

Zoltán István Dormán – Gábor Görgényi – Margit Horváth

# *Evaluation of the Internal Control System at Central Budgetary Institutions*

**SUMMARY:** During the audit on the final accounts for 2011, the State Audit Office of Hungary (SAO) reported on the operation of internal controls in a separate report, the background and results of which are presented in the present paper. The assessment of the operation of the internal control system was conducted using a 400-question questionnaire, which in turn was evaluated by a proprietary algorithm, generating the qualification of the components and the whole of the internal control system. Based on the summary and evaluation of results, it was determined that in 2011, the development and operation of the internal control system of central budgetary institutions fundamentally fulfilled its function. The operation of internal controls proved to be 85 per cent partially or entirely compliant at the 28 institutions and chapter-managed appropriations audited. The assessment proved that if internal controls were missing or not adequately established at the budgetary institutions audited, the deficiencies in their operation could be linked to the errors uncovered in the budget reports; furthermore, a correlation could be observed between the quality of internal audit activity and the compliance of the operation of the internal control system.

**KEY WORDS:** internal control, control system, internal audit, budget report, State Audit Office

**JEL CODES:** H10, H3, H60

In its action plan for 2010–2013, the INTOSAI Internal Control Standards Sub-Committee<sup>1</sup> established diverse tasks. Its goals include establishing standard indicators for the internal control system, integrating the internal control and risk management related concept of INTOSAI GOV (INTOSAI's directives on good governance) into ISSAIs (INTOSAI standards), drawing up a document about reporting on internal controls, and creating an e-platform.

A decision was made at the sub-committee meeting that a survey will be conducted among Member States in two areas (the role and significance of risk management in the case of institutions, and the preparation of

statements and reports on the operation of internal control).

The Act on the State Audit Office set as a task<sup>2</sup> for the SAO to evaluate the operation of the internal control systems of public finances. The evaluation could provide assistance at the audited institutions regarding the elimination of deficiencies related to the internal control system, the modernisation of the legal regulations concerning the internal control system and internal audits and, furthermore, it allows for the surveying of the impact of the internal control system on the budget report.

During the auditing of the implementation of the current budget (final accounts), every year the SAO assesses the operation of the internal control systems of audited institutions, and as the result of this assessment determines

*E-mail address:* [dormaniz@asz.hu](mailto:dormaniz@asz.hu)

the size of the sample related to the audit of budget reports.

Over the last few years, the evaluation of the internal control mechanisms of the central organs of public finances was included as a separate point in the reports drawn up on the control of the execution of the current budget of the Hungarian Republic. The 2009 changes in legislation justified a broader survey and the preparation of an independent report, which complies with the domestic legislation as well as the international standards. As a result, in 2012, during the audit on the final accounts for 2011 and closely linked to it, the SAO reported on the operation of internal controls in a separate report<sup>3</sup>, the background and results of which are presented in the present paper. The audit of the operation of the internal control systems of budgetary institutions cannot be separated from the audit of the final accounts, as the result of the former determines the audit sample size.

The previous survey carried out by the SAO was in 2001 on 20 of the chapters of the central budget, and within that 651 budgetary institutions – of these 40 were audited on-site – in order to gather information about the operation of the internal control mechanisms and to identify the risks inherent in those control mechanisms as well as the extent thereof. An independent report was prepared on the task.<sup>4</sup>

## THE OBJECTIVE OF THE STUDY

*„Our primary objective is to improve the quality of the internal control systems of public finances, which in turn will improve the quality, efficiency and effectiveness of the utilisation of public funds” (László Domokos, 2012).<sup>5</sup>*

The significance of the study lies not only in the statutory changes already mentioned in the preface, but also in the recognition that the

appropriate establishment and operation of internal control systems largely contribute to the efficient and effective use of public funds.

Because the SAO report on internal controls is academic in nature, our objective for writing the study was to scientifically assess the outcomes of the audit by presenting the deeper professional correlations we have found. The scientific analysis of the topic is necessary, because the nature and the length of the SAO reports do not make it possible to present the professional tasks that are carried out in the background on which the findings are based.

The audit related to the internal control system was carried out by the SAO in connection with the audit of the final accounts of 2011 as an independent audit. The audit made it possible for the SAO to present the National Assembly and Government with a comprehensive picture of the quality of the internal control and internal control system of central budgetary organs – including the chapter-managed appropriations managed by them – and in particular about whether they regulated the internal control system and internal audit in accordance with the statutory requirements, and whether the rules were actually enforced in practice. The audit’s findings provided assistance at the audited institutions to eliminate deficiencies related to the internal control system, as well as to modernise the legal regulations concerning the internal control system and internal audits.

The audit conducted was a regularity audit, the provisions on the implementation of which are contained in the Audit Manual of the SAO<sup>6</sup>, ISSAI 100, ISSAI 300 and ISSAI 4200 standards, with the condition that in the case of regularity (financial) audits, the audit and evaluation mainly covers the controls that promote the protection of assets and resources, and ensure the completeness and accuracy of accounting records<sup>7</sup>.

The purpose of the study furthermore is – relying on the data of the SAO audit – to assess the effect of the internal control system on the budget report by proving the following hypothesis, according to which if the internal control system – and within that internal audit – is regulated and operates well, the report will be reliable, and if the internal control system operates badly that will affect the reliability of the budget report (qualified opinion).

Following the presentation of the components of the internal control system and the review of relevant literature, the study will present the methods, technical solutions and results of the assessment of the internal control system. The conclusions will be drawn based on the results of the assessment of the internal control systems on the basis of the professional substantiation by the findings of the SAO report.

## INTERNAL CONTROL, INTERNAL CONTROL SYSTEM

Internal control/internal control system is not one event or circumstance, but a series of actions that permeate an entity's activities. These actions occur throughout an entity's operations on an ongoing basis. They are pervasive and inherent in the way management runs the organisation. Internal control is, therefore, different from the perspective of some observers, who view it as something added on to an entity's activities, or as a necessary burden. The internal control system is intertwined with an entity's activities and is most effective when it is built into the entity's infrastructure and is an integral part of the essence of the organisation.

The essence of the internal control system, as an inseparable part of organisational management, is to include the rules, procedures, practical methods and organisational structures,

which have been specifically designed to help management reach their goals. In addition, also to prevent, expose and correct any events that might impede on reaching those goals. However, it is up to the decision of the head of the budgetary organ how to achieve compliance with the recommendations of the standards relevant to the establishment of regulations, whether it is achieved through the use of existing regulations, or by possibly updating those regulations, and their mode, format and content is also up to the head of the relevant budgetary organ (guidelines for Internal Control Standards for Public Sector, p. 6).

An effective internal control system, no matter how well conceived and operated, can provide only reasonable – not absolute – assurance to management about the achievement of an entity's objectives. An effective system of internal control reduces the probability of not achieving the objectives. However, there will always be the risk that internal control will be poorly designed or fail to operate as intended (Kovács, 2009) (*See Chart 1*).

