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The Role of Systematic Internal Control and Audit in Reducing Management Risk at Hungarian Local Governments

SUMMARY: The financial risks to the local government sector have recently reached a level that presents a major threat not only to local governments but to the entire national economy. This paper therefore aims to point out the significance of internal controls, the absence or insufficiency of which is a significant factor in the deterioration of the financial situation and assets of individual local government and thus, indirectly, in increasing risks at the national level. The method of risk analysis was used to select twelve Hungarian local governments for an examination of the design and operation of internal controls in individual processes of asset management. The audits found that in a number of local governments, internal controls had not been incorporated into processes, or had been inadequate, preventing the controls from performing their functions.

KEYWORDS: internal control, local government, risk
JEL CODES: H11, H50, H72, H75, M42

Recent years have seen a significant deterioration in the financial equilibrium of local governments and an increase in the associated financial risks. Therefore, one of today's key tasks is to assess, in an appropriate manner, the financial risks arising, and to promote the regularity and transparency of public finances (Vígvári, 2009). An integral part of this is the correct evaluation of assets and asset management based on international standards.

The regularity and effectiveness of a local government's asset management is essentially determined by the design, presence and operation of an appropriate internal control system (Sepsey, 2011a). The absence or inadequate operation of internal controls could negatively impact the financial situation and assets of economic organisations, including local governments, and could also lead to wasteful financial management (Sepsey, 2011b; Baltaci – Yilmaz, 2006).

This paper aims to highlight the paramount importance of the design and adequate operation of internal controls at local governments and beyond, and to facilitate, by systematically collecting conclusions, more transparent and effective financial management. The paper also aims to test the method of risk-based selection in terms of how suitable it is for identifying the focus of future audits.

Owing to the nature of the subject, it is important to establish the conceptual framework of the paper; consequently, internal controls and their role in the financial management of local governments are discussed first. This is

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followed by a section on material and method explaining the criteria for the selection of the local governments covered in the paper. Furthermore, an account is given of the experience gained from previous audits with relevance to the internal control system. The findings section gives a brief summary of the financial and economic risks to the local governments selected, which is followed by a detailed treatment of the controls the audits found to be inadequate. Before conclusions are drawn, a case study illustrates the consequences of the absence of internal controls. A brief summary is offered at the end of the paper.

INTERNAL CONTROL SYSTEM

Our argument is based on the proposition that "*order creates value*" (Domokos, 2011). That is to assume that order is a prerequisite for creating value, which again requires that an internal control system adequately operate at all levels of the organisation.

An internal control system is not limited to financial audits in the strict sense. An internal control system is a system of processes incorporating all the principles, procedures and internal policies which the budgetary institution should design and operate to ensure that all of its activities are regular and comply with the requirements of economy, efficiency and effectiveness (Kovács, 2007).

Local governments manage public money and public assets. Consequently, it is their fundamental statutory obligation to operate an adequate internal control system. Such a control system should ensure the transparency, regularity and reliability of their financial management, the protection of resources against losses, and the fulfilment of accounting obligations. An internal control system, when operated adequately, minimises the risk of errors and irregularities, thereby ensuring that financial management does not involve any waste, abuse or improper use.

Within each component of the internal control system, it is the right and obligation of the head of the budgetary institution to define the quantity, quality, strictness and requirements of the internal controls.[1] At local governments, the town clerk is in charge of designing and operating a control environment, a risk management system, control activities, an information and communication system and a monitoring system which facilitate decision-making and, in the course of implementing those decisions, legal and regulatory compliance, probity, and resource protection.

For budgetary institutions, Act CXCV of 2011 on Public Finances defines internal control as follows: "*...the internal control system is a system of processes designed by the budgetary institution with a view to managing risks and obtaining objective assurance in order to ensure that the budgetary institution performs its activities (operations) in a regular manner and in accordance with the principles of reliable financial management (economy, efficiency and effectiveness), fulfils its accounting obligations, and protects the resources of its organisation against losses (damage) and improper use*".

That is, internal control is a management tool with direct relevance to the goals of the organisation. Whatever the mission of an organisation, its fulfilment involves a number of risks. Internal control can help mitigate risks, while providing reasonable[2] assurance that the mission will be fulfilled and that the general goals set will be achieved.

