

# **Basic principles of internal controlling at budgetary institutions**

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*In the past months at the time of the reforms of the new millennium the modernisation and transformation of the public sphere to meet the needs of globalisation and those after our accession to the European Union have been the constant topics in our country. The challenges of globalisation, the harmonisation of law and the process of standardisation require all countries to ensure transparency and comparability so that is why it is important for the public institutions that their internal and external systems should converge and be compatible both at the level of the institutions and sectors. Our paper presents the theoretical basis and principles of the controlling systems of budgetary institutions and it also aims to paint a thorough picture about the legal background of the controlling system as well as its changes. The paper also strives to be informative and give a direction towards the further and deeper study of the topic for those interested by putting the major principles, standards and the most important measures of legislation into a unified framework.*

*Key words: public sphere, internal controlling, INTOSAI, controlling standards, changes in regulations*

## **The background of internal controlling**

„The legal and growing need of society is the accountability of people and institutions engaged in managing public assets as well as the assurance of the transparency of managing public assets. Controlling is not autotelic. Both the internal controlling, regulating and checking system of the state budget and the external controlling from the National Audit Office must ensure that the demands of legality, the accepted standards such as accountability, transparency, economical nature, efficiency and effectiveness be met. The system of using public money and accountability must be created without any gaps and a successful operation must also be ensured.”

The quotation above is from the publication<sup>1</sup> of the National Audit Office containing rules of controlling, which fully contains all the tasks of internal controlling together with their place and role in the organisations of the public sphere. Internal controlling as an integrated, consistent system should totally embrace all the processes of the public institutions, thus helping the work of the external controlling of the audit office, ensuring transparency and accountability.

Due to the efforts of the public sphere to modernise and make efficiency better, nowadays it is indispensable to create and run a suitable internal controlling system. There is growing demand for the accountability of people managing and receiving public funds, which can only be realised by means of a suitably implemented control inserted into the process. Only the efficient and effective internal controlling is able to identify and correct the possible faults, drive the operation of the organisation into the right direction and run the whole institution efficiently. Based on the basic principles of controlling, the suitable internal controlling and checking system is able to minimise the shortcomings and irregularities as well as their risks. To create such a system it is indispensable to clarify the theoretical points of the internal controlling systems together with their implementation into practice. These processes require every budgetary organisation operating at any level to use and manage the resources in a more and more efficient way ranging from financial resources to the human ones. The more and more emphasised role of internal controlling is highlighted here –that is why this process was given a greater role when examining the practice of the past years.

The importance of controlling was realised by the organisations of the private sphere some decades ago by spending huge amounts of money to make the feedback process more and more efficient. Unfortunately, this approach was built into the public sphere after a long time allowing inefficient and often prodigal activities to gain ground. The difficult years past, the bigger and bigger burden on the budget, compliance with the expectations of the Union put the importance and efficiency of managing public funds into the limelight, which can be realised by means of a suitably created and run internal controlling system in the first round.

In general, the quality and adequacy of work performed by the organisations of public administration to meet the requirements primarily depend on the qualification, professional competence and competency of the people working there. That is why all employees of the organisation must realise the responsibility for their own task and performing it up to the suitable standard so the creation of the parts and principles of the internal controlling system also belong to the tasks of those to be controlled.

Another important criterion of a suitable and efficient controlling system is that all the principles and controls stated in the system apply to the whole organization in general. Another important thing to be realised is that controlling is not for its sake, not autotelic, rather, it is the integral part of the controlling process that helps and coordinates it by highlighting the possible faults and shortcomings. That is why we should state that the irregularities done and shortcomings finally go back to the weaknesses of internal controlling.

However, it is important to note that the internal controlling system itself cannot replace an independent external audit. It is the interest of all organisations to create an efficient internal controlling system to protect the financial and human resources. It is the task and responsibility of the organisation that the quality of work performed there and the internal working order of the organisation should comply with those outlined in regulations and other legal documents. As the public administration manages the funds of society and taxpayers, it is by all means necessary to have an independent, external controlling based on rules fixed ahead whose breakdown between the areas to be checked is presented by the figure below. The role of external controllers is not only to reveal the faults but by throwing light to the internal controlling system they are able to make it more efficient and compatible with national and international standards. Unfortunately, the capacity of external controlling is not enough to check all public institutions every year – that is why the importance of internal controlling is stressed. When compared to the 52,000 controlling days of 2002, the capacity of the National Audit Office has significantly been improved (more than 65,000 controlling days), the present capacity still significantly lags behind the necessary amount.

