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Internal Controls in Local Governments

SUMMARY: The State Audit Office of Hungary has audited 100 local governments in 2012 and 2013 as for the development of internal controls - the aim of this study is to highlight the main deficiencies. According to the findings, the content of the organizational and operational rule is not properly specified in the 84% of the audited local governments. Besides, the lack of, or inadequate content of other control environment elements typifies almost 20% of the examined local governments. Therefore, the complex control elements such as risk management and monitoring that are based on the basic control components (control environment) are functioning inappropriately (more than 80% of the cases). Satisfactory functioning of internal controls of local governments should be enhanced by identifying and distributing the best practices.

KEY WORDS: local governments, municipalities, internal control, control element, control model

JEL CODES: H11, H40, H70, H83, M48

Various management sciences are placing ever greater emphasis on leaders being able to establish the necessary processes to achieve the goals of the organisation under their management both inside and outside the enterprise. The establishment and operation of an appropriate controlling system is essential for this.

In the Hungarian jargon the meaning of controlling has only in recent years begun to depart from the strict sense of the word. In reality controlling is not only an audit tool but also a management tool. *Hágen* (2008), in his doctoral thesis, defines controlling, through the processing of various definitions, as a management subsystem founded on the unity of planning, accounting, auditing and provision of information.

An adequately audited and managed operation is not the sole property of the business sector. In order for public sector institutions to fulfil their intended role in increasing the

welfare of society they also require an adequately established and operated controlling system. In public administration this role is fulfilled by the three-level public finance control system (Lentner, 2013).

The study focuses on the internal control system of the public finances' subsystem of local governments, consequently ensuring that the science of public administration view is present. By doing so, it does not deny but rather supports the interdisciplinary character of the science of public administration.

The aim of the current paper is to present the main deficiencies characteristic in the establishment of local government internal control systems and to draw the relevant complex conclusions on the basis of this. It is not the aim of this study to present the State Audit Office of Hungary's detailed audit methodology.

In the first half of the study we outline the system alongside which we performed the analysis in the study. After determining the internal control ideology we present the sources

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of the data used in the study and the methods by which they are processed. We then discuss the results alongside the control system's five dimensions, followed by the summary.

INTERNAL CONTROLS

We can only truly understand the role of the internal controls in local governments if we are adequately able to define them. The aim of the current chapter is to identify the system (including the internal control concept) alongside which local governments carried out their audits.

The internal control system

As we briefly touched on in the introduction: for an organisation to achieve its stated goals it needs to have a management information system which serves as a basis for all management decision making and, at the same time, ensures that steps are taken in the direction of the organisation's goals.

Internal controls, or more precisely the lack of or inadequate operation of these, resulted in such a level of cumulative risk by the mid '80s in the United States that in 1985 the most significant commentators on economic life, independent organisations and interest groups, founded an organisation called The Committee of Sponsoring Organizations – COSO. In addition to those organisations representing the accounting profession in America and the organisation of internal auditors the committee also contained active participants in, and representatives of, economic life (COSO, 2014).

The committee developed guidelines for uncovering fraud, identifying, managing organisational risks and established a system of internal controls.

From the point of view of our study we must emphasise the committee's three-dimensional matrix which graphically demonstrates the structure of the internal control system (see *Chart 1*).

