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STATE AUDIT  
OFFICE OF HUNGARY

# R E P O R T

on the activities of the State Audit Office of Hungary in 2005

0608

J/3.

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## **REPORT**

### **on the activities of the State Audit Office of Hungary in 2005**

The State Audit Office of Hungary (the SAO), the financial and economic audit organisation of the National Assembly, annually reports on its activities carried out in the previous year to the members of Parliament. Since the parliamentary cycle that began in 1998, the report on the annual activities of the SAO has not only been put on the agenda of several committees, but has also been regularly discussed at the plenary sessions, and the discussions have been concluded with parliamentary resolutions containing a brief evaluation of the SAO's activities and the future development trends.

In the 1998-2002 parliamentary cycle the SAO contributed to the activity of the National Assembly with 161 reports, and the committees discussed 67 reports. In the period between 2002 and 2005, which has just terminated, we prepared 244 reports, 59 of which were included in the agenda of the committees. Altogether we made 3,600 recommendations, which were substantiated by conducting 5,500 on-site audits. The SAO's findings were also utilised in the justification of recommendations and motions, as well as in parliamentary interventions before the discussion of the items on the agenda, interpellations and political debates.

The report on the SAO's annual activities makes a systemic evaluation of audit experiences, and a review of measures taken as a result of the recommendations, as well as the review of the influencing factors possible. At beginning of each parliamentary cycle, based on our audits we have the possibility to draw attention to processes that influenced the public sector, including public finances and, to a certain extent, the entire national economy in the past four years, as well as to the underlying correlations.

The reliable completion of our audit tasks, which have continuously expanded since the SAO was established, was facilitated by the fact that we plan our tasks and utilise the available resources for several years ahead, partly with regard to the changing economic environment. For this reason, first in 1998 and then in 2002 we prepared four-year strategies adjusted to the time horizon of the parliamentary cycles, and thus determined the arranging principles, focal points and main trends of our work for a medium term.

The primary objective of our strategy for the period 2002 to 2006 included developing audit methodology in line with international standards and EU requirements, making the audits qualifying the reliability of final accounts more complete, modernising audits of local governments, as well as developing

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a comprehensive advisory activity evaluating the utilisation of public funds and public property.

In the spirit of continuity we strengthen these trends of actions and processes. In addition – adjusting to the new challenges – our primary objective in the next four years is to contribute to the reform-scale reorganisation of public finances through audits that focus on the neuralgic points critical for the transparent and balanced operation of the public sector and public finances, and to foster the restructuring of the local governmental system in compliance with the EU's regionality requirements. On top of all this, in order to ensure compliance with the EU requirements and the utilisation of benefits arising from Hungary's EU membership, and, equally importantly, to present the authenticity of the financial system and management of national economy, the SAO is hereby the first– from among the national Supreme Audit Institutions of the new Member States – to join the group of countries that submit annual trend report on auditing the utilisation of EU funds.

This report of ours – which was closed at the presidential board meeting held on April 24, 2006 – reviews and summarises the findings of audits conducted in 2005 in relation to the subsystems of public finances, the public property, the large community supply systems, the utilisation of EU funds and other top priority areas. The report presents the major features and figures of the utilisation of the findings, and points out how the improvement of audit quality serves the balanced and organised operation of the SAO. The report also presents research activities that relates to the audit activity and provides the foundation for the advisory activity, as well as the operation and financial management of the SAO.

The SAO provides the National Assembly with further details of its annual financial management in the framework of the process related to the final accounts. In compliance with the Act on the State Audit Office of Hungary, the financial management of the SAO is audited by an independent chartered accountant mandated by the Speaker of the National Assembly following a tender procedure.

The SAO's summary reports in English are available on the SAO's website ([www.asz.hu](http://www.asz.hu)).

## **1. THE TASKS OF THE STATE AUDIT OFFICE OF HUNGARY IN 2005**

The Constitution and other legal regulations fully ensure the legal conditions and guarantees required for the independent operation of the SAO.

The legislation related to the SAO is actually a three-level regulation system, since the SAO's place and status in the state organisation is basically determined by the Constitution, its audit obligation and authority are determined by the Act on the SAO and the provisions of other legal regulations, while the leadership, management, audit and other activities of the SAO, its operation, financial management are specified by the Operational and Organisational Rules and other internal regulations approved by the President of the SAO.

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The number of laws related to the audit activity and operation has been continuously increasing since the establishment of the SAO. Apart from the Constitution and the Act on the State Audit Office of Hungary, the SAO tasks are specified by another 24 acts. However, the tasks and mandates of the SAO, which are particularly broad even by international comparison, do not only mean direct and exclusive audit obligation and authority, but also such activities, usually based on audit experiences, which are important for the improvement of the transparency and accountability of the utilisation of public funds and public property, and which strengthen the constitutional function of the state<sup>1</sup>.

Some of these legal provisions directly determine the utilisation of the SAO's annual audit capacity, while other provisions indirectly influence the utilisation of the capacities. The coordination of capacity required to accomplish tasks set in the laws and the various audit tasks poses a challenge for our institution each year due to our limited audit capacity.

The organisation fulfilled its audit obligation and mandate set in the laws in 2005 by conducting 102 audits.

## **1.1. Audit tasks, areas and focal points**

The SAO fulfils its audit obligations based on an annual audit plan. The annual audit plan is approved by the SAO's President following the discussion in the National Assembly's Audit Committee. The SAO (the President of the SAO) determines the topic, objective, venue and timeframe of the planned audits within the framework of the relevant legal requirements.

The audit plan for 2005 contained 98 topics. As many as 37 audits were under way already in 2004, and 25 audits were planned to be completed in 2006.

The original plan was supplemented by the following four new audits during the year: audit of the financial management of the Public Foundation for Nature and Society Friendly Development, the audit of the financial management of the National Secretariat of the Hungarian Red Cross taking into account public subsidies received in 2003 and 2004, the audit of the system and practice of management of frauds and irregularities related to subsidies received from the EU's Structural Funds, as well as the audit of the public utility development subsidies utilised for road and sewerage projects in the years 2002 through 2005.

In 2005 as many as 71 audit reports were published<sup>2</sup>. On top of that, three audits were concluded with a report signed by one of the Directors General instead of the President (SAPARD's certification audit of 2004, and the 2004-2005 certification audit of the organisation acting as the Paying Agency of

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<sup>1</sup> SAO initiatives, motions or calls are included in 5 legislative acts, our countersigning tasks are contained in 2 legislative acts, the SAO's opinion forming tasks are specified in 3 legislative acts, while 4 legislative acts provide our organisation with recommendation and cooperation related mandate.

<sup>2</sup> Apart from the audit reports, the SAO reports on its activities to the National Assembly on an annual basis.

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EAGGF's Guarantee Section). **The SAO completed its tasks planned for 2005.**

Our audit activities required 67,596 direct<sup>3</sup> audit days, 2,521 days more than in the previous years. The number of our staff has not increased for two years. This 3.7% increase in capacity was made possible by the launch of distant learning programmes and the more intense utilisation of IT solutions. The resulting growth in human resources was first of all utilised in auditing the final accounts.

In 2005, the audit tasks required by the law to be **performed with certain regularity** (annually, biannually and regularly) absorbed 75% of the audit capacity of the SAO.

Audits that must be performed **annually** continue to represent top priority tasks (giving an opinion on the fairness of the state budget, auditing the final accounts of the budget, auditing the application for and accounting of subsidies provided for local governments, as well as auditing the operation of the Hungarian Privatisation and State Holding Company and the Hungarian News Agency Corporation).

Four reports were prepared on this subject. The task that required the largest capacity was the audit of the execution of the 2004 budget, which absorbed 24% of the annual audit capacity.

In 2005, five reports were prepared on the implementation of **biannual** audits (audits of three political parties and two party-affiliated foundations).

As many as 40 reports were published on the completion of **regular** audit tasks. The comprehensive audit of the financial management of local governments accounted for the major part of the tasks. It was decided by the National Assembly in 2003<sup>4</sup> that in each parliamentary cycle the SAO must audit each local government at least once, and within this framework, comprehensive audits must focus on local governments with significant budgets or property. The National Assembly also fostered that separate SAO reports be published about the comprehensive audits of local governments of the capital, districts, counties, as well as towns with county rank. This task was completed in a time proportionate manner in the past years. If the audits of the 1,288 local governments planned for year 2006 are completed, the SAO will achieve the objectives set for this four-year term.

Apart from the report summarising the findings of audits on the financial management of local governments, as many as 21 separate SAO reports were drawn up (the local governments of 5 counties, 7 towns with county rank, as well as about 1 capital and 8 district local governments).

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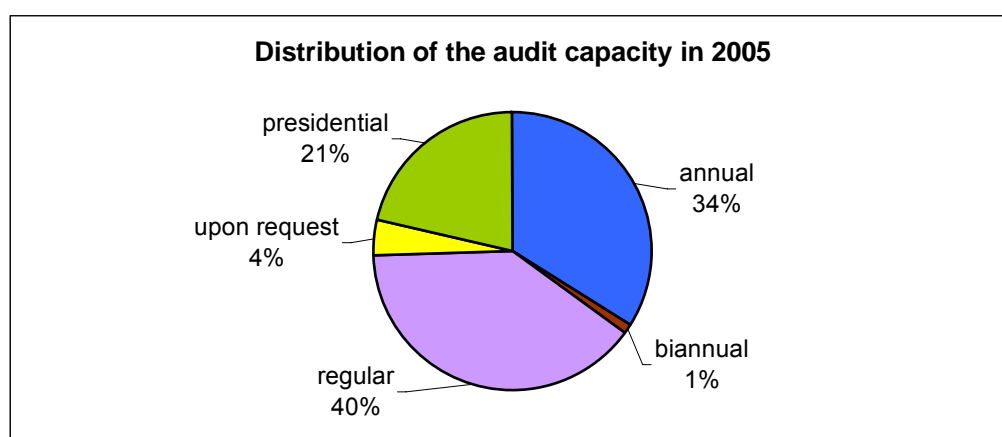
<sup>3</sup> Direct audit day: capacity used for the audit, as well as the legal, quality assurance and IT support that can be directly charged to the audit.

<sup>4</sup> Parliamentary Resolution 35/2003. (IV. 9.).



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The SAO prepared reports on the comprehensive audits spanning several years of ten budget chapters. These reports include those budget chapters that are fundamental for the constitutional order (National Assembly, Presidency of the Republic, Ministry of Justice, Constitutional Court). Regular tasks in 2005 also included the audit of the National Bank of Hungary, the operation of the National Radio and Television Commission (ORTT), the National Self-Government of Slovaks, the financial and economic activities of the National Self-Government of Germans living in Hungary, the accounting of funds utilised during the European Parliamentary elections, and the funds utilised for the organisation of the definitive national referendum in 2004, the audit of the Central Nuclear Fund, as well as the audit of political parties that did not receive central funding.



