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THE ROLE OF INTERNAL AUDIT IN IMPROVING FINANCIAL MANAGEMENT AND CONTROL IN THE PUBLIC SECTOR REPUBLIC OF SRPSKA

Summary: *The aim of this study is to analyse the efficiency of the use of public funds by budget users in the Republic of Srpska. The hypothesis tested in the research is that internal audit, as one of the three elements in the system of internal financial controls in the public sector, is a key element of successful management and realization of budget users' tasks in a public, economical, efficient and effective way. The study identifies many of factors that may affect the increase in the quality of business of entities from the public sector of the Republic of Srpska.*

In addition, the research confirmed the hypothesis that the role of internal audit is crucial in terms of financial management and control systems, in assessing the most risky areas, defining control objectives, defining and implementing system review programs in the highest risk areas, and making recommendations to improve controls there where necessary. Bosnia and Herzegovina, a candidate country for membership in the European Union, has begun activities to establish and develop internal audit in accordance with the concept of the system of public internal financial control in the public sector - PIFC (Public internal financial control), developed by the European Commission. In the last few years, there has been an intensive development of internal audit, and efficient public administration has a key role in the European integration process.

The paper is based on publicly available literature, primarily legal and other regulations governing the field of financial management and control and internal audit, using data and information obtained from the Central Unit for Harmonization of Financial Management and Control and Internal Audit and taking into account the requirements of International Standards for professional internal audit practice.

Key words: *public sector, financial management and control, internal audit, risk management*

JEL classification: *H83*

INTRODUCTION

One of the prerequisite for Bosnia and Herzegovina's accession to the European Union (EU) is the obligation from the Stabilization and Association Agreement, which implies the establishment of a system of internal financial controls based on internationally recognized standards of governance and control (Chow and Pontoppidan 2019). Negotiating Chapter 32 - Financial Supervision is of great importance for BiH, which covers the four most important areas: public internal financial control, external audit, protection of the EU's financial interests and protection of the euro against

counterfeiting. The Public Administration Reform Strategy and the accompanying Action Plan adopted by the Government of the Republic of Srpska state the obligation to establish a system of internal financial controls in the public sector of the Republic of Srpska in accordance with internationally recognized standards of financial management and control (hereinafter: FMC). Public administration reform has a key role in the process of European integration, but in addition, the main reason for public administration reform is the responsibility and cost efficiency of the civil service (Vivian and Maroun 2018).. Given that BiH is on the path to joining the EU, and that the EU has expressed demands for transparency and accountability for part of the spent public funds, the need has arisen for the introduction of public financial control in the public sector. The primary regulation governing the FMC in the Republic of Srpska is the Law on the System of Internal Financial Controls in the Public Sector of the Republic of Srpska (hereinafter: the Law). All budget organizations are expected to implement the PIFC, and the Central Unit for Harmonization of Financial Management and Control and Internal Audit (RS Ministry of Finance) is the institution responsible for drafting methodological guidelines and coordinating the development of the PIFC in the public sector of the Republic of Srpska.

The subject of this study is the research of the role of internal audit in the public sector of the Republic of Srpska, defining the role and importance of internal audit in the FMC system, risk management in the public sector and the contribution to the effectiveness of this process. One of the basic tasks of internal audit is to assist (advise) management in achieving its objectives, providing a systematic and disciplined approach to assessing and improving the effectiveness of risk management, controls and management processes. In this way, internal audit becomes an important factor and participant in the overall system and management process.

The aim of this study is to show the role of audit in the FMC system in the public sector of the Republic of Srpska and to point out what effects of the work of internal auditors have contributed to improving the work of the organization.

The aim of the study is to point out that internal audit contributes to better management of the organization through supervision, testing and recommendations.

