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Internal Audits at Local Governments

Audit Experiences of the State Audit Office of Hungary

SUMMARY: Internal audit applied by local government does not fulfil its functions and in reality does not contribute to the proper, regulated, economical, efficient and effective management of local governments. In the majority of local governments internal audit has a systemic attitude, which consistently fails to assess and to develop the effectiveness of the risk management and controlling procedures of local government. This situation partly results from the contradictions between the Act on Local Governments and the Act on Public Finances and partly from the misapplication of internal audit and the misinterpretation of its role. The State Audit Office (SAO), also taking into account international standards, has put particular emphasis on the assessment of the operation of internal audit in local governments for many years. On the basis of the experiences resulting from such audits, well founded proposals can be submitted for reasonable amendments to statutes, with particular regard to the comprehensive reform of the Act on Local Governments.

KEY WORDS: internal audit, local government, audits performed by the State Audit Office, internal control system, performance audit
JEL CODES: R50, M48

OBJECTIVE

Those who are attempting to meet internal audit requirements as heads of budgetary institutions or even as internal audit managers amidst the wave of legislative changes of recent years have to face serious challenges. I think the situation is even more difficult for those who are responsible for the development and correct operation of the internal control system and internal audits in local governments.

I sincerely hope the arguments supporting my claims will be convincing and I also hope that my work will prove useful to legislators and as a consequence the field in question will also see legislation based on a thought-out and mature concept. I hope that as a result, contradictions existing due to the diverging statutory provisions applicable to local governments in

terms of their internal control systems and internal control will be eliminated and it will be defined clearly who's responsible for what and what kind of means they have to enforce legal provisions. If the provisions are clear and enforceable, the governing bodies governing local governments must also hold internal audit departments accountable in terms of efficient operation and this will allow for great steps to be made towards making the use of public funds in the sub-systems of local governments more transparent, efficient, and effective and stronger accountability will ensue as well.

Firstly I will review the actual (or supposed) inaccuracies and gaps of legislation, with particular attention to local government internal audits; then I will present the conclusions drawn from the examination performed by the SAO of the compliance of the operation of local government internal audits, and providing a reason why internal audits are so important

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from aspect of audits performed by an audit institution. At the end of my study – with regard to the Local Government Act currently under revision – I will make a recommendation for the reformation of local government internal audits. As internal auditing is part of the internal control system, therefore logically if the internal audit does not fulfil its function, then – in part or as a whole – the internal control system itself cannot accomplish its objectives either. The renewal of internal audits goes hand in hand with the reform of internal control systems of local governments.

CHANGES OF THE LEGISLATIVE ENVIRONMENT

The goal of the present paper is not to present and analyse the last twenty years of the development of the Hungarian financial audit system in detail, but I feel that due to a number of legal interpretation uncertainties and legislative oversights, the field of internal auditing has been controversial ever since the establishment of local governments and the consequences of this are rather grave. In part because the internal audit failed to uncover the irregularities and negligence, and as a result local governments have incurred damages; and partly because it has not fulfilled its function, i.e. it has not contributed – at least not to the extent required by the legislator – to the development of the operation of the audited entity or to increasing its efficiency. This latter also constitutes financial damages for the given local government, but we cannot disregard the drop in public confidence either with respect to the operation of the democratic institutional system.

Act LXV of 1990 on Local Governments (ötv) entered into force on September 30, 1990, and at the time regulations regarding financial audits were contained in Act II of 1979 on Public Finances (ápt) and Government Decree

No. 23/1979. (VI. 28.) MT of the Council of Ministers on the Implementation of Act II of 1990 on Public Finances (vhr). Even at this point it was a problem that the ápt. was not amended at the same time the ötv. entered into force, and in the local government system (that is fundamentally different from the council system) the application of the provisions of the ápt. and the vhr. poses an almost irresolvable problem. Legislative uncertainty was increased by the fact that the majority of statutes on public sector financial audits were repealed by the National Assembly as of January 1, 1991, but no new provisions were created to replace them until Act XXXVIII of 1992 on Public Finances (áht.) entered into force (July 3, 1992). The situation became slightly more complicated by Act XX of 1991 on the Tasks and Scope of Authority of the Local Governments and Their Organs, of the Commissioners of the Republic, and of Certain Centrally Governed Organs (htv) which entered into force on July 23, 1991, because as a financial management duty and power of notaries it specified that notaries are responsible for the financial-economic (sic!) audits of budgetary institutions established and maintained by the given local government.

In my opinion, interpretation problems that still exist today in the field of local government internal audits are the result of the initial lack of clarity in legislation. The legislators did not think it through that given the unique regulatory needs an audit model should be developed which would indeed allow the accomplishment of public finance audit objectives – applicable to local governments – introduced by the áht. (adherence to regulations concerning public finances; collection of the revenues due to the sub-systems of public finances; economical, cost-efficient and regular utilisation of public finance funds; efficiency and regularity of asset management; adherence to accounting and documentation order). The local government is not identical to the mayor's office neither in a legal nor in a sociological sense.

In my opinion, the legislator failed to review how the duties and powers of the representative council, the mayor and the notary should be divided with respect to audits. ‘Legal confusion’ grew because due to the fact that— in the absence of the well thought-out division of duties and powers – the National Assembly failed to create the harmonisation of the legal institutions established by the various laws, and as the result of different terminology, individual interpretation gained ground which poses a very high risk in auditing the utilisation of public funds. This risk was increased by the fact that without clear, detailed and enforceable regulations, it proved to be an impossible task to ensure uniform practice in the close to 3,200 local governments, and at the same time prevent or at least decrease the occurrence of errors that have incurred and are still incurring damage and losses. Government Decree 15/1999 (II. 5.) on the Governmental, Supervisory, and Internal Budgetary Auditing of Agencies Funded from the Central and the Social Security Budgets (Ber₁) did not cover local government internal audits, therefore this particular field was unregulated for years (until November 2003).

Why don't I consider the division of auditing duties and powers between the representative council, the mayor and the notary sufficiently thought-out?

Initial Situation in 1990

Pursuant to ötv provisions, local governments are legal entities, the assets of the local governments are made up of its properties and intangible assets that serve the accomplishment of local government objectives. The representative council being responsible for the safety of the financial management of the local government decides on the exercising of rights attributable to the owners. Local government duties and powers belong to the representative council. Besides the htv. provision pursuant to

which the representative council reviews the experiences of the audits of budgetary institutions established and maintained by it on a regular basis, the representative council¹ had no duties or powers in the field of auditing and had no direct legal opportunities for audits.

