



CONTROLLING AND INTERNAL AUDITING AT THE MINISTRY OF DEFENCE

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Abstract: *This paper discusses the theoretical foundations and definitions of controlling and internal auditing as tools that help the organisation's management in managing business compliance and business continuity, with the purpose of meeting the organisation's objectives, by assessing the effectiveness of risk management inside the organisation, as well as of control and management. Considering the contemporary trends in organisational management, where the management is faced with frequent crises that require rapid and comprehensive action and response to risks, where internal auditing information is focused on the past, there is a need to implement controlling in organisations to provide help to the management for the future. The aim of this paper is to highlight the need to introduce controlling at the Ministry of Defence in order to improve the work of this organisation and to provide strong support in preventing the existing problems and to develop innovative systems of solutions that go beyond mere financial reporting.*

Keywords: *controlling; audit; management; Ministry of Defence.*

1. INTRODUCTION

System of internal controls, being one of the segments of controlling public spending in the Republic of Serbia, is defined by regulations governing financial business risk management. Ministries and public sector companies have an obligation to establish such organisational and managerial structure so as to provide for the legitimacy of the business, including adherence to guidelines and applicable standards, with continued monitoring of adequacy and effectiveness of this structure in practice. Monitoring and control over public spending should also ensure the achievement of strategic objectives and an organisation's objectives, which are to be used to inform the public on a regular and transparent basis of the results and activities of all actors in the public sector (1).

The Ministry of Defence is one of the key beneficiaries of public funds that has introduced the principle of internal controls by way of legal regulations. The system of internal controls includes a series of controlling activities of individual sections and individuals in the defence system, but this paper will focus on the financial management and control system and internal auditing. The person responsible for establishing the said systems by applying and developing them is the Minister of Defence. The implementation of the systems of internal control is the responsibility of all categories of beneficiaries.

The purpose of this paper is to highlight the need of introducing and permanently applying controlling at the Ministry of Defence. The first part of the paper defines

the concepts of controlling and internal auditing in general. The second part of the paper presents an analysis of the existing legal norms governing internal controls in the Republic of Serbia by introducing the system of financial management and control (FMC) and internal audit. The third part of the paper examines the efficiency and content of the system of internal controls, financial management and control and internal audit at the Ministry of Defence, the regulations that govern it, thus demonstrating to the scientific community that the system of internal controls is an effective way to ensure that an organisation conducts its business based on public spending in a legal and cost-saving way.

The primary hypothesis of the paper is: Controlling, as a partner to management, is a necessary tool for effective risk management and response.

The paper includes an analysis of the Consolidated Annual Report on the Status of Internal Financial Control in the Public Sector in 2020 and an analysis of the measures provided in the Reports on Overview of the Work Quality of Internal Auditing in the Republic of Serbia in 2016, 2017 and 2019, as well as in the reports of the State Audit Institution for 2018, 2019 and 2020, which imply the direction in which the very system of internal controls should evolve.

2. THE CONCEPT OF CONTROLLING AND INTERNAL AUDIT

The need for establishing internal controls in the public sector emerged in the second half of the 20th century as a

democratic legacy in countries with developed economies. As education and eloquence of their citizens continued to grow, a need to make the public sector's business more transparent also emerged, thus boosting the interest among the public. Systems of internal controls are to provide support and help the management of businesses of public fund beneficiaries. The purpose of internal controls is to ensure a legitimate course of action in achieving the set objectives, to enhance and monitor efficiency and effectiveness of doing business, to protect against non-earmarked expenditure of funds and to assist in discovering frauds. By way of reporting, it should also present results of the organisation as "public value" (2).

Internal control in general can be observed from a timeline perspective, it being:

1. preventive – before or at the very beginning of an activity;
2. ongoing or detective – during the activity;
3. subsequent or corrective – at the very end or after the activity has been conducted, with the purpose of reviewing mistakes, omissions and frauds (3).

Controlling originally appeared as a form of assistance to company management, prior to and during the process of planning and conducting the activities. It emerged as a key factor of management focused on profit, whereas in the non-profit organisations it served as assistance to public fund beneficiaries in managing and achieving the set objectives. Therefore, controlling is a process and way of thinking that is formed inside a team of managers and controllers as a cross-section of two sets of responsibilities and duties (Figure 1) (4).

