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RAZPRAVE • DISCUSSIONS

THE STATE AND THE NEED FOR DEVELOPMENT
OF INTERNAL CONTROL AND AUDITING
SYSTEMS IN BOSNIA AND HERZEGOVINAStanje in potreba po razvoju notranjega nadzora in
sistema notranje revizije v Bosni in Hercegovini

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Abstract

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The need for establishment of internal control and auditing systems within companies and other organizations and institutions in Bosnia and Herzegovina is greater than in developed democratic systems. It is understandable given the fact that the country is in the process of transition and establishing democratic institutions and legal regulations for their functioning in a complex political system. The state's experience and the need for development and organization of internal control and closely related internal auditing systems can be expressed by determining the aim of internal auditing in organizations, and above all its mission, organizational position, method of work and operation, and other.

Key words: internal control, internal auditing system, organizational system

Izvleček

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Potreba po vzpostavitvi notranjega nadzora in sistema revizije v podjetjih in drugih organizacijah in institucijah v Bosni in Hercegovini je večja kot v razvitih demokratičnih sistemih. To je razumljivo, če upoštevamo dejstvo, da je država v procesu tranzicije in vzpostavitve demokratičnih institucij ter pravne regulative za delovanje v kompleksnem političnem sistemu. Izkušnje s stanjem ter potrebo po razvoju in organizaciji notranjega nadzora in tesno povezanega sistema notranje revizije lahko označimo, če določimo cilj notranje revizije v organizacijah z njenim poslanstvom, organizacijskim položajem, metodami dela in drugimi dejavniki.

Ključne besede: notranji nadzor, sistem notranje revizije, organizacijski sistem

1 Introduction

The organization of internal control is not a new concept. It has been applied around the world for more than a hundred years. In Bosnia and Herzegovina, it is an essential part of building the market system, which is preoccupied with the transitional process of organizational and functional reconstruction of the existing system. The existing system needs to be adjusted to market demands and to world and European standards. Currently, some regulations in Bosnia and Herzegovina only casually mention the system of internal control, but not in the sense of legal obligation. For such reasons it is hard to determine the aim, content, and field of activity of internal control, and its organization and operation are left to the will and ability of management. The usefulness of internal control systems is seen in business results. In our business process, the outcomes are often unlike what is planned. Causes can be diverse, objective and subjective: carefulness, error in planning, objectivity, incomplete realization, etc. If the process is more complex, then its operation is harder to oversee, which makes the control more important. The system of internal control and auditing needs to be incorporated in every organizational system in a way that will allow it to regulate and monitor all internal and external flows, which can have long-term consequences.

Political, professional and science communities are preoccupied with the fundamental problem of finding the causes of business failures in Bosnia and Herzegovina, and with seeking the answer to the question to what extent can internal control and auditing be effective in solving the crisis within the entire institutional business community. The function of internal control and auditing within an organization can do only as much as management is prepared to invest in it. The management should give them a wide area of operations, unlimited access to information, authority that will secure respect for their suggestions, and needed personnel and material resources. The system of internal control and internal auditing should establish such control mechanisms that will allow timely responses to both internal and external environmental risks. For these reasons, building an infrastructure in Bosnia and Herzegovina that is suitable for the operation of internal control and internal auditing is more than just a need and demand of the market system.

2 The concept and mission of internal control and internal auditing

In practice, the system of internal control includes a wide spectrum of specific procedures and acts, including control in accounting, processes, purchasing, distinction of duties, and financial reporting. The system of internal control requires efficient communication within an organization, and it must be supported by good procedures of internal control. The responsibility to form and supervise the system of internal control lies within the management of the organization and not within the external auditor, because his sole purpose is to give judgment on the defects and functioning of such systems. Internal control should be treated as an *organizational system* that is continually applied within an organization. Because of that, it must be in accord with all general acts and organizational rules issued

JEL: M42

by the management. According to authorities, internal control should operate based on principles of self-control, which means that all employees, no matter their function, should carry out their assignments timely, efficiently, and responsibly. The management is especially responsible for the realization of all assignments of individual functions in the area of internal control.

Within the system of internal control, we should distinguish *internal accounting control*, *internal administrative control*, and *internal auditing*.

Internal accounting control refers to measures that contribute to the security of property and reliability of financial records. It includes procedures for giving authorizations for financial transactions, the use of prescribed and generally accepted policies and procedures for accounting, separation of tasks for keeping records in such a manner that one person doesn't have control of entire transactions, accounting reports to those responsible for operations and keeping property, physical control of access to property, and internal auditing.

Internal administrative control operates where there is no internal accounting control. It incorporates organizational plans, policies, procedures, records and other measures that secure the carrying out of operations consistently and in accord with goals set by the management. Internal administrative control is primarily about establishing operational efficiency and respecting management policies, and it is usually only indirectly related to financial records. It often includes mission and organization policy statements, functional plans of systematization, procedure manuals, descriptions of responsibilities, employee educational programs, information systems, systems for keeping documents, control of physical or electronic access to sensitive areas or files, as well as other measures for the control of program operations.

Internal auditing represents an independent and professional consulting activity that secures objective analysis aimed at improving the business activity of a given organization. This activity helps the organization to achieve its goals by applying systematic and disciplined methods of evaluation and improvement of risk management, and control and management processes. Efficient internal auditing has a clear system of operation that implies sources that secure the realization of given duties, and separate authority for reporting by qualified and responsible employees. The well-established function of internal auditing emphasizes the effect of internal control. Internal auditing, among other functions, must examine and evaluate the efficiency of internal control systems, and the quality of accepted responsibility reports, especially those related to expenses. As such, it represents a service to management and serves as an »extended arm« of management in areas of supervision over both vital systems. The aim of internal auditing is to help the members of an organization determine responsibilities and perform their tasks efficiently. For that purpose, internal auditing supplies analysis, evaluations, and

recommendations, and gives advice and information related to the business activity of the organization.

