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## Public internal financial control reforming in Ukraine: conceptual foundations and practices

**Abstract**

*Introduction.* In the conditions of crises, the availability of effective public financial control is a primary need for the state.

*The purpose* of the research is theoretical justification of conceptual principles of public internal financial control and development of guidelines for the implantation of public internal financial control in the modern system of public financial control in Ukraine.

*Results.* The authors of the article have examined basic elements of the present public financial control and presented a critical analysis of the relevant issues. The article determines the place of internal control in the public financial control system and proves the necessity of public internal financial control via using official statistics data of public internal financial control.

According to the official data for the last 9 years, a rapid decline in the total number of audits in Ukraine from 17,563 in 2007 to 2,668 in 2016 is observed. In this regard, the year 2014 stands out. A sharp increase in the number of audits up to 24,000 marked that year, which was primarily due to a large number of audit controls of public procurement, which were probably initiated because of the aggravation of the political situation, connected with the changes in the government. This explains why the figures of 2014 should be considered as not a typical one.

The conducted research covers the main approaches to public internal financial control. The basic problems of reforming the current public financial control system are formulated.

*Conclusions.* The authors of the article have developed proposals related to the development of the internal financial control system in the public financial control in Ukraine, namely the guidelines concerning the implantation of public internal financial control in the modern public financial control system in Ukraine, as well as successive stages of reforming public internal financial control at three independent levels.

**Keywords:** Internal Control; Public Financial Control; Public Internal Financial Control; State Audit Service of Ukraine

**JEL Classification:** G28; P43

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**Реформування державного внутрішнього фінансового контролю в Україні:****концептуальні засади та практика реалізації****Анотація**

У статті наведено основні елементи діючої сьогодні системи державного фінансового контролю та зроблено її критичний аналіз. Обґрунтовано місце внутрішнього контролю в системі державного фінансового контролю та за допомогою офіційних статистичних даних доведено необхідність державного внутрішнього фінансового контролю.

Встановлено наявність основних підходів до державного внутрішнього фінансового контролю. Сформульовано основні проблеми реформування поточної системи державного фінансового контролю. Розроблено пропозиції, спрямовані на розвиток внутрішнього контролю в системі державного фінансового контролю в Україні, а саме: запропоновано методичні рекомендації по впровадженню державного внутрішнього фінансового контролю в сучасну систему державного фінансового контролю в Україні. Визначено послідовні етапи реформування державного внутрішнього фінансового контролю на трьох незалежних рівнях.

**Ключові слова:** внутрішній контроль; державний фінансовий контроль; державний внутрішній фінансовий контроль; Державна аудиторська служба України.

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**Реформирование государственного внутреннего финансового контроля в Украине:****концептуальные основы и практика реализации****Аннотация**

Рассмотрены основные элементы действующей сегодня системы государственного финансового контроля и сделан её критический анализ. Определено место внутреннего контроля в системе государственного финансового контроля и с помощью официальных статистических данных доказана необходимость государственного внутреннего финансового контроля. Установлено наличие основных подходов государственного внутреннего финансового контроля. Сформулированы основные проблемы реформирования текущей системы государственного финансового контроля. Разработаны предложения, направленные на развитие внутреннего контроля в системе государственного финансового контроля в Украине, а именно: предложены методические рекомендации по внедрению государственного внутреннего финансового контроля в современную систему государственного финансового контроля в Украине. Определены последовательные этапы реформирования государственного внутреннего финансового контроля на трёх независимых уровнях.

**Ключевые слова:** внутренний контроль; государственный финансовый контроль; государственный внутренний финансовый контроль; Государственная аудиторская служба Украины.

**1. Introduction**

The current stage of development of the Ukrainian economy is characterised by a number of crises, instability of external and internal political environment and other negative phenomena. Undoubtedly, all these factors have impact the quality of public financial management. Under such conditions, the effective public financial control is a primary need for the state.

To build a system of public financial control, which would be able to perform the control function of public finance effectively, it is essential to formulate clear and understandable conceptual bases of public financial control. The presence of such bases will bring public finance management to a new level.

**2. Brief Literature Review**

A considerable number of scientists have been studying issues related to conceptual bases of public financial control, including I. Basantsov [1], V. Hlushchenko [2] A. Ivanytska [3] O. Natarova [4], V. Pikhotskyi [5], I. Stefaniuk [6], I. Chuhunov and V. Fedosov [7], Yu. Futorska [8], and I. Chumakova [9].

