

FINANCIAL MANAGEMENT AND CONTROL – TRENDS AND PRACTICES IN SERBIA

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Abstract:

The development of the financial management and control system in the public sector creates prerequisites for economical, efficient and effective management of public resources, but also for preventing abuses, reducing the risk of corruption and transparent and objective reporting to the public about the spending of funds. A successfully implemented system and the formation of a management culture in accordance with the requirements of the European Union - consequently leads to the establishment of the basic principles of corporate management in public sector entities in Serbia. The implemented control mechanisms within the financial management and control system include the entire organization, all operational and strategic units in the function of achieving defined goals. The aim of this paper is to assess the current state of the established mechanisms of internal financial control and the progress of public sector institutions in establishing an appropriate legal and institutional framework to support the internal financial control system.

Keywords: *internal control, risk management, public sector*

Introduction

Financial management and control is established and evaluated by management and it is a component of internal financial control in the public sector. It represents the entire system of financial and non-financial controls, including organizational structure, methods and procedures and not only financial systems, but also operational and strategic systems of organizations in the public sector[14]. Internal control system is one of the most important and fundamental concepts, which includes all processes, always regarding achieving objectives, eliminating obstacles and avoiding the risk and taking the necessary measures against them [25].

A prerequisite for risk assessment is the establishment of objectives that are linked at different organizational levels and internally consistent. Any system of internal control

has a number of components. Firstly the system has to be established through financial and procedural rules, the system has to be operated by responsible and appropriately trained personnel, and subjected to independent review to ensure and assess whether procedures are working as intended. Usually this checking and monitoring role will be undertaken by an internal audit unit. The effective system of Internal control can provide reasonable but not absolute assurance use of resources and safeguarded of assets, also that transactions are authorised and properly recorded in a way that allows for the timely identification and correction of material errors. Internal control is vital to ensure that resources are properly managed, which at the same time strengthens the responsibility for managing these resources [12].

Internal control is based upon a system of management information, financial regulations, administrative procedures and a system of accountability as well as strong formal project management [19]. Internal control also provides a framework for risk management, to allow organisations to both identify and mitigate risks. Internal control is vital to ensure that resources are properly managed, and that accountability is maintained. Financial management and control includes the entire organizational structure through the establishment of processes, procedures and a complete system of financial and other controls, including internal audit. In this way, it supports the achievement of corporate goals through support in managing business in the organization in a correct, economical, efficient and effective manner. It comprises of following component [8]:

- The control environment
- The entity's risk assessment process
- The information and communication system,
- Control activities
- Monitoring

Internal controls are designed in such a way as to improve performance and lead to the achievement of the organization's goals. In this context, risks that threaten the achievement of goals at all organizational levels were also identified. Control mechanisms include all aspects of an organization - all employees, processes and infrastructure. In general system of financial control in Serbia is implemented by the government, i.e. the

Central Unit for Harmonization of the Ministry of Finance, with the aim of ensuring that the operations of budget users is in accordance with relevant regulations and the principles of good financial management, of transparency, efficiency, effectiveness and economy.

In the public sector, internal financial control represents control in a broader sense, including but not limited to financial control and internal audit. This means that it includes the principles and qualities of good management. Effective internal controls are when all employees and the appropriate environment work together[10]. Internal control is not an end in itself, but a means to an end. The aim of the work is to address this topic by looking at the support of control mechanisms on conducting business in organization in a correct, economical, efficient and effective way, based on a comparison of the results in the consolidated annual report of the Central Unit for Harmonization of the budget users in relation to the observed weaknesses of them from the State auditing institution. Internal control is carried out by people and it does not represent only certain policies and patterns, but employees at all organizational levels by establishing adequate control mechanisms through their business processes provide support to managers in achieving the organization's goals. With this article, the authors also wanted to emphasize the importance of the correlation between adequately established control mechanisms and risk management, which provide reasonable assurance, for the achievement goals, thereby influencing the improvement of business performance of the organization's and adequate spending of public funds.