Internal Auditing is a significant part of the entire auditing process. A branch within an organization implements it, organizes, and applies a program of internal auditing as a complete test of the effectiveness of all aspects of the internal control system. The most important activities of internal auditing are inspecting the level of the organization, development and advancement in the efficiency of individual business functions, examining the way of making business decisions, operation of information systems, and other activities that evaluate and review the operation of the business.

3 The conditions and the need for development of internal control and internal auditing in BiH

3.1 Internal control and internal auditing in companies

The starting point in the *development of internal control* within companies is reflected in the prevention and detection of deviations that result from fraud and error. With the development of a market economy and increasing competition, the operation and organization of companies has become more complex; administration is more and more decentralized, and control is only mentioned in the sense of preventing direct theft of property and money. Because of this misunderstanding, it is usually forgotten that it is a very efficient and not fully used mechanism.

»Internal control comprises a wider area than just accounting and auditing. It relates to all areas of activity: sales, purchases, and production. Internal control includes self-control of direct executors as a regular operation, and control of direct and higher managers.«¹

Therefore, internal control in companies is incorporated in business operations processes and actions, with the intention of securing management control over entire company operations. In this way, we control the achievement of individual goals in order to reach the main objectives, such as securing assets, and increasing profit and capital.

»Internal control is array of procedures shaped by management aimed at gaining assurance of goal achievement in the following categories:

1. business efficiency,
2. financial reporting reliability, and
3. concurrence with applicable laws and regulations.«²

A control procedure means certain policies and procedures that, together with other conditions set by the management, should secure acceptable guarantees for reaching given objectives. Internal control is a tool inside the organizational structure and business operations that

¹ Prof. dr. Radmila Kovačević: Revizija u tržišnom gospodarstvu. Informator, Zagreb, 1993, str. 57.

² William F. Messier, Jr.: Revizija, Faber & Zgombić Plus, Zagreb, 1998., prijevod: Auditing a systematic approach, 1997, str. 191.

make it possible for the management to control operations. Control and supervision of company operations is one of the key responsibilities of the management. Efficient control is only partially achieved by personal supervision of the most important events. The control should be efficient even in the absence of a responsible manager from the scene of events. This is only possible if the principles of internal control are integrated in the organizational structure of the company. Only then could we expect desired results, such as:

1. property security,
2. loyalty of personnel toward company policy,
3. operational efficiency,
4. accurate and trustworthy accounting.

Internal control is closely related to the accounting system that has incorporated control procedures, meaning that it must contain a part of internal control and must rely on control procedures (internal control) organized outside the accounting system in other business functions.

Internal control inside the accounting system efficiently contributes to reaching the following objectives:³

- transactions should be made in accordance with general or specific management authorization;
- transactions should be immediately recorded in current amounts, in appropriate class, in the accounting period in which they were made, and in such a manner that it will allow preparation of financial information within boundaries of accepted accounting policies and should reflect responsibility for property;
- access to property should only be allowed in accordance with management authorization; and
- the reported inventory of property should be compared with actual existing property at acceptable intervals, and appropriate action taken in connection with any discrepancies.

A high- quality and efficient internal control system, especially within accounting systems, should be the primary objective of every manager, as in developed countries where it is a part of tradition or even a legal obligation. Considering the fact that every employee enforces internal control, these controls can be subject to various failures and errors resulting from the human factor. Failures can be the result of misunderstandings, wrong evaluations, carelessness, negligence, incompetence, etc. This is why it is necessary to formulate at least the basic indicators of established internal control, which can include existence of written rules, procedures, standards of behaviour and ethical standards, separation of duties, necessary qualifications of employees familiar with rules of behaviour, etc.

In practice in BiH, the model of founding internal control exists without any written rules or regulations. Instead, managers usually verbally delegate responsibilities and

competencies to mid-level managers and other workers, or even try to prevent theft by appointing non-responsible, but »trustworthy« persons outside of predetermined and properly defined employment policy. This shows that there is internal control, whether or not people are aware of it. A first step should be made so that people would become aware of their own importance, and begin to build a system of internal control that will be fully documented and defined. If internal control within a company is not founded on written documents, evaluation of such control is considerably more difficult, but not completely impossible. In such cases, it is at least necessary to identify and record those existing and functioning controls, and after that, evaluation should be made of their efficiency and level of reliability, with the possibility of creating and defining recommendations that will improve internal control.

The quality of external auditing of financial reports, which is obligatory in most BiH companies, is compromised because internal control is not functioning. The opinion of independent external auditors provides reasonable assurance that financial records are real and objective and contain no notable mistakes. The term »reasonable assurance« means there is certain risk that financial records may contain notable mistakes, but that the auditor will not reveal them. In order for an external auditor to be able to apply a model of auditing risk and to minimize the possibility of notable mistakes, it is essential to realize, check, and even record the efficiency of applied internal control measures within the client's organization. This is a very difficult task for the external auditor because internal control in BiH companies is not adequately documented or defined in written documents.

External auditing of companies in Bosnia and Herzegovina neglects previous activities of auditing that relate to evaluation of internal control, and with such actions, it compromises the reality and objectivity of their independent opinions and »reasonable assurances.« In the end, external auditors are expected to contribute by providing suggestions and recommendations for the enhancement of the internal control present in those companies where they do their auditing.