As many as 21 reports were prepared on audits carried out **on the basis of the decision of the SAO's President**. In line with the strategic requirements, during the selection of the topics of these audits, preference was given to audits presenting and evaluating the completion of tasks outside public finances, as well as audits presenting and evaluating the status and operational conditions of healthcare, social and cultural services that influence the living conditions of the population.

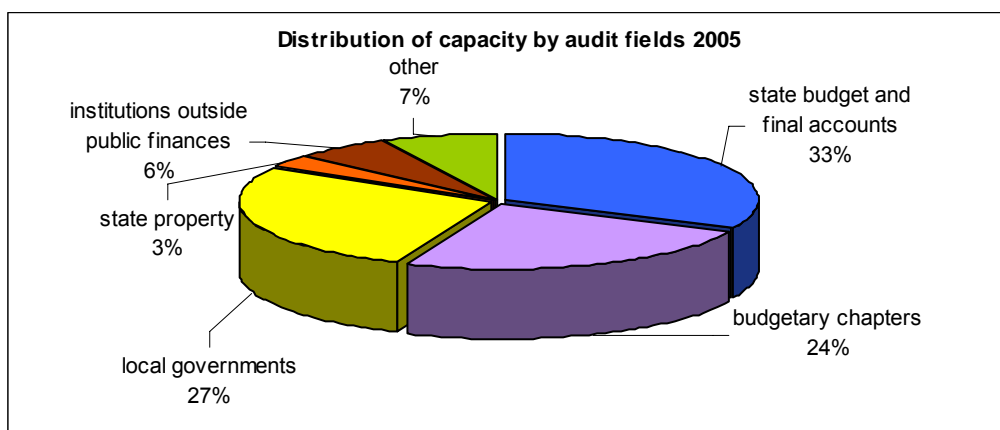
The SAO investigated the water and public utility investments implemented with the support of funds transferred by the local governments outside public finances, the operation of several state owned financial institutions (Eximbank, Export Credit Insurance Ltd., Hungarian Factoring Ltd. and the financial management of two public foundations.

The following audits were of great public interest: audit of the model experiment of managed healthcare, audits of the utilisation of funds serving the fulfilment of family policy objectives, the audit of the adult education and library services of local governments, the audit of the status of local government owned baths and spas, as well as the audit of the maintenance of public cemeteries.

In 2005 one report was prepared **upon the request of the Government**, which focused on the audit of the Public Foundation for Nature and Society Friendly Development.

In line with Parliamentary Resolution No. 43/2005. (V. 26.), in 2005 the SAO focused its audit capacity on the audit of the final accounts and on the

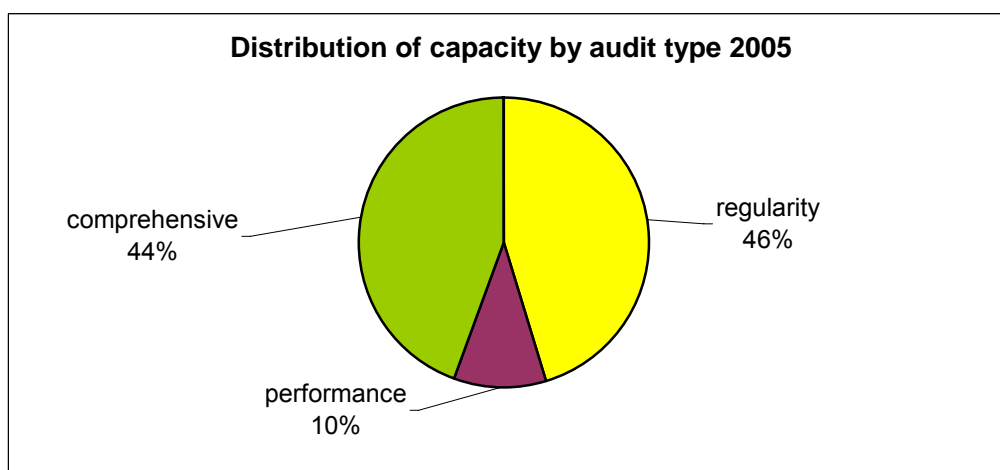
comprehensive audit of local governments. The latter absorbed nearly 80% of the 16,306 auditors' day capacity used for local governments.



The SAO classifies its audits according to **three main types**. Due to the schedule of the regular audits of the budgetary chapters, the ratio of the so called comprehensive audits<sup>5</sup> was unusually high in 2005.

The regularity audits – financial regularity (33%) and other regularity (13%) audits – must typically be conducted annually or biannually (auditing the final accounts, audit of the financial management of political parties, certification audits of SAPARD and EAGGF agencies in relation to EU matters). For these audits the SAO uses altogether approximately the same capacity as for comprehensive audits (44%).

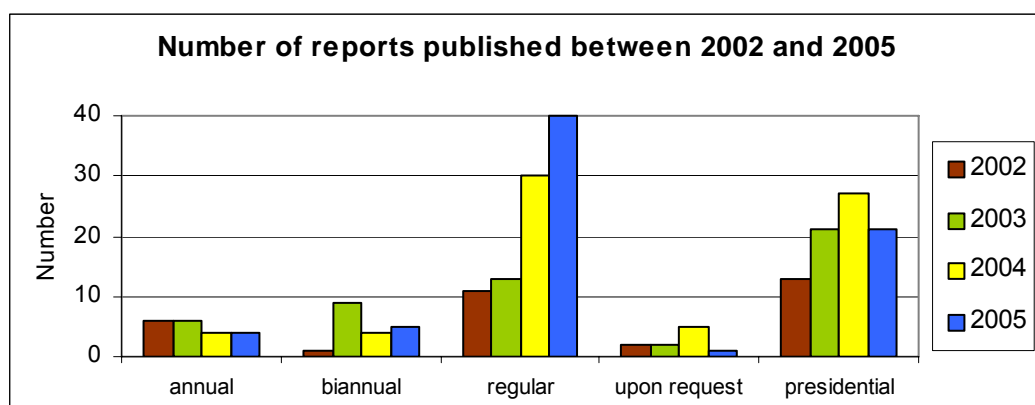
Performance audits accounted for 10% of the annual audit capacity.



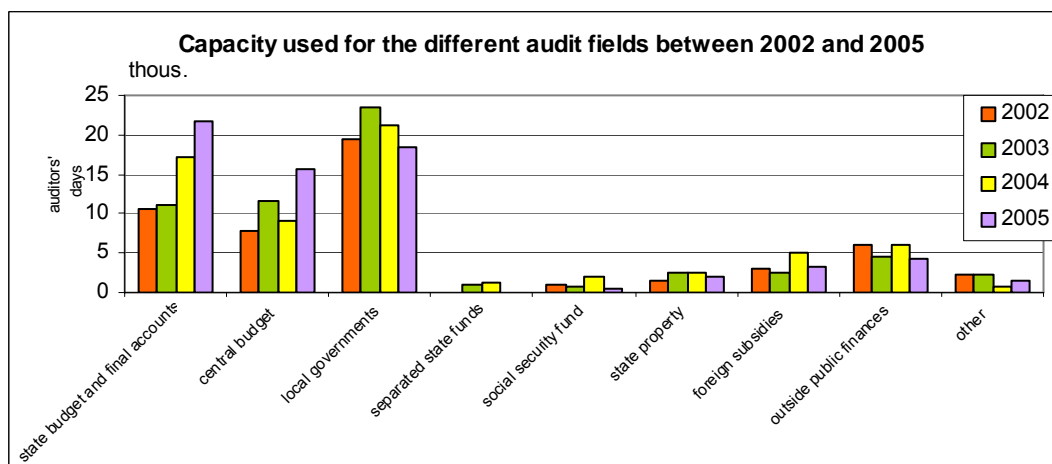
<sup>5</sup> The comprehensive audit aims at the audit of the internal management, control and supervisory system serving the operation of organisations as well as the implementation of projects and activities. The comprehensive audit focusing on certain areas simultaneously includes the main features the regularity and performance audits within the framework of a single audit.

The distribution of the audit capacity by audit type was similar to the average of the previous years. The shifts in proportions between the different years arise from the changing character of the audit tasks.

**In the past four years** the SAO published a total of number of **240 reports on audits**<sup>6</sup>, out of which 138 were annual, biannual or regular audits, 94 audits were conducted upon the decision of the President of the SAO, and 8 were performed upon the request of the National Assembly or the Government.



The growth in the number of regular audits is related to the fact that independent reports are published on the audits of priority local governments. During this period, the SAO submitted 38 such reports to the National Assembly. The drop in the number of reports on annual audits is attributed to the fact that the formerly separate reports (on the utilisation of funds provided to local governments) were incorporated into the report on the final accounts.



<sup>6</sup> The audit reports do not include the reports on the annual activities of the SAO.

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## **1.2. Other tasks of the State Audit Office of Hungary**

Other activities of our organisation include several authorisations and tasks that are prescribed by the Constitution, the Act on the SAO and other legal regulations, which authorisations and tasks go beyond the audit obligations and mandates.

The President of the SAO countersigns the contracts related to the borrowings of the central budget, and gives an opinion on the proposals for further development of the accounting system and the public internal financial control system. He comments on the internal audit regulation of the State Property Holding Company, and makes recommendations for the chairman of the supervisory board and chartered accountant of the State Property Holding Company, as well as the chartered accountant of the central bank, the chartered accountants of the separated state funds, and forms a preliminary opinion about the person to be appointed as the President of the Hungarian Tax and Financial Control Administration.

Pursuant to the Act on public finances, in business organisations with registered capital exceeding HUF 200 million and where the state is the majority shareholder the chairman of the supervisory board is recommended by the SAO upon the request of the head of the business organisation.

### **1.2.1. Countersigning and opinion forming authority**

On behalf of the Republic of Hungary, in November 2003 the Minister of Finance signed a contract on a stand-by credit line of EUR 500 million. The contract, which was countersigned by the President of the SAO, contained an option for a possible extension of the contract by one year, two times. In 2005, the Government Debt Management Agency initiated the extension of the contract. The extension was countersigned after the documents related to the extension of the stand-by credit line were checked for regularity.

The SAO's opinion forming authority – given in connection with the changes in the accounting rules – was exercised when amending the Act on accounting and the government decrees on the main features of financial reporting and book-keeping obligations of organisations of public finances, as well as on the main features of financial reporting and book-keeping obligations of treasury accounting.

