



# Improving Accountability in Public Spending through the Establishment of Appropriate Control Mechanisms

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## Table of contents

<b>Introduction</b>	<b>2</b>
Corruption as a wide-spread phenomenon in BiH	2
Remedy for corruption	2
Structure of the BiH public sector auditing	3
Public spending in BiH	3
Sources of financing of public institutions	4
Present and proposed control mechanisms	4
<b>Problem description</b>	<b>5</b>
<b>Policy options</b>	<b>7</b>
<b>Conclusion and recommendations</b>	<b>17</b>
Public disclosure and the auditing requirement	17
Contracting auditing to external companies	17
Internal auditing committees	17
Supreme Audit Institution	18
Application of accounting standards	18
Appendices	19
Bibliography	20
Web links	21

## Summary

This policy study provides a set of constructive and progressive solutions for the needed revision of the applicable policies and practices, intended to ensure greater control and transparency over the financing and operations of public institutions in the Republic of Srpska and Bosnia and Herzegovina.

Transparent financial reporting and the establishment of adequate control mechanisms have proved to be the key factors of anti-corruption and anti-fraud combat in any modern society. The proposed solutions are based on an analysis of the current legislation and practices. They are targeted at key decision-makers at the relevant levels of government, with a particularly strong focus on the implementation of the proposed framework to fill the gap that currently exists in the legislation regulating public spending.

One of the most common control mechanisms over public spending is the audit of financial accounts. The main purpose of auditing is the verification of records and accounts. Auditing as a function contributes significantly to the transparency and efficiency of public spending, as it diagnoses excessive and irregular spending. However, auditing financial accounts does not eliminate completely all deficiencies in the spending of a particular organization, even though it adds value and credentials to its financial accounts.

## Introduction

### Corruption as a wide-spread phenomenon in BiH

Despite long-lasting reforms, comprehensive analyses and billions of dollars of foreign aid that have been invested in the post-war development of Bosnia and Herzegovina over the past 15 years, the country still faces challenges such as corruption and its institutional inability to combat it. Politicians in Bosnia and Herzegovina claim that the country is implementing the majority of European practices in anti-corruption combat. Public officials as well as the general public underestimate the significance of different measures that are used to report corruption. One of these measures is the Corruption Perception Index reported by the methodology developed by Transparency International. According to the TI Corruption Perception Index for 2010, Bosnia and Herzegovina shares places 91 to 97 with countries such as Djibouti and Gambia. Kosovo is the only European country ranking lower on this scale than BiH. It is at the very bottom in terms of the presence of corruption in public administration.<sup>1</sup> Other relevant research also places the country on the list of the most corrupt European countries, while pointing out that the form of corruption as prevalent in Bosnia and Herzegovina is a most severe one, damaging the basic structural elements of society and thus disabling the country and partially its institutions to function efficiently and effectively. A lack of the political will and of a clear strategic framework and mechanisms for the implementation of anti-corruption policies has characterized all these past years.

<sup>1</sup> For full details visit [http://www.transparency.org/policy\\_research/surveys\\_indices/cpi/2009](http://www.transparency.org/policy_research/surveys_indices/cpi/2009)

It seems that corruption is no longer regarded as a social problem, but rather as a way of doing and solving things. This is also confirmed by various reports (e.g. Global Corruption Barometer) of the many international organizations and institutions operating in Bosnia and Herzegovina, all of them showing that the country is losing battle against corruption, faring increasingly worse on these lists each year.

### Remedy for corruption

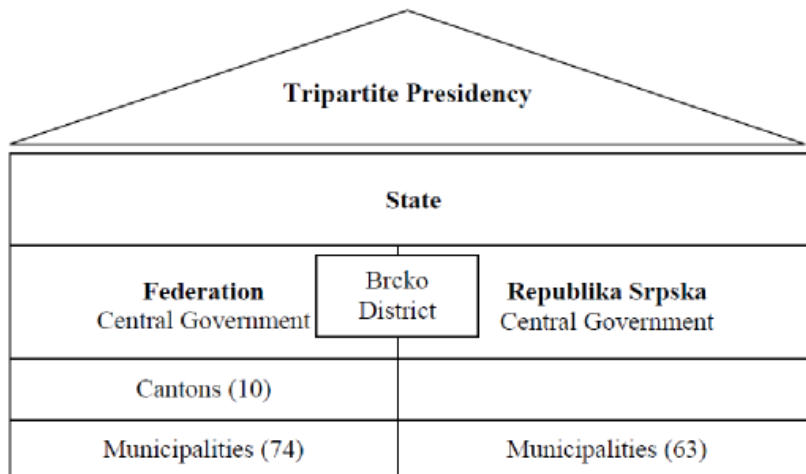
Corruption is a highly complex phenomenon. Struggle against corruption requires the adoption of a set of regulations against corrupt practices, a full-fledged code of conduct, campaigns that increase public awareness of this problem, education of civil servants, development of efficient internal controls, sanctions and incentives, as well as an open approach towards financial reporting. Most corruption takes place in an informal manner and through isolated contacts. Parties involved in corruption thus leave very little evidence that may be considered conclusive. Social expectations are that auditors should play an effective role in reducing, if not eradicating, corruption.<sup>2</sup> On the other hand, auditors can succeed in fighting corruption only if an adequate environment exists for such action. Furthermore, auditors tend to concentrate on tangible or physical proof, which they often find hard to gather. Thus, they often feel that they cannot do much about corruption. Nonetheless, although they cannot quantify corruption, auditors can indicate the existence of opportunities for corruption. This paper aims to specify the role of auditors in fighting corruption in the Republic of Srpska and to propose ways for its enhancement. In addition to that, it suggests the actions needed to enforce more transparent and open public spending by incorporating particular provisions in the RS legislation on the transparency of audit reports.