The establishment and *development of internal auditing* in companies is determined by many factors, above all by economic globalization, the emerging presence of companies on foreign markets, the number of branch offices, decentralization of accounting (an accounting department in every branch office), lack of integration of information systems, etc. All these as well as other factors call for auditing of internal financial reports. The area of operation of internal auditing should encompass all types of auditing (financial auditing, operations auditing and management auditing). For the establishment of internal auditing, the key is to train personnel and create a methodology of internal auditing. It is also necessary to provide suitable accommodation and IT equipment because this is a usual problem for everybody who wants to set up a new service. Still, for the job of internal auditing, the most important element is trained personnel. These should be persons with a good knowledge of accounting, accounting and information systems of the

³ USAID Projekat reforme računovodstva javnog sektora u BiH, Interna kontrola Priručnik za korisnike, Sarajevo - jun / lipanj, 2004.

company, and with some experience in accounting. This means that such persons should be transferred from accounting to internal auditing jobs.

Accordingly, establishment of internal auditing must pass through multiple stages, such as:

- a) *establishment of internal auditing:*
 - education of internal auditors (courses for internal auditors or in some other way);
 - creating methodology of internal auditing; (adapted to accounting and information technology, with application of other people's experiences, use of international auditing standards of internal and external auditing that can be applied to internal auditing as well, etc.);
 - planning of internal auditing work (2-year plan, 1-year plan, and monthly plans);
- b) *execution of internal auditing (to a limited extent due to available time):*
 - financial auditing (review of some internal financial reports), and
 - management auditing (advising management about some problems in the area of accounting and finance, etc.)
- c) *advising management on relations with external auditors about auditing, accounting and financial problems.*

We will also list some of the more important factors and individual tasks of internal auditing that companies can encounter in their organization and operations:

- independent internal auditing, which is largely expressed through organizational status and its position within the hierarchical structure of the company, to whom it reports, who makes decisions about its planning, etc.;
- understanding the usefulness of internal auditing by management and providing support for it;
- the lack of personnel training in companies for internal auditing jobs;
- limited possibilities of bringing trained and professional accounting experts and internal auditors into a company;
- shortage of practical experience in internal auditing, especially concerning Bosnia and Herzegovina;
- absence of national and international standards of internal auditing in BiH;
- relationship between internal and external auditing, etc.

To organize and create conditions and possibilities for operation of internal auditing in Bosnia and Herzegovina, it is necessary to look for system solutions or, at least initially, a way for their resolution. There should be support for this from external auditors because this would make their job easier. The presence of internal auditing is an important factor in the external auditor's evaluation of an internal control system (evaluation of inherent and control risk). Support could also be gained by convincing management of the need for internal auditing, the importance of its independence (relative), organizing internal auditing within a hierarchical structure as is usual in companies/corporations in the EU and the USA, explaining the purpose and mission of internal

auditing (about types of auditing—financial auditing, operations auditing, and management auditing), and about help in training internal auditors.

The methodology should contain procedures for planning auditing as an organizational part (section, sector, service), planning the activity of internal auditing from planning individual audits to activity reporting, and monitoring the actions of management toward internal auditing reports. During the creation of methodology, it would be very useful to use the experiences of the EU and the USA that are available in professional literature, or existing cooperation with external auditors adapted to existing accounting and information systems (especially due to a shortage of integration of information systems, a larger number of control procedures are needed, and by knowing today's situation and the weakness of an accounting system, more attention will be given to that). The primary condition that makes internal auditing possible is its independence (relative, of course), and without it there would not be freedom of opinion and judgment. Without freedom of opinion and judgment, reports and findings could not be true and objective.

That is just one side of the story, and the other is that in the internal auditing business professionalism and morality must be fully represented in people who do it. Because of that, all those who do internal auditing and whose mission is to prepare internal auditing for operation by world standards, must accept the professional principle of internal auditors »carved« during years of practice. These ethical principles of conduct of internal auditors't are contained in the Code of Professional Ethics for Internal Auditors. They were defined by the Institute of Internal Auditors in 1968 in New Orleans, and are comprised of eight principles:

1. The members must be objective, diligent and responsible in carrying out their duties.
2. The members must have trust from their employers and be devoted to their employers, but must not consciously take part in any illegal or inconvenient acts.
3. The members must refrain from taking actions that are in conflict with the interests of employers, or could distract them from carrying out their duties objectively.
4. The members must not accept compensation or gifts from employees or clients, or for any job related to the employer, without the knowledge and consent of management.
5. The members must be sensible in their use of information obtained throughout auditing. They must not use confidential information for personal needs or in a way that could harm the employer.
6. During expression of opinion, members must have sufficient evidence to support such opinion. In reporting, members must bring to light all the facts known only to them, but which, if not revealed, could alter a reviewed report or hide unlawful acts.
7. The members must continually strive to improve their knowledge and the success of their services.
8. The members must support the goals of the Institute of Internal Auditors. In the course of their work, they must

follow high norms of professionalism, morality and dignity founded by the Institute of Internal Auditors and its members.⁴

During the organization of internal auditing, it is necessary to recommend to management that it be relatively independent, and at the same time, internal auditors should follow the declared ethical principles.

It is certain that The Code of American Internal Auditors could be applied in BiH practice. However, an individual or several individuals within the company could not define such a Code, so it would be useful to form a section of internal auditors that will, I hope soon enough, be founded on the state level in BiH.