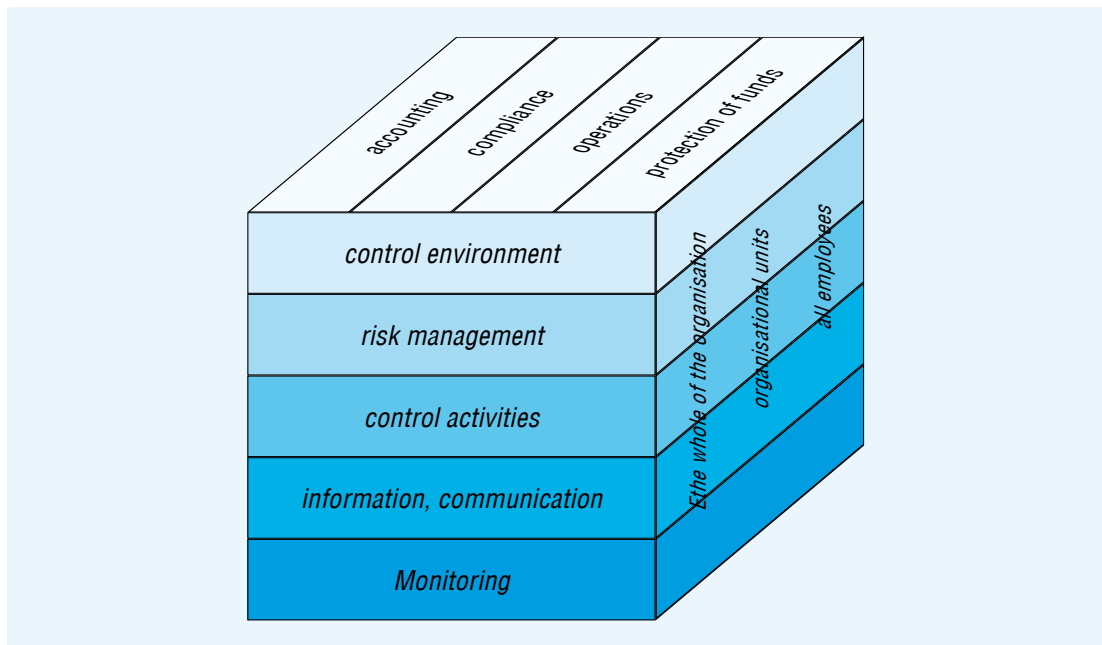
Later the International Organization of Supreme Audit Institutions developed, on the basis of COSO's three dimensional model, its international directive regarding the establishment of internal control standards, ISSAI 9100 (INTOSAI, 2004).

Although, within the framework of the current study, we accept the general validity of the COSO model in the analysis of local government internal control systems we must note that other systems were also developed in the 1980s. These include, among others, *Merétey – Vida* (2006) CoCo (Criteria of Control –), and the Turnbull system – the essential elements of which do not differ from each other and so, regardless of which adaptation we elect to use, can achieve satisfactory results (KPMG, 1999).

Internal control and local governments

The establishment, operation and development of local government internal control systems is prescribed by legal regulations (Act on the Local Governments of Hungary, Act on Public Finances, Government Decree on the Internal Control System and on the Internal Audit of Central Public Administration Bodies) the implementation of which is the responsibility of the head of the budgetary institution. The aim of the internal control system is to ensure that, in the course of their operation and financial management, institutions performing public functions carry out their activities economically, efficiently, effectively and in accordance with regulations. Meanwhile they naturally must meet their accounting obligations and

INTERNAL CONTROL – THREE-DIMENSIONAL MODEL



Source: COSO, 1992

protect their resources from loss, damage and improper use.

On the basis of this we can define the internal control system in the case of local governments in the following way:

“The internal control system includes all rules, procedures, practical methods, organisational structures, risk management techniques and control activities which facilitate the organisation’s achievement of its goals.” (Ministry of Finance, 2010)

MATERIAL AND METHOD

The sample

On the basis of our study the State Audit Office of Hungary began its audits in 2012 and 2013 with the aim of evaluating the establishment of internal control systems in local governments.

SAO selected the sample, made up of 100 local governments, in two stages from the almost 3,200 local governments. The capital and its districts, as well as towns with county status, were not included by SAO in the audit because these are audited more frequently than other local governments on the basis of their level of risk. The first step was to select from the State Audit Office’s risk management system those local governments about whose activities announcements of public interest or indications of press monitoring had been received. A further criterion taken into consideration when selecting the locations was the experience with earlier audits and when there had last been an SAO audit in the settlements.

Announcements of public interest were generally in relation to regularity deficiencies, infringement of financial accounting and financial management regulations or inappropriate financial management of public assets.

The final composition of the sample was made in the second step by random sampling on the basis of which 60 villages, 16 large villages and 24 towns were included (*see Chart 2*).

As Chart 2 shows towns and large villages are overrepresented, while village local governments are underrepresented in the sample. It is interesting that large villages are overrepresented, while towns and villages are underrepresented in the comparison based on their population. (*See Chart 3*)

Last but not least Chart 3 demonstrates well that the sample distribution is not even and is not, in an appropriate manner, representative of the total population in terms of both settlement size and territorial location. *Table 1* data also support this.

