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Review

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THE ROLE OF INTERNAL FINANCIAL CONTROL SYSTEMS IN THE EFFICIENT USE OF BUDGETARY FUNDS IN THE PUBLIC SECTOR

Abstract: *The system of internal financial controls in the public sector of the Republic of Srpska represents a framework of financial and other control mechanisms, encompassing organizational structure, methods, and procedures of internal control established by the responsible official of the entity. Its purpose is to ensure successful management and achievement of the entity's objectives in a transparent, lawful, economical, efficient, and effective manner. A well-designed and properly implemented internal financial control system ensures compliance with the applicable legal framework, which is reflected through the accountable use of entrusted public funds and contributes to efficient and effective reporting. The responsibility for establishing, implementing, and maintaining the internal financial control system lies with the head of the public funds beneficiary, i.e., the highest level of management. The aim of this paper is to highlight the role of internal financial control systems in the efficient utilization of budgetary funds within the public sector. The methods used in the research include the descriptive method and a survey questionnaire. This paper aims to provide a theoretical contribution, expand the existing body of fundamental knowledge in this field, and demonstrate how an established internal financial control system can influence more efficient spending and allocation of financial resources in the public sector.*

Key words: *internal financial control system, budgetary funds, public sector*

JEL Classification: *H61, H83, M40, M49*

INTRODUCTION

The obligation to establish and develop a system of internal financial controls (PIFC – Public Internal Financial Control, hereinafter: PIFC) in the public sector of the Republic of Srpska (hereinafter: RS) arises from the signed Stabilization and Association Agreement. It represents one of the areas requiring alignment of legal regulations under Chapter 32 – Financial Control, within the accession negotiation process between Bosnia and Herzegovina and the European Union. To this end, the PIFC Strategy follows the recommendations of the competent bodies of the European Commission. The European Commission aims to guide all potential member states toward developing internal controls not only for the use of their own resources but also to establish a control environment that ensures the purposeful spending of EU funds. The public sector plays a significant role in the economic structures of most countries worldwide and directly influences the social and economic development of a state. It determines the success of

every development plan. The development of the public sector began in the 18th and 19th centuries when the state assumed responsibility for meeting the needs of the wider social community, which the private sector was unable to fulfill. The public sector can also be defined as a system of activities governed by the state through laws, rules, and procedures, which elaborate constitutional freedoms and rights of citizens, as well as public interests. According to the OECD Glossary of Statistical Terms, the public sector encompasses the general government sector plus all public enterprises, including central banks.

The system of internal financial controls is centered on improving transparency, financial discipline, and the purposeful use of public funds—that is, the transparent, economical, efficient, and effective management and control of public resources. The topic of this paper is “The Role of Internal Financial Control Systems in the Efficient Use of Budgetary Funds in the Public Sector.” Through conducted research, the paper will examine whether this system influences the efficient spending of budgetary funds in the public sector. The development of internal financial control systems creates the conditions necessary for achieving the objectives of public fund beneficiaries efficiently, thereby contributing to increased efficiency, effectiveness, and economy within the overall fiscal system. The internal financial control system constitutes a comprehensive framework that includes a range of financial and non-financial controls. These incorporate organizational structures, methods, and procedures that extend beyond purely financial areas and apply to all operational and strategic segments within public sector entities. This framework creates the necessary preconditions for public fund users to achieve their defined objectives, primarily related to meeting public needs (Romić et al., 2017, p. 79). By building such a system on stable foundations, the conditions are established for the rational use of public funds and increased productivity of public sector entities. The participation of the public sector in the overall economic system is highly significant, as this sector concentrates substantial resources and represents the largest employer.

1. EVOLUTION OF THE INTERNAL FINANCIAL CONTROL SYSTEM IN THE PUBLIC SECTOR OF THE REPUBLIC OF SRPSKA

Bosnia and Herzegovina, a candidate country for membership in the European Union, has initiated activities aimed at establishing and developing internal auditing in accordance with the concept of the Public Internal Financial Control (PIFC) system in the public sector, as developed by the European Commission. In recent years, there has been a noticeable intensification in the development of internal financial controls, while an efficient public administration plays a key role in the process of European integration. One of the prerequisites for Bosnia and Herzegovina’s accession to the European Union (EU) is the fulfillment of obligations arising from the Stabilization and Association Agreement, which includes the establishment of an internal financial control system based on internationally recognized standards of financial management and control (Chow & Pontoppidan, 2019, p. 287).