**3. The purpose** of the research is theoretical justification of conceptual principles of public internal financial control and development of guidelines for the implementation of public internal financial control in the modern system of public financial control in Ukraine.

**4. Result**

Today, scientists have identified a number of concepts that are or were characteristic for different countries at different times. According to international practice, there is a difference between two diverse approaches to internal control. The first and more traditional one is characterised by delegated, but centralised control. Specially created bodies or financial controllers under the supervision of the central authority, such as the Ministry of Finance, execute the control function. Managers rely on centralised control services when making financial decisions. Thus, the concept of responsibility of the manager is not developed. Decentralised internal audit does not play any role, further financial controllers fulfil financial audit and independent audit system do not exist.

Another approach to public financial control is the concept of PIFC (public internal financial control) based primarily on the responsibility of the head of the entity that manages public funds. This concept includes basic principles stated in the Lima Declaration of Guidelines of control [10] and in the Framework of Internal Control COSO (Committee of Sponsoring Organizations of the Treadway Commission) [11].

Such concept is prevalent in many countries of the European Union.

Since 2005, with the approval from the Cabinet of Ministers of the Concept of Development of Public Internal Financial Control in Ukraine [12] (hereinafter - the Concept 2005) a concept that is prevalent in European countries has been a basis for building a system of public financial control. The introduction of new models of public financial control represents not only the basic needs in improving the national public financial management system, but also represents a key prerequisite for Ukraine's accession to the European Union.

The approved Concept provides introduction of public internal financial control and concerns neither external public financial control nor independent financial control (audit). The basic principle of public internal financial control is a clear distinction between internal control and internal audit. Internal audit should determine how internal control is carried out, including the methods of previous control. The basis of internal control is the responsibility of the head of the relevant body for management and development of the budgetary institution, etc. as a whole is the basis of internal control.

As shown in Figure 1, public internal financial control has three components: internal control, internal audit and their harmonisation.

According to the Concept 2005, harmonisation objectives are:

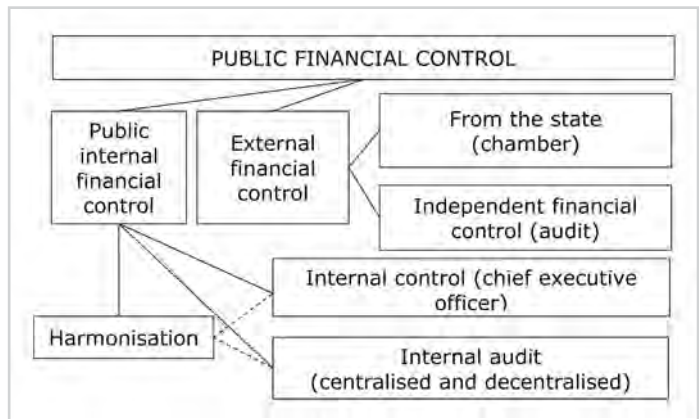


Fig. 1: Place of public internal financial control in public financial control and its components

Source: Developed by the authors based on Concept 2005 [12]

- provision of the Minister of Finance with assistance in determining the direction of the state financial policy and improvement of internal control system with regard to internal control;
- in internal audit - methodological support of internal audit; provision of internal auditors with advice on the application of internal audit standards; creation of a reliable and sustainable structure of internal audit in government.

Preparation of annual reports on internal control and internal audit in the public and municipal sector is one of the functions of harmonisation.

It should be stressed that since the managerial responsibility lays the basis of the modern concept of public internal financial control, internal control plays a leading role in the functioning of all public internal financial control. Figure 2 shows the main purpose of internal control and the managerial function.

As shown in Figure 2, while performing the managerial function, heads of budgetary institutions, etc. provide an adequate system of internal control and supervise the realisation of internal control in terms of Concept 2005. The overall purpose of internal control is to obtain assurance that goals and objectives are achieved the authority and decisions (both financial and non-financial), that are taken, correspond to a number of principles:

- legality;
- austerity;
- efficiency;
- productivity;
- transparency.

Thus, the responsibility of the head is not limited to financial matters, as non-financial management decisions can have an impact on the goal and objectives of the institution.

Internal audit, which must be independent in relation to the system of internal control, should monitor the achievement of the main goal of internal control.

These conceptual principles of public internal financial control have only partially been reflected in the application of public financial control in Ukraine and the reform process is accompanied by considerable problems. Such issues have been brought into focus by a great number of Ukrainian scholars and practitioners.