We have already mentioned external auditors that can give support to the establishment and operation of internal auditing. The support should be comprehensive and achieved because internal auditing, through its good operation, reduces all risks that result from external auditing. By the way, it is usual for people from the company who know the company's situation and weaknesses of internal controls, accounting and information systems, to do the internal auditing. Therefore, the cooperation of internal auditing is useful for planning external revision. The information about weaknesses must catch the attention of external auditors so they can complement their activities with them. In the same manner, the information about weaknesses and shortcomings revealed by external auditors are used in the planning of internal auditing. The relationship described here between internal and external auditing can be considered correct and useful. Nevertheless, there is a danger that under pressure of the »authority of outside experts« (who come from abroad or from outside the company), management will only direct internal control toward areas and activities recommended by external auditing. This is when internal auditing becomes dependent upon external auditing, and it could be said that it becomes »the invisible extended hand of external auditing.« Such cases raise a question not only about the independence of internal auditing, but also about the »independence« of management, considering the fact that the decision about the operation of internal auditing (administration of internal auditing) is left to its external auditor, who should, by the nature of his work, provide the service of financial reports auditing.

The role, demands, and position of internal auditing that we have described cannot be achieved in the short term. It is not a reality in Bosnia and Herzegovina for the following reasons:

- a) There is a very small number of companies with a defined strategy of development and appearance on foreign markets with stiff competition;
- b) The managers of most of our companies are still more concerned with »survival« than with development strategy;

- c) Because of misunderstandings, internal auditing is not given those assignments that are considered important in developed countries;
- d) In most companies (larger corporations, including public companies in BiH), internal auditing did not get its deserved position in the modern market economy;
- e) There is a shortage of adequately trained and educated internal auditors who could acceptably complete their assignments.

However, in order to apply it to companies in BiH, the process of contemporary development of internal auditing should continually be watched, upgraded, and pointed out. Internal auditors should be given special attention with regard to their training, providing instructions for how they will determine the methodology for evaluating the reality of the stated goals, and how they will recommend to management the measures for eliminating unfavorable results with regard to the stated goals. For business practice in Bosnia and Herzegovina, the stated concept of internal auditing in companies is extremely popular and should represent a »new philosophy of business.«

3.1.1 Organizational status of internal auditing within companies

The efficiency of internal auditing and the efficient use of its results depend upon the organizational status of internal auditing within the company. Internal auditing is the extended arm of management, and it can never be completely independent. Still, in order for internal auditing to give realistic evaluations and recommendations to management, it must be independent in a way that it can fully apply professional rules (*lege artis*). It is up to management because if management does not accept such a view, then there is a high probability that evaluations and recommendations of internal auditing will not be objective enough, and management cannot make use of such information if it lacks objectivity. In that case, the purpose of internal auditing is lost, so it is in management's interest to secure the independence of internal auditing, primarily to set it in such a position within the hierarchical structure that will give it *relative independence*, and in that manner secure for itself realistic evaluations and recommendations about financial reports and operations.

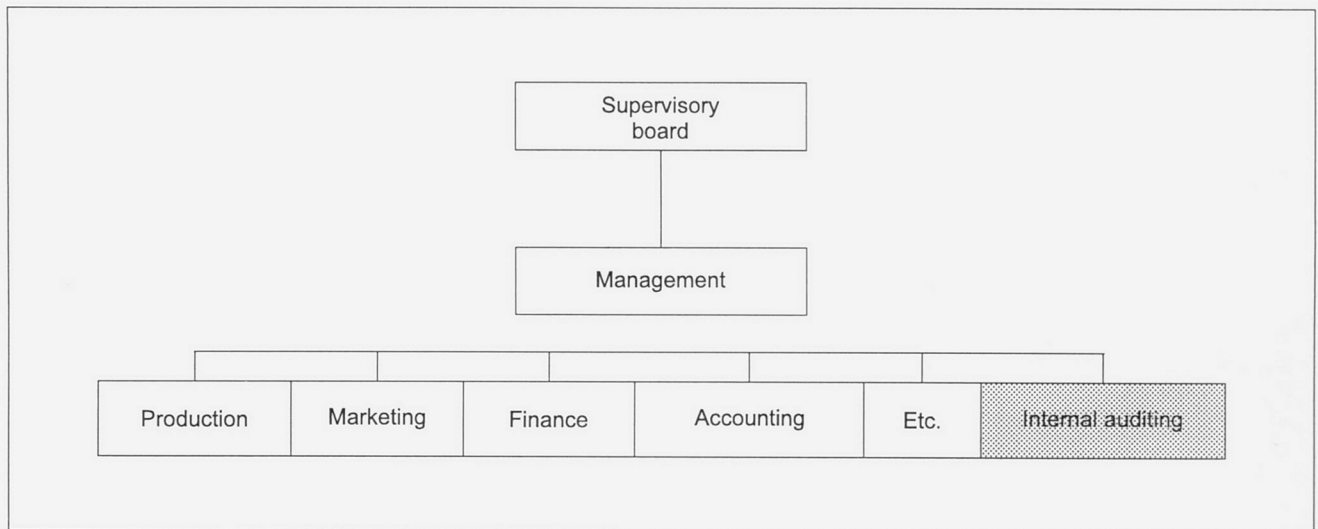
The organizational status of internal auditing depends on internal factors such as the size of the company, the nature of business activity, the abilities of personnel, and so on, and it is up to the management to decide on all of these factors.

There are various models of internal auditing organization. However, it is possible to outline two of the most frequently used ones:

- a) Internal auditing relative to other functions and organizational entities within a company;
- b) Internal auditing as a supreme body of the management or the board of directors.

In the first case, internal auditing is an autonomous organizational unit with equal status to other organizational

⁴ Prof. dr. Ivo Spremić: Standardi interne revizije, zbornik radova XXXIII simpozija Hrvatske zajednice računovođa i finansijskih djelatnika, Zagreb, 1998. godina.