1. FINANCIAL MANAGEMENT AND CONTROL

The law defined the system of internal financial controls in the public sector of the Republic of Srpska as a system of financial and other controls that includes, in addition to organizational structure and methods and procedures of internal controls, established by a responsible person with the aim of successful management and public, efficient and effective way. The public sector includes users of the budget of the Republic of Srpska, units and users of local self-government funds, as well as extra-budgetary funds, agencies, public companies, institutions and organizations in which the Republic of Srpska is the majority owner (hereinafter: entities).

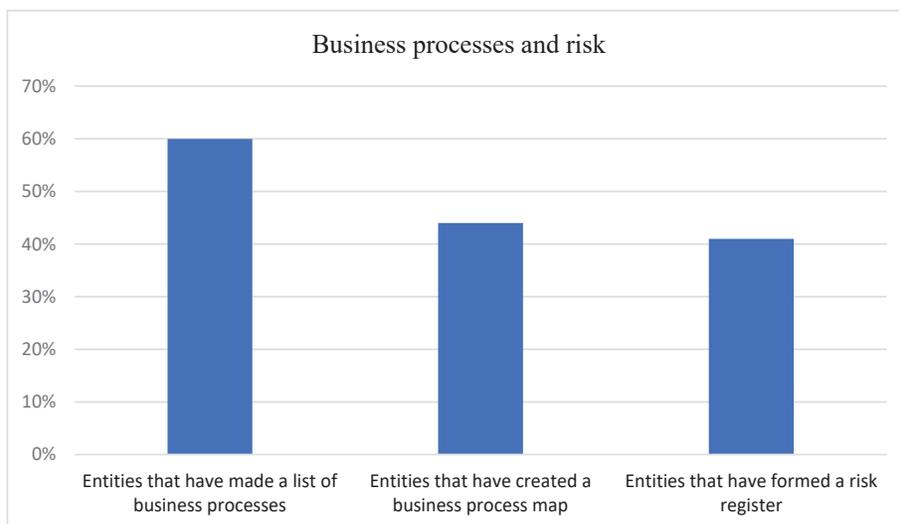
The system of internal financial controls in the public sector of the Republic of Srpska consists of FMC, internal audit and the Central Unit for Harmonization of Financial Management and Control and Internal Audit (CHU).

The establishment of the FMC system is mandatory for all public sector entities and at all levels within the entity, regardless of their size and number of employees.

Activities on the establishment and development of FMC in the public sector of the Republic of Srpska are carried out systematically, primarily through the development of relevant regulations that define the methodological framework and organization of training by the CHU.

The head of the entity establishes the FMC through acts and procedures and is responsible for their proper and efficient functioning. The established FMC enables the fulfilment of the entity's goals in an efficient, effective and economical way on the one hand, as well as to ensure compliance with relevant laws, bylaws and internal acts during the implementation of daily activities in achieving the defined goals.

According to the Annual Report on the Establishment and Development of Internal Financial Control in the Public Sector of the Republic of Srpska as of December 31, 2020. (CJH 2021), in the Republic of Srpska there are over 1,000 public sector entities that are obliged to establish a system of financial management and control in accordance with the Law. By the end of 2020, a person responsible for FMC was appointed in 320 entities, and 227 entities submitted a Report on the implementation of planned activities on the establishment and development of financial management and control systems. An overview of public sector entities that conducted a list of business processes, developed a business process map and formed a risk register, according to the submitted reports of the CHU, is given in Graph 1.



Graph 1. Records of business processes and risk register (Authors, CJH data 2021)

In the case of entities that have formed a register of risks, the risks are mostly determined at the level of key business processes (58%), followed by the level of operational objectives (57%). Also, a small number (33%) of the aforementioned entities that submitted the report underwent internal audit, given that in most of them there is no internal audit unit (entities do not meet the law criteria for establishing it).

