

CONTROLLING HIGH LEVEL CORRUPTION IN CROATIA: THE ROLE OF AUDIT

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## **ABSTRACT**

The thesis analyses the problem of high level corruption in Croatia, aiming to answer the question: to what extent can the audit of the government contribute to corruption control in Croatia, and what lessons can the Western Balkan region learn from the Croatian case?

Croatia has been chosen as a case study in the context of the EU enlargement as the best performing candidate country, which has gone through the whole process of pre-accession negotiations, which were the driving force for changes. The analysis is based on two aspects: analysis of the national integrity system and analysis of the State Audit Office in Croatia, with the goal to assess the role of audit in corruption control in Croatia, but also to show major problems which can be more effectively overcome in the region.

The analysis found that the State Audit Office in Croatia fulfils all legal requirements for effective functioning and contribution to corruption control; however, there is a gap between the legal framework and the implementation in practice. The two major problems have been found: lack of independence, which implies interference of the government, and lack of follow up of the findings of audit, due to poor cooperation and support from the parliaments, government or the judiciary. The key lesson for the region is the importance of the political will and strengthening of integrity system in order to make supreme audit institutions effective.

**Key words:** corruption control, audit, supreme audit institutions, Croatia

## LIST OF ABBREVIATIONS

|         |                                                                                                                     |
|---------|---------------------------------------------------------------------------------------------------------------------|
| CPI     | Corruption Perception Index                                                                                         |
| EU      | European Union                                                                                                      |
| INTOSAI | International Organisation of Supreme Audit Institutions                                                            |
| NIS     | National Integrity System                                                                                           |
| SAI     | Supreme Audit Institution                                                                                           |
| TI      | Transparency International                                                                                          |
| USKOK   | Ured za suzbijanje korupcije i organiziranog kriminaliteta - Office for Combating<br>Corruption and Organized Crime |

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## Introduction

“Corruption is one of the greatest challenges of our age - a challenge that must and can be confronted” (Pope 2000, XV). Although differing in definition, understanding and proportions, it is present in all societies. Every society has its own strategy to fight corruption. However, generally speaking, every policy aiming to control corruption should include interdependent pillars of national integrity, namely parliament, executive, judiciary, watchdog agencies (anticorruption agencies, supreme audit institutions, and ombudsman), media, civil society, and international agencies (Pope 2000 and 2008; Stapenhurst and Kpundeh 1997; Dye and Stapenhurst 1998).

This thesis is based on the national integrity system (NIS) approach and pillars of integrity developed by Transparency International and Jeremy Pope (2000 and 2008). The approach has been used by Transparency International in their work in combating corruption, but also as the basis for their publications such as the TI Source Book (2000) or NIS country reports. It is a holistic approach - focused on inter-relationship of different institutions, rather than on each institution separately, and grounded in the values of the society and public awareness, with the aim to achieve sustainable development, rule of law and greater quality of life, thus making corruption less attractive (Pope 2000).

However, the question that comes to mind is: within the national integrity system, who will control the highest level corruption; corruption within the highest political elite – the government? To answer this, Santiso (2006) questions the importance and effectiveness of autonomous audit agencies. Regarding other pillars, Ramkumar and Krafchik (2005) highlight the role of civil society organizations. Some other scholars (cf. Stapenhurst et al. 2006) emphasize the importance of the parliament and its leadership role. However, supreme audit institutions are the

only institutions that can control political parties, their funding and electoral campaigns. In this sense they can significantly contribute to transparency and accountability of the government.

Most authors emphasize three main types of audit, namely compliance audit, financial audit, and performance (cf. Shah 2007; Dye and Stapenhurst 1998; Stapenhurst and Titsworth 2001; Van Zyl 2008). Although each of those has a potential to detect corruption, performance audit adds value to detection by setting out recommendations for change and improvement. However, this is also the most complex and demanding type of audit, which requires adequate funding, independence and educated and experienced staff with investigational and analytical skills (Waring and Morgan 2007).

Audit as a means of corruption control is not given much attention in the literature about combating corruption. Moreover, in practice, the use of audit in curbing corruption is neglected (Kahn 2007). The Croatian literature on corruption does not cover the role of audit at all. With the exception of a book published in 2009 (Akrap et al.) and one chapter on corruption and audit, there is lack of relevant academic work on this topic. In this context, the present thesis will contribute to the debate about curbing corruption in Croatia from the neglected angle of supreme audit institutions.

Following that, the thesis will focus on watchdog agencies, particularly on audit and Supreme Audit Institutions (SAIs) and external audit. It will analyse the problem of high level corruption and government expenditures, answering the question: To what extent can the audit of the government contribute to corruption control in Croatia, and what lessons can the Western Balkan region learn from Croatian case? To answer this question, the State Audit Office in Croatia will be assessed through criteria and prerequisites for efficient functioning of SAI's presented by Dye and Stapenhurst (1998). In addition, analysis will be placed in the context of the national integrity system in Croatia, as well as in the comparison with the Western Balkan region. In general, it will be argued that the potential of Supreme Audit Institutions and audit of

the government are underused and underestimated as a means of corruption control. On the one hand, cause for this situation can be found in too much influence from the government and underdeveloped independency of the Supreme Audit Institutions. On the other, in lack of political will and follow up of results and recommendations of audit.

The thesis is divided in four chapters. The first chapter will introduce two main concepts, namely corruption and audit, as well as methodology and case selection. The second chapter present the theoretical approach for fighting corruption, namely the National Integrity System. The pillars of national integrity will be discussed in depth in order to assess the major actors in corruption control, as well as to position audit and audit institutions in the debate about fighting corruption. The third chapter will focus on audit in the context of corruption control. Three main types of audit will be introduced, with an emphasis on performance audit. Finally, the case study of Croatia will show national integrity system and functioning of audit in practice by assessment of the State Audit Office – according to formal criteria, but also implementation of these criteria in practice. The case will show lessons that can be learnt from the process of strengthening SAI during pre-accession negotiations: importance of political will, support and cooperation with other pillars of integrity system, and emphasis on follow up of the findings of audit. The applicability of lessons is, however, limited to the Western Balkans region, which is facing similar problems - high levels of corruption, pressure from the EU conditionality and lack of cooperation among pillars of national integrity. Nevertheless, it is an important contribution to solving the problem of high levels of corruption in the region.

## 1. Definitions, Case Selection and Methods

Regarding the focus of the thesis, it is necessary to define two main concepts, namely corruption and audit. Broadly defined by Transparency International, “corruption is the abuse of entrusted power for private gain”. However, in the present thesis the term corruption will be used interchangeably in the sense of high level corruption or *grand* corruption - the one that “pervades the highest levels of a national Government, leading to a broad erosion of confidence in good governance, the rule of law and economic stability” (United Nations 2004, 10).