The ötv stipulates that the mayor is responsible for the regularity of financial management, represents the representative council, ensures the execution of the budget, makes commitments on behalf of the local government and may also authorise other persons to do this. In my view, the responsibility for the regularity of financial management exists in an uneven manner. For it is the notary's responsibility to indicate to the representative council, the committee or the mayor any statutory infringements detected in connection with their decision. In the absence of such indication, the mayor's responsibility in the field of the execution of the budget – form a regularity aspect – does not exist. This is reinforced by the regulation that commitments – with certain exceptions – can be made only after countersigning, and the control of adherence to regulations on financial management² is – among other things – the countersigning officer's responsibility. If the countersigning officer feels that the commitment does not infringe on the regulation on financial management, then he/she provides the countersignature and, in my interpretation, assumes the responsibility that the commitment had indeed been made in a regular manner. As pursuant to the htv, in local governments the notary has the power to countersign commitments, in my opinion this means that in reality it is the notary who is responsible³ for the regularity of financial management. The ötv and the htv provide no tools whatsoever for the mayor in the field of audits.

All this means that with respect to the mayor's office (and in the end the local government), the notary has the key role in the development and operation of audits.

According to the áht, the executing body of the financial management of the local government is the mayor's office, headed by the notary, who, among other things, is responsible for the organisation and operation of the internal audit of the mayor's office (as a budgetary institution). Pursuant to Government Decree No. 96/1987. (XII. 30.) PM of the Ministry of Finance on Supervisory Budgetary Audits and the Internal Audit of Budgetary Institutions that was in force at the time, the notary determined the tasks of the internal auditor in an annual work schedule, and pursuant to the htv. the notary was responsible for the financial-economic audit of budgetary institutions established and maintained by the local government. However, with the entering into force of Ber₁, its legal background ceased to exist. The relationship of the notary and the mayor is unevenly regulated by the ötv., as the mayor controls the mayor's office according to the decisions of the representative council and within its own local government powers.

Further Legislative Amendments

The amendment of the áht that entered into force on November 27, 2003 stipulated as the objective of internal audits – in contrast to the previous regulation – that the internal audit is an independent advisory activity that provides material certainty, the goal of which is to develop the operation of the audited entity and to increase its efficiency. In order to achieve the goals of the audited entity, the internal audit must be carried out methodically and using a system-oriented approach, and must develop the efficiency of the risk management, audit and control procedures of the by 'providing findings and proposals to the head of the budgetary institution'. In the case of local governments this is the notary in charge of the mayor's office or the head of the local government's budgetary institution. There is no mention of a mayor or representative council.

I feel, and later on will attempt to prove my assumption, that in the majority of local governments the objectives of internal audits that changed after the legislative amendment were incorrectly interpreted, and as a result the majority of audits featured in the internal audit plan were not aimed at the evaluation and development of risk management, audit and control procedures, but were instead 'reviser' audits, in-line with the former approach (petty cash, mission, fuel accounts, mobile phone use, request for per capita subsidies, review of accounting).

In terms of the regulation of the internal audit of local governments, Government Decree No. 193/2003. (XI. 26.) on the Internal Audit of Budgetary Institutions⁴ (Ber₂) that entered into force on November 27, 2003 is considered a milestone. Its scope as it were extended to local government budgetary institutions, therefore the statute provided the heads of local government budgetary institutions with the criteria for the requirements, on the basis of which the heads of budgetary institutions (including notaries at the head of mayor's offices) can organise and efficiently execute internal audits. From that moment a clear opportunity opened up for the State Audit Office to evaluate the development and operation of internal auditing during the audits of the financial management of local governments. Following the entry into force of Ber₂, there were already regulations in place, adherence to which was a requirement that local governments could be held accountable for – in terms of internal audits – during the relevant audits thereof.

'Only' a Two-Year Delay

With respect to local governments, the new regulations introduced by the áht, pursuant to which public finance audits must be executed through financial management control and internal auditing, entered into force with a two-year delay on August 31, 2005. The amendment of the ötv finally dealt with the audit of budget-

ary institutions as well, as it stipulated that this must be conducted within the framework of the internal audit of the local government. However, the provision according to which the operation of a financial administration and audit system that ensures the proper, regulated, economical, efficient and effective utilisation of funds available to the given local government is the responsibility of the notary in charge of the mayor's office does raise some doubts. Let me demonstrate the irrationality of the fulfilment of this statutory requirement with the most extreme example: besides the Budapest Mayor's Office, 214 budgetary institutions and 44 business organisations take part in performing the tasks of the Municipality of Budapest. How could the head notary ensure the regulated, economical, efficient and effective use of funds with respect to the whole of the local government?

Again I seem to be observing the contradiction that the duties and powers of the representative council, the mayor and the notary partly overlap, and the notary receives exaggerated mandates, and at the same time responsibility, however, his/her public law status is much weaker. The fact that the notary is responsible not only for the operation of the financial administration and control system, but also for certain control activities (countersigning of commitment making and voucher issue, as well as legality controls) causes serious problems as well. This creates a situation of incompatibility, and in itself weakens the efficiency of the internal control system.

Increasing the regulatory problems of the aforementioned 'triangle' is the fact that following the 2005 amendment, it is the representative council which approves the annual internal audit plan. If after all the main objective of the internal audit is to evaluate and develop the efficiency of the risk management, audit and control procedures of the audited entity, then we could say that it is the person responsible for the development and operation of the system – the notary – who seems to be the person

most suited to approve the annual plan, and not the 'irresponsible' representative council. As the htv is still in force, pursuant to this regulation the notary has the right to execute the supervisory audit, which means that the approval of the annual plan should also be the notary's task. Taking this thought further, it leads us to the issue of the establishment and operation of the internal control system that covers the whole of the local government.

In this respect, however, another argument for change is that the members of the representative council and the mayor have been directly elected to manage the local government, exercise the proprietary rights over the assets of the local government, be held accountable by their constituents and bear the consequences of their decisions (always in the political sense, but rarely in the financial sense of the word). That is, it is not the notary who should not be responsible for the establishment and operation of the system, but the mayor due to the enforcement of the single-person responsibility. With respect to the council, it is difficult to carry out the establishment and operation of the internal control system, and enforcing responsibility would also be complicated.

