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QUALITY SYSTEM
CONDITION FOR
SUCCESSFUL BUSINESS
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PROCEEDINGS**



**ASSOCIATION
FOR QUALITY AND
STANDARDIZATION
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SYSTEM OF INTERNAL CONTROLS IN THE PUBLIC SECTOR OF THE REPUBLIC OF CROATIA

Assistant prof. Ivana Martinčević¹

Assistant prof. Mirko Smoljić²

Ivana Marijan, bacc.oec.³

Abstract: *The system of internal controls in the public sector is defined as a complete system of controls established by the heads of budget users with the aim of successful management and accomplishment of tasks. Pursuant to the Law on the System of Internal Financial Controls in the public sector, internal audit is part of a comprehensive internal control system, as an independent and objective activity of providing expert opinion and advice with the aim of adding value and improving the business of budget users, and improving the effectiveness of risk management, control and management processes. The system of internal controls in the public sector of the Republic of Croatia is based on the concept of PIFC (Public Internal Financial Control) developed by the European Commission to assist candidate countries in reforming their internal financial control systems. The concept is based on international standards of internal control and practices of European countries. Due to their complexity, internal control systems require monitoring and assessment of their adequacy and functionality through a system self-assessment conducted by management through internal and external audit activities. The self-assessment of the system is important in the process of determining the risks that threaten the achievement of certain goals and enables timely and adequate response and the establishment of certain controls. The system of internal controls is in the function of ensuring proper, legal, economical, efficient and effective management of budget funds, ie good financial management. The aim of this paper is to analyze the system of internal controls of the public sector and to explain and present the process of conducting internal control in the public sector of the Republic of Croatia.*

Keywords: control, internal control, system of internal controls, audit, public sector

JEL Classification M20, M40, M42

1. INTRODUCTION

The system of internal controls in the public sector of the Republic of Croatia is based on the concept of PIFC (Public Internal Financial Control) developed by the European Commission to assist candidate countries in reforming their internal financial control systems. The concept is based on international standards of internal control and practices of European countries. The process of the

¹ Ivana Martinčević, University North, Koprivnica, Croatia, ivana.martincevic@unin.hr

² Mirko Smoljić, University North, Koprivnica, Croatia, mirko.smoljic@unin.hr

³ Ivana Marijan, University North, Koprivnica, Croatia, ivmarijan@unin.hr

internal control system requires constant monitoring and assessment of adequacy and functionality, which is carried out through self-assessment by management, but also by internal and external audit activities. Self-assessment of the internal control system in the public sector is of great importance in order to identify potential risks that may jeopardize the achievement of the set goals. The system of internal controls in the public sector of the Republic of Croatia is accompanied by a statement on fiscal responsibility which confirms that the work of the public sector ensures legal and purposeful use of funds and efficient and effective functioning of the internal control system. In order for the entire system of internal controls in the public sector to function properly and adequately internal audit is responsible, which provides public sector leaders with clear and reliable information on whether the internal control system is established and satisfactory and whether the established controls are implemented and effective. Internal audit also provides recommendations for improving the internal control system. The aim of this paper is to present the system and functioning of the system of internal controls in the public sector of the Republic of Croatia and to present the procedure of performing the internal audit process in the function of quality management.

2. PURPOSE AND CHARACTERISTICS OF THE INTERNAL CONTROL SYSTEM

The system of internal controls is defined according to the Manual on the system of internal controls for budget users (2019) as a set of principles, methods and procedures of internal controls established by the responsible person of the institution for successful management and achievement of general objectives, such as: ethical, economical, efficient and effective manner, compliance of laws and other regulations, protection of funds from losses, abuse and damage, strengthening responsibility for achieving business goals and reliability and comprehensiveness of financial and other reports. The system of internal controls is in the function of ensuring proper, legal, economical, efficient and effective management of budget funds, ie good financial management. The system of internal controls in the public sector of the Republic of Croatia places emphasis and is aimed at monitoring business processes with recording and monitoring of revenues and receipts, expenditures and expenses, tender procedures and contracting, and monitoring of assets and liabilities. In accordance with the mentioned areas and their monitoring, the final consequences of the financial effects of operations, ie undertaken or non-undertaken activities, implemented decisions, implemented investment projects in the public sector are visible. The basic feature of the system of internal controls and good financial management in the public sector of the Republic of Croatia includes managing based on the principle of "value for money", management responsibility at all levels of management and a systematic approach and view of controls. Given that the system of internal controls in the public sector is regulated by the Manual on the system of internal controls for budget users, the manual itself very clearly and precisely emphasizes that the internal control system should be adaptable to changes in the environment and that changes do not require additional budget if the system itself can direct and control the financial effects of business in the function of achieving business goals. „Value for money” management should ensure that quality standards are met in the provision of services to citizens and other activities carried out by institutions and that this is done in an economical, efficient and effective way, ie that as little financial resources as possible are spent, and provide quality service. (Manual on the system of internal controls for budget users, 2019). In order for the public sector to be managed and function according to the principle of "value for money", it is necessary that the business goals be clearly defined as well as the way of their realization with a clear definition of the working group that will work on the realization of goals and performance verification. In order for the defined goals to be successfully realized in the public sector, it is necessary to establish a clear line of authority and responsibility that will be based through transparent and consistent management. „Value for money” management with developed management responsibility at all levels of management requires an adequate system of internal controls. The provision of the Public Sector Internal Control System Act (Official Gazette 78/15) defines the interconnected components that make up the internal control system, namely the control environment, risk management, control activities, information and communication, monitoring and evaluation of the system (table 1).

