WAIVER OF FINES FOR COMMITTED BREACHES OF BUDGETARY RULES

The existing legal framework providing for a non-transparent system of waiver of fines for committed breaches of budgetary rules is kept under the proposal. An irrational system under which when a breach of budgetary rules is established, for example as a result of a committed criminal act, relatively high fines are imposed for such a breach at the budgetary level, however, these fines are routinely waived without any legal safeguards often on the basis of a reciprocal political favours. In the past, the previous minister of finance Kalousek waived a fine for a breach of budgetary rules imposed on a project benefiting his party colleague Schwarzenberg, who at the time was a minister of foreign affairs.⁷ In a similar scenario, a project realised by a company owned by the current minister of finance Babiš received a fine in the amount of CZK 6 million (approx. EUR 222 000) by politicians from the regional council of central Bohemia; this fine was later reduced by more than 99 % to CZK 37 000 (approx. EUR 1 370) plus interests in the similar amount⁸ (the project is currently under fraud investigation by OLAF).

This highly corruption-prone system which creates advantages for ones and discriminates against others is maintained under the current draft law, only the amounts of the fines are slightly modified. The draft law, thus, petrifies the state illustrated by the PROMOPRO case: in this case public officers from the Office of Government were convicted by a court for having committed criminal acts related the use of public funds. On the basis of this court judgement, the responsible tax authority decided that the budget funds in this case were used in violation of the legislation on financial control and imposed a fine to the Office of Government for this latter breach in the amount of CZK 848 million (approx. EUR 31.4 million). Since it was politically unbearable that this probably highest fine in the history of financial administration is then entirely waived, as it has been frequently done, the Government decided that the payment of this amount will be avoided by a budgetary accounting operation (certain public media called it even an "accounting trick"): of this amount, CZK 748 million was technically debited from the government budgetary reserve and the remaining CZK 100 million was paid from the budget of the Office of Government, which at the same time, was re-credited by the same amount in the form of special budget contribution. This case illustrates another example of irrational, non-transparent and highly corruption prone methods of (non)enforcement of the Czech budgetary rules.

Those favour based waivers of previously legally imposed fines established in accordance with the applicable budgetary rules violate the EU rules on prohibition of state aid. A EU law compatible framework would provide for a framework where the rules for establishing corrections (fines) for violations of budgetary rules would be established in advance, that is at the moment when a subsidy would be known: under such framework it would be known before that violation of small, less serious or very formal errors would be sanctioned by a small fine in a pre-determined amount whereas for serious violations of budgetary rules resulting from criminal acts established by court judgements would be sanctioned by a higher fine in a pre-set amount. In such system the waivers would become superfluous and could be abolished.

⁷ http://zpravy.idnes.cz/schwarzenberg-nemusel-vracet-dotaci-dve-/domaci.aspx?c=A110825_091624_domaci_jj

⁸ <http://domaci.ihned.cz/c1-65199190-babisovo-capi-hnizdo-dostalo-pred-lety-pokutu-6-milionu-za-cerpani-dotaci>



Centrum of Excellence for Good Governance, z. s. is the independent and no-party oriented think tank, which focuses on research, education and policy advocacy in the area of good governance in the spirit of democratic rule of law.