

THE COMPONENT OF CONTROL WITHIN THE FRAMEWORK OF INTERNAL FINANCIAL CONTROL IN PUBLIC SECTOR SUBJECTS AT THE CENTRAL AND LOCAL LEVEL OF RNM

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Abstract

In recent years, there has been growing demand for transparent financial reporting in developing countries, including the Republic of North Macedonia, as well as an accompanying expansion of the responsibilities of financial officers. Every time public sector entities fail in inefficient financial management, there is a call from interested parties to check and strengthen internal control to prevent failure. Large sums of money are lost due to internal control not working effectively. After financial failures, the focus is on strengthening checks and balances on entities to ensure that these failures do not occur again. Then, when discussions began to focus on the nature of internal control in public sector entities, there was a need for the incorporation of factors and processes that contribute to the construction of effective internal control systems, respectively the COSO Integrated Work Framework in the RNM legislation. Therefore, the purpose of this paper is to analyze and compare the performance over the years of the control activity component which is designed in a way to increase the value of the subject and to influence the improvement of financial discipline. The research underscores that without the proper functioning and development of internal controls and effective financial management, an entity cannot successfully achieve its objectives.

Keywords: Internal control, financial management, COSO Framework, public sector, subject.

1. Introduction

The Concept of Internal Public Financial Control (IPFC) has been developed by the European Commission to provide a structured and operational model to assist national governments in redesigning their internal control environments and in particular improving their control system in the public sector, through international standards and the best practices of the European Union.

Internal Public Financial Control is a concept and strategy developed by the European Commission to assist candidate countries in reforming their public internal financial control systems.

The process of strengthening the internal public financial control system by the requirements for the construction of modern internal control systems in the public sector in the Republic of North Macedonia is implemented through the development and application of the principles of decentralized management responsibility (managerial responsibility) and the creation of a functionally independent internal audit. The purpose of this process is to establish a system that guarantees the reasonable use of public funds, as well as the prevention of irregularities, suspicions of fraud, and corruption.

IPFC is a complete and comprehensive system of internal control implemented by the Government of the Republic of North Macedonia or other institutions to which it is delegated, to ensure that financial management and control of budget expenditures are by the existing laws, budget descriptions, and principles of sound financial management, transparency, efficiency, effectiveness, and economy. IPFC covers all measures to

control all income, expenditure, assets, and liabilities. It is internal control in a broad sense that includes functionally independent internal audits.

This concept is important for introducing higher standards of public expenditure control, with a special emphasis on "value for money" (economy, efficiency, and effectiveness) unlike traditional systems, which place more emphasis on the regularity that exists in the states that claim to join the European Union.

The Ministry of Finance of the Republic of North Macedonia is responsible for coordinating the development, establishment, implementation, and maintenance of the internal public financial control system and within the Ministry of Finance, it is the Central Harmonization Unit.

The need for clarification of the factors and processes that combine to build effective internal control systems was recognized in the United States of America by the Sponsoring Committee of Organizations of the Treadway Commission (COSO). In 1992, COSO issued the document *Internal Control – An Integrated Framework of Work*, providing a blueprint for establishing internal controls that promote efficiency, minimize risks, help ensure the reliability of financial statements, and comply with laws and regulations. In the literature, you can see the reference made regarding Enterprise Risk Management (ERM). This terminology is used because COSO has its origins in the private sector, although its analyses and statements have equal application in the public sector. COSO has adopted an approach of analyzing the company's or organization's objectives from a risk-focused perspective; that is, they see a major responsibility of management as being the identification and assessment of risks facing the organization.

One of the early conclusions to emerge from the first meetings of COSO members was that, as a term, "internal control" means different things not only to different organizations but also to different managers within them.

