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Challenges in Implementing the Concept of Public Internal Financial Controls in the Public Sector of Bosnia and Herzegovina

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Abstract

The requirements of joining the European Union have imposed the need for candidate countries to reconsider their control mechanisms related to the use of public funds, and to assess the extent to which they ensure compliance with the principles of good governance, including economy, efficiency and effectiveness. During the pre-accession negotiations, candidate countries are expected to set up and develop internal financial control systems to prepare for all the challenges they face by joining the European Union and participating in EU funds. Availability of EU funds for one country largely depends precisely on the quality of the established internal financial control system. In order to facilitate the establishment of such a system, the European Commission has developed a concept called Public Internal Financial Control based on international standards and best practices of EU countries. The aim of this paper is to examine the extent to which the Public Internal Financial Control concept has been implemented in the public sector of Bosnia and Herzegovina, what challenges public institutions in B&H currently face in this context, and what are the recommendations for overcoming identified challenges.

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Introduction

Public Internal Financial Control (PIFC) is a complete system of financial and other controls established by the public entity to successfully manage and accomplish its tasks (Obhodžaš & Rička, 2012). Internal financial control in the public sector includes measures to control all government revenues, expenditures, assets and liabilities. It also covers internal control systems and procedures in public institutions and helps to ensure that public funds are appropriately spent and that they achieve the expected value for the money (Batova et al., 2019). The overall purpose of internal control is to obtain assurance that goals and objectives are achieved by authority and decisions (both financial and non-financial) that are taken, corresponding to several principles: legality; austerity; efficiency; productivity; transparency (Dikan et al., 2017).

The three main pillars of the PIFC concept are: (i) financial management and control (hereafter FMC) in terms of managerial responsibility for internal control processes, (ii) functionally independent internal audit (hereafter IA) and (iii) Central Harmonization Unit (hereafter CHU).

According to the PIFC concept, the first level of control should be at the manager level. This means that each public manager is responsible for establishing and maintaining an FMC system for planning, programming, budgeting, accounting, controlling, reporting, archiving and monitoring tasks. Particularly important is strengthening the preventive function of FMC systems (Meiss et al., 2018).

FMC systems are being developed to help organizations in the public sector to achieve set goals, such as compliance of the business with regulations, plans, contracts, policies and procedures; performing activities in a proper, ethical, economical, efficient and effective manner; protection of assets, liabilities and other resources from losses that can be caused by mismanagement, unjustified spending and use, and protection from irregularities, misuse and fraud; reliable, complete and timely financial reporting and monitoring of business results.

The Committee of Sponsoring Organizations of the Treadway Commission (n.d.) (hereafter COSO) has designed an Internal Control-Integrated framework (hereafter COSO model) in 1992, as a generally accepted international model for establishing, managing and evaluating internal control systems. In 2013 COSO released an updated version of its Internal Control-Integrated Framework with the following five components, which should contribute to the achievement of the organization's mission, strategies, and related business goals:

- a) Control environment (ethical values, integrity and competence of employees, management style and management style, defining the mission and goals of the organization, organized organizational structure with clearly defined authorities and responsibilities for the implementation of activities, written rules and human resources management practices);
- b) Risk assessment (identifying and assessing the likelihood of risks occurring and their impacts taking into account organizations, taking the necessary actions especially through the application of the FMC system for risk mitigation, documenting risk data in risk registers, reporting major risks and management activities risks and the ability to adopt a risk management strategy);
- c) Control activities (written rules, principles, procedures and other measures put in place to achieve the objectives of reducing risk to an acceptable level - authorization procedures, transfer of authority and responsibility, separation of duties, double signature system, complete, accurate, correct and up-to-date recording procedures business transactions, procedures that ensure the

protection of property and information from alienation and damage, surveillance, etc.);

- d) Information and communication (relevant, up-to-date, accurate and accessible information for financial management purposes, effective communication at all levels, building an appropriate information management system, documenting business processes and transactions including system descriptions via flowcharts, accounting and archiving system to produce adequate audit trail, development of an effective, timely and reliable reporting system);
- e) Monitoring activities (performed through regular management and monitoring activities, self-assessment and internal audit, with the purpose of evaluating the functioning of the FMC system and its timely updating, and determining measures for its continued development).