Same as for corruption, there is no single definition of audit. In general, an audit is “a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users” (American Accounting Association in Hayes et al. 1997, 2). However, in the review of definitions by Akrap et al. (2009), two types of audit are distinguished: internal and external. According to the Institute of Internal Auditors “internal auditors are integral to the organization and provide ongoing monitoring and assessment of all activities”, whereas “external auditors are independent of the organization, and provide an annual opinion on the financial statements” (THEIIA). Although the difference exists, the two types are not mutually exclusive, but rather complementary – the better internal audit, the better quality of the findings of external audit, since it uses the findings of internal audit (Akrap et al. 2009). Following that, the focus of the thesis will be on the Supreme Audit Institutions, external audit and detection of high level corruption in Croatia.

Croatia has been chosen as a case study in the broader context of the EU enlargement as the best performing candidate country, which has gone through the whole process of pre-accession negotiations, and next Member State. Considering the Western Balkan region and its high levels of corruption (according to TI CPI all countries are below 4.1), learning about the problems and possible improvements in Croatia could give an example for the rest of ex-Yugoslav countries in



solving the problem of corruption in pre-accession process with an emphasis on supreme audit institutions.

The thesis will be based on qualitative research and secondary sources data, scholarly articles, government action plans, as well as standards and guidelines of relevant institutions, such as the International Organisation of Supreme Audit Institutions and the Institute of Internal Auditors for assessment of the State Audit Office in Croatia. In addition, progress reports of European Commission and SIGMA external audit assessments will be used for comparison of the audit in the Western Balkan region.

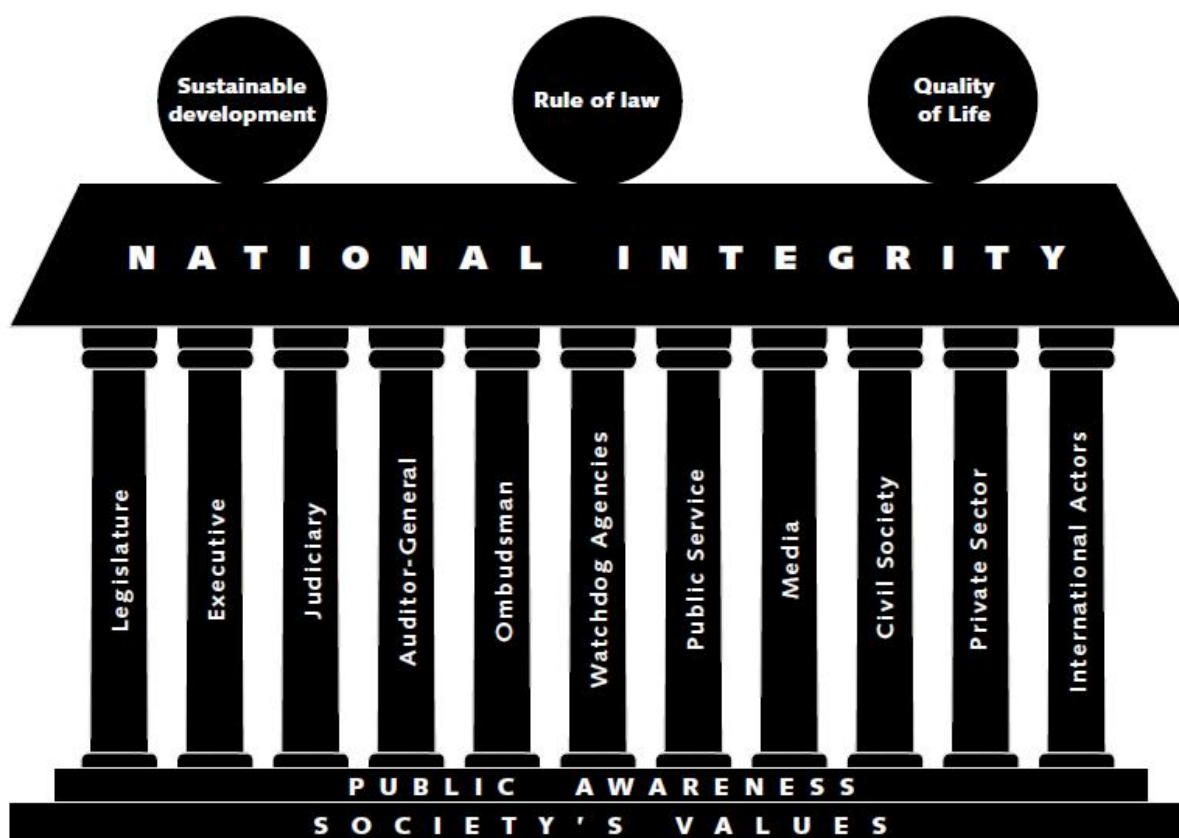
Due to lack of literature on audit and work of the State Audit Office in Croatia, a semi structured interview was conducted with the President of the National Committee for Monitoring of the Implementation of the Anti-corruption Strategy, Mr. Željko Jovanović. Since the Committee is responsible for monitoring of the anti-corruption plan, it has the best overview of the institutions involved in curbing corruption, as well as their significance, role and success. The interview will be used in the fourth chapter for assessment of the State Audit Office in practice. The State Audit Office in Croatia has also been contacted, however without reply.

## 2. Theoretical approach

The accountability of government is crucial for the promotion of public interest and reduction of corruption. The system of horizontal, rather than vertical accountability insures separation and dispersion of powers, making all actors ‘watchers and watched’ at the same time. If it is a part of national strategies for curbing corruption, accountability contributes to the ‘integrity system’ – a comprehensive reform of civil services and government processes. First introduced by Ibrahim Seushi, president of TI Tanzania, the ‘integrity pillars’ have become the leading framework used by the Transparency International in the form of National Integrity System Approach (NIS). NIS, which was further developed by Jeremy Pope (2000; 2008), represents a holistic approach - focused on inter-relationship of different institutions, rather than on each institution separately. The aim of every NIS is to make corruption less attractive, i.e. more risky with low returns. Depicted as a Greek temple (Picture 1), NIS is grounded in the values of the society and public awareness, trying to achieve sustainable development, rule of law and greater quality of life. Although the pillars may be different in different societies, they usually include:

- Executive,
- Parliament,
- Judiciary,
- Civil services,
- ‘Watchdog agencies’ (such as Auditor-General or Anticorruption Agencies),
- Civil society,
- Mass media,
- International agencies (Pope 2000; 2008).