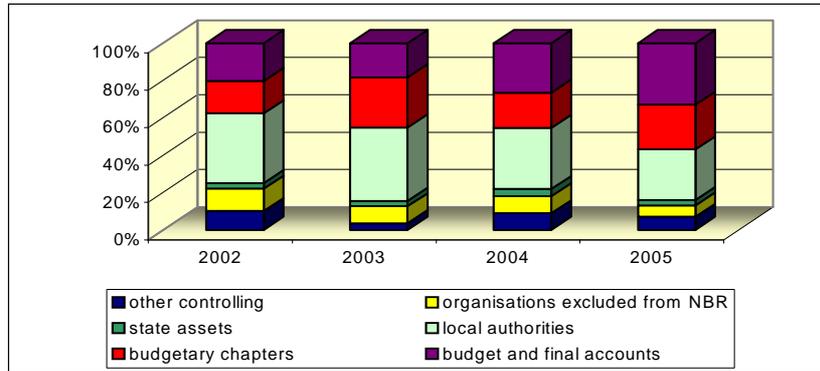


Figure 1  
Breakdown of audit office controlling between 2002-2005  
Adapted from: National Audit Office

During the creation of the internal controlling system we must not forget, however, the most important requirements towards the system. These requirements are based on generally accepted principles of both external and internal controlling.

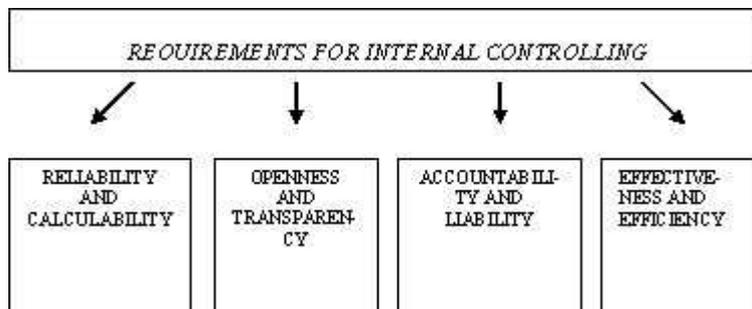


Figure 2  
Requirements for internal controlling  
From: own construction based on Endre Ákos

The principles outlined above mean the cornerstones of creating controlling systems that need to be applied consistently both in the case of internal and external controls. It is important to note when applying these principles that these four factors presented are never independent from one another. The omission or incorrect application of one principle will surely weaken the efficiency of others. Some basic principles are annexed by other further important principles for the sake of a better and more efficient application and implementation.

1. The principle of „*reliability and calculability*”<sup>1</sup> draws attention to the highlighted importance of managing public funds. Thus function by all means needs external controlling, which can measure and compare the real operation of state owned organisations with the desired status.
2. The principle of „*openness and transparency*” aims to exclude corruption from the system accompanied by other principles like accessibility, availability, the publicity of private activities and the justification of decisions.
3. The principle of „*accountability and liability*” is in close connection with the two principles detailed above. The real objective of internal controlling is the consistent application of this principle by preparing „ground” to an independent external controlling, which is mainly to examine compliance with the legal system.
4. The principle of „*effectiveness and efficiency*” proves to be the newest principle in the checking system of the public sphere. One of the key elements of the planned reform in public administration is the notion of effectiveness. This principle should not only be expressed in managing public funds but also in the everyday operation of internal controlling.

The basic principles outlined above can seem to be ideas and a well-constructed system in themselves. Unfortunately, if they are not integrated into the strategies and laws of internal and external controlling. Furthermore, the interpretation of these principles as a system is a very impotent factor embodied in the transitional period between input (task) and output (decision, execution) as illustrated by Figure 3.