In my opinion the legislator was not consistent when – in spite of the fact that it is the representative council that approves the annual audit plan – it stipulated that internal control should specify findings and recommendations for the notary and the mayor, which the mayor can put on the agenda of the next meeting of the representative council. Through this solution it became clear that the utility of internal audits is primarily apparent with respect to the notary⁵ who is actually responsible for the operation of the financial administration system; and also that the legislator has introduced an inexplicable filter with respect to the representative council. The mayor is only obliged to inform the council that ordered the audits about the findings and recommendations of the

internal audit if he/she feels it is justified (which gives way to very subjective interpretation). It would have been more appropriate if the mayor was obliged to inform the representative council in each and every case.

Regulations of the ötv concerning audits have remained unchanged since January 1, 2007, in spite of the fact that áht. provisions regarding internal audits have been significantly amended on January 1, 2009 and January 1, 2011 as well. The regulations of the internal control system are in many ways uninterpretable and unenforceable due to the amended provisions of the ötv (the ötv does not use the term internal control system, it mentions the internal control of local governments despite the fact that there is no internal control in place for local governments, this is a term that is only applicable to budgetary institutions, executive control is not independent, according to the ötv it is not part of the internal control system etc.).

WHY THE OPERATION OF INTERNAL AUDITS IS SO IMPORTANT FOR THE STATE AUDIT OFFICE?

The 9th Congress of the International Organization of Supreme Audit Institutions (INTOSAI) in Lima adopted – by acclamation of the delegates – the Lima Declaration of Guidelines on Auditing Precepts in October 1977. The principles laid down in said declaration are still valid today and are authoritative with respect to the status and activity of all supreme audit institutions – therefore the State Audit Office of Hungary as well. The separation of external and internal audits stood the test of time, and the provision which states that as an external auditor it is the supreme audit institution’s task to review the efficiency of the internal audit continues to set the direction to follow. If the supreme audit institution deems the operation of internal audit successful, then – without infringing on the

general audit rights of the supreme audit institution – attempts should be made for the most appropriate division or handover of tasks possible and the development of cooperation.

With the growth of public consciousness, the demand grew for users of public funds – persons or institutions – to account for their activities and to be held accountable if needed. In order to enforce this rightful need, however, the processes and systems which are essential for accountability must be established. To have effective settlement, the establishment of appropriate information, control, evaluation and reporting systems is also necessary. The creation of statutory frameworks is the task of the legislative organ and the government, and within the given organisation the head of the organisation is obliged to develop and operate the systems, and is also responsible for the accuracy and adequateness of the form and content of financial statements and other information. One of the basic principles of audits performed by an audit institution is that an appropriate internal control system⁶ minimises the risks of errors and irregularities. It is the audited entity’s obligation to operate internal controls that help adherence to applicable laws and regulations, the enforcement of rectitude in decision making, the protection of resources and settlement. It is the supreme audit institution’s obligation to evaluate the operation of the control system, and if controls are inadequate, insufficient or missing, the SAI must make proposals and recommendations to resolve the problem.

THE METHOD OF THE EVALUATION OF THE OPERATION AND COMPLIANCE OF INTERNAL AUDITS CONDUCTED AT LOCAL GOVERNMENTS

One of the objectives of the comprehensive audits conducted at local governments between 2003–2006 was to evaluate whether the con-

trols (or according to the phrasing at the time: the established and operational internal management and regulation system, and the fulfilment of internal audit functions) ensuring the regularity of financial management adequately helped execution. The audit at the time was basically a regularity audit, where the State Audit Office reviewed whether the given local government had set up the frameworks required for the fulfilment of internal audit obligations and ensured the organisation and implementation of audit assignments.

At the end of the cycle – in 2006 – the State Audit Office⁷ stated that the quality of the audit integrated into the work process had not improved compared to previous years. The performance of financial management and process-integrates audit assignments did not take place or were performed incompletely. Due to the deficiencies observed there is a high risk of the internal control systems of local government offices not being able to prevent or indicate material errors or irregularities. The report stated that the situation with regard to the performance of internal audit assignments somewhat improved compared to previous years, because the number of local governments that ensured the establishment and operation of the internal audit organisation increased; and they prepared and had approved the internal audit manual. However, the professional quality of the execution of internal audits, the usability and utilisation of audit results was still unsatisfactory.

The 2006–2010 strategy⁸ of the State Audit Office set as its objective the task that the SAO transform and modernise the comprehensive audits of local governments with significant budgets, and contribute to the increased utilisation of resources received due to EU membership. A major part of the new audit programme reviewed whether the given local government had put in place and operated internal controls in the processes of budget planning,

financial management, final accounts preparation, the financial/accounting IT system and internal auditing. The government auditing assessed the organizational and regulatory framework of the internal auditing of local governments as well as whether the internal controls and internal auditing had contributed to reducing control risk by uncovering regulatory and operational errors, initiating measures, and by auditing the implementation of recommendations.

In the interest of ensuring efficient auditing, the State Audit Office wished to concentrate its resources on the areas where the likelihood of errors is the greatest and the effect of those errors – if they do occur – is likely to be significant. The focus of the audit work was on the likely areas of occurrence of errors related to audit objectives, i.e. audit-specific risks⁹, and it assessed and rated the adequacy of the regulatory environment; it concentrated on the possibilities of the improvement of the weaknesses and internal contradictions of this environment and management. During audits, the auditors identified and evaluated the risks in established internal controls in the aforementioned fields according to the following categories:

- low: controls – if operating – provide adequate protection against occurrence of errors,
- medium: controls – if operating – provide protection against the majority of possible errors,
- high: controls – due to their lack of development or incomplete development – do not provide sufficient protection against possible errors.

The identification and qualification of risks within internal control related to the development and regulation of the organisational frameworks of internal audits has also been performed. Auditors posed 53 questions in the field of internal auditing, and the maximum number of risk points was 84. During risk

assessment local governments that scored up to 17 points received a low rating, whereas those scoring between 18–34 points were awarded a medium rating, and in the case of those whose score was above 35 points, the risk was deemed high, i.e. no controls had been established, or their implementation was incomplete to the extent that they did not protect against eventual errors.

In addition to assessing compliance of establishment with the applicable rules, afterwards, the State Audit Office of Hungary also assessed the compliance of the operation and application of the established controls, i.e. whether the controls function appropriately, if they are used in practice and whether they can prevent, uncover and correct the errors occurring in the course of their use. During evaluation three qualifications were used: excellent, good and weak. Compliance of the controls is excellent if (if they are operational) – with the exception of a few eventual minor shortcomings – they comply with the regulations and the highest level of requirements. If the number of shortcomings was significant but it did not compromise operative compliance and errors prevention of the audited area, control operation was granted a ‘good’ rating. If the controls were unable to prevent, uncover or correct errors – because they had not been established, or their establishment was incomplete – which,

has, in turn, put effective and reliable operation at risk, control operation was granted a ‘weak’ rating. The assessment of the compliance of internal auditing consisted of 52 questions and the maximum score was 82 points. Internal auditing was considered ‘weak’ if the local government only attained 49 points. The rating of internal auditing was ‘good’ if the local government’s score was between 50 and 66 points, and it was ‘excellent’ if it was 67 points or more.