In 2016, the Law on the System of Internal Financial Controls in the Public Sector of the Republic of Srpska entered into force, as published in the “Official Gazette of RS,” No. 91/16. The law defined the internal financial control system in the public sector of the Republic of Srpska as a system of financial and other controls, which, in addition to the organizational structure, includes the methods and procedures of internal control. These are established by the responsible official with the aim of successful management and achievement of defined objectives in a transparent, lawful, economical, efficient, and effective manner (Rakonjac, Babić & Mičić, 2022, p. 208).

The public sector of the Republic of Srpska includes the following organizations: beneficiaries of the Republic of Srpska’s funds, local self-government units and beneficiaries of local government budgetary funds, off-budget funds, agencies and other institutions, public

enterprises, institutions, and organizations in which the Republic of Srpska holds a majority ownership stake.

The Institute of Internal Auditors defines the public sector as consisting of governments and all publicly controlled or publicly funded agencies, enterprises, and other entities that provide programs, goods, and/or services established through public policy and legislation to serve the public good, which is their overarching purpose. A key characteristic distinguishing public sector organizations is that they have a mandate to serve, protect, and promote the public good rather than generate profit, as is the case in the private sector (Novaković, Milovanović & Gligorić, 2022, p. 57).

The system of internal financial controls in the public sector consists of:

- 1) Financial Management and Control,
- 2) Internal Audit, and
- 3) The Central Harmonization Unit for Financial Management and Control and Internal Audit, established within the Ministry of Finance (hereinafter: the Central Unit), (Law on the System of Internal Financial Controls in the Public Sector of the Republic of Srpska, 91/16, Article 3).

2. SCOPE AND OBJECTIVES OF THE INTERNAL FINANCIAL CONTROL SYSTEM

In order for the objectives of the internal control system to be achieved, they must be linked to the information circulating within the organization. This pertains to the control of the timely preparation of accurate, reliable, and relevant information presented through various reports to both internal and external users.

Unlike operational and informational objectives, compliance objectives relate to ensuring that the entire operation of the organization complies with relevant laws, regulations, policies, decisions, and other valid internal acts.

The purpose of the internal financial control system in the public sector is reflected in the following:

- Conducting operations in a lawful, ethical, economical, and effective manner;
- Ensuring compliance of operations with laws, regulations, policies, plans, and procedures;
- Protecting assets and other resources from losses caused by poor management of public funds, unjustified and non-transparent spending, as well as safeguarding against irregularities and fraud;
- Strengthening the accountability of managers for the successful achievement of set business objectives;
- Timely and transparent financial reporting, as well as monitoring business performance.

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

Activities related to the establishment and development of the internal financial control system in the public sector of the Republic of Srpska are carried out systematically, primarily through the drafting of relevant regulations that define the methodological framework and through the organization of training by the Central Harmonization Unit for Financial Management and Control.

The head of the entity establishes the internal financial control system through financial management and control and internal audit, supported by adopted acts and procedures, and is responsible for their proper and efficient functioning. The established internal financial control system enables the entity to achieve its objectives in an efficient, effective, and economical manner, while also ensuring that the implementation of daily activities in achieving defined objectives complies with relevant legal, regulatory, and internal acts.

With the increase in public awareness, the need for managing public goods also rises, making managerial responsibility increasingly visible and significant. Efficient public administration plays a key role in the EU integration process, as it must enable successful negotiations with the European Union. Managers of entities using public funds are directly responsible for defining objectives, implementing strategic plans, managing risks, ensuring legality and regularity, as well as for the efficient and effective management of public resources. They are also responsible for establishing conditions for lawful and ethical employee behavior and for adopting internal acts to establish and develop the system of internal financial controls.