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<sup>1</sup> The more detailed description of principles can be found in the work of Endre Ákos entitled About the certain principles of the internal controlling system of the public sphere

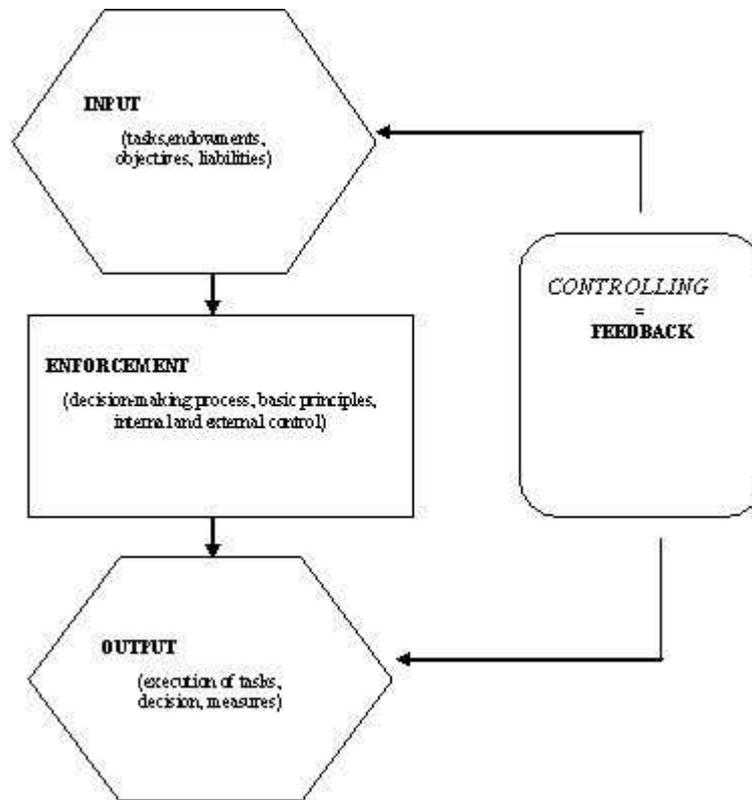


Figure 3  
The flow chart of the internal controlling system of the public sphere  
From: own compilation

Internal controlling should not be interpreted as a single function or independent unit whose task is to check financial accounts and documents. This applies to all the work processes and tasks of the public sphere that require decisions and action. Internal controlling as a feedback function reports about the quality of work to be done, the regularities of decisions and the efficiency of the managerial-controlling function.

INTOSAI<sup>2</sup> as well as the National Audit Office defined the standards and requirements that should be consistently and compulsorily used in the controlling system of every country some years ago. To make the internal controlling system of the public sphere effective and serve the interests of the institution and society the best, it is necessary to take these standards into consideration at the creation of the system.

<sup>2</sup> International Organisation of Supreme Audit Institutions

**INTOSAI Controlling Standards**

<p><b>GENERAL STANDARDS:</b></p> <ul style="list-style-type: none"> <li>▪ Independence,</li> <li>▪ Competence,</li> <li>▪ Proper care,</li> <li>▪ Other general standards</li> </ul>	<p><b>STANDARDS OF CARRYING OUT CONTROL:</b></p> <ul style="list-style-type: none"> <li>▪ Planning,</li> <li>▪ Controlling and checking,</li> <li>▪ Internal controlling and regulatory system,</li> <li>▪ Proofs,</li> <li>▪ Checking financial accounts,</li> </ul>	<p><b>STANDARDS OF MAKING A REPORT:</b></p> <p>Form:</p> <ul style="list-style-type: none"> <li>▪ Address,</li> <li>▪ Date,</li> <li>▪ Signature,</li> </ul> <p>Content:</p> <ul style="list-style-type: none"> <li>▪ Completeness,</li> <li>▪ Subject,</li> <li>▪ Legal ground,</li> <li>▪ Compliance with standards,</li> <li>▪ Topicality,</li> </ul>
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Figure 4  
INTOSAI Controlling Standards  
FROM: INTOSAI, Checkpoints guide

Based on these standards, the National Audit Office has declared the points below in its own controlling decree:

1. Independence:
2. Authority of access:
3. Professional competence:
4. Proper care:
5. Confidential handling of information:

The consideration of these standards applies not only to external controlling but also their integration into internal systems is practical to create harmony. In case of controlling inside the organisation the meanings of these definitions will change as the internal controller is in a different situation regarding his position and work than an auditor. Nevertheless, care, proper professionalism and trust should all be built into the system based on independence (work performed outside the „control” of the management).

Knowing all these theoretical information and bases, the next part will cover the rules of the internal controlling system that mean the practical implementation of the above mentioned factors.