Review of these areas was conducted using the performance audit method. Performance auditing assesses the control environment ‘retroactively’ because its set of tools enables it to uncover the real shortcomings and weaknesses of the control environment and to propose forward-thinking solution recommendations. This method was also used to assess control performance¹⁰.

AUDIT EXPERIENCES OF THE STATE AUDIT OFFICE OF HUNGARY

Between 2007–2010 the State Audit Office of Hungary complied with its auditing obligations mandated by the National Assembly regarding the financial management of local governments. The Municipality of Budapest was the only local government that did not undergo such a comprehensive audit. This latter short-

Table 1

LOCAL GOVERNMENTS AUDITED BETWEEN 2007-2010 ACCORDING TO LOCAL GOVERNMENT TYPE
(with the exception of the Budapest Municipality)

Name	2007 (fact)	2008 (fact)	2009 (fact)	2010 (fact)	2007–2010 total
County	5	5	4	5	19
Town with county rank	5	6	6	6	23
District of the capital	6	6	6	5	23
Town	66	65	66	66	263
Large village	9	2	4	1	16
Village	76	25	32	36	169
Total	167	109	118	119	513

fall was made up for by the State Audit Office in the first half of 2011. *Table 1* shows audits conducted according to years and local government type.

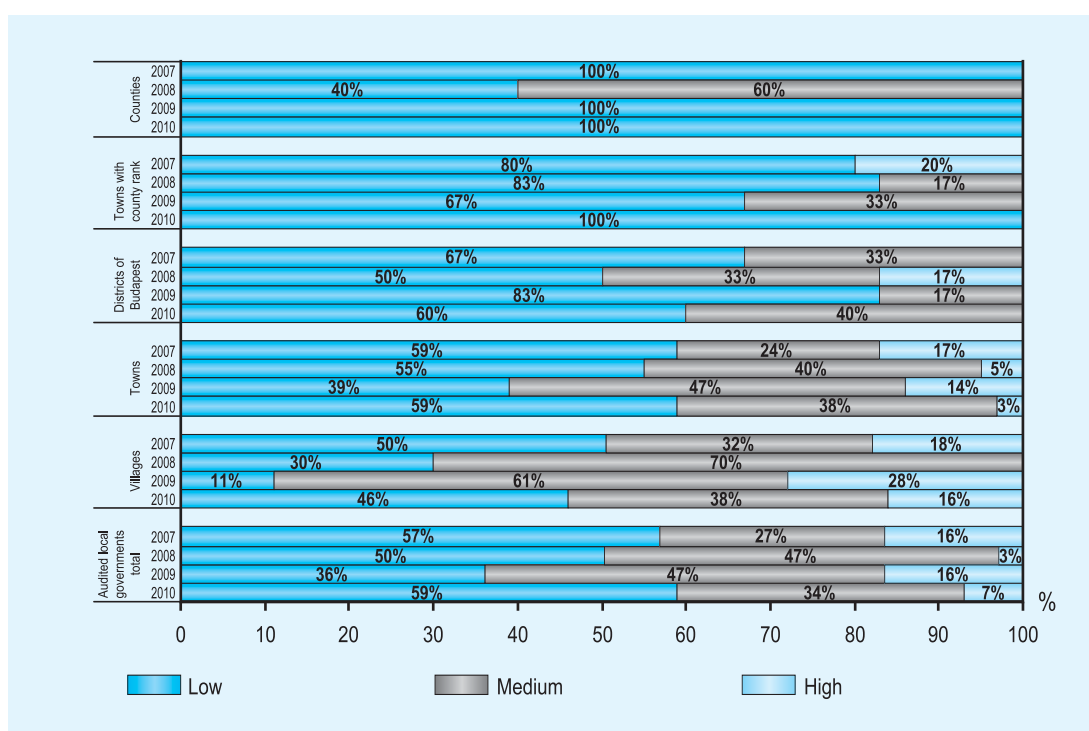
The risk of the organisational frameworks and levels of regulation of internal auditing among the local governments audited in 2010 – during their 4-year term – was the best considering the ratio of low risk local governments. The local government of every audited county and town with county rank received a low risk rating and there were not any local governments among the districts of Budapest that received a high risk rating either. City local governments are also showing signs of this improving trend, however, 37 of the audited local governments in villages were rated high risk. In spite of the uncovered deficiencies, I feel that the situation is not so bad. This evalu-

ation, however, is made slightly more unfavourable by the fact that during the 2010 audit the Municipality of Budapest was qualified as high risk. National data is shown in *Chart 1* with the exclusion of this particular local government.

Part of the reason behind gradually improving results was probably the audit activity of the State Audit Office, as the audit schedule announced for four years in advance and the identical audit plans, local governments were aware that an audit was going to take place and were also able to learn from the deficiencies, irregularities found at other local governments. As a result, they managed to correct similar errors, after which the public sector audit established that the organizational framework complied with the relevant rules. Despite the fact that the task of the central harmonisation

Chart 1

THE RISK OF THE ORGANISATIONAL FRAMEWORKS AND LEVELS OF REGULATION OF INTERNAL AUDIT ACTIVITY



Source: Állami Számvevőszék

and coordination of the internal financial audit of public finances had already been applicable to the Minister of Finance since November 27, 2003 and that Point *b*), Paragraph (2), Article 121/B of the áht established that the Minister of Finance shall draw up, publish and regularly review the directives, methodological guidelines applicable to the overall system of internal financial auditing of public finances, the implementation of this task in the field of internal auditing was rather sluggish¹¹, which is why it also failed to bring any results.