<sup>2</sup> Akram Khan, M. (2006) Role of audit in fighting corruption, Paper prepared for Ad Hoc group Meeting on Ethics, Integrity and Accountability in the Public Sector: Re-building Public trust in Government through the Implementation of the U.N. Convention against corruption



## Structure of the BiH public auditing sector

The public auditing sector in Bosnia and Herzegovina is structured in such a way that it follows the constitutional architecture of the country. The country is administered through a three-layered system of governance, as depicted in the chart below.



## The constitutional architecture of Bosnia and Herzegovina<sup>3</sup>

<sup>3</sup> For full details visit <http://publicintelligence.net/bosnia-and-herzegovina-country-assistance-strategy-fy08-fy11/>

In line with the chart given above, there are principally three Supreme Audit Institutions (SAIs) in Bosnia and Herzegovina, each having jurisdiction over an area as specified by law. These are:

- Audit Office for the Institutions of the Federation BiH
- The Supreme Office for the Republic of Srpska Public Sector Auditing
- Audit Office of the Institutions of BiH

The BiH State Supreme Audit Institution has jurisdiction over state-level institutions, while legal entities and institutions at the entity level are within the jurisdiction of the other two offices.

The Supreme Audit Institutions of Bosnia and Herzegovina have a firm legal basis in the three respective external audit laws, which are generally in line with international standards, but external audit is not as yet anchored in the Constitutions of the country. Since 2000, the three SAIs have gradually improved their audit capacity and enhanced their audit coverage, by increasing the number and professional capacity of their staff and by developing new methodologies for the parliamentary committees responsible for discussing audit reports.<sup>4</sup>

<sup>4</sup> SIGMA (2009), Bosnia and Herzegovina External Audit Assessment.

## Public spending in BiH

It is crucial to mention that the country inherited a robust public sector system from the socialist period, which has been additionally elaborated in the meantime, due to its complex constitutional architecture. One direct consequence of the increasing number of public institutions is greater spending in the public sector. It has been observed that public spending in Bosnia and Herzegovina has grown consistently over the years. The consolidated budgets of BiH, FBiH and RS have increased from 2.5 billion BAM in 2005 to nearly 5.9 billion BAM in 2011<sup>5</sup>. The projected budget for 2012 for the Republic of Srpska is 1.8 billion BAM.<sup>6</sup> It is hard to say how much the combined budgets of all levels of authority in Bosnia will amount to, but some estimates say they are likely to reach the sum of over 6 billion BAM. It is important to emphasize

<sup>5</sup> For full details visit: [http://www.oma.uino.gov.ba/04\\_izvjestaji.asp?l=b](http://www.oma.uino.gov.ba/04_izvjestaji.asp?l=b)

<sup>6</sup> Ministry of Finance of Republic of Srpska (2011), Draft budget for 2012, November 2011.

that this figure takes into account the funds distributed through the budget system, but there is significant funding that is generated through state-owned enterprises and self-financed public institutions. Some estimates say that these account for at least another budget. These institutions are mostly on the entity level and are managed by the entity governments. All these figures indicate that more money is in circulation, which in combination with the weak institutional system could mean increased susceptibility to corrupt practices.

### **Sources of financing of public institutions**

The majority of public institutions are financed through the budget, although a sizeable portion of funding is also generated through either the provision of services or the collection of various taxes and duties. Although almost all public institutions have their internal audit committees, the practice so far has shown that control and public oversight over these institutions is rather poor. Members of these internal committees are usually elected based on their political suitability and do not possess the required expertise. At this moment, the control mechanisms existing within these institutions may be deemed as rather ineffective, as long as new corruption cases are reported on a regular basis. The general perception is that public institutions are not operating in a transparent manner and the public is often unfamiliar with the way they expend funds. These nontransparent practices have resulted in a situation where there are never enough resources to cover all the necessary costs.

### **Present and proposed control mechanisms**

The main objective of this research is to identify control mechanisms that can restrict corruption and the mismanagement of public funds in RS. The introduction of these control mechanisms will be proposed through changes to the current public policies in the area that regulates public spending. Along with the identification of adequate control mechanisms, it is necessary to enforce more transparent and open public spending by incorporating specific postulates on the transparency of financial and audit reports of public sector institutions. To achieve the specified objectives, this paper must also analyze the current legislation, its benefits and shortcomings. On a practical level, this study will not be able to cover all public entities that exist in the Republic of Srpska or Bosnia and Herzegovina. It will focus on those entities that fall under the definition of public entity. In brief, it will analyze the current situation regarding the financial control of public institutions, providing some illustrative examples of how the inadequacy or even absence of control has contributed to the policy problem as defined above. Finally, it will offer certain recommendations that policy-makers should consider in the future.

The proposed changes ought to leave less room for corruption and fraudulent activities by creating additional control mechanisms over the spending of public resources. Internal control mechanisms may be established through the establishment of more efficient audit committees for all public entities.<sup>7</sup> At this point, the competences of such bodies are not clearly defined. An additional external control mechanism may be provided through setting the requirement that all state institutions and public companies must have their financial statements audited by an accredited audit company at least once every three years. Once the audit has been carried out, the audit committee should monitor the implementation of the recommendations given by the external auditor.

<sup>7</sup> Article 41 of the Directive 2006/43/EC of the European Parliament and of the Council of Europe of 17 May 2006 gives similar recommendations.