MATERIAL AND METHOD

The local governments participating in the case studies were selected from nearly 3,200 Hungarian local governments on a risk basis. In essence, this involved setting a risk order based on a predefined number of indicators, calculated from the local governments' statements describing their financial situation and assets.

The following indicators were used: (1) change in land and buildings and rights to immovables, (2) change in net worth, (3) change in concession assets and managed assets, (4) acid test ratio, (5) short-term liability ratio, (6) repayment coverage, (7) indebtedness, (8) guarantees for undertakings, (9) risk of loans taken, (10) surplus ratio, (11) ratio of assistance to non-viable local governments, (12) revenue flexibility index and (13) expenditure flexibility index.

Data to produce the selected indicators were obtained through several channels. Sources of information included the current system for local government reporting, and, to a limited extent, data requested from individual local governments.

Based on 2009 and 2010 data for the indicator system, the local governments were classified into three groups: priority local governments, towns and villages.

The risk order was established within each group. A specified number of local governments[3] with the highest aggregate scores[4] were examined to determine the causes of their high scores. Where specific indicators or data gave rise to any uncertainty, the local government concerned was requested to provide additional evaluation and evidence in a customised certificate.

Following the selection method explained above, the local governments of five[5] towns and seven[6] villages were designated for the 2011 audit on the financial management system of local governments.

As part of the audit on the financial management systems of local governments in varying circumstances, their debt management activities and financial situations were analysed for the 2007–2010 period. For the latter, the so-called CLF method was used, which consistently distinguishes between revenues and expenditures of the budget and their balances as either current (direct operating items related to the duties of local governments) or capital (related to assets) (Bende – Szabó, 2007). *(See Chart 1)*

The CLF method is centred around the concept of financial capacity (net operating income). The borrowing capacity and long-term solvency of a local government is described by means of its financial capacity. Net operating income is derived from the balance of the current budget (operating income) by subtracting principal repayments. Financing a negative net operating income from capital surplus or additional loans is an indication that financial management is financially not sustainable.

Although there is little difference in the content of the indicators used to select the local governments, the CLF method is appropriate as it allows a more efficient identification of internal controls with a negative impact on financial situation, or the absence of such controls.

In specific areas of the financial management of local governments[7] previous (audit) experience[8] was used to identify the following controls as the primary source of risk:

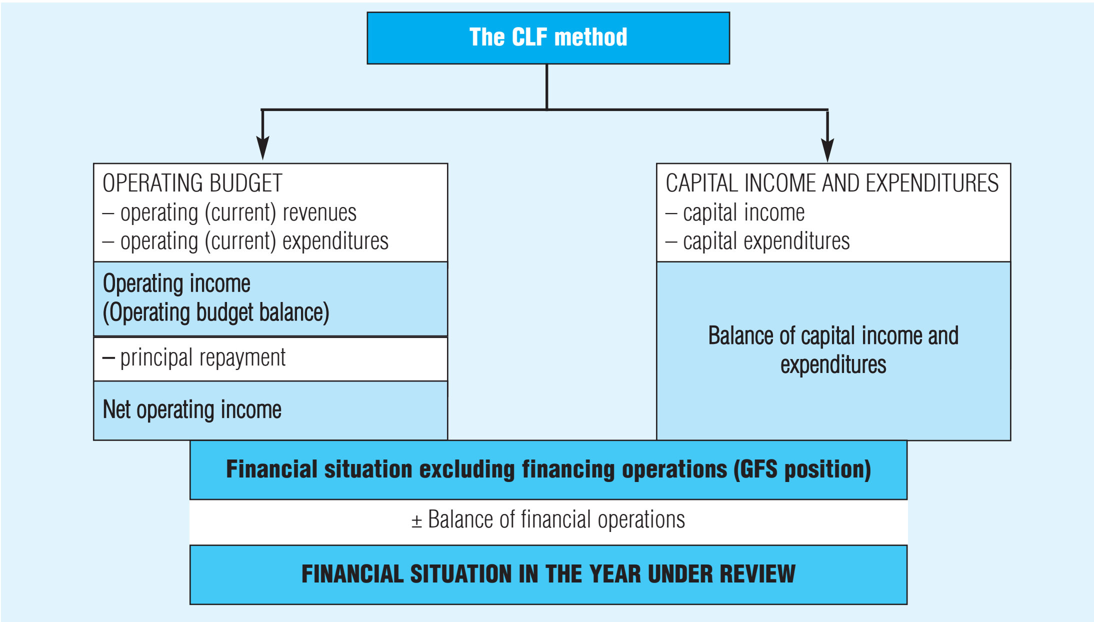
1. countersignature on commitments,
2. certification of professional performance,
3. countersignature on vouchers.