The most frequently deficiencies were the following:

- the representative councils did not determine the method of performing internal audits;
- the notary did not ensure – provided no internal auditor was employed – the organisation of internal auditor activity using external resources (associations, enterprises);
- when task performance was entrusted to an association or an enterprise, there was no agreement concluded that would have stipulated that internal auditing tasks shall be managed by the association or how the tasks determined for the internal audit manager by legislation shall be performed;
- internal audit obligations had not been determined in the rules of organisation and operation of local government offices;
- during regulation the functional independence of internal auditors was not ensured;
- they did not have a strategic audit plan supported by an internal audit risk analysis;
- the content of the annual audit plan did not conform to the legal provisions;
- the annual audit plan did not conform to the strategic plan;
- annual audit plans were not well-founded due to the absence of rules of procedure regarding risk management;
- the rules of procedure for risk manage-

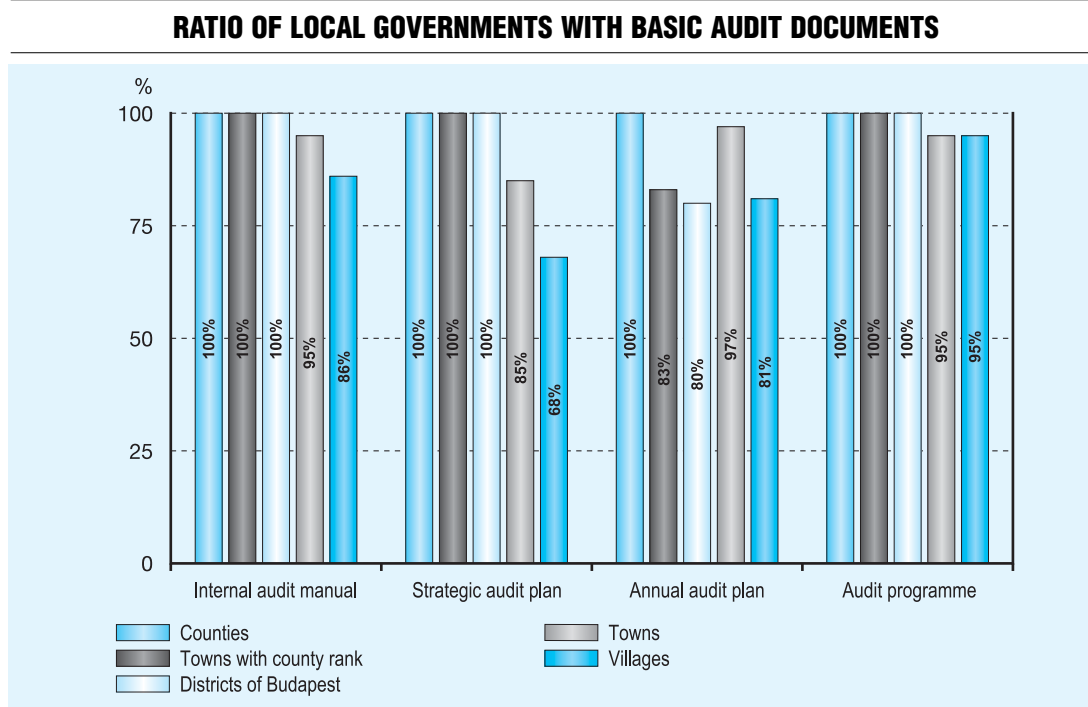
ment in force were not taken into account when preparing the annual audit plan;

- the annual audit plan did not contain time-frames for extraordinary audits;
- the representative councils did not approve the annual audit plan within the deadline set by the ötv;
- the audit of areas deemed high risk was not planned in the risk analysis that forms the basis of the annual audit plan;
- there was no audit programme prepared for each audit approved by the internal audit manager and in line with legal provisions in terms of content;
- the internal audit manual was not prepared or supplemented according to the content requirements laid down by legislation;
- they did not ensure that internal auditors have higher education qualifications and at least two years of professional experience.

With respect to local governments audited in 2010 being in possession of the basic audit documents (internal audit manual, strategic and annual audit plan, audit programme), the situation is shown in *Chart 2*, which in my view reflects acceptable rates. For annual audit plans, the reason for the deficiencies observed in the case of towns with county rank and the districts of the capital is that the audit plans were not approved before the deadline set by the ötv or the person authorised to do so.

The management of audited local governments exhibited a very favourable attitude during the audits. They highly appreciated the SAO's intention to help and its effort to prevent errors. In the majority of cases they already took the necessary measures to remedy deficiencies during the on-site audit. In my opinion, this allowed government auditing to become much more efficient and effective because as a result of voluntary measures, the correction of irregularities was based on – for future endeavours – the honest intention of the management and was not the result of the for-

Chart 2



Source: Állami Számvevőszék

mal execution of the re-commendations made by the State Audit Office of Hungary. I think that voluntary compliance with the law is much more effective than any measures that in many cases are not actually adhered to. Formal measures without true conviction greatly reduce the added value of government auditing. However, by the utilisation of the benefits of cooperation and partnership, the added value of audits is apparent immediately and is maintained in the long-term.

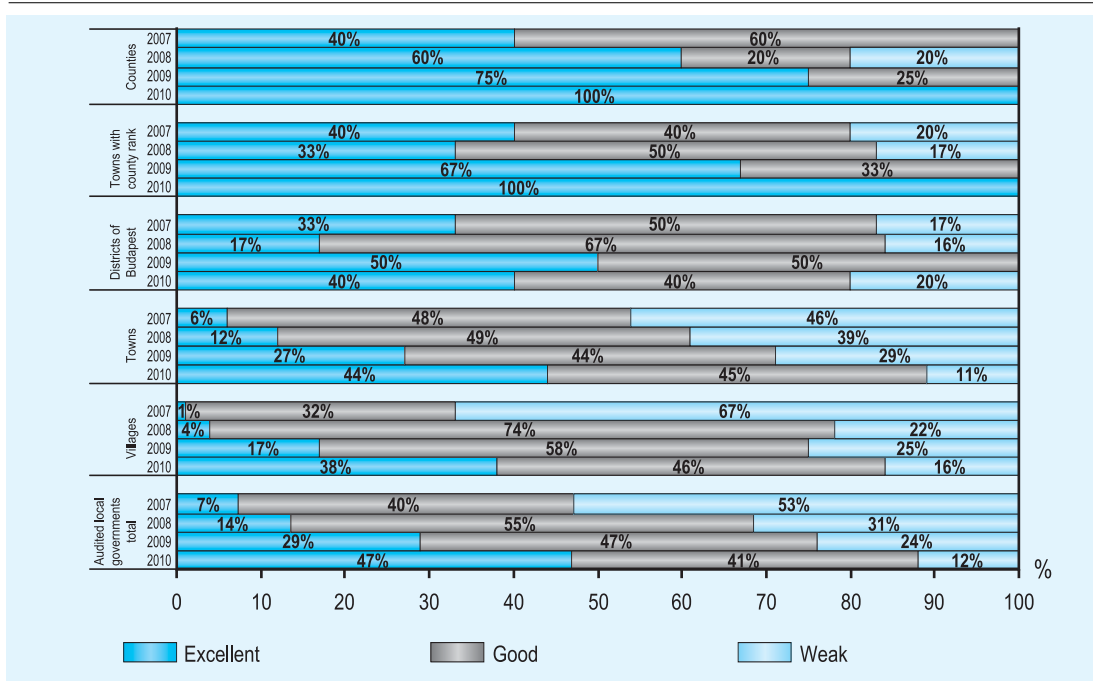
Risk identification and evaluation was followed by the analysis of the internal audit's operational compliance. Surely no lengthy explanation is required concerning the fact that if the risk of establishing controls was high, that is controls – due to their lack of development or incomplete development – do not provide adequate protection against possible errors, then logically their compliance during operation was also weak. Local governments also received a weak rating if the risk related to