The second segment of PIFC is internal audit, an independent, objective persuasion and consulting activity created to add value and enhance the organization's operations. It helps the organization achieve its goals by using a systematic methodology for analysing business processes, procedures and activities with the aim of identifying organizational problems and recommending solutions (Stanišić, 2013). The methodological framework for IA involves planning, risk assessment, testing of controls, analysis of information, preparation of audit reports, monitoring implementation of recommendations, organization of internal audit work papers, programs, checklists and more.

According to the common definition, internal audit has the following tasks: (i) reviews the internal control system and their compliance with laws, regulations, policies and procedures; (ii) determines the existence of property and its adequate protection; (iii) determines the economy, efficiency and effectiveness of the use of all budget user resources, including human resources; and (iv) consider achieving budget user targets (Sever & Lajoš, 2008).

The CHU, as the third segment of the PIFC, is in charge of coordinating and harmonizing the methodology and guidelines for financial management and control, as well as an internal audit in the public sector. Its competence includes, inter alia, training of internal auditors and persons involved in financial management and control. CHU manages the process of change and development of financial management, internal control and internal audit.

In order for any internal control system to be effective, it must be linked to external supervision instruments. Thus, Shevchuk and Shevchuk (2017) recommend the formation of so-called a three-level system model of state financial control, which should include budgetary inspection, internal and external audit, and government supreme audit.

Below, we will outline the current level of implementation of PIFC in Bosnia and Herzegovina (B&H).

Public Internal Financial Control in Bosnia and Herzegovina

By signing the Stabilization and Association Agreement in 2008, B&H undertook to develop internal controls in the public sector by drafting and adopting appropriate regulations, including FMC, functionally independent IA, and independent external audit systems in B&H, in accordance with internationally accepted control and audit standards, as well as methodologies and best practices of the European Union.

Although the Law on Internal Audit of B&H Institutions was adopted in 2008, even at the time of writing this paper it has not fully come to life. The Council of Ministers' Strategy for the Establishment of PIFC in B&H Institutions from December 2009 envisaged that the relevant legal framework for PIFC would be adopted within three years (end of 2012) and that public institutions would fully implement it in about five years (end of 2014). Hence, by the end of 2014 the establishment of the PIFC in public institutions was not completed in accordance with EU requirements, nor was a functional internal audit established.

In the mentioned period, not even half of the planned number of internal auditors was employed in the public institutions, and only half of the planned internal audit units were functional and published their reports. Most of the established internal audit units did not consistently apply the relevant standards and methodology for the work of internal audit.

Nevertheless, till today, significant progress has been made and the function and role of internal audit have become clearer recognized in the institutions of B&H, as part of the overall system of internal financial controls of the public sector. According to the Annual consolidated internal audit report for 2018, prepared by the CHU B&H (2019), internal audit in B&H institutions is functionally and personnel established or in the process of establishment, in accordance with applicable regulations, in all 18 institutions of B&H which are scheduled to establish internal audit.

The situation in the field of FMC still requires numerous improvements. There are public institutions in B&H that have not carried out even the basic activities regarding the establishment of FMC systems, i.e. documented key business processes; made a map of business processes; and established a register of risks that needs to be implemented and updated continuously. The FMC reporting segment, although established, is still incomplete and public institutions remain inefficient in the process of establishing their functional organizational structure.

The legal framework for PIFC in B&H is defined in more detail at the entity level and includes laws and bylaws that regulate this area. Therefore, in the following, we will analyse in detail the legal and institutional framework of the PIFC within both entities of B&H, Federation of Bosnia and Herzegovina (hereinafter FB&H) and the Republic of Srpska (hereinafter RS).

PIFC in Federation of Bosnia and Herzegovina

CHU FB&H was established in 2010 and is authorized to develop in the field of IA and FMC, oversee the implementation of all applicable regulations in these areas and coordinate the establishment and development of a comprehensive PIFC system in the public sector in the FB&H.