2. Methodology

The control activity represents the policies and procedures introduced as an addition to the control environment and the risk assessment process of the subject, with the help of which the achievement of the defined objectives of the subject can be realistically expected. Therefore, this process serves to ensure reasonableness for the achievement of the subject's objectives regarding the reliability of financial reporting, the effectiveness and efficiency of operations and compliance with laws and regulations in force, and the methods that are applied to the achievement of research results differ from the theoretical character and methods of gathering of facts. For the study, analysis was taken from annual reports on the operation of the internal public financial control system, of the Ministry of Finance of the Republic of North Macedonia. The years of comparison are 2018, 2019, and 2020. In 2018, were presented 131 budget users, in 2019, 141, and 2020, were presented 148 budget users. Also, this study will clarify more concretely the controls divided into two main components, in the written internal procedures and the procedures for implementing additional controls. The method that will be used in this paper is the descriptive method. This methodology will reflect the progress of the component of the control activity in the public sector entities of the local and central level in the Republic of North Macedonia, which is designed in a way to increase the value of the entity which will affect the improvement of its financial discipline.

3. Components of internal control

Financial management and control are implemented based on internationally accepted standards for internal control, which the Republic of North Macedonia has accepted and published in the official gazette (GZRM, 2010, no. 147).

There are different methodologies and approaches to internal control, but the most widely used is the COSO Framework.

The COSO framework is a powerful tool in the sense that it allows the subject to focus on the key structures, values, and processes that together form this concept of internal control, outside of the usual narrow financial focus (Bozhinovska, 2001, p.34).

Internal control consists of five interrelated components. They originate from the way the entity's management conducts operations and are related to the management process.

The five components of internal control according to COSO's definition are:

- **Control environment**

The control environment includes (GZRM, 2010, no.90, article 14): the professional and personal integrity of leaders and employees in the subject, the leader's way of thinking and work style, organizational structure that ensures the division of responsibilities, hierarchy, and clear rules, rights, obligations and level of information, management policies and practices with human resources and the employee competences.

- **Risk assessment**

Risk management includes the verification, assessment, and control of possible events or circumstances that may have a negative impact on the achievement of the entity's goals, to assure that those goals will be realized (GZRM, 2010, no. 90, article 15).

- **Control activities**

Control activities include (GZRM, 2010, no. 90, article 16): procedures for authorization and permission, division of duties in such a way that it will not be allowed that an official person at the same time be responsible for permission, execution, accounting and control, the double signature system, rules for access to tools and information, ex-ante and ex-post financial control, procedures for complete, accurate, precise and up-to-date accounting of all transactions, notification and control of activities, the evaluation of the efficiency and effectiveness of transactions, the procedures for monitoring, the procedures for managing human resources, and the rules for documenting all transactions and activities related to the subject's activities.

- **Information and communication**

Information and communications include verification, collection, and systematization of reliable and secure information, effective horizontal and vertical communication at all levels of the hierarchy, construction of adequate information system, documentation and graphic overview of the system which contains rules for preparation, implementation, carrying, using and archiving documents, documenting all operational processes and transactions. The development of an effective and reliable notification system includes levels and deadlines for notification, reports presented to managers, and forms of notification after discovering errors, irregularities, misuse, fraud, or unintended use of tools (GZRM, 2010, no. .90, article 17).

• Monitoring

Adequate functioning of the system for financial management and control is controlled by monitoring (GZRM, 2010, no. 90, article 18).

If the entity's management assumes that the data used for monitoring is accurate without a basis for that assumption, then there may be errors in the information, leading management to draw incorrect conclusions based on its monitoring activities.

All the components are important; therefore the effectiveness and efficiency of operation of the five components must work to conclude that the internal control is working excellently.