These controls are essential to mitigate inherent risks,[9] and their effective operation has a decisive impact on the quality of the control system. Key controls enable one or more operational failures of other controls to be detected and eliminated. The advantage of key controls over other controls (personnel controls, management controls, physical controls) is that it is relatively easy to test them and that their effective and consistent operation provides protection against two or more operative errors.

The audit of key controls to obtain an adequate level of assurance requires significant resource capacity; consequently, so-called multi-step compliance tests were conducted for the sake of cost-effectiveness (Lolbert, 2007). Essentially, the method involves a ran-

Chart 1

THE CLF METHOD



Source: own editing based on Bende – Szabó (2007)

dom sample of the population of the items in the high-risk areas designated for the audit, the examination of which is limited to obtaining sufficient appropriate evidence on whether or not the control tested is compliant (SAO, 2008b). Subject to the assurance required and the tolerable (acceptable) errors, using the method to test 30–100 items normally allows a reliable opinion to be established on whether or not the controls are operated in compliance with the objective set for areas involving up to thousands of items/transactions. The random sampling was performed using IDEA software.

RESULTS

The financial and economic situation of the audited local governments

The financial situation assessment based on the CLF method found that with nearly all of the local governments involved in the audit, the level of indebtedness had increased, coupled with a reduction in reserves and deterioration in solvency (liquidity). This is certainly not surprising as the criteria for risk-based selection were similar. More importantly, the audits highlighted that in the processes described, a major role was played by deficiencies in measures aimed at the management of financial risks.[10]

With the entities audited, there was a high risk from the fact that in the period under review, most had suffered significant blows to their capacity to generate an operating income despite subsidies for local governments with financial problems through no fault of their own, primarily owing to reductions in budget subsidies and assigned revenues and higher current expenditures, with no room left to introduce new local taxes. Net operating income, also reflecting principal repayments, had significantly declined each year. A negative value indicates excessive debt service with several local governments. Overdue trade accounts payable had increased, and reserves had run out by 2010. Additionally, overdraft facilities to ensure liquidity had become chronic, which adds significantly to the risk of financing future operating expenditures.

Deficient internal controls and their impact on financial management

Involving 12 local governments, the audit covered a number of controls. First a description is provided of those detected in previous audits.

With a majority of the audited local governments (11), the internal controls identified in previous SAO audits as key to specific areas of asset management, i.e. (1) countersignature on commitments, (2) certification of professional performance, and (3) countersignature on vouchers, did not function properly. The deficiencies and omissions detected in the operation of these controls pose the risk of irregular expenditures. The audit found that in a number of cases commitments had not been put in writing and written commitments had not been countersigned prior to payments being made. Prior to commitments such as contracting, the local governments concerned had not assured themselves that expenditure appropriations and funds were available, and had also failed to check whether the commitments complied with the rules of financial management. Before the expenditures were made, they had not certified professional performance, thereby failing to ensure that the payments were legal, that amounts were correct, and that the terms of contracts and orders had been fulfilled. Additionally, the failure to put commitments in writing, countersign written commitments and certify professional performance had not been detected by the countersigning officers processing the vouchers.

Where commitments are not reviewed by a countersigning officer, there is the risk that commitments are undertaken without any budget funds to cover them. The deficiency of this control also poses the risk that the commitment (such as a contract) will fail to comply with statutory or local requirements applicable to financial management. Failure to certify professional performance may result in the payment of incorrect amounts or to ineligible parties, or payments in connection with which the task/service undertaken has not been completed. Where this problem also fails to be detected by countersignature on vouchers – the last key control before payment – the deficiency of internal controls will entail the risk of payments without the services ordered being performed as provided for in decisions, contracts or orders, potentially leading to wasteful financial management.