their organisational frameworks and regulation levels in terms of internal auditing was low or medium but auditors, during the audits, obtained assurance that the established controls did not work.

The findings of audits conducted between 2007 and 2010 in this respect are shown in *Chart 3*, which does not contain the results of the audit of the Municipality of Budapest. The Municipality of Budapest received a weak rating for the compliance of its internal audit activity.

The Chart shows in detail that even though significant progress had been made in this field since 2007 (the proportion of local governments with weak ratings dropped from 53 to 12 percent), in 2010 internal audit activity was inadequate in one district of the capital, as well as seven towns and five villages. At the Szeged mayor's office, which is a town with town rank, there was no actual internal audit, in contrast with the supervised budgetary institutions and

COMPLIANCE OF THE EXECUTION OF INTERNAL AUDIT ACTIVITY



Source: Állami Számvevőszék

business associations, which is why these latter received an excellent rating, while the mayor’s office a weak rating from the SAO. The chart is not suitable for making such distinctions. Compliance was weak in the case of the Municipality of Budapest as well.

It was once again proven that establishing organisational frameworks and regulating the performance of the given activity in themselves are not enough. It is also necessary for the internal audit to actually work. It also became very clear that the audit by the State Audit Office conducted with respect to the operation and compliance of internal control systems does actually fulfil an actual demand and these audits have considerable added value.

Which were the most frequent deficiencies?

No audits were conducted with regard to

- the establishment and operation of the FEUVE system in line with central and local regulations at the local government office and local government budgetary

institutions; the economy, efficiency and effectiveness of the operation of the financial administration and audit systems; the management of available resources; the protection and increasing of assets; public procurements and public procurement procedures;

- the management of available resources, assets protection and augmentation, the reliability of accounting statements, reports at the business and non-profit entities, asset management companies ensuring the majority control over the local government or being influenced by the local government in question;
- beneficiary organisations in the filed of the proper utilisation of subsidies provided from the local government budget for special purposes.

Audits were not conducted according to the audit programme content stipulated by legislation, and the functional independence of

internal auditors was not ensured during auditing.

The content of the reports on the audit findings did not conform to legal provisions, and the follow-up of measures proposed in the internal audit reports was not ensured.

When preparing the annual audit report, the internal audit manager failed to evaluate the material and personnel conditions of the internal audit within the framework of self-assessment, and as a result did not make recommendations to the notary on the harmonisation of conditions with the annual plan.

The planned internal audit of local government offices was not performed completely in 15 percent, almost one quarter of the cases.

No audit report was prepared, the procedural requirements of the audit manual were not adhered to in the case of the uncovering of acts that provided grounds to launch criminal, misdemeanour, damage proceedings or disciplinary action.

In light of the above deficiencies, the short statement made at the beginning of the study that said local government internal audits are not fulfilling their functions becomes more understandable. We can observe that the high number of deficiencies listed indicates that internal auditing is not operating adequately in local governments. One of the reasons for this – as I have written in detail before – is that the legislator failed to take into account the unique features of the local government system when it made the notary responsible for the establishment and operation of the internal control system¹² (*including internal audits*); but at the same time gave the representative council the power to approve the audit plan and to determine the number of auditors. On the other hand, the internal control system and the modern concept of internal auditing, which forms a part of that system was quite slow to gain ground in the municipal sub-systems. According to this concept, it is not restricted

to traditional financial and the related administrative control, but rather it includes a much wider interpretation of managerial control. The internal control system is a complex process which is implemented by the management and employees of an organisation and which is developed in order to determine risks and to provide reasonable assurance in the interest of the organisation achieving the following objectives during its mission:

- activities (operations) should be performed in a regular, ethical, economical, efficient and effective manner;
- its accounting obligation should be fulfilled;
- should adhere to applicable laws and regulations;
- it should protect the organisations' funds from losses, improper use and damages.

Given this definition, we can clearly see the legislative error, namely that the representative council exercising local government rights and the mayor directly elected by the citizens have no actual impact on the establishment and operation of the control system (except for the approval of the annual audit plan and the report regarding final accounts), even though the accomplishment of local government objectives would primarily be their interest. As a consequence they have to play a key role during both establishment and operation.

Based on the SAO's audits we can state that: the internal control system of local governments currently does not ensure the accomplishment of the previously mentioned objectives and this is greatly due to the improper operation of internal audits. If we presume that internal audit is mainly aimed at the evaluation of the effectiveness of the internal control system and its objective is to ensure that the internal control achieves the intended result, and if it uncovers deficiencies, these must be reported to management, then with respect to the appropriate operation of

internal audit we can make two (logically relevant) statements.

① If the internal control system is working appropriately, then logically the internal audit is also fulfilling its function.

② If the operation of the internal control system is incomplete or inadequate, that means there are also problems with the internal audit, as it did not uncover the deficiencies of the internal control system, did not evaluate the operation of the control system in time, even though that was its task, or it did not draw the correct conclusion during evaluation.