4. Component of controls in central and local level of the public sector subjects of rmv

Control activities have different objectives and are applied at different levels of subject and data processing. They may be included in some segments of the control environment and the risk assessment process of the entity. The Ministry of Finance of the Republic of North Macedonia, based on Article 13 paragraph (2) of the Law on Internal Public Financial Control (GZRM, no. 90/2009), announces the Standards of internal control in the sector public, including Controls which consist of:

Procedures

Separation of dutiesSupervision

Resolving deviations

Continuity of activities

Control strategies

Access to the resourceThe following table will clarify more concretely the controls divided into two main components, in the written internal procedures and the procedures for implementing additional controls:

CONTROL	THE YEAR 2018		THE YEAR 2019		THE YEAR 2020	
	CENTRAL AND LOCAL LEVEL		CENTRAL AND LOCAL LEVEL		CENTRAL AND LOCAL LEVEL	
	131 BUDGET USER		141 BUDGET USER		148 BUDGET USER	
	NR.	%	NR.	%	NR.	%
Written internal procedures (regulations, instructions) which, as a continuation of the acts, regulate these processes in more detail:						
a) the process of preparing and implementing the strategic plan	69	52.8	64	45.5	71	48
b) the process of preparing and implementing the budget request/budget proposal	100	76.3	105	74.5	115	77.7
c) the process of recording business events and transactions	98	74.8	96	68.1	108	73
ç) the process of supplies and agreements	103	78.6	107	75.9	115	77.7
d) the process of managing property - material and non-material means	81	61.8	76	53.9	80	54
d) the process of payment of personal funds	58	44.3	61	43.3	61	41.2
e) the process of returning budget funds spent without justification or wrongly paid	61	46.6	60	42.5	65	43.9
Updating internal procedures	103	78.6	105	74.5	111	75
Ensuring the implementation of the principle of separation of duties by the law and standards, respectively that the same person is not responsible for approval, implementation, accounting, and control	97	74	103	73	108	73
Implementation of additional control of the use of budget funds (for example, on-the-spot control of paid subsidies, grants, aid, various compensations, budget funds transferred to end users, etc.)	77	58.8	82	58.2	87	58.8
The procedure for implementing additional controls is regulated through written procedures	46	35.1	45	31.9	52	35.1

The procedure for implementing additional controls on the use of dedicated budget funds is:						
a) part of the regular work of organizational units in institutions	80	61.1	87	61.7	92	62
b) ad hoc obligation in cases where there is a need for additional controls (for example, in cases of anonymous submissions for possible irregularities in the use of budget funds)	69	52.7	74	52.5	74	50
Written procedures related to the preparation and implementation of strategic plans, preparation, and implementation of the financial plan/budget, supplies, and agreements, and additional and similar controls, contain ordinances on the way of cooperation and activities for second-line budget users	24	18.3	27	19.1	27	18.2
Knowledge of the measure of the budget user of the second line that has regulated control activities in the processes of preparation and realization of financial plans/budgets, supplies and agreements, management with property, and similar.	17	13	20	14.2	20	13.5

Source: Annual report on the operation of the public financial internal control system 2018, 2019 and 2020

Budget users at the central and local level for most important work processes have adopted written rules, namely internal acts (regulations and instructions) which, based on other laws and regulations, regulate in more detail the rules of conduct, define participants, powers, and responsibilities, control activities, including previous and additional controls, and description of forms.

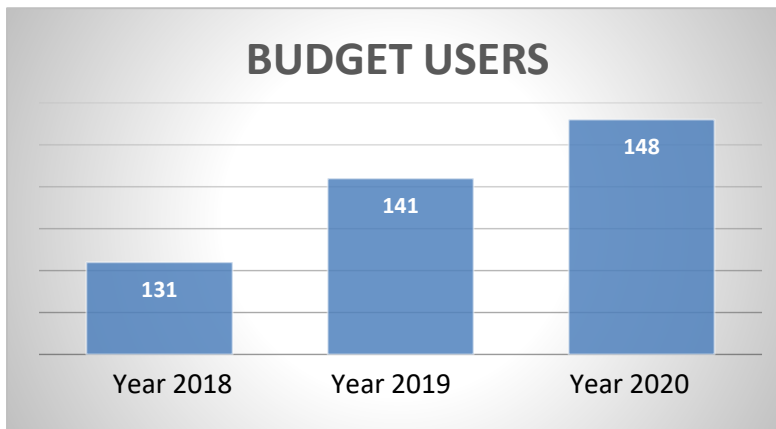


Figure 1. Budget Users (2018-2020)
Source: Author's calculation

Figure number 1 shows graphically the number of budget beneficiaries (local and central-level public sector entities). In 2018, 131 budget users were presented, in 2019, 141, and 2020, we have 148 budget users presented in the graph. It is seen that from year to year, we have an increase in the number of entities that have submitted an annual report for internal financial control to the Ministry of Finance of the Republic of North Macedonia.