Managerial responsibility lies with the head of the entity, but through delegation of authority, responsibility is also transferred to lower-level managers and employees. This is achieved by concretizing tasks within defined processes so that it is clear who controls what, on what basis and within what deadlines, how the performed controls are documented, and so forth.

Operational data serve as a solid foundation for economic decision-making and appropriate actions, both for internal and external information users (Vuković Perduv, Čeklić & Čeklić, 2018, p. 110).

Managers in the public sector who are committed to achieving set goals, efficient resource use, ethical behavior, and pronounced accountability create an environment where the internal financial control system should be applied in the execution of activities. This application implies that internal control manages transition from a conservative, inspector-like, and passive auditing approach to a new proactive approach focused on improving the entity's operations and helping it achieve its defined objectives (Mattei & Guthrie, 2021).

The internal financial control system, implemented through financial management and control and internal audit, acts as an internal "guardian," aiming for the consistent implementation without exception of all defined public regulations and the reduction or mitigation of all risks encountered by public sector entities in their operations. By introducing the internal financial control system, public sector entities strive, through internal discipline, to contribute to strengthening financial stability, which has significant implications for the overall financial stability of the state. The real effects of the internal financial control system in the public sector and the quality of data presented in financial reports, as well as the enhancement of fiscal responsibility, are best demonstrated by the experiences of European countries that have achieved significant savings in public sector existence and attained higher levels of fiscal responsibility through this system (Vuković Perduv, Kremenović, Beke-Trivunac, Vidnjević & Jelić, 2024, p. 125).

3. APPLICATION OF THE INTERNAL FINANCIAL CONTROL SYSTEM IN THE PROCESS OF SPENDING BUDGET FUNDS IN THE PUBLIC SECTOR

The term "budget" refers to the estimation of budgetary revenues and expenditures for a single fiscal year. Budget fund users include government bodies, organizations, and other public sector entities financed from the budgets of the Republic, municipalities, cities, and funds. Budget funds for a fiscal year comprise budget revenues and receipts from non-financial assets, receipts from financial assets and borrowing during the current fiscal year, unspent earmarked funds from budget grants and transfers from previous periods, and surpluses allocated by decisions of the competent authority. Budget funds are utilized to finance the functions of budget users, to carry out their tasks, and for other purposes in accordance with the Constitution, laws, and regulations of local government units and funds. All European Union member states have established internal control systems within the public sector, implemented in accordance with their general legal frameworks and harmonized among legislative, executive authorities, and supreme audit institutions. Although the concept of internal control varies among EU members, there is a shared consensus that such a system contributes to improving operations and successful financial management, ensuring proper, economical, efficient, and effective use of

budgetary, i.e., fundamentally public funds, while protecting the assets and resources of public sector entities. Public administration reform plays a key role in the European integration process. Beyond that, a primary rationale for reforming public administration is enhancing accountability and cost-efficiency in the civil service. Government agencies support accounting systems aligned with conventional accountability principles tailored to jurisdiction-specific requirements (Vivian and Maroun, 2018).

The obligations to establish systems of internal financial controls in all Western Balkan countries were undertaken upon the signing of the Stabilization and Association Agreement (SAA) with the European Union. Bosnia and Herzegovina, in particular, is committed to cooperation in the areas of auditing and financial control, as defined by Article 90 of the Stabilization and Association Agreement. This cooperation is implemented through the establishment of systems for financial management and control and independent internal audit, as well as through the creation and strengthening of Central Harmonization Units and independent external audit systems.

The fundamental regulatory framework for establishing internal financial controls in the public sector is based on the International Standards for the Professional Practice of Internal Auditing (Beke-Trivunac, 2023) and the five components of the widely accepted COSO framework (Committee of Sponsoring Organizations of the Treadway Commission). These components are:

1. Control Environment
2. Risk Management
3. Control Activities
4. Information and Communication
5. Monitoring and Evaluation of the System.