## Problem description

Every now and then, new cases of mismanagement of public funds are discovered in Bosnia and Herzegovina and the Republic of Srpska. What makes this problem significantly more serious is the fact that a growing number of such cases have been revealed over time. These anomalies occur in almost all segments of Bosnian and Herzegovinian society. They are common to all tiers of government in Bosnia and Herzegovina, whether it be the state, entity, cantonal or municipal level. Although the country's society is quite heterogeneous, it seems that corruption is equally prevalent among all ethnic groups living in the country. Some estimates claim that between 600 and 700 million BAM are misused annually due to the poor management of public funds.<sup>8</sup>

<sup>8</sup> For full details visit <http://www.tender.ba/Aktuelno.html>

Such irregularities are typically uncovered by the state auditors and members of the media. Progress in this area will only be made when sufficient public pressure is exerted on government institutions to act rationally and accountably. When facts about how state institutions expend their funds are disclosed, the general public will not only be informed about it, but the officials leading these institutions will feel that they are supervised and controlled. Such additional pressure will influence them to act more responsibly. The power of pressure as created by the public disclosure of information was frequently confirmed by Mr. Bosko Ceko, Auditor-General for the public sector of the Republic of Srpska. When asked if he was ever under pressure from politicians or representatives of public institutions under audit, he frequently emphasized that it was not a problem when they, as state auditors, give a negative opinion or qualification on the financial accounts of a particular public institution; problems arise when such an opinion is publicly disclosed, whether on Web site or elsewhere. Main principle of work is transparency; therefore, all reports that we issue are put on official Web site. Consequently, in case an opinion is not revealed publicly, the institution that is subject to control is likely to feel protected and privileged.

The current situation in the country regarding the financial control and oversight of public accounts is not satisfactory. There are even cases of high-ranking officials such as ministers admitting publicly to having, or having had, no knowledge of the actual financial situation in some public companies, as in the case of the Railways of Republic of Srpska. Even though the financial accounts of this particular company had been audited (even by the external auditor), the stakeholders did not take these into account and therefore problems in this company were accumulating.<sup>9</sup> They escalated into a two-month strike that occurred in 2011. The strike was suspended after lengthy and exhausting negotiations between state representatives on one side and the company workers on the other. None of the negotiating sides offered a solution to the problems accumulated in the company and it is reasonable to expect that the strike will happen again. Inappropriate reporting on the public accounts of some institutions has threatened to lead to a complete breakdown of their operations, so much so that, for instance, the District Prosecutor's Office of Banja Luka has not been able to carry out some of the most important investigations in the country.<sup>10</sup>

<sup>9</sup> For full details visit: <http://www.capital.ba/prikrivani-podaci-o-poslovanju-uzeljeznicama-rs/>

<sup>10</sup> For full details visit <http://www.nezavisne.com/novosti/bih/Okruzno-tuzilastvo-BanjaLuka-Dug-blokirao-istrage-91431.html>

Apart from these examples, there are public companies which do get their financial accounts audited on an annual basis. Unfortunately, these reports are nowhere to be found publicly, which leaves space for speculation and rumors. An illustration of this is the case of the Public Company Republic of Srpska Motorways. This public company has taken a number of loans from both national and international creditors, on the condition that its financial accounts are

<sup>11</sup> For full details visit: <http://novitalas.com/2011/07/23/jp-putevi-rs-na-racunufali-4-miliona/>

audited by trustworthy and credible audit companies. In 2011, the media reported on an alleged case of embezzlement in this company.<sup>11</sup> This may be seen as indicative of nontransparent financial reporting, adding reasons for public speculation and distrust regarding the consumption of public funds.

<sup>12</sup> Transparency International, Bosnia and Herzegovina (2007), National Integrity System Study

The process of privatization helped reveal incriminating evidence linking certain layers of authority with public money mismanagement, indicating poor governance of public companies and proving various irregularities. Although little of this incriminating evidence has been taken to court, it is indicative of the existence of corrupt practices. For instance, it is not uncommon to see in the media that certain goods or services that were the subject of public procurement were overpaid for at least several times than their market price. This makes it easy to conclude that such criminal activities could not be undertaken without the direct participation and support of high-ranking power structures.<sup>12</sup> There are everyday examples of fraud and asset misappropriation exacerbated by the country's weak institutional capacities, which are uncovered by the media or made public or even incidentally revealed during political conflicts between political opponents. Two separate and highly indicative cases illustrate the country's weak institutional capacities. The first concerns a case of money embezzlement committed by an accountant who was working for a public institution at the entity level. The accountant forged signatures of authorized persons in order to access the money deposited in the current account of the institution. The accountant kept doing this for approximately two years, and it was reported that the total amount he took from the account by forging signatures was around 300 thousand BAM.<sup>13</sup> The second case concerns the misappropriation of assets, where the presiding judge of a municipal court charged more money for the court fees than what was prescribed by the Law on Court Taxes. Although the extra money was not used for private purposes, this clearly indicates deficiencies in the internal control system of the particular municipal court.

<sup>13</sup> For full details visit: <http://www.glassrske.com/vijest/6/hronika/38584/lat/Crna-hronika-vikend-14-15-april.html>

All of the above examples demonstrate that not only are institutions very weak, but also **control mechanisms for public spending are either non-existent or very poor**. Therefore, **non-transparent and uncontrollable spending of public resources leaves room for all kinds of corrupt and fraudulent activities**. On the other hand, the reaction of relevant authorities such as the Prosecutor's Office or of the public is customarily more than cautious and lethargic – we can even say non-existent.<sup>14</sup> The bottom line is that it is the interests of taxpayers and general public to establish such control mechanisms. They are the most seriously jeopardized by such practices.

<sup>14</sup> For full details visit: <http://www.glassrske.com/vijest/6/hronika/19821/lat/Nedija-Sehalic-oslobodjena-optuzbe.html>



## Policy options

Public officials must be held accountable to the public and to the legislature for their performance and management of public funds and assets. The unit by which financial accountability is measured is information, but officials are unlikely to always agree with members of the legislature as to the quantity and quality of information that should be provided. The Audit Office of the Institutions of BiH stands at the peak of the financial accountability pyramid. It is therefore crucial that the selection of this office-holder not be in the gift of the ruling political structure. If it is, it is somewhat like asking the burglar to select the watchdog. Indeed, political appointments of auditors-general have been the basic cause of many of the problems with integrity systems in various parts of the world.