### **1.2.2. Authority to make recommendations**

For the last time the President of the SAO recommended nominees for the post of chartered accountant at the Hungarian Privatisation and State Holding Company in 2005, at the National Bank of Hungary in 2001, at the Hungarian Development Bank in 2004, and at the Homeland Fund (which is a separated state fund) in 2005. Applications for the post of chartered accountant were invited within the scope of authority of the SAO's President (from 2002, altogether seven chartered accountants submitted their applications).

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Apart from the chairman of the supervisory board of the Hungarian Privatisation and State Holding Company, the chairmen of the supervisory boards of state business organisations specified in the Act on public finances are recommended by the Secretary General of the SAO. Due to the short deadline available for the nominations, an application procedure is announced before the nomination (once every year), and in case applications are submitted upon concrete invitation, the nominee for the post of the chairman of the supervisory board is selected from among the successful applicants (nomenclature).

In the period between December 31, 2003 and December 31, 2005, altogether 614 people were included in the nomenclature. Four names were deleted due to death, therefore the list of potential nominees contained 610 persons at the end of last year. As of December 31, 2005, as many as 107 of these persons were supervisory board chairmen upon the SAO's recommendation.

In 2005, as many as 92 requests were received from the companies. After compliance with the calls to complete incomplete documents, 91 requests could be considered as requests for assistance. By December 31, 2005 the secretary general of the SAO made nominations for 86 business organisations. In relation to the other five requests preparation of the nomination was still under way on the last day of the year.

In the period between December 31, 2003 and December 31, 2005 the SAO examined requests for assistance submitted by a total of 168 business organisations, as a result of which we nominated 150 persons included in the nomenclature in case of 150 requests, based on the decision of the Secretary General. Eighteen of the submitted requests did not fall within the SAO's scope of authority in line with the relevant legal regulations.

The SAO can make a well-founded recommendation for personal nomination based on the data and information available at the time of the nomination. Therefore, in order to implement the nomination task in a manner transparent for the general public, too, it prepared Nomination Statutes, which are published and continuously updated together with the related nomenclature on the SAO's website.

## **2. AUDIT FINDINGS OF THE STATE AUDIT OFFICE OF HUNGARY**

In the past four years the economy and politics have increasingly focused on the problems of budget planning and management. When commenting on the current budget appropriation bill and auditing the execution of the budgets we place the emphasis on the regularity and legality of financial management. Our aim is to ensure that the National Assembly could decide about the approval of the bills on the basis of the most comprehensive information and being aware of the possible risks of execution. Therefore, we pointed out deviations from the plans, the risks of non-compliance with the revenue appropriations, as well as the regular underplanning of certain expenditure appropriations (e.g. pharmaceutical subsidies) and the reliability of the reports.

In the past years it has become a common practice to amend certain revenue and expenditure appropriations – or in 2004 even the estimated deficit – during the year or at year-end either by the Government or the legislation. This resulted

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in growing differences between the original budgetary appropriations and the actual appropriations. This practice considerably diminishes the transparency of the budgetary processes and the effects thereof, and makes it almost impossible to monitor and analyse the financial and economic decisions, and to assess their impacts. The trends experienced in the past years have also drawn attention to the methodological issues of budgetary planning.

After finding significant discrepancies between the budgetary deficit and the planned deficit we have proposed the Government several times to initiate the amendment of the provision pertaining to the obligation of drafting a supplementary budget, because in the absence of a supplementary budget a significant part of the budget gets out from the controlling and decision-making authority of the National Assembly. We proposed to improve the methodology of budget planning, to lay firmer foundations for the planning of revenue and expenditure appropriations based on macroeconomic forecasts, and to revise the Act on public finances. We urged the development of the regulatory background of investments implemented in PPP schemes, the registration of state liabilities and the presentation of the numerical impacts of the projects launched on the budget.

Our experience shows that budgeting is not simply an annually recurring, mandatory technical task. Instead, the content of the approved document is a constitutional issue that must be linked to suitable security, responsibility and duty guarantees. This approach serves stability and is in harmony with the requirements arising from Hungary's EU membership. We must meet the relevant EU requirements, the convergence requirements, and the individual annual budgets must reflect such internal proportions and economic policy concepts that enable Hungary to adjust to the seven-year budgeting period of the European Union.

Such a budget document can only be prepared if mutual agreement is reached about the role of the state. We cannot postpone reconsidering what shifts in emphasis are required. It is an equally important issue what rights should be vested to the Government and the National Assembly in budget planning. Such guarantee requirements should be enforced that would link the preparation and submission of the state budget, and the obligation to prepare a supplementary budget to compliance with more stringent conditions, including fiscal limits, too.

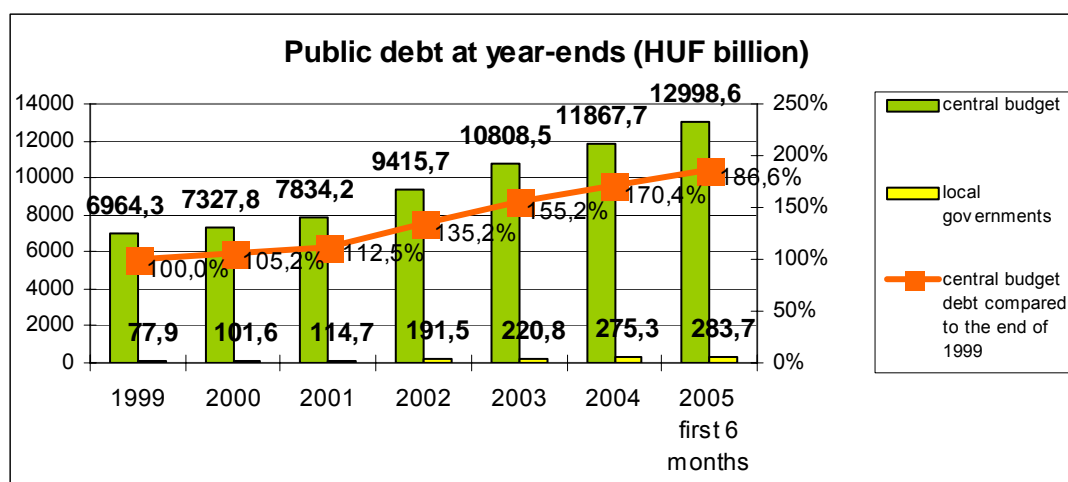
In the past four years, on average we spent one third of our capacity on auditing local governments. In relation to the aforesaid this supports our conclusion that we cannot postpone the comprehensive reconsideration of the system of local governmental task performance and resource regulation, including the content and extent of state tasks. After reviewing the tasks and powers of local governments, the financing and management system must be further developed in a comprehensive manner (including the complete revision of the system of subsidies), and the contradictions must be eliminated between the weight, proportion and funding possibilities of the mandatory and voluntary tasks of local governments.

All these issues assume and require the full reconsideration and clarification of the responsibilities and tasks of the state, and then the proper, practice-oriented regulation thereof.

## 2.1. Main findings classified by the subsystems of public finances<sup>7</sup>

### 2.1.1. Central budget

In 2004, the gross debts of the central budget continued to increase at a considerable pace, although the growth was slower than in the previous two years. Although the debt ratio of 57.0% compared to the GDP was lower than in the previous year, it was significantly higher than the debt ratio of 2001 and 2002. Within the public debt, the debts of the central budget are determining: they accounted for 97.7% at the end of 2004.



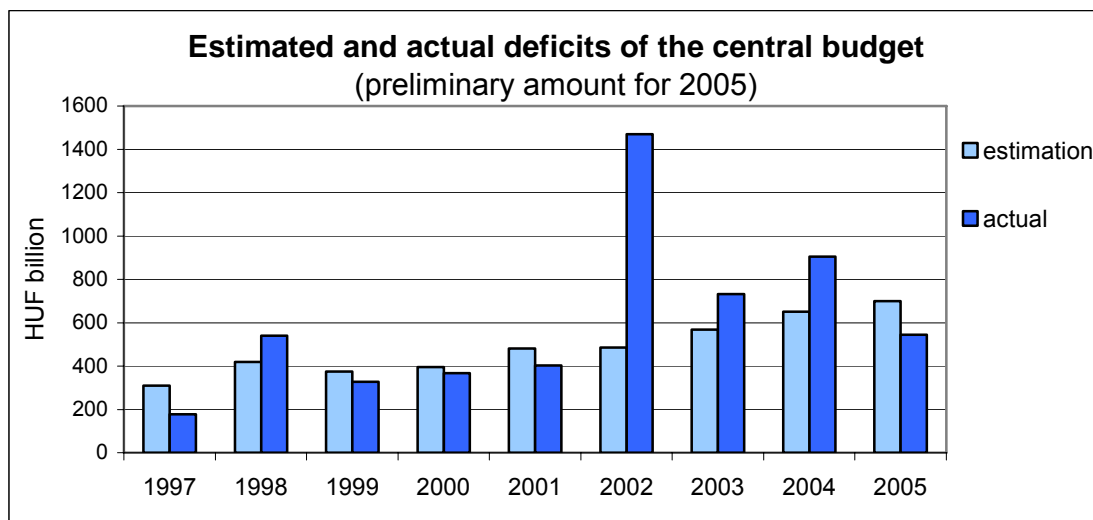
**The general government deficit, the major component of which is the central budget deficit, has become a central issue of the budget policy.** The growth of revenues could not, or could only partially counterbalance the amount of expenditures above the planned level. Except for year 2003, the higher than planned cash flow deficit of the budget was induced by the growth of expenditures exceeding the growth rate of revenues.

According to auditing the final accounts in 2005, the position of the central budget continued to deteriorate in 2004. The balance-sheet footings and deficits – similarly to the previous years – significantly deviated from the legally fixed and modified amounts alike. The higher than planned growth rate of the deficit, which has been continuously accelerating since 2002 compared to the GDP, somewhat dropped compared to the outstandingly high rate experienced in 2002, however it was still very high in 2003 and 2004<sup>8</sup>. Since 2002, the

<sup>7</sup> Due to their nature, the findings of the SAO audits pertain to a longer or shorter period preceding the audits, and the reports contain the figures for the closed financial years. Our report is based on the findings of the 2005 reports, however the trends and conclusions show beyond the budget years.

<sup>8</sup> In 2004, the actual total expenditure (HUF 6,237.6 billion) and the deficit (HUF 904.5 billion) increased the earmarked figures by HUF 63.0 billion and 218.2 billion, respectively, while the total revenue (HUF 5,333.0 billion) differed from the revenue appropriation by HUF 155.0 billion.

deficit/actual expenditure ratio has continuously and considerably exceeded both the original and the modified ratios (by 2.3 to 3.5 percentage points). Due to the increasing debts of the central budget, the amount of the interest – which also forms part of the deficit – has regularly increased, and its size determines and restricts the scope of action of the budget.