V. Pikhotskyi notes that «in Ukraine many government agencies and financial control services have already been created and operate today. These include the Treasury, the State Audit Service of Ukraine, the Ministry of Finance, tax and customs inspection bodies of key spending units, the National Bank of Ukraine and its territorial bodies, the Chamber of the Autonomous Republic of Crimea and the Accounting Chamber of Ukraine. However, we must recognise that a clear distinction between the tasks of these authorities is still missing. There is also no clarity in the interaction between all the supervisory authorities among themselves and with the audit institution, which operates outside the system of public financial control» [5].

I. Basantsov focuses his attention on one conceptual issue: «being in the executive branch and, moreover, forming the highest body of the executive power, the Cabinet of Ministers of Ukraine, the State Financial Inspection of Ukraine should execute only internal control within the system of executive power and not the function of independent public audit, i.e. representative control» [1].

O. Natarova believes that «the current changes in regulatory support help to reduce the loss of financial resources, however an appropriate level of public finances management has not been reached» [4].

Such thoughts accumulate, and they have been expressed for a long time. One should agree with I. Chumakova who believes that the slow reform is due to «the lack of awareness of leaders at various levels about the nature of public internal financial control that would ensure practical

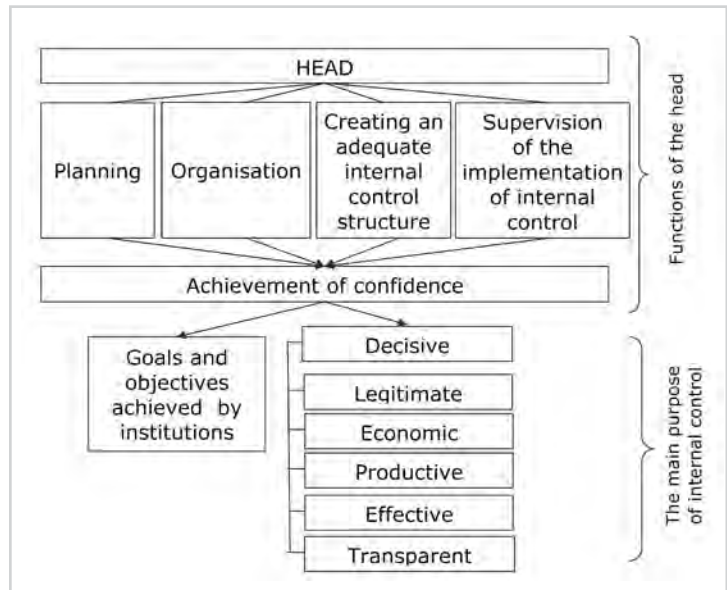


Fig. 2: Managerial function and main purpose of internal control  
Source: Compiled by the authors based on [3]

application of reforms in this area; also because of the lack of development of the legal basis for internal control, including financial management and responsibility (accountability) of the heads of budgetary institutions» [9].

I. Stefaniuk expressed a similar thought in 2009: «According to the first part of the European model of internal financial control about financial management and control by the head through creating certain systems (but not audit activities as it is mostly understood in Ukraine). These systems focus on priorities and risk management rather than on events habitual to the administrative command management model» [6]. According to I. Stefaniuk, «... internal control is not limited to the activities of specialised units, such as revision control unit in the ministry. Instead, you need to define clearly the procedures, rules, obligations and responsibilities of each manager, and especially the head for the results of the work» [6].

Problems of practical application of public internal financial control are observed after analysis of the reports from the State Financial Inspection (in October 2015 reorganized into the State Audit Service of Ukraine).

According to the data published on the official website of the State Audit Service of Ukraine [13] for the last 9 years, a rapid decline in the total number of audits from 17,563 in 2007 to 2,668 in 2016 is observed. In this regard, the year 2014 stands out. A sharp increase in the number of audits up to 24,000 marked that year, which was primarily due to a large number of audit controls of public procurement, which were probably initiated because of the aggravation of the political situation, connected with the changes in the government. This explains why the figures of 2014, should be considered abnormal.

Despite the continued decrease in the number of control procedures, the percentage of inspections is invariably above 90% (Figure 3).

As shown in Figure 3, revisions continue to prevail in the structure of control measures. This is against the background that the number of violations detected annually remains almost unchanged - about UAH 3-3.5 billion. The amount of detected violations per one control measure increases, however, taking into consideration the inflation and other processes that devalue the national currency, this figure cannot directly indicate the increasing efficiency of audits.