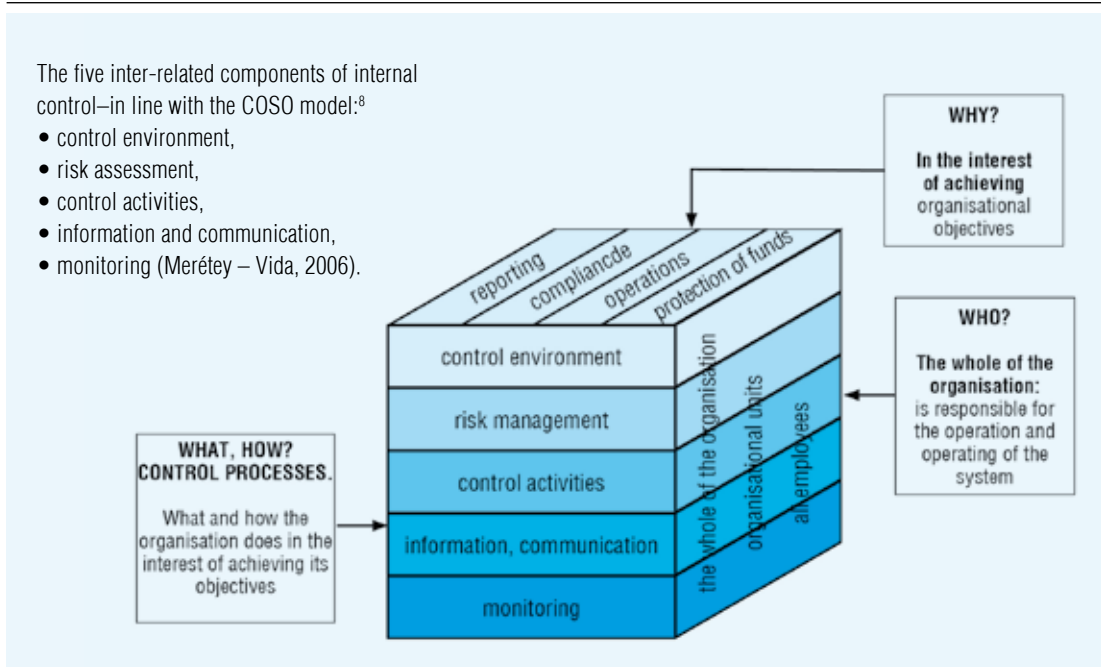
The current Hungarian regulation of internal control systems can be outlined in a three-level structure. The 'regulatory pyramid', which shows the individual internal control components from top to bottom, explaining them in increasing detail. The highest level is statutory regulation, followed by the government decree level and the explanation gradually gets down to the practical guidelines.

The Hungarian 'regulatory pyramid' defines the content elements of the internal control system and clearly settles the issue of responsibility for establishment and operation (*See Chart 2*).

Within the framework of establishing the control environment, in the interest of ensuring appropriate operation, the management of the organisation has to define

Chart 1

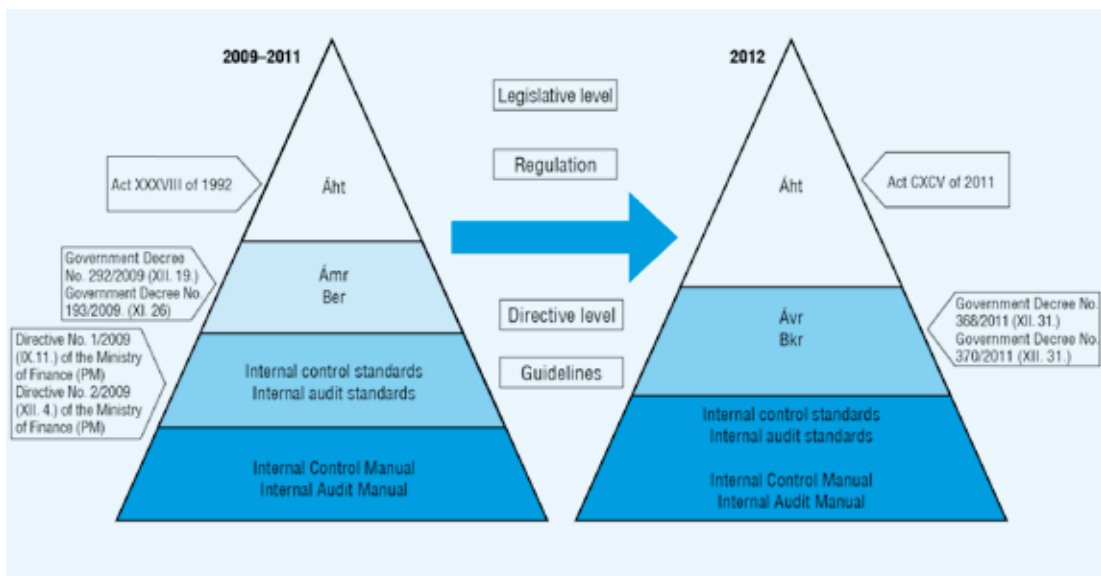
### THE THREE-DIMENSIONAL MATRIX OF INTERNAL CONTROL (MAIN COMPONENTS)



Source: COSO: Internal Control – Integrated Framework, www.coso.org,

Chart 2

### THE THREE-LEVEL STRUCTURE OF THE CURRENT HUNGARIAN REGULATION OF INTERNAL CONTROL SYSTEMS ('REGULATORY PYRAMID')



Source: authors' own editing, using the documents Presentation of the Internal Control System of Hungarian Public Finances 2011 and 2012

and regulate every necessary process and the components thereof, in addition to creating an organisational structure that most efficiently supports the processes, the necessary material and human resources, training, skills and ethical requirements and external relations (Gyüre, 2012).

During risk management the internal risks of appropriately performing the activities, processes, operations and the extent of risk assumption must all be assessed. Based on the assessment, the appropriate response measures must be developed and enforced to mitigate the risks.<sup>9</sup>

The control activities are the tools, procedures, and mechanisms, which are created by the head of the organisation to help facilitate the achievement of the goals of the organisation. These procedures may include the preparation of consultations, related executive reviews, as well as the establishment of procedures and scopes of responsibility, which ensure the separation of key job roles and restrict physical access to asset components and accounting registries.<sup>10</sup>

Information and communication includes the definition and acquisition of relevant and reliable information, as well as the transmission thereof to employees and managers in an appropriate form and in due time to ensure that their obligations – including their internal control related obligations – can be met.<sup>11</sup>

Monitoring ensures that the activities and the realisation of goals are tracked. The monitoring of internal controls covers the regular supervisory activity of management and other operations, which are performed by employees within the framework of their regular tasks. One of the main functions of internal audit is to help management monitor how effective internal controls are.<sup>12</sup>

Every worker of the organisation plays an important role in implementing internal control, but management bears overall responsibility for the creation and implementation of the internal

control system, in addition to the supervision and documentation of the appropriate operation of the system.

The existence of the internal control system in and of itself does not guarantee effective operation of the organisation. The risk responses given to keeping the effects found in connection with the identification of external and internal risks or opportunities within the adequate range, as well as the results of the control measures taken to implement them are considered to be the guarantees of the efficient achievement of the goals of the organisation in question (Ivanyos – Roóz, 2010).

## METHODS THE TECHNICAL SURVEY SOLUTIONS USED IN THE SAO REPORT

The SAO drew up the quality assessment procedure of its internal control system based on EU and international practices and its experiences during a select set of years.

In 2001 and in the years that followed, the worksheets used for the assessment procedure contained yes/no questions on the comprehensive topics of financial regularity audits for every topic involved (the seven areas: the regulation of the institution, the control function of the Treasury embedded in a work process, operation of independent internal audit, regulation of accounting activity, IT support of accounting activity, regulation of the IT environment, operation of the IT system). The processing support system assessed the risk per area and aggregated it (with different weights assigned to the worksheets representing the areas) as well on the basis of the answers given to the yes/no questions.