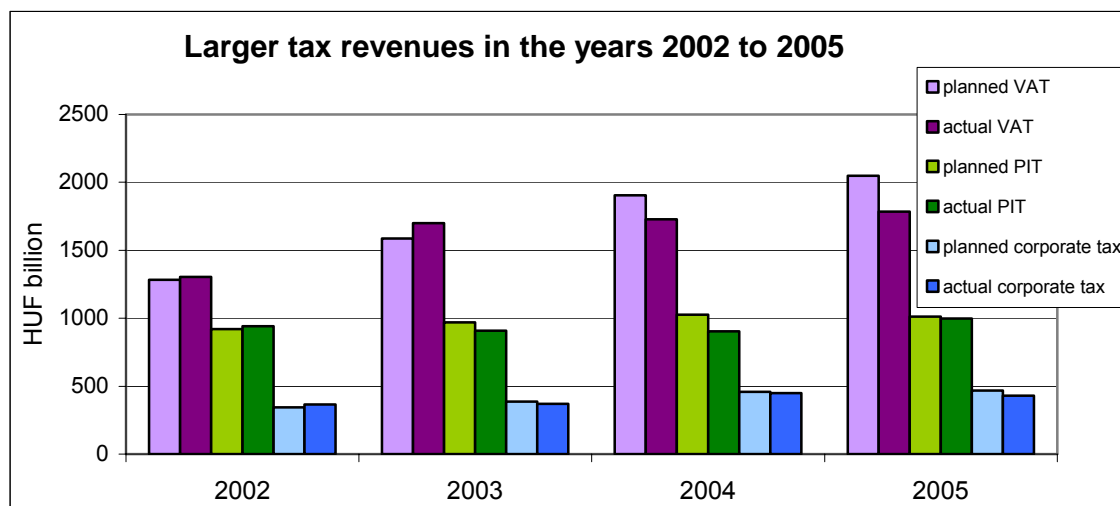
Subsidies provided for the central budgetary organisations and chapter managed appropriations fluctuated in the different years (77.6%, 78.8%, 75.8%), although they demonstrated a falling tendency. The central budget deficit was first of all linked to operational expenses that are expected to trigger neither future growth in revenues, nor cuts in expenditure. The balance of the central budget was significantly influenced by the deficit of the social security funds, which increased to HUF 423.9 billion (i.e. more than quadrupled) from 2002 to 2004.

The growth in the budget deficit occurred despite the fact that several austerity measures were taken from 2003 on to curtail expenses. In order to create the harmony between the tasks and resources, in certain areas of financial management resources were curbed on the basis of the so called “lawn mower” principle, and several finance-technical measures were introduced to improve the position of the budget of the given year. During the planning of the budget for 2005, restrictive measures aimed at creating the conditions for balance were given greater emphasis than at any time before. As a result of these measures, too, the deficit of HUF 699.7 billion calculated from the total expenditure and revenue was nearly one quarter less than the actual figure for the previous year.

However, the actual size of the deficit – which exceeds the “planned” deficit each year – indicates that the measures introduced to curb expenditure can only temporarily slow down the growth rate of the deficit, since neither a financially sound system of state tasks has been developed, nor has been the institutional system adequately revised. The complex reform of the entire system of public finances is equally urgent for compliance with the Maastricht criterion, which is indispensable for the introduction of the euro.



The fact that the legally prescribed cash flow deficit was significantly exceeded in 2004 was attributed to the joint impact of the less than planned revenues from the major tax types (VAT, Personal Income Tax, corporate tax), as well as of lawful payments made above the appropriations in the case of certain expenditure items. The position of the budget was especially deteriorated by the lower than planned VAT revenues. In terms of expenditures, the increase in the deficit was first of all caused by additional payments made under debt service, interest repayments, housing subsidies as well as subsidies paid on a case-by-case or normative basis.



All this reinforces our opinion about the budget appropriation bills of the former years that some of the major revenue appropriations of the budget are overplanned, and some of the expenditure appropriations – especially those that can be exceeded without the amendment of the budget – are underplanned<sup>9</sup>. The risks inherent in planning are even more increased by the fact that the current regulation pertaining to the mandatory supplementary budget<sup>10</sup> gives too much scope of action for the current government, and counteracts the efforts to “restrain” the deficit. This is why we have urged the restriction of the relevant legal provisions for three years now, but our efforts have yielded no success yet.

The 2004 measures that aimed at increasing the revenues, curbing the expenditures, and thus at reducing the deficit were unprecedented compared to the former years, yet they could not be regarded as steps leading to the consolidation of the central budget. The 2004 deficit was reduced by mandating the business organisations in majority state ownership to pay interim dividends, by the comprehensive audits of the VAT returns of

<sup>9</sup> Opinion on the budget appropriation bill of the Republic of Hungary for 2003 (0241), 2004 (0338) and 2005 (0449).

<sup>10</sup> In pursuance of § 41 (2) of the Act on Public Finances “the Government shall submit the National Assembly a supplementary budget bill in case the sum of the aggregate balances of the central budget, the social security funds and the separated state funds specified in the Act on budget differs from the approved sum by at least 5% of the total expenditure of these items.”

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businesses with EU tax numbers prior to the payment of the VAT, by the payment of the so called 13th month allowances in 2005, by the requirement to create mandatory reserve and the restriction of its utilisation, however these measures unfavourably influenced the 2005 deficit, i.e. their impact did not show beyond the two years in question.

**The series of measures that primarily focused on meeting the deficit requirements and yielded short-term results did not reinforce the implementation of the budgetary objectives**, the quality requirements of the performance of state tasks, the operation of the system of interests of the budget, and contributed to the growth of debts of the budgetary organisations. As a result of these measures and the deficiencies of financial management, the favourable tendencies observed in the debts of budgetary institutions in the previous three years did not continue in 2004. In fact, they came to a halt and started to move in the opposite direction in the second half of the year.

Changes in the structure of the chapters of the central budget and in the tasks and powers of the individual budgets were first of all related to the coming and going of governments.

In 2002 and 2004, the structure of the chapters of the central budget first of all changed in relation to the shift in governments, however some restructuring of tasks between the different chapters happened almost every year. The slight growth in the number of chapters (from 28 in 2002 to 31 in 2005) implies significant, sometimes repeated, restructuring of the content.

The comprehensive audits of the chapters also indicated the results of incorporating formerly divided, but coherent tasks in one chapter and the results of the establishment of chapters with more distinct profiles. **However, the establishment of new chapters and restructuring was not preceded by more in-depth analyses, calculations and studies about budgetary and human resources.** The Government's provisions about the operational conditions of the affected chapters and the regrouping of appropriations were incomplete and were made later than necessary. The changes made to the tasks and structure of the chapters during the year were not properly considered in terms of the sectoral and professional tasks to be performed, human resource management, or the economic financial and accounting processes. Interim restructuring adversely influenced the economic, financial and accounting processes alike, since the transfer of the material and personal conditions did not happen in each field, or if it did happen, it did so with unnecessary extra work or delays.

The implementation of the division of labour within the governance was usually not sufficiently prepared and organised within the affected ministries either<sup>11</sup>. The organisational structure of the "new" ministries was often modified even after the establishment of such ministries, partly because of the

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<sup>11</sup> Report on the audit of the operation of the "Ministry of Youth, Family, Social Affairs and Equal Opportunities" budgetary chapter (0568), Report on the audit of the "Ministry of Employment and Labour" budgetary chapter (0543).

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ad hoc and unjustified nature of the related measures, and sometimes because of personal changes. The harmony between the tasks and the organisation is lacking, or is developing only slowly.

Once we encountered the development of task and performance indicators that aimed to support the development of harmony between the tasks and staff of an audited institution.

The incomplete review of the state tasks and the institutional frameworks thereof, and the lack of harmony with the resources continue to be the tension points of planning and financial management. **The institutional reviews and downsizing performed in accordance with central measures did reduce the staffs of the managing organisations of the chapters, however they did not trigger adequate results, since in parallel with this, the staff of background institutions, outsourced non-profit companies and other companies usually increased.** It could be observed in several ministries that the difficulties of task performance arising from the shortage of staff were overcome via assignments and additional expenses. Outsourcing was usually not justified by preliminary cost-benefit analyses<sup>12</sup>. During the planning of the 2006 budget, the review and modernisation of the institutional system of the chapters was again a priority task. Continuing the practice of the former years, the chapters did not assume an active role in the implementation of these objectives within the framework of the budget planning process.

Our findings first of all draw attention to the fact that the downsizing of the governmental staff without adequate task analysis and differentiation does not contribute to the improvement of the conditions of the public finances.

In the light of auditing the final accounts, the system of rules and conditions of the financial management of the central budgetary organisations deteriorated despite the fact that the provisions of the Act on Public Finances became more and more stringent. **The restructuring of the government in the middle of the year, the regrouping of tasks and appropriations among the chapters, the – occasionally full – replacement of the staff that had adequate knowledge about the professional tasks, and the impacts thereof caused serious problems in the continuous and quality performance of the tasks.**

The financial management discipline keeps deteriorating due to the fact that the Ministry of Finance “traditionally” approves the appropriation reserve

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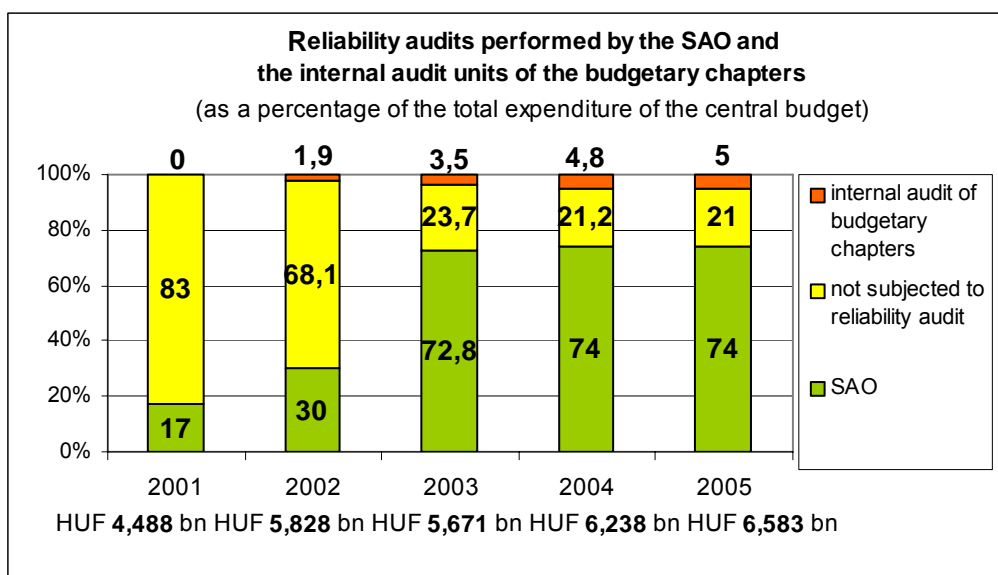
<sup>12</sup> Report on the audit of the operation of the “Ministry of Education” budgetary chapter (0534), Report on the audit of the operation of the “Ministry of Informatics and Communications” budgetary chapter (0532), Report on the audit of the system of state tasks performed by institutions outside public finances (0467).

formation beyond the legally set deadline, e.g. it approved the appropriation reserve for 2004 only in the middle of December 2005<sup>13</sup>.

