

# Internal Financial Control

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## 1. INTERNAL FINANCIAL CONTROL AND INTEGRITY CHALLENGES IN THE WESTERN BALKANS

Integrity implies individual honesty, consistent adherence to moral values, institutional rectitude, compliant and consistent operations, as well as good governance, ethics and professionalism.<sup>1</sup> The notion of integrity can be associated with an individual, but can also be seen as institutional integrity. At the individual level, it implies personal ethics, honesty, persistence, consistency and observance of law.<sup>2</sup> Institutional integrity is closely linked to the integrity of the employees. Strengthening integrity in the public sector contributes to reducing the risk that public offices will be exercised contrary to the purpose for which public institutions have been established, which improves the public institutions' operations and increases the public trust in them.<sup>3</sup> Public internal financial control strengthens the public sector ethics and accountability.

Public internal financial control comprises: financial management and control, internal audit and harmonisation, and coordination of financial management and control and the internal audit performed by the competent organisational unit of the national ministries in charge of public finance. Financial management and control is a comprehensive internal controls system carried out through the policies, procedures and activities set up by an institution's management, designed to provide reasonable assurance that the institution's decisions and operations comply with the appropriate legal regulations, internal acts, procedures and contracts, ensuring complete, realistic and reliable financial and business records, a sound financial

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1 Anti-Corruption Agency, *Manual for Development of Integrity Plans*, Anti-Corruption Agency of the Republic of Serbia, Belgrade 2012, p. 4. Text available at: [http://www.acas.rs/wp-content/uploads/2010/07/Prirucnik\\_konacna\\_verzija.pdf](http://www.acas.rs/wp-content/uploads/2010/07/Prirucnik_konacna_verzija.pdf), 15.1.2017.

2 Bureau for Social Research, *Analysis of the Development of Integrity Plans in the Courts in Serbia*, Bureau for Social Research (BIRODI), <http://www.sudije.rs/files/file/JASBIRODI%20Analiza%20planova%20integriteta.pdf>, 15.1.2017.

3 *Ibid.*, p. 3.

management, as well as assets and data (information) safeguarding.<sup>4</sup> Internal audit is an independent and objective consultancy activity in order to increase the value of assets and improve the organisation's operations.<sup>5</sup> Its work includes assessing the risks that threaten the organisation's operations and minimising their adverse impacts on the implementation of the organisation's objectives, as well as improving the control systems that are in place. The control systems need to contribute that the organisation's operations comply with rules and regulations, and that they are conducted in an economic and efficient manner, to safeguard assets and minimise the possibility that they are misused, destroyed or damaged.<sup>6</sup>

Internal financial controls implemented in public sector institutions contributes not only to the strengthening of institutional and employees' personal integrity, but also the citizens' trust in these institutions. In addition, putting in place financial controls increases both the transparency of and accountability for the use of public funds by public institutions. That is why over the past decade the Western Balkan countries have invested considerable funds in public internal financial controls and public integrity building, which is also an EU accession conditionality.

Public sector employees should have a high degree of accountability for the use of public assets. This accountability is often identified with financial accountability, which requires a network of internal and external control mechanisms, including adequate accounting, financial reporting and internal and external audit.<sup>7</sup> Public internal financial control strengthens accountability and professionalism of both the management and other employees. As a result, citizen trust in public institutions will also increase.

Unlawful and unauthorised use of public funds is a weakness that is common to all the Western Balkan countries' integrity systems. Poor financial management is frequent and difficult to suppress. Public money is often perceived as funds whose use is not restricted, nor regulated by law, and which can therefore be managed at will. There is still a lack of

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4 Definition of financial management and control is included in Guidelines for Internal Control Standards for the Public Sector, INTOSAI GOV 9100, Intosai Professional Standards Committee. p. 6. The text can be found at: [http://www.issai.org/en\\_us/site-issai/issai-framework/intosai-gov.htm](http://www.issai.org/en_us/site-issai/issai-framework/intosai-gov.htm), 15.1.2017.

5 Definition of internal audit is included in International Standards for the Professional Practice of Internal Auditing (revised in 2016, applied as of January 2017). Standards are available at: <https://na.theiia.org/translations/PublicDocuments/IPPF-Standards-2017-Serbian.pdf>, 15.1.2017.

6 J. Suput, "Harmonisation of Internal Audit Regulations with International Standards", in: *Good Administration and Internal Audit* (ed. D. Suput), Belgrade 2012. p. 96.

7 A. Rabrenovic, *Financial accountability as a condition for EU membership*, Institute of Comparative Law, Belgrade 2009, p. 55.

awareness that public money comes from the taxpayers and that the all elected governments are accountable to the citizens for its use.

Misuse of public funds has a particularly adverse impact on the citizen trust in the public institutions. This is a particularly sensitive issue when it comes to public finance. Specifically, the objective of public institutions is not to gain profit, but to provide public goods. That is central for the functioning of any state. Public spending should not only serve the needs of the citizens, but also the state. Since the production of public goods incurs certain costs (public expenditures), it is necessary to provide funds (public income) to finance those costs.<sup>8</sup> A majority of public incomes are based on levies (taxes, fees, and contributions) paid for by the citizens. If the state funds are not used rationally, the citizens will largely resist paying them. Overspending of public funds and insufficient public income can create budgetary deficits, which will negatively affect the functioning of the state and its ability to fulfil its objectives in the longer term.

Despite the considerable efforts put into establish internal financial control systems in Western Balkan countries in recent years, the systems are still not fully for several reasons. One of the reasons is their civil law system and little tradition of risk assessment, internal control and audit instruments, which come primarily from the private sector and common law systems.<sup>9</sup> Furthermore, other problems that affect the relatively weak integrity systems in the Western Balkan countries is inefficient implementation of laws, limitations in terms of human resources, space and other capacities for their implementation. It seems also that professional ethics is insufficiently developed and needs to be strengthened.

To improve public expenditure control mechanisms, it is necessary to continue the current efforts to establish effective internal financial control systems and reinforce public sector employees' and managers' personal responsibility and accountability for the use of public funds. The above controls serve as a mechanism that reduces and prevents mistakes and irregularities at the institutional level. That enables the distribution of managerial accountability with institutions. Adequate internal financial controls enable a uniform distribution of accountability, that is, delegation of powers to the so-called middle management, which is also an opportunity to depoliticise decision-making at the institutional level.