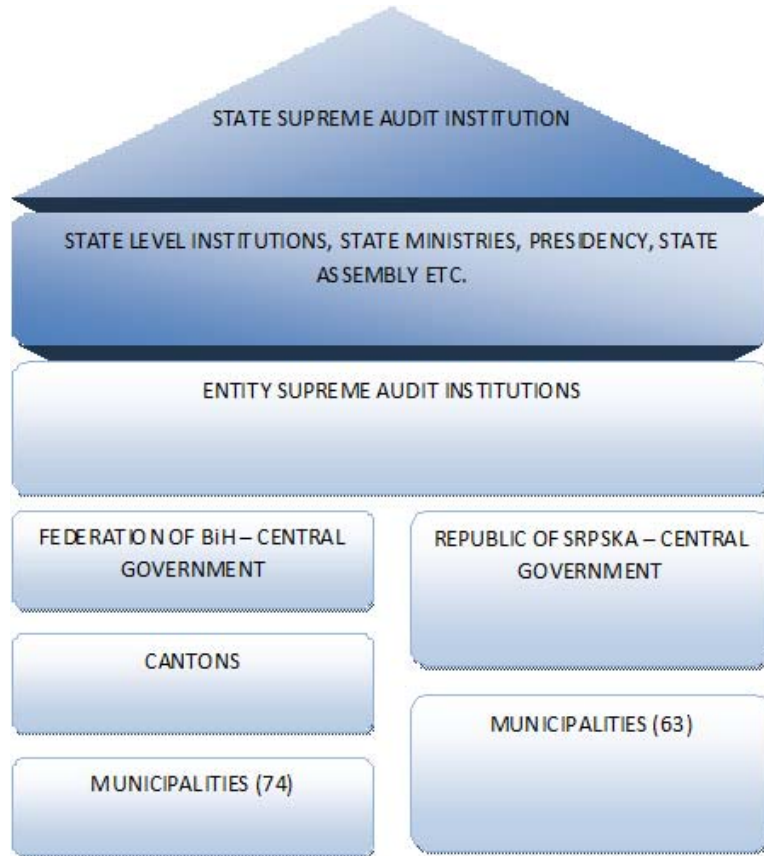
While certain auditors have the authority to take action on their findings, this authority is mostly limited. These actions usually include giving recommendations or submitting conclusions to some other bodies for action. **The real power of the auditor rests on the fact audit reports are made public.** At this point, there is no provision in the Law on Public Enterprises of the Republic of Srpska or any other law that stipulates this authority. Audit reports that are carried out by commercial auditing companies for public entities are not released in the Official Gazettes or made public in any other ways. Unlike the legislation of Bosnia and Herzegovina, the Directive 2006/43/EC of the European Union clearly specifies provisions for statutory audits of public entities, along with the requirement that they must be made public. It clearly defines conditions under which audit reports are to be released together with other necessary supporting documentation. The imperative for the public disclosure of financial accounts as well as audit reports has to be made explicit in the RS legislation that regulates the work of public institutions.

Certain improvements have been made in this area recently. In 2011, the Government of the Republic of Srpska carried out a process wherein each ministry had to analyze the relevant current legislation in terms of its compatibility with that of the EU. The process was prompted by the commitments taken on by the country's signing of the Stabilization and Association Agreement. As a result, changes were made to the Law on Public Companies, which stipulates that all financial and organizational structures of companies have to be revealed publicly. This represents an improvement, although the Law does not give a precise definition of the terms 'financial and organizational structure'.

One of the pillars of control over the spending of public funds is control in the form of annual audits of financial statements. Audits of institutions play a crucial role in the prevention of various corruption-related activities. By making their reports publicly available, they help the media and society as a whole become aware of the financial situation in a particular institution. This may also trigger a new momentum in that journalists might start asking the ruling politicians and heads of public companies tricky questions.<sup>15</sup> Such disclosures ought to spur decision-makers to start acting in a more accountable way. More transparent financial management of public companies will help not only decision-makers, but also all other stakeholders in reaching their decisions.

<sup>15</sup> For full details visit: <http://www.oslobodjenje.ba/index.php/swf/swf/index.php?id=3836>

As previously indicated, the structure of the Supreme Audit Institutions in BiH follows the constitutional structure of the country as presented in the chart below:



Speaking figuratively, the supreme audit institution is the backbone of a country’s integrity system. As the body responsible for controlling government income and expenses, the auditor-general acts as a sort of a watchdog over its financial integrity and the credibility of reported information.

The classic description of the role of the office is that the auditor-general audits the appropriation of funds on behalf of the legislative bodies. He is the external controller of government, acting on behalf of the taxpayer, through parliament, and it is on his investigations that parliament has to rely for assurances about the accuracy and regularity of government accounts.

The fundamental purpose of auditing is the verification of records, processes or functions by an entity that is sufficiently independent of the subject under audit as not to be biased or unduly influenced in its dealings. The degree of thoroughness and level of detail of audits vary but, in general, they should fully examine the accuracy and integrity of actions taken and records kept.

The United Nations Convention against Corruption treats audit requirements as elements of prevention, in both the public sector and the private sector, but specific elements of the Convention, such as the requirements to preserve the integrity of books, records and other financial documents, make it clear that the functions of deterrence, detection, investigation and prosecution are also contemplated.<sup>16</sup>

<sup>16</sup> Anti-corruption toolkit UN, 3rd edition, (2004) For more information visit: [http://www.unodc.org/documents/corruption/publications\\_toolkit\\_sep04.pdf](http://www.unodc.org/documents/corruption/publications_toolkit_sep04.pdf)





As with many preemptive actions, auditors prevent corruption by making it riskier and more difficult, while at the same time laying foundations for responsive and corrective measures in cases where it is not prohibited or deterred. **Audits work primarily through transparency.** While some auditors have the authority to act on their own findings, their responsibilities are usually limited to investigation, reporting on matters of fact, and occasionally to making recommendations or referring conclusions to other competent bodies for action. **While auditors may report to different bodies such as governments, boards of directors or internal audit committees, their real power resides in the fact that audit reports are made public.**

Once an audit is carried out, it serves the following specific purposes:

- It verifies information independently and establishes an accurate picture of the institution or particular function that is being audited.
- It identifies internal control weaknesses, administrative flaws, or other shortcomings that insiders may be unable or reluctant to recognize.
- Public sector audits place credible information in front of the public, thus putting political pressure on the stakeholders in power to act in response to the problems identified.

