

Financial Controls, an Old Function in a New Role

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SUMMARY

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The phenomenon of financial controls is as old as money. The ancient rulers wanted to know if their subordinates gave an accurate report on how the tax revenues was spent. Traders in Lombardy wanted to be ensured that their employees had not cheated. The owners of joint stock companies are also curious whether the board that leads the company and the managers act in the owners' interest when managing the company. I believe that the appearance and consolidation of the financial system, which is without internal values and based on trust, and the increasing need for financial stability have given increasing role to financial controls. The global financial crises in the third part of the 1990's has resulted a new situation in the operation of the international financial system. It has been pointed out that financial stability can only be guaranteed by global regulation and control, supervision and audit. Financial controls have been put in a new position qualitatively due to the development of the uniformed controlling procedures and the internationally co-ordinated operation of institutions. It cannot be ruled out that financial controls will be the generator and creator of global co-ordination. This article tries to discuss the arguments of this hypothesis as well as present some data supporting it.

ABOUT THE CONCEPT OF CONTROL AND AUDIT

Control and audit can be defined economically, politically, sociologically and organisation theoretically as a function, which is inherent in economic processes to deal with uncertainties and to achieve certain goals set by the stakeholders. The content of this function could be approached from several angles:

- Control and audit is an activity which analyses the accomplishment of certain actions, processes or events in accordance with a previously defined system of conditions. These activities are always part of a supervisory function, a management or guidance process. The analysis covers the difference between the actual facts and the expected goals, the reasons for the differences, the consequences and reveals the preventive measures that can be taken. Control and audit becomes separate function in the properly differentiated guiding and/or managing system, and can be institutionalised in various control and audit organisations. The institutionalised function or its appearance in a separate form is the consequences of a development phase and/or the results of regulatory acts.
- In technological terms control and audit is an economic analysing method, the combination of work and process-organisation principles set by the

characteristic feature of the activity as well as the action and the policy. All three elements of the definition are important. The analysis is linked to the fact that uncertainty needs to be solved or avoided. This means that one has to define the determinative factors concerning the function of the controlled and audited process, organisation or program, furthermore to discover the interaction between the various factors. To achieve this various analysing methods are available that range from a simple comparison through the methods of elementary statistics to the application of different models. The adequate method of analysis is not sufficient for appropriate control and audit. That is to say, the function of control and audit operates according to various interest criteria. It is required partly to take into consideration these interests, as well as to tackle the conflicts arising from the different viewpoints concerning the function. By introducing special work and process organisation principles and by set proceeding the different viewpoints and counter-interests can be excluded.

Control and audit always takes place in a previously defined field or space, in previously set of interests. Special work-organisation procedures, proceedings of control and audit as well as the expected behavioural norms of controllers and auditors have been created to

tackle the clash of interests without jeopardising the functions of control and audit.

In those economies in which the institutions are highly developed the function of control and audit is at great degree differentiated. In the everyday work of running the economy increasing number of functions of control and audit are used. Concerning the logic of market economy control and audit focuses mainly, but not exclusively, on financial processes. It is also the role of control and audit to ensure, just to name but a few, the basic pillars of the society, financial reports of different companies, the tax return of various participants of the economy, reports on government spending and providing data on the basis of the statistical system. With the economic function of the government managing a country has also become a lot more complex. In the public sector an increasing volume of resources are concentrated. As a result of this, in the field of traditional public finances fundamental changes are necessary concerning control and audit. State participation and the fluctuation in the range of regulations do not question the necessity of control and audit, but they might change its philosophy and professional approach.

Control and audit methods have been developing parallel with the ever broadening range of control and audit.

THE EVER-INCREASING ROLE OF CONTROL AND AUDIT IN THE MODERN MIXED ECONOMIES

The novelty of the past two decades has been the appreciation of financial control and audit in the economy as a whole. The roots of these changes are to be found in the changing economic and business climate. In one word one can call the new situation globalisation. Globalisation is based on the following factors:

- The technical environment of the economy has changed radically. Information technology-independent from the sectors- has revolutionised not just how information is processed, but also logistics and the organisation of production and services. This new technology is, however, a new source of uncertainty and risks.
- The financial sector has gone through deregulation since the 1960's and as a consequence of this, liberalisation has dissolved the segmentation of financial markets. This process has triggered the liberalisation of international trade which was initiated by GATT and later by WTO.
- The increasing size of companies and activities of certain companies are stretched into international networks of companies.