Review of the problem

The system of financial management and control in the public sector was designed with the aim of ensuring compliance with legal and institutional requirements, to promote the concept of corporate management in the public sector, to ensure accountability and good internal control systems. Although there are several different styles of effective management, they all have one common feature, which is the attention paid to the proper implementation of internal control principles in accordance with international standards significantly in public sector organizations, which are not uniform and there are large differences in the way of performing their work, but the standards of a good management

system are generally the same and generally applicable [16]. Public sector organizations vary in size, do not function within the same legal framework, that is, they do not have a uniform organizational structure. It is important to recognize the diversity of these organizations and different management models, which require special consideration and impose different types of responsibilities[26]. These are the reasons that the internal control represents an area of interest for all users of public funds, as well as for the external auditor when providing conclusive audit evidences, necessary for underlie the audit opinion [4].

Public sector reforms aimed at new public management have conditioned general expectations that the management of public funds will be fully in accordance with the law and appropriate standards. The reforms brought about a change in the character of public officials, but also radical transformations of public management styles [16]. The system of internal management and control creates a supportive environment for activities that are carried out in order to achieve the expected results in the most efficient and effective way, which will enable the provision of quality public services that are integrated and directed towards users and concentrated on results, which requires that all business systems be oriented towards performance measurement [1]. The performance of public affairs can also include open partnerships with other organizations of the public sector, as well as with economic entities, which also includes efficient and effective implementation of public affairs, safeguarding and management of public funds [15].

The FMC (*Financial Management and Control*) system includes the following, interconnected, elements defined in accordance with international internal control standards, which includes the COSO [7] framework:

- control environment;
- risk management;
- control activities;
- information and communication;
- monitoring (supervision).

It is important to point out that the primary responsibility for the adequate establishment of a financial management and control system rests with the heads of the organization, which is in accordance with the law and the appropriate standards, that

public funds are managed with absolute integrity, that is, that public funds are spent in a manner prescribed by law [19]. In order for all responsibilities to be realized, for all responsibilities to be realized, it is necessary for all those responsible for managing affairs within the public sector to establish and maintain an appropriate structure for managing the affairs and funds entrusted to them. In accordance with the principles of corporate management, the responsibility for results, i.e. the achievement of goals, rests with the managers of the organization and cannot be transferred to other persons. In accordance with the guidelines for the delegation of management responsibility [13] to enable managers to devote their time to important decisions and activities, but also that managers at lower levels of the organization have their own level of responsibility.

The control environment refers to the defined standards, processes and structure in the organization [22]. It creates internal organization and discipline, and thus represents the foundation of the overall system of internal controls, because it reflects the "tone at the top" which also outlines the structure and flow of authority and directives within the organisation and reporting procedures [11]. Each public sector organization, respecting the standards and guidelines, establishes such an organizational and managerial structure, which will ensure the legality of activities and transactions, while monitoring the adequacy and effectiveness of this structure in practice. This includes monitoring the achievement of strategic and operational goals, as well as reacting and responding adequately to risks, on the basis of which the public is regularly and transparently informed about the results and activities of the organization[23]. Every business activity, i.e. program and project in an organization in the public sector must have an internal control system in which the established goals are monitored. This system consists of procedures, rules, policies and instructions that are designed to ensure the achievement of the organization's goals in the most efficient way [3].

In the context of the adequate establishment of the financial management and control system, managers encourage an environment that promotes control [5]- this means that the attitude of managers towards the internal control system should demonstrate high ethical and personal standards, integrity, diligence, loyalty and honesty.

Also, the development of financial management and control, require public companies to pay more attention to the risks and their impact on the overall business.

This means that managers have the responsibility to identify risk exposures with respect to each activity, organizational unit, or system in a particular organization [2]. The exposure is evaluated in terms of the impact it will have on the organization and the probability of materialization of risk. Managers also make decisions about controlling and responding to risks, harmonizing risk and control measures, taking into account the costs of implementing control measures. Once the risk management system is in place, managers must adapt to external and internal changes in order to avoid critical risks to the organization in the future [6].

The effective establishment of control activities actually means that it is necessary to establish an adequate structure of basic operations in the public sector organization, which includes clear and understandable policies, operational and performance standards, budgets, plans, systems, procedures, etc., which resolve identified risk exposure and reduce it to an acceptable level [5].

In order to perform the work more efficiently, the system of adequate financial management and control requires adequate delegation (transfer) of authority and responsibility within the assigned competencies in order to perform the work more efficiently and effectively and achieve the goals of the organization. Viewed in this way, managers should design and implement control processes that motivate, channel and/or otherwise direct employees to perform tasks in a way that enables the achievement of positive results. In addition to the above, there is also a system of constant monitoring in order to determine the effectiveness through which the control processes achieve the planned purpose in a timely manner and submit reports on this[18].