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8 S. R. Stojanovic, *Fiscal Federalism*, Institute of Comparative Law, Center for Anti-war Action, Belgrade 2005, p. 25.

9 A. Rabrenovic *et al.*, "Historical Development of Mechanisms for Preventing Corruption in the South-East Europe" in: *Legal Mechanisms for Preventing Corruption in the South-East Europe with a Special Focus on the Defence Sector*, (ed. A. Rabrenovic), Institute of Comparative Law, Belgrade 2013, p. 23.

## 2. WHAT ARE THE INTERNAL FINANCIAL CONTROL STANDARDS FOR THE PUBLIC SECTOR?

International standards for internal financial controls are based on the common European and internationally accepted principles and best practices for public sector financial management and control. The area of internal financial controls is considered “soft acquis”, as it is not part of the common EU legal framework, bearing in mind that the EU legislation does not contain any legal provisions in that field and that they are within the exclusive competence of the Member States.<sup>10</sup>

The standards for internal financial controls are contained more directly in the standards adopted by international organisations: International Standards for Internal Auditing are contained in the Standards of the Institute of Internal Auditors (IIA),<sup>11</sup> and the International Organisations of Supreme Audit Institutions (INTOSAI).<sup>12</sup> The European Commission has confirmed that their application is considered best practice, stating that the most important standards in the field of public internal financial controls are contained in the INTOSAI Guidelines for Internal Controls Standards for the Public Sector, and in the IIA documents.<sup>13</sup>

Internal financial controls must comply with the INTOSAI, IIA standards, and the EU best practice, and that is why all the countries in the region have regulated internal audit in accordance with the above standards and refer to their application in the national legislation. In accordance with that, in all countries that are members of the Institute of Internal Auditors, certified internal auditors are obliged to abide by the Standards for Professional Practice of Internal Auditing, established by the Institute of Internal Auditors (IIA).<sup>14</sup>

10 I. Rakic, “Internal and External Audit”, in: *Legal Mechanisms for Preventing Corruption in the South-East Europe with a Special Focus on the Defence Sector*, (ed. A. Rabrenovic), Belgrade 2013. p. 143.

11 International Standards for the Professional Practice of Internal Auditing. The revised standards have been applied since 1 January 2017. Available at: <https://na.theiia.org/standards-guidance/mandatory-guidance/Pages/Standards.aspx>, 4.6.2017.

12 Guidelines for Internal Controls Standards for the Public Sector-INTOSAI GOV 9100, Guidance for Reporting on the Effectiveness of Internal Controls: SAI Experiences in Implementing and Evaluating Internal Control- INTOSAI GOV 9110, Internal Control: Providing a Foundation for Accountability in Government-INTOSAI GOV 9120, Guidelines for Internal Control Standards for the Public Sector – Further Information on Entity Risk Management-INTOSAI GOV 9130. Available at: <http://www.intosai.org/issai-executive-summaries/intosai-guidance-for-good-governance-intosai-gov.html>, 4. 6. 2017.

13 ECCIA Position Paper on Internal Auditing in Europe, European Confederation of Institutes of Internal Auditing, Brussels 2005. As cited in I. Rakic, “Internal and External Audit”, p. 144.

14 *Ibid*, 146.

With respect to the standards for internal financial controls for the public sector, one must mention: Guidelines for Internal Control Standards for the Public Sector,<sup>15</sup> International Professional Practices Framework,<sup>16</sup> and the INTOSAI standards.<sup>17</sup>

**Guidelines for Internal Control Standards for the Public Sector** specify the standards for financial management and control in the public sector (FMC),<sup>18</sup> adopted by the International Organizations of Supreme Audit Institutions. They include the Internal Control Integrated Framework, defined by Committee of Sponsoring Organization on the Treadway Commission (COSO).<sup>19</sup> However, they do not specify the internal audit function, and they refer to the above financial management and control component instead.

Another framework relevant for the professional practice of internal audit is the International Professional Practices Framework, a conceptual framework established by the International Institute of Internal Auditors integrating:

- 1) Mandatory Guidelines,<sup>20</sup> which are essential for the professional practice of internal auditing, and
- 2) Strongly Recommended Guidelines<sup>21</sup> describing the practice for the effective application of Mandatory Guidelines.

**Mandatory Guidance include:**

- Definition of Internal Auditing;
- Code of Ethics, and
- International Standards for the Professional Practice of Internal Auditing, including Attribute Standards and Performance Standards.

**Strongly Recommended Guidance include:**

- Implementation Guidance
- General Assumptions, and
- Practice Guides.

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15 Guidelines for Internal Control Standards for the Public Sector (INTOSAI GO 9100).

16 International Professional Practices Framework.

17 In addition to the above, Internal Audit Independence in the Public Sector standards (INTOSAI 9140) and Coordination and Cooperation of Supreme Audit Institutions and Internal Auditors in Public Sector (INTOSAI 9150) standards are also relevant to the overall internal financial control system in the public sector.

18 Financial Management and Control.

19 The Committee of Sponsoring Organization on the Treadway Commission.

20 Mandatory Guidance.

21 Strongly Recommended Guidance.

In addition, **INTOSAI GOV 9140**<sup>22</sup> and **INTOSAI 9150**<sup>23</sup> standards are also relevant to the internal auditing practice in the public sector. The former refers also to the use of other sources that regulate internal audit independence: The Institute for Internal Auditors standards, ISSAI 1610 – Using the Work of Internal Auditors, adopted by the International Organization of Supreme Audit Institutions, and International Standards on Auditing 610 adopted by the International Auditing and Assurance Standards Board.<sup>24</sup>

**INTOSAI 9150** defines the coordination and cooperation of Supreme Audit Institutions and internal auditors in the public sector.

In accordance with the Guidelines for Internal Financial Control Standards for the Public Sector, internal audit is part of the public internal financial control system.<sup>25</sup> This system consists of three components:

- 1) financial management and control;
- 2) internal audit, and
- 3) their harmonisation and coordination.