Where certain anomalies are identified, auditors present a mechanism through which issues can be referred to law enforcement or other disciplinary authorities that are independent of the institution under audit.

Audits differ markedly in scope, subject matter, the powers of auditors, the independence of auditors from the institutions or persons being audited, and what is done with reports and conclusions and other results. Audits range in size from minor contractual arrangements, in which an auditor may be asked to examine a specific segment or aspect of the business activities of a private company, to the employment of hundreds of audit experts, responsible for auditing an entire range of activities of a large government. Auditors may be mandated to carry out specific tasks, although that can compromise their independence; or they may be given general powers, not only to conduct audits but to decide which aspects of a business or public service they will examine each year. Public sector auditors are generally in the latter category because of the large volumes of information to be examined, the expertise required and the sensitivity of much of the information under review. The need for a high degree of autonomy and resistance to undue influence is also an important reason for giving public sector auditors such discretionary authority.<sup>17</sup>

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<sup>17</sup> Ibid.

Depending on the extent of control and the degree of objectivity needed, audits may be carried out by specialized units acting from within a government, or by fully independent institutions or private external companies. Internal audits are useful for quick, efficient review of inside activities and, in some cases, for auditing that requires access to sensitive information. However, these institutions are under the control of the head of the unit being audited, and may not be made public or reported outside the organization involved. External audit contractors offer much greater independence and better guarantees of transparency and public access to findings.

According to the Law on Public Auditing Sector in Republic of Srpska, The Supreme Office for the Republic of Srpska Public Sector Auditing is in charge for the audit of public accounts of all ministries, courts and other governmental bodies, municipal bodies, public funds and other public institutions. Furthermore, Law specifies that Supreme Office carries out annual audit of

the consolidated financial accounts of the budget of government of Republic of Srpska. The frequency and modality of audits of individual institutions is decided upon by the Supreme Office, taking into account any previous audits by commercial companies conducted in line with applicable standards.<sup>18</sup> Since its inception in 2001, the Supreme Office for the Republic of Srpska Public Sector Auditing has carried out several hundred audits. These numerous audits have contributed significantly to the control of public spending and the implementation of relevant laws. By comparison, only 2% of the entities audited in 2001 were given positive and unqualified opinions, while that figure was as high as 33% in 2010. Clearly, some progress has been made in the area of public spending. Unfortunately, due to the poor understanding of audit reports and the lethargy of relevant bodies/authorities, only a few of these reports have led to charges being brought by the Prosecutor's Office.<sup>19</sup>

In that sense, it is important to emphasize that the Supreme Office for the Republic of Srpska Public Sector Auditing has carried out audits at almost all levels of government during the past decade. This office has made efforts to try and identify perpetrators of illegal actions and activities, although other institutions have ignored its good intentions. There have been instances of audit report denials by members of National Assembly. Although some cases have been publicly disclosed, primarily by the media, the response by the competent authorities has been muted and slow.

However, **a significant proportion of public institutions, municipalities, public companies as well as self-financed institutions that manage public funds remain unaudited and thus uncontrolled.** The reasons for this are found in the fact that the Supreme Office for Auditing is limited in its capacity and resources. In 2011, the Auditing Committee of the National Assembly of the Republic of Srpska proposed to increase the budget of the Supreme Office. However, the proposal was rejected by the parliamentary majority in the National Assembly, thus showing that the governing political structures do not recognize the importance of financial control of public spending. Moreover, the Auditor-General was publicly criticized for giving a qualified opinion on the consolidated financial accounts of the 2010 budget. This critique came from the current Minister of Finance of the Republic of Srpska in the form of a statement, claiming publicly that the work of the Auditor-General ought to be examined by another institution, despite the fact such practice is not prescribed by law.

However, certain (albeit limited) improvements have been made in dealing with the institutions and persons in authority that have received negative audit reports by the Supreme Office for Auditing. In 2010, the Auditing Committee of the National Assembly of the Republic of Srpska succeeded in amending the Rule Book of the National Assembly of the Republic of Srpska to request a public hearing of the person in authority of any institution receiving a negative opinion. Accordingly, in 2011, after the Ministry of Sport, Youth and Family received a negative opinion on its financial statements for 2010, the committee in charge conducted a public hearing of Minister Proko Dragosavljevic.<sup>20</sup> The public hearing resulted in a ruling by the Parliamentary Committee whereby all documentation indicating or pertaining to corrupt activities by the Ministry in question were to be submitted to the Prosecutor's Office. Apart from this, the Committee also proposed budget cuts for the afore-mentioned Ministry for the next fiscal year.