With the increase of public awareness, the need for the management of public goods increases, and managerial responsibility is becoming more and more evident and significant. A key role in the European integration process is played by efficient public administration, which should enable successful negotiations with the EU. Managers of public funds beneficiaries are directly responsible for defining goals, implementing strategic plans, managing risks, respecting legality, regularity as well as efficient and effective management of public funds, establishing conditions for legal and ethical behaviour of employees, adopting internal acts for establishing and developing FMC and others. Management responsibility refers to the head of the entity, but by delegating authority, the responsibility is transferred to lower managers and employees. This is achieved by concretizing the tasks in the defined processes, in a way that it is clear who controls what, on what basis and within what deadlines, how the implemented controls are proved, etc.

The most important segment of FMC are business processes, as a key prerequisite for determining the risk of the entity and compiling a risk register. The process of establishing FMC begins with listing (mapping) business processes. Business processes are determined and listed primarily at the level of organizational units, and then the course of the process is prepared with the employees

who participate in the processes. Business processes are already present within the business system of the entity because on the basis of them everyday activities take place, but they are invisible if they are not listed, i.e. they take place according to unwritten rules and they are not always easy to recognize. When mapping processes, a process flow diagram is created showing inputs, tasks, and activities in the appropriate order. Folders and flow charts help make the business process visible, and contribute to better understanding and communication among employees.

If the processes in the entity are not listed or prescribed adequately, the possibility of arbitrariness in the work process increases, i.e. the terrain is created for various types of abuse that can have a negative impact on the business and goals of the entity. One of the most important principles for the establishment of FMC is the definition and precise division of functions, tasks, duties and responsibilities. Public sector entities are considered regulated if there are procedures and rules in each process and sub-process of their functioning. The business process is a general, comprehensive part of a particular action, and the procedure is the steps and manner of action within the process.

After identifying the business processes, the procedures for the listed processes are developed with the application of the COSO framework (control environment, risk assessment, control activities, monitoring and control and information and communication). The COSO framework is aimed at including FMC in the management process and is a generally accepted system of internal controls, ie good practice of internal control.

A very important feature of the FMC system is that it extends throughout the entire public sector organization and affects all its aspects - all employees, activities, processes, etc. Also, the FMC system is primarily a system of preventive nature, because during the implementation of certain activities, omissions can be noticed and appropriate measures can be taken to prevent their further effect and reduce potentially negative consequences. The quality of the FMC system primarily depends on the general attitude of the entity's management towards the existence and observance of clear business rules.

In order to realize the full benefits from the establishment of FMC, it is necessary to ensure that the implementation of the system does not end with formal compliance with relevant regulations, but to ensure continuous implementation as designed, and to adapt to risks and changes.

An efficient system of internal control implies continuous monitoring of the achieved level of development of the FMC system in institutions, through the prescribed forms (semi-annual and annual) of reports (Santis and Grossi and Bisogno 2018).. A system of complete, timely and reliable reporting on the efficiency and effectiveness of the established FMC system should result in improving the quality of work of public sector entities.

2. ROLE AND SIGNIFICANCE OF INTERNAL AUDIT IN THE PUBLIC SECTOR

Internal audit is one of the three components of the system of internal financial controls in the public sector of the Republic of Srpska, the implementation of which should provide supervision over the transparency of the use of public funds and the efficiency of public administration. According to the Law, internal audit is an independent, objective assurance and consulting activity created with the aim of adding value and improving the business of the entity. It helps the entity achieve its objectives by providing a systematic and disciplined approach to assessing and improving the effectiveness of risk management, controls and governance processes. The aim of the internal audit is to provide the head of the public sector entity of the Republic of Srpska with objective assurance and advice that will help him in the efficient execution of his duties, while checking whether the established management and control mechanism is economical and efficient, and consistent with objectives. entity, making recommendations regarding the activities to be audited. Internal audit performs ex-post review (supervision), primarily the functioning of the FMC system and the implementation of the entity's operations in accordance with the adopted objectives.

In the Republic of Srpska, entities organize an internal audit unit with at least two employed internal auditors, which includes those internal auditors who are in training, and the manner of organization is prescribed by law.