The financial management and control standards imply an internal controls system that is implemented through the policies, procedures and activities introduced by and under the responsibility of a public funds user's management, and designed to manage risks and to provide a reasonable assurance that the organisation's mission will be achieved in an lawful, proper, economical, efficient and effective manner. These standards are based on the following internal control components:<sup>26</sup>

- 1) control environment;
- 2) risk assessment;
- 3) safeguarding activities;
- 4) information and communication, and
- 5) monitoring.

The Central Harmonisation Unit is the central organisation at the country level, responsible for the preparation and promotion of the financial

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22 Internal Audit Independence in the Public Sector, INTOSAI GOV 9140. Available at: <http://www.intosai.org/issai-executive-summaries/view/article/intosai-gov-9140-internal-audit-independence-in-the-public-sector.html>, 4.6.2017.

23 Coordination and Cooperation between SAIs and Internal Auditors in the Public Sector – INTOSAI GOV 9150. Available at: <http://www.intosai.org/issai-executive-summaries/view/article/intosai-gov-9150-coordination-and-cooperation-between-sais-and-internal-auditors-in-the-public-s.html>, 4.6.2017.

24 I. Rakic, "Internal and External Audit", p. 147.

25 Public Internal Financial Control.

26 This definition is contained in the Guidelines for Internal Control Standards for the Public Sector.



management and control and internal audit methodology in accordance with the internationally accepted standards and best practices.<sup>27</sup> It is usually organised as a unit within a ministry of finance.

The main principle underlying the overall public internal financial control system is the managerial accountability principle. According to this principle, the manager of a budget user organisation is accountable for the management and control of the operations of the organisation he/she manages. In addition, the manager is accountable for identifying and achieving the organisation's specified objectives, whose fulfilment would be ensured to a great extent by the internal financial control system.<sup>28</sup> This principle is reflected also in the national legislation relating to the public internal financial control system.

### 3. WHAT IS THE LEGAL FRAMEWORK FOR INTERNAL FINANCIAL CONTROL IN THE WESTERN BALKANS COUNTRIES?

In most Western Balkan countries, the public internal financial control system is established by primary legislation. Some countries regulate it under a single law, while others regulate it under two separate laws (one law regulating financial management and control, and a separate law regulating internal audit). In addition, the internal financial control system is subject also to secondary legislation adopted at the national level to facilitate the implementation of the general legal acts in this area. Unlike other Western Balkan countries, the Republic of Serbia regulates internal financial control under two separate regulations (bylaws) adopted by the Ministry of Finance.

#### 3.1. ALBANIA

Albania regulates the internal controls system under two separate regulations. Financial management and control is regulated by the Law on Financial Management and Control in Albania,<sup>29</sup> while internal audit is regulated by the Law on Internal Audit in the Public Sector.<sup>30</sup> The basis for the adoption

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27 I. Rakic, "Internal and External Audit", p. 150.

28 V. R. de Koning, Public Internal Financial Control, 2007, <http://www.pifc.eu/translation/Pifc-Bosnian.pdf>, p. 51. As cited in I. Rakic, "Internal and External Audit", p. 150.

29 Law on Financial Management and Control in Albania, Law Nos. 296/2010 and 110/2015.

30 Law on Internal Auditing in the Public Sector, No. 114/2015.

of these regulations is the Law on the Management of Budgetary System in Albania.<sup>31</sup> In addition to the above acts, internal auditing practice and financial management and control are regulated also by the guidelines for their implementation in practice, adopted by the Ministry of Finance in line with the international standards, such as the Financial Management and Control Manual.<sup>32</sup>

**The Law on the Management of Budgetary System in Albania**, in Chapter 6, specifies the overall budget system supervision, auditing and inspection system. The provisions of this Chapter stipulate that the Minister of Finance is responsible to establish the public internal financial control system. In accordance with the Law on the Management of Budgetary System, the above system comprises financial management and control, independent and decentralised internal audit function, and the Central Harmonisation Unit within the Ministry of Finance. The latter is in charge of harmonisation, coordination, implementation and operations of the financial management and control and internal audit system. In accordance with the above provision, all public institutions are obliged to establish an adequate financial management, control and internal audit system.<sup>33</sup> In addition, separate provisions of the Law on the Management of Budgetary System specify the financial management and control system and the internal audit system.<sup>34</sup> However, these internal financial control components are regulated more specifically under separate laws.

**The Law on Financial Management and Control** specifies the financial management and control rules of the public sector in Albania, including procedures, administrative network, and implementation rules, as well as managerial accountability for budget planning, execution, control, accountability and reporting. In accordance with that, the above system needs to ensure the efficient, effective and economical use of public funds and compliance with the principles of transparency and legality to avoid losses or misuse of public funds.<sup>35</sup>

**The Law on Internal Auditing** specifies the public sector internal audit scope, activities, mission, principles, organisation, competencies and accountability.<sup>36</sup>

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31 Law on the Management of Budgetary System, No. 9936/2008.

32 The Manual is available at: [http://arkiva.financa.gov.al/minfin/pub/financial\\_management\\_and\\_control\\_manual\\_1643\\_1.pdf](http://arkiva.financa.gov.al/minfin/pub/financial_management_and_control_manual_1643_1.pdf), 4.6. 2017.

33 Article 66 of the Law on Management of the Budgetary System in Albania.

34 Article 67 specifies the financial management and control system, while Article 68 specifies the internal auditing system in the public sector.