The procedures are available to managers and employees, and are updated depending on changes in laws and other regulations on which they are based, changes in the operation of the institution, as well as the results of the external evaluation of the internal control system and the self-evaluation of the internal control system.

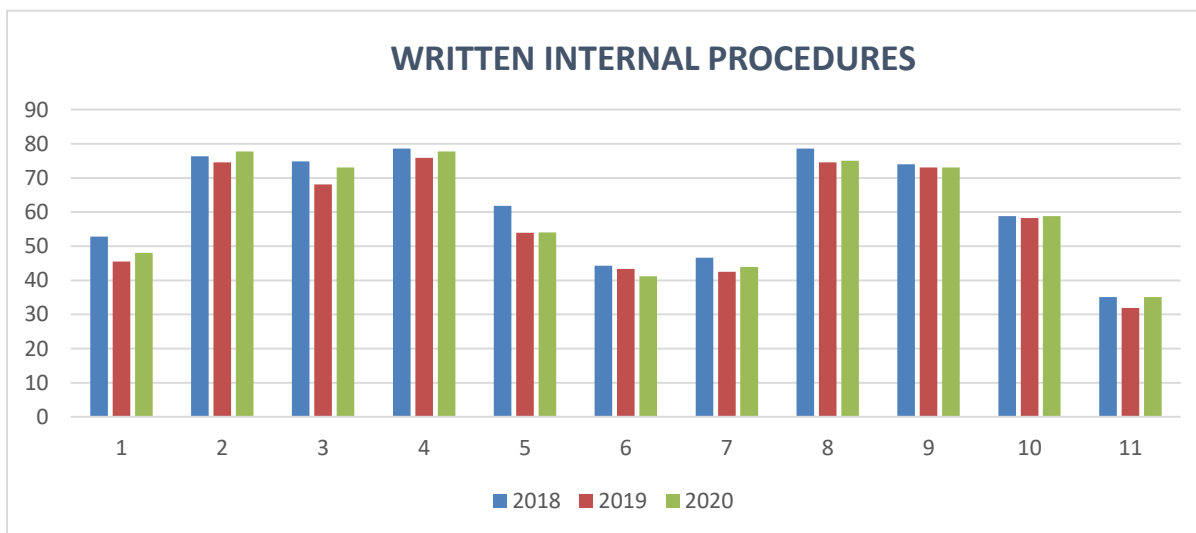


Figure 2. Written internal procedures
Source: Author's calculation

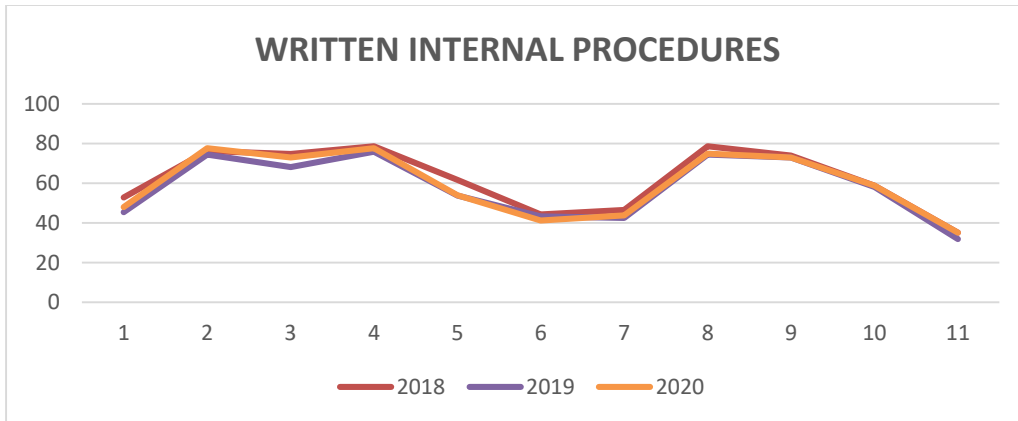


Figure 3. Trajectory of past internal movements
Source: Author's calculation

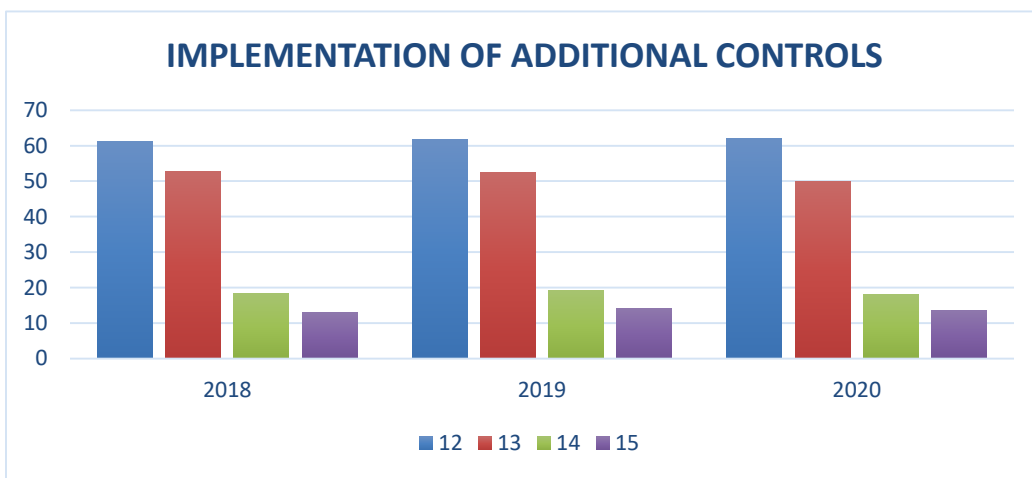