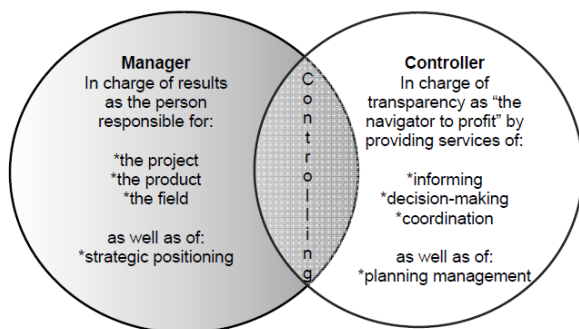


Figure 1. Controlling as a cross-section of activities of managers and controllers.

Source: (Marjanović V. 2013).

Control is often identified with controlling. These two concepts, however, are not identical in their primary function. Controlling refers to the function within an entity dedicated to enhancing efficiency and effectiveness in the implementation of plans for the purpose of achieving objectives and adapting the processes threatened by internal and external risks. As a tool for coordination of business processes, controlling is focused on the future (5).

Internal audit is, on the other hand, a control of public spending conducted after the activity has been completed and it ranges from verifying the accuracy of financial documents to making a critical assessment of the activity completed.

In contemporary practice, audit is a process of independent and objective verification of an organisation's financial accounts. The importance of audit depends on the context in which it appears. Nowadays there have been quite a few talks about the audit of privatisation, which essentially means to revise the transformation of property structure of social enterprises and public companies. This term is sometimes observed also in the judiciary sector – in the form of auditing questionable processes or laws. This refers to the renewal of certain judicial procedures, based on evidence, that might radically alter the court's final decision, or to the revision of laws that need to be adapted to new trends. The most important forms of auditing, however, take place in the economy sector. Throughout the history of evolution of economic thought, many authors and institutions have tackled the scientific definition of the concept of audit.

International standards on auditing define auditing as follows: the objective of auditing of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (6).

G. Vinten points out that internal auditing is a continued and detailed inspection of seemingly sound organisations with the aim of obtaining insight into the actual status or position of the organisation and its environment, so as to attain better control over its future business (7). Unlike other definitions of internal auditing, this definition emphasises the need to place focus of internal auditing on improvement of future business and not only on reviewing past events.

Essentially, internal auditing is an inspection of accounts relying on financial indicators and statements, whereas controlling is a permanent inspection of the achievement of the set objectives of the entire organisation.

3. LEGAL GOVERNANCE OF INTERNAL CONTROLS IN PUBLIC FUND BENEFICIARIES

A series of legal documents has been adopted in the Republic of Serbia that monitors and controls public expenditure through budget and special types of controls. Budget execution implies control of budget funds expenditure, whereby the Law on Budget System envisages several levels of control, organised as internal and external control. The Law on Budget System defines that public fund beneficiaries are to establish two forms of internal controls in their respective organisations, those being financial management and control and internal auditing (8).

The legislator has defined financial management and control in the form of a rulebook as a system of policies, procedures and activities aimed at achieving objectives. The primary objectives that public fund beneficiaries are to set through risk management are the following:

1. doing business in compliance with regulations, internal acts and contracts;

2. completeness, veracity and integrity of financial and business statements; and
3. sound financial management and protection of assets and data (9).

System of financial management and control is in the jurisdiction of the manager of a public fund beneficiary and the managers of their lower-level organisational units. Monitoring and evaluation of this system is carried out by the employees by way of self-assessment based on the 2013 COSO framework and by way activities of internal auditing. Therefore, this system does not exclude subjectivity, whereas the responsibility for establishing and developing the system is delegated on a beneficiary level.



Figure 2. Establishing a system of financial management and control in the key public fund beneficiaries in the Republic of Serbia.

Source: Consolidated Annual Report on the Status of Internal Financial Control in the Public Sector in the Republic of Serbia in 2020.

Based on the Consolidated Annual Report on the Status of Internal Financial Control in the Public Sector in the Republic of Serbia in 2020, it is evident that this status is

not at the required level in ministries, which are expected to adopt a higher standard of implementing financial management and control. Insufficient attention is being paid to introducing systems of internal controls, risk management strategy and description of the business processes (Figure 2).

On the other hand, independent internal audit in an organisation is a prerequisite for objective overview of the status and for making an evaluation of the results that corresponds to the requirements of the legislator and the public. This is also supported by the fact that when internal audit operates independently, it provides objective assessments and recommendations and it is efficient in providing an added, higher level of monitoring of the internal controls and has a vital role in the risk management process.