35 Articles 1 and 2 of the Law on Financial Management and Control.

36 Article 1 of the Law on Internal Auditing in Albania.



## 3.2. BOSNIA AND HERZEGOVINA

At the state level of Bosnia and Herzegovina, the financial management and control system is not regulated by one, but by several legal acts. Public sector internal audit is regulated by the **Law on Internal Audit in the Bosnia and Herzegovina Governmental Institutions**.<sup>37</sup> In addition, internal audit is regulated by other regulations that are essential for its functioning. Decision on Adoption of the Professional Code of Ethics for Internal Auditors, the Internal Audit Charter, and the Internal Audit Manual including the Standards for Internal Auditing in the Bosnia and Herzegovina Governmental Institutions, adopted by the Ministry of Finance and Treasury of Bosnia and Herzegovina, is of particular importance.<sup>38</sup>

However, unlike the internal audit system, financial management and control system is not regulated under a separate regulation. The basis for its establishment is the **Law on Financing Bosnia and Herzegovina Governmental Institutions**.<sup>39</sup> In addition to the Bosnia and Herzegovina budget preparation, adoption, execution, accounting, reporting and supervision, the integrated treasury account for the Bosnia and Herzegovina governmental institutions, and public investments, this law regulates the principles underlying the system and the financial management and control harmonisation in the Bosnia and Herzegovina public institutions. Chapter IV of the Law on Financing Bosnia and Herzegovina Governmental Institutions stipulates: the purpose, objectives and scope of the financial management and control component, the establishment of the above system in the Bosnia and Herzegovina governmental institutions, responsibility for the establishment of financial management and control, devolution of powers, the role of the Central Harmonisation Unit, and the procedures of taking action in case of irregularities or fraud.<sup>40</sup>

The financial management and implementation rules are specified more specifically in the Manual on Financial Management and Control in the

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37 Law on Internal Audit in the Bosnia and Herzegovina Governmental Institutions, *Official Gazette of BiH*, Nos. 27/2008 and 32/2013.

38 Decision of the Ministry of Finance and Treasury of Bosnia and Herzegovina on Adoption of the Professional Code of Ethics for Internal Auditors, the Internal Audit Charter, and the Internal Audit Manual including the Standards for Internal Auditing in the Bosnia and Herzegovina Governmental Institutions number 01-1-02-1-203-1/11 dated 3 March 2011. The above documents are available at: [http://mft.gov.ba/bos/index.php?option=com\\_content&view=article&id=682&Itemid=186](http://mft.gov.ba/bos/index.php?option=com_content&view=article&id=682&Itemid=186), 4.6. 2017.

39 Law on Financing Bosnia and Herzegovina Governmental Institutions, *Official Gazette of BiH*, Nos. 61/2004, 49/2009, 42/2012, 87/2012 i 32/2013.

40 The above issues are regulated by Articles 33a to 33i of the Law on Financing Governmental Institutions of Bosnia and Herzegovina.

Bosnia and Herzegovina Governmental Institutions,<sup>41</sup> and by the Guidelines for the Implementation of the Risk Management Process in the Bosnia and Herzegovina Governmental Institutions.<sup>42</sup>

### 3.2.1. Bosnia and Herzegovina Entity-Level Internal Financial Control Regulations

In addition to state level, the public internal financial control system is regulated by separate regulations of two Bosnia and Herzegovina entities: the Federation of Bosnia and Herzegovina, and the Republic of Srpska.

#### 3.2.1.1. Bosnia and Herzegovina Federation Level Regulations

The internal financial control system at the level of the Federation of Bosnia and Herzegovina is regulated by two legal acts: the Law on Financial Management and Control in the Public Sector in the Federation of Bosnia and Herzegovina,<sup>43</sup> and the Law on Public Sector Auditing in the Federation of Bosnia and Herzegovina.<sup>44</sup>

**The Law on Financial Management and Control in the Public Sector in the Federation of Bosnia and Herzegovina** governs financial management and control and specifies the common framework principles and standards relating to the establishment, development and implementation of the above system. This regulation defines the responsibility for the establishment, development and implementation of the financial management and control system, as well as the competencies of the Central Harmonisation Unit within the Federal Ministry of Finance – and other public organisations – in terms of the implementation of the financial management and control system at the Federation level. Other Ministry of Finance acts relevant to the implementation of financial management and control include: Manual on Implementation of Financial Management and Control in the Public Sector in the Federation of Bosnia and Herzegovina,<sup>45</sup> and the Standards of Internal Control in the Public Sector in the Federation of Bosnia and Herzegovina.<sup>46</sup>

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41 Decision on the Publishing of Manual on Financial Management and Control, number 03-1-02-1-4-306-1/14 dated 11 December 2014. The Manual is available at: [http://mft.gov.ba/bos/images/stories/chj/pravilnici/PRIRUCNIK-Konacna\\_verzija\\_bos\\_23\\_12\\_2014.pdf](http://mft.gov.ba/bos/images/stories/chj/pravilnici/PRIRUCNIK-Konacna_verzija_bos_23_12_2014.pdf), 4.6. 2017.

42 Decision on the Publishing of Guidelines for the Implementation of the Risk Management Process in the Bosnia and Herzegovina Governmental Institutions, *Official Gazette of BiH*, No. 29/2015.

43 Law on Financial Management and Control in the Public Sector in the FBiH, *Official Gazette of the FBiH*, No. 38/2016.

44 Law on Public Sector Auditing in the FBiH, *Official Gazette of the FBiH*, No. 47/2008.

45 Manual on Implementation of Financial Management and Control in the Public Sector in the Federation of Bosnia and Herzegovina, *Official Gazette of FBiH*, No. 6/2017.

46 Standards of Internal Control in the Public Sector in the FBiH, *Official Gazette of the FBiH*, No. 75/2016.

**The Law on Public Sector Auditing in the Federation of Bosnia and Herzegovina** governs: the competencies, principles, establishment, procedures and activities, reporting and other issues relevant to the internal audit practice in the public sector. In addition to the above, another act relevant to internal audit practice is the Manual on the Criteria for Establishment of Internal Audit Units in the Public Sector in the Federation of Bosnia and Herzegovina.<sup>47</sup>

### 3.2.1.2. Republic of Srpska

The Republic of Srpska regulates internal financial controls in a different way. In this Bosnia and Herzegovina entity, this issue is regulated by a single legal act. **The Law on the Internal Financial Control System in the Public Sector**<sup>48</sup> provides the legal basis for: financial management and control, internal auditing, methodology, standards, and other issues relevant to the establishment, development and implementation of the public internal financial control system. In accordance with the Law, the above system includes: financial management and control, internal audit, and the Central Harmonisation Unit for Financial Management and Control and Internal Audit, established within Ministry of Finance.