**Picture 1:** National Integrity system: the Greek temple



**Source:** Pope 2000, 35

Pillars depend on social awareness and values – if they are strong, the foundation is stronger and vice versa. Furthermore, if some of the pillars collapse, the whole construction is endangered, especially affecting the rule of law, sustainable development and quality of life (Pope 2008; Dye and Stapenhurst 1998). Finally, every pillar has a corresponding practices or rules which are crucial in reducing corruption, absence of which represents weaknesses of the system. The pillars and corresponding practices are presented below.

| PILLAR                 | RULE/PRACTICE                                   |
|------------------------|-------------------------------------------------|
| Executive              | Conflict of interest rules                      |
| Legislature            | Fair elections                                  |
| Judiciary              | Independence                                    |
| Civil services         | Ethics                                          |
| Watchdog agencies      | Enforceable and enforced laws; public reporting |
| Civil society          | Freedom of speech                               |
| Mass media             | Access to information                           |
| International agencies | Effective mutual legal/judicial assistance      |

However, these practices should not be seen as exclusively attached to the specific pillar, but rather as supplement to the institutional pillars in making National Integrity System (Pope 2000; 2008).

When talking about the pillars separately, each of them has a significant role in controlling corruption. However, the crucial moment for democratic accountability is presented in free elections and **parliaments** which can contribute to corruption control by opening up the work of public officials to the public, thus making it transparent and more accountable (Pope 2000). Stapenhurst et al. (2006) emphasize the leadership role of the parliaments in curbing corruption. Parliaments are the tool of the public for influencing executive, especially if the executive is not directly elected.

Pope (2000) argues that the leadership and the central role in corruption control and support of the integrity system lies in the **executive**. In its relationship with other institutions, executive provides prerequisites for corruption control, such as resources for watchdog agencies and independence of judiciary. On the other side, within itself, government has to provide the leadership and political will, thus being transparent, accountable and acting in the line with the rule of law (Pope 2000).

A government can be hold accountable also through independent **judiciary**. As Pope (2000) argues: *an independent, impartial and informed judiciary* is crucial in making the government *just, honest, open and accountable*. To be able to do that, judges should have the power to review the compliance of government decisions with the law, without a threat for their position. Moreover, judiciary has to be prevented from corruption within itself. This refers especially to appointments, which should be done in cooperation with judiciary, rather than exclusively by the parliament or the executive (Pope 2000). Finally, Buscaglia and van Dijk (2003) put a special emphasis on the role of independent judiciary for implementation of anti-corruption laws in the public sector.

**Public service** is very often seen as a highly politicised arena prone to nepotism and corruption (Pope 2000). In their analysis of growth of corruption in public sector, Buscaglia and van Dijk (2003) have found that especially high level corruption is strongly negatively correlated with two variables, namely *independence of civil service from political pressure* and *immunity of public service from political interference*. They suggest that the key determinant for fighting corruption in the public sector is quality of the police, courts and prosecution. Stronger institutions as well as involvement of civil society can significantly contribute to reduction of corruption (Buscaglia and van Dijk 2003).

Through promotion of public interest, **civil society** today has the legitimacy to represent people and challenge government legitimacy, as well as call for its accountability. Furthermore, civil society organisations also provide networks of experts which can tackle issues of public concern, such as corruption (Pope 2000). Moreover, civil society has an important role in maintaining the solid ground of the NIS, namely public awareness (Stapenhurst et al. 2006). Some international organisations, such as OECD (2003) go so far as to claim that it is an *unchallenged statement* that civil society has a key role in fighting corruption. They especially emphasise the role of **international organisations**, such as Transparency International, Open society Institute or International Chamber of Commerce, in fighting corruption on international level (OECD 2003).

In addition to the contribution of civil society to public awareness, **mass media** has an important role of exposing corruption affairs to the public (Stapenhurst et al. 2006). Pope (2000, 119) notes that “[w]ithout information there is no accountability [...] Access to information on the part of the people is fundamental to a nation’s integrity system”. He points out the independence of media as crucial factor in effective reporting. However, freedom of journalists is always constrained by the owners, especially in the case when the state is the largest one. Therefore the freedom of media should be ensured by the law. Similar concerns and conclusions can be found in the analysis of Buscaglia and van Dijk (2003): lower proportion of state owned

media, more competition in media sector, as well as more involvement of media in reporting corruption are positively correlated with lower levels of corruption.

Finally, according to Pope (2000), an important contribution to corruption control also comes from the ‘**watchdog agencies**’, namely public accounts committee, auditor-general, ombudsman, or anti-corruption agency. To be effective, an anti-corruption agency should be independent, have financial resources and support from the government. Some of the main reasons for failure of anti-corruption agencies can be found in lack of political will, resources, independence, fear of consequences, inadequate legal framework, and lack of accountability or corruption in anti-corruption agencies themselves. In any case, these agencies cannot fight corruption by themselves, but only in cooperation and with the support of other pillars of integrity. Similar rules are valid for the effective work of ombudsman: independence, resources and support from the parliament and the executive. Moreover, functions and powers of ombudsman must be visible, accessible and recognised by the public. Finally, since ombudsman does not have legally binding powers, its cooperation with civil society, which can support its findings, is crucial (Pope 2000).

Civil society also has a key role in making audit institutions ‘heard’ (Ramkumar and Krafchik 2005). Since the government is disposing public money, it is in interest of public to be aware of how this money is used. In general, main roles of supreme audit institutions include “ensuring that the Executive complies with the will of the Legislature, as expressed through parliamentary appropriations; promoting efficiency and cost effectiveness; and, preventing corruption through the development of financial and auditing procedures designed effectively to reduce the incidence of corruption and increase the likelihood of its detection” (Pope 2000: 75).

Having in mind the role of each institution mentioned, it is hard to assess which one could be the most significant – they are inter-dependent and can successfully fight corruption only in cooperation with each other. Nevertheless, not all of them are considered to have equal potential

in fighting corruption. Next sub chapter will focus on the importance and potential of supreme audit institutions, with the focus on key models and features of successful supreme audit institutions.

## **2.1 Supreme Audit Institutions**

Supreme Audit Institutions are not only important for holding governments accountable, but also in the sense of achieving better fiscal governance. Through examination of tax revenues, public expenditures and public debt, SAIs contribute to corruption detection and control, as well as to greater efficiency of public spending (Santiso 2006). SAIs contribute to good governance in general because they promote ethical behaviour, efficiency and cost effectiveness, thereof increasing the possibility of detection of corruption and making it more costly (Dye and Stapenhurst 1998).