Considering that in the first step of the sample selection process we took the aspect of risk into account and used random sample selection in the second step, we can say overall that the sample is not representative and that this must be taken into account when evaluating the results.

Data collection

The data required for the evaluation of the internal control system were collected by the State Audit Office with the help of a pre-compiled questionnaire of 152 questions based on the SAO's audit programme. The validation of the data occurred in all cases within the framework of an on-the-spot check and so the data are an accurate reflection of the actual situation.

Data processing

The data were evaluated in accordance with the five elements of the control system (control environment, risk management, control

activities, information, communication and monitoring) – using descriptive statistic methods, cross tabulation analysis and factor analysis. The data processing and display were performed using Microsoft Excel and SPS programmes.

RESULTS

Control environment

We understand the establishment of the control environment to be the sum total of the internal policies and rules of procedure as well as relevant external legal regulations on the basis of which local governments perform their everyday (legitimate) operations. The content and range of the internal policies and rules of procedure are prescribed by various legal regulations¹ for local governments.

The control environment provides the framework within an organisation which influences the employees' control consciousness. The control environment, through its discipline and structure, lays the foundations for all other elements of the internal control.

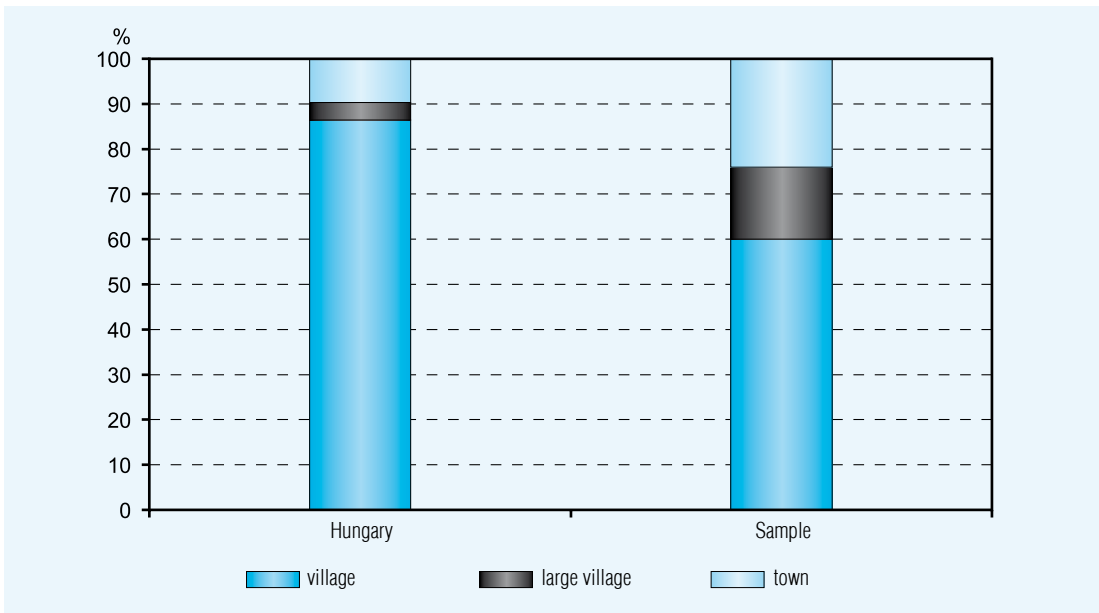
In the evaluation of the local government control environment we examined 17² control elements which are contained in *Table 2*.

Firstly we examined the composition in which deficiencies uncovered in the control environment occurred.

In the 100 local governments altogether 411 control environment related discrepancies came to light among both policies and rules of procedure (hereinafter collectively: policies) arising from absence (199 cases) or inadequate contents (212 cases).