An effective system of internal control mechanisms requires from public sector organizations the entire control framework established through each business process and procedures within it, with an assessment of control activities and identified risks. The result is a general assessment of control activities through a self-assessment that is required at least once a year from all budget users, with the aim of providing reasonable assurance about the effectiveness of the internal control system [19].

Adequately established system of financial management and control represents general interest in order to protect public resources, therefore managers of public sector organizations are obliged to establish an internal system that will be clear, transparent

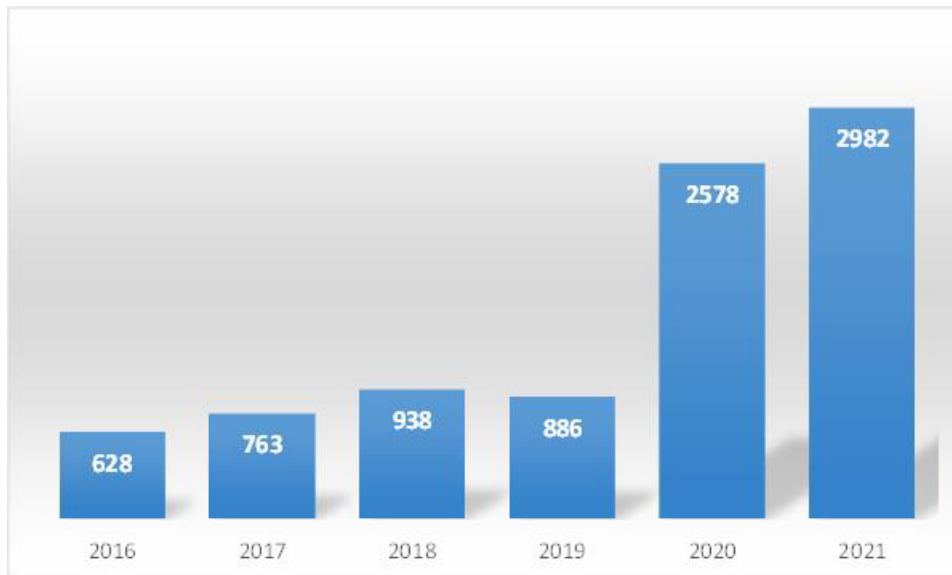
and in accordance with valid regulations, but at the same time effective in achieving goals [17].

The role of internal auditors is particularly important for the organization, as it provides objective and reasonable assurance about the effectiveness of the management and internal control systems, as well as the risk management system.

Research questions

Requirements related to an effective internal control system in public sector organizations don't only refer to the assessment of control activities, but should be viewed more broadly in terms of their adequacy and effectiveness of the entire internal control system. In this context, the research in this article tried to answer the question of the progress in the implementation of the financial management and control system based on the annual consolidated report of the Central Unit for Harmonization of the Ministry of Finance of the Republic of Serbia and what are the recommendations of the internal audit related to the general system of internal control and its adequacy based on the report of the State Audit Institution.

The author's idea is to point out the contribution of establishing an independent internal audit in the public sector organizations themselves. The process of reviewing the established system of financial management and control is carried out by the organization itself internally, or by an external authorized body, or by an internal auditor within the organization, that is, by an organization for internal audit of major users of public funds. The purpose of quality assessment is the regular/periodic evaluation of the financial management and control system, especially the internal system control of users of public funds, in order to detect critical deficiencies that could affect the achievement of the organization's goals and to support the further development of this system by providing adequate recommendations to users of public funds.



Graph 1. The number of processed annual reports on the FMC system submitted by beneficiary of public funds by reporting years, *Source: Consolidated annual report for 2021 [20]*

For 2021, a total of 2982 public beneficiaries submitted an annual report on the Financial Management and Control system and all received reports are included in the analysis [20]. The high reporting rate saw further growth. With the 2013 framework, COSO introduces 17 principles of internal control [9]. Each principle relates to one of the five components and each principle includes several points to focus on. The principles enable the effective functioning of the five components of internal control and the entire system of internal controls. In order to demonstrate that the principle is present and working, the organization must understand the purpose and application of the principle, help employees understand the principle and apply it, then see the principle's weakness or absence, all of which require management attention[14].