**We performed the financial regularity audit to certify the reliability of the final accounts figures in line with the relevant provisions of the SAO's strategy.** We audited 86% of the total revenue, and nearly 74% of the total expenditure of the central budget for 2004.

At the internal audit units of budgetary chapters, the audit of the reliability of the institutional reports is conducted slowly, in a manner different for each chapter. The increased number of financial regularity audits performed by the chapters extended to 9% of the institutions.

Task performance is indicated by the fact that reliability audits conducted by budgetary chapters affected 1.9% and 4.8% of the total expenditure of the budget in 2002 and 2004, respectively. In 2004, the financial audit did not extend to 21.2% of total expenditure. This also means that in the case of audits carried out of budgetary chapters there is great uncertainty in the application of the standard methodological theory and practice, as well as in terms of harmony between the external and internal audit activities. On the surface all this manifests itself in the form of citing capacity and resource shortage as a cause.



Further serious efforts must be made by the Government to create the conditions for the comprehensive audit of final accounts by 2010 in pursuance of parliamentary resolutions, the Act on Public Finances and the relevant government decree. It will then become possible for the SAO to certify with a professional declaration towards the National Assembly that the report on the execution of the budget is real and reliable.

<sup>13</sup> The appropriation reserves for 2001, as well as for 2002 and 2003 were approved by the Ministry of Finance in November 2002 (well after the legally set deadline) and in the December of 2004, respectively.

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The lax discipline of financial management and accounting is indicated by **the findings of the reliability audits that are less favourable than a year before**, and the high ratio of negative opinions<sup>14</sup>. Financial regularity audits that were concluded with qualified opinions first of all revealed major problems in relation to the authenticity of the financial position shown in the balance sheets of public administration legal titles, institutional groups and chapter managed appropriations, as well as the utilisation of budgetary resources for purposes other than earmarked in the case of the latter.

According to the findings of our survey aimed at auditing the level of regulation of internal audit functions and procedures, and the level of development of the systems, as well as according to the findings of audits carried out by budgetary chapter, **the control systems of the ministries were not efficient enough**. This first of all manifested in the fact that the deficiencies revealed during the audits were recurrent, and the measures necessary for the elimination thereof were often not implemented. In most institutions the inadequate regulation and operation of the IT environment pose a high risk in the internal audit system. IT deficiencies can first of all be found in the field of security policy, the IT security regulation and property protection. The internal audit systems of budgetary chapters and institutions reduced the control risks only to a limited extent.

The control mechanisms of budgetary chapters that were not or were only slightly affected by governmental restructuring typically created improving conditions for the regular financial management of the ministries and for monitoring the property elements.

Based on the findings of performance audits conducted in relation to chapter managed appropriations it can be generally concluded that **at the subsidy paying agencies the system of subsidies was not linked to a standard monitoring system, no performance requirements, criteria or result categories were defined**. Therefore, when evaluating the utilisation of budgetary subsidies the SAO could only rely on whether the objective formulated in the invitation for tenders was met or not.

We placed special emphasis on the audit of the experiences of the first year of Hungary's EU membership during the audit of the final accounts, too. We concluded that Hungary's contribution to the community budget was fulfilled in accordance with the schedule and instalments prescribed by the European Union. **The lack of invitation and submission of tenders in line with**

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<sup>14</sup> As a result of financial regularity audits conducted at nearly 100 institutions of the budgetary chapters by the SAO and the supervisory organisations of the budgetary chapters, adverse opinion were issued in case of 8.7%, qualified opinion were issued in case of 21.7%, and an opinion including the emphasis of matter were issued in case of 21.6% of the reports of the institutions. Adverse opinion were issued in case of 22.2%, qualified opinion were issued in case of 11.1% and an opinion including the emphasis of matter were issued in case of 44.4% of the reports prepared on chapter-managed appropriations

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**the EU requirements continues to be a weak point of the utilisation of EU funds<sup>15</sup>.**

The planning of the 2006 budget was carried out in less favourable conditions than in the previous years; the planning methods did not develop. The deadlines set in the Act on Public Finances for the process of budget planning were not met. The Ministry of Finance issued the planning circular in September, as a result of which the chapters could start the planning process one and a half months later than in the previous years.

Due to the lack of continuation, the “competitive bidding” method developed for chapter planning and applied in the previous year could only be considered as an experiment. The development of performance indicators that lay the foundations for normative financing, and planning based on evaluating analyses have not yielded success to date.

**The transparency of the planning and utilisation of public funds is hindered** by the fact that the exact content, structure and compilation methodology of the budget and final accounts bills are not defined. We point this out year after year – albeit with little success. The general explanation and its annexes, the presented data content and the time series change year after year. For the lack of certain figures and statements it is not always possible to determine whether the relevant requirements of the Act on Public Finances were met or not. The figures for the different years are hardly comparable, and it is extremely difficult to follow the changes in the ratios.

Well-founded decision-making – as well as the SAO’s opinions meant to support such decision-making – was also hampered by the fact that liabilities spanning several years are not summarised in the proposals with sufficient transparency or detail, wherefore the impacts of running or planned Public Private Partnership (PPP) projects that play an important role and involve multi-year liabilities cannot be assessed<sup>16</sup>.

However, the findings of the audits of PPP schemes also shed the light on the fact that **the development and service cooperation between the public and the private sectors imply high risks as long as the proper methodology for efficiency calculations, a legally binding rules of procedure indispensable for implementation**, as well as an organisation responsible for coordination, evaluation and control are missing.

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<sup>15</sup> Report on the audit of the execution of the 2004 budget of the Republic of Hungary (0540).

<sup>16</sup> The 2005 bill did not present in full the appropriations of expenditure items implying multi-year liabilities in pursuance of § 36 (1) c) of the Act on public finances. In the main volume of the budget bill for 2006 compliance with this requirement either failed or was only partial.

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### 2.1.2. Separated state funds

The number of funds with separate finances within the system of public finances continuously grew from 2003, until it reached six in 2006 (together with the Wesselényi Miklós Flood and Inland Waters Compensation Fund, the Research and Technology Innovation Fund, the Homeland Fund, and the National Cultural Fund). This process is not in harmony with the budget policy decision of 1998 aimed at the radical reduction of separated state funds and at the strengthening of the sector managing function of the chapters, on the basis of which some of the funds were integrated as chapter managed appropriations into the budgets of the ministry that managed said funds. At the same time, the legally set objectives and tasks were left untouched.

In the light of experience, the establishment of the new funds was not always well thought over. The realisation of the legally set objectives of the funds is hampered by the fact that the allocation of resources to their respective tasks heavily depends on the position of the central budget. All this raises **the need for a complex review of the system of budgetary funding for sector specific tasks based on the impact assessment of the possible forms of solution**. The individual funds are managed and their financial processes are realised in different organisational structures (chapter, ministerial department, budgetary organisation, non-profit company), and the mechanisms for setting the service charges and distributing the resources also differ from fund to fund.

The financial statements of the separated state funds are audited by chartered accountants in line with the legal regulations. Pursuant to the audits, unqualified opinions were issued in case of all financial statements of these funds operating in 2004.

The audit methodology of the separated state funds and the social security funds differ from the practice followed by the SAO. As a result of the SAO's reliability audits, the content issues of the execution of the budget are also highlighted. So that the SAO could qualify not only the reliability of the central budget, but also that of the final accounts of the state budget – which was raised in the report on the SAO's activities in 2004 – it would be reasonable to reconsider the current regulation.

The weight of this subsystem within the state budget increased due to the growth in the number of funds, and the total sum of their revenue and expenditure, but the increase was proportionately not significant (HUF 233.8 billion in 2002 – 2.7%; HUF 304.7% in 2004 – 3.1%).

The financial condition of the separated state funds can still be regarded balanced, and their surpluses realised in certain years improved the balance of public finances. The Labour Market Fund's cash flow balance of nearly minus HUF 3 billion in 2004 – instead of the planned "breakeven" point – decreased the reserves accumulated in the previous years, but it did not cause liquidity problems.

Similarly to the previous years, in 2006 the separated state funds could plan their expenditures so that they would not exceed their revenues, i.e. reach a "breakeven" position. (The Central Nuclear Financial Fund was an exception to

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this rule, where the balance was planned with surplus revenues in order to finance long-term tasks.) In relation to the general government deficit we did not sense risk factors in the budget bills of the funds.

In terms of budget size, the **Labour Market Fund**, which accounts for 80% of the subsystem, is the largest among the separated state funds. It fulfils the state tasks related to the promotion of employment and the management of unemployment through the national network of labour organisations. The total expenditure of the Labour Market Fund increased by 10.6% from 2002 to 2004 (to HUF 244.6 billion). The appropriation for 2005 is HUF 278.7 billion.

A priority task is the enhancement of employment and the activity of the population in the labour market, however this did not manifest in the proportions of active and passive employment policy tools, in the final accounts figures for 2004, or in the planned figures for 2006. In 2005, the number and ratio of registered unemployed people increased (especially among young entrants to the labour market and people near the retirement age). This also contributed to the fact that the volume and proportion of active and passive employment policy tools financed from the fund changed for the benefit of the latter. More and more money from the fund is spent directly or indirectly on the operational expenses of organisations that are linked to the Labour Market Fund by performing its tasks and by participating in the distribution of its financial assets (13% in 2004).

Together with the system of objectives and tools of the gradually transforming employment policy, the structure of the fund's expenditures also changed. However, the changing labour market processes were not accompanied by the review of the legislative background of the supporting and service providing activities. The changes justify the review of the planning system and legislative background of the fund, including the elaboration of a separate law on the Labour Market Fund. We emphasised the need for such law in the report on the SAO's 2004 activities, too.

The right of disposal over the **Central Nuclear Financial Fund** changed twice in 2003 and 2004, in line with the changes made to the supervisory body of the National Nuclear Energy Agency. The first change was made upon the EU recommendation for the separation of the supervision of entities in charge of high priority tasks at the level of the authorities, and then in relation to the restructuring of tasks within the governance. The operation of the fund was not significantly influenced by the modification of the right of disposal. The appropriations of the fund were observed: in 2004, the fund's revenues equalled HUF 27.6 billion, which is 60% higher than the amount yielded in 2002. However, the legal regulation pertaining to the utilisation of the fund did not make it possible to support infrastructure development within the settlements, which would have won the confidence of the population.