The Control Environment is the standard of internal control and the foundation of the entire system. The internal control system will not be effective or efficient unless the control environment is established in a way that upholds integrity and ethical values—primarily demonstrated through the actions of the entity's management. The leadership sets the tone by establishing behavioral standards through a code of conduct and by promoting ethical values. Another key component of the control environment is the professional competence and expertise of employees, as well as the organizational structure that ensures the achievement of business objectives in alignment with the entity's mission and vision.

Risk Management involves proactively considering potential events that may occur and taking timely measures to minimize risks, thereby reducing adverse effects or consequences that institutions may face in the future. It is a process of identifying, assessing, and monitoring risks, taking into account the strategic objectives of entities as defined in their strategic documents.

Control Activities are the policies, procedures, and actions adopted by the entity's management to achieve organizational objectives while minimizing operational risks. All these policies are documented in the Book of Business Processes, which is aligned with the applicable legal regulations. Control activities are efficient, economical, and functionally linked to planning documents, with the aim of protecting the resources and assets of the public sector entity.

Information and Communication, as the fourth component of the COSO model, represent one of the key elements, as the achievement of an entity's objectives depends heavily on the smooth, timely, accurate, and high-quality flow of information. It is essential that information is accessible and that communication flows in both directions – from employees to management and vice versa.

Monitoring and Evaluation of the System involve activities aimed at assessing the quality of operations within a specific period, as well as determining the effectiveness of the internal control system. All employees within the entity are responsible for this COSO component. If weaknesses or deficiencies are identified, they should inform their superiors about the observed irregularities or shortcomings.

The system of internal financial control in the public sector represents the overall framework of all financial and non-financial controls established by the head of a public sector entity. The purpose of this system is to provide reasonable assurance that public funds are used and managed in accordance with the law, in a transparent, economical, efficient, and effective manner.

Considering the internal financial control system, the fundamental principles underpinning public sector management are accountability and transparency.

In the future, more proposals are expected for reducing, mitigating, or eliminating risks and for evaluating the functioning of the existing internal financial control system. The use of application-level and function-level controls enhances the performance of the internal financial control process (Li et al., 2018, p. 73).

Professional, objective, and independent heads of internal audit and financial management and control coordinators should play one of the very important role in the public sector of the Republic of Srpska in the coming period. They are expected to provide fair and objective support to the head of the entity in identifying irregularities and unlawful activities, as well as in creating and maintaining the overall internal financial control system in the public sector (Abernathy, Kubick & Masli, 2019, p. 4).

4. RESULTS OF THE EMPIRICAL RESEARCH

The information obtained as a result of the empirical research was gathered through a survey questionnaire distributed among internal auditors, financial management and control coordinators, and public sector officials. Most of the questions were of a closed type: direct questions, multiple-choice questions, and intensity-scale questions. The empirical research was conducted using a survey questionnaire designed as a segment of the broader study on the role of the internal financial control system in the process of public budget spending. To achieve the research objectives, data were collected from both primary sources (field research) and secondary sources (desk research). The collection of primary data was carried out through a survey method using a structured questionnaire. A total of 32 respondents from 32 public institutions participated in the research, including:

1. Employees responsible for financial management and control in the public sector who shared their opinions by completing the questionnaire;
2. Internal auditors who filled out the survey and whose views are the subject of analysis;
3. Other public sector officials working in various administrative roles.

The results obtained through the survey are presented in tabular form.

In response to the question: "Do you have experience in performing tasks related to internal financial controls?" The answers are presented in Table 1, providing an overview of the respondents' experience in the field of internal financial controls based on the survey data.

Table 1. Experience in Performing Tasks Related to Internal Financial Controls (Authors, 2025)

Response	Number of Respondents	% of Respondents
Yes	24	75,00 %
No	8	25,00%
Total:	46	100,00 %

Out of the total number of respondents, 75.00% have experience in performing tasks related to internal financial controls, while 8 respondents, or 25.00%, do not have experience in this area as they are engaged in other professional duties.

