Časopis za poslovnu teoriju i praksu
The paper submitted: 22/04/2020
The paper accepted: 17/06/2020

UDK 005.25:657.635(497.6)
DOI 10.7251/POS2024153S
Preliminary communication

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STATUS OF CONTROL ENVIRONMENT IN BOSNIA AND HERZEGOVINA – EMPIRICAL STUDY

Summary: *The subject of this research is the status of the control environment in the organizations of Bosnia and Herzegovina perceived by the internal auditors. The aim is to identify the best, but also the weakest practices that the organizations and internal auditors are facing within the domestic environment, and to indicate some future actions needed in order to improve this element of the whole internal control system. The research is organized in the form of a self-assessment questionnaire by applying the 11-Point Likert Scale. The given assessments indicate that the major focus is on the formal structures, while soft controls are represented to a much lesser extent. The majority of examinees have confirmed that the weakest link refers to the top management, i.e. boards. Comparing the assessments from different industries, it is evident that the control environment management, including its audit, is under a strong impact of laws, regulations and the related accountabilities of organizations and internal auditors. Although the research has shown that there are cases of best practices applied, in-depth data analysis and informal interviews with individual internal auditors give the impression that knowledge, experience, interest and awareness in the organizations of Bosnia and Herzegovina are not on a satisfactory level required in order to grasp the significance of corporate culture and to give it due attention. This situation relates not only to top management but also to internal auditors dealing with the assessment and improvement of the control environment.*

Key words: *control environment, best practices, internal auditors, self-assessment*

JEL classification: *K23, M14, M49*

INTRODUCTION

The Control Environment, also known as corporate culture, is the foundation of COSO's model of *internal control* (COSO 2013, 4) and COSO's model of *enterprise risk management* (COSO 2004, 3). The significance of control environment has been recognized by many authors and experts who agree that the part of the blame for the financial crisis in 2008, but also for other well-known corporate failures in the 21st century, can be related to the weaknesses of control environment (Clayton and Scroggins and Westley 2002, 15-16; Ho 2009, 177-189; Sabri 2013, 141-146; Oke 2015).

The first step in the establishment of the control environment is to provide a formal (written) framework with clearly defined management structures based on unambiguous and clearly communicated values and procedures. However, written instructions, procedures and manuals are not enough since they have to be implemented. All organizational levels, as management, so the staff, have to understand, accept and comply with the given framework. Therefore, it is essential to take also into account the informal, behavioural aspects relating to values, beliefs, attitudes and human behaviour which represent soft controls embedded into the control

environment. According to some researchers (Hitt and Haynes and Serpa 2012, 439), one of the strategic leaders' priorities in the 21st century will be the creation and maintenance of strong and solid organizational culture focusing on the key values such as innovations, learning and recognizing the value of human capital and teamwork. Unlike the former researches, the modern ones believe that organizational culture can be used to achieve competitive advantages, better work efficiency and employee production (Rashid and Sambasivan and Johari 2003, 708-728; Tharp 2009, 2). Many pieces of research state that strong organizational culture is the primary determinant in creating better organizational performance and sustainable competitive advantage (de Waal 2010, 5-33; Shahzad et al 2012, 975; Xiaoming and Junchen 2012, 31-32; Owoyemi and Ekwoaba 2014, 168). Therefore, without strong and effective organizational culture, i.e. *control environment* there is no effective system of internal control, nor the long-term and sustainable performance of organizations (Stojanović 2015, 16).

The aim of this research has been to: (1) *gain insight into the status of the control environment in domestic organizations;* (2) *identify the best and weakest practices;* but also, to (3) *offer recommendations for strengthening the control environment in Bosnia and Herzegovina.* At the beginning of this study, the researcher assumed: (a) that the most of organizations in Bosnia and Herzegovina (B&H) *do not have clearly defined and established elements of control environment;* and that (b) *there is a difference among organizations in public and private sectors,* resulting from the differences in laws and regulations but also in requirements set by regulators and supervisors in different sectors.