THE APPRECIATION OF THE FUNCTION OF CONTROL AND AUDIT IN THE NON-FINANCIAL SECTOR

Globalisation has dramatically increased the operational risks among non-financial companies. The increase in company size, the widespread locations of their premises, the applied technologies have all increased the sources of risks. In these conditions traditional company management practices and methods have lost their efficiency. Hardly can one overrate the change of paradigm that has actually taken place in the view and management practices of various companies. Corporate governance depends on two significant pillars to operate large, global businesses. One of the pillars is the management body in which the most important interest bearers concerning the business can be found. The other pillar is the internal control system, which can minimise by self-regulation the dysfunctions in business operation. The essence of the concept is that the only way to operate an increasing complex business efficiently and manage it for the satisfaction of its stakeholders is by creating and/or strengthening the internal control mechanism of businesses, in a partly self-regulated way and partly by the representation of and continual negotiations with the affected parties. As a result, the intended operation will be guaranteed. The key terms of this paradigm are internal control and the altered function of internal audit. This new approach of business operation is reflected in the establishments of voluntary organisations, i.e. consulting committees, e.g. Treadway Committee, Cadbury Committee, to deal with problems emerging in the private sector. International institutions such as the World Bank, OECD, INTOSAI, IFAC Public Sector Committee, have soon realised the significance of this question and they have tried to accomplish the new paradigm in an institutionalised form and to promote the international practice of supervision, control and audit.

THE ROLE OF CONTROL AND AUDIT IN THE MONETARY SYSTEM

As a result of a long evolution, today's monetary system is a monetary system without internal values. After the demonetisation of gold and since the creation of the monetary system international monetary institutions have been playing key roles. Such institutions are the Bank of International Settlement (BIS) established in 1930 and the institutions on Bretton Woods, established in 1944. The most important functions of the latter ones are the regulation and control of the operation of the international monetary system. On national level the central bank and the supervisory boards control the various financial services. The bank- and the stock exchange supervisory have become separated and

independent from the central bank because of the increased need for regulation and control. Central banks mainly concentrate on monetary stability, and on control on the money creation of commerce banks preventing an unwanted growth of money supply. Apart from these, central banks regulate, support and control national payment systems. In the case of partial convertibility central banks control currency transactions as well.

The second pillar of the monetary system is the bank and stock exchange supervisory committees. Due to the need to prevent further bank crisis which was so typical in the 1970's as a result of an international debt crisis, bank and stock exchange regulation and supervisory control to enforce the regulations have been appreciated. From the point of the topic it is negligible to mention what kind of forms these supervisory boards of financial services take. Actually they might range from unified, or attached to specific financial services, they might be individual bank supervisory, insurance supervisory or stock market supervisory. The question whether any of these supervisory functions are connected to the central bank is also negligible. The installment of the supervisory functions and their institutionalised forms depend on the country's monetary system, its traditions and its exact political situation. What is worth mentioning, though, is that the regulations and supervision of the supervisory boards are in accordance with supranational agreements, e.g. OECD, and characterised by voluntarily accepted norms, e.g., Basle Concordat and agreement upon "International Convergence of Capital Measurement and Capital Standards", which contains bank supervisory recommendations.

With globalisation the international monetary system has become permanently vulnerable. The most dramatic event that has to be mentioned is the 1997-98 south-east Asian financial crisis, which can be considered as the first global crisis. It became obvious that all crisis, let it be bank or currency crisis, are infectious. The local financial crisis gets widespread in a deregulated and liberated world economy easily causing serious damage all over the world. In these circumstances the idea emerged to set regulations to avert further global crisis. There are two Bretton Woods institutions that take key roles in preparing and managing a program with which the international financial system can be strengthened. The essence of the program is the action with which the national and international financial systems can be ensured to be stabilised. The main fields of the program are the following:

- to reveal the reasons of vulnerability in the system and to correct it in time
- to choose the proper exchange rate systems and operate them
- to improve the supervisory of the financial sector
- to make the economic policy of the countries more transparent
- to simplify the loan policy of the IMF

➤ to involve the private sector in the prevention of financial crisis and if it is necessary in its handling

Consequently, the activity of the IMF has to adopt a new role, a requirement to be the guard of the prudent international standard. The Economist *Special Report*, 28th September, 2002.; Báger 2003;