The fund's revenues mainly come from payments made by the Paks Nuclear Power Plant Ltd., and the stability of value must be ensured with budgetary subsidies. The subsidies supporting the stability of the fund's value did not follow the schedule contained in the medium and long term plans, which was partly due to the annulment of the relevant legal provision between 2001 and 2003. The unpaid subsidies will be paid time-proportionately by the Paks Nuclear



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Power Plant Ltd. by 2017. The objectives of the fund played a subordinate role in the planning process of the state budget. In the planning process of the budget the Ministry of Finance has approved less than necessary appropriations for investment purposes, especially since 2004. The restriction of the expenditures increased the liquid assets of the fund, which improved the opinion about the general government deficit.

As a result of the developments that have been carried out, the disposal of radioactive waste is taken care of in the short run. However, due the cap on the appropriations for investment purposes, the development projects aimed at the final disposal of such wastes have been postponed. The delay may entail larger costs and the unjustified expansion of the temporary depot. The accounting order of the non-profit company in charge of the fund did not make it possible to compare the expenditures with the corresponding appropriations of the Act on budget, wherefore we could not evaluate the cost-efficiency of the performance of state tasks by a non-budgetary organisation.

The **Wesselényi Miklós Flood and Inland Waters Compensation Fund**, which was set up to mitigate the damage that the population incurred due to floods and inland waters, started its actual operation only in 2004. However, the findings seem to justify those doubts that we raised already in the report on auditing the 2003 final accounts. In spite of the expectations, the residents living in the endangered areas have not yet been involved in the mitigation of damage on the basis of the principle of insurance. The main reason behind this is the lack of effective demand and the ability of self-support, as well as the fact that the residents concerned expect to rely on state support. For the time being we do not see any chance for increasing the number of customers. This is why we proposed to review the need to maintain the fund. According to the 2006 budget, the Wesselényi Miklós Flood and Inland Waters Compensation Fund fulfils the operational criteria prescribed for fund only formally, its own revenues are insignificant for making payments in connection with the fund's task, in fact, they cover only a fraction of the operational costs.

The **Research and Technology Innovation Fund**, which aims at supporting the innovative activities of businesses, yielded HUF 35.4 billion in revenues in 2004. The operation of the fund has so far not justified the reason for which it was established. The objective of the fund, i.e. the utilisation of its resources in the economy in the form of support and incentive to innovative activities, has not been achieved. Most of the financial assistance was granted to budgetary institutions. In the light of the experiences gained in 2004 and 2005, we do not believe that the appropriations for 2006 will be reasonably utilised. In 2004, the fund's financial status was stable. However, its operation in the future is largely influenced by changes affecting its revenues, such as the temporary revocation of the guarantee rule pertaining to the extent of budgetary subsidy, and the expected elimination of the local business tax, which serves as a source for the innovation contribution.

The **Homeland Fund**, which is designed to support various objectives of ethnic Hungarians living outside the borders of Hungary, started to function in the second half of 2005, wherefore we can form an opinion thereon only in the coming years.

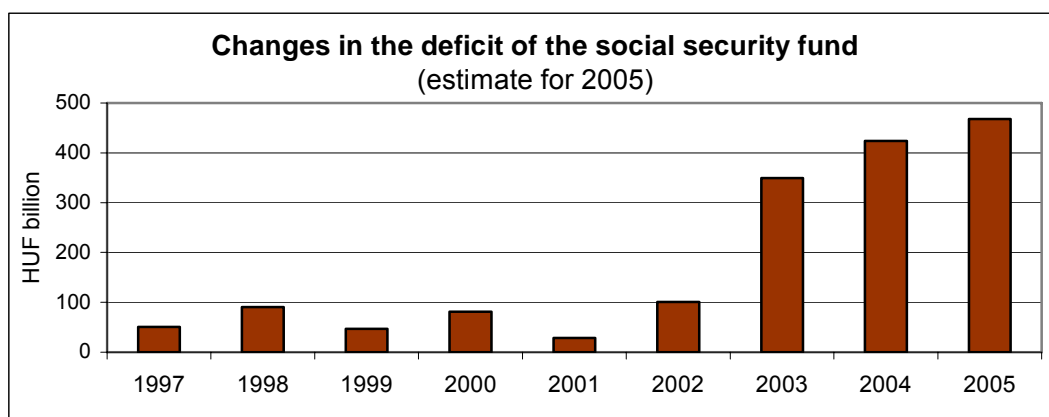
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### 2.1.3. Social security funds

The financial statements of the Pension Insurance Fund and the Health Insurance Fund that form the social security subsystem of public finances were audited by chartered accountants in 2004, too, in compliance with the legal provision. According to the unqualified opinion, reports give a true and fair view on the financial and earnings position of the funds.

The total expenditure of the social security subsystem of public finances grew at a rate and amount higher than that of revenues between 2002 and 2004, and this tendency was reflected in the figures planned for 2005, too<sup>17</sup>. **The financial condition of both funds deteriorated more unfavourably than planned, similarly to the previous year.** The deficit of the funds typically grew dynamically, it quadrupled compared to the 2002 level, and its ratio to the GDP is increasing, too. Within the funds, the deficit of the Health Insurance Fund was paramount (HUF 86.7 billion in 2002 and HUF 343.7 billion in 2004), which was caused by the reduction of contribution rates (revenues) and the lack of replacement of lost resources from the central budget. The deficit of the Pension Insurance Fund was smaller, although increasing (HUF 14.2 billion in 2002 and HUF 80.2 billion in 2004), which was triggered by the lower than needed compensation from the central budget to offset the reduction of the contribution rates and the introduction of the pension reform.

The settlement of the deficit was provided for by the Act on the final accounts in the form of remission, in line with the current practice. In connection with the permanent problems of the balance of the Health Insurance Fund we have pointed out for years that the requirements of the Act on Public Finances aimed at the restoration of the balance of revenues and expenditures have not been enforced<sup>18</sup>.



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<sup>17</sup> In 2002, the expenditure and revenue of the social security funds totalled HUF 2,517.1 billion and HUF 2,416.2 billion respectively. The same figures for 2004 were HUF 3,150.8 billion and HUF 2,726.9 billion. The expenditure and revenue appropriations for 2006 are HUF 3,376.0 billion and HUF 3,043.3 billion, respectively.

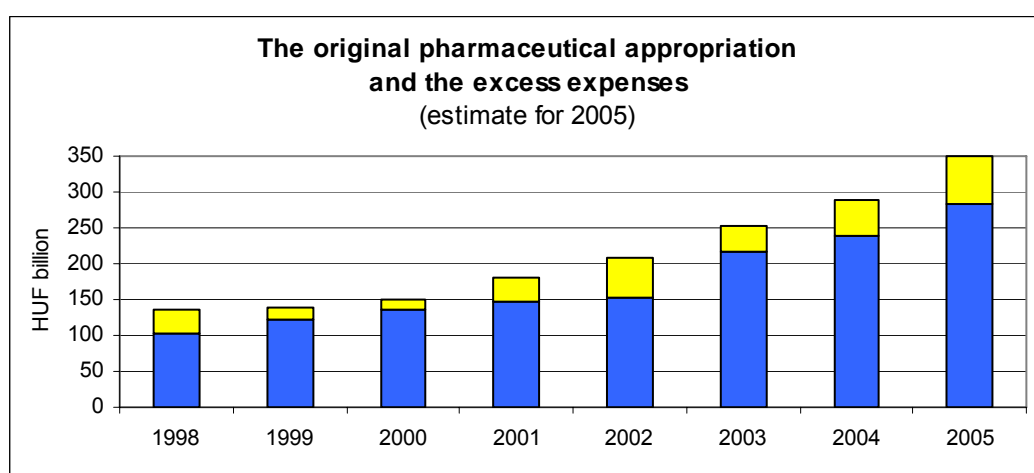
<sup>18</sup> This requirement was annulled as of January 1, 2006.

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The lower than planned contribution revenues of the funds were primarily due to the fact that the growth of the gross earnings mass was also lower than expected. At the same time, however, in the case of certain legal titles the expenditures exceeded the planned values. In our opinion formed about the budget appropriation bills we have repeatedly drawn attention to the recurrent underplanning of the major expenditure appropriations of the social security subsystem, and the risks of performance.

In 2004, less money was spent on financing therapeutic and preventive healthcare services from the **Health Insurance Fund** than planned. "Savings" were partly attributed to the governmental measures in March (freezing of funds), and partly to the fact that year-end reserves were not distributed among the healthcare service providers, proportionately to the level of performance. During the year, the forint value of the performance units significantly increased, which was due to the incorporation of the coverage of pay measures implemented in 2002, and the introduction of the performance/volume limit introduced in 2004.

**The pharmaceutical expenditure appropriation continued to be insufficient. Pharmaceutical subsidies continue to be the neuralgic point of healthcare.** The appropriation was exceeded at the legal title "pharmaceutical subsidies to outpatients". The growth in expenditure was probably not triggered by the quantitative growth of medicine consumption, but rather by the consumption of new, expensive drugs, the changes in prices and the level of subsidy, as well as the prescription habits of the physicians<sup>19</sup>. The successful implementation of state measures aimed at influencing drug consumption, the reduction of the pace of growth of drug expenses was hampered by the lack of fundamental regulatory and registration conditions. The activities of the central organisations involved in setting the prices and the rate of subsidisation were not adequately coordinated. Legal regulations did not specify unambiguously the prices and the related subsidies.

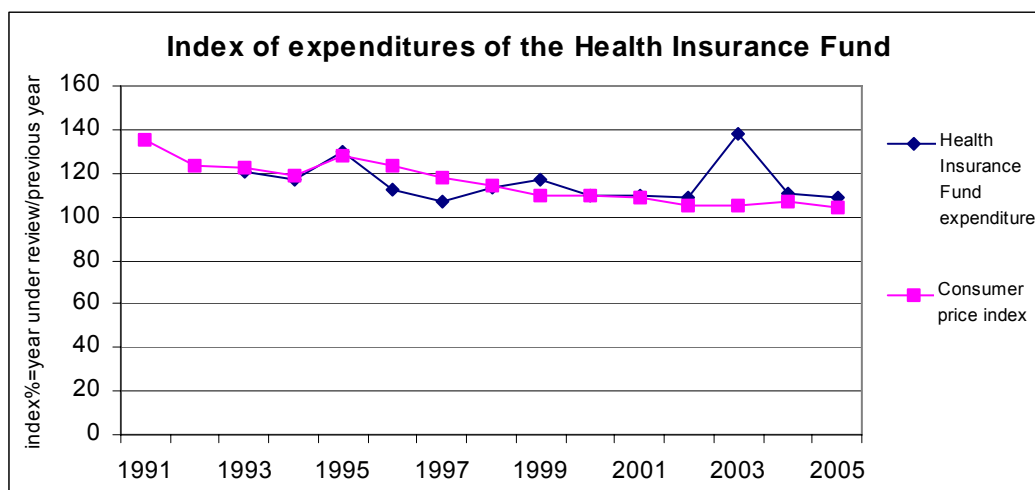


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<sup>19</sup> Report on the audit of the system of subsidies and financing of pharmaceuticals, and on the status of consumption (0448).