## 3.3. KOSOVO\*

The Kosovar internal controls system is regulated by two separate legal acts: **The Law on Internal Audit**<sup>49</sup> and **the Law on Public Financial Management and Accountability**.<sup>50</sup> The Law on Internal Audit stipulates the purpose for its adoption, and therefore the purpose for the internal audit. Accordingly, internal audit is established to improve budget efficiency and financial discipline, and to increase legality in the public expenditures recording, management and control.

In addition, implementation bylaws, such as the **2010 Manual on Public Sector Internal Financial Controls**,<sup>51</sup> have been adopted to facilitate the application of the general regulations in this field. This secondary legislation is also important for the internal controls operations. The Manual regulates the COSO framework and the accountability principle in exercising public powers. Another important bylaw is the Manual on Public Spending, which

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47 Manual on the Criteria for Establishment of Internal Audit Units in the Public Sector in the FBiH, *Official Gazette of the FBiH*, Nos. 82/2013 and 74/2014.

48 Law on the Internal Financial Controls System in the Public Sector, *Official Gazette of RS*, No. 91/2016.

49 Law on Internal Audit No. 02/L.74.

50 Law on Public Financial Management and Accountability No. 03/L-048.

51 Treasury Financial Rule No.01 on Public Internal Financial Control.

regulates the use of public funds and internal controls, and the decentralised public funds management system for all budget institutions.<sup>52</sup>

### 3.4. MACEDONIA

In the Republic of Macedonia, the internal financial control system is regulated by the **Law on Public Internal Financial Controls**.<sup>53</sup> The Law regulates the public internal financial control system that includes financial management and control, internal auditing, and their harmonisation, and which is established in accordance with the international standards for internal controls and internal auditing. It regulates also the terms and conditions for the implementation of the examination procedure for certified internal auditors in the public sector. In addition to the above Law, the Ministry of Finance bylaws relevant to the internal financial control system include: the Manual on the Procedures for Granting Authorisations,<sup>54</sup> the Manual on Internal Audit Procedures and Practises and Internal Audit Reporting Procedures,<sup>55</sup> the Manual on Internal Audit Charter,<sup>56</sup> and the Code of Ethics for Internal Auditors.<sup>57</sup> In addition to the secondary legislation, the Internal Controls Standards for the Public Sector<sup>58</sup>, and the International Standards for the Professional Practice of Internal Auditing<sup>59</sup> are also relevant to the internal financial control system operations.

### 3.5. MONTENEGRO

Montenegro regulates the internal financial control system under the **Law on Internal Financial Control System in the Public Sector**.<sup>60</sup> In order to improve the internal auditing practice, the Ministry of Finance of Montenegro

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52 Financial Rule No. 01/2013/MF on Public Funds Expenditure covering expenditure and internal control and the decentralisation of expenditure management to budget organisations.

53 Law on Public Internal Financial Controls, *Official Gazette of the Republic of Macedonia*, Nos. 90/2009, 188/2013 and 192/2015.

54 Manual on the Procedures for Granting Authorisations, *Official Gazette of the Republic of Macedonia*, No. 147/2010 and 34/2011.

55 Manual on Internal Audit Procedures and Practises and Internal Audit Reporting Procedures, *Official Gazette of the Republic of Macedonia*, No. 136/2010.

56 Manual on Internal Audit Charter, *Official Gazette of the Republic of Macedonia*, No. 136/2010.

57 Code of Ethics for Internal Auditors, *Official Gazette of the Republic of Macedonia*, No. 136/2010.

58 Internal Controls Standards for the Public Sector, *Official Gazette of the Republic of Macedonia*, No. 147/2010.

59 International Standards for the Professional Practice of Internal Auditing, *Official Gazette*, No. 113/2014.

60 Law on the Internal Financial Controls System in the Public Sector, *Official Gazette of Montenegro*, Nos. 73/2008, 20/2011 and 30/2012.

has enacted several bylaws, of which two are of special importance: the Manual on Internal Audit Procedure and Practices,<sup>61</sup> the Manual on Financial Management and Controls Establishment and Implementation Procedures and Practises.<sup>62</sup> In addition to the above law and bylaws, the guidelines and instructions issued by the Central Harmonisation Unit within the Ministry of Finance also have a special importance for the public internal financial control operations.

**The Law on Internal Financial Control System in the Public Sector** specifies the public internal financial control system in Montenegro, which, in line with the international standards, includes provisions on financial management and control and internal auditing. The Law specifies: the methodology, standards, and other issues relevant to the establishment, development and implementation of the public internal financial control system. In accordance with the Law on Internal Financial Control System, and the Manual on Financial Management and Controls System Establishment and Implementation Procedures and Practises, in 2016, the Ministry of Finance issued the Instructions for the Preparation of Financial Management and Control Improvement Plan.<sup>63</sup> The reason for its adoption is reflected in the need to adopt a common approach in the public sector that would be based on the managerial responsibility to establish internal control, the existence of the prescribed documentation, and the implementation of and compliance with internal controls in each organisational unit in the organisation, as well as the responsibility of all public sector employees to comply with internal controls.

### 3.6. REPUBLIC OF SERBIA

The Republic of Serbia regulates the general elements of the public sector internal financial control system in the **Law on the Budget System**,<sup>64</sup> and further specifies it in the secondary legislation: the Manual on Common Criteria and Standards for Public Financial Management and Control System Establishing, Functioning and Reporting,<sup>65</sup> and the Manual on Common

61 Manual on Internal Audit Procedure and Practices, *Official Gazette of Montenegro*, No. 32/2009.

62 Manual on Financial Management and Controls System Establishment and Implementation Procedures and Practises, *Official Gazette of Montenegro*, No. 37/2010.

63 The Instructions are available at: [www.mif.gov.me/ResourceManager/FileDownload.spx?rId=259817&rType=2](http://www.mif.gov.me/ResourceManager/FileDownload.spx?rId=259817&rType=2), 4.6.2017.

64 Law on the Budget System, *Official Gazette of the Republic of Serbia*, Nos. 54/2009, 73/2010, 101/2010, 101/2011, 93/2012, 62/2013, 63/2013, 108/2013, 142/2014, 68/2015-separate law, 103/2015 and 99/2016.