The absence of or failure to comply with key controls could have severe economic consequences in itself; however, the local governments in the sample were found to have additional deficiencies which posed the same degree of risk as the circumstances explained above.

Prior to asset management decisions, the procedures to support those decisions had not been completed. None of the local governments had required and, consequently, carried out either an analysis of the sustainability of investments and renovations, or an account of maintenance costs, also failing to require and carry out a cost-benefit analysis where appropriate (in the period under review, the 12 local governments implemented approximately a total of 10 billion HUF worth of investments and renovations without these internal control procedures in place). As a result of their failure to conduct a preliminary assessment of maintenance costs and a sustainability analysis, they implemented developments creating facilities, providing for the operating costs of which may present an operating risk should the municipal operating income be insufficient to raise the funds to finance them.

Another deficiency is that in connection with commitments involving future debt (loans, bond issues), none of the local governments had required an assessment of the financial risks; prior to undertaking the commitments, the inherent risks had not been assessed despite the 12 local governments raising approximately a total of 4 billion HUF from loans and bonds over the period.[11]

Without an assessment of financial risks, decision-makers had made decisions involving future debt which could be detrimental to the financial equilibrium of their local governments. When a gradually decreasing operating income no longer provides the funds to finance principal and interest costs, additional external funds need to be raised, which carries the risk of a debt spiral developing, as the CLF model also reflected.

The absence or inadequate design of internal controls also led to the failure to detect the violation of the statutory obligation to ensure the transparency of the use of public monies: of data of public interest relating to asset management data on specific-purpose operating support and on contracts worth at least 5 million HUF net for the procurement of goods, construction and services had not been published on the website of the respective local government.

With the local governments of villages, basic errors were also found in the internal control system. Owing to the absence of accounting controls and the consequent deficiencies of stocktaking, the integrity of the accounting balance sheet was not substantiated. Omissions in ensuring the integrity of balance sheet data carries the risk that stakeholders (decision-makers, partners, banks, etc.) will not make economically sound decisions; thus the risk resulting from the inadequate operations of the local government will cause difficulty for other economic agents.

With a significant proportion of the entities audited, the tasks to be performed had not been specified in quantitative and qualitative terms in the public services contracts. None of local governments' representative councils had required checks on how public duties were discharged. No such checks were carried out.

Failure to enforce ownership is also poses a risk to the financial equilibrium of local governments. Without the design and operation of fundamental ownership controls, ownership could not be enforced effectively with local governments controlling business associations:

- None of the audited local governments had required their delegates to supervisory boards to report on their activities to the representative council; consequently, no such reporting had taken place;
- The operations of such associations had not been audited as part of internal audit at audited local governments with majority stakes in business associations. The local governments had failed to check whether the funds (529.8 million HUF in total) provided for operating purposes had been used appropriately.

Formal internal controls

Audit findings suggest that the deficiencies of internal controls were mostly the result of failure to design such controls. The unfortunate fact, however, is that designing internal controls does not mean that the audit assignment has been completed. Previous audits often found that internal controls did not work despite having been designed and regulated in accordance with legal provisions.

It is important to emphasise that internal controls fulfil their functions if they involve substantive checks. Formal controls such as signatures and annotations are not sufficient in themselves as they do not help detect and correct operational failures. The audits also revealed problems of this kind.

CASE STUDY – MUNICIPALITY OF BUDAPEST

In terms of the certification of professional performance, the Municipality of Budapest had designed internal controls in compliance with applicable legal provisions. Yet, in one of the areas tested as part of the audit, i.e. the 2009 payments of remuneration to non-employees, it was found that the certification of professional performance had not been operating although apparently everything was in order. Namely, prior to the payments, the persons authorised to certify professional performance had certified fulfilment of the tasks provided for in contracts of agency by means of annotations including their signatures and the dates as specified in the internal policy. However, with several contracts of agency, the audit found these controls to be formal. The persons authorised to do so had certified professional performance of contract work despite the fact that either the documents proving the agents' performance of the tasks under the contracts had not been available, or the documents enclosed could not credibly prove that payments were justified by contractual performance (with items checked in the random sample, such payments amounted to 32 million HUF).

