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

Benina Veledar

School of Economics and Business in Sarajevo, University of Sarajevo, B&H

Maja Letica

Faculty of Economics, University of Mostar, B&H

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Introduction

- 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.

PIFC concept (1)

- 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 (hereafter **PIFC**) based on international standards and best practices of EU countries.
- The aim of this paper is to examine:
 - the extent to which the PIFC concept has been implemented in the public sector of Bosnia and Herzegovina (hereafter B&H),
 - what challenges public institutions in B&H currently face in this context, and
 - what are the recommendations for overcoming identified challenges.

PIFC concept (2)

- PIFC is a complete system of financial and other controls established by public entity with the aim of successfully managing and accomplishing its tasks (Obhodžaš and Rička, 2012).
- 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).

PIFC concept (3)

- In context of internal control it is important to mention the COSO model.
- The Committee of Sponsoring Organizations of the Treadway Commission (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:
 - Control environment,
 - Risk assessment,
 - Control activities,
 - Information and communication, and
 - Monitoring activities.

PIFC in Bosnia and Herzegovina (1)

- 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 present time it has not fully come to life.
- 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.
- The most of the established internal audit units did not consistently apply the relevant standards and methodology for the work of internal audit.

PIFC in Bosnia and Herzegovina (2)

- Still, significant progress has been made and the function and role of internal audit has become clearer recognized in the institutions of B&H.
- According to the Annual consolidated internal audit report for 2018, prepared by the CHU B&H, 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.
- 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 Republic of Srpska (hereinafter RS).

PIFC in FB&H (1)

- 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.
- CHU FB&H 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.

PIFC in FB&H (2)

- 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 on the basis of 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.

PIFC in FB&H (3)

- 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.
- At the beginning of 2017, the Rulebook on the implementation of FMC was adopted.
- 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.

PIFC in FB&H (4)

- 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.

PIFC in FB&H (5)

- 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.
- There is still a need to improve the risk management process in the organization in accordance with the Risk Management Guidelines.
- There is also a need to improve human resource management through the employment of professional and competent persons.

PIFC in RS (1)

- The Law on the System of Internal Financial Controls in the Public Sector of the RS 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.
- 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 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 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).

PIFC in RS (2)

- There are 1000 public sector entities in the RS obliged to establish a system of FMC.
- 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.

PIFC in RS (3)

- 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.
- The intention is to improve FMC in the future, especially in key processes for quality management of public funds.
- Difficulties in this process are reflected primarily in the lack of staff capacity and lack of experience for the development of the FMC system.

Discussion and Conclusion (1)

- The aim of internal control system 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.

Discussion and Conclusion (2)

- The basic features of a quality PIFC system has to include the following:
 - Value for money management,
 - Managerial responsibility at all levels of governance,
 - Systematic approach and understanding of controls.
- 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.

Discussion and Conclusion (3)

- One of the limitations of the research is primary focus on the 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 neighbouring countries.

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