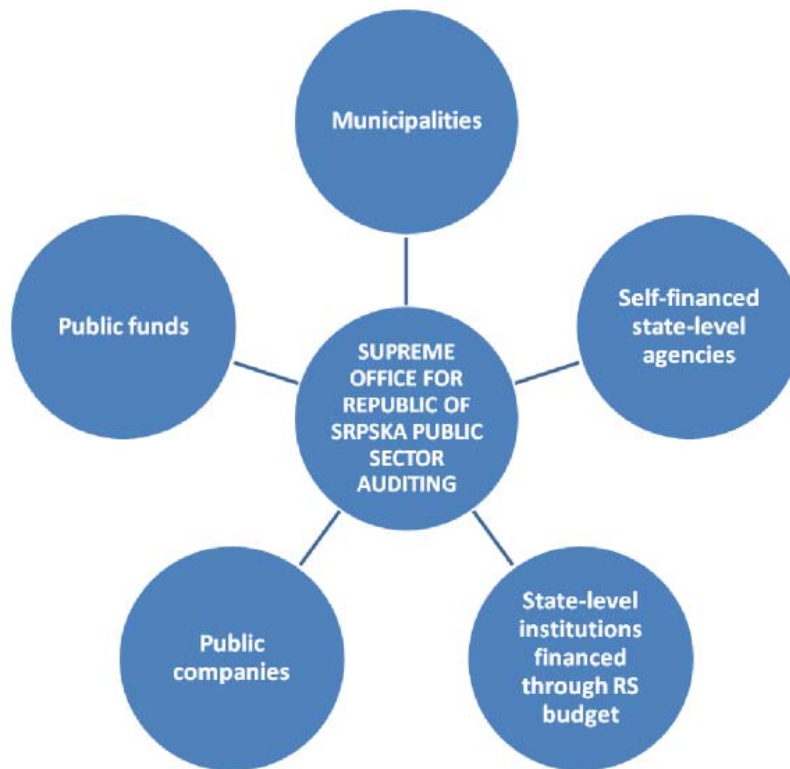
<sup>18</sup> Law on Public Sector auditing, Official Gazette of Republic of Srpska 98/05, Article 18

<sup>19</sup> For more information please visit: <http://www.mojevijesti.ba/novost/75086/borba-protiv-korupcije-samo-deklarativna>

<sup>20</sup> For full details visit <http://www.6yka.com/index.php/prokdod>



The chart below summarizes the structure of public institutions in the Republic of Srpska:



The latest data for the Republic of Srpska reveal that the Supreme Office for the Republic of Srpska Public Sector Auditing has carried out 39 audits for the year 2010. The table below compares the total number of institutions audited with the total number of institutions that exist. This figure is for the fiscal year 2010 only.

Type of institution <sup>21</sup>	Number of audits in 2010	Total number of institutions	Coverage percentage
Public institutions financed through the budget (government and its bodies)	25	86	29%
Self-financed public institutions	2	13	15%
Public funds	3	12	25%
Public companies	0	23	0%
Municipalities	9	63	14%
<b>Total</b>	<b>39</b>	<b>197</b>	<b>20%</b>

It is evident from the above diagram and table that the supreme office for auditing cannot control all budget and non-budget funds. Budget beneficiaries are somewhat easier to control, since they all receive funding from a single source, while on the other hand public companies are self-financed through the provision of their usually monopolistic services. So, for instance,

<sup>21</sup> For full details visit Report of the Auditor-General of the the Republic of Srpska on the Audit of Consolidated Financial Statements

if we compare the consolidated revenues of all companies that comprise the Power Utility of the Republic of Srpska (Elektroprivreda RS), it is easy to conclude that they equal one-third of the annual budget (600 million BAM of 1.8 billion BAM) of the Republic of Srpska. It is symptomatic that over the past several years, most of the corruption cases occurred in institutions that are seldom audited or controlled. This problem could be resolved by imposing an audit requirement on all public entities and making these reports publicly available.

Thus far, the practice regarding the audit requirement as well as the public disclosure of audit results has varied and is highly unspecified. Different institutions act differently concerning the auditing of their financial accounts. While some institutions and public companies are required by law to get their accounts audited by a private external auditing contractor, the majority of them are not required to do so. One positive example is that of the Regulatory Commission for Energy of the Republic of Srpska, which selects an auditor using a transparent selection procedure each year. These reports are also publicly available for downloading from its Web site. This institution has gone even further, by adopting special internal acts regarding the availability of information in line with the Freedom of Information Act. Another positive example of such practice is the Public Broadcasting Service of the Republic of Srpska (locally known as the RTRS). This public company has also adopted internal rules requesting the auditing of its financial accounts, as well as the obligation to publicly disclose the related reports.

On the other hand, accounts of the Power Utility of the Republic of Srpska (Elektroprivreda RS) are also audited and controlled annually by an external auditing company. Since all individual companies comprising the electric utility system are listed on the Banja Luka Stock Exchange, these reports are available for the general public. However, the main report on the consolidated financial accounts of the entire system is not publicly disclosed anywhere. Such a situation is explained by the fact that such a report would reveal some confidential information about the system, which is in fact directly inconsistent with the Freedom of Information Act currently in force in Bosnia and Herzegovina.

The situation regarding the process of financial control is probably the worst in the case of the public funds. Three public funds manage the largest financial resources, and they are the Pension and Disabilities Insurance Fund of the Republic of Srpska, the Health Insurance Fund of the Republic of Srpska, and the Republic of Srpska Investment-Development Bank. In reality, the Republic of Srpska Investment-Development Bank manages six different public funds, and these are:

- Housing Fund
- Development and Employment Fund
- Fund for the Development of the Eastern Part of the Republic of Srpska
- Shares Fund
- Restitution Fund of the Republic of Srpska
- Real Estate and Claims Funds

The Pension and Disabilities Insurance Fund of the Republic of Srpska collects pension contributions from all legal entities in the Republic of Srpska. The annual budget of the Fund amounts to approximately one billion BAM. The last time the Supreme Office for the Republic of Srpska Public Sector Auditing carried out an audit of this entity was two years ago. The Health Insur-



ance Fund of the Republic of Srpska collects health contributions from all legal entities in the Republic of Srpska. The annual budget of this Fund amounts to approximately a half a billion BAM. The last time this entity was audited by the Supreme Office for the Republic of Srpska Public Sector Auditing was two years ago. The audit reports on both of these Funds revealed certain breaches of law; nevertheless, there is no legal requirement for them to hire an external auditing company.