During the last ten years, in connection with the changes in the statutory environment and the experience gained during the surveys – keeping the basic principles the same – the worksheets serving the purposes of the

survey have been continuously modified. In the course thereof – to different extents – the structure of the worksheets have been changed, the questions have been changed and expanded on, and in several cases the points of risk associated with the questions have been modified; moreover, the weight of the various worksheets have modified as well.

The audit of the internal control system covered all five components of the control system (control environment, risk management, control activities, information and communication, and monitoring). The assessment of internal audits was performed at two levels – as part of the assessment of the internal control system and as an individual element.

The execution of the audit of the internal control system and internal audit of the central budgetary organs in 2011 was supported for the five components of the internal control system by the worksheets developed for the evaluation of the internal audit. The worksheets contained two types of – yes/no and Likert scale–questions. The survey was conducted using 398 questions<sup>13</sup>. The worksheets were evaluated in line with the relevant statutory requirements, an expert model created on the basis of the audit experiences of the

preceding years, and an algorithm created on the basis of the model in a Microsoft Office Excel environment. The various questions, groups of questions, and the internal control sub-areas were assigned various weights on the basis of the expert model, which exerted an above average or below average influence on the compliance level of the whole of the control system, depending on the type of area in question.

For example, with regard to the control environment, if the budgetary organ did not have internal regulations that meant more error points than if they had one that was largely deficient. In the latter case, however, with the help of the Likert scale type questions it was possible to make the qualification of the regulations concerned stricter or make the final results more permissive.

Table 1 illustrates the distribution of the questions.

When filling out the worksheets we used the basic testing procedures (direct detailed investigations), information requests, analytical procedures and testing.

For the yes/no questions we used the analytical procedure – to a lesser extent information request – whereas for the Likert

Table 1

**DISTRIBUTION OF THE QUESTIONS USED TO EVALUATE THE INTERNAL CONTROL SYSTEM**

INTERNAL CONTROL SYSTEM	Yes/no questions (pcs)	Likert scale questions (no. of questions)	Total number of questions		Compliance score assigned to the questions
			(pcs)	(%)	
Control environment	222	17	239	60%	315
Risk management	13	1	14	4%	17
Control activities	102	11	113	28%	106
Information and communication	21	1	22	6%	47
Monitoring	9	1	10	3%	14
Total	367	31	398	100%	499
Internal audit	84	8	92	–	88

Source: State Audit Office

scale questions, where answering the question was related to testing controls, we used testing from the basic procedures.

The nature of the audit evidence was directly documented for the yes/no questions, while in the case of the Likert scale type questions, verbal evidence was also allowed to be used – if necessary – in addition to the documented audit evidence, the reliability of which – depending on the decision of the person carrying out the audit – was supported by records or certification.

In the course of answering Likert scale questions, the person carrying out the audit had to qualify the subcomponents of the internal control system on a scale of 1–7 on the basis of the professional experience gained during the audit.

Compliance scores were assigned to the yes/no and Likert scale type questions. Depending on the responses given to the questions on the worksheets, the five components of the internal control system, and the subcomponents thereof, were assigned aggregate compliance scores. The compliance scores, were on the one hand generated from the answers given to yes/no questions and on the other hand to the answers given to the Likert scale questions, which were based on the experience gained during the audit.

The evaluation system automatically calculated the ratio of the obtained and maximum compliance scores – expressed as a percentage – of components of the control system based on the answers given to the yes/no questions, as well as the percentage ratio of the compliance score given for the answers given to the Likert scale questions as compared to the maximum compliance score of 7. The simple average of the two characteristic percentage values showed the extent to which the subcomponents of the control system comply with the criterion representing 100 per cent. Based on the indicator defining the percentage of compliance, the evaluation

system put the subcomponents of the control system into categories as per *Table 2*.

With respect to the various components of the internal control system, it was a crucial condition of achieving an at least “partially compliant” qualification that the percentage ratio achieved was at least 70 per cent, and 85 per cent for a “compliant” qualification.

The aggregate assessment of the internal control system was performed on the joint qualification of the five components of the internal control system, using mathematical averaging. Due to their significance, two of the components – control environment and control activity – were featured with double weight. The principle of aggregate assessment is similar to the principle applied to the assessment of individual pillars, i.e. “compliant” qualification stands for high control certainty, while “partially compliant” and “non-compliant” qualifications stand for medium and low control certainty respectively.

## RESULTS

The development and operation of the internal control system of central budgetary institutions fundamentally fulfilled its function in 2011; at the same time, however,

*Table 2*

### THE COMPLIANCE EVALUATION OF THE COMPONENTS OF THE INTERNAL CONTROL SYSTEM

Value of compliance %	Qualification of the given component/subcomponent of the internal control system
>=85%	“compliant”
>=70%	“partially compliant”
<70%	“non-compliant”

Source: State Audit Office



the SAO audit did uncover factors in several areas of system components that adversely affected the efficient and effective operation of controls. The assessment of the internal control system, including internal audits, was performed by the SAO with regard to the 28 budgetary institutions<sup>14</sup>, and the chapter-managed appropriations at 11 chapters<sup>15</sup>. The audit was conducted with the comparison and synthesis of the preliminary audit conducted according to the method developed for this specific reason and the experience gained on-site.

With respect to institutions under audit and chapter-managed appropriations, the SAO qualified the operation of internal controls partially or entirely compliant in 85 per cent of cases, and non-compliant in 15 per cent of cases. The aggregate compliance of the various components of the internal control system showed a 70.9 per cent result. Proportionally, “non-compliant” qualifications were higher (27 per cent) in the case of chapter-managed

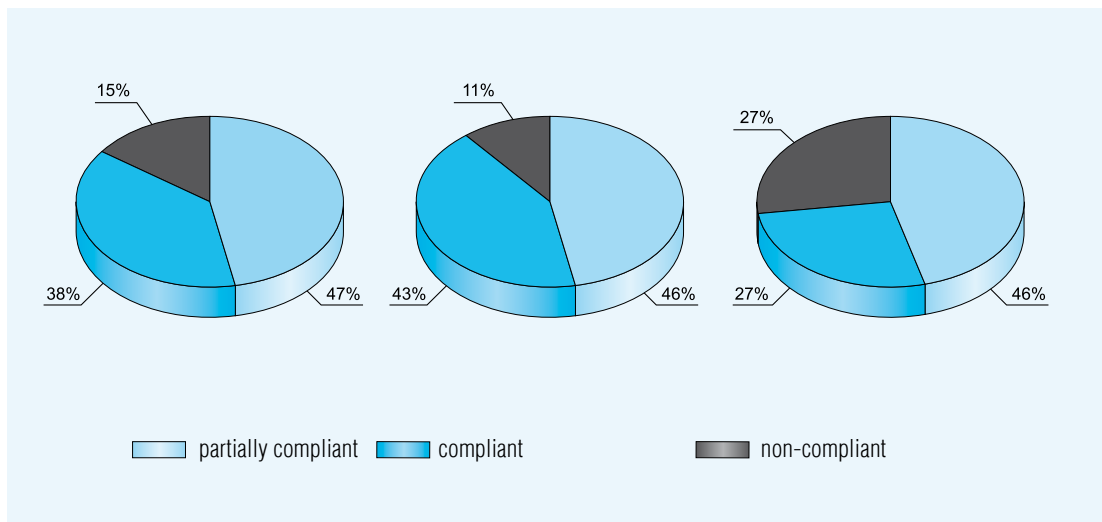
appropriations than in that of institutions (10.7 per cent). The significant difference is due to the fact that all control components were weaker in the case of chapter-managed appropriations. This was particularly apparent in the case of the control environment and the information and communication components (See Chart 3).