In response to the question: "Is an internal financial control system established in your institution?", the survey results are presented in Table 2.:

Table 2. Overview of Research Results – "Is an Internal Financial Control System Established in Your Institution?" (Authors 2025)

Response	Number of Respondents	% of Respondents
Yes	24	75,00 %
No	2	6,25%
Don't know	6	18,75%
Total:	32	100,00 %

Out of 32 respondents, 75.00% confirmed that an internal financial control system is established in their institution. A smaller number of respondents answered that they do not have an established internal financial control system in their institution or that they are unsure whether such a system is in place, as shown by the data in the table.

Table 3. Overview of Research Results – "Can the internal financial control system improve the institution's operations?" (Authors 2025)

Response	Number of Respondents	% of Respondents
Yes	28	87,50%
No	0	0,00%
Not sure	4	12,50%
Total:	32	100,00%

Out of the total number of respondents who participated in the survey, 28 respondents, or 87.50%, confirmed that the internal financial control system can influence the improvement of operations in their institutions, while 12.50% of respondents were uncertain whether this system can impact the improvement of operations.

In response to the question: "Are internal documents issued in institutions that prescribe the procedures and reports of internal financial control?", the survey results are shown in Table 4.

Table 4. Overview of Research Results – "Are internal documents issued in institutions that prescribe procedures and reports of internal financial control?" (Authors 2025)

Response	Number of Respondents	% of Respondents
Rulebook on Internal Controls and Internal Control Procedures	24	75,00%
No	4	12,50%
Not sure	4	12,50%
Total:	32	100,00 %

The research results show that the institutions of the respondents have adopted the Rulebook on Internal Controls and Internal Control Procedures, as confirmed by 75.00% of the respondents. Additionally, the results indicate that 12.50% of respondents are uncertain whether internal documents are adopted at the institutional level, which suggests they are not sufficiently

involved in the area of internal financial controls, while 12.50% of respondents confirm that internal documents have not been adopted at the institutional level. Through the survey questionnaire, respondents were asked the question: "Can the implementation of the internal financial control system influence the efficient spending of budgetary funds?" The overview of the data obtained from the research is presented in the following table.

Table 5. Overview of research results – "Can the implementation of the internal financial control system influence the efficient spending of budgetary funds in the public sector?" (Authors 2025)

Response	Number of Respondents	% of Respondents
Yes	25	78,12%
No	3	9,38%
Not sure	4	12,50%
Total:	32	100,00 %

The presented research results show that 78.12% of respondents agree that the internal financial control system can influence the more efficient spending of budgetary funds. A total of 9.38% of respondents disagree that the internal financial control system can affect more efficient spending of budgetary funds, while 12.50% selected the option "I am not sure," indicating that they are not sufficiently familiar with this area and therefore cannot provide a more precise opinion.

CONCLUSION

The system of internal financial controls represents a mechanism for increasing the efficiency, effectiveness, and economy of public sector operations, which is realized through the effort to eliminate or mitigate risks in operations and to increase the degree of legality in the actions of public sector entities. The Ministry of Finance of Republika Srpska, specifically its integral part—the Central Harmonization Unit—has significantly contributed to the implementation of the internal financial control system through numerous seminars, workshops, and professional guidelines provided to public sector entities for implementing the system of internal financial controls.

In today’s business environment, the existence of the internal financial control function in the public sector is necessary so that shortcomings in functioning can be timely identified and work on improving operations can be undertaken. For management to ensure the efficient spending of budgetary funds and to counteract errors and manipulations that may arise in operations, it is necessary to provide efficient functioning of the internal financial control system, adequate human resources, a quality ethical code, continuous employee training related to the detection of errors and manipulations, clearly written rules of conduct, and suppression of misconduct. To achieve the full effects and benefits of implementing the internal financial control system, it is essential that there is a change in the awareness of employees in public sector entities regarding the benefits that the application of internal financial controls has on their work.

The system of internal financial controls is a dynamic system that requires continuous work on its improvement, practical implementation, and raising employee awareness, because this system will produce real effects only when it is applied from the highest management levels down to the lowest execution levels, which will also reflect on the quality of data presented in reports. For faster achievement of financial stability and bringing public finances within rational limits, complete implementation of the internal financial control system is necessary.

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