Table 1. Internal control system components

Internal control system components	Description	Internal control system based on the components of the internal control system
Control environment	"The control environment consists of personal and professional integrity, ethical values of employees and their competence, and way of leadership and management style"	"It focuses on considering whether the mission of the organization is clearly defined and whether there is a vision of business and a planned approach to business, with an analysis of the organizational structure, which includes how to share powers and responsibilities and the reporting line."
Risk management	"Risk management is a complete process of identifying, assessing and monitoring risks, taking into account the objectives of budget users, and taking the necessary measures to reduce risk"	"The internal control system deals with identifying risks that may be a threat to the realization of set goals and taking measures to prevent the activation of risks, or minimize their effects."
Control activities	"Control activities are written rules, procedures and measures established to achieve the objectives by reducing the risk to an acceptable level"	Through the system of internal controls, control activities imply "separation of duties in the part of giving authority for preparation, processing, recording and payment; double signature system; rules that ensure the protection of property and information; procedures for complete, accurate, correct and up-to-date recording of all business transactions; documentation rules and the like "
Information and communication	"An important component of the internal control system is the information and communication system given the importance of business information for management and control functions. "	The system of internal controls requires "effective communication at all levels in the organization, building an appropriate information management system and the establishment and development of an effective, timely and reliable reporting system"

Monitoring and evaluation of the system	"Monitoring and evaluation of the internal control system shall be carried out in order to assess its proper functioning and ensure timely updating. "	"Monitoring and evaluation of the system is performed through continuous monitoring, self-assessment and internal audit. "
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Source: author's according to the Manual on the Internal Control System for Budget Users, 2019., p. 10-11, Croatia

A very important feature of the internal control system is the so-called. systematic approach and view of controls, in which "classic" control activities represent only one of the components of the internal control system" (Manual on the internal control system for budget users, 2019). The system of internal controls of the public sector of the Republic of Croatia in practice integrates different areas of business, so in order to function properly, it is necessary to constantly assess and harmonize with the needs of the system itself.

3. CENTRAL HARMONIZATION UNIT

The Sector for Harmonization of the Development of the Internal Control System (Central Harmonization Unit) is an organizational unit of the Ministry of Finance of the Republic of Croatia, in charge of coordinating the development of the internal control system in the public sector.

Coordination of the development of the system of internal controls in the public sector in the Republic of Croatia includes:⁴

1. "preparation of laws and sub-legal regulations for the development of the internal control system,
2. coordination of the development of the internal control system with the ministries responsible for structural reforms, administrative reforms and other institutions,
3. development of guidelines for the development of the internal control system and methodology of internal audit work,
4. organization of training for managers and persons involved in coordinating of the development of internal control systems and internal auditors,
5. cooperation with professional organizations and other bodies in order to promote the system of internal controls in the public sector,
6. preparation of a consolidated annual report on the system of internal controls in the public sector,
7. keeping the register of internal audit units and the register of certified internal auditors for the public sector,
8. checking the application of the framework for the development of the internal control system in order to adequately monitor the development of budget users and gather information for its improvement".

The central harmonization unit is an organizational unit in the Ministry of Finance of the Republic of Croatia in charge of coordinating PIFC (Public Internal Financial Control) in the public sector of the Republic of Croatia. PIFC introduces a systematic approach to management through: "strategic planning, program planning, risk management, powers and responsibilities for the achievement of objectives and budget management, records and reporting systems, self-assessment of financial management and control systems (Statement of fiscal responsibility, questionnaire for self-assessment of financial systems management and control) and internal audit".⁵ As already mentioned, the system of internal controls in the public sector of the Republic of Croatia is based on the concept of PIFC (Public Internal Financial Control) developed by the European Commission, which