Generally, the transparency of the reform process remains low. Special reports on application of internal control in institutions are not provided, although the Concept 2005 for 2012-2016 provides application of a new model of the internal control system in the public and communal

sectors. In 2017, we expect the summarizing of two phases of the reform in the system of public internal financial control, prioritisation of further development on the central and local level according to the tendencies of socio-economic development.

According to information from public sources, there is only enhanced action on application of internal audit and training of internal auditors, which is important, although its effectiveness will be significantly lower without the theoretical development and normative application of conceptual principles of internal control, as internal audit focuses not so much on the actions of inspection (revision), but on the analysis the effectiveness of internal control institutions.

The main efforts of the central body of the public financial control should focus on the development and application of internal control systems. Currently, the regulation of this issue is at near-zero level.

The Concept of 2005 is not formally a legal act (it did not pass the registration procedure at the Ministry of Justice of Ukraine), and therefore is declarative and recommendatory. The Budget Code of Ukraine is almost the only document that contains requirements for internal control (Table 1).

Analyzing the provisions of the Budget Code given in Table 1, we should note that they only set the basic concepts regarding internal control and internal audit, which, in turn, is not directly comparable with the rules described in the Concept 2005. In general, it is required to adapt the terminology to the domestic legal system.

The Law of Ukraine «On main principles of public financial control in Ukraine» as of 26 January 1993 No. 2939-XII, which should be basic by its essence, contains only fragmentary mentions of internal control, as in Part 1 of Article 8, which states that an audit institution exercises public financial control and monitoring of internal control and internal audit in spending units [15].

Even the tasks of the State Audit Service of Ukraine were formulated

with no regard for the conceptual principles of public internal financial control, although the mentioned tasks have changed in comparison with the objectives of the State Financial Inspection of Ukraine, after approval of the 2016 Regulations on the State Audit Service of Ukraine (Table 2).

As seen from Table 2, the tasks performed by the State Audit Service of Ukraine were extended if compared to State Financial Inspection of Ukraine. However, the delegated powers of the newly formed body have undergone major changes, which requires further study. As part of our research, it is worth noting that finally the powers included monitoring of internal control and internal audit of budget funds. Such powers are delegated for the first time since the approval of the Concept 2005.

All this suggests that there is no proper regulation of internal control which is the basic component of public internal financial control in Ukraine.

Considering the 2016 Annual Management and Performance Report for the EU Budget [18], one can see that, the

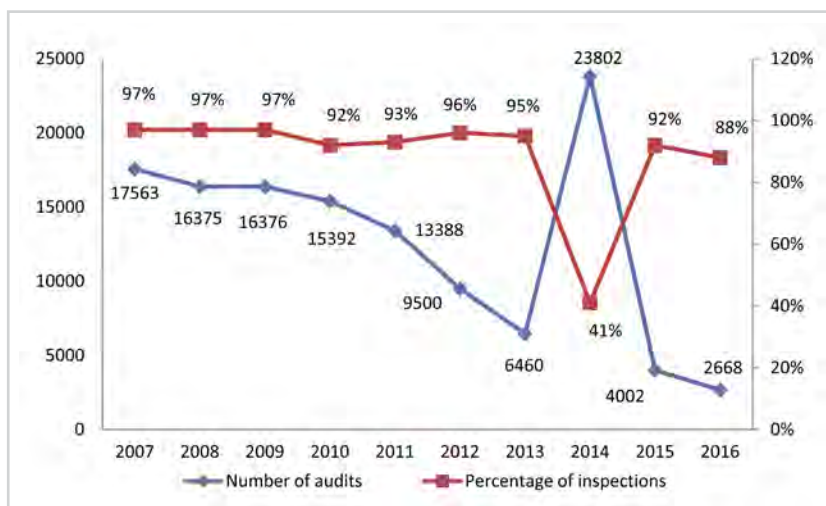


Fig. 3: Number of audits and percentage of inspections in 2007-2016

Source: Compiled by the authors based on the reports of the State Audit Service of Ukraine [13]