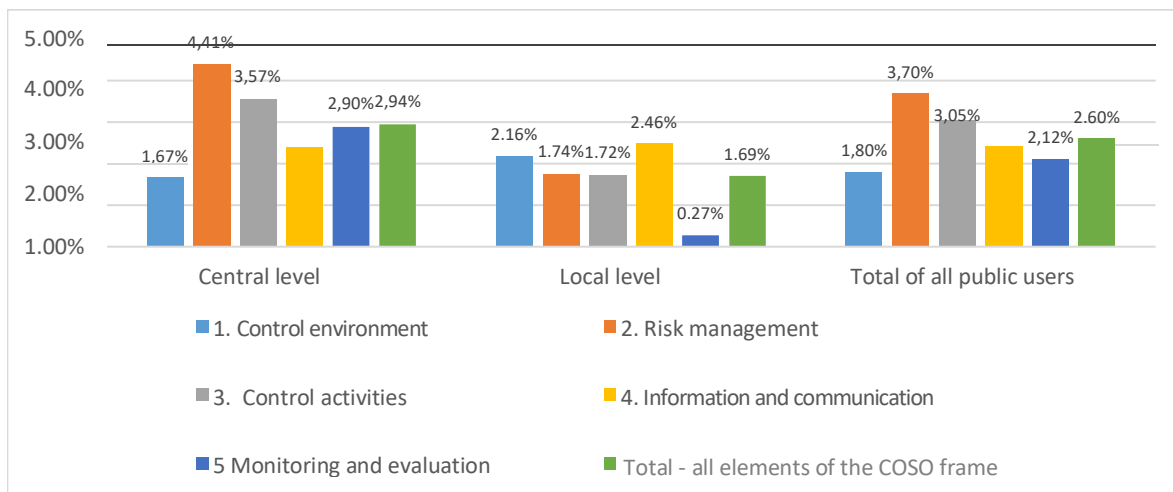
The annual report on the FMC system in the part of self-assessment, consists of 74 issues grouped in five areas from the perspective of the COSO framework for internal controls. Compulsory social security organizations, public companies and ministries with administrative bodies have clearly positioned themselves as leaders when it comes to the level of assessment of the FMC system. There is a need for improvement when it comes to individual users of public funds at the local level. The assessment of the level of establishment / implementation of the FMC system is based on the 2013 COSO

framework [9]. Overall, the results for the five elements of the FMC framework, the segments of the control environment, control activities and especially the information and communication system deserve solid marks.

The analysis of results by levels and categories of public sector entities shows that organizations at the central level in most cases report better results compared to the local level. Also, there was a noticeable improvement in the self-assessments of indirect users, which was reflected in the increase of overall assessments in certain elements. Key areas that require additional engagement in a larger number of users of public funds are monitoring and assessment, as well as risk management.

The average scores for the elements of the COSO framework are relatively uniform and amount to (4,08) for the element of monitoring (supervision) and assessment, to (4.48) for the component of information and communication [20]. All results are significantly above the average, which is best sublimated by the average grade for all FMC elements of priority entities of public sector (4.22), which is 14.50% higher than the overall average grade of all public sector entities (3.69) [20].

The following graph shows the growth rates (in %) of average grades by elements of the KOSO framework for the period 2020-2021. years.



Graph 2. Growth rates (in %) of average grades by elements of the KOSO framework (2020-2021), *Source: Consolidated annual report for 2021* [20].

The average growth rate of grades for all elements of the FMC system in the period 2020-2021. is 2.60% [20] average score of the risk management component recorded the

highest growth rate (3.70%), while the lowest level of average score growth was expressed by the COSO element control environment (1.80%) [20] which is understandable, considering the high initial value and stable growth in previous period. Immediately after the risk management component, control activities have the highest growth rate (3.05%), which indicates a high correlation between these two elements. The score for monitoring (surveillance) recorded a growth of 2.12%, while for the element of information and communication the growth is 2.42% [20].

Observing the priority subjects of the public sector as a separate category, it is imperative that in the coming period they improve the level of organizational establishment of the FMC system, above all when it comes to the preparation of key documents. The share of organizations from this group that have completed business process maps of 77.91% is still not satisfactory [20]. Work on creating risk registers is also urgent, because only 70.93% of priority public entities met this criterion. On the other hand, the data on the annual growth of the number of priority public entities that have business process maps of 16.36% is encouraging. Growth in the segment of creating risk registers is somewhat more modest (5.45%)[20]. Overall, further developments can be expected when it comes to the organizational establishment of the FMC system in accordance with modern standards.