The establishment of internal audit units is prescribed by Art. 8, 9 and 10 of the Law on Internal Audit and Article 5 of the Rulebook on Criteria for Establishment of Internal Audit Units in the Public Sector of the FB&H (Official Gazette of the FB&H No. 82/13 and 74/14), with the intention of ensuring its organizational and functional independence.

CHU FB&H, among other things, checks the quality of IA activities regularly through annual internal audit reports in order to gather information to improve the methodology and standards of work and in this regard, prepares annual consolidated internal audit reports in the public sector in the FB&H.

The Annual Consolidated Report on Internal Audit in the Public Sector in the FB&H for 2018 is the eighth report on IA activities in the public sector in the FB&H prepared and submitted by the Federal Ministry of Finance to the Government of the FB&H. It was prepared based on 67 submitted annual reports on performed internal audits

and activities of internal auditors who were appointed in public sector organizations in the FB&H. Despite the fact that the manner of establishing IA in the FB&H is clearly regulated by applicable laws and regulations governing this area, out of 73 subjects obliged to introduce IA by the Rulebook on Criteria only 48 systematized the IA unit. However, of that number, in 30 units are staffed by one or no auditors, which is also not in line with international standards for professional internal audit practice.

The development of the regulatory framework for FMC in the FB&H formally began in 2016 with the adoption of the Law on financial management and control. In 2016, the Standards of Internal Control in the Public Sector in the FB&H were also published, which filled the gap created by the expiration of the Guidelines for the Establishment and Strengthening of Internal Control among Budget Users (Official Gazette of the FB&H No. 19/05). At the beginning of 2017, the Rulebook on the implementation of FMC was adopted, which introduced the obligation to appoint a coordinator for FMC and further development the provisions and forms related to reporting on the FMC system in public sector organizations.

The holder of the establishment and development of the FMC system in the public sector in the FB&H is the Federal Ministry of Finance and within it the CHU, which has been preparing a consolidated annual report on the FMC system in the FB&H for 2 years. For 2018, the consolidated report was prepared on the basis of 81 individual annual reports on the functioning of the FMC system by public institutions directly to the CHU and 7 consolidated reports for cantons submitted by cantonal ministries of finance, which consolidated a total of 408 annual reports of their users. Consequently, the FMC consolidated report for 2018 includes a total of 489 reports from public sector organizations in the FB&H, significantly more than in the previous, first reporting year, when a total of 287 annual reports were submitted.

The submitted data indicated that certain segments of COSO are well developed among public organizations, while the level of development of other segments is at a very low level. In order for financial management and control as a system to achieve results in the organization, a synergy of all five COSO elements in the organization must be achieved (control environment, risk management, control activities, information and communication and monitoring and evaluation).

The development of FMC is aimed at linking the planning and execution of the budget/ financial plan in accordance with the defined goals of the organization; risk management in order to achieve the set goals; as well as measuring results through the establishment of performance indicators and performance measurement.

In addition, there is still a need to improve the risk management process in the organization in accordance with the Risk Management Guidelines, because good risk management in the organization and development of adequate responses to identified and assessed risks directly improves strategic and annual plans and established internal controls in the organization. This causal link comes to the fore in the next phase, because the establishment of good internal controls will prevent the activation of potential risks and help achieve the set business goals while avoiding omissions and irregularities in the management of public funds.

There is also a need to improve human resource management through the employment of professional and competent persons, investing in their continuous training in accordance with the needs of the workplace, upgrading the system of motivation and rewarding employees.

PIFC in the Republic of Srpska

The Law on the System of Internal Financial Controls in the Public Sector of the RS (Official Gazette of the RS No. 91/16) is the primary regulation governing the area of

FMC and IA in the RS, as elements of the PIFC system in the public sector of the RS. According to the PIFC concept and good practices of the countries that joined the EU in the period from 2000 onwards, the CHU is the basic structure within the Ministry of Finance, which has the obligation and authority to harmonize and coordinate drafting regulations for FMC and IA, monitors the application of regulations and reports on the level of development of FMC and IA in the public sector of RS. Institutional establishment of the CHU started in 2009 by appointing the head of the CHU.