Organization of internal auditing as a specialized service⁵

units, such as production, finance, accounting, marketing, etc. Its status as a control function is not adequate because that status is equal to those organizational units it must supervise or control.

There are organizational solutions in which internal auditing is a specialized service within a company just like other services: accounting, finance, personnel, and others. This organizational solution does not correspond to the primary assumption of efficient internal auditing because it is dependent upon those organizational units it controls, which leads to reduced reality and objectivity of its evaluations and recommendations to the management.

In developed business conditions, internal auditing is often organized as a supreme body of the management and the supervisory board.

In order to guarantee the independence of internal auditing and to confirm the support of the management, instead of organizing internal auditing as a supreme body, it is possible to establish an auditing committee. An auditing committee gives independence to internal auditing through the direct responsibility of the auditing committee.

It is clear that there are numerous organizational solutions and positions of internal auditing within the organizational structure of a company. The primary assumption of its functioning is:

- that it is formally and informally independent, and
- that it have management support (public support)

3.2 Internal auditing and internal control within the banking system

When we talk about the banking system generally, the important question is how to recognize and forestall

disturbances on the financial market and protect the banking sector from insolvent clients. A banking crisis can begin with different disturbances on financial markets, and that is an attribute of developed market economies. However, even in conditions of stable exchange rates and low inflation, a banking crisis can occur because of microeconomical factors within the banks alone. An analysis of studies about the causes of problems in national banks around the world shows that the majority of shortcomings in the banking sector are linked with bad management and inadequate external and internal supervision.

The Office of the Controller of the Currency completed a study on the causes of problems in national banks and discovered the following:⁶

Contemporary banking supervision focuses solely on the microeconomical causes of banking crises. Overextension of the bank, fast growth, bad credit policy, concentration of loans, associated judgment, defiance of time frames, loan, interest and currency system, weak actions of asset returns, and weakness in planning and cosmetic accounting, are some of the main microeconomical indicators of bank failures. Behind these causes are the key factors: *weak internal control regulators*.

Studies done within the World Bank classified the main indicators that point to the emergence of problems in the bank:⁷

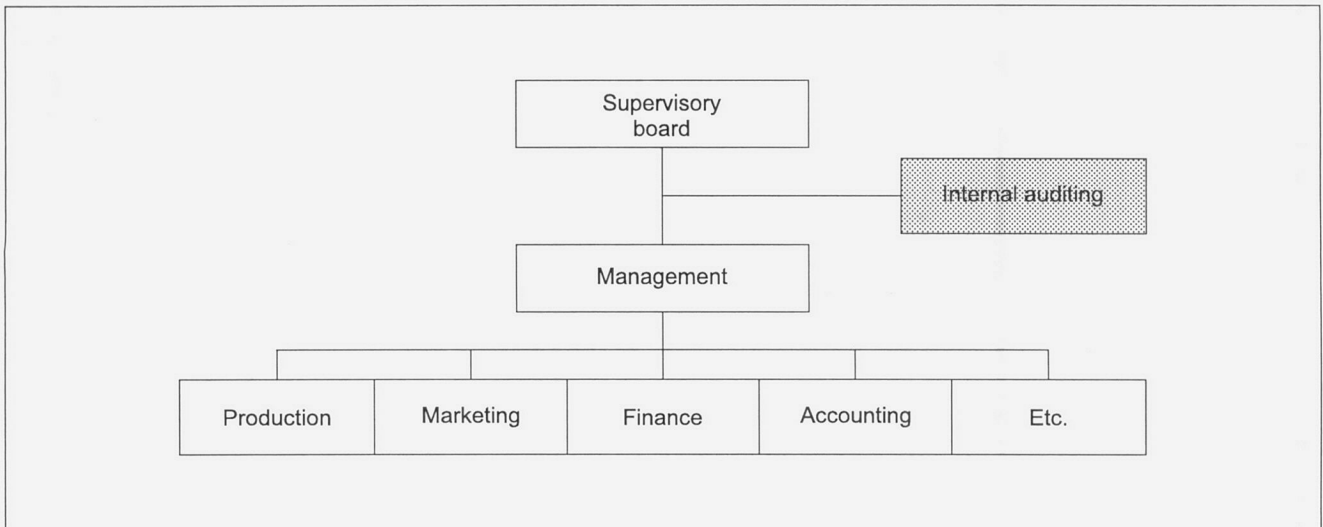
- Bad judgment (Inadequate guidelines for loan approval)
- Overdue reports about the bank's business results
- Problems in branch offices, associated companies, or with big clients
- Large turnover in personnel and changes in management
- Change of auditor

⁵ Prof. dr. Ivo Spremić: Uloga interne revizije i istraživanje mogućnosti načina organizovanja. Zbornik radova XXXI. Simpozija Hrvatske zajednice računovoda i finansijskih djelatnika, Zagreb, 1996. Str. 149.

⁶ Bank Failure: An Evaluation of the Factors Contributing to the Failure of the National Bank, Controller of the Currency, Washington, 1988.

⁷ Source: A. Sheng: «Bank Restructuring: Lessons from the 1980, s», World Bank, 1996.

Organization of internal auditing as a supreme body



- Swift growth of assets
- Problems with liquidity
- Use of political power
- High costs without real reflection on business improvement
- Public complaints
- Incompetent or uninformed management and dominant director.

The analysis of causes in this case shows a lack of timely reaction by the control body of the banks. It can be concluded that the root of the mentioned causes is a failure of internal control and auditing. The problem of weak control regulators has been present for a long time.