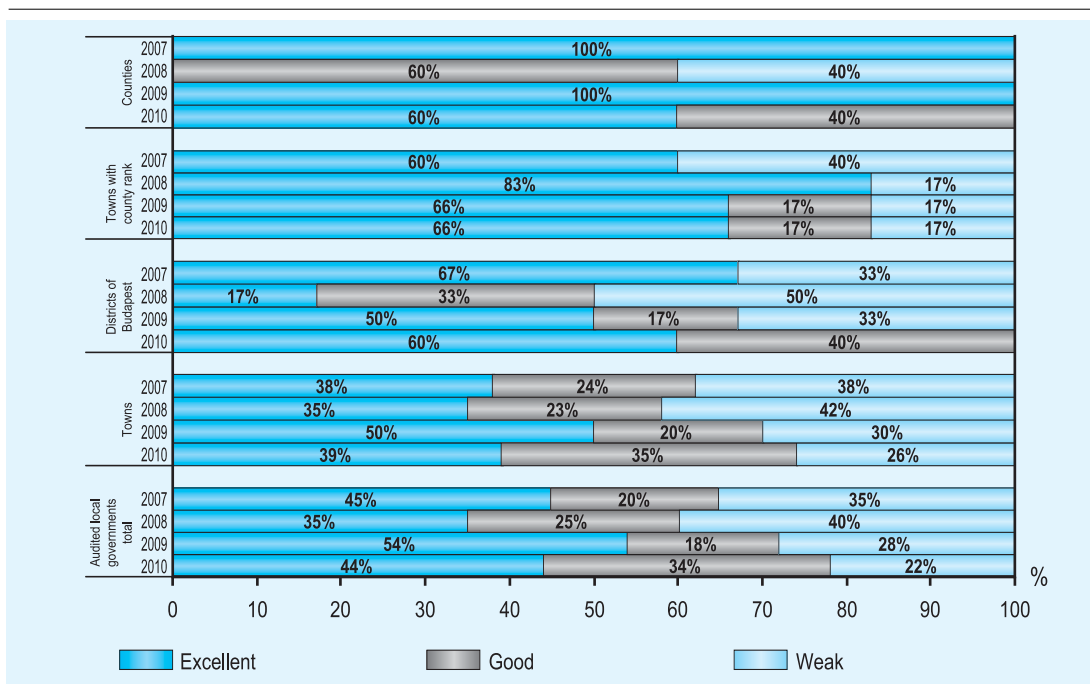
The audit findings of the State Audit Office regarding the establishment and appropriate operation of internal control systems support my views, according to which in the majority of local governments internal audits do not prevent, uncover and point out the deficiencies of internal control systems.

Chart 4 shows the compliance of the operation of internal controls in the processes of budgetary planning and preparation of final accounts based on SAO audits. Over the course of four years, the State Audit Office evaluated the compliance of controls in all local governments of counties, towns with county rank and districts of the capital, as well as 263 local governments of towns.

Though the proportion of weak-rated local governments has gradually improved, in 2010 there were still 73 local governments that fell into this category. The SAO performed this audit at the Municipality of Budapest in 2011 and the capital also received a weak rating. In the case of a weak rating the conclusion can be drawn that the controls are inadequate – in one of the most important areas – to protect the funds, but this should have been discovered by the internal audit even before the government audit took place.

Chart 4

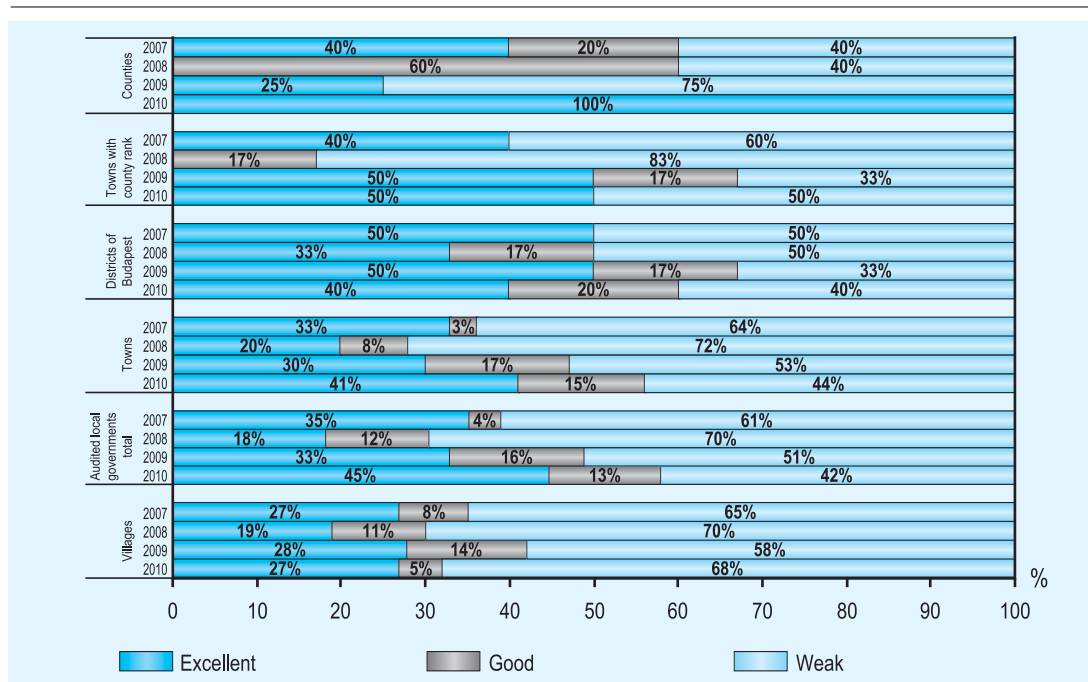
THE COMPLIANCE OF THE OPERATION OF INTERNAL CONTROLS IN THE PROCESSES OF BUDGETARY PLANNING AND PREPARATION OF FINAL ACCOUNTS



Source: Állami Számvevőszék

Chart 5

COMPLIANCE OF THE OPERATION OF TECHNICAL PERFORMANCE CERTIFICATES AND VOUCHER-COUNTERSIGNING



Source: Állami Számvevőszék

The auditing of the compliance of the operation of technical performance certificates¹³ and voucher consignment¹⁴ as two ‘key controls’¹⁵ also point to the inadequate protection of funds and the inadequacy of controls in terms of the execution of operations. *Chart 5* shows the aggregated data of the audits performed between 2007 and 2010. The audited local governments are the same as the above cited local governments. I shall present the data of village local governments separately.

The final conclusion – the operation of the key controls is inadequate – is similar to the rating of the controls established for the budget planning and final accounts processes, however, in this regard the controls of twice as many local governments (138) turned out to be weak. During a similar audit completed at the beginning of 2011, the Municipality of Budapest received a weak rating.

These government audit experiences also confirm that had internal auditing worked properly at these local governments, the establishment and operation of the internal control system would have been examined within the framework of such internal auditing and would have also discovered and corrected the deficiencies that the audits of the SAO later discovered and established.

SUMMARY

The reader has every right to ask what the next step is; what should and what can be done.