At the current level of development and resources allocated to the CHU, it monitors the establishment and development of FMC and IA in the public sector RS based on information contained in annual reports on the implementation of planned activities on establishment and development of FMC and IA. The last of a total of 5 consolidated annual reports refers to 2019 (CHU, 2019) and was made on the basis of annual reports submitted by public sector entities.

When it comes to IA, a total of 63 entities of the public sector of RS established the function of internal audit in their organizations in one of two ways: by organizing an internal audit unit within the entity (54 entities); or by systematizing the position of one internal auditor (9 entities). Therefore, it is necessary to strengthen the capacity of internal audit units in entities that meet the legal requirements and to more clearly define the powers of internal audit units when it comes to departmental competence.

At the same time, there are 1000 public sector entities in the RS obliged to establish a system of FMC. So far, a person responsible for FMC has been appointed in 299 entities, while 284 entities have submitted self-assessment questionnaires for 2019. There is a significant increase in the number of submitted reports in 2019 compared to 2018 (101%), as well as an increase in the number of appointed persons by 22%. However, a large number of entities still have not started the process of introducing FMC, despite the obligation arising from the Law.

When assessing the COSO elements, certain areas stood out as weaker. Special attention should be paid to the assigning responsibilities to managers at all levels, for the establishment, development and implementation of FMC systems, as well as delegating tasks and work tasks in the field of FMC to all employees. It is necessary to develop an awareness of the importance of risk identification and risk management, i.e. to incorporate risk management into the planning and decision-making process; to establish risk registers. Despite the fact that a number of public sectors entities have completed these activities, it is necessary to make a map and description of business processes.

The intention is to improve FMC in the future, especially in key processes for quality management of public funds (strategic planning, preparation and execution of the budget/ financial plan, contracting and procurement, internal and external reporting). Difficulties in this process are reflected primarily in the lack of staff capacity and lack of experience for the development of the FMC system, and then the lack of understanding and support for the development of the FMC system and its importance for the organization.

Discussion and Conclusion

There is no internal control system that can absolutely guarantee the elimination of the risk of irregularities and unconscious errors. The aim is to ensure a satisfactory level of certainty that irregularities will not occur, and if they occur, an appropriate level of government will be notified.

Any internal control system can be compromised if a number of dishonest persons in key positions work in collusion to undermine it and if they are able to forge relevant documents. A sufficiently complex set of control activities may make it difficult to connect these individuals, but on the other hand, may have a negative impact on the effectiveness of the organization.

The development of a good PIFC system requires communication and cooperation between all interested parties. Since the development of the PIFC cannot be completed because it is an ongoing process in which the organization is constantly developing and improving, it is necessary to continuously obtain information on the state of the internal control system from the users in order to provide insight into the current state and plan activities for further development and improvement. It should always be borne in mind that the improvement of the processes of public sector organizations ultimately improves the services they provide to the citizens.

The basic features of a quality PIFC system have to include the following:

1. Value for money management, which means that when providing services to citizens and conducting other activities in the organization, quality standards must be met, that is, providing quality service with the least possible use of financial resources, while respecting the deadlines.
2. Managerial responsibility at all levels of governance, which implies the establishment of an adequate organizational structure within which lines of authority and responsibilities are clearly defined at all levels of management that must be firmly established, transparent and consistently applied.
3. Systematic approach and understanding of controls, which means that PIFC is realized through five components (control environment, risk management, control activities, information and communication, monitoring and evaluation of the system).

In this regard, further development of PIFC in B&H requires (i) improvement of the current regulatory and methodological framework; and (ii) quality and continuous education of management, internal auditors and appointed coordinators for FMC.

One of the limitations of the research is primarily focused on budget organizations, which represent the biggest, but not the only component of the public sector. Public companies have been omitted from the analysis despite the fact that the application of the Law on Internal Audit is not limited exclusively to public institutions, but its provisions as a "lex specialis" may also apply to public companies. Therefore, conducted research can serve as a basis for similar researches aimed at finding at what level of development are IA and FMC in public companies in B&H. It would be also interesting to carry out similar researches in the neighbouring countries.

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