Over time, internal audit has developed into a highly professional advisory function whose field of work is intensively developing - from the evaluation of accounting and financial reports to the verification and evaluation of economy, effectiveness and efficiency of the entire business process. Based on the above, internal audit in theory and practice is said to have the characteristics of "3 E" (economy, effectiveness and efficiency). Internal audit should include examining and evaluating the adequacy and effectiveness of the FMC system in order to improve the entity's operations.

The entity's management has an obligation to assess risks and establish effective controls in order to achieve the set / defined goals and reduce business risk (Dashkeev and Turnovsky 2018). In their oversight function, public sector internal auditors assess and report on the success of these efforts. Internal auditors carry out activities in a systematic and objective manner in order to gain a detailed understanding of the nature of the business process and draw conclusions based on the evidence gathered. This approach enables internal auditors to gain an objective picture of problems, resources, roles and responsibilities, as well as to transfer this knowledge in the form of findings, conclusions and recommendations, thus encouraging stakeholders to look at their activities, processes and problems from a new angle. In this way, internal auditors contribute to increasing the success of business processes that are subject to audit and at the same time increase the ability of the entity to more successfully solve similar problems.

The head of the entity is responsible for establishing a functional and independent internal audit as an important element of the internal financial control system.

Internal auditors also help the entity to look at things in advance, by recognizing trends and pointing out upcoming challenges, before problems arise. They need to recognize the risks and opportunities that arise as a result of the rapid development of science and technology and the complexity of today's society.

According to the Law, internal audit activities include five phases, namely: risk assessment, audit planning, audit performance, reporting and monitoring the implementation of given recommendations.

Given the limited human resources in internal audit units, it is common for audit engagements to be based on risk assessment in the entity's most critical areas of business, which allows them to help the entity reduce their impact or better assess acceptable risk. Risk has always been a reality of every business entity's business. Risk-based internal audit provides useful and valuable information that enables the entity to better manage its risks. Assessing the effectiveness of a risk management system is a very complex activity, which requires significant knowledge and skills from internal auditors, especially in the circumstances of a great lack of literature, guidelines and instructions in the subject area. In carrying out these activities, it is very important to take care to provide the independence and objectivity of internal auditors. The ultimate responsibility for risk management rests with the entity's manager, and internal audit should be actively involved in this process through the monitoring and evaluation of the risk management system, as it can significantly contribute to its improvement. The role of internal audit in the risk management process depends on many of factors such as the size of the entity, risk profile, training of internal auditors and others.

The activity of the internal auditor is not limited, as is often thought, to identifying problems in the business of the entity, but also to continuously finding new solutions and proposing them to the head of the entity.

When checking the reliability of available, available documentation, internal auditors evaluate the policy, procedures, authorities, quality of decision-making and management, quality of methodologies and procedures, individual phases of the entity's operations, etc. In this way, verified

and verified information makes business decisions more reliable, secure and faster, because the same is based on information verified by professional, objective and independent persons (employees).

Also, internal audit investigates and analyses plans, programs, policies and procedures in order to more objectively assess planning at the level of the entity and its organizational units, especially in terms of assessing the possibility of achieving goals and the adequacy of organizational solutions that should ensure their achievement. At the same time, the task of internal audit is to critically monitor the implementation of overall and individual plans, and inform the head of the entity about deviations from standards and planned objectives, and to make recommendations regarding possible corrective actions to eliminate or reduce deviations (DeFond and Zhang 2014).

Internal audit reporting involves compiling reports on the conducted audit and is the crown of the effort made in planning the audit and performing audit engagements. Reporting on the results of the performed internal audit is regulated by the International Standards for the Professional Practice of Internal Auditing (hereinafter: International Standards), namely: Standard 2400 - Communication of Results, Standard 2410 - Reporting Criteria and Standard 2420 - Quality of Reporting. Reports must include the objectives, coverage and results of the engagement. Also, internal audit reports must be accurate, objective, clear, concise, constructive, complete and timely, ie given at the right time in accordance with the importance of the covered issues in order to enable the management to take appropriate corrective actions (Chychyla and Leone and Minutti 2019).