The study has shown that there are bright examples where best practices have been applied and the control environment has been seriously assessed and managed. However, there are significant variations in assessments among organizations in different sectors (public, financial and industrial), as a result of different regulations, but also among the organizations in the same sector. The causes of such variations could be explained by the fact that managers, in the first place, but also of the internal auditors have different levels of knowledge, experience, interest and consciousness regarding the significance of corporate culture and control environment.

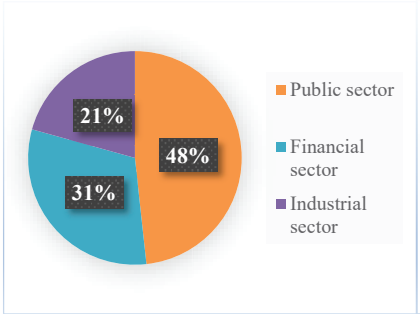
1. THE METHODOLOGY OF RESEARCH

1.1 Population and sample

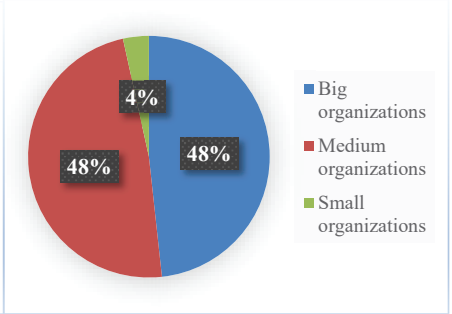
Considering that the total number of organizations in B&H cannot be precisely determined, and it is changing all the time, the total population is open or infinite aggregate. Thus, the population for this study has been the subset of the total aggregate, i.e. organizations which have the internal audit functions responsible, among other things, for the assessment of control environment in their organizations. Examinees are mainly the members of the Associations of internal auditors in Bosnia and Herzegovina, employed in the organizations of all three main sectors in B&H (public, financial and industrial).

The questionnaires have been distributed to 260 internal auditors but only 30 internal auditors (11,5%) answered and took their part in this empirical study. The sample provided in this way is called the *appropriate sample* (consisted of the available units of the total subset). The constraints of such sample include: its representativeness; most units of total aggregate (all the organizations in B&H) have no chance to be included in the sample (since they are not covered by this study); the direction and extent of variations between sample values and values specific for all the unites of the basic set remain unknown, and there is no chance to determine the statistical error of the sample. However, the sample carries some characteristics of the *simple random sample* since every unit of the subset had the same chance to be included in the sample, but it depended on their interest and willingness to fill the questionnaire and send it to the researcher. Considering the issues of the small sample and its representativeness, the results of the study have been presented to the focus group and discussed with individual internal auditors. In this way, study results have been additionally checked and confirmed to a certain extent.

The self-assessment type study has been organized in an anonymous way, but the examinees were required to state in which sector their organizations operate (public, financial or industrial) and what is the size of their organizations (big, medium or small). The following two graphs (1 and 2) show the structure of the sample by sectors and size of organizations where internal auditors who took part in this study work.



Graph 1. Participation of each sector in the study (Author)