If we accept the position that banking crises are associated with weak internal control and auditing, then the degree of development of these functions within banks in BiH can answer this question: Do BiH banks have quality, autonomous control procedures that are ready to recognize and forestall a possible crisis? In BiH, the Law of Banks defines the field of internal auditing. It is responsible for risk identification, monitoring and evaluation in bank operations, and making sure that banks have established an internal control system that secures risk reduction through risk management. In carrying out his duties, the internal auditor must have authorization for uninterrupted work, and he is obliged to cooperate with the auditing committee. He reports to the auditing committee; however, in cases of major differences, the internal auditor informs the supervisory board, who must solve the problem. The Banking Agency brought minimum standards of internal and external auditing

to banks that are obligatory. In that context, the internal auditor must independently evaluate the adequacy, efficiency, and success of the internal control system, and give information to the auditing committee about the application of that system and recommendations for its improvement.

The bank's internal auditing program, as a minimum, must:

1. include the following elements:
 - a) clearly defined goal of internal auditing and responsibility of internal auditor;
 - b) the definition of all risky banking operation areas;
 - c) the extent of coverage and details of internal auditing at certain risky banking operation areas;
 - d) the list of priorities for internal auditing and evaluation of risk with explanation;
 - e) method and timeframe (interval) of reporting to auditing committee on all aspects of internal auditing;
2. develop in detail planning elements and procedures of internal auditing, including:
 - a) interval-frequency of internal auditing activity;
 - b) the subject of operational working programs of internal auditing;
 - c) documentation basis of completed internal auditing activities;
 - d) creation of reports on completed internal auditing activities, method and timeframe (interval) of reporting to the auditing committee.

To achieve the goals of internal auditing, the subject of internal auditing must be detailed and comprehensive. The frequency of internal auditing activities must secure the

»Problems that contributed to the fall of banks«

Shortcoming - problem	%
Absence or disobedience of credit policies	81%
Inadequate system of securing compliance with internal policies or banking laws	69%
Inadequate supervision over key employees or departments	63%
Inadequate system for identification of bad loans	59%
Decision-making dominated by one person: Director, Shareholder	57%
Absence or disobedience of ALM policies	49%
Abuse of position	35%

achievement of its goals, with more frequent activity in risky banking areas. In the application of internal auditing procedures, *working programs* must prepare a manual for the work of the internal auditor. Every operational working program must provide a clear and brief description of the activities listed below, as well as a logical presentation of individual procedures. The included procedures can vary according to the size of the bank, the area that is subject to the specific internal auditing procedure, and the complexity of the bank's business operations. In the content of internal auditing working programs there must be, as a minimum, procedures for:

1. unexpected audits, where and when they are possible;
2. taking control over records and files chosen for auditing;
3. survey and evaluation of a bank's policies, procedures, and internal control system;
4. harmonizing subsidiary and analytical records with general ledger;
5. checking the selected transactions and conditions.

All conclusions of the internal auditor must be formalized in written reports that contain suggestions for necessary corrective action. The reports must be timely, clear, and brief, they must be delivered to the auditing committee, and the management must be informed.

We will mention just a few notions about the implementation of internal control regulations in BiH banks:

- *Reporting of internal auditing* in banks in Bosnia and Heregovina complies with the Law of Banks and decisions of the Banking Agency, even though by international standards internal auditors should above all inform the management, and other levels only occasionally or as the need arises. In any case, it is imperative to inform that level which has enough authority to enforce the suggested corrective actions, even if informing during the ongoing, regular work of auditors should be directed toward lower levels. In their activities, the internal auditors in BiH banks have a high level of cooperation with internal controls, and that cooperation is essential and useful because it reduces the auditor's workload. However, internal auditing in BiH banks is primarily concentrated on credit portfolios, business with citizens and organizations, financial statements, and bank liquidity. The subjects of auditing correspond with the most risky areas of the banking business, so an important position is often skipped: risk management auditing.
- The negative indicator is also the fact that a very small number of banks lists the *internal control system* as a *subject of auditing*, and by international standard it should be of primary interest to internal auditors. This fact could be partially explained by a misunderstanding of how a system of controls incorporated in the business process operates. By developing the profession of internal auditing, it is possible to expect that the evaluation of the presence and efficiency of internal controls will take its place in internal auditing.

- *The independence of internal auditors* in banks, especially those with predominantly domestic capital, is questionable. In all internal auditing standards, independence is highlighted as a fundamental condition for efficient auditing. The one way to secure its independence is for internal auditing to have an appropriate position within the organizational structure. In ideal conditions, a special body should be responsible for the independent auditing committee.
- The most frequently *used methods* of internal auditing within BiH banks are case studies and interviewing, inspection, and testing. Observation is used sporadically, as it is one of the main methods used by internal auditors during inventory. *Flow diagrams* are not in wide use for now, which is unfortunate because they are best for presenting business processes and possible controls in them. For these reasons, the methodology of internal auditing is at a low level.
- Securing adequate *respect for objections and suggestions from internal auditors* is difficult, and that is one of the primary prerequisites for their contribution to the banking business. To secure respect for auditors' reports, it is necessary to gain support from the bank's highest levels and to develop and improve the culture of control.
- *The implementation of international standards of internal auditing* is at a low level, while formulation of the code of professional ethics for internal auditors is making progress.

3.3 The status and position of internal supervision among budget users

The status and regulatory basis for internal supervision among budget users is not defined on a state level in BiH, and is dependent on entity governments and laws. The Budget User Accounting Act in the Federation of BiH defines:

»The budget users will secure the system of regular internal accounting supervision (internal control). By internal accounting supervision it is verified if accounting transactions are executed in accordance with the law, if there is adequate accounting documentation, and if financial statements provide complete, reliable and trustworthy information about results of financial operations and about financial positions.«⁸

This document sets principles that institute internal supervision, and rules that must be obeyed in budget accounting and recording of assets acquired and spent by budget users. The main principles of internal supervision among budget users should provide the main directions for establishing effective and efficient internal control to the management.