The majority of public sector organizations stated that during 2021 they were also faced with major challenges in functioning in the circumstances caused by the pandemic. The challenges are reflected in management and communication, the difficult implementation of various work segments and in impossibility of achieving the expected results. In addition it is also difficult the operational organization of services with a reduced number of employees who are available to carry out regular business activities due to infection and disease, and due to the adjustment of working conditions with a limited number of employees due to the prevention of contact and the spread of disease. Due to the increase in the electronic exchange of information and communication, they emphasized the need to establish and develop information systems that include key business processes, enable the performance of regular operational activities, increase efficiency, smooth operation and continuity of business, and at the same time support

control functions, i.e. considering that it is necessary to provide technical equipment for work and increase the digital literacy of employees.

The introduction of irregularity management in public sector organizations represents an important tool for the managers for the purpose of monitoring the FMC system, additional optimization of organizations operations and reducing the risk of misuse of public funds. During 2021, the largest number of public sector entities (94.16%) had no confirmed suspicions of irregularities[20], 5.84% reported that they had confirmed irregularities, of which 63.10% were resolved within public entities, 0.60% were resolved outside public entities, and 36.31% both internally and externally[20] .

Based on the review of the results from the report and on the recommendations of the State Audit Institution regarding the general system of internal control and the adequacy of the established control mechanisms, we can conclude that all users of public funds are not aware of the benefits of internal audit, which as a function adds value to the organization. The situation is better at the central level, with the direct users of public funds, and the best is in organizations of mandatory social insurance, which are obliged by other regulations to establish an independent and effective internal audit.

Analysis and discussion

For the user of public funds, internal control is defined as an integral process which is carried out by the management and all employees of the organization. It is designed to respond to risks, as well as to provide reasonable assurance regarding the achievement of results while simultaneously acting in the public interest and accomplishes the organization's mission [27].

The responsibility for the functioning of the financial management system and internal control in the public sector lies with the managers of the users of public funds, with the help of other senior managers [19]. They are formally and fundamentally responsible for the establishment and development of an adequate and effective internal control system in their organizations.

All users of public funds are obliged to submit an annual report on the functioning of the internal control system to the Central Unit for Harmonization, which is based on self-assessment. Based on the recommendations in the report of the state audit institution, we can conclude that these answers are often subjective and that there is no

awareness of the importance and contribution of the internal control system in the context of more effective business operations[. In order to get a more realistic picture of financial management and control of the system in the prefix, it is necessary to take into account the external verification of the system [19]. So the authors compared the assessments given in the previous chapter from the perspective of the state audit institution, based on their annual reports.

On this basis, research questions were also asked. It is important to point out that the state audit and budget inspection test the application of financial management and control from their own angle, as well as that their recommendations continuously encourage users of public funds who are subject to audit, to dedicate themselves to improving their financial management and control systems [26]. The state of the FMC system is, as before, viewed from the perspective of the COSO framework for internal controls. Key aspects of the control environment have been implemented to a large extent (integrity and ethical values, mission and vision as essential prerequisites, efficient organizational structure, as well as clear reporting lines)[7]. In the field of risk management, significant progress has been made, but it is still necessary to invest efforts in the further development of this segment [24].

There is space for improvement in the areas of defining control activities, as well as in the area of IT infrastructure project planning. It can be concluded that, although some control mechanisms are already incorporated into business processes, updating and improving business processes, or revising control activities that are in the function of risk management, are not performed regularly in practice. Information and communication systems represent the best segment of FMC with relatively high marks in all public users categories. On the other hand, the area of supervision and evaluation of the FMC system represents the aspect that needs to be improved the most and within which the highest range of average values was registered.