Tab. 1: The Budget Code of Ukraine regarding internal control	
Article of the Budget Code of Ukraine	The requirement relating to internal control
Article 2 Part 49	Managing budget funds means a range of activities of a budget process participant according to their authority related to generating and using budget funds, exercising control over compliance with budget legislation, which are aimed at meeting objectives, tasks and specific results of their respective activities and ensuring efficient and effective use of budget funds for the intended purpose
Article 22 Part 5 Paragraph 9	A key spending unit exercises internal control over the completeness of revenues, budgetary commitments taken on by spending units of lower level and recipients of budget funds, and over their spending of budget funds
Article 26 Part 3	Spending units represented by their directors arrange internal control and audit and are responsible for control and audit in their respective institutions and subordinate government-funded institutions.  Internal control means a range of measures used by the director to ensure compliance with legislation and efficiency of spending budget funds, and achieve results in line with the established objective, tasks, plans, and requirements to the activities of a government-funded institution and its subordinate institutions.  Internal audit means the activities of an internal audit unit in a government-funded institution aimed at improving management system, preventing illegal, inefficient and ineffective use of budget funds, errors or other drawbacks arising in government-funded institution operation and its subordinate institutions, and improving the internal control.  The main foundations for exercising internal control and conducting internal audit and the procedure for setting up internal audit units are established by the Cabinet of Ministers of Ukraine.

Source: Compiled by the authors based on the Budget Code of Ukraine [14]

Tab. 2: **Changes in the main tasks of the State Financial Inspection of Ukraine and the State Audit Service of Ukraine**

State Financial Inspection [16]	State Audit Service [17]
The main objectives of the State Financial Inspection of Ukraine are to implement the state policy on public financial control, as well as proposals for its formation.	The main objectives of the State Audit Service of Ukraine are as follows: 1) application of the state policy in the field of public financial control; 2) submission of proposals to the Minister of Finances to ensure public financial control; 3) performance of public financial control, which evaluates effective, legitimate, targeted and effective use and preservation of public financial resources and other non-current assets, and provision of budgetary savings; 4) provision of administrative services when needed.

Source: Developed by the authors

COSO framework is used to build the internal control system in the countries of the European Union. Besides, the European Commission regularly updates its internal control framework in line with the revisions of the COSO framework. For example, with the latest revision, the COSO framework moves from a compliance-based to a principle-based system of internal control.

Nevertheless, the process of organising and modernising public internal control at the proper level takes from 10 to 15 years, as noted in the Compendium of the public internal control systems in the EU member states 2012 [19], although public internal control has, of course, always existed in one form or another in each country.

At the same time, most developing countries have faced and continue to face a number of problems that are very similar to those in Ukraine. Countries that are not part of the European Union are of particular interest. We have analysed the experience of Albania, Serbia, Kosovo, Bosnia and Herzegovina, as well as Romania which is an EU member state. It has been found out that all of them are solving the problems related to:

- the necessity of financial management and control institutional building, identification and design of controls, training and capacity development of the financial officers [20];
- increasing transparency in fiscal management process through community engagement, interaction and interactive collaboration among all stakeholders [21];
- the old system of control which does not provide sufficient security for units to successfully fulfil their objectives along with the understanding that the risk management is almost not an explored area [22];
- integration of the financial control in the field of internal management control [23];
- difficulties in adjusting only one approach in development of PIFC [24]; and many others.

Therefore, the primary task before scientists and practitioners is the theoretical justification and application of internal controls at the level of regulations and development of criteria for assessing its effectiveness, which should form the basis of the relevant reporting in internal control that could be the starting point for the application of internal audit.

The authors suggest the following scheme of application of public internal financial control system in Ukraine (Figure 4).

The scheme proposed in Figure 4 provides a step-by-step application of key principles of public internal financial control which were outlined in the Concept 2005. It also takes into account the basic requirements for the internal controls that are provided with regard to the conceptual basis of the COSO framework, as well as the latest developments by the Institute of Internal Auditors (IIA) [25], including a number of publications and the so-called tri-linear model protection (Three Lines of Defense Model) [26].

The first phase of the current analysis of operation of internal control institutions (especially budgetary institutions) is aimed at

identifying the goals and objectives of all objects of internal control, major decisions taken by the directors and other leading personnel and determining risks, which will prevent the achievement of previously specified objectives, goals or cause violation of the principles of legality, economy, efficiency, effectiveness and transparency.

The second phase is based on the results of the first phase and aims to develop internal control procedures which provide the manager with assurance that purpose and objectives are achieved and the decisions correspond to the principles. The phase also includes the definition of criteria (indicators) which will be included in a specialised report form or added to the existing document, which will testify the effectiveness of internal control.

The performance indicators identified in the second phase should be basic information, which is subject to review through internal audit procedures to be determined in the third phase.

The fourth phase will consist of codification of the results of all the previous phases and their approval in the form of regulations.