The RS Investment-Development Bank together with all its funds is the largest financial state institution in the Republic of Srpska. The total assets of all its funds combined are estimated at several billion BAM. A law exists which stipulates its annual auditing (Law on the Investment-Development Bank). However, only reports on the Investment-Development Bank have been submitted to the National Assembly of the Republic of Srpska for adoption, whereas the reports on the Funds have never been disclosed publicly. This makes little sense and renders auditing purposeless, since it is the Funds that actually approve loan placements.

As far as municipalities are concerned, there is limited control over their financing as well, and it is exercised solely by the Supreme Office for RS Public Sector Auditing. Municipal budgets vary significantly, ranging from around 1 million BAM (e.g., the Municipality of East Old Town of Sarajevo) to the 140 million BAM (the budget of the City of Banja Luka, considered the largest municipality in terms of resources). No audit of the budget of the largest municipality has been carried out in three years.

In theory, it would be possible to engage the Supreme Office for RS Public Sector Auditing to inspect all public institutions on an annual basis, although such a practice would require a significant increase in the budget of this institution. Such a scenario is very unlikely to happen, since authorities at all levels are trying to tighten the belt. Apart from this, consistent annual inspection of any institution may prove counter-productive to some extent, as the objectivity of the auditor-general may come under threat.

As it stands, the Supreme Office for RS Public Sector Auditing puts forward an annual plan, which is then adopted and approved by the National Assembly of the Republic of Srpska. The selection procedures for institutions that are to be audited have to be carefully designed. Even though no external expertise is used in the selection, it may prove useful and worthwhile.

Engaging the private sector in the financial control over the expenditure of public money would have its pros and cons. The private sector is definitely more productive and efficient, but one has to keep in mind that it functions on a commercial basis. Perhaps the most effective solution would be a combination of private and government-financed or state auditing. Accordingly, it is possible to specify the following policy options regarding the audit requirement:

Policy option	Zero-option (current situation)	Alternative 1 (mandatory annual auditing of all institutions)	Alternative 2 (auditing contingent upon previous report)	Alternative 3 (auditing contingent upon previous report)
Requirement for annual audit by Supreme Office for Auditing	No (only to the extent it is prescribed by the plan of the Supreme Office for Auditing)	No (only to the extent it is prescribed by the plan of the Supreme Office for Auditing)	No (Audits would be carried out by the Supreme Office for Auditing of only those institutions whose accounts were previously found to be out of order.)	No (Audits would be carried out by the Supreme Office for Auditing of only those institutions whose accounts were previously found to be out of order, as well as according to its annual plan.)
Requirement for annual audit by private company	Unspecified (only sporadic)	Yes	No (Institutions would be audited annually every three years in case their accounts were previously found to be in order. Otherwise, they would be audited annually.)	No (Institutions would be audited once every three years in case their accounts were previously found to be in order. Otherwise, they would be audited annually.)
Frequency of audit by private contractor	Unspecified	Annual	Once every three years	Once every three years
Transparency requirement	Unspecified	Yes	Yes	Yes
Cost estimate	Moderate	Very high	Medium	High
Coverage of institutions	Moderate	Full (100%)	Medium	High

The zero-policy option is the one currently exercised. It means there is no requirement in the current legislation for mandatory annual audits, and the audits carried out by the supreme office for auditing are implemented according to an annual plan. On the other hand, the applicable legislation does not specify the frequency or transparency of audits carried out by private contractors either. Consequently, the reports of private auditing companies, which are engaged occasionally, are not disclosed publicly.

Alternative 1 sets the requirement for all public institutions to be regularly audited by a private contractor on an annual basis. In addition to this, the Supreme Audit Institution would carry out audits of these institutions according to its plan. This policy option would prove to be too costly, as it would cover all public institutions in the system. The benefits of such practice would not prove worthwhile, since substantial resources would be spent.



Alternative 2 sets the requirement for all public institutions to be regularly audited by a private contractor at least once every three years. In case irregularities are found by a private contractor, the institution in question would become subject to an inspection by the Supreme Office for Auditing. Although this option would require only minor rises in costs, it would cause too heavy a reliance on the private contractor and its opinion regarding the financial position of a company.

Alternative 3 sets the requirement for all public institutions to be regularly audited by both the Supreme Office for Auditing and a private contractor. Private contractors would only be hired once every three years, provided the company's accounts are in order, while at the same time the engagement of the Supreme Office for Auditing would take place according to its plan. Apart from this, the engagement of the Supreme Office for Auditing would also be necessary in cases where irregularities have been revealed by a private contractor.

Although the costs to implement this policy option would be somewhat relatively high, it would certainly impose stronger financial discipline among the public institutions. In addition to that, it would also result in significant costs savings, as institutions would be supervised and controlled on a more consistent basis. Therefore, in the circumstances, this policy option would turn to be the most feasible and practical one.

One has to keep in mind the positive and negative aspects of hiring private-sector auditing companies to do the job of verification of records. One of the greatest benefits of such a decision is that it would help reduce bureaucracy. Private contractors can also prove to be more efficient than the SAIs by their nature. By the same token, private contractors work for money after all and they can easily feel pressurized by the client in a sense that they will not get the job if they do not succumb to the requests of the client. Thus, contracting audit projects to external companies could put the performance of duties at risk. Audit companies are increasingly made to tender for audit projects and unease has grown among auditing professionals that dropping contract prices may damage the quality of work of auditors, a concern which has become a major problem for the profession in certain countries.

Unless contracting out is a deliberate move aimed at reducing the accountability of state auditors, such a move would be based on an unspoken belief that they lag behind the best practice in the private sector when it comes to auditing commercial organizations. This indicates the need to better equip the Supreme Office for Auditing. If, however, circumstances dictate that a particular audit will best be conducted externally, constitutional propriety will be ensured if the Supreme Office for Auditing maintains jurisdiction but, contingent upon consultation with the competent authorities, decides to sub-contract a private sector firm to carry out the work. It is of critical importance that the Supreme Office for Auditing be, and remain, the statutory auditor of all public bodies. Certainly, the notion that a public agency should be free to select between competing private firms to which they should be accountable – and for how long – flies in the face of the concept of sustainable accountability.