Figure 4. Implementation of additional controls
Source: Author's calculation

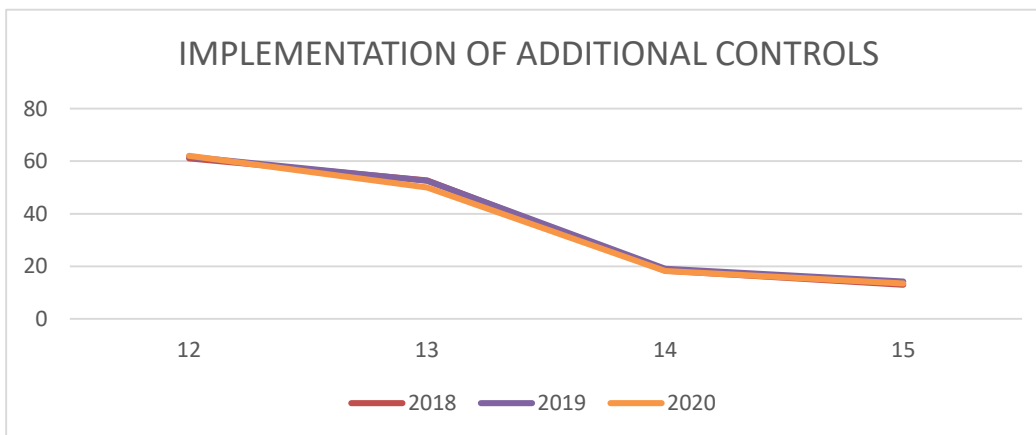


Figure 5. Trajectory of implementation of additional controls
Source: Author's calculation

In these three years, there have been ups and downs regarding the improvement in the regulation part of the procedure for performing additional (ex-post) written checks. If we talk in terms of percentage, then it is presented as follows: in 2018 it was 35.1% with a slight decrease of 31.9% in 2019 and returning to the same situation as in 2018 in 2020 of 35.1%.