Graph 2. Participation of different size

1.2 Scale of assessment

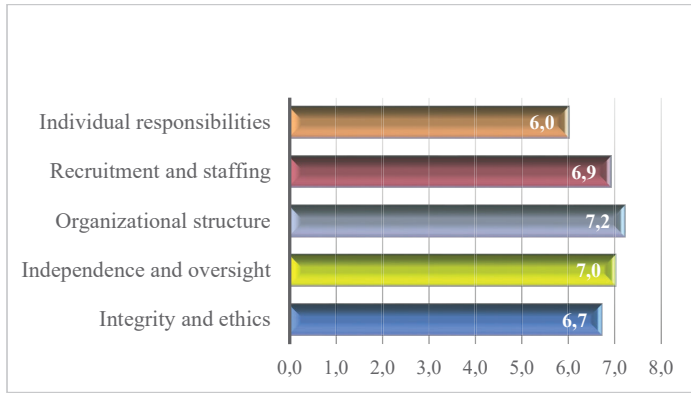
The study has been organized in the form of control environment self-assessment questionnaire where the examinees had to assess its five elements. Each control environment element has been assessed through a number of questions and each one of them represent some of the best practices. Examinees added estimates, to each question, from 10 to 0 where each estimate signify the extent of compliance with a given practice.
The assessment is based on Likert 11-point scale, where point 10 is given for the absolute compliance (totally agree), while point 0 is given for the absolute non-compliance (totally disagree). Some researchers have proven (Shing-On Leung 2011, 412) that having more scale points seems to reduce skewness, and the 11-point scale, ranging from 0 to 10, has the smallest kurtosis and is closest to normal. Also, the application of this scale is recommended when using self-reported measurement scales as is the case with this empirical study.

2. STUDY RESULTS AND CONTROL ENVIRONMENT ASSESSMENT

Control environment in B&H has been assessed through five elements:

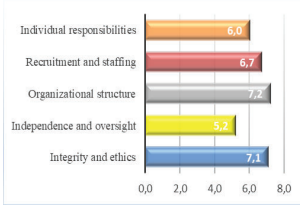
- Integrity and ethics;
- Independence and supervision;
- Organizational structure;
- Recruitment and staffing, and
- Individual responsibilities.

Average estimates for each element are presented in Graph 3. As can be seen, 'Organizational structure' is given the best estimate, while 'Individual responsibility' and 'Independence and supervision' are given the worst estimates.

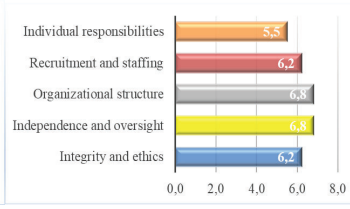


Graph 3. Average estimates of control environment elements (Author)

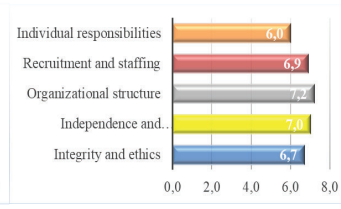
Since one of the assumptions was that there are variations in control environment status in the organizations of different sectors, the comparative analysis of these elements' estimates has been done by sectors (public, financial and industrial) as well. Graphs (4-6) present how the organizations from different sectors have estimated each of the control environment elements.



Graph 4. Average estimates of public sector (Author)



Graph 5. Average estimates of financial sector (Author)



Graph 6. Average estimates of industrial sector (Author)

2.1 'Integrity and ethics'

The average estimate for this element of the control environment, given by all participants, has been 6,8. By comparing the estimates of 'Integrity and ethics' among sectors, it is evident that this element has received the highest estimate from the public sector (7,1), a bit lower from the financial sector (6,7) and the lowest estimate was given by the industrial sector (6,2). These variations in estimates make sense because public sector organizations are supposed to demonstrate a higher level of ethics and integrity while providing public services to citizens. Besides, these organizations are subject to the supervision of supreme auditing institution (SAI) which has an important role in the system of accountability, as internally, so externally – towards citizens and users of public services (Čajić Kužet and Babić, 2019, 144).

By comparing these estimates among organizations of different sizes, it has been concluded that medium-size organizations attach a higher estimate to 'Integrity and ethics' (7,3) than large organizations (6,3). This could be explained in a way that in smaller organizations individual behaviours are more visible than in larger organizations and therefore ethics and integrity are perceived as more important.