To be able to perform its role, key prerequisites have to be met, namely SAIs should have:

- a clear mandate;
- independence;
- adequate funding and staff;
- knowledge and experience (Dye and Stapenhurst 1998).

The formal mandate of SAIs should be clearly based on the constitution or some other legal document, defining the role, scope and powers of SAIs (IIA 2006). According to Dye and Stapenhurst (1998) the most effective way for the parliament to define the mandate of SAIs is through the Audit act. They add that SAIs should be independent from interference of the government when reporting to the parliament. Independence also includes free choice of issues audited, as well as what is reported. Adequate funding is crucial for full performance of audit

duties. It also affects staff competence because it is reflected in wages and training of the staff (IIA 2006). Finally, exchange of knowledge, best practices and experiences contribute to harmonisation of standards and higher quality of audit (Dye and Stapenhurst 1998). In addition to these key four features, SAIs should also have support of stakeholders, including government officials, media and citizens; professional audit standards; and unrestricted access to records and employees (IIA 2006).

If these conditions are met, SAIs can significantly contribute to increased government accountability as well as good governance in general. SAIs have developed from static to more active and involved actor, which is described by Dye and Stapenhurst, as “moving from a role of observer to a more pro active role as an improver” (1998, 11). Furthermore, in many countries SAIs have become institutions which are trusted by the public and, therefore, can contribute even more to the credibility of the state and government accountability. The credibility of SAIs comes from good performance as well as awareness of the public that SAIs are not a political institution. SAIs can also contribute to the reforms through their recommendations for improvement and greater transparency (Dye and Stapenhurst 1998).

To conclude, government audit is crucial for accountability of the government as well as for the good governance. Through audit reports public is informed about how the tax money is spent, which can result in increased trust in the government when the reports are positive, but also in greater responsibility in the case of negative findings. As noted by the Institute of Internal Auditors (IIA), audit of the government has three major roles: oversight, insight and foresight. Whereas oversight evaluates whether the policies have been implemented as planned, insight is more oriented towards best practices and benchmarks, trying to assist the decision-makers in deciding on the right policy or programme. Finally, foresight provides decision makers with trends and possible challenges. To be able to fulfil described roles, audit institutions use different types of audits, namely financial, compliance or performance audit (IIA 2006). The role of audit,



especially in the context of corruption control, as well as the main types of audit will be presented in the next chapter.

### 3. Audit for Anti-Corruption

Little attention has been given to corruption audit in the literature about corruption control. Starting from the International Organisation of Supreme Audit Institutions and its Journal of Government Auditing, from 2000 to 2005 only two articles on this topic were published (Kahn 2007). In addition, one more article was published in 2007 (archive of the International Journal of Government Auditing<sup>1</sup>).

Same as in the literature, audit in practice is a neglected tool in fighting corruption (Kahn 2007). On the one side, perceiving audit and SAIs as merely corruption detectors can harm the cooperation between auditor and auditees, which is the reason why SAIs tend to avoid detecting corruption as their primary task. This creates a gap between expectations of the public and mandate of SAIs: the public perceives corruption more important than compliance with laws and procedures, and believes that SAIs should be focusing on detection of corruption (Busse 2007; Dye 2007). However, audit reports rather focus on recommendations and detection of opportunities for corruption in the form of holes in regulations or procedures (Kahn 2007). Nevertheless, although SAIs might not have investigation powers like public prosecutor, they have indispensable experience and understanding in the area of accounting and could more easily detect irregularities (Busse 2007). Attention should also be drawn to the quality of audit staff – by taking a strict *clerical approach* based on compliance, they are more likely to miss the objective of audit and commit systematic failures with serious consequences. Therefore, audit staff has to have appropriate education and training in the area of public procurement in order to determine flaws in the objectives and processes (Dye 2007).

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<sup>1</sup> Busse, Klaus-Henning. 2007. The SAI's Role in Combating Corruption. *International Journal of Government Auditing*. Available at <http://www.intosaijournal.org/archivededitions/archived.html>

### 3.1 Types of Audit

Types of audits differ according to the objectives that they aim to achieve. In this sense, we can distinguish financial, compliance, controls, performance, forensic, and computer audits (Dye 2007). In general, types of audits can be divided in two groups, depending on time (*ex post* (financial) and *ex ante* audits) and according to their focus – compliance, attestation and performance audit (Schaeffer 2008). However, most of the audit literature emphasizes three main types, namely compliance audit, financial audit, and performance audit (cf. Shah 2007; Dye and Stapenhurst 1998; Stapenhurst and Titsworth 2001; Van Zyl 2008). Financial, compliance and performance audit together make an *audit framework* or *comprehensive auditing* for comprehensive and complete overview of the organisation audited (Dye and Stapenhurst 1998).

Compliance audit is the basic element of audit (Shah 2007). It checks how the money has been spent regarding right purposes and authorisation. In other words, it checks if the rules were complied with, rather than the appropriateness of financial transactions (van Zyl 2008). This type of audit often detects corruption (Dye 2007).

Financial audit is based on documents such as receipts, financial statements or accounting (Shah 2007). It presents accuracy of finances in the sense of control and reporting. It can be conducted in two ways: comparing financial and non financial information (where the internal control system is strong enough to provide non financial information) or comparing financial information with evidence such as invoice - where internal controls are weak (van Zyl 2008). In general, financial audits are not meant to detect corruption, although this is not excluded from the results of the financial audit (Dye 2007).

Performance audit (*value for money* - *VFM*) is based on efficiency, effectiveness and economy, the lack of which can be a sign of corruption (Stapenhurst and Titsworth 2001). Its aim is to “measure a government’s success in executing its functions for society” (Shah 2007, 232), or in other words to compare previously defined objectives with performance and results. VFM is

based on analysis of outputs and outcomes, legal and ethical compliance, as well as resources use and information systems. Although its main purpose is not to detect corruption, due to area of high risk that it is involved in, performance audit can discover irregularities and corruption (Dye 2007).

“The full scope of government auditing includes regularity and performance audit” (INTOSAI’s Auditing Standards in INTOSAI 2004). Recently, SAIs are more oriented towards performance auditing because that reveals the most from government’s actions. Performance audit adds more value than financial audit, which is merely concerned with financial credibility, or compliance audit, which is oriented only to compliance with the laws and procedures (Dye and Stapenhurst 1998). Therefore, the next subchapter will describe performance audit according to guidelines and recommendations of International Organisation of Supreme Audit Institutions (INTOSAI). It will show the comprehensiveness of performance audit, but also challenges and complexity of its tasks.