Based on the aggregate assessment of the internal control system, close to half of the 28 institutions (13 institutions) received “compliant” qualifications; 12 received “partially compliant” qualifications; while three (Prime Minister’s Office (ME), Ministry of Rural Development (VM), and the Ministry of National Resources (NEFMI) received “non-compliant” qualifications.

The evaluation of the internal control system of institutions is shown in Chart 4. The lowest compliance score was given to the Hungarian Intellectual Property Office (SZTNH), the Hungarian Financial Supervisory Authority (HFSA), the Public Procurement Council

Chart 3

**THE AGGREGATE QUALIFICATION OF THE INTERNAL CONTROL SYSTEM IN THE CASE OF INSTITUTIONS AND CHAPTER-MANAGED APPROPRIATIONS**

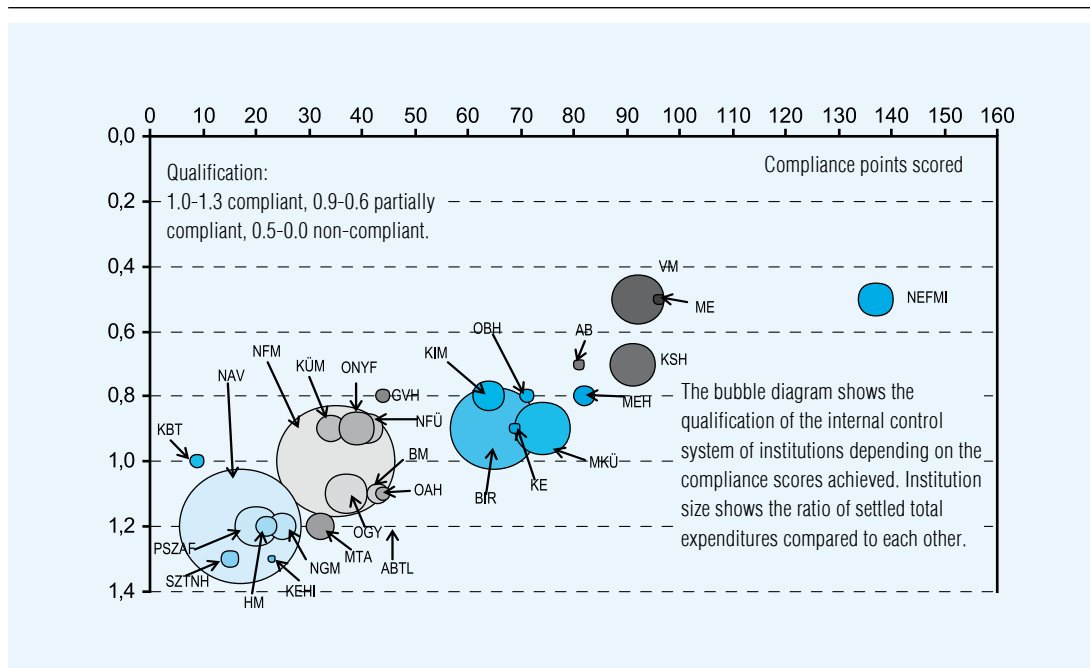


Source: Report no. 1298 on the audit of the regularity of the internal control system and internal audits conducted at central budgetary institutions included in the audit of the final accounts



Chart 4

**COMPLIANCE MAP FOR THE EVALUATION OF THE INTERNAL CONTROL SYSTEM OF INSTITUTIONS**



Source: Report no. 1298 on the audit of the regularity of the internal control system and internal audits conducted at central budgetary institutions included in the audit of the final accounts, p. 32

(KBT) and the National Tax and Customs Administration (NAV).

**CONTROL ENVIRONMENT** During the individual evaluation of the pillars of the internal control system, based on the assessment, the control environment was characterised by the highest compliance level (92.9 per cent), which control environment is determined by organisational structure, the level of internal regulations and human resource management. The organisational structure, the determination of responsibility and competence conditions and tasks as well as internal regulations were all in line with statutes and internal control standards. The level of internal regulation showed improvement; at the same time, however, deficiencies were observed in the fields of the regulation of public procurement and information security. This is indicated

by the fact that in close to three quarters (20 institutions) of public procurement regulations, comprehensive procedures covering the entire process of public procurement and supporting the audits of these processes were not defined, and neither were the supporting documents and follow-up lists. In the case of one fifth of institutions (six institutions), IT regulations did not establish business continuity or disaster recovery plans. The organisation with the best results in the field of control environment was the Government Audit Office (KEHI), with regulation compliance of 97.8 per cent. Even the Ministry of National Resources (NEFMI), which obtained the lowest score, performed at a compliance level of 80 per cent.

**INFORMATION AND COMMUNICATION** According to the qualification, information and communication is the control pillar with the

second highest compliance level (85.7 per cent). The internal regulations defined the form of communicating information; the employees received the information required for their work in time and all regulations were available. One of the deficiencies was that 13 institutions (46.4 per cent) had no communication strategy; moreover, four institutions (14.3 per cent) failed to establish the proper procedural order for irregularities and the suspicion of corruption report.

**CONTROL ACTIVITY** Overall, the control activity of institutions functioned well (71.4 per cent), which control activity included, among other things, the taking of and compliance with measures ensuring regular operation. The four eyes principle was enforced in financial management, and the separation of jobs and competences was carried out. The main deficiency was observed in the field of the auditing of public procurement, where the operation of controls was not adequately supported by audit lists in the case of seven institutions.

**RISK MANAGEMENT** In the case of budgetary institutions, risk management – which serves to prevent factors endangering the regular and effective performance of activities through the assessment of these factors – was the control pillar which achieved the second lowest (42.9 per cent) compliance level. Based on the aggregate assessment, the risk management of five<sup>17</sup> institutions had a compliance level of 100 per cent, and there were 13 that did not reach 70 per cent. The institutions failed to comprehensively ensure the regulation of risk management activities (60.7 per cent compliance level) and deficiencies were observed in practical application (42.9 per cent compliance level). The fact that the risks of fraud and corruption were not assessed and that acceptable risk levels, risk reactions and countermeasures were not defined all added to these deficiencies.

**MONITORING** Overall, the lowest (39.3 per cent) compliance level was achieved in the field of the monitoring activity of institutions. There is significant dispersion in institution results (25.0 per cent, 96.4 per cent compliance level), with three institutions<sup>18</sup> achieving the best performance, but with four<sup>19</sup> other institutions performing below the 50 per cent compliance level. The low qualification was due to the fact that in the case of close to 40 per cent (11 institutions) of institutions, the establishment of the monitoring system is “non-compliant” and almost a third (11 institutions) failed to determine a monitoring strategy. 42.9 per cent (12 institutions) failed to perform the self-assessment of internal control systems; however, 75.0 per cent (21 institutions) corrected the errors uncovered by the internal audit. The monitoring pillar includes internal audit activity, the monitoring of the operation of the internal control system, and in turn the facilitation of the development of the internal control system through the support of the management’s activity exercising regular control.