Decreases in the three analyzed years were observed in the part of the existence of written internal procedures for the process of:

-the statement of own funds in 2018 with 44.3%, continuing in 2019 with a slight decrease of 43.3% and ending with 2020 with a decrease of 41.2%.

As for the procedure for the implementation of additional controls on the use of budget funds, there were problems in:

-ad hoc obligations in cases where the need for additional controls appears (for example, in cases of anonymous submissions for possible irregularities in the use of budget funds) also in 2018 52.7%, 2019 52.5%, and in 2020 50%.

The average percentage of the three analyzed years is 13.5%. A slight increase was observed in the procedures for the implementation of additional controls on the use of budget funds for the regular work part of organizational units in public sector entities at the central and local level by 61.1% in 2018, 61.7% in 2019, and 62% in 2020.

The majority, about 77% of budget users in the three analyzed years 2018, 2019, and 2020, have written internal procedures in the process of supplies and agreements. The principle of "segregation of duties" is applied mainly in 73% of entities so that no individual is simultaneously responsible for initiating, approving, and recording transactions, paying, reconciling, and reviewing reports. The updating of internal procedures, including regulations and instructions, is carried out in 76% of public sector entities at the central and local levels.

5. Conclusions

The analysis of the data related to the controls shows that, in the three years we have analyzed (including 2018, 2019, and 2020), minimal improvements have been observed in the regular work of the organizational units in the subjects charged with it, as well as the existence of the knowledge to what extent the budget users of the second line have adjusted the control activities in the processes of preparation and realization of finances, plans/budgets, procurement and agreements, property management and similar.

More than half of budget users of central and local level entities have written procedures for key processes in financial management and control. Because of this, there is a need to strengthen the controls of all budget users by improving and updating the approved procedures and the establishment of control activities aimed at the results of operations by the defined goals.

We conclude that if new regulations are drawn up in the public sector entities at the central and local levels, the existing regulations will be changed, competencies will be changed and new technologies will be invested, we will also have an increase in effectiveness and efficiency at work on the part of the employees.

So we conclude that the internal financial control in the public sector can help the subject to ensure:

- compliance with laws, regulations, policies, plans and procedures;
- reliable and comprehensive financial and other information;
- efficient and effective operation and use of resources and
- property protection.

6. Recommendations

The leaders of the subjects constantly monitor the implementation of the work goals and tasks of the employees to ensure the effective and efficient performance of the work, therefore, from this point of view, improvements are needed in the:

- implementation of procedures for monitoring control activities to ensure that controls are carried out as planned and updated by changes in operation and environmental conditions;
- the identification of deficiencies found in controls, namely unwanted events that prevent the realization of the subject's work goals, as well as in the elimination of deficiencies;
- the implementation of additional controls on dedicated payments and the use of donations, transfers, assistance, and subsidies for users, to check whether the allocated funds have been used for the intended purpose, otherwise the return of misused funds is ensured, and
- strengthening additional controls in the form of administrative and inspection controls.

Improvements are needed in assessing the potential impact of introducing new regulations, changing existing regulations, changing competencies, and introducing new technologies. If it is not possible to apply the principle of "segregation of duties" due to the limited number of employees, managers will put in place other measures to reduce the risk that one person will be able to make and cover up mistakes, irregularities, and fraud in the performance of his duties.

Depending on the type of property and information, as well as the assessed risk of possible loss, misuse, and unauthorized alienation, in most cases, restrictions on access to assets and information should be defined, as well as an annual inventory of assets and liabilities. Adequate measures for fire protection and occupational safety must be implemented, replacements must be made in case of temporary absence of workers, and contracted works or other obligations arising from contracts must be performed well. Finally, public sector entities at the central level as well as those at the local level must have written procedures that must be comprehensive, complete, and clear, classified for important activities, and be available for all employees involved. For any important activity and/or event, the entity must ensure the existence of appropriate documentation of the operations.

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