### 3.2 Performance Audit

Performance audit has two main focuses, namely to examine whether stated goals that correspond to the social needs were met and if they were achieved at the lowest cost. Although performance audit is not concerned with social needs as such, it can question the grounds and means of objectives (NAOF 2007). In other words, performance auditing aims to answer two questions: *Are things being done in the right way?* and *Are the right things being done?* (INTOSAI 2004).

Unlike financial and compliance audit, because of the complexity of issues audited, performance audit is more flexible and not in the form of a check list. It is flexible in deciding on objectives, subjects and methods and based on audit of economy, efficiency and effectiveness. Audit of economy refers to the low costs, efficiency that the resources were used in the best way, and

effectiveness compares what has been done with what was intended to be done. In more detail, when assessing economy, auditors are focused on inputs (means or equipment) and whether this was the most economical way to use public funds. Following economy, audit of efficiency further examines the use of resources. Specifically, it is concerned about cost effectiveness and quality and quantity of services, trying to answer the question: *Are we getting the most output – in terms of quantity and quality – from our inputs and actions?* It includes analysis of human and financial resources, government programmes in the terms of monitoring, execution and evaluation, and public services - in the sense of quality, are they client oriented and delivered on time. Finally, effectiveness audit is concerned about two main questions, namely are the objectives of a policy achieved, and whether they are results of that policy or some other circumstances (INTOSAI 2004).

According to INTOSAI (2004), methods of performance audit differ along countries and their traditions, focusing on impartial assessment of meeting different criteria and accountability or independent analysis and causes of the problems. Following that, two different approaches to performance audit can be distinguished, namely results-oriented and problem-oriented approaches. Intuitively, results-oriented approach is mainly concerned with achieved results, based on previously defined audit criteria or goals, objectives and regulations. On the other side, problem-oriented approach does not include audit criteria, but rather definition and analysis of the problem. The main aim of SAIs in this type of audit is to examine the root of the problem and analyse it from different perspectives. Although both approaches are demanding, accountability auditing is more similar to compliance and financial audit, which makes it easier to conduct. On contrary, going by the book can jeopardize the main goal and potential of performance auditing.

However, performance audit also has its challenges. Some of them include funding, staff salaries, staffing in the sense of different disciplines, quantity and quality, organisational structure, audit

selection and reporting model. Finally, an important factor is training: because University degree does not ensure practical knowledge, a lot of SAIs either employ auditors from other audit organisations or organise on-job training by themselves (AGA 2006).

These factors become especially relevant in the context of the complexity of conducting performance audit. Performance audit consists of three phases, namely planning, field work, and reporting. Planning phase includes five steps: gathering information, risk assessment, assessing vulnerability to risks, defining objectives and determining the scope of audit, methodology, fieldwork programme and the budget. After detailed planning comes field work and data collected, which is crucial for the strength and credibility of the report. Field work does not mean only data collection, but also weighting evidence, analysing, combining sources and data, as well as documenting the whole process. Finally, findings have to be presented in the form of a report. For performance audit there is no form to fill in, but every report is unique due to different environment and issues that it addresses (Waring and Morgan 2007).

In sum, performance audit is a complex and comprehensive task that requires experience, analytical and investigational skills, flexibility as well as appropriate funding. Not every SAI has financial or human resources to conduct it. Nevertheless, when talking about corruption control, performance audit can be a powerful means of control – even the last resort if accounts and law compliance seem to be in order. However, as Kahn (2007) argues, although it is generally agreed in the literature that performance audit can detect corruption, it is often hard to clearly state the cause of failure of the projects and distinguish between human mistake and corruption. Nevertheless, certain indicators for corruption exist. In the terms of economy, efficiency and effectiveness, following signs of corruption can be noted:

- Economy: constant increase of the scope of the work and costs, weak accountability for exceeding budgets, increase of prices after the competitive bidding process,

- Efficiency: accumulation of unnecessary equipment, maintenance expenditures too high, lack of investment in infrastructure and regular maintenance, often extensions to contractors
- Effectiveness: no performance indicators, dissatisfaction of the client due to lower quality, lack of effective complaints mechanisms (Kahn 2007).

Performance audit can prevent these consequences by involvement of top managers in the process, who should: support performance audit, require detailed data collection regarding performance and prefer performance over compliance audit (Kahn 2007).

As noted in Waring and Morgan (2007), although audit is meant to hold governments accountable, performance audit also adds to the possible solutions of change. In this sense, audit institutions have to balance between being watchdog institutions, as well as offering advice for improvement.

## **4. Corruption Control and Audit in Croatia**

The fight against corruption in Croatia is closely connected with EU accession and conditionality. The reforms started with the coalition government of Ivica Račan in 2002 and the first National Programme for Combating Corruption (Bađun 2006; Malenica and Jeknić 2010). In March 2006 Croatian Parliament adopted new National Programme for Combating Corruption for the period from 2006 to 2008, which was oriented to implementation rather than merely adoption of anti-corruption legislation like the previous one (Bađun 2006). New and revised Strategy for Combating Corruption, as well as the corresponding Action Plan were adopted in 2008. However, a significant change in fighting corruption in Croatia happened after the resignation of the former Prime Minister Ivo Sanader in 2009, when several high level officials were arrested (Malenica and Jeknić 2010).

Recently, Croatia has closed the negotiation chapter 23 – Judiciary and fundamental rights, where one of the major issues was widespread corruption, and especially political corruption. In this context, the next subchapters will present and assess national integrity system and state Audit Office in Croatia.

### **4.1 National Integrity System in Croatia**

In general, NIS reports assess institutions relevant in corruption control (cf. chapter 2) based on their capacity, procedures and internal governance, and role in the integrity system. Assessment includes both legal framework and functioning in practice, as well as highlighting differences between the two. In addition, the report includes analysis of political context, which is indispensable for in-depth analysis of the whole integrity system (Transparency International).



A survey of national integrity system in Croatia was done in 2007. Regarding executive in Croatia, since there were no clear regulations about checks and balances during 1990s, oversight over Government has been improved: legislation is in place, authorities and limitations are clearer. However, problems still exist in implementation, especially when it comes to prosecution of high level officials. In these cases independent media and civil society have the key role in pushing for action. When it comes to the Parliament, it passes laws and adopts strategies relevant for curbing corruption. However, the leadership role (cf. chapter 2) is lacking - the first National Strategy for curbing corruption was initiated by nongovernmental organisations and only afterwards discussed in the Parliament (First et al. 2007).