65 Manual on Common Criteria and Standards for Public Sector Financial Management and Controls System Establishing, Functioning and Reporting and Public Sector Controls, *Official Gazette of the Republic of Serbia*, Nos. 99/2011 and 106/2013.

Criteria for Organisation and Standards and Methodological Instructions for Internal Audit Practices and Reporting for the Public Sector.<sup>66</sup>

In accordance with the **Law on the Budget System**, internal financial controls in the public sector include rules on financial management and accountability for public funds users and internal audit of the public funds users. The law also harmonises and coordinates the financial management and control activities and the internal audit that is carried out by the Ministry of Finance's Central Harmonisation Unit.<sup>67</sup> The Law provides the legal basis for the establishment of financial management and control for all public funds users,<sup>68</sup> and internal audit of all public funds users.<sup>69</sup>

**The Manual on Common Criteria and Standards for Public Financial Management and Control System Establishing and Reporting** specifies the common criteria and standards for the establishment and operations of and reporting on the financial management and control system in the public funds users.

**The Manual on Common Criteria for Organization and Standards and Methodological Instructions for Internal Audit Practices and Reporting for the Public Sector** specifies the common criteria for the organisation of and the standards and methodological instructions for internal audit practices and internal audit reporting. In addition, it specifies further the internal audit activities in the public funds users.

#### 4. KEY ISSUES FOR ENSURING FULL IMPLEMENTATION OF LEGAL PROVISIONS COMMON TO ALL WESTERN BALKAN COUNTRIES AND HOW TO OVERCOME THEM

As it is a new field in the Western Balkans, it appears that internal control still has not become fully operational, and that the concept is in the initial phase of development. Even though the regulations governing public internal financial control have been adopted a while ago, this field of work is either not established at all or is not fully operational in public institutions. That may

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66 Manual on Common Criteria for Organization and Standards and Methodological Instructions for Internal Audit Practices and Reporting for the Public Sector, *Official Gazette of the Republic of Serbia*, No. 99/2011, 106/2013.

67 Article 80 of the Law on the Budget System.

68 Article 81 of the Law on the Budget System.

69 Article 82 of the Law on the Budget System.



be due to a lack of awareness about its importance, but also to uncertainties regarding its practical application.

Both the components of the internal financial control system – financial management and control, and internal audit – should be developed simultaneously. One of the functions of internal audit is to verify the adequacy of the financial management and control systems that have been established. That is why the nonexistence of one component has an adverse effect on the other. If an adequate financial management and control system is not established in an institution, the functioning and competence of the internal audit unit established within that institution will be undermined. Similarly, if internal audit is not established within an institution, the adequacy of financial management and control system may be questioned.

Risk assessment is a precondition for establishing an efficient and reliable internal control system. This is why an institution has to appoint a person or a working group in charge of financial management first. After that, business processes and procedures need to be established to determine the risks to all business processes in the institution. Furthermore, control activities in the form of written policies and procedures should be established to minimise the risks threatening the business processes, along with other activities envisaged in the internal control standards, and other documents relating to the establishment of the financial management and control system.

Risk management is of critical importance for optimal use of public funds. This is why public institutions have to adopt risk management strategies. Risk identification, assessment, quantification and control to which public institutions are subjected should be developed and continuously adjusted to new circumstances in all organisational units. Therefore, the risk management strategy must be regularly reviewed to reflect the implementation of the risk management process, at least once in every three years, and in case of any major change in the control environment in the institution.<sup>70</sup>

In practice, problems include the lack of risk assessment and identification with regards to important business processes and activities, and the failure to develop the risk register or the risk management strategy or to carry out the assessment of the existing business process safeguards, which is a precondition for assessing risk management.<sup>71</sup> According to

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70 V. Janjic, J. Suput, *Financial Management and Control System in Public Prosecutors' Offices, Association of Public Prosecutors and Deputy Public Prosecutors of the Republic of Serbia*, Belgrade 2014, p. 114.

71 Report on the Audit of the Annual Report of the Ministry of Justice for 2015 (Final Report), SAI No. 40113/16-041-307/26, Podgorica, July 2016. Available at: [www.dri.co.me/1/doc/Report on the Audit of the Annual Financial Statement of the Ministry of Justice for 2015](http://www.dri.co.me/1/doc/Report%20on%20the%20Audit%20of%20the%20Annual%20Financial%20Statement%20of%20the%20Ministry%20of%20Justice%20for%202015)

the public financial management and control standards, internal control should be a dynamic process that continuously adjusts to the changes in the organisation. Therefore, an assessment should always start from the existing procedures and from a critical evaluation of the efficiency of internal controls, to improve them.

Risk management is one of the four main elements of internal control. It is a process of identifying and analysing risks for the purpose of pursuing the institutions' objectives.<sup>72</sup> Only once the risks are identified and analysed, it will be possible to define the risk mitigating activities, or to bring the risks to an acceptable level. When it comes to the public sector, one of the most frequent risks that may jeopardise the institution's operation is the risk of illegal use of public funds. Therefore, if this risk is identified in a business process, measures need to be implemented to eliminate it or to bring it down to an acceptable level. Such measures can include written procedures or internal rulebooks that identify both personal responsibility and accountability for the use of public funds.

While most problems in practice relate to a well-functioning financial management and control system, there still appear to be some uncertainties about the functioning of internal audit as well. In some cases, there is no functionally independent internal audit unit, which in itself weakens the function of financial management and control. It may also have an adverse effect on the execution of the budget at the institutional level.<sup>73</sup> In some cases the internal audit has not been established or it operates inadequately. That may be caused by the fact that the internal auditors are assigned tasks that are not within their competence (e.g. development and implementation of integrity plans).<sup>74</sup> Such practice affects the independence of their work

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and the Financial Audit Report of the Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina for 2015, BiH Governmental Institutions Audit Office, no. 01/02/03-08-16, Sarajevo, May 2016, p. 6. Available at: [www.revizija.gov.ba/revizioni\\_izvjestaji/finansijskarevizija/Izvjestaji\\_2015/?id=4883](http://www.revizija.gov.ba/revizioni_izvjestaji/finansijskarevizija/Izvjestaji_2015/?id=4883), 17.1.2017.