According to the Rulebook on Common Criteria for Organisation and Standards and Methodological Instructions for Internal Audit Operations and Reporting in the Public Sector, public fund beneficiaries have an obligation to establish internal audit. They are required to do so by forming a functionally independent organisational internal auditing unit within their organisation (if they have more than 250 employees) or to hire an internal auditor (if the public fund beneficiary is under the threshold for forming a separate organisational unit) (10).

Establishing internal audit units in the public sector

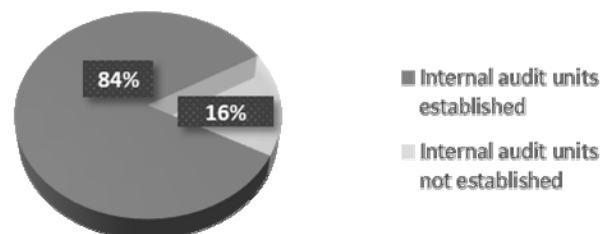


Figure 3. Establishing internal audit units in ministries and organisations of public fund beneficiaries in the Republic of Serbia.

Source: Reports on Overview of the Work Quality of Internal Auditing in the Republic of Serbia for 2016, 2017 and 2019. Central Harmonization Unit, Internal Audit Department, Ministry of Finance.

Reports on Overview of the Work Quality of Internal Auditing in the Republic of Serbia for 2016, 2017 and 2019, covering the period from January 1st, 2015 to September 30th, 2019 and including 31 entities with obligation to introduce internal auditing, state that 83.9% of the ministries and organisations of public fund beneficiaries have established internal auditing units (Figure 3).

Out of the total number of inspections of the work quality of internal auditing, 18 entities, i.e., 58.1%, did not provide even the minimum prescribed number of internal auditors, which raises doubts concerning absolute adherence to the internal auditing standards (11).

4. FINANCIAL MANAGEMENT AND CONTROL AND INTERNAL AUDIT AT THE MINISTRY OF DEFENCE AND THE SERBIAN ARMED FORCES

System of internal controls of public spending in the Ministry of Defence and the Serbian Armed Forces is defined pursuant to bylaws in jurisdiction of the Minister of Defence, whereas the authorising officers are responsible for establishing efficient internal control when it comes to the defence system.

Internal control of costs for military purposes, expressed in the budget of the Republic of Serbia, is carried out by the financial service authorities of units and departments of the Ministry of Defence and the Serbian Armed Forces, the Accounting Centre of the Budget and Finance Sector with the Ministry of Defence, the Defence Inspectorate, the Military Intelligence Agency and Criminal-Investigation Team and internal audit of the Ministry of Defence (12).

In 2011, the Rulebook on Financial Operations in the Ministry of Defence and the Serbian Armed Forces introduced the principle of financial management and control. Organisational unit of the Ministry of Defence in charge of the budget and finance manages the operations of the finance department within its jurisdiction and, in addition to other tasks, it is in charge of introducing the system of financial management and control in the Ministry of Defence. Authorising officers on all levels of command up to level-four material and financial authorities (MFO) are responsible for establishing the system of financial management and control, and it is the duty of both authorising officers and all the employees to implement this system (13).

The Rulebook specifies that the system of financial management and control is a component of public internal financial control and that it is observed as an entire system of financial and nonfinancial controls, including all elements of the organisation. It also stipulates that risk management will, to a reasonable extent, provide guarantees that the organisation's objectives will be achieved.

The Consolidated Annual Report on the Status of Public Internal Financial Control in the Republic of Serbia in 2020 does not say that the Ministry of Defence has had any omissions whatsoever in carrying out its implementation and reporting duties. The system of financial management and control at the Ministry of Defence works, but not to the extent that is necessary. The key reasons that justify this relate, primarily, to the fact that while introducing the system, the managing officers in charge did not pay sufficient attention to it nor did they have interest in doing so (14).

The fact that the risk management strategy is updated every three years and that the controls that are to reduce risks to an acceptable level are carried out once a year leads to a conclusion that in times of frequent global crises, especially in light of the recent events including the COVID-19 pandemic and the Ukraine war, the

dynamics of risk management is not appropriate and that the response to the challenges is untimely.

In the same year when the system of financial management and control was established at the Ministry of Defence, the internal auditing department was established, as well, and internal acts were adopted, as well as the Internal Auditing Charter and internal auditing ethical code, all of which has made it possible to establish internal auditing in the defence system. On the other hand, the internal auditing department is an independent authority in the organisation of the public fund beneficiary that reports directly to the incumbent Minister of Defence.