Separate attention is given to the political parties, with an emphasis on the lack of regulation of their financing, as well as financing electoral campaigns. This has not been clearly solved even today. Legally looking, the Judiciary is autonomous, independent, and functions according to the Constitution and laws, but it is still perceived by the public as highly corrupt (First et al. 2007). That the reforms were needed is also clear from European Commission Progress Reports (2006-2010) and the process of negotiations – chapter 23, Judiciary and fundamental rights was one of the most controversial issues and among last ones closed.

Public service is also a weak pillar prone to corruption. The reasons can be found in centralised decision making with lack of coordination, political appointments, non-transparent process of employment, non-adequate education. Furthermore, communication of civil society with the Government, as well as their participation in legislation process is weak and insufficient. The independence of media is sometimes threatened by the interference of the executive, and the Law on Free Access to Information is not implemented properly (First et al. 2007).

The report also mentions watchdog agency USKOK<sup>2</sup>, as well as the State Audit Office. USKOK was established as a part of the State Attorney in 2001, with the aim of more efficient corruption control and decrease of perception of corruption. The State Audit Office is described as independent body in charge of financial control of public sector. However, nothing is mentioned about the success or the challenges of the Audit Office or USKOK (First et al. 2007).

The conclusion suggests further strengthening of institutions, with an emphasis on the role of the executive. It also brings recommendations for improvement of corruption control and transparency, some of which include:

- establishment of an independent body for prevention and education about negative effects of corruption and the need for its prevention,
- improvement of working conditions of USKOK,
- amendment of laws on public procurement and conflict of interest,
- adoption of law on financing political parties,
- effective protection of whistleblowers,
- adoption of codes of ethics in public services, as well as encouraging the implementation of such measures in the private sector,
- integration of corruption control content at all levels of the education system, providing resources and creating mechanisms of state responsibility for negative consequences of corruption (First et al. 2007).

After a closer look at these findings, in comparison with 2007, today we should see some improvements and the implementation of the above-mentioned recommendations. However, not all recommendations are feasible, effective or clear to the same extent, especially when it comes to their implementation – how to integrate corruption control in education system or what are

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<sup>2</sup> Ured za suzbijanje korupcije i organiziranog kriminaliteta - Office for Combating Corruption and Organized Crime

exactly mechanisms of state responsibility and how to achieve them. Overall, 2007 NIS report is more concerned about legal framework than its implementation in the practice and assessment, which leaves the room for improvement in the future.

Moreover, findings of the report sound optimistic when compared to perception of corruption of these institutions among the people (Table 1). According to Global Corruption Barometer (2009), 66 per cent of the people in Croatia believe that the Government is somewhat or very ineffective in fight against corruption. Regarding political parties, 69 per cent of the people see them as very or extremely corrupt. Furthermore, 67 per cent think the same about the Parliament. Moreover, the pillars which are perceived as the most corrupt include the Judiciary and public service – over 70 per cent of the people think these institutions are very or extremely corrupt. Considering the role of the Government, political parties and the Parliament, as well as political will for curbing corruption, such negative perception shows that the leading pillars in Croatia are, not only unstable, but also corrupt within themselves. With the judiciary perceived as the most corrupt among the pillars (77 per cent), it is hard to trust that corruptive actions will be prosecuted. Finally, with the system lacking integrity, as well as political will and support of the key pillars - Executive, Parliament and Judiciary, other pillars cannot effectively contribute to the corruption control. Following described integrity system; next subchapter will describe and assess the supreme audit institution in Croatia – the State Audit Office, and its role in corruption control according to the criteria introduced in the chapter 2.1.

**Table 1:** Perception of the extent to which each category is affected by corruption

|                           | <b>Parliament</b> | <b>Political Parties</b> | <b>Judiciary</b> | <b>Civil Servants</b> | <b>Media</b> |
|---------------------------|-------------------|--------------------------|------------------|-----------------------|--------------|
| <b>Not at all corrupt</b> | 2 %               | 2 %                      | 1 %              | 1 %                   | 4 %          |
| <b>2</b>                  | 5 %               | 4 %                      | 2 %              | 3 %                   | 10 %         |
| <b>3</b>                  | 20 %              | 19 %                     | 12 %             | 16 %                  | 28 %         |
| <b>4</b>                  | 26 %              | 25 %                     | 21 %             | 27 %                  | 21 %         |
| <b>Extremely corrupt</b>  | 41 %              | 44 %                     | 57 %             | 46 %                  | 30 %         |
| <b>DK/NA</b>              | 7 %               | 6 %                      | 6 %              | 6 %                   | 6 %          |

**Source:** adapted from Transparency International 2009

## 4.2 The State Audit Office

In an organisational sense, the State Audit Office mostly fits Westminster or monocratic model (cf. Dye and Stapenhurst 1998; Santiso 2006), with the Auditor General as the head of the Office, appointed by the Parliament. Auditor General also has its advisory body - the Expert Council, which consists of his assistants, deputy as well as external experts in area of law and economics. The Parliament appoints the Auditor General, and the Office is accountable to the Parliament – by submitting annual reports (SAO).

The EU conditionality and pre-accession reforms have had an important impact on development of independence of the Audit Office in Croatia. Since the beginning of pre-accession negotiations and the first Progress Report (2006), European Commission have warned about insufficient financial independence of the Office. Development of the Office was intensified in 2007 after the beginning of negotiations on chapter 32 – Financial control. In the same year SAO adopted INTOSAI standards in audit practice, as well as the new Strategic Plan for the period from 2008 to 2012. However, European Commission noted that further progress is needed in training as well as in functional and financial independence. Finally in 2010, after the constitutional changes, the State Audit Office became a constitutional category – with independence granted in the constitution (Državni Ured za Reviziju 2010; Croatia Progress Reports 2006-2010).

Together with other pillars of national integrity system, the State Audit Office is included in the Action Plan for Curbing Corruption. The Action Plan from 2008 prescribed 195 preventive measures, out of which five were to be implemented by the State Audit Office. The role of the Office was mainly connected to financing political parties and electoral campaigns, financial control in public sector and establishment of closer cooperation with the Ministry of Finances (The Action Plan 2008). The Revised Action Plan for the period 2010 - 2013 reduced the number of measures to 145, out of which only two involve the Audit Office: organisation of training for

audit of finances of political parties, with a special emphasis on detecting potential risks for corruption, and education and quarterly meetings with the Ministry of Finances, with the aim of strengthening and faster development of system of Public Internal Financial Control (The Revised Action Plan 2010).

This clearly shows that the role of the Office is undermined and restricted only to political parties. On the one hand, supreme audit institution is the only institution that can examine funding of political parties, and therefore this can be considered as its main task. On the other hand, however, as shown in previous chapters, SAIs have greater potential, especially through performance audit. However, certain criteria have to be fulfilled. When accessing the State Audit Office according to mandate, independence, funding, staff and knowledge (cf. chapter 2.1), it formally meets all these criteria as presented in next subchapters.