**INTERNAL AUDIT** Based on the aggregate assessment regarding the internal audit activity of budgetary institutions, the regulation and operation of this activity was compliant at 82.1 per cent (23 institutions) of budgetary institutions audited. At the same time, the evaluation of internal audit activity was negatively impacted by the fact that during their audit activities, institutions failed to examine the establishment and operation of the internal control system, the management of resources (assets in particular) or the reliability of settlements and budget reports, or did not examine these in sufficient depth. Another deficiency was that beyond financial and regularity audits, internal auditors only performed other types – system, performance, and IT – of audits on an ad-hoc basis. As a result, the selection and implementation of au-

dit tasks was only compliant at 12 institutions (42.9 per cent).

For years now during the audit of final accounts, the SAO has determined that internal audits cannot fully perform their tasks due to capacity problems. This finding was supported by the fact that seven institutions (25 per cent) ensured the performance of internal audit tasks through external funds. Twenty-five of the institutions (89.3 per cent) felt the staff numbers of organisational units conducting the internal audits were sufficient, which is contradicted by the fact that they failed to perform priority audits due to a lack of capacity.

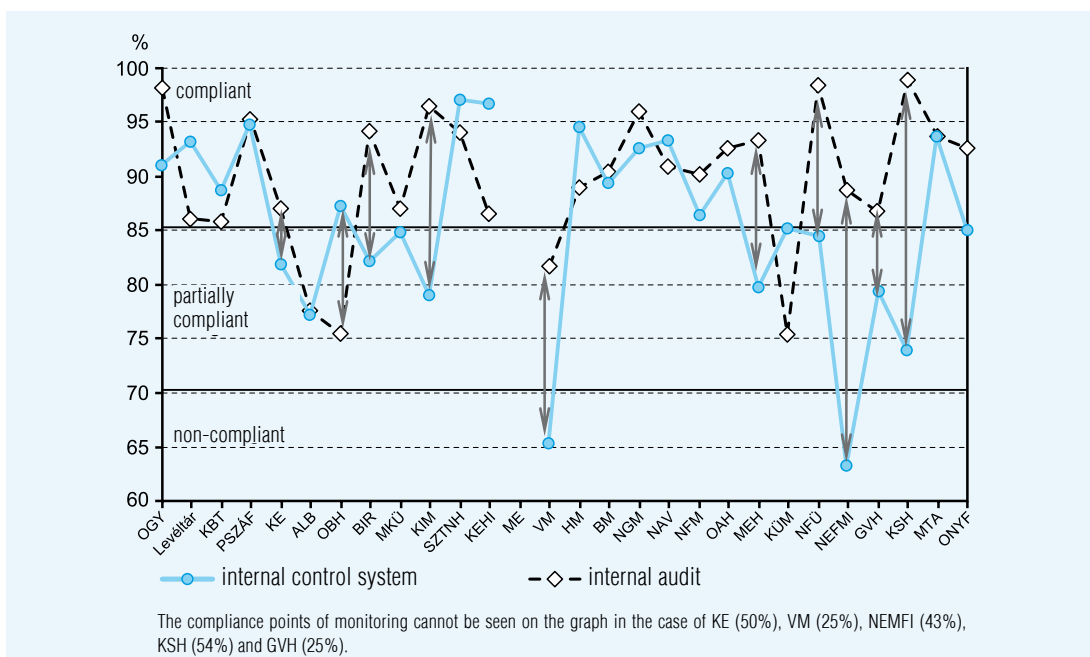
Based on the assessment system, of the components of the internal control system, the compliance level of monitoring is the lowest. As *Chart 5* shows, the compliance of

the internal control system and internal audit at the institutions showed a correlation in the year under review. In the case of institutions where internal audit activity did not function properly, there were also deficiencies in internal controls.

The Chart confirms the correlation of internal audit and internal controls at the majority of institutions; the difference value between the qualification of the internal control system and internal audit was under 15 percentage points at 85.7 per cent of examined institutions, between 15 and 20 percentage points at 7.1 per cent and was only above 25 percentage points in two cases. The high difference values were typically due to unique factors; therefore, their distorting effect should not be included in the calculation of the correlation coefficient. Unique factors impacted correlation strength

Chart 5

**THE RELATIONSHIP OF THE INTERNAL CONTROL SYSTEM AND INTERNAL AUDIT OF CENTRAL BUDGETARY INSTITUTIONS WITH RESPECT TO COMPLIANCE**



Source: Report no. 1298 on the audit of the regularity of the internal control system and internal audits conducted at central budgetary institutions included in the audit of the final accounts

at eight institutions; the correlation coefficient calculated for the remaining 20 institutions was therefore  $r = 0.56$ , i.e. moderate or strong correlation was observed. Correlation is particularly clear in the case of 11 institutions<sup>20</sup>, as shown on the chart, as the values of internal audits and qualifications of internal controls are practically identical, with the difference between compliance values below 3 percentage points. The correlation coefficient in this case is  $r = 0.78$ , which represents a very strong correlation between the internal control system and the operation of internal control activity.

The high-low lines (double-headed arrows) shown in the Chart indicate the difference between the compliance percentages of the internal control system and the internal audit if the the compliance levels do not fall into the same range in the case of ten<sup>21</sup> institutions. In these cases, the qualification of the internal control system and the internal audit<sup>22</sup> was assigned different values because qualification values fell between different boundaries.

The deviations marked by high-low lines can be traced back to three reasons:

- deficiency of regulation levels and operation within the internal control system, more precisely the field of monitoring;
- deficiencies of regulation levels and operation in other areas of the components of the internal control system;
- deficiencies of regulation levels and operation in the field of internal audits;

During the audit, besides the examination of the relationship of the internal control system and internal audit, we also compared the opinions given on the 2011 budget reports for the 28 institutions and the chapter-managed appropriations of 11 budget headings with the qualification of the internal control systems, in the interest of finding correlations between the operating deficiencies of any of the internal control system elements and the reliability of the budget reports. The relationship of the

qualified opinions of budget reports audited during the execution of the budget and the internal control system is shown in *Chart 6*.

As shown in the Chart, the correlation between the qualified opinions of budget reports and the internal control system can be clearly proved.

At the same time, the relationship also indicates the significance of the appropriate operation of the internal control system, as it greatly contributes to the regular operation of the given budgetary institution and the regular and goal-appropriate utilisation of chapter-managed appropriations.

In the case of one of the audited bodies, the National Development Agency (NFÜ), the SAO gave an adverse opinion with regard to the consolidated report on the chapter-managed appropriations of the EU Developments (UF) chapter, where we qualified the operation of the internal control system as “non-compliant”. The correlation is also clear in the case of organisations which received approving and “compliant” qualification<sup>23</sup>, where the appropriately operated internal control systems greatly contributed to the issuing of the approving opinion.

**IN THE CASE OF QUALIFIED OPINIONS**, the error or deficiency was the result of the inadequate operation of several components of the internal control system. (*See Table 3*)

In Case ①, in the case of the chapter-managed appropriations of the UF chapter, the errors substantiating the issuing of the qualified opinion could be traced back in the area of accounting to the inadequate functioning of internal controls and accounting support functions related to IT systems, as a result of which correspondence of general ledger accounting and the analytical records was not ensured.