Deficiencies in the local governments' by-laws were the most frequent error (17 per cent³ of all deficiencies found) followed by the lack of a civil servant performance evalu-

THE NATIONAL SETTLEMENT COMPOSITION AND BREAK-DOWN OF THE SAMPLE BY SETTLEMENT TYPE



Source: own editing based on CSO and SAO data

SETTLEMENTS IN THE SAMPLE



Source: own editing

Table 1

SAMPLE BREAK-DOWN BY TERRITORIAL ENTITY, %		
County	Hungary	Sample
Bács-Kiskun	3.77	4.04
Baranya	9.55	2.02
Békés	2.38	2.02
Borsod-Abaúj-Zemplén	11.35	13.13
Csongrád	1.90	3.03
Fejér	3.43	10.10
Győr-Moson-Sopron	5.80	6.06
Hajdú-Bihar	2.60	2.02
Heves	3.84	8.08
Jász-Nagykun-Szolnok	2.47	3.03
Komárom-Esztergom	2.41	3.03
Nógrád	4.15	5.05
Pest	5.93	6.06
Somogy	7.80	6.06
Szabolcs-Szatmár-Bereg	7.26	6.06
Tolna	3.46	3.03
Vas	6.85	5.05
Veszprém	6.85	7.07
Zala	8.18	5.05

Source: Central Statistical Office (CSO), State Audit Office of Hungary (SAO)

ation system (15.33 per cent). The rules on asset management did not meet the prescribed requirements in 32 local governments and in the case of 24 local governments there was no adequately established audit trail. Significant deficiencies were also found in relation to fire prevention, work safety, stocktaking, and accounting and irregularity management policies (See Chart 4).

In the local governments of the sample an average of one policy was completely missing.

We gain a more complex picture if we examine which are policies for which absence/deficiencies collectively occur and whether there is any correlation between the individual

factors and the nature of the settlement (settlement type).

On the basis of the Kaiser–Meyer–Olkin and Bartlett test (0.623, sig 0.00) the variables (the control environment’s elements) are moderately suitable for factor analysis (Sajtos – Mitev, 2007). Of the 26 control variables included in the analysis, the individual factors organised in descending order on the basis of their own values, we isolated four factors which were analysed by the Scree plot (see Chart 5).

On the basis of Tables 3 and 4 the programme included those in the first factor where the policies were entirely absent. The

Table 2

CONTROL ENVIRONMENT EVALUATION ELEMENTS	
Control elements	
Bylaws	
Inventory management and stocktaking policy	
Evaluation policy	
Prime cost calculation policy	
Funds management policy	
Documentation rules	
System of accounts	
Accounting rules	
Rules of procedure for irregularity management	
Audit trail establishment	
Economic programme	
Work safety policy	
Fire prevention policy	
Adequacy of economic manager's qualification	
Civil servant performance evaluation	
Rules on the financial management of local governments	
Rules on asset management	

Source: own editing

second factor chiefly contained inadequate policies (the local governments had prepared them but their contents were inadequate). The third factor includes local government financial management related policies while the final – fourth – factor markedly contains bylaw deficiencies.

Following this we examined whether there was a correlation between the individual factors and the type of local government (village, large village or town), that is whether the individual errors or deficiency groups are linked to types of settlement.

Taking into consideration that the reliability of categorisation based on factor values is extremely low⁴ we can state that the individual control environment deficiencies appear independently of the type of local government.

Risk management

“Risk assessment is the process of identifying and analysing relevant risks to the achievement of the entity’s objectives and determining the appropriate response” (INTOSAI, 2004).