Internal audit should, in parallel with the increasingly complex requirements for business decision-making in modern conditions, continuously develop new approaches in the implementation of the activities of internal auditors. Internal audit should be aimed at assessing potential risks in certain areas of business and advising the head of the entity on the possibilities of managing the identified risks, ie. creating and monitoring an appropriate system of internal controls that will effectively reduce these risks. The subject of internal auditors' scrutiny should be the overall future-oriented business.

It is very important that the internal audit establishes cooperation and trust with the head of the entity and the audited entities, because only in that way can it justify its existence.

3. DIRECTIONS OF INTERNAL AUDIT DEVELOPMENT

In the early 2000s, the United States was rocked by corporate scandals due to inaccurately presented information and falsified financial reports, and internal control was treated primarily as a mechanism to prevent errors, fraud and theft. Unlike the US, EU countries advocate a principles-based approach to internal control. Unlike the American approach, which views internal control only from the aspect of financial reporting, the European approach is much broader and includes risk management, as one of the more effective elements of financial reporting.

Coordination of the establishment and development of the system of internal financial controls in the public sector of the Republic of Srpska is the responsibility of the CHU.

It is crucial for internal audit in the public sector of the Republic of Srpska in the coming period to gain reputation and trust, and this can only be achieved by achieving and maintaining a high level of expertise, objectivity and independence of internal auditors in the entity. Only in this way can internal auditors provide support and assistance to the head of the entity in risk management and the creation and maintenance of the entire system of internal controls (Abernathy and Kubick and Masli 2019).

Internal audit units should formulate an internal audit charter issued by the head of the entity, which regulates the general approach of internal audit, purpose and goal of audit, independence, role and scope of internal audit, responsibility of the head of internal audit unit, access to documentation, personnel and physical assets relevant to the performance of audit activities, etc.

Internal auditors must be well acquainted with the entire business of the entity and its system of internal controls (Steccolini 2019). Therefore, it is very important in the coming period to take care of the continuous professional development of internal auditors to improve their knowledge, skills and other abilities, and in accordance with International Standard 1230 - Continuing Professional Development.

In addition to general and special audit knowledge, for the successful functioning of the internal audit unit in the public sector, internal auditors must also have knowledge in the field of accounting and finance, informatics, organization and management, etc. The professional knowledge of internal auditors must be continuously upgraded.

Considering the observed activities of the heads of public sector entities in terms of commitment to achieving set goals, efficient use of resources, ethical behaviour and emphasized responsibility, an environment is created in which internal auditors need to change their approach to their activities, to move from passive auditing to a new proactive approach oriented towards improving the business of the entity and helping the entity to achieve its defined goals (Mattei and Guthrie 2021).

Today, the world has a special emphasis on expectations from internal audit in terms of its active involvement in creating added value of the entity, primarily by generating the information needed to identify, understand, and assess potential risks. The continuous tasks of internal auditors should be to take care of upgrading and maintaining a quality overall system of internal controls as a risk management instrument, and to correct the identified shortcomings and problems in this system in cooperation with the head of the entity.

Internal auditors will continue to act subsequently - assessing the results achieved and errors in order to avoid them in the future, but also preventively - where they will have activities to assist the head of the entity in assessing potential risks and proposing a system of internal financial controls. time to remove (reduce). The subject of the internal auditor's audit will be the entire business of the entity facing the future. The internal auditor's reports are only a means of communication between the internal audit and the audited entity, the head of the entity in which the internal auditor presents audit results and performance assessments of the audited area examined with recommendations of necessary corrective actions. In the future, even more proposals are expected to reduce, mitigate or eliminate risks and assess the functioning of the existing system of internal financial controls (Li et al. 2018).