In Cases ② and ③, the qualification of the statement was due to a unique/one-off accounting item. In these cases, the internal

Chart 6

### THE RELATIONSHIP OF THE QUALIFIED OPINIONS OF BUDGET REPORTS AND THE INTERNAL CONTROL SYSTEM

Total of institutions and chapter-managed appropriations	Number of institutions	Number of chapter-managed appropriations	System elements / Budgetary institutions audited	INTERNAL CONTROL SYSTEM														REPORT					
				Control environment		Risk management		Control activities		Information and communication		Monitoring		Internal audit	AGGREGATE EVALUATION		Statements	Unqualified		Qualified			
				o	a	o	a	o	a	o	a	o	a		o	a		Opinion approving	Opinion with emphasis of matter	Opinion limited	Opinion adverse		
1	1		OEY																	X			
2	2		Archives																	X			
3	3		Public Procurement Council (KBT)																	X			
4	4		HFSA																	X			
5	5		Presidency of the Republic (KE)																	X			
6	6		AB																	X			
7	7		AJBH (GRH)																	X			
8	8		BIR (OITH)																	X			
9	9		MKO																	X			
10	10		KIM management																	X			
11	1		KIM chapt. man.																		X		
12	11		SZTNH																				
13	12		Government Audit Office (KEHI)																	X			
14	13		ME management																	X			
15	2		ME chapt. man.																	X			
16	14		VM management																		X		
17	3		VM chapt. man.																		X		
18	15		HM management																		X		
19	4		HM chapt. man.																		X		
20	16		BM management																				
21	5		BM chapt. man.																				
22	17		NGM management																				
23	6		NGM chapt. man.																		X		
24	18		NAV																		X		
25	19		NFM management																				
26	7		NFM chapt. man.																		X		
27	20		GAH																		X		
28	21		MLH																		X		
29	22		KOM management																		X		
30	8		KOM chapt. man.																		X		
31	23		NFI institution																			X	
32	9		UF chapt. man.																			X	
33	24		NEFMI management																		X		
34	10		NEFMI chapt. man.																		X		
35	25		GVH																		X		
36	26		HCSO																		X		
37	27		MTA management																		X		
38	11		MTA chapt. man.																		X		
39	28		ONVI																			X	

- original qualification
- amended qualification, taking into account the statements on measures already made or planned to be made on the correction of control deficiencies uncovered
- "non-compliant" qualification
- "partially compliant" qualification
- "compliant" qualification

Source: authors' own editing based on the data contained in report no. 1298 on the audit of the regularity of the internal control system and internal audits conducted at central budgetary institutions included in the audit of the final accounts

Table 3

**CORRELATION BETWEEN THE QUALIFIED OPINIONS OF BUDGET REPORTS AND THE INTERNAL CONTROL SYSTEM**

Reference	Name of institution	The aggregate qualification of the internal control system	Qualification of internal audit	Qualified opinion	Qualification relationship with components of the internal control system
①	EU Developments chapter-managed appropriations	"non-compliant"	"partially compliant"	adverse	The harmony of data from analytical records generated from the IT systems supporting accounting, the general ledger and the statements was not systematically ensured. The NFÜ failed to perform the comprehensive end-of-year reconciliation of claims. The provisions laid down in the NFÜ's accounting policy and inventory regulations as well as the internal closing circular were not enforced in practice.
②	NFÜ institution	"partially compliant"	"partially compliant"	limited	The asset recording software allowed for the recording of items deviating from accounting provisions, i.e. the irregular taking into stock of vehicles, which the managerial audit failed to identify as a problematic item.
③	ONYF	"partially compliant"	"compliant"	limited	The limiting opinion was the result of a one-time accounting error uncovered in the case of non-regular payments. The current system of accounts (control environment) did not contain the booking of the problematic accounting item according to accounting provisions, and managerial audit (control activity) and the four eyes principle could not be enforced in this case.

Source: authors' own editing based on the data contained in report no. 1298 on the audit of the regularity of the internal control system and internal audits conducted at central budgetary institutions included in the audit of the final accounts



control system was unable to handle the accounting settlement process with regard to the unique economic events. The weak point of the internal control system was not uncovered because in the financial field in the year under review relevant risks were not assessed (ONYF) or identified (NFÜ, chapter-managed appropriations of the UF chapter), (risk management). In the case of the NFÜ, the self-assessment (monitoring) of the internal control system was not performed.<sup>24</sup>

*“In order to increase the efficiency of public administration, the SAO makes good practice public property, and transfers the information and knowledge obtained as a result of the audits to the users of public funds.”* (State Audit Office Strategy, 2011–2015, p. 6)

In the interest of increasing the role of internal controls, it was a significant measure on the part of the SAO to provide an opportunity for institutions following the closing of the au-

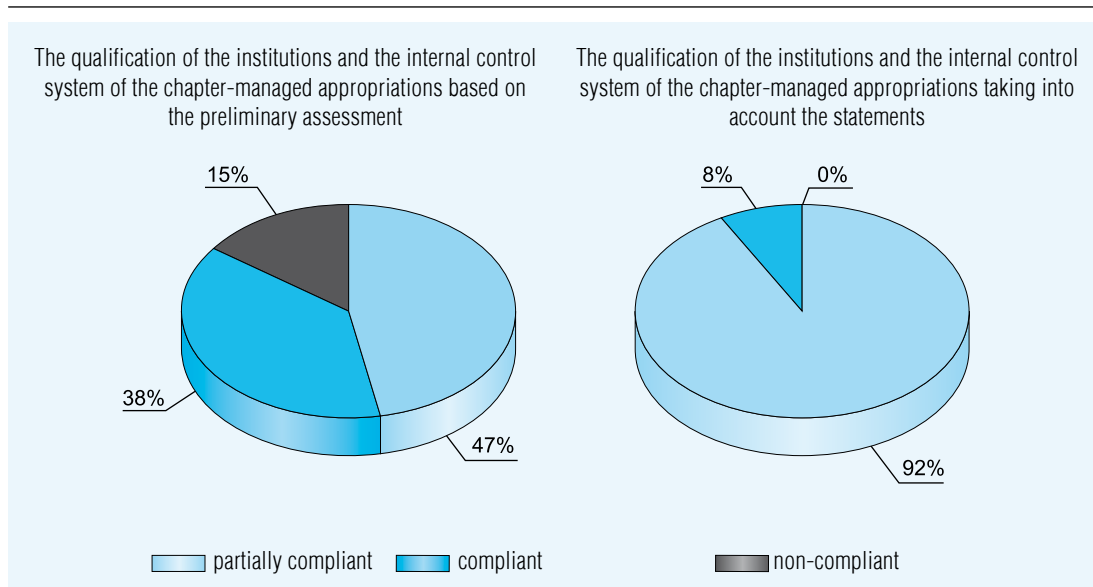
dit to comment on measures already made or planned to correct the control errors uncovered by the SAO, which measures serve the establishment and strengthening of “good practices”. In their recent statements, the heads of the institutions controlling the chapters undertook to correct the control deficiencies and errors. Based on the statements made, they repeated the assessment of the internal control systems, based on which the aggregate evaluation of control pillars improved by 31 per cent, to a compliance level of 92.9 per cent. (See Chart 7)

### CONCLUSIONS

The five main components of the internal control system (control environment, risk management, control activities, information and communication, and monitoring) make up a tight system of correlations. The key factors

Chart 7

#### THE CHANGE OF THE AGGREGATE QUALIFICATION OF THE INTERNAL CONTROL SYSTEM AT INSTITUTIONS AND CHAPTER-MANAGED APPROPRIATIONS TAKING THE STATEMENTS MADE INTO ACCOUNT



Source: Report no. 1298 on the audit of the regularity of the internal control system and internal audits conducted at central budgetary institutions included in the audit of the final accounts



of the effective operation of the internal control system are managerial commitment (tone at the top), effective risk management (predicting, avoiding, managing and bearing risks) as well as a well-functioning monitoring system. It is because of the latter that the supporting role of internal audit also becomes more significant.