## **The legal aspects of the system of internal controlling**

Hungary's accession to the European Union and the requirement of a more regular, efficient and transparent use of public funds has made the transformation of the internal financial controlling system of the state budget (BIFCS) essential. After the acceptance of the strategy on the change of the system prepared by the Ministry of Finance, these days the inclusion of the three pillars of the new system – i.e. built in the process, preliminary and subsequent management controlling (BPSMC), internal controlling as well as central coordination and harmonisation and the creation of the proper legal regulation have taken place. On the one hand, the existing laws have been modified [mainly Act XXXVIII. of 1992 on the state budget (SB) and government decree 217/1998. (30 December) on the functioning of the state budget (SBF)], and new ones [primarily government decree 193/2003 (26 November) on the internal controlling of budgetary institutions (ICD), as well as the structural funds of the European Union and government decree 233/2003 (16 December) on the creation of financial executive, accounting and controlling systems to be attached to the receipt of the support of the Cohesion Funds] were born, on the other hand.

*Three laws are important to be mentioned in connection with the controlling of European Union support:*

1. Government decree 80/2003. (7 June) on the order of financial planning, executing and checking of European Union pre-accession support (effective from 7 July 2007) that was prepared by the Ministry of Finance includes the EU-conform rules about the checking of the use of support.
2. Also it was the Ministry of Finance that prepared government decree 233/2003 (16 December, effective from 1 January 2004) on the creation of financial executive, accounting and controlling systems to be attached to the receipt of the support of the Structural Funds and Cohesion Funds of the European Union that also includes the controlling regulations of support deriving from Union funds (BPSMC, internal controlling, 5-15 % controls, publishing final statements).
3. The Office of the Prime Minister and the Ministry of Finance jointly made government decree 1/2004 (5 January) that became effective on 5 January 2004 on the institutions responsible for the national use of support from the Structural and Cohesion Funds of the European Union, which is in close connection with the former decree.

According to some people, preparation was not flawless, what is more, there were serious backwardness at institutions and the institutional system was not ready to receive Union support. Certain parts of the monitoring system were put to the right place only at the end of 2004 and in 2005. According to the National Audit Office preparation should have been done with a much greater level of responsibility; and such a situation should have been created even by the end of 003 and not only by the beginning of May that could make the receipt of Union funds possible with no risks (BIHARY 2005).

Continuous development, the training and education of specialists are indispensable for the running and maintenance of a system. Within the frames of a twinning project as well as in additional training programmes the preparation of controllers for the application of methodology meeting both international and EU expectations has been started. An important headway is that the training of Certified Internal Auditors acknowledged by the IIA was launched in Hungary.

Based on the new system regarding all the sub-systems of public administration BPSMC and the creation and running of internal controlling are compulsory at each budgetary institution. The above mentioned different recommendations and methodological guides can ease this. The practical implementation of the new system is an extremely important task significantly assisted by ÁBPE Inter-Departmental Committee as a forum for reviewing and discussing the tasks of system development and coordinating the things to do.

The carefully compiled checking direction can mean a starting point for the creation of the risk management activity of budgetary institutions at the same time. Risk analysis itself is advisable to be carried out in the planning phase of the given task and done systematically. These pieces of information provide the right impulses to perform internal controlling. However, the result of the audit can assist in realising further risks. The world and the surroundings always change; more and more information is created that need to be reassessed continuously.

The question of who should be responsible for the creation and implementation of the new system at the given budgetary institution can be raised. Regarding the position of the internal auditor, he is hardly capable of it but we cannot obviously state that then the financial director or the director of managerial tasks should perform this duty. The creation of a reliable controlling track recording and describing all the activities of the given institution assuming even greater controlling capacity of more people needs a longer period than the 90 days stipulated by law. This meant a new task even at the central organisations of state control (e.g. National Audit Office, KEHI). The creation of the special system of BPSMC about their own organisation, the completion of the controlling track, error managing guide and code of operation required significant amount of work (MOHOS 2005).

A totally satisfactory result could only be obtained if the systems of all organisational units and activities were controlled, which could make an opinion

of the existing or missing checking points by reviewing all processes. This „transparency”, revision could also direct attention to the risks that accompany the given task. On organisational level it is practical to perform this task at the highest level as a well-orchestrated, coordinated one with proper decision-making and measure-taking authority.

### **Summary**

Based on the things mentioned above, we can see that our budget as well as budgetary institutions still face a lot of things to do. Transformations, however, should not disregard the challenges of the new millennium by considering the requirements of efficiency, accountability and transparency. The objective of our paper was to paint a thorough picture about these tasks outlining the theoretical and legal bases in the creation of controlling systems, that will hopefully be used by budgetary institutions and local authorities in a few years' time with success and efficiency and that we, tax paying citizens will also feel.

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