Considering the variability in given estimates, we can conclude that the majority of examinees assess 'Integrity and ethics' in their organizations in the range from 4,9 to 8,7. This means that this element of control environment is attached a rather high estimate. In terms of 'Integrity and ethics'' estimations, the researcher is mostly sceptical for two reasons: (1) some other researches have shown that people are not completely objective with self-assessments, especially in terms

of ethics and integrity (Grieser et al 2017, 2), and (2) based on informal conversations with internal auditors from different organizations, the researcher got the impression that this element of control environment is much weaker than presented by the study results.
Nevertheless, the study has shown that the highest level of compliance (assessed by 8) can be found in the following areas:

- ✔ *There is a code of conduct and/or ethics policy and it has been adequately communicated to all levels of the organization;*
- ✔ *Code of conduct and/or ethics policy establishes what is right and wrong by respecting the local laws, rules and regulations;*
- ✔ *Top management hired from outside (the members of managing/supervising board), new employees and business partners are made familiar with the importance of high ethics and controls.*

On the other hand, the lowest level of compliance relates to the following practices:

- o *The organization has established tolerance levels for deviations to its standards of conduct (such tolerance levels are communicated throughout the organization and the deviations*
  are evaluated in a timely manner);
- o *The organization periodically analyzes issues to identify trends and root causes to evaluate whether modification of policies, communication, training or controls are necessary;*
- o *The organization have a process to evaluate the performance of individuals and teams against its standards of conduct.*

2.2 'Independence and supervision'

The average estimate for this element of the control environment, given by all participants, has been 6,0. By comparing the estimates of 'Independence and supervision' among sectors, it is evident that this element has received the highest estimate from the financial sector (7,0), a bit lower from the industrial sector (6,8) and the lowest estimate was given by the public sector (5,2). These estimates also make sense because private capital has stronger motives to oversee the management process.
By comparing these estimates among organizations of different sizes, it has been concluded that medium-size organizations attach a lower estimate to 'Independence and supervision' (5,4) than larger organizations (6,8). This could be explained in a way that, in a larger organization, there is a broader gap between governance and ownership functions, they have more stakeholders and they are under the magnifying glass of the public. Therefore, they are regulated more strictly and more subject to supervision.
Considering the variability in given estimates, we can conclude that the majority of examinees assess 'Independence and supervision' in their organizations in the range from 3,8 to 8,2, which is significant variability.
The examinees agreed that the highest level of compliance (assessed by 7) can be found in the following areas:

- ✔ *The structure of the board (managing/supervising board), including the number of its members, their background and expertise, are appropriate given the nature of the organization;*
- ✔ *The audit committee has a charter outlining its duties and responsibilities;*
- ✔ *The audit committee has adequate resources and authority to discharge its responsibilities.*

On the other hand, the lowest level of compliance (assessed by 5) relates to the following practices:

- o *The composition and skills of the board members are periodically evaluated to assure that*

directors have the expertise to ask probing questions of management and to take appropriate actions;

- *The board members participate in training as appropriate to keep their skills and expertise*
  current and relevant.

2.3 'Organizational structure'

The average estimate for this element of the control environment, given by all participants, has been 7,1. By comparing the estimates of 'Organizational structure' among sectors, it is evident that this element has received the highest estimates from the financial and public sector (7,2) and a bit lower from the industrial sector (6,8). These estimates could be explained by the fact that the financial and public sector are being regulated more strictly and more subject to external supervision.
If we compare the average estimates of 'Organizational structure' among organizations of different sizes, the study has shown that there are no significant variations among them. The estimations of this element demonstrate the lowest level of variability and the majority of examinees assess 'Organizational structure' in their organizations in the range from 5,5 to 8,7.
The study has shown that the highest level of compliance (assessed by 8) relates to the following:

- ✔ *There is appropriate segregation of incompatible activities (i.e., separation of accounting for, and access to, assets) both physically and through access to the IT systems.*

On the other hand, the lowest level of compliance (assessed by 6), appears in the following areas:

- *There are appropriate policies for matters such as accepting new business, conflicts of interest and security practices and they are adequately communicated throughout the organization.*
- *Reporting lines are evaluated periodically and they enable the execution of authorities and responsibilities and the flow of information to manage the entity's activities.*

2.4 'Recruitment and staffing'