To increase the efficiency of such steps, we propose their realisation at three separate levels: central (the level of the Cabinet of Ministers and the central body of the public financial control), sectoral (the level of individual ministries, and possibly economic sectors) and individual (the level separate budget institutions). This branching will contribute to a more accurate consideration of the peculiarities of each unit of internal control and to the development of criteria appropriate to the circumstances.

As a result of the consideration of conceptual principles of public internal financial control, we have discovered the presence of two basic approaches to public internal financial

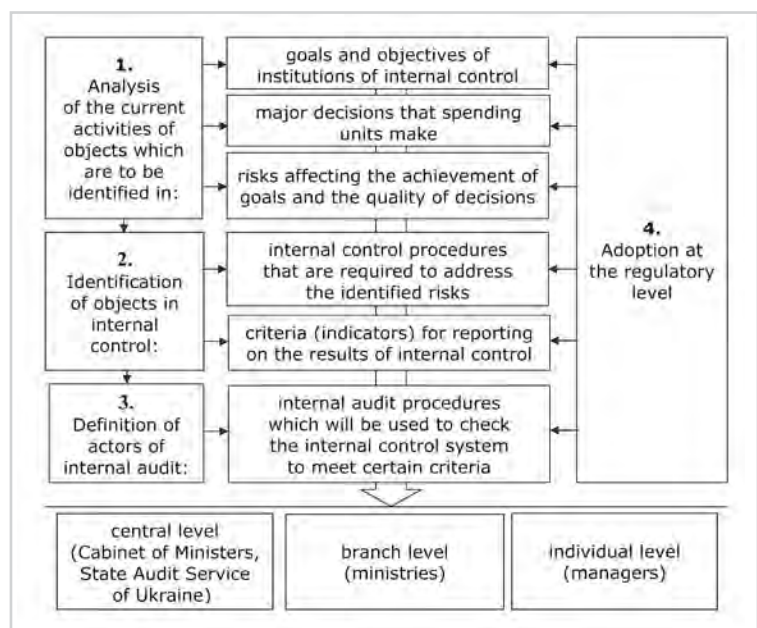


Fig. 4: **Scheme of application of public internal financial control in the modern system of public financial control in Ukraine**

Source: Compiled by the authors

control with the leading role of centralised controls and monitoring of prevalence, based on the responsibility of the head-spending unit. It has been determined that in Ukraine the course of bringing of the existing system of public financial control to the second approach to public internal financial control is approved.

An analysis of the application of public internal financial control has revealed a slow pace of its application, which is caused by a lack of understanding of the components of the declared approach to public internal financial control and the mismatch of regulatory framework that prevents gradual introduction of new models and prevalence of post-control in control procedures.

Guidelines for the application of public internal financial control in the modern system of public financial control in Ukraine are proposed as a relevant scheme which involves the successive phases of application of public internal financial control at three independent levels. The scheme corresponds to the leading modern developments of international organisations with expertise in matters of internal control.

Thus, studies show that the conceptual principles of public internal financial control that prevail in the world have been applied in Ukraine since 2005, but the level of application still remains primary. One of the key factors impacting the situation is the lack of attention to the basic component of public internal financial control, which is internal control, the development of theoretical and methodological guidelines for the application of which should become a priority for the government and scientific community. The solution of this task will lead to a new level of understanding of public internal financial control that will facilitate rapid applica-

tion of directions of public financial control in Ukraine, approved by the Concept 2005.

## 5. Conclusions

As a result of consideration of conceptual principles of public internal financial control, we have defined two basic approaches to public internal financial control with the leading role of centralised control and monitoring of prevalence based on the responsibility of the managing director. It has been determined that in Ukraine the course of bringing the existing system of public financial control into compliance with the second approach to public internal financial control is approved.

The analysis of the application of public internal financial control revealed the slow pace of implementation, which is caused by a lack of understanding of the components of the declared approach to public internal financial control and the mismatch of the regulatory framework that prevents gradual introduction of new models and prevalence of post-control in control procedures.

The guidelines for the application of public internal financial control in the modern system of public financial control in Ukraine have been proposed as a relevant scheme which involves the successive phases of application of public internal financial control at three independent levels. The scheme corresponds to the leading modern developments of international organisations with expertise in matters of internal control.

It is necessary to remember that the European Commission emphasises that coordination and harmonisation of the PIFC organisation processes offer multiple paths. More than half of the countries have established special units for this purpose.

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