⁴ <https://mfin.gov.hr/istaknute-teme/sredisnja-harmonizacijska-jedinica/107>

⁵ <https://mfin.gov.hr/istaknute-teme/sredisnja-harmonizacijska-jedinica/pifc/219>

continued the further development of this system with the accession of the Republic of Croatia to the European Union. In order to more clearly and better connect the development of the internal control system with the existing Budget Act and the Fiscal Responsibility Act, in 2015. the Public Sector Internal Control System Act was adopted, which regulates the "system of internal controls in the public sector of the Republic of Croatia which is in the function of ensuring the application of the principles of sound financial management and creating preconditions for strengthening fiscal responsibility and internal audit as part of that system which is in the function of independent and objective assessment of internal control and consulting systems in order to improve the institution's operations"⁶. Given the breadth of the area covered by the internal control system, its systematic development requires active cooperation of the Central Harmonization Unit with key actors: with ministries responsible for structural and administrative reforms, with institutions involved in the management and implementation of EU-funded projects and others key participants in the development of this system. Their functioning in practice depends primarily on the budget users themselves, who are responsible for applying and developing certain elements of the system in their daily operations (Manual for Financial Management and Control, 2019). The system of internal controls is being developed for a reason, and that is that public sector institutions improve and improve their business through this system.

4. ROLE AND PURPOSE OF AUDIT IN THE PUBLIC SECTOR

Generally speaking, audit means researching, verifying or examining accounts, financial documentation and checking their accuracy (Crnković, 1997). the word audit itself comes from the latin word "revidere" which means to see again and accordingly audit represents a subsequent review and review of business processes and conditions (Tepšić et al., 1984). The audit includes examination of documents and reports, internal control systems, accounting and financial procedures and other records to determine whether the financial statements present a true financial position and results of financial activities in accordance with accepted accounting principles and standards. The control of the system of internal controls in the public sector of the Republic of Croatia is performed by internal auditors who obtain their certificate for performing internal audit activities in the public sector at the Ministry of Finance of the Republic of Croatia. The control of the system of internal controls in the public sector of the Republic of Croatia is performed by internal auditors who obtain their certificate for performing internal audit activities in the public sector at the Ministry of Finance of the Republic of Croatia, which conducts basic training of internal auditors, but also continuous training of internal auditors who already have the certificate in question. External audit activities under the jurisdiction of the State Audit Office are indispensable procedures in the development and control of the internal control system in the public sector. According to Article 54 of the Constitution of the Republic of Croatia (Official Gazette 85/10), the State Audit Office is the highest audit institution for the public sector of the Republic of Croatia, which is independent in its work. The State Audit Office was established in 1993. under the State Audit Act and began operations in November 1994. The system of internal controls in the public sector is defined as a complete system of controls established by the heads of budget users with the aim of successful management and accomplishment of tasks while their control is performed by the internal audit of the public sector of the Republic of Croatia while the overall oversight of the competence is under the state audit. Pursuant to the Law on the System of Internal Financial Controls in the Public Sector, internal audit is an independent and objective activity of providing expert opinion and advice with the aim of creating added value and improving the operations of budget users and assists the user in achieving objectives by applying a systematic and disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes. In addition to supporting all budget users to achieve budget objectives through the definition and development of strategic and annual plans, public sector internal audit is based on objective risk assessment, evaluates the effectiveness of financial management and control systems to ensure reliable information and business efficiency.