72 INTOSAI GOV 9100-Guidelines for Internal Control Standards for the Public Sector- these stands were revised in 2016. Available at [http://www.issai.org/en\\_us/site-issai/issai-framework/intosai-gov.htm](http://www.issai.org/en_us/site-issai/issai-framework/intosai-gov.htm), 17.1.2017.

73 Report on Audit of Parts of Financial Statements on Regularity of Operations of the Ministry of Public Administration and Local Self-Government for 2015. No. 400–1598 / 2016-03 / 28, Belgrade, 16 November 2016, p. 20. and the Report on the Audit of Consolidated Financial Statements for the Final Account of the City of Sabac for 2015, no. 400-954/2016-04. Text available at: [www.dri.rs/revizije/poslednji-izvestaj:135.html](http://www.dri.rs/revizije/poslednji-izvestaj:135.html) and Financial Audit Report of the Ministry of Foreign Trade and Economic Relations of Bosnia and Herzegovina for 2015, BiH Governmental Institutions Audit Office, no. 01/02/03-08-16-1-521/16, Sarajevo, May 2016. p. 6. Text available at: [www.revizija.gov.ba/revizioni\\_izvjestaji/finansijskarevizija/Izvjestaji\\_2015/?id=4883](http://www.revizija.gov.ba/revizioni_izvjestaji/finansijskarevizija/Izvjestaji_2015/?id=4883), 17.1.2017.

74 Report on the Audit of the Annual Report of the Ministry of Foreign Affairs and European Integration for 2014 (Final Report), SAI No. 40113/16-041-126/23, Podgorica, April 2016. Text available at: [www.dri.co.me/1/doc/Izvjestaj](http://www.dri.co.me/1/doc/Izvjestaj), 17.1.2017.

and is not in accordance with Internal Standards for the Professional Practice of Internal Auditing.<sup>75</sup>

Standard 1100 for internal auditing prescribes that internal audit activities must be independent and that internal auditors must be objective in performing their work. Independence and objectivity is a must when it comes to both internal auditors and chief audit executives. According to Standard 1112, chief audit executive cannot be responsible for activities concerning risk management. In addition, according to Standard 1130A1, internal auditors must refrain from assessing specific operations for which they were previously responsible. Acting contrary to the mentioned standards is a violation of the internal audit independence and impartiality principle, which weakens the internal audit function.

In some cases, internal audit is confused with the role of budget inspection, which indicates that the role of internal audit is not properly understood.<sup>76</sup> Internal audit is not an inspectorate, it works for the institution's management to improve its existing financial management and control system, in order to optimise public expenditures and the execution of the institution's business processes.

Finally, a problem that occurs in practice in terms of the functioning of the financial management and control systems is a lack or inadequacy of the risk register. The following section includes examples of such registers and the instructions on how to develop them.

## 5. EXAMPLES OF BEST PRACTICES IN THE AREA OF INTERNAL FINANCIAL CONTROL

One of the best practices to ensure a creation of an adequate financial management and control system at the institutional level is to establish a risk register. Only once the risks are assessed, the risk mitigation measures can be proposed. The register should record all the risks for specific business processes that have been identified in a systematic review of the organisation. The register should include the following data:

- Business process objectives
- Identified risks (description)

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75 International Standards for Professional Practice of Internal Auditing, translation by the Institute of Internal Auditors of Serbia. Text available at: <https://na.theiia.org/translations/PublicDocuments/IPPF-Standards-2017-Serbian.pdf>, 17.1.2017.

76 Financial Audit Report of the Ministry of Foreign Affairs of BIH for 2015, no: 01/02/03-07-16-1-639/16, Sarajevo, June 2016, pp. 7–8. Text available at: [www.revizija.gov.ba/revizioni\\_izvještaj/finansijska\\_revizija/izvještaji\\_2015/?id=4886](http://www.revizija.gov.ba/revizioni_izvještaj/finansijska_revizija/izvještaji_2015/?id=4886), 17.1.2017.

- Risk scoring (impact on business process and likelihood of occurrence)
- Risk prioritisation
- Defining the risk response (measures for mitigating the risk)
- Appointing a person responsible to implement the measure
- Setting the implementation time line
- Status (monitoring, oversight)

Risk identification and assessment, risk management, monitoring and reporting are described more specifically in the Risk Management Strategy.

### I RISK SCHEDULE

BUSINESS PROCESS OBJECTIVES		IDENTIFIED RISKS		Timeline (Date)	Responsible person	
No.	Description	No.	Description		Section	Name/ title
1		1				
2		2				
3		3				
4		4				

### II RISK SCORING

RISK		Date	Assessor 1		Assessor 2		Total		
	Description		Likelihood	Impact	Likelihood	Impact	Likelihood	Impact	Total risk assessment
1									
2									
3									
4									

### III – RISK PRIORITISATION

No.	Description	Total likelihood	Total impact	Score	Priority	Risk response	Risk mitigating measure	Entrusted to	Implementation timeline	Status
1										
2										
3										
4										

### IV – UNACCOUNTED RISK

Risk number	Risk description	Total likelihood	Total impact	Score	Comment/ information

Based on a systematic risk assessment it is possible to propose risk mitigating measures. One of the measures is to set up written procedures to be adopted at the institutional level, to bring the risks to achieving the institution's objectives to the acceptable level, specified in the risk management procedures. These procedures should be approved by the manager of the publicly funded entity, as he/she is responsible to establish, maintain and improve the financial management and control system.

The procedures are not a legal act but an internal document. That is why it is always a challenge to ensure that the employees abide by these procedures. One of the ways to achieve that is for the manager to prescribe, in an internal rulebook, that failure to abide by the written rules and procedures constitutes grounds for disciplinary liability of employees. There is no universal model

for the procedures. However, they should include the elements given in the example below.