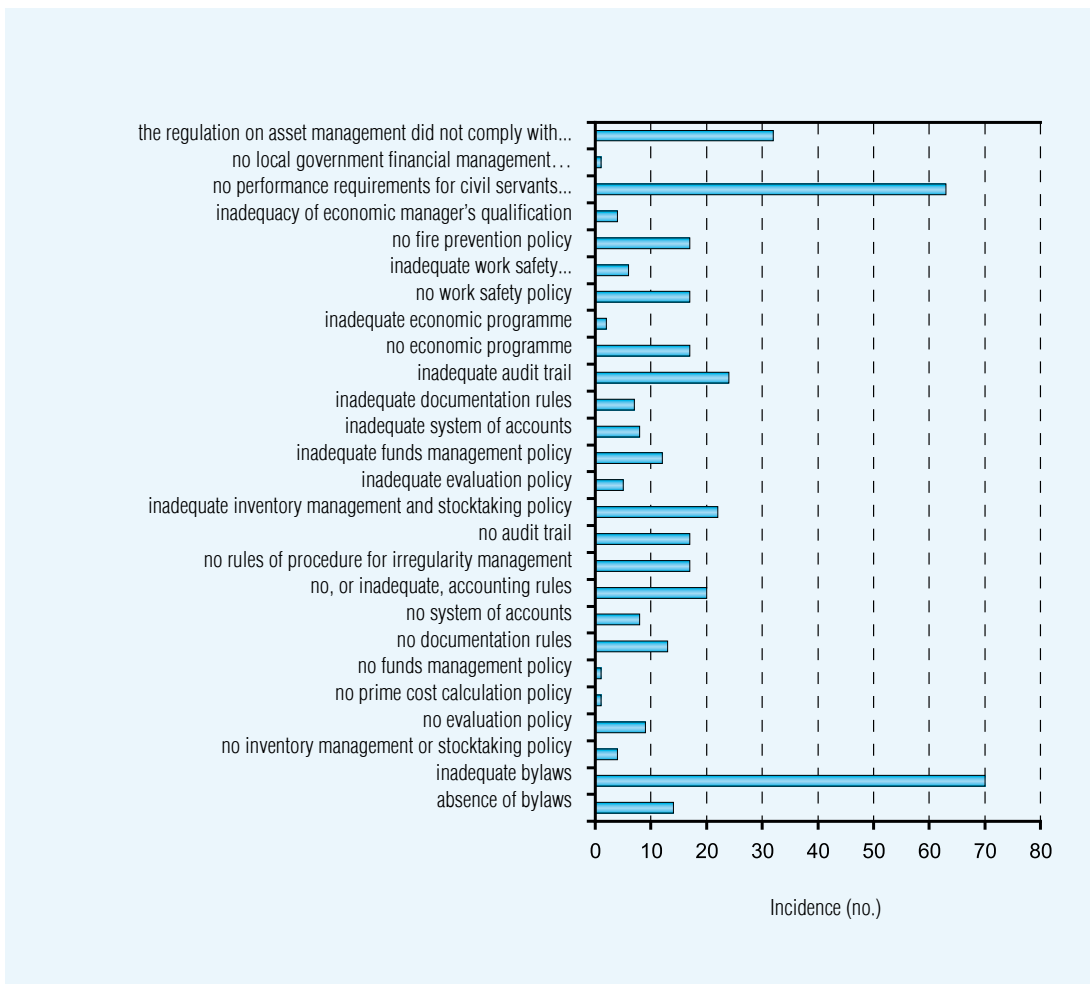
In relation to the local governments’ risk management activities we isolated four variables.

- ① no risk analysis performed
- ② inadequate risk analysis
- ③ risk management measures were not matched to the risks
- ④ Asset declaration obligations were not recorded in the bylaws⁵

The incidence of the individual deficiencies is presented in *Chart 6*.

In the overwhelming majority of local governments adequate risk management measures

CONTROL ENVIRONMENT DEFICIENCIES IN LOCAL GOVERNMENTS



Source: own editing

were not specified of which only a part may be attributed to shortcomings in the risk analysis. Considering the high proportion of cases we did not examine whether there was a correlation between the adequacy of the risk management system and the type of settlement.

On the basis of this we can say that the local governments' risk management activities are inadequate – despite the fact that the sample was not representative. On the basis of the high proportion it is worthwhile putting this control function under the microscope throughout the country.