The average estimate for this element of the control environment, given by all participants, has been 6,6. By comparing the estimates of 'Recruitment and staffing' among sectors, it is evident that this element has received the highest estimate from the financial sector (6,9) a bit lower from the public sector (6,7) and the lowest estimate was given by the industrial sector (6,2). These estimates also make sense considering that financial and public sector are more subject to regulation and external supervision but, also, these two sectors generally have more accountability as a result of a larger number of stakeholders and customers. This higher level of accountability might be the reason for recruiting more qualified and experienced staff.
When comparing the average estimates of 'Recruitment and staffing' among organizations of different sizes, the study has shown that the examinees, employed by medium-sized organizations, attach higher estimates to this element (6,9) than those working in large organizations (6,5). Since competences and qualifications of employees are more evident in smaller organizations, that could explain the variations in estimates by the organizations of different sizes.
Regarding the variability in given estimates, a majority of examinees assess 'Recruitment and staffing' in their organizations in the range from 5,0 to 8,2.
The study has shown that the highest level of compliance (assessed by 9) relates to the following:

- ✔ *There are written job descriptions, reference manuals or other forms of communication to inform personnel of their duties.*

On the other hand, the lowest level of compliance (assessed by 5-6), appears in the following areas:

- o *Entity's policies include succession plans for senior executives and contingency plans for assignments of responsibilities important for internal control;*
- o *There are periodic evaluations of departmental staffing needs (particularly with regard to knowledge and experience of management and supervisory levels within the accounting, information systems and financial reporting areas).*

2.5 'Individual responsibilities'

The average estimate for this element of the control environment, given by all participants, has been 5,9. This element, together with 'Independence and supervision' (assessed by 6), has received the lowest estimates. By comparing the estimates of 'Individual responsibilities' among sectors, it is evident that this element has received the highest estimates from the financial and public sector (6,0) and the lowest estimates from the industrial sector (5,5). Also, these variations could be explained by the same fact that financial and public sector are more subject to stricter regulation and external supervision but and that these two sectors are more accountable as a result of a larger number of stakeholders, i.e. customers.

When comparing the average estimates of 'Individual responsibilities' among organizations of different sizes, the study has shown that the examinees, employed by medium-sized organizations, attach higher estimates to this element (6,1) than those working in large organizations (5,7). This could, as well, be explained by the fact that individuals are more visible, and also responsible, in smaller size organizations.

Regarding the variability in given estimates, a majority of examinees assess 'Individual responsibility' in their organizations in the range from 4,3 to 7,5.

The examinees demonstrated that the highest level of compliance (assessed by 6,7) when it comes to this element of the control environment, relates to the following:

- ✔ *Management set realistic (i.e., not unduly aggressive) financial targets and expectations for operating personnel.*

On the other hand, the lowest level of compliance (assessed by 5,0), appears in the following areas:

- o *The organization provides measures, incentives and other rewards that are aligned with ethical values and performance related to internal control, including financial and nonfinancial measures;*
- o *Management and the managing/supervising board evaluate the performance of internal control responsibilities, including adherence to standards of conduct and levels of competence; and appropriate rewards or disciplinary actions result from such evaluations;*
- o *Management has processes and controls in place to evaluate and hold outsourced service providers (and other business partners) accountable for their internal control responsibilities.*

CONCLUSION

Considering that the study has not included all the organizations in Bosnia and Herzegovina, but only those that have the internal audit functions established and those which internal auditors were willing to take part in this research, it is obvious that the sample is not

representative. Therefore, the findings of the study do not represent the objective portrait of the control environment status in all the organizations in Bosnia and Herzegovina. Actually, we could say that this is just the insight into the control environment perceived by those who are really engaged in it.