During the mapping out of the correlation system of the main control component, it would be expedient to view control environment as a feature, mainly due to managerial commitment, as no well functioning control system can exist in its absence. A well-established control environment in itself does not ensure the appropriate operation of the control system. Risk management is a highly important control element which, if it functions well, impacts the operation of all other control components including control activities, information and communication, and monitoring. Monitoring activity, which in its process also includes internal auditing, subsequently impacts the control component preceding it in line.

Based on the results of the survey on the internal control systems of institutions, we can determine that the main directions of the further development of the internal control system for the top-level management of institutions are the improvement of the quality of risk management activity, the strengthening of controls supporting the adherence to the provisions of the kbt<sup>20</sup>, the more thorough and more frequent audit of the settlement of funds provided through application from chapter-managed appropriations and the constant updating of internal regulations. Closely related to this is the fact that in recent years, the weight, role and professional activity of internal audits have weakened. The internal audit did not perform the audit of the entire control system, and as a result, the management had no information on which areas need development with respect to the internal control system.

The results confirm our assumption that besides the auditing of the regular operation of financial controls, the organisational units conducting internal audits – in the interest of complying with statutory provisions – should place greater emphasis on auditing the organisation's risk management, its economy, efficiency and effectiveness of operation, as well as the control activities related to the reliability of budget reports.

However, it is very important to distinguish between institutions that operate their internal control systems well and those that still have deficiencies in this regard. In this latter case, in the interest of ensuring more wide-spread audits concerning the internal control system, it would be expedient to review the staff numbers and weight of internal audit which, if necessary, could require the increase of staff numbers in internal audit and the review and development of professional competencies. In such cases, the consulting role of internal audit is limited to correcting existing errors, which means adapting to circumstances. If the operation of control systems is adequate, internal audit activity may take on new meaning; the number of internal auditors may be reduced and audits may place greater emphasis on consulting activities that support the top-level management of the institution in avoiding problems arising in the future in advance, in other words influencing circumstances instead of adapting to them.

The objective of the study – to survey the impact of the internal control system on budget reports and to confirm their correlations – was achieved. With regard to the 28 budgetary institutions and the chapter-managed appropriations at 11 chapters, the impact of the internal control system on the reliability of the statement was confirmed. This could provide further reference points to extend the investigation to other budgetary institutions; furthermore, recommendations

could be made using the results on excluding budgetary institutions from the auditing of the next year's final accounts, where the internal control system operates appropriately and this appropriate operation in turn ensures the reliability of the annual budget report.

The Ministry for National Economy (NGM) prepared its draft report on the 2011 situation and operation of the internal control system of public finances for the government. In the draft report, the NGM makes separate mention of the survey (Quality Assessment Questionnaire of the Internal Control System)<sup>26</sup> it conducted involving 188 budgetary institutions on the establishment of their internal control systems. The SAO received this draft report to provide an opinion. The draft report gave positive confirmation regarding the fact that the methodology developed by the SAO is suitable for the quality assessment of internal control systems and, based on the survey, the conclusions are valid.

The private sector also provided support for the SAO for the observations made in the report. Based on what was said at the 2012 conference of the Public Benefit Association of Hungarian Internal Auditors (BEMSZ)<sup>27</sup>, the non-appropriate operation of monitoring and risk management represents a problem not just for the players of public finances, but also for large corporations which are major factors in the private sector. It is no coincidence that in September 2012<sup>28</sup>, the COSO<sup>29</sup> Committee published its draft of the new Internal Control – Integrated Framework to be published in 2012 for the purposes of receiving opinions on the document. The new document updates the original 1992 framework with the conceptual approaches of the 2004 COSO ERM and the 2006 guideline as well as the control experiences of the past decade. Logically, this will also bring about the changing of the INTOSAI directive and national standards in the near future.

#### NOTES

<sup>1</sup> The INTOSAI Internal Control Standards Subcommittee is the oldest functioning group within the organisation. Since its establishment in 1984, the sub-committee has conducted active professional activities in the field of the internal control of public sector organisations. In 1992–2001, the State Audit Office of Hungary performed the presidential tasks of the sub-committee, which tasks were taken over by the Polish audit office from the Belgian audit office in 2010.

<sup>2</sup> Section 5 (6) of Act LXVI of 2011 on the State Audit Office sets out the task of the SAO, according to which, “During its audit, the State Audit Office of Hungary shall evaluate compliance with the accounting rules of public finances, as well as the operation of the internal control system of public finances”.

<sup>3</sup> REPORT on the audit of the regularity of the internal control system and internal audits conducted at central budgetary institutions included in the audit of the final accounts (1298)

<sup>4</sup> REPORT on the audit of internal control mechanisms operating in the field of the central budget V-15-235/2000-01.

<sup>5</sup> On 9 October 2012, The Public Finances Audit Unit of the Public Benefit Association of Hungarian Financial and Economic Auditors and its Pest County Chapter organised a conference entitled “Audit and Control in Public Finance”. The conference was opened by László Domokos, the President of the State Audit Office of Hungary. In his speech the President talked about the significance of controls and shared the experiences of the latest SAO report.

- <sup>6</sup> Audit Manual of the SAO, Section I.3.1 of Book 4 and Section I.1 of Book 5
- <sup>7</sup> According to Section 3 of ISSAI 300 – Field Standards in Government Auditing
- <sup>8</sup> A decision was made at the XVII Congress of INTOSAI (Seoul, 2001), that the 1992 INTOSAI directive on internal controls will be updated based on the standard concept developed by COSO for internal controls.
- <sup>9</sup> Based on the INTOSAI GOV 9100 directive, the Act on Public Finances (Áht.), the Government Decree on the Rules of Operation of Public Finances (Ámr.) and the Government Decree on the internal control system and internal audit of central budgetary institutions (Bkr.)
- <sup>10</sup> Based on the INTOSAI GOV 9100 directive, the Act on Public Finances (Áht.), the Government Decree on the Rules of Operation of Public Finances (Ámr.) and the Government Decree on the internal control system and internal audit of central budgetary institutions (Bkr.)
- <sup>11</sup> Based on the INTOSAI GOV 9100 directive, the Act on Public Finances (Áht.), the Government Decree on the Rules of Operation of Public Finances (Ámr.) and the Government Decree on the internal control system and internal audit of central budgetary institutions (Bkr.)
- <sup>12</sup> Based on the INTOSAI GOV 9100 directive, the Áht., the Ámr. and the Bkr.
- <sup>13</sup> The questions were drawn up on the basis of Directive 9100 of the INTOSAI GOV, the Act on Public Finances (Áht.), the Ámr., the Ber. Directive No. 1/2009 (IX. 11.) of the Ministry of Finance (PM) on the Internal control standards of public finances, Directive No. 2/2009 (XII. 4.) of the Ministry of Finance (PM) on the Internal audit standards of public finances, the Internal Control Manual of the Ministry of Finance 2010, and the Guidelines to the monitoring system of the budgetary organs – Ministry for National Economy, October 2011.
- <sup>14</sup> National Assembly (OGY), National Security Historical Archives (Archives), Public Procurement Council (KBT), Hungarian Financial Supervisory Authority (HFSA), Presidency of the Republic (KE), Constitutional Court (AB), Office of the Parliamentary Commissioner (OBH), Courts of Justice (BIR), Prosecution Service of the Republic of Hungary (MKÜ), Ministry of Public Administration and Justice (KIM), Hungarian Intellectual Property Office (SZTNH), Government Audit Office (KEHI), Prime Minister's Office (ME), Ministry of Rural Development (VM), Ministry of Defence (HM), Ministry of the Interior (BM), Ministry for National Economy (NGM), National Tax and Customs Administration (NAV), Ministry of National Development (NFM), Hungarian Atomic Energy Authority (OAH), Hungarian Energy Office (MEH), Ministry of Foreign Affairs (KÜM), National Development Agency (NFÜ), Ministry of National Resources (NEFMI), Hungarian Competition Authority (GVH), Hungarian Central Statistical Office (KSH), Hungarian Academy of Sciences (MTA), and Central Administration of National Pension Insurance (ONYF)
- <sup>15</sup> Chapter-managed appropriation of the KIM, ME, VM, HM, BM, NGM, NFM, KÜM, UF, NEFMI, and MTA chapters
- <sup>16</sup> PSZÁF, ALB, BIR, BM, NGM, KÜM, and EMMI (NEFMI)
- <sup>17</sup> Archives, PSZÁF, SZTNH, BM, and MTA
- <sup>18</sup> PSZÁF, KEHI, and HM
- <sup>19</sup> ME, VM, EMMI (NEFMI), and GVH