The audit found that the Municipality of Budapest had failed to design controls to verify performance of the tasks involved in public road maintenance.[12] The adequate operation of the controls had also been prevented by the impractical settlement system provided for in the public services contract. Namely, the contract provides for a flat fee system under which financial accounts would be drawn up between the parties only one and a half years after the first payment in the year concerned. This in itself made it impossible to check the work performed[13] or to operate the internal controls adequately, since, owing to the nature of the work, performance could not be checked, in terms of either quality or quantity, a year and a half later. As a result, FKF Zrt. had failed to perform its task to technical and professional standards, and poor quality work entailed extra tasks as additional repair work had to be done following pothole patching and road marking maintenance, within their expected lifespan. The audit found that maintenance was performed in insufficient quality on half of the road sections checked in terms of pothole patching, and on three quarters in terms of road markings.

It was also found that internal controls had failed to operate in respect of the unit prices of the service provider, i.e. the Municipality of Budapest had not obtained assurance that those unit prices were reasonable. It was partly due to the absence of these controls that the unit prices charged by the Municipality's own company for hot patching were significantly higher than the average of those charged to local governments polled in a questionnaire survey. Despite the exceptionally high unit prices, however, the Municipality of Budapest decided, citing a lack of funds, to commission the lowest level of public road management services in both 2009 and 2010, failing to provide even the minimum conditions required by legal regulations.

CONCLUSION

In specific areas of local governments' financial management, internal controls were assessed for compliance regarding design and operation, which involved detecting basic regulatory and regularity deficiencies and omissions which had played a part in the failure to adopt measures to manage risks and in the development of financially detrimental processes.

Key deficiencies detected in the audit of local governments

- Internal controls were absent or had been poorly designed.

- Key controls (countersignatures on commitments, certification of professional performance, countersignatures on vouchers) were not functioning properly.
- Prior to asset management decisions, the procedures to support those decisions had not been completed.
- There had been no requirement to assess the financial risks involved in commitments.
- Accounting controls were absent (primarily with the local governments of villages).
- Public services contracts had failed to specify requirements pertaining to quantity and quality.
- Ownership had not been enforced (no reporting obligations for members delegated to supervisory boards, no audits as part of internal audit on the operation of firms owned by the local governments).
- Owing to deficiencies in the control environment, adequately designed controls had not fulfilled their function.

The presence of key controls identified in preparing the audit proved to be essential for the proper functioning of internal controls; however, other sources of significant risk were also identified. Although the deficiencies listed were not unknown to us, the methods used for and after selection helped to establish the real weight of each internal control, i.e. to determine the controls the absence of which carries the greatest risks.

Findings suggest that the method applied in the audit is suitable for the cost-effective detection of real and significant risks to the financial management of local governments, and of the substantive connections between internal controls and financial and economic situation. Consequently, the findings of this audit may provide the focus for additional audits on internal controls.

However, the deficiencies identified help not only audits but local governments themselves, allowing managers responsible for the design of internal controls to develop, in a targeted manner, the control system of the organisation they represent. This is of great help primarily (but not exclusively) to smaller local governments.

The audit also found that with the local governments selected, the extent of negative changes in the asset, financial and other indicators varied by settlement type, as mandatory municipal tasks and population size had a fundamental impact on financing.

In summary of the foregoing, internal controls are of outstanding significance to all entities, including local governments. However, the absence of or failure to comply with internal control is fraught with risk. Such risks may be presented in a variety of forms, from irregular payments through failure to enforce ownership, to financially and economically unsound investments. These are all risks that may have a major impact on the financial and economic situation of the entity (in this case, local government) concerned. Consequently, accountable managers should do everything within their means to mitigate the risks discussed in this paper by designing and operating an adequate internal control system.

Notes

[1] The Act on Public Finances provides that the head of the budgetary institution is responsible for the organisation and efficient operation of the internal control system, including internal audits.

[2] Reasonable assurance means that the costs of internal control should not exceed the benefits it provides.

[3] Local governments with the greatest risk in terms of asset management and financial situation.

[4] Pursuant to the decision of the supervisory manager, the causes of high scores were examined at approximately three times the number of local governments appropriate for auditor capacity.