Minor response of internal auditors, to take part in the study, points at two significant conclusions. Above all, we can conclude that the questionnaire is not an adequate tool for investigating such delicate issues as those relating to the control environment and its elements. Considering the feedback provided by individual internal auditors in informal interviews, the impressions on control environment status got in this way are quite discrepant comparing to those got from the study itself. This discrepancy raises the question of the objectivity of some assessments. As indicated by other researches, this study has also shown that questionnaires are not the best tool when performing self-assessments because examinees have a tendency to give higher estimates than those that would be given if they were more objective. Most probably, workshops, focus groups and interviews, including all staff on all organizational levels, would be a more appropriate approach. This way, examinees would have an opportunity to better understand what is required from them and, therefore, to provide more objective answers and assessments. The second conclusion, derived from this modest interest in the study, indicates that most internal auditors do not perceive control environment as an important issue to deal with or they are not familiar with it good enough to answer the questions in the questionnaire. Thus, minor participation in this study also represents an important indicator of how many internal auditors are aware of the significance of the control environment in Bosnia and Herzegovina and how much they are ready to cope with this challenge.

Nevertheless, the answers given by the examinees do indicate the current status of the control environment in the organizations of Bosnia and Herzegovina which has been additionally confirmed by individual internal auditors in informal interviews. The assessments have led to the conclusion that major emphasis has been put on formal structures (‘hard controls’), while soft controls are much less present. This is obvious considering the general assessment of each control environment element where 'Organizational structure' was given the highest estimate, while ‘Individual responsibilities’ and ‘Independence and supervision' received the lowest estimates. Such status has been even better presented by the individual assessments of the compliance, i.e. in compliance with the best practices for each control environment element. It is obvious that formal controls (such as written policies, procedures, manuals etc.) exist, but when it comes to their implementation, i.e. active control environment management, the situation is quite different. The majority of weakest practices (where the incompliance is present in most cases) indicate that the weakest link of the whole control environment (and consequently total system of internal controls, risk management and corporate governance) is *top management* – managing/supervising boards and auditing committees. The majority of examinees agree that competences of boards’ members are not being evaluated (regularly or at all), they do not participate in professional training and other forms of skills improvement, and, also, they are not engaged in control environment management actively (e.g. *tolerance levels for deviations to the standards of conduct have not been established and these deviations have not been assessed on a regular basis; periodical analyses of issues to identify trends and root causes are not being performed; there is no evaluation of the performance of internal control responsibilities, including adherence to standards of conduct and levels of competence; and there are no appropriate rewards or disciplinary actions resulting from such evaluations...*).

All in all, the study has shown that control environment management, including its auditing, remains under the strong influence of legislation and the accountabilities of the organizations and auditors in this respect. This is quite obvious considering the variations in estimates of certain sectors.

Those who participated in this research have clearly indicated that there are bright examples who apply the best practices and who really understand the problems relating to the control environment and its significance. However, detailed analysis, as well as the informal interviews

with individual internal auditors, give an impression that the competences, experience, expertise and awareness in Bosnia and Herzegovina are not on a level required to comprehend the importance of corporate culture and to give it due attention as by the top management and executives so by most of the staff dealing with its assessment and improvement (such as internal auditors).

Considering all the above mentioned, we can conclude that strengthening of the control environment in the organizations of Bosnia and Herzegovina should start with raising the awareness and competences of those who are responsible and accountable for the whole governance process. Their tone on the top is crucial for the ambient where other people work and perform their duties and they are role models to be followed – either positive or negative. Therefore, strong control environments could be achieved in Bosnia and Herzegovina's organizations in at least two ways:

(1) There should be a legal obligation that professional managers (board members, CEOs, executives) go through training, in order to improve their competences and skills on a regular basis, and their performance should be subject to periodical evaluations; and
(2) Internal auditors could contribute to the strengthening of control environment awareness by persistently emphasizing, in their reports, the weaknesses of and risks resulting from the control environment. Moreover, the even stronger impact could be achieved by organizing workshops and focus groups where the key staff would discuss the issues relating to the control environment and share the ideas for overcoming these issues.

Finally, acquiring new knowledge and learning new approaches and techniques would be of a huge help on this path.

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