4. SIGNIFICANCE OF INTERNAL AUDIT FOR FUK

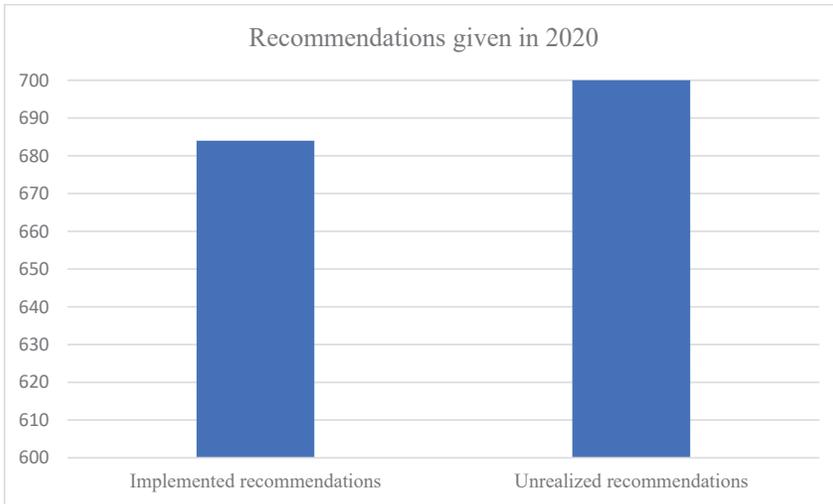
In the public sector entities of the Republic of Srpska, 64 entities established internal audit by organizing a unit or department for internal audit, and 8 entities by systematizing the position - internal auditor without forming a unit or department (CJH 2021).

By establishing internal audit with at least two employed internal auditors, the head of the internal audit unit and the internal auditor, the minimum requirements prescribed by the Law and international principles and standards regarding the functioning of internal audit have been met. At the end of 2020, 42 entities in the Republic of Srpska established internal audit in accordance with regulations, while in 22 entities the internal audit unit operates with less than two employed internal auditors.

Establishing and conducting internal audit with one internal auditor does not enable the realization of functional independence of internal audit, as well as the performance of internal audit work of greater complexity in accordance with international standards.

According to the Annual Report on the Establishment and Development of Internal Financial Control in the Public Sector of the Republic of Srpska as of December 31, 2020. (CJH, 2021), the Annual Report on Internal Audit for 2020 was submitted by 67 entities that planned 465 audits in the observed period. In 2020, a total of 405 audits were performed in which 1,384 recommendations

were given, while the total number of implemented recommendations in the observed year was 684 (49%), which is shown in Graph 2.



Graph 2. Implementation of given internal audit recommendations
(Authors, CJH data 2021)

In entities in which the FMC system is established, internal auditors use, among other things, identified processes and organizational parts of the entity, as well as risk assessment of identified processes, ie organizational parts, when drafting the strategic plan of internal audit. If the entity has established a FMC and a process book with a list and description of the process, the identified risks by process and strategic planning to the internal auditor are significantly simpler.

FMC activities, description of business processes includes identification of basic elements of the process and includes an audit trail from start to finish, employees responsible for implementation, manner and deadlines for implementation of certain processes and activities, etc.

During the audit, during the preliminary planning and determination of the objectives of the process and system, and risk, the work of the internal auditor was significantly facilitated by using a well-established and developed FMC system.

On the other hand, FMC should use internal audit reports, monitor the implementation of recommendations, the response of the control environment, and perform risk assessment and improve internal controls in accordance with the given recommendations.

It means, internal audit and financial management and control (FMC) are two branches of the same tree.

FMC is a combination of procedures established by management that enable the fulfilment of the goals of the entity in an ethical, efficient, effective and economical way on the one hand, and to perform daily activities to achieve defined goals to ensure compliance with legislation, protection of property and resources and reliable reporting from others.

Effective FMC can provide the head of the entity, regardless of the quality of form and manner of establishment, only reasonable, not absolute assurance regarding the fulfilment of the entity's objectives, because FMC depends on human factors and is subject to omissions in defining, establishing, interpreting, understanding, disrespecting or abuse, etc.