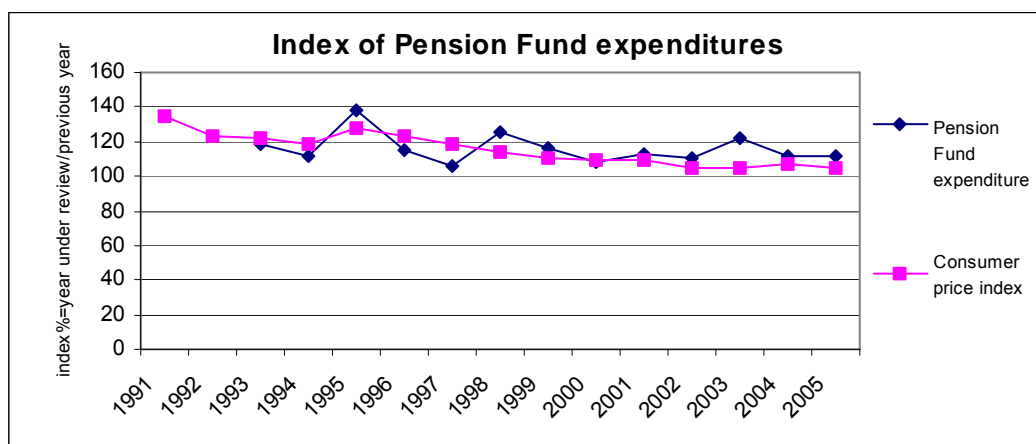
The measures taken in 2004 to curb the growth of pharmaceutical subsidies did not yield the expected results. The freeze on the prices of drugs introduced in March was ruled unconstitutional by the Constitutional Court. The renewal of the contracts between the Hungarian State and the drug manufacturers/distributors until the end of 2006 was aimed at the stabilisation of the system of subsidies. The terms and conditions of the contract were only partially implemented already in relation to the year 2004, wherefore we recommended the comprehensive audit thereof. Our experience shows that the contract will not necessarily be appropriate for the development of a firm system of subsidies in the longer run.

**The 2006 budget of the Health Insurance Fund planned with a deficit implies several risks.** It is probable that a worse financial position will emerge due to the overplanned amounts of contribution revenues and the underplanned amounts of several expenditure items. The appropriation for therapeutic and preventive healthcare services that can be used without limitation is smaller than the amount of the expected performance in 2005, which poses a risk by itself. The greatest change in the financing of therapeutic healthcare services is the development of an integrated specialised healthcare fund. The appropriation for pharmaceutical subsidies is also considered uncertain, partly due to the agreement with the manufacturers, and partly due to the measures aimed at influencing drug prescription and consumption practices. (Efforts made in the latter issue have not been successful yet.) The SAO questions the fulfilment of the subsidy appropriation, which is significantly lower than it was in 2005.



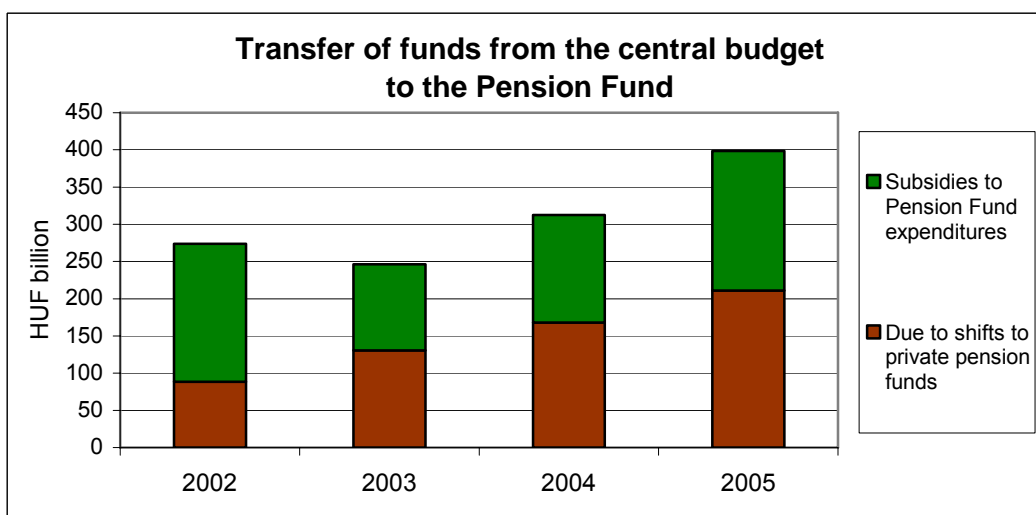
The higher than planned growth of pension expenditures at the **Pension Insurance Fund** was due to the additional expenses related to the supplementary pension raises, the underplanned automatic measures, the further increase of the paid amount of pensions for the 13th month, as well as the continuing effects of pension raises introduced on an equitable basis. **The 2006 balance of the Pension Insurance Fund implies significant risks in term of balance.** The determination of the expected size of pension expenditures is not well-founded, since the planners did not consider the financial impacts of the supplementary pension raise implemented in November 2005, they did not take into account the quantitative impact of the

already approved increase of the survivor's pension, and nor did they count with the changes in the composition of pensioners.



The experiences of the past few years well characterise the provisions of the budget act of 2006 despite the fact that balance improving measures were taken for the social security funds at the expense of the central budget. This means that the central budget assumes responsibility for the provision of healthcare service to a certain group of the population.

We found that in both funds the revenue appropriations from contributions were overplanned, while the expenditure appropriations were underplanned in several items (e.g. pension expenditures, pharmaceutical expenditures).



**The 2006 budget also reflects that the reform of the large provision systems of public finances did not make any progress despite the repeated efforts of the Government.**

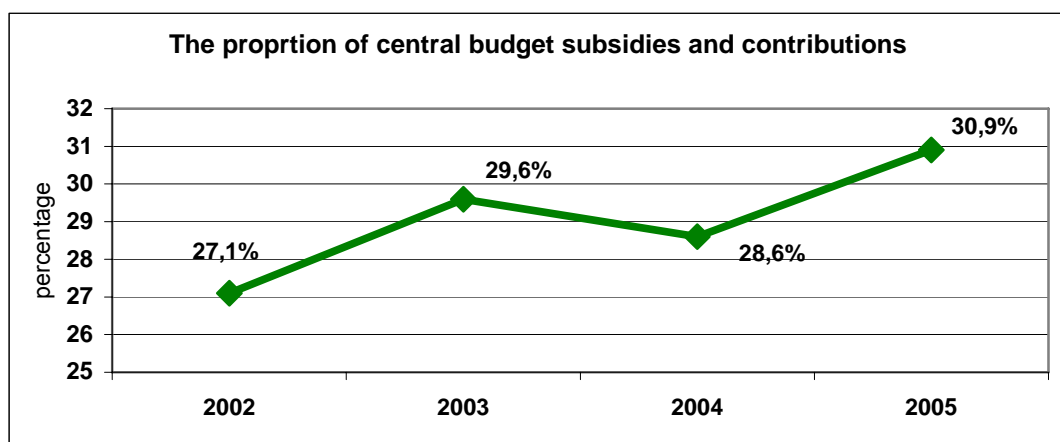
Acceleration of the reform is all the more justified because with the continuous growth of the budget deficit, the ratio of expenditures allocated to these systems is practically constant, which means that the operation of the system in the current structure is becoming more and more costly.

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#### 2.1.4. Characteristics of the financial management of local governments

While the expenditures of local governments were growing at a constantly high rate, their ratio compared to the GDP practically remained the same (13.6% in 2004).

The amount of state contributions and subsidies increased by 24% between 2002 and 2004 (they totalled HUF 769 billion in 2004). However, the ratio these contributions and subsidies represent in GFS type expenditures decreased in 2004 due to the higher growth rate of local governmental expenditures. (According to the budgetary appropriations for 2005, the subsidies are expected to rise proportionately).



In the past ten years, the property of local governments according to the books increased by nearly ten times, the gross asset value totalled HUF 9,618 billion in 2004. The decade-long growth process came to a halt in 2004. The considerable increase in assets in 2002 and 2003 was the result of the review of the cadastre of real property, the inclusion of local government owned real properties into the stock, as well as the simultaneously completed evaluation. The number of real properties registered without assigned value decreased to one tenth, i.e. from 580,000 to 51,000 since 2001.

The expenditures of the 3,187 local governments and 1,827 local minority governments in 2004 (HUF 2,690 billion) increased the expenditures incurred in the previous year by 6.2%, while the revenues (HUF 2,673.5 billion) were 6.9% higher than in 2003. In 2004, the expenditures of local governments exceeded the revenues by HUF 16.5 billion, wherefore the deficit shows a better position than in 2002 (HUF 117 billion). However, the deteriorating economic position of local governments is indicated by the fact that the deficit is expected to grow again according to the appropriations for 2005 and 2006 (HUF 31.8 billion and HUF 34.8 billion, respectively).