#### ***4.2.1 Clear mandate***

The State Audit Office was established in 1993 with the State Auditing Act. According to the Act, scopes and responsibilities of the Office are clearly stated and include audit of:

“public incomes and expenditures, the audit of financial statements and financial transactions of government units and local and regional self-government units, legal entities being partly or wholly financed from the budget, public enterprises, companies and other legal entities owned in major part by Republic of Croatia or local and regional self-government units, use of EU funds and funds of international organizations or institutions for financing of public needs” (Article 1).

#### ***4.2.2 Independence***

After becoming a constitutional category in 2010, the independence of the Office is guaranteed by the Constitution. Article 54 states that:

“[t]he State Audit Office shall be the supreme audit institution of the Republic of Croatia, and shall be autonomous and independent in its work. The State Audit Office shall be managed by the Auditor General, who shall report on its work to the Croatian

Parliament. The establishment, organisation, purview and operation of the State Audit Office shall be governed by law” (Article 54).

In addition to the Constitution provisions, the State Auditing Act prescribes the eight years mandate of the Auditor General, which can be renewed. Moreover, Auditor General can be dismissed before the end of the mandate on his/her own request, in the case of admission to other position or if his/her capabilities are undermined (Article 13).

#### **4.2.3 Adequate funding and staff**

The resources for funding of the Office are secured in the state budget. Looking at the available data from the last four years, funding has been stable, with the executed budget lower than the planned one (Table 2). Regarding the staff, the Office has the capacity to employ 307 employees. However, in 2010 the number of employees was 279. Due to anti-recession measures and the ban of employment in the public sector, the number was not increased. Out of 279 employees, 229 are state auditors with high education degree. Audit is usually performed by a team, which allows cooperation and combination of different skills of auditors and contributes to higher quality, but also education of the staff. In 2010 the Office conducted 770 audits and fully realised the annual plan (Državni Ured za Reviziju 2010).

**Table 2:** Budget of the State Audit Office (in HRK)

|               |                 | 2007          | 2008          | 2009          | 2010          |
|---------------|-----------------|---------------|---------------|---------------|---------------|
| <b>Budget</b> | <b>planned</b>  | 52.561.000,00 | 54.723.000,00 | 52.721.736,00 | 53.895.980,00 |
|               | <b>executed</b> | 50.245.453,37 | 51.499.725,00 | 51.696.399,86 | n.a.          |

Source: Državni Ured za Reviziju 2008, 2009, 2010

#### **4.2.4 Knowledge and experience**

As mentioned before, the European Commission has warned about lack of training of auditors, especially in the field of financing political parties. As shown in the Table 3 below, although not completely used, additional resources were planned for improvement of capacities in 2007 and 2008.

**Table 3:** Budget of the State Audit Office for training of the staff (in HRK)

|                              |                 | 2007       | 2008       | 2009 | 2010 |
|------------------------------|-----------------|------------|------------|------|------|
| <b>Professional training</b> | <b>planned</b>  | 200.000,00 | 200.000,00 | -    | -    |
|                              | <b>executed</b> | 147.133,40 | 44.347,00  | -    | -    |

Source: Državni Ured za Reviziju 2008, 2009, 2010

Training is also provided through internships in the European Court of Auditors in Luxembourg and conferences, seminars, courses and workshops organised by the Office. Exchange of experience is achieved through international cooperation, namely membership in international professional organisations (INTOSAI and EUROSAI), pre-accession negotiations with the EU and its twinning programmes, bilateral cooperation with SAIs from other countries, as well as cooperation with different international organisations from the field of corruption control and use of EU pre-accession funds (Državni Ured za Reviziju 2010).

#### **4.2.5 Sum of the Analysis**

In conclusion, with its mandate to audit all levels of the government, from local to state, the State Audit Office has an important role in curbing corruption. It fulfils relevant requirements, in terms of the legal framework, for effective auditing and possibility to contribute to corruption control. However, implementation is still questionable. Although there have been major improvements when compared to the period before pre-accession negotiations, discrepancies between practice and laws still exist. This particularly refers to the independence of the Office (Interview).

Although it is the core of effective functioning, so far the Office has not been completely independent. This is shown by the so called ‘Kamioni’ affair, which involved former Minister of Defence of the Republic of Croatia and pressures from the ex-prime minister (Interview). The affair came out in 2009, when the full report of the State Audit Office from 2004 about procurement of trucks for the Ministry of Defence appeared in the media. The audit discovered that the Minister ordered the trucks by direct negotiation with the company *Eurokamioni* without clear justification. Moreover, audit report noted that in the tender procedure for the same type and number of vehicles the Ministry offered 28.9 million HRK, and in the process of direct negotiations 5.5 million HRK more. Finally, the Ministry bought five trucks less than planned - and at a higher price. The full report with mentioned findings was never delivered to the Parliament, and the Auditor General at that time (Šima Krasić) did not send them to the State Attorney and request the investigation (Jutarnji list). However, after the affair was covered in media, the State attorney requested the State Audit Office for the full reports. After the criminal investigation, charges against former Minister were pressed in 2009. One year later he was convicted to four years in prison (DORH).

In conclusion, the State audit Office in Croatia has become more influential under the pressure of EU and the beginning of pre-accession negotiations. In the past several years legal framework has been harmonised with the EU *acquis*. However, as the ‘Kamioni’ affair shows, genuine implementation is still lacking. Another important lesson is the importance of media in revealing corruption – measures were undertaken only after the affair was presented in media. Furthermore, considering the Action Plan for curbing corruption and only two measures that the Office is responsible for (cf. chapter 4.2), it is clear that its capacity and importance in corruption control are undermined. Moreover, follow up for the most important role of the Office – controlling political parties – is nonexistent. Although the State Attorney has to investigate



negative findings of audit, when it comes to financing of political parties, regardless of reported irregularities, so far none of the parties has ever been sentenced for non-transparent funding.

Finally, in addition to formal requests for functioning of the State Audit Office, crucial factor is political context: not only support of the Government, Parliament and State Attorney, but also international pressures, such as EU conditionality. Three important events that positively affected work of the Office include already mentioned negotiations with the EU, resignation of ex Prime Minister charged for corruption, and change of the Auditor General after the function has been performed by the same person since the Office was established. Further strengthening is expected after the forthcoming parliamentary elections and possible change of the government and the governing party, which is shaken by corruption affairs (Interview).