The tasks of the internal auditing department at the Ministry of Defence are governed by the Rulebook on Internal Organisation and Job Systematisation. Those are the following: reviewing compliance with the existing financial regulations, instructions and procedures; evaluating effectiveness of internal controls; evaluating effectiveness of exploitation of funds; inspecting reliability and integrity of record-keeping and reporting; payments and contracts; reviewing accounting statements; inspecting irregularities; regularity of revenue collection and record-keeping thereof; security of property and lists thereof, i.e., cataloguing property; inspection of the budget distribution, so as to ensure legal compliance and secure sufficient funds; and other tasks included in the scope of the department's operations (15).

The scope of operations of the internal auditing department is not limited. It includes all programmes, procedures and activities. It has free access to all managing officers and their employees, all the records, property and data that are the subject of auditing. Internal audit at the Ministry of Defence operates independently and plans its work programme based on an overall risk assessment. It regularly adopts a three-year internal auditing strategic plan, as well as annual plans of internal auditing. From 2018 to 2020, it audited 13 entities and issued 93 recommendations (Figure 4).

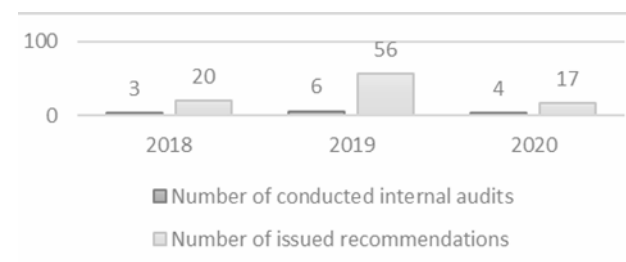


Figure 4. Overview of conducted internal audits at the Ministry of Defence and the number of issued recommendations.

Source: Report on Auditing Financial Reports of the Ministry of Defence for 2018, 2019 and 2020. State Audit Institution.

All incompliances and irregularities identified while auditing the presented documentation of the inspected activities relate to the financial indicators and data. Recommendations have been made regarding thereof so as to eliminate the said irregularities. There were no

recommendations classified as high or low priority. In the statements, the auditors only identified medium-priority reporting errors, irregularities and mistakes that affect the financial reports when there is no immediate risk of loss (Figure 5). No immediate response upon identifying the problems was necessary. They were rather to be rectified before preparing the following report.



Figure 5. Overview of the issued recommendations per priority for the Ministry of Defence.

Source: *Report on Auditing Financial Reports of the Ministry of Defence for 2018, 2019 and 2020.* State Audit Institution.

The system of internal controls at the Ministry of Defence is legally governed by a series of regulations, instructions, procedures and activities, including the organisational structure, and it is formally introduced on all levels of command and management and implemented in practice. Internal controls, financial management and control and internal audit are defined as components of internal financial controls, but due to insufficient attention paid to the nonfinancial indicators, there is a need to introduce controlling. Among other things, the role of controlling is to plan and report, continually, by combining nonfinancial and financial reports, with the purpose of achieving the organisation's set objectives.

5. CONCLUSION

Modern way of managing business entities is not just the focus of managing budget execution and controlling the earmarked funds expenditure, but also nowadays, in this growingly turbulent business environment, successful risk management, as well as compliance with the legal norms, are becoming the objectives of success. Such defined objectives focus on financial management, and insufficient attention is being paid to the results.

Internal auditing as a function of subsequent control provides entry parameters for establishing an efficient system of financial management and control, but in the very delivery of material and financial management. The

overall objectives of an organisation require constant monitoring of procedures, activities, management operations and risks. Therefore, introducing controlling as a separate function and employing expert personnel, a certified controller, would provide the management with full control over achievement of objectives for the benefit of the entire organisation. The proposed thesis is confirmed by the fact that subjectivity is not excluded from the system of financial management and control. An independent and well-trained controller with full integrity would serve as a partner to the management, working together on identifying incompliances with the objectives, on having complete monitoring of risks and would also testify to the success of the organisation's business.

Controlling affects the quality of making business decisions and management, and it contributes to enhancing business quality. Based on above, a conclusion can be made that the level of development of controlling in the Republic of Serbia is not fully aligned with contemporary notions of its role in business, i.e., that the level of its development does not correspond to the attained level of development of this profession in countries with developed marked economies, but also that its implementation at the Ministry of Defence would offer a new dimension for a more efficient management of the entire organisation.

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