## PROCEDURE EXAMPLE

State

Address:

Name of Institution

Phone number:

Number: (under which  
the document is recorded)

e-mail:

## PROCEDURE TITLE (E.G. PROCEDURE FOR CONTROLLING SALARY CALCULATION AND PAYMENT)

	<b>DEVELOPMENT</b>	<b>IMPLEMENTATION</b>	<b>APPROVAL</b>
<b>Job title</b>	Job title of the person who is developing the procedure	The organisational unit in which the risk mitigating procedure is implemented	Job title of person who approves the written procedure (the manager of the institution in which the procedure is adopted)
<b>Person</b>	Name and surname of the person developing the procedure		Name and surname of the person approving the procedure
<b>Signature</b>	Signature of the person developing the procedure		Signature of the person approving the procedure

To be delivered to:

- The manager(s) of the organisational unit(s) in which the procedure will be implemented, and
- The employees who will implement the procedure in the course of their work

In addition to the information indicated in the first page of the written procedure, the second page should include the following:

- Introductory remarks
- Scope of application, and
- Related regulations



Introductory remarks usually include information on the primary and secondary legislation governing the business process (e.g. public funds users' salary calculation and payment), in addition to explaining why the procedure has been adopted (e.g. to minimise the possibility of the misdemeanours specified in a relevant law, relating to salary calculation and payment for public funds users).

Scope of application is a part of the written procedures describing the business process or processes to which the procedure applies (e.g. the salary calculation process, the salary payment process, etc.).

The content of the written procedures is given in the table below. The first column describes phases or steps in the business process. The second column should include the description of a specific activity that is a component of the business process. The third column lists the documents relevant for the carrying out that specific activity. The fourth column designates the person responsible to implement a specific phase/step in the procedure, according to his/her job title. The last column includes the data on other organisational units or other authorities that must be contacted to carry out a specific phase in the business process. These columns are the integral parts of the procedure, while the number of rows depends on what the manager thinks is necessary to ensure that all the activities that constitute the business process are carried out in accordance with the rules and regulations, to improve the accountability of all the employees involved and minimise the risks (which are largely of internal nature) that may jeopardise the execution of the specific business process.

<b>Procedure phases/steps</b>	<b>Description</b>	<b>Documents</b>	<b>Responsible person</b>	<b>Links to other authorities and organisations</b>

The table can be followed by some notes: e.g. that a specific regulation is expected to be adopted which may have an impact on the procedure at hand, and that the procedure would have to be harmonised with that regulation in the future. Just as the manager is responsible for the adoption of written procedures, he/she is also responsible for their revision. However, amendments to the written procedure may also be proposed by employees who take part in a business process in the institution. The reason for that may be a change in the primary or secondary legislation, but also the need to improve the control of the business process. In case of amendments to the

written procedure, all employees involved in the execution of such processes need to be informed of the new (revised) contents of the written procedures.

### EXAMPLE 1

An example of good practice in the establishment of internal control systems includes: the appointment of a person or group within the institution to be in charge of, establishing, implementing and developing financial management and control; the set-up of internal rules and procedures necessary for the establishment and implementation of the internal management and control system; the adoption of the integrity plan; the development of the risk register and the risk mitigation strategy; the development of internal rules and regulations that clearly set out duties and responsibilities at the level of the institution; the introduction of dual signature system; proper cataloguing of all business transactions, and the establishment of an adequate internal control system by the finance department manager.

When it comes to good practice regarding the functioning of internal audit, it implies the development of a strategic internal audit plan that defines its activities, objectives, and mandatory adherence to the Code of Ethics for Internal Auditors.<sup>77</sup>

### EXAMPLE 2

Good practice for internal financial control in public institutions implies also the development of an Action Plan for the adoption of internal rules and procedures for the establishment, implementation, and development of the financial management and control system. The adoption of separate internal rules and procedures for public procurement through direct negotiation process, the appointment of officials in charge of the establishment and development of financial management and control, the establishment of business books that contain a set of internal rules and procedures that the employees need to respect in order to minimise risks and to comply with law when performing financial transactions and controlling supporting documents should also be addressed. These procedures relate primarily to the process of drafting and adopting budgets, procedures for recording of invoices and their payment, cashier operations, free access to information, and the use of land and mobile phones, representation costs, salary calculation methods, public procurements, the financial report preparation

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<sup>77</sup> Audit Report of the Annual Financial Report of the Ministry of Science for 2015, Final Report no. 40113/16-021-87/20, Podgorica, July 2016. Text of the report available at: <http://www.dri.co.me/1/doc/lzvje%C5%A1taj%%20o%20reviziji%20Godi%C5%A1njev%20finansijskog%20izvje%C5%A1taja%20Ministarstva%20nauka%20za%202015.%20godina.pdf>, 21.3.2017.

procedure, treatment of outstanding commitments, and the procedure for the approval of business trips.

In addition, good practice could mean also the adoption of an internal act (instructions) on the terms and condition for using fuel and vehicles in public ownership, the adoption of the rulebook on the signature, the establishment of internal procedures for small-value procurements, and the mandatory adoption of a risk management strategy that should inform the written rules and procedures. When it comes to internal audit, one of the indicators of good practice can be whether all internal audit recommendations are implemented within the specific timelines.<sup>78</sup>

## 6. TRAINING EXERCISES

1. Conduct a risk assessment at the institutional level based on real parameters. Based on the risk assessment, give proposals for the establishment the internal control mechanism that would reduce these risks to an acceptable level. Present the identified risks at the institutional level orally, and give the proposals for mitigating them (rulebooks, written procedures).
2. Draft an example of written procedures that would reduce the identified risks to an acceptable level.
3. List the main drawbacks of the existing control mechanisms at the level of the institution, and give proposals for overcoming them. Present and explain the proposals (orally).

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78 Audit Report of the Annual Financial Report of the Environmental Protection Agency for 2015, Final Report no. 40113/16-024-55/19, Podgorica, July 2015. The text of the report available at: <http://www.dri.co.me/1/doc/Izvje%C5%A1taj%20o%20reviziji%20Godi%C5%A1njeg%20finansijskog%20izvje%C5%A1taja%20Agencije%20za%20za%C5%A1titu%20%C5%BEivotne%20sredine%20za%202015.%20godinu.pdf>, 21.3.2017.