- <sup>20</sup> OGY, KBT, HFSA, MKÜ, SZTNH, BM, NGM, NAV, OAH, MEH, MTA
- <sup>21</sup> KE, OBH, BIR, KIM, VM, MEH, NFÜ, EMMI (NEFMI), GVH, KSH
- <sup>22</sup> The assessment of internal audits was performed at two levels—as part of the assessment of internal control system and as an individual element. Internal audit—as part of the internal control system—does not represent an individual component within the internal control system; it is part of the monitoring system. Within the framework of the assessment of the internal control system, the internal audit has been qualified with respect to its activity aimed at examining the control system. The internal audit supports the monitoring of the operation of the internal control system, the priority tasks of which include facilitating the development of the internal control system.
- <sup>23</sup> OGY, Archives, KBT, PSZÁF, BIR, MKÜ, KEHI, HM, NAV, OAH, KüM, MTA, HM chapter-managed appropriation, NFM chapter-managed appropriation
- <sup>24</sup> The control component affected by the given error or deficiency is shown in brackets.
- <sup>25</sup> Act CXXXIX of 2003 on Public Procurement
- <sup>26</sup> Pursuant to Section 62 of Act CXCV of 2011 on Public Finances and Point d) of Section 51 (1) of Government Decree No. 370/2011. (XII. 31.) on the internal control system and internal audit of central budgetary institutions (bkr), within the framework of central cooperation and harmonisation, the Minister responsible for public finances monitors and examines the application and implementation of statutes, methodological guidelines as well as standards related to international internal controls and those published by the Minister responsible for public finances and internal audits.
- <sup>27</sup> 19-21.09.2012 BEMSZ Conference: The cooperation of lines of defence in organisations, lecture: The revaluation of the role of controls in the public sector
- <sup>28</sup> Committee of Sponsoring Organisations of the Treadway Commission
- <sup>29</sup> <http://www.ic.coso.org/>

#### LITERATURE

- DOMOKOS, L. (2012): Ellenőrzés és kontroll az államháztartásban (Auditing and control in public finances (Keynote address at the MPGEKE conference)
- GYÜRE, L.-NÉ (2012): Belső kontrollok kialakítása és működtetése az önkormányzati vagyongazdálkodás kockázatainak csökkentésére (The role of systematic internal control and audit in reducing management risk at Hungarian local governments), *Public Finance Quarterly* 2, pp. 183–193
- IVANYOS, J. – ROÓZ, J. (2010): Új megközelítés a közsféra belső kontrollrendszereinek értékelésére (A new approach of evaluating the internal control systems of the public sector), *Public Finance Quarterly* 2010/2. 2, p. 368
- KOVÁCS, S.-NÉ (2009): Az államháztartási kontrollok rendszere, belső kontroll, belső ellenőrzés a nemzetközi standardok és a vonatkozó jogszabályi változások tükrében (The system of public finance controls, internal control and internal auditing in light of international standards and relevant statutory changes). *Egészségügyi Gazdasági Szemle (Health Care Management Review)* 3, pp. 12–18

MÉRÉTEY–VIDA, Zs. (2006): Belső kontrollrendszer különböző felfogások tükrében (The internal control system in light of various approaches). Szakmai füzetek, BGF, 22. pp. 90–98

ACT XXXVIII of 1992 on Public Finances (Áht.)

ACT CXCV of 2011 on Public Finances (Áht.)

GOVERNMENT DECREE 292/2009. (XII. 19.) on the Rules of Operation of Public Finances (Ámr.)

GOVERNMENT DECREE No. 370/2011. (XII. 31.) on the internal control system and internal audit of central budgetary institutions (Bkr.)

STATE AUDIT Office of Hungary (2001): JELEN-TÉS a központi költségvetés területén működő, belső kontroll mechanizmusok ellenőrzéséről (REPORT on the audit of internal control mechanisms operating in the field of the central budget) (0115)

STATE AUDIT Office of Hungary (2008): Az Állami Számvevőszék Ellenőrzési Kézikönyve / A számvevőszéki ellenőrzés szakmai szabályai (Audit Manual of the State Audit Office of Hungary / Technical rules for auditing)

STATE AUDIT Office of Hungary (2010): Strategy 2011–2015.

STATE AUDIT Office of Hungary (2012): JELEN-TÉS a belső kontrollrendszer és a belső ellenőrzés szabályszerűségének a zárszámadási ellenőrzésbe bevont központi költségvetési intézményeknél le-

folytatott ellenőrzéséről (REPORT on the audit of the regularity of the internal control system and internal audits conducted at central budgetary institutions included in the audit of the final accounts) (1298)

COSO (1992): Internal Control – Integrated Framework

INTOSAI (2001): ISSAI 100 Basic Principles in Government Auditing, Online: [http://www.issai.org/media\(629,1033\)/ISSAI\\_100\\_E.pdf](http://www.issai.org/media(629,1033)/ISSAI_100_E.pdf)

INTOSAI (2001): ISSAI 300 Field Standards in Government Auditing, Online: [http://www.issai.org/media\(631,1033\)/ISSAI\\_300\\_E.pdf](http://www.issai.org/media(631,1033)/ISSAI_300_E.pdf)

INTOSAI (2004): INTOSAI GOV 9100 Guidelines for Internal Control Standards for Public Sector, Online: [http://www.issai.org/media\(574,1033\)/INTOSAI\\_GOV\\_9100\\_E.pdf](http://www.issai.org/media(574,1033)/INTOSAI_GOV_9100_E.pdf)

INTOSAI (2010): ISSAI 4200 Compliance Audit Guidelines, Compliance Audit Related to the Audit of Financial Statements, Online: [http://www.issai.org/media\(798,1033\)/ISSAI\\_4200\\_E\\_Endorsement\\_version\\_June.pdf](http://www.issai.org/media(798,1033)/ISSAI_4200_E_Endorsement_version_June.pdf)

MINISTRY FOR National Economy (2012): A Magyarországi Államháztartási Belső Kontrollrendszer bemutatása (Presentation of the internal control system of Hungarian public finances)

MINISTRY OF Finance (2010): Belső Kontroll Kézikönyv (Internal Control Manual)