⁶ Ibidem

5. PLANNING AND PROCESS OF PERFORMING INTERNAL AUDIT IN THE PUBLIC SECTOR OF REPUBLIC OF CROATIA

Internal audit planning is a fundamental function of the management process for all budget users. The internal audit planning process in the public sector of the Republic of Croatia is carried out at two levels: at the level of the internal audit unit and at the level of the individual audit process. According to the Manual for Internal Auditors (2019), audit planning implies the development of strategic and annual internal audit plans, and planning at the level of the individual audit process implies the development of the Individual Audit Plan and Program. The link between them stems from the fact that strategic and annual plans form the basis for the development of individual audit plans. The planning of the internal audit process, as already mentioned, implies the definition of a strategic and annual internal audit plan, which is based on the risk assessment of the relevant business unit. The mentioned strategic plan is reviewed and adjusted every year in order to give a clear picture of business and to reflect significant changes in the goals, priorities and activities of the institution and institutions within its competence and the results of the risk assessment. The strategic and annual internal audit plan is proposed by the head of internal audit and adopted by the responsible person of the institution. The annual internal audit plan should clearly and logically explain the connection with the strategic internal audit plan on the basis of which it is adopted. Using defined strategic goals, internal auditors analyze programs and assess the significance of each individual program in relation to the achievement of strategic goals. When conducting the internal audit procedure, the internal auditors determine the objectives for the three-year period, ie define in which way and in which areas the internal audit unit plans to contribute to the improvement of the business system. It is also necessary to identify key areas of audit by assessing their significance. In order to assess the significance of the selected key areas, it is necessary to determine the categories by which the significance is considered and their method of evaluation. Furthermore, by defining potential ie. key audit areas, internal auditors also identify risk factors and assess the effects and likelihood of risks. Risk identification means identifying events or problems that may arise and affect the implementation of goals, priorities, functional activities, the implementation of programs, projects and the like. The strategic and annual plan when planning the internal audit process are the key and starting points for the planning itself and later the implementation of internal audit. The strategic plan sets out the objectives of the internal audit and the strategic direction for the internal audit unit in terms of resources and its future development, and it is submitted to the Central Harmonization Unit of the Ministry of Finance of the Republic of Croatia. The annual plan, on the other hand, implies and contains general and specific objectives and proposes audits to be performed in the next year, and is prepared by the head of the internal audit unit on the basis of the strategic plan. The process of performing internal audit is a systematic process that is manifested through organized and purposeful planning, performance and reporting of work results. The task of internal audit is to assess internal controls and provide an independent and objective expert opinion on their adequacy, application and effectiveness. Internal audit assesses the established system of internal controls and depending on the results of the assessment, recommendations for improvement are given. The internal control process consists of the following methodology: preparatory activities and preliminary risk assessment, assessment of the internal control system, reporting on results, monitoring the implementation of recommendations (table 2).

Table 2 . Methodology of performing individual internal audit

Methodology of performing individual internal audit	Description	Phase/Activities
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Preparatory activities and preliminary risk assessment	"It is carried out to collect information on the area / process / activities to be audited and to gather information on the basis of which a preliminary risk assessment is carried out, the objectives and scope of individual internal audit and the program of individual internal audit are determined"	<ol style="list-style-type: none"> 1. Collecting information on the area / process / activity being audited 2. Preliminary risk assessment 3. Development of a plan and program for performing individual internal audit
Assessment of the internal control system	"It is carried out in order to collect audit evidence on the basis of which internal auditors determine the actual situation in the area / process / activity being audited, determine the causes of deviations from the actual situation, ie the causes of identified deficiencies, weaknesses and / or problems	<ol style="list-style-type: none"> 1. Conducting audit procedures 2. Formulation of draft audit findings, opinions and recommendations
Reporting on results	"The purpose of the reporting phase is to communicate the results of the individual internal audit to the audited entities and management, ie the responsible person of the institution and other interested organizational units in the institution"	<ol style="list-style-type: none"> 1. Drafting an audit report 2. Coordinating the draft audit report with the audited entities 3. Preparation of the final audit report 4. Distribution of the final audit report
Monitoring the implementation of recommendations	"Monitoring for the purpose of gathering information on whether the activities for the implementation of recommendations are carried out in accordance with the established deadlines and on the basis of which the internal audit can measure its added value"	

Source: author's, according to the Manual for Internal Auditors, p.33 - 45, 2019, Croatia

The Head of the Internal Audit Unit is responsible for monitoring the entire internal audit process in order to ensure efficiency in the allocation and use of resources and consistency with audit objectives and scope. Irregularities and fraud have a negative impact on the work of all bodies, and internal auditors have an important role to play in preventing and detecting irregularities in the conduct of internal audit.

6. CONCLUSION

The presented system of internal controls in the public sector of the Republic of Croatia is based on the concept of PIFC (Public Internal Financial Control) developed by the European Commission to assist candidate countries in reforming their internal financial control systems. The system of internal controls is in function and organized with the aim of successful and quality management and to achieve the set goals and tasks of the public sector. In order for the internal control system itself to function in an adequate and proper manner, and whether the established controls are implemented and whether they are effective, internal audit is in charge. Internal audit is an independent and objective activity that provides expert opinion and advice on the functioning of the internal control system in the public sector of Republic of Croatia and contributes to the creation of added value and business improvement. System of internal controls and internal audit in the Republic of Croatia is strictly regulated through a number of laws, regulations, procedures, manuals that regulate this area of activity. The functioning of the internal control system in the form of a report is submitted to the Government of the Republic of Croatia with the purpose of comprehensive review of the level of development and to determine activities for further development of the internal control system and internal audit. A well-organized and set up system of internal controls leads to the quality functioning of the public sector, which ultimately leads to successful and transparent operations, achievement of goals and plans and leads to quality planning and realization of the public sector budget of the Republic of Croatia.

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а) Управљање квалитетом -- Зборници

б) Менаџмент -- Зборници

в) Управљање ризиком -- Зборници

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