The incorporation of effective internal supervision, as a group of interconnected and synchronized measures, methods and procedures, with the goal of securing the

⁸ Član 20. Uredbe o računovodstvu proračuna/budžeta u Federaciji Bosne i Hercegovine «Službene novine Federacije BiH», broj 47/98).

property of consumer units, provides for the development of reliable financial and administrative information. It is the point of supervision to show irregularities in the monitored unit and to direct its activity toward desired goals. Internal supervision will secure the prevention system of internal control, whose aim is to verify the regularity of use of budget assets.

The effective and reliable accounting system of the consumer unit will minimize the frequency of abuses and corruption in the use of public assets. However, its existence is not enough to rule out the possibility of unwanted actions. The active and professional approach of those working in internal supervision, who best know the organization and the nature of the job, contributes to the reduction of corrupt and criminal activities on the part of budget users. Because of that, the managers of budget users in BiH must realize that a strong structure of internal control represents the basis for control of the consumer unit, its mission, activity and resources it uses. The responsibility for establishment of an adequate and efficient internal control structure is on the management. The manager of every budget organization must be sure that an adequate internal control structure is established, reviewed, and improved in order to stay efficient. The critical point is the positive approach and support of managers to that process. Each one of them must possess personal and professional integrity. They must uphold a level of personal capability in order to understand the importance of development, implementation, and maintenance of internal control efficiency.

The management can organize an independent auditing function within the budget organization as a key part of the internal control structure (internal auditing function). First, it is necessary to establish the goals of the auditing function and avoid placement of any limitations on auditors in reaching those goals. The chief of every auditing unit should be directly responsible to the manager of that organization, and the manager is, on the other side, responsible for providing enough resources and competent personnel for the execution of auditing operations. In that sense, the managers must work together creatively with internal auditors on the identification of risks and the creation of clearly applicable controls. Therefore, the managerial structures in budget users are responsible for the establishment of an efficient control environment within their organizational unit. That responsibility emanates from their position as the managers of public resources.

An internal control set by the management of budget users helps them to secure the reasonable belief that the budget user is:

- obeying the law, regulations, and internal guidelines and rules;
- promoting transparent, efficient, and effective operation, and achieving the planned objectives;
- protecting resources from fraud, unpurposeful spending, abuse and bad management;
- securing the quality of services provided to citizens by budget users;

- developing and keeping reliable and transparent financial information related to management and reporting.

All budget users should apply their own internal supervisory system that is adequate for their organizational structures. All internal control systems should be documented. The lack of a universally specified system of internal control results from different situations in every institution. Especially large organizations will need more complex systems of supervision. All of them should satisfy the defined principles, and the external auditors of budget users will be the judges of the efficiency of the internal supervision system in accordance with those principles.

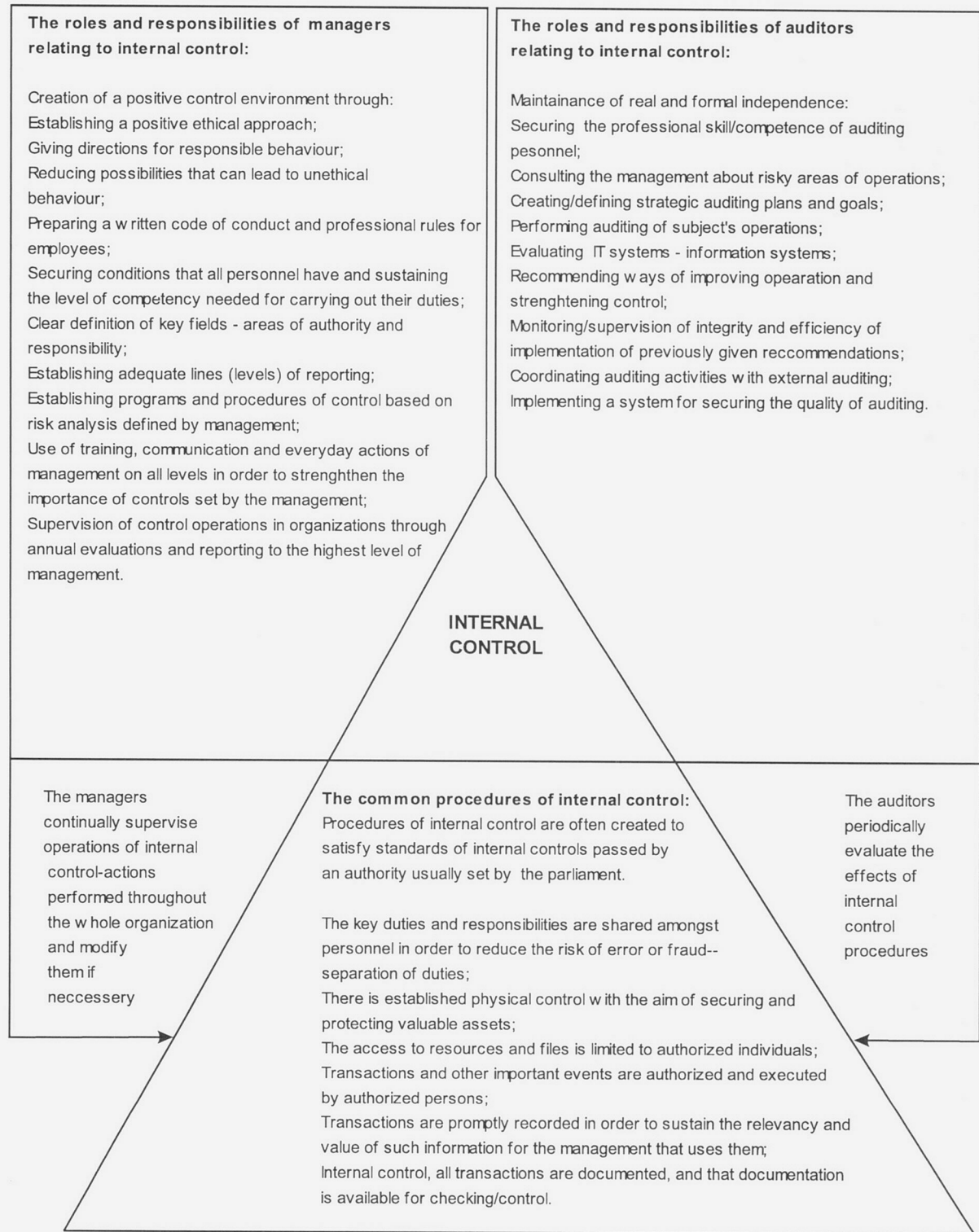
Even though in BiH there are still some gaps in the law with regard to budget users and the establishment of internal control and internal auditing, every integration of internal supervision into the budget system is needed and every step in that direction is valuable. Nevertheless, it is also a fact that the system of internal supervision is not applicable in BiH in the amount and the quality needed and expected. This is confirmed by external auditing findings of the Office of Budget Auditing on the level of the Federation, and on the state level of BiH.