That being said, there will be occasions, particularly in countries where auditing resources in the public sector are scarce, where private sector firms will have to play a role. A conflict of interests is an inherent danger in contracting out the functions of the supreme office for auditing. A private auditing firm should be banned from providing other services to the public institution being audited, at least for as long as the duration of the audit contract. Indeed, a most compel-

ling argument deployed by the private sector is that an external auditor can provide a range of additional financial services presently not provided by auditors-general. This argument ignores the importance of conflict-of-interest considerations in public sector work.

Perhaps the most powerful argument against contracting auditing services to the private sector is that the supreme office for auditing acts as a filter between the audited departments, ministries and individuals, and the legislature. If the legislature cannot rely on the supreme office for auditing to single out the most important issues, it will be confronted by a range of reports originating from countless accounting firms. In the face of many individual reports, each with its own claims for the legislature's attention, the task for the legislature of identifying the most important issues will be an extremely demanding and time-consuming one.

In some countries, the modern trend is for government-owned or government-controlled companies to be freed from the supreme office for auditing examination by gaining authority to appoint a private sector auditor to conduct an audit under the auspices of its own legislation and beyond the oversight of the supreme office for auditing. Such practice would not be possible under the circumstances, as the supreme office for auditing is fairly independent in making its annual audit plans.





## Conclusion and recommendations

### ***Public disclosure and the auditing requirement***

1. **The imperative for the public disclosure of audit reports has to be made explicit in the legislation that regulates public entities.** The real power of auditors remains in the fact that audit reports are made public. These actions usually mean giving recommendations or submitting conclusions to some other bodies for action. At this point, there is no specific provision in the Law on Public Enterprises or in any other law in the Republic of Srpska that stipulates this. Some audit reports on public entities are neither released in the Official Gazette of the Republic of Srpska nor made public in any other way. Unlike the legislation of Bosnia and Herzegovina, the Directive 2006/43/EC of the European Union clearly specifies provisions for statutory audits of public entities. It clearly defines conditions under which audit reports are to be released along with other necessary supporting documentation. However, certain improvements have been made in this area in the second half of 2011. When Bosnia and Herzegovina signed the Stabilization and Association Agreement, it took on the commitment to make changes to the relevant legislation with regards to the transparency of financial and organizational structures. In line with this requirement, the Republic of Srpska has amended its Law on Public Enterprises in this direction. Along with that, it has also introduced a regulation whereby all public entities are required to disclose information on how they utilize public assets. Nevertheless, this regulation still does not oblige them to publicly release their financial and auditor reports. In addition to this, the interpretation of this legislation and regulation will probably vary among institutions, because it does not specify a particular form that financial statements and notes should take. Furthermore, it does not specify the level of detail either, so one can assume that institutions are going to put only the most general information on their Web-sites.

### ***Contracting auditing to external companies***

2. **Public institutions should be audited by credible external auditing companies.** By contracting out financial control, not only will better oversight of these institutions be achieved, but responsibility for it will also be shared. These proposed changes aim to leave less room for corrupt activities by creating additional control mechanisms over the spending of public resources. Such additional external control mechanisms may be generated through the introduction of the requirement that all state institutions and public companies must get their financial statements audited by an accredited auditing company at least once in a period of three years. Once an audit has been carried out, the relevant audit committee should monitor the implementation of the recommendations given by the external auditor in its report. In case any breaches of law or irregularities are reported, the supreme audit institution would also carry out an audit in order to confirm or deny such findings. In this way, control of the financial resources would be focused more closely on those institutions that turn out to be problematic.

### ***Internal auditing committees***

3. **Strengthening internal audit committees.** Internal control mechanisms may be established through the creation of an audit committee for every public entity.<sup>22</sup> At this point, competences of such bodies are not clearly defined.

<sup>22</sup> For full details visit Directive 2006/43/EC of the European Parliament and of the Council of Europe of 17 May 2006

***Supreme Audit Institution***

4. **Strengthening the capacity of the Supreme Audit Institution.** Fighting corruption and fraud requires a many-sided approach involving a thorough reform of the public administration, judiciary and, above all, the cultural values of a particular society. Representing an irreplaceable element of that combat, the supreme audit institutions have to be given continuing unqualified support both in terms of funding, and logistics.

***Application of accounting standards***

5. **Ensuring the full application of International Accounting Standards for Public Sector as the best practice in the field of financial reporting.** Relevant international institutions have set a framework for the process of financial reporting, which outlines the form and content of financial reports to be made by public institutions.



## Appendices

**Appendix A:** List of institutions that were subject of the research

**Budget institutions:** Government of Republic of Srpska and its ministries, Supreme Office for Republic of Srpska Public Sector Auditing, district and municipal courts and prosecutors' offices;

**Self-financed public institutions:** Regulatory Commission for Energy of Republic of Srpska, Republic of Srpska Securities Commission, Banking Agency of Republic of Srpska, Insurance Agency of Republic of Srpska, Republic of Srpska News Agency (SRNA);

**Public funds:** Pension and Disability Insurance Fund of Republic of Srpska, Health Insurance Fund of Republic of Srpska, Republic of Srpska Investment-Development Bank, Housing Fund, Development and Employment Fund, Fund for Development of Eastern Part of Republic of Srpska, Shares Fund, Restitution Fund of Republic of Srpska, Real Estate and Claims Funds;

**Public companies:** Power Utility of Republic of Srpska (Elektroprivreda RS – matično preduzeće) a.d. Trebinje, Public Broadcasting Service of Republic of Srpska (Radio-Televizija Republike Srpske), PC Republic of Srpska Motorways (JP Putevi RS), Airports of Republic of Srpska (Aerodromi RS a.d. Banja Luka);

**Municipalities:** Banja Luka, Laktasi, Prijedor, Istočno Sarajevo

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