The audits of the State Audit Office conducted between 2007–2010 pointed out that there is an error in the system, the compliance of internal audits is weak, similarly to the compliance of controls in several key

areas. This is why a system-level solution is needed.

In my view, the comprehensive reform of existing legal regulations is unavoidable. It is necessary that the new local government act regulate the role and place of internal audits by taking the unique features of the local government system into account.¹⁶ The reformed regulations must ensure that the establishment and operation of the internal control system that facilitates the accomplishment of local government objectives and accountability is the right and obligation of the elected head of the local government, the mayor. This solution conforms to the international standards on internal control systems, and therefore a practical application of a wider interpretation of managerial control would become possible. Since the notary is not the elected head of the local government, the actual person in charge of the mayor's office would also be the mayor, putting an end to the current uneven situation (the mayor controls and the notary manages the mayor's office). As a result of the proposed change, the mayor would be responsible for the establishment and operation of the internal control system, he/she would approve the annual internal audit plan and naturally the representative council would have the right to order extraordinary audits. As a result, the internal control system designed to discover, prevent and correct the errors and deficiencies jeopardizing the accomplishment of municipal objectives would not be one of the responsibil-

ities of a bureaucrat – the notary —, but rather it would be the responsibility of the mayor, the elected head of the local government. Perhaps this idea does not fall far from the government's intentions as the concept of the new local government act includes the reinforcement of the mayor's position and the awarding of new duties and powers. On the other hand, some of the public administration powers would be taken away from the notary and as a result the mayor's office would be in charge of actual local government matters, which would mean the notary's role would decrease, but would be able to perform control activities much more effectively.

Through the above presented solution, the mayor – as the leader directly elected by the citizens – would get the opportunity to establish and operate the control system that facilitates the accomplishment of local government objectives, and naturally he/she would also bear the responsibility for the inadequacy of the operation of the control system as well as any errors and deficiencies. By thinking the above through, we can arrive at the conclusion that the appointment (dismissal) rights of the notary should belong to the mayor.

Based on audit experiences, a change is indeed required. I am certain that the solution proposed is professionally and politically well-founded. Without a well operating internal control system, there cannot be a regular, economical, efficient and effective utilisation of public funds.

LEGAL REGULATIONS

Act II of 1979 on Public Finances (ápt)

Act XXXVIII of 1989 on the State Audit Office (Act on the State Audit Office), as of July 1, 2011
Act LXVI of 2011

Act LXV of 1990 on Local Governments (ötv)

Act XX of 1991 on the Tasks and Scope of Authority of the Local Governments and Their Organs, of the Commissioners of the Republic, and of Certain Centrally Governed Organs (htv)

Act XXXVIII of 1992 on Public Finances (áht)

Government Decree No. 23/1979. (VI. 28.) MT of the Council of Ministers on the Implementation of Act II of 1979 on Public Finances (vhr)

Government Decree No. 96/1987. (XII. 30.) PM of the Ministry of Finance on Supervisory Budgetary Audits and the Internal Audit of Budgetary Institutions

Government Decree No. 15/1999. (II. 5) on the Government, Supervisory and Internal Audits of Central, Social Security and Public Budgetary Institutions (Ber¹)

Government Decree No. 193/2003. (XI. 26.) on the Internal Audit of Budgetary Institutions (Ber²).

NOTES

¹ I do not consider the audit opportunities of the financial committee as regulated by Article 92 (13) of the ötv. as such.

² As pursuant to the áht., during financial management the enforcement of not just regularity, but also of economy, efficiency and effectiveness must be ensured, this means that in this respect the notary is responsible for ‘everything’.

³ Naturally, the mayor’s responsibility exists if, for example, he/she makes a commitment without countersigning.

⁴ The preceding Ber₁ did not cover local government budgetary institutions.

⁵ In this case we have every right to ask: why doesn’t the notary approve the internal audit plan.

⁶ The internal audit is part of the internal control system.

⁷ Report No. 0705 on the Activity of the State Audit Office of Hungary in 2006, p. 29. For more details on the subject see Point II. 3.1 of Report No. 0726 on the 2006 Comprehensive and Other Regularity Audits of the Financial Management Systems of Local and Minority Local Governments.

⁸ Strategy of the State Audit Office of Hungary 2006–2010, Budapest, 2006, pp. 4–6

⁹ Risk means the possibility of the occurrence of an event or the failure to carry out a necessary action which negatively impact or hinder the accomplishment of the goals of the audited entity. Risk is characterised by probability and significance. The result of the occurrence of a risk event or non-compliance is, in fact, the error (erroneous information, irregularity, crime, inadequate operation, weak performance), the significance of which can be characterized by its size (value) and impact (consequence). (Audit Manual of the State Audit Office of Hungary, Book 4, 9.4., 2008)

¹⁰ Methodology of Performance Audit – State Audit Office of Hungary, February 7, 2008.

¹¹ The Directive on the Internal Control Standards of Public Finances was published in September 2009, while the ‘Internal Control Manual’ in 2010,

¹² According to the obsolete term use of the ötv [ötv Article 92 (3) and (4)] the notary is obliged to operate a financial administration and control system which ensures the proper, regulated, economical, efficient and effective utilisation of funds available to the local government; and ensures the internal financial audit of the local government through financial management control (financial administration and audit) and internal auditing in line with relevant legislation.

¹³ The issuer of the technical performance certificate must check – based on verifiable documents – before

the expenditure is cleared for payment, and certify based on technical considerations that the expenditures have been incurred rightfully, the issuer must also verify the relevant amounts and the rendering of any commitments against consideration – provided that the payment thereof or a part thereof becomes due after consideration is rendered. [Paragraph (1), Article 76 of Government Decree 292/2009 (XII. 19.) on the Operational Rules of Public Finances (hereinafter referred to as *Ámr*)].

¹⁴ In terms of the responsibilities of the countersigning officer, the legislator specifies the appropriate application of the regulations pertaining to the countersigner of the commitment, and supplements them with two additional tasks (the countersigning officer must verify the technical

performance certificate and the fact of the enforcement thereof). [Paragraph (2), Article 79 of the *Ámr*]

¹⁵ A key control is a control, which is the strongest among the control procedures used for the purposes of averting potential errors. The effective and consistent operation of a key control must be testable relatively easily and they must provide protection against two or more operative errors. (Audit Manual of the State Audit Office of Hungary, Book 5, p. 83)

¹⁶ In my view, the concept published by the Ministry of the Interior does not contain fundamental changes in this respect compared to the current version.

LITERATURE

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