The recommendations that is given in the consolidated report also refer to the implementation of mechanisms for monitoring the FMC system, i.e. the assessment of the adequacy and efficiency of its functioning. The manual of the Ministry of Finance on the implementation of the FMC system, the instructions are clearly given to budget users about the importance of continuous assessment activities, for the reason that each

organization analyzes the perceived weaknesses in time, and then monitors the implementation of corrective activities[19]. It is important to point out that the largest number of users who submitted the report stated that they are familiar with the content of the recommendations and that they are working on their implementation, but there is still concern because there are the users who submitted the reports, but they don't implementing the recommendations from previous reports. Deficiency of personnel and resources is mainly cited as the reason for not implementing the recommendations, a number of users also stated that the pandemic stopped the implementation of the recommendations. The lack of knowledge and skills of managers and employees in the process of establishment and development of FMC was identified as the most important weakness in the submitted report about FMC systems.

A great drawback is that some of the most important users of public funds dont have business proceses maps and risk registers. Even 7 ministries do not have maps of proceses (33.33%), while 8 of them (38.10%) dont have a risk register[20]. Risk management strategy was not adopted by 6 ministries (28.57%) [20]. Nine public companies (25.00%) did not create business process maps, 11 public companies (30.56%) did not create a risk register, while 11 public companies (30.56%) did not adopt a risk management strategy. In the case of cities, 12.00% did not create maps, risk register 24.00% and risk management strategy 12.00%[20] . The local level reports lower grades compared to the national level for all elements of the COSO framework. The weakest results of self-assessment are observed at the level of indirect users of public funds and at the central and local levels. The area of monitoring and evaluation of the FMC system continues to be the element of the COSO framework with the lowest average score. Although significant progress has been observed in comparison to last year, it is necessary to maintain the rate of growth of grades in the risk management segment. Updating and improving business processes and/or revising control activities that are in the function of risk management in practice is not carried out regularly. The authors of this article want to emphasize their observation that all five components of internal control are interconnected and must be present throughout all business processes, at all levels in the organization. The management of the organization, depending on its assessment of the functioning of internal controls, can decide on the detailed application of the

individual principles that make up each component. The extent to which each component will be implemented depends on the size and complexity of the organization, the type of activity, philosophy and management culture in the organization.

Conclusion

Financial management and control as a way of managing and controlling should not be viewed as a separate system, but as an integral part of all activities and functions of the entity which must be embedded in all financial and non-financial processes. The managers in public sector have an obligation and responsibility to ensure the best use of resources while taking measures to reduce losses, wastage, prevent abuse and prevent and detect fraud and corruption. They also should be aware that a strong internal control structure is the foundation for achieving business goals and purposes of their business.

The subject of research in this article is the analysis of the development of the financial management and control system, which regardless of the legal obligation, is proceeding very slowly in order to show that the establishment of adequate control mechanisms significantly contributes to the achievement of better results. The analysis of FMC development was observed on the basis of reports submitted by public sector entities in performing a self-assessment of the FMC system. The annual report / questionnaire is created by the Central Unit for Harmonization of the Ministry of Finance of the Republic of Serbia, and it is grouped by the components of the COSO framework. Based on the responses from the Questionnaire, it is determined the weaknesses of the system and plan activities related to their elimination.

Self-assessment of controls is considered a reliable means of evaluating effective management and helps management and internal auditors to create added value in the organization. Looking at the results from the report, we can conclude that the most common problem in the introduction of the process approach for the users of public funds is the inability to see how the process works as a whole. Business processes are often inflexible because the participants in the process have little understanding of the whole process. Understanding the whole is a key condition for the possibility of process improvement. Bearing in mind the insufficient awareness of the importance of internal control mechanisms, the fact that a third of large budget users do not have an adequately

established FMC system, which we saw in the research, it is clear that in Serbia the system of internal financial controls has not taken root in full capacity.

It is also important to emphasize that in order to successfully establish an adequate and efficient system of financial management and control as a whole, it should include at the first managers of organizational units and other employees who, with their knowledge, experience and knowledge of how the organization functions, can do this job successfully. It is difficult to expect that this work can be successfully done by someone "outside the organization" who would be trusted and who is not sufficiently familiar with the way business processes unfold and how the organization functions as a whole. By involving management and employees in this work, instead of someone else "outside the organization" doing it, the quality of system implementation will increase, as well as the responsibility of employees and its full would not be experienced by employees as something imposed from the outside and which cannot be implemented in practice. An effective mechanism that would successfully act on a more positive approach of management and employees is appropriate training on financial management and control so that they can do this job successfully. The author's intention is to help policy makers and decision makers in public entities to increase awareness of the importance of adequately established internal controls in public sector organizations.

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