[5] Emőd, Kalocsa, Nagyecsed, Pomáz, Vásárosnamény

[6] Almamellék, Csobánka, Felcsút, Foktő, Gyöngyöspata Tiszainoka, Vál

[7] Payments relating to leases, public services purchased, maintenance and minor repair services, the renovation of buildings, the purchase and construction of buildings and loans to business associations, payments to organisations outside of public finances to provide operating and capital funds, revenues from the sale of property, the lease of premises owned by the local government, and sale of long-term investments.

[8] Previous audits by the State Audit Office of Hungary between 2007 and 2009 indicated high risk with close to two thirds of local governments in terms of specific internal controls as well as the design and operation of the internal control system. In 2009, the SAO found weak compliance of the internal controls tested with about half of the 118 internal controls audited (Report No. 1019 on the 2009 Audit on the Financial Management System of Local Governments).

[9] The aggregate of factors that may prevent the audited entity from the adequate discharge of its duties and the achievement of its goals. These may include risks at an organisational level as well as inherent risks specific to the audit objectives (SAO, 2008a).

[10] Default risk, repayment risk, interest and exchange rate risk, risk of business associations, future operating risk

[11] Mostly to raise the previously unavailable funds required for investments and renovations implemented using EU funds

[12] Within the assets of the Municipality of Budapest, the public road network is a significant asset amounting to about a third of all assets (656 billion HUF). The maintenance of public roads in a condition suitable for safe transportation is a municipal task affecting the everyday lives of millions of people. Public roads in the capital are used by over three million passenger vehicles and lorries and approximately the same number of passengers travelling by public transport. Public road maintenance is a budget item that requires continuous funding (3–5 billion HUF annually). In the period under review, the Municipality of Budapest tasked one of its own companies, FKF Zrt. with public road maintenance.

[13] Payments without on-the-spot checks amounted to 1.7 billion HUF in total.

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Act CXCV of 2011 on public finances

Annex

INDICATORS USED FOR RISK ASSESSMENT

INDICATOR	CALCULATION	DATA SOURCDE
Change in land and buildings and rights to immovables	Current balance sheet value–value carried in the balance sheet for the base year	Accounting balance sheets for the year under review and the base year
Change in net worth	Current balance sheet value–value carried in the balance sheet for the base year	Accounting balance sheets for the year under review and the base year
Change in concession assets and managed assets	Current balance sheet value–value carried in the balance sheet for the base year	Accounting balance sheets for the year under review and the base year
Acid test ratio	Receivables + marketable securities + liquid assets/short-term liabilities (values in the year under review and in the previous year)	Accounting balance sheets for the year under review and the previous year
Short-term liability ratio	Short-term liabilities/total liabilities (values in the year under review and in the previous year)	Accounting balance sheets for the year under review and the previous year
Repayment coverage	Principal repayments + interest/budgetary revenues*–budgetary expenditures bearing no interest (data for the year under review and the previous year)	Statements for the year under review and the previous year
Indebtedness	Short-term + long-term liabilities/total funds (values in the year under review and in the previous year)	Accounting balance sheets for the year under review and the previous year
Guarantees for undertakings	Value in the year under review–Value in the previous year	Accounting balance sheets for the year under review and the previous year
Risk of loans taken	Liabilities denominated in foreign currencies/total long-term liabilities (values in the year under review and in the previous year)	Statements for the year under review and the previous year
Surplus ratio (double weight)	Budgetary revenues*–budgetary expenditures/budgetary revenues (data for the year under review and the previous year)	Statements for the year under review and the previous year
Ratio of assistance to non-viable local governments	Subsidies/budgetary revenues* (data for the year under review and the previous year)	Statements for the year under review and the previous year
Revenue flexibility index	Specific own revenues**/budgetary revenues* (data for the year under review and the previous year)	Statements for the year under review and the previous year
Expenditure flexibility index	Capital expenditures/total budgetary expenditures (data for the year under review and the previous year)	Statements for the year under review and the previous year

* Residues used from previous years

** Local tax + duty + vehicle tax + interest revenues (Source: RIHSAO – The financial situation of the local government system)

*** In application of the principle proposed by INTOSAI