The importance and the need for integration of internal supervision among budget users are best represented in the reports of internal auditors. The list of weaknesses and deviations in business resulted from either the nonexistence or the shortcomings of internal supervision among budget users, and from its mismanagement. By analyzing the mentioned reports, through a combination of the auditor's expressed opinions and publicly presented findings, it has been found that there are significant faults in the operation of budget users. On these grounds, recommendations were sent in order to eliminate the spotted faults.

It is general remark that *the responsibility of management* in public administration is not at a satisfactory level, primarily in the area of public financial management, which requires the use of necessary measures for overcoming such conditions and improving the work of public administration. It has been revealed through budget auditing that the conclusions of the Parliament of FBiH and BiH and the recommendations of auditing are not followed thoroughly, so the same faults have been detected for several years in a row. Therefore, the management of institutions is not working hard enough on eliminating those faults.

The such example is *the unsatisfactory establishment of an internal control system* as a primary prerequisite for effective financial management, and the introduction of the internal auditing function, even though the Office of Budget Auditing and the Parliament of FBiH and BiH recommended the establishment of an internal control system. In addition to these faults, observed among almost all budget users, there is an evident failure to apply the Law of the Budget and the Law of Budget Execution, mostly in regard to the *unpurposeful spending of budget funds in excess of granted funds*, and the nonexistence of a complete analysis and recommendations for savings in the budget.

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There is also evident *defiance of procedures and timeframes for passing the Budget; unrealistic planning of income and expenses*; not taking measures for securing, collecting, and keeping the public (internal) revenue; irregularities in payments and in the recording of assets; incomplete application of bookkeeping and accounting rules; non-compliance with rules regarding the purchase of goods, services and contracting; untimely assembly and delivery of annual statements, etc.

In all, considering the mentioned problems, it can be said that the business results of budget users are at an undesirable level. It is urgent to adopt the legal framework in BiH, primarily the accounting records and standards, in accordance with internationally accepted standards in the public sector. Special attention must be shifted towards the conclusions of external budget auditors in the FBiH and BiH, *strengthening internal control and internal auditing functions*, with securing the written rules and procedures that all employees among budget users will follow, intended at improving the efficiency of operations, the reliability of financial reporting, and consistency with regulations. The responsibility of the management and others for their work is the key factor of fair and successful business.

This analysis points out the necessity for establishing internal control and internal auditing among budget users as a prerequisite for the selection of adequate and quality management of budget users in the territory of Bosnia and Herzegovina.

4 The economic loss and long-term consequences of non- functioning of internal control and internal auditing systems in BiH – final considerations

The constitutional system of BiH is very complex and inadequate for a market-oriented economy. In such circumstances, it is difficult to control and manage a process at the macro and micro level. Contemporary economic theory and the practice of developed market countries confirm that control is the primary tool for managing all aspects of life. The process of reorganizing the social and economic systems in BiH neglected the control system and its mechanisms. These shortcomings have a direct influence on the social, economic, and even the political development of internal auditing in the economy and the public sector of BiH. The greatest deviations are in the public sector. It must be kept in mind that the public sector spends about 60% of total GDP in BiH. The general conclusion of auditing findings is that the major deviations are in the area of public spending, and they are the result of nonexistence of internal supervision and control. It is similar in the banking and economy sectors. The fact is that the banking sector of BiH has witnessed the largest growth and development. The establishment of internal auditing in the banking sector is defined by system solutions, but its effectiveness is very modest. According to

the report of the National Bank of BiH, in 2003 commercial banks and 1234 ghost companies laundered BAM 1.7 billion. It raises the question of how this is possible if they have installed an internal control and auditing system. If we add the economic sector to this, we can only imagine how big the financial loss is and what the long-term consequences would be for the state of BiH. One possible answer in overcoming this condition is in creating an NGO of auditors at the state level. This should be preceded by a legal framework, obligatory for all sectors that will establish internal supervision, control, and auditing systems. It is then necessary to speed up the creation of such an NGO that will stand up to its mission like those in developed economies.

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