Control activities

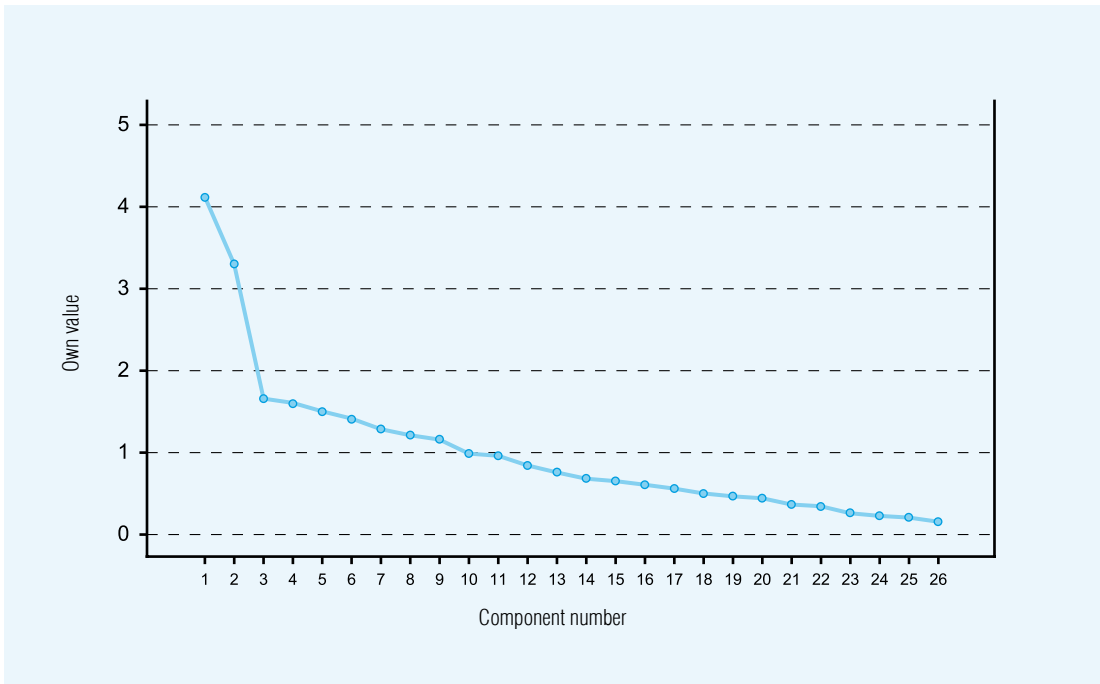
“Control activities are the policies and procedures established to address risks and to achieve the entity’s objectives” (INTOSAI, 2004). The control activities interlace the whole organisation and its every level and function.

The deficiencies found in the local governments' control activities are summarised in *Table 5*.

Most deficiencies were detected in relation to the establishment of the financial management control system (in half of the local