The increasing role of financial control and audit is not restricted only to the monetary system. Financial control and audit is a traditional function in the fiscal system too. The fiscal system, besides the monetary system, is part of the financial system. The increasing volume of the applied resources of the fiscal system and the fact that government finances have become international matters, take the aid to developing countries or the realisation of the European integration for example, have appreciated the traditionally used role of control and audit in this sector. International trust requires the transparency of the national fiscal systems. As far as the EU is concerned, there is special preference on the transparency of the Common Budget. This need caused the establishment of GFS, i.e. Government and Financial Statistics System operated by the IMF as well as the establishments of the international accounting standards of the public sector, and last but not least, the creation of the fiscal statistic system operated by Eurostat. The institutions that deal with the control and audit of the fiscal sector operate an international organisation called INTOSAI to ensure the uniformed control and audit principles and practices. In the EU as well as in NATO there are very strict financial control and audit institutions.

The most dynamically changing and most uncertain elements of the financial systems are the financial markets. With the globalisation of the financial markets, the incredibly quick development of financial innovations have resulted the biggest threat for some nations and for the stability of the international financial system. In the financial markets not only do the previously mentioned supervisory institutions operate as controllers and auditors but also there are monitoring institutions, auditing companies and rating agencies as well. The control and audit activities are carried out on the basis of voluntarily accepted and internationally consistent standards. Both in accounting as well as in ratings various standards did exist after the First World War but these standards were typically localised. However, in the 1960's the effort to harmonise and co-ordinate internationally the accounting and reporting practices speeded up. In this field one can witness the competition of IAS, which relies on European traditions, and of GAAP, which reflects the traditions of the US capital market. As far as ratings are concerned, the standards are based mainly on the experience of US companies. The supranational regulation and control is an institution that serves the international hegemony well but at the same time badly. The USA seems to rule the key fields of the financial system. The appearance of the common currency in Europe has not yet presented the existence of an alternative reserve currency. The various supranational

institutions are themselves the fields of competition for the hegemony. The dramatic developments of recent years have been the appearance of mistrust in the previously trustworthy monitoring institutions. The scandal of ENRON is just the dramatic example of the contradictions in the system. Monitoring institutions are profit oriented, and what is more, there is an oligopolistic situation in that market. Profit orientation and the oligopolistic competition resulted services that are not compatible with the basic functions, and one needs to take just a small step to commit fraud or forge the balance sheet.

After the bankruptcy of ENRON the US legislation passed the so-called Sarbanes-Oxley Act to ensure that financial reports are trustworthy. The situation is fairly similar concerning the rivaling accounting standards, i.e. IAS and GAAP. Despite the well-known management scandals the American Stock Exchange Supervisory insists on the application of GAAP. In October, 2003 the Financial Times organised a conference on which there was a heated debate on this topic. Finally, the participant came to an agreement saying that the American Stock Market Supervisory would also accept the plan to prepare a globally accepted accounting standard.

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Összefoglaló

Régi funkció új szerepben

A tanulmány a pénzügyi ellenőrzés szerepét, fejlődését új aspektusban mutatja be. A modern pénzügyi rendszerekben az ellenőrzési funkció önálló, összetett intézményrendszerből álló alrendszerbe szerveződik. A pénzügyi ellenőrzési rendszer funkciói a pénz iránti bizalom fenntartása, a gazdasági szereplők pénzügyi beszámolóinak hitelesítése, a pénzügyi rendszer stabilitásának biztosítása és a közpénzek korrupciómentes, szabályos és eredményes elköltésének szavatolása. A globalizáció a gazdasági szereplők interdependenciáját, technológiai és pénzügyi sebezhetőségét rendkívüli mértékben kiélezte. A tanulmány azon állítás mellett érvel, hogy a pénzügyi stabilitást szolgáló, a nemzetállamok feletti koordináció éppen az egységesülő pénzügyi ellenőrzéssel teremthető meg.

Резюме

Новая роль старой функции

В данном исследовании в новом аспекте рассматривается роль и развитие финансового контроля. В современных финансовых системах функция контроля организуется в подсистему, состоящую из самостоятельных, сложных по составу институциональных систем. Функциями системы финансового контроля являются поддержание доверия к деньгам, удостоверение подлинности финансовых отчётов участников хозяйственной деятельности, обеспечение стабильности денежной системы, а также гарантирование эффективного и законного расходования общественных денег с исключением коррупции. Глобализация чрезвычайно обострила интердепенденцию участников хозяйственной деятельности, их технологическую и финансовую ранимость. В исследовании доказывается, что наднациональная координация, обеспечивающая финансовую стабильность, создаётся как раз посредством унифицирующегося финансового контроля.