#### 4.3 Region in Comparison

In comparison to Croatia, the whole Western Balkans region is going through deep reforms on their way to the European Union. Efforts to change can also be seen in the area of financial control and audit institutions. Aiming to meet prerequisites for effective performance of supreme audit institutions, Western Balkan countries adopted relevant legislation, introduced INTOSAI standards and granted independence to SAIs in their constitutions. However, in practice, some problems still remain.

In 2007, after the Constitution changes, State Audit Institution in **Serbia** was granted independent status. However, although the members of the Institution were appointed, and regulations were in place, it was still not functional due to the fact that only two auditors were recruited by the end of 2008. As a consequence, there was no control over public expenditures. The first audit after 2001 was done for the 2008 budget, but only partially due to lack of staff

(Serbia Progress Reports 2007-2010). However, findings of the audit have not been followed up – out of 19 misdemeanour charges, only three final verdicts have been made (EMG).

**Bosnia and Herzegovina** has four supreme audit institutions (the State, two Entities and Brčko District) which are coordinated through the Coordination Board. Strengthening of the capacities of the audit institutions started in 2000 and the Law on Auditing Institutions was adopted in 2006. However, Auditor General (state level) was appointed only in 2008, with a delay of two years. Moreover, SAI is financially dependent on the Ministry of Finances, which often causes interference of the executive and undermines the work of SAI as an independent institution. Finally, although the reports of SAI are transparent, available online and discussed in the media, results and follow up are not visible (SIGMA 2009; BiH Progress Reports 2007-2010).

The State Audit Office of **Macedonia** reported irregularities in financing political parties regarding donations during 2006 elections. However, no sanctions are prescribed in the law. The European Commission warned about lack of effective implementation of anti-corruption laws, especially loopholes discovered by the State Audit Office and lack of follow up on the reports of the Office. Ineffectiveness can be attributed to the poor cooperation with the Parliament, as well as weak judiciary and lack of enforcement of court decisions. The changes in the Law on the State Audit Office, in 2010 strengthened the independence of the Office. However, the Parliament is still not obliged to react to the reports and recommendations of the Office (FYROM Progress Reports 2007-2010).

The supreme audit institution in **Albania** is the High State Court. The Court is less focused on financial and more on compliance audit. So far, auditing legislation in Albania is not completely in line with INTOSAI standards and independence of the Court is questionable (SIGMA 2009).

In **Montenegro** the State Audit Institution was established in 2004 and granted independence in the constitution in 2007 (Montenegro Progress Report 2010). The Office of Auditor General in **Kosovo** is still a very young institution. SIGMA Report (2009) emphasises the problem of

ownership, connected to the number of foreign experts employed, which lead to lack of training and education of the local people. The Office is not considered to be financially independent due to the fact that the government can influence its work through the budget. Finally, the Office has not been delivering reports on time, cooperation with the Parliament is not developed and only 35 per cent of recommendations are implemented (SIGMA 2009; Kosovo Analytical Report 2010).

All in all, it is evident that audit in the Western Balkans region is still not a powerful means which can contribute to curbing corruption. Although legislation is mostly in place, in practice it is not implemented and state audit institutions are not functional. A common problem can be seen in inadequate capacities and training, lack of financial independence as well as possibility of the government to interfere in work of SAIs. Another problem is follow up of the findings and recommendations of the SAIs. This can be attributed to poor cooperation and support from the parliaments, but also from other institutions such as the government or the judiciary.

## Conclusion

The thesis analysed the problem of high level corruption and government expenditures, answering the question: To what extent can the audit of the government contribute to corruption control in Croatia, and what lessons can the Western Balkan region learn from Croatian case. Considering the Western Balkan region in the context of the EU enlargement, the case study of Croatia, as the best performing country in the region, showed the state of national integrity system and impact of the EU on audit. The State Audit Office in Croatia fulfils all formal (legal) requirements for effective functioning and contribution to corruption control: clear mandate, independence guaranteed in the Constitution, adequate funding and staff, as well as international cooperation, knowledge and experience. However, the gap between the legal framework and the implementation in practice exists. The study has shown two major problems, namely lack of independence and follow up of the findings of audit. From this we can conclude that the underlying causes for lack of effectiveness can be found in weak national integrity system. Finally, it can be argued that under these circumstances, namely lack of cooperation among pillars and lack of follow up, audit cannot effectively contribute to corruption control. Nevertheless, their potential is significant when they operate in supportive environment. This was shown through the case of 'Kamioni' affair, which was discovered only after the resignation of ex Prime Minister, who is charged for corruption and imprisoned at the moment.

Based on the above, what lessons can be learned from Croatia? For the neighbouring countries – strengthening of the national integrity system. For the European Union – emphasis on follow up together with the legal requirements. First, corruption in the region is in general widespread and high. Prerequisites for SAIs to be functional, together with legal compliance, include support of the stakeholders – media, civil society, government, parliament, judiciary, etc. Strengthening of the national integrity systems is the first step towards strengthening and development of SAIs and their role in the corruption control. On the other side, we can say that these developments

are pursued by the EU conditionality. For greater effectiveness, in addition to harmonisation of the legal framework, EU should put more emphasis on the results and findings of the audit – requiring for follow up of audit recommendations.

To conclude, it can be argued that the region is facing two major challenges, namely overall corruption control with the aim to strengthen main pillars of integrity (executive, legislature, and judiciary) and introduction of performance audit. Without political will from the top, all other pillars can hardly function in the sense of curbing corruption. Support and cooperation from the top enhances not only work of SAIs, but also other institutions relevant for corruption control such as anticorruption agencies, civil society and media. Important impulses for change in Croatian case can be found in pressures from the EU, resignation of the former Prime Minister Ivo Sanader, as well as in the recent change of Auditor General. These three factors advanced political environment in which the State Audit Office operates, thus adding to its independence.

Another challenge is performance audit. As mentioned in chapter 3, performance audit could contribute not only to the corruption control, but also can bring up solutions for change and further improvement in governance. However, as noted by Waring and Morgan (2007), before performance auditing can be conducted, functional financial audit has to be in place. Going further, to be able to conduct effective financial audit, SAIs have to, not only fulfil formal requirements including independence, adequate staff and funding, but also apply them in practice. This is the stage where the Western Balkan region is currently located. From adoption of legal framework imposed by the EU conditionality, through proper implementation and functional auditing, to performance audit is still a long way to go.

Finally, some challenges are left to academia as well. The lack of literature about audit and its role in corruption control, not only in Croatia, but also broader, certainly leaves room for further research about mechanisms of strengthening national integrity systems, which would enhance the environment for more effective work and contribution of audit to corruption control.

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