Chart 5

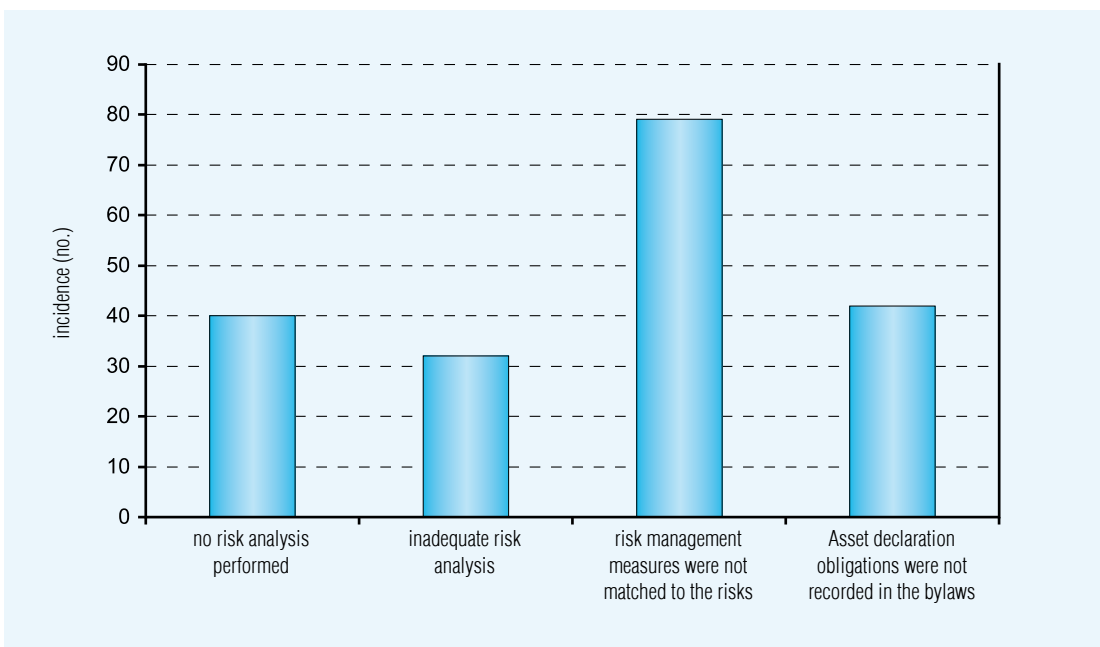
CONTROL ENVIRONMENT SCREE-PLOT



Source: own editing

Chart 6

RISK MANAGEMENT DEFICIENCIES IN THE LOCAL GOVERNMENTS EXAMINED



Source: own editing

Table 3

THE RESULTS OF THE FACTOR ANALYSIS				
Rotated Component Matrix				
Variable	Component			
	1	2	3	4
KK4	0.726	0.029	0.089	-0.185
KK3	0.664	-0.101	0.074	0.183
KK20	0.659	0.146	0.036	-0.038
KK8	0.651	-0.056	0.109	-0.028
KK7	0.631	-0.078	-0.071	-0.116
KK6	0.586	-0.072	-0.065	0.144
KK22	0.527	0.088	0.111	0.374
KK15	-0.082	0.778	-0.008	0.006
KK9	0.194	0.661	0.014	0.011
KK13	-0.048	0.647	-0.102	0.11
KK14	-0.033	0.626	0.058	0.149
KK12	-0.061	0.615	0.206	-0.074
KK16	-0.144	0.612	0.064	-0.091
KK24	0.176	0.435	0.034	0.115
KK17	-0.126	0.311	-0.272	0.31
KK10	0.47	0.096	0.685	0.024
KK11	0.506	0.035	0.624	-0.104
KK25	-0.079	-0.113	0.485	-0.177
KK23	0.04	-0.09	-0.468	-0.135
KK26	-0.178	0.204	0.402	0.391
KK5	0.058	-0.02	-0.38	-0.145
KK18	0.155	0.039	0.348	0.039
KK21	-0.128	0.043	0.127	0.611
KK1	0.372	0.308	0.005	0.589
KK2	-0.228	-0.124	0.007	-0.571
KK19	0.045	0.138	-0.044	-0.377
Extraction Method: Principal Component Analysis				
Rotation Method: Varimax with Kaiser Normalization				
a. Rotation converged in six iterations.				

Source: own editing

Table 4

CONTENT OF THE FACTORS	
Factor 1	Lack of evaluation policy (KK4) Lack of stocktaking and stock management policy (KK3) Lack of work safety policy (KK20) Lack of system of accounts (KK8) Lack of documentation policy (KK7) Lack of funds management policy (KK6) Lack of fire prevention policy (KK22)
Factor 2	Inadequate system of accounts (KK15) No, or inadequate, accounting rules (KK9) Inadequate evaluation policy (KK13) Inadequate funds management policy (KK14) Inadequate stocktaking and stock management policy (KK12) Inadequate documentation rules (KK16) Lack of civil servant performance evaluation system (KK24) Inadequate audit trail establishment (KK17)
Factor 3	Lack of irregularity management procedure (KK10) Lack of audit trail (KK11) Lack of local government financial management related regulation (KK25) Inadequacy of economic manager's qualification (KK23) Local government asset management regulation doesn't meet prescribed requirements (KK26) Lack of prime cost calculation policy (KK5) No economic programme (KK18)
Factor 4	Inadequate work safety policy (KK21) Lack of bylaws (KK1) Inadequate bylaws (KK2) Inadequate economic programme (KK19)

Source: own editing

Table 5

DEFICIENCIES IN THE CONTROL ACTIVITIES OF THE LOCAL GOVERNMENTS EXAMINED	
Control activity	Incidence (no.)
No, or inadequate, financial management control (FMC)	50
No reporting procedure policy	30
No financial management authority indicated	42
Inadequate exercise of financial management authority and documentation system	39
Inadequate qualification of civil servant responsible for financial management	7
Rules of procedure for payments not requiring written commitment is missing or inadequately documented	48

Source: own editing

governments audited), followed by the rule of procedure for payments that did not require written commitments. Of the local governments audited, 42 per cent failed to appoint staff members with financial management powers, while another 39 per cent had inadequate systems for exercising financial management powers and documentation.

The cross tabulation analysis for the deficiencies by settlement types shows that the lack of reporting rules of procedures is most prevalent among the local governments of villages, while failure to appoint staff members with financial management powers, as well as inadequate systems for exercising financial management powers and documentation are more characteristic of towns. With regard to other deficiencies there are no significant correlations with the settlement types.

Considering that control activities form the basis of adequate risk analysis, it can be stated that weaknesses in risk analysis are mainly due to the inadequate control activities of local governments.