The role of internal audit in relation to FMC is to assess the areas most at risk in terms of key control objectives, define and implement a program review of systems in areas of high risk, inform the head of the entity on the adequacy of controls, make recommendations where necessary and monitor implementation of the same (action plan) by the audited entity.

The internal audit approach, which is based on the COSO Internal Control Framework, may result in a comprehensive overview of the overall control system in the entity. With this approach, internal audit contributes to the harmonization of objectives and the most significant risks, which is an important moment in increasing the credibility of internal audit as a profession, as well as its importance for the entity in which it operates. The system is considered effective when it meets the standard of internal control according to the COSO framework. The value that internal audit adds to the entity is expressed through auditing current issues, business processes and making recommendations. The internal audit process provides an opportunity for internal auditors to assist the entity in moving from imperfect to perfect control in a constructive manner, thus contributing to a lasting increase in the well-being of the entity itself.

According to International Standards (Standard 2130 - Control), it is defined that the internal audit activity must assist the organization in maintaining the effectiveness of controls, assessing their effectiveness and efficiency and promoting continuous improvement. Also, the Law prescribes the role and tasks of internal audit, and defines that internal audit is performed in order to provide objective expert opinion and advice on the adequacy of the FMC system in order to improve the business of the entity. However, internal auditors cannot and must not be a substitute for an adequate and strong system of financial management and control. The task of internal auditors is to (not) confirm the adequacy of existing controls and the adequacy of their application.

In practice, it is possible that the audit of a certain process does not reveal even the slightest irregularities in relation to laws, bylaws, internal acts and good practice, although a system of internal controls has not been established and documented, when certain "unwritten rules" are applied. This process is also risky and requires a system of internal controls to ensure compliance with legislation and avoid divergent interpretation and application in practice.

The following seven steps need to be taken to assess the financial management and control system:

1. determine control objectives for the process,
2. determine the expected controls whose effective functioning would contribute to the achievement of objectives,
3. get acquainted with the process,
4. identify and record actual controls,
5. assess, consider the weaknesses and strengths of the system,
6. test controls,
7. draw a conclusion about the controls.

A very important question for the internal auditor is certainly what and how to state in the report, especially when taking into account the large amount of details that were obtained during the implementation of the internal audit process (Beromeu and Magee 2015) . The COSO framework implies that all deficiencies should be identified and presented, and that even the smallest errors should be investigated to see what caused them. All identified shortcomings of the FMC that may affect the realization of any of the objectives of the entity, should be informed to the authorities who can take appropriate steps.

CONCLUSION

The research confirmed the hypothesis that internal audit, as one of the three elements in the system of internal financial controls in the public sector of the Republic of Srpska, is a key element of successful management and accomplishment of budget users in a public, economical, efficient and effective way.

Also, the research results showed that internal audit in the public sector of the Republic of Srpska is still not sufficiently recognized by managers as a mechanism by which to influence more transparent, efficient, effective and economical use of public funds and creating added value.

Executives are still unaware of the role and importance of internal audit in the public sector, or for some reason do not want to be aware of it.

One of the goals of the paper was to determine the degree of establishment of internal audit units in entities that have the obligation to establish it - the research showed that the current situation regarding the establishment of functional and independent internal audit is not at an enviable level. Establishing an adequate FMC system and implementing the recommendations given by internal auditors can contribute to savings and improvements in the spending of public funds and directly add value to the business of each budget user. Also, the FMC system needs to be continuously monitored in order to assess the effectiveness of its operation and timely update, to ensure that controls operate in accordance with the plan and change in accordance with changes in business and the environment.

This research confirmed that internal audit in the public sector of the Republic of Srpska still does not have the power to significantly affect the efficiency of public funds use by budget users, and pointed out the need for the state to pay special attention to the benefits of internal audit in increasing business quality.

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