Information and communication

“A precondition for reliable and relevant information is the prompt recording and proper classification of transactions and events. Pertinent information should be identified, captured and communicated in a form and timeframe that enables staff to carry out their internal control and other responsibilities. Therefore, the internal control system as such and all transactions and significant events should be fully documented.” (INTOSAI, 2004).

During the audit we examined whether information, required for substantiated local government decisions, was available at the right time and in a correct manner.

We identified three problem areas: data security, disclosure rules and the policy on access to information of public interest.⁶

While data security was found to be inadequate in 47 per cent of local governments, the lack of disclosure rules and that of the policy on access to information of public interest was identified in 39 and 31 per cent of local governments respectively.

Based on the results of the cross tabulation analysis all three deficiencies were most prevalent in village local governments.

It can also be stated that the identified weaknesses are mainly related to external communication; however, data security deficiencies in local governments raise more serious concerns.

Monitoring

“Internal control systems should be monitored to assess the quality of the system’s performance over time. Monitoring is accomplished through routine activities, separate evaluations or a combination of both” (INTOSAI, 2004).

In 92 out of 100 local governments there was no system for monitoring the implementation of goals or the existing system was incomplete. Similarly to risk management, we did not conduct further audits on the monitoring systems; however, in spite of having a representative sample, we can assume that other local governments also had significant deficiencies in this area.

CONCLUSIONS

Setting up an internal control system in local governments plays a crucial role in implementing organisational goals, establishing proper and sound financial management, and in a broader sense, an integrity-based public administration.

Although used as a non-representative sample, the 100 local governments, audited within the framework of this study, can be used

to draw certain conclusions regarding the establishment of control systems and the proper operation of control activities throughout the entire subsystem of local governments.

The data analysis, applying a three-dimensional model of internal control, revealed that the weaknesses in the control environment of local government operations are primarily present in the complex control elements that are built on one another. The inappropriate establishment and operation of the risk management system relies on the control activities; however, significant discrepancies are also revealed in elements of the latter. Based on the same correlations, the monitoring system should keep track of existing systems and processes; however, proper monitoring is not possible while these systems and processes remain inadequate. This observation is also supported by the shortcomings detected in the control environment. According to the results of the factor analysis, local governments either fail to regulate their processes (Factor 1) or their bylaws are not fully in line with regulations (Factor 2).

It should be noted that the deficiencies in local government regulations regarding proper and sound financial management are inter-related; therefore, if a local government has

problems with one of its control elements, it is highly likely that there are deficiencies in its management as a whole.

It is also noteworthy that the State Audit Office found irregularities in 84 per cent of local government bylaws, which can be considered the most important regulatory document regarding local government operations.

In spite of the legislators' efforts to define the appropriate framework of local government management as clearly as possible – including the establishment of internal control systems – these controls are also influenced by additional soft factors. These include weak management, mistakes during the establishment of the control systems, the human factor and the fact that the internal control system in itself is unable to ensure that the main goals will be achieved. Any of the above could prevent the internal control system of a local municipality from fulfilling the role it is meant to.

Considering that there are local governments which are able to set up and operate a good internal control system within the available legal framework, we must strive to identify best practices, make sure that local governments comply with regulations willingly and promote knowledge transfer between them.

NOTES

¹ Acts: Act on the Local Governments of Hungary, Act on Public Finances, Act on Accounting, Act on National Assets, Act on Public Officials, Act on Certain Obligations of Declaration of Property, Act on Labour Safety, Act on Informational Self-determination and Freedom of Information government decrees: Government Decree on the Implementation of the Act on Public Finances, Government Decree on the Specificities of the Reporting and Book-keeping Requirements Applicable to General Government Organisations, Government Decree on the Internal Control System and on the Internal Audit of Central Public Administration Bodies, Government Decree

on the Common Provisions of the Document Management in Public Administrative Bodies

² In total 26 variables were present since we treated separately the existence or lack of policy/rules of procedure.

³ Altogether the audit uncovered 414 deficiencies in relation to the control environment.

⁴ The individual factors' contribution to the discriminant function measured on the basis of the Wilks' Lambda is above 0.95 in all cases.

⁵ The deficiencies in the bylaws essentially belong to the control environment but we identified the obligation to make asset declarations as an element of the risk management system.

⁶ Deficiencies in the regulatory documents were mainly related to the control environment; however, disclosure rules and the policy on access to information of public interest were identified as info-communication elements.

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