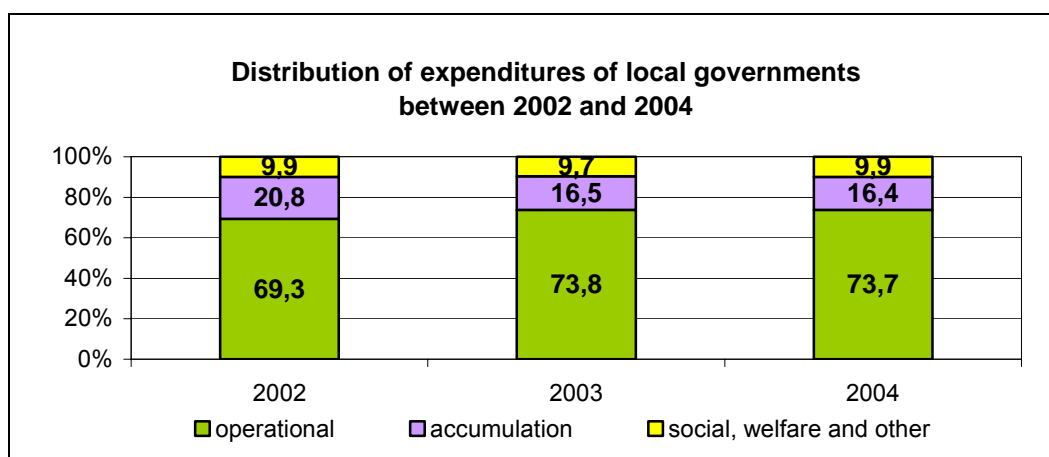
**The system of local governmental resource regulation and support underwent only minor modifications.** Income centralisation continues to be strong, while tasks, scopes and responsibilities are decentralised. **The elaboration of proposals for the development of resource regulation,**

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**and the review of the required local governmental tasks and powers pursuant to the relevant government decrees are still to come.**

Despite this fact it can be regarded as an achievement that upon the SAO's repeated proposal, the division of the personal income tax was modified in 2003: the freely usable ratio grew from 5% to 10%. The local governmental revenues were also positively influenced by the fact that the entire revenue from the motor vehicle tax was allowed to be used locally. While the 2004 budget primarily focused on cost-saving and efficiency enhancing measures to be implemented at local governments and their institutions, the regulation for 2005 promoted task proportionate funding and in some places the simplification of administration. In the system of normative contributions – in the field of public education – the development of a more efficient network of institutions is encouraged by supplementary contributions. In the field of social care and child welfare part of the general normative contributions were replaced with contributions linked to concrete tasks, which promotes the allocation of resources to those local governments that actually perform the given task.

**It is an unfavourable phenomenon that the operational expenses tie up a growing part of expenditures for the year under review,** and the ratio of funds for accumulation purposes decreased. The ratio of social and welfare allowances, and other expenditures was practically constant in the period between 2002 and 2004.



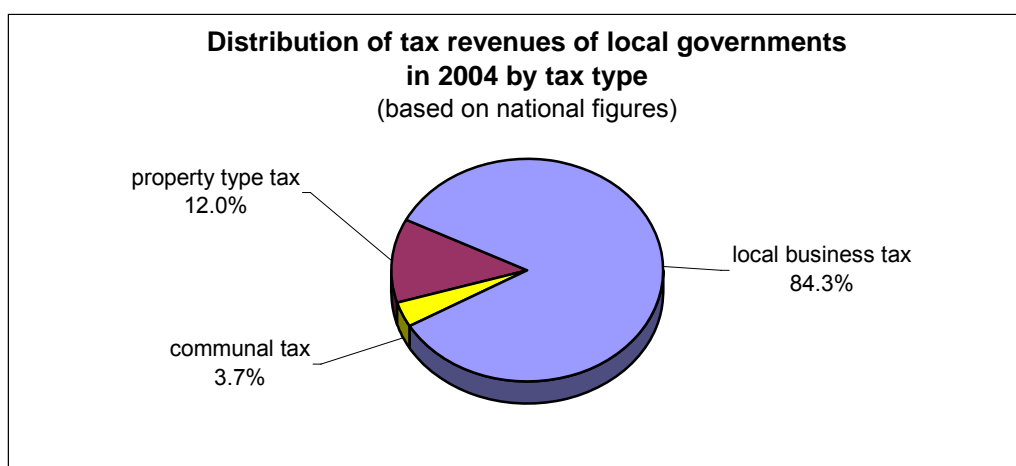
Within the operational expenses, the growth of personal expenses was determining in 2002 and 2003, as an ongoing result of the increase of personal allowances, including the 50% increase in the salaries of civil servants. However, in 2004 the growth of actual costs exceeded both inflation and the salary increase. This was due to the growth in expenditure triggered by operational purpose VAT expenses and the growth of natural gas prices.

In 2004, the goal was to retain the real value of earnings. The planned earnings growth equalled the inflation rate of 6%. The central budget provided 4% of the required resources, the rest had to be generated by local governments. Since during the year the earnings did not change as planned, local governments received HUF 2.5 billion from the 2004 central budget to increase the earnings of civil servants they employed. According to the plans,

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the funds required for the 6% pay rise planned for 2005, and the “reimbursement,” of earnings for the 13th month had to be provided for with local measures in public administration. The central budget provided 5.5% of the resources required for the 6% pay rise of civil servants.

**Due to the drop in subsidies and their real value, local governments made efforts to increase their own revenues.** The ratio of own revenues did not change considerably between 2002 and 2004 (26% and 28%, respectively). Within the own revenues a significant source of income was the local tax. In the period between 2002 and 2004, local tax revenues increased by 23.7%. (They totalled HUF 367.2 billion in 2004.) This favourable tendency could occur in part due to fact that the number of exemptions and discounts was reduced, the upper tax rates increased, and certain items and rates were valorised. As many as 97% of the audited local governments used the opportunity to impose local taxes. They most often decided to levy local business taxes and communal taxes on private persons. Similarly to the previous years, 84% of the local governments’ tax revenues came from the local business tax. Our audit experience shows that local governments of towns can increase their own revenues in certain fields – albeit only to a smaller extent.



**The budget balance of local governments did not improve in 2004.** Financial management was hindered by the fact that local governments also had to contribute to the formation of reserves designed to improve the general government balance, which was set at HUF 11 billion and HUF 22 billion in 2004 and 2005, respectively. The unfavourable shift in the balance was entailed by the assumption of excessive liabilities, the low level of utilisation of certain institutional capacities, the unreasonable organisational structure of task performance, as well as by the drop in the population and the number of children. In order to improve the balance, local governments with deficient resources increasingly introduced austerity measures: they reduced their operational expenses and accumulations, the number of employees, and decided about the restructuring, merger, or occasionally about the liquidation of certain institutions.

In order to increase revenues, nearly 90% of local governments with deficient resources sold some of their property. However, in the past years nearly two

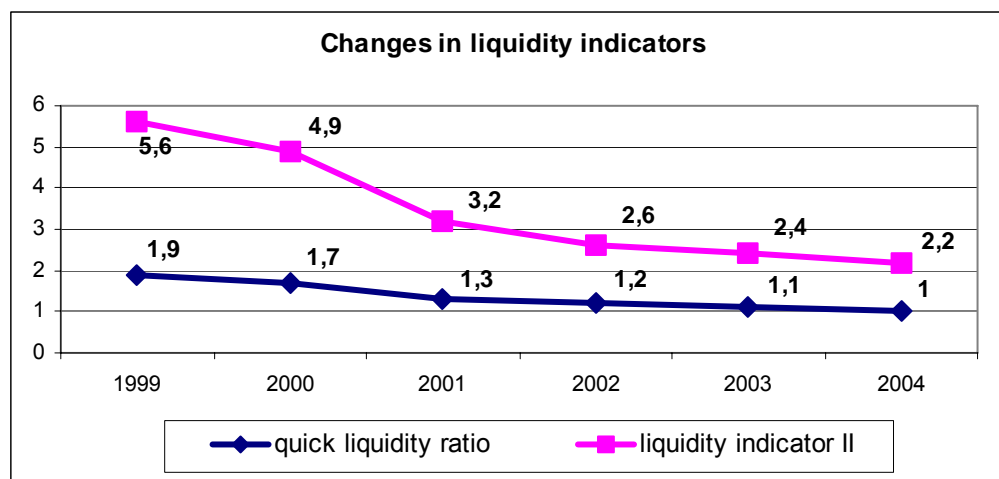


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thirds of the audited local governments kept violating the obligation to examine the upper limit of debt generating responsibilities as specified in the Act on local governments before making any such decision.

The local governmental liabilities totalled HUF 305.3 billion in 2004 (without liabilities arising from the transportation of goods and without other short-term liabilities), which is higher than the liabilities of the previous years. **The high level of liabilities means that local governments could meet their public service obligations only with the help of external resources.** As much as 77% of the liabilities were long-term liabilities. It is noteworthy that in the same year the growth rate of short-term borrowings was 7% higher than that of credits taken for investment and development purposes a year before.

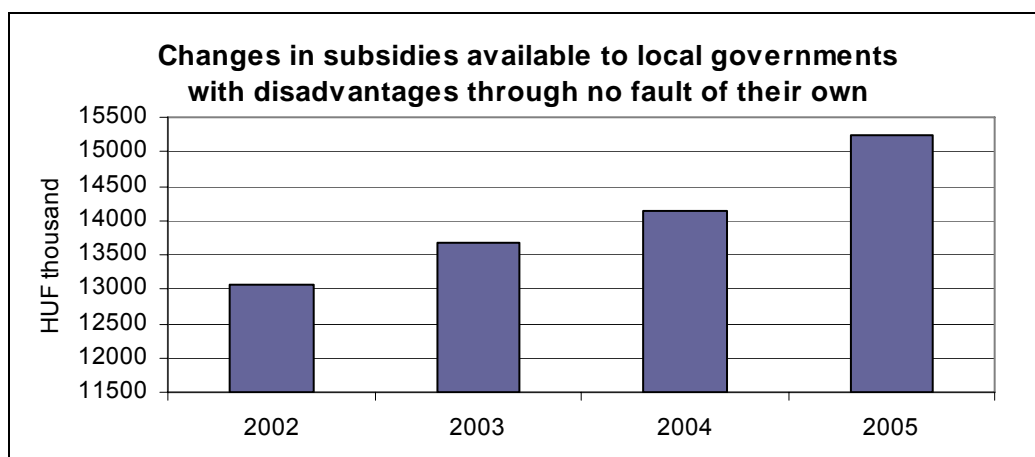
The deterioration of the financial condition of local governments is indicated by the liquidity indicators the value of which continuously dropped in the period between 1999 and 2004<sup>20</sup>.



The number of local governments with disadvantages through no fault of their own (ÖNHIKI) that received financial assistance dropped from 1,279 in 2002 to 1,118 in 2004, while the subsidies were also slightly curbed. In 2002 and 2004, ÖNHIKI subsidies totalled HUF 16.7 billion and HUF 15.8 billion, respectively. This collectively resulted in the increase of subsidies per local government from HUF 13 billion in 2004 to HUF 14.1 billion in 2004. (According to the preliminary figures, the amount of subsidy per local government grew to HUF 15.2 billion in 2005.)

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<sup>20)</sup> Quick liquidity ratio (liquid assets/short-term liabilities), liquidity indicator II (liquid assets + receivables + securities/short-term liabilities).



In 2004, more than 50% (574) of the local governments receiving ÖNHIKI subsidies were required to repay some of the subsidies. Repayable subsidies equalled HUF 1,147.2 million, i.e. 7.3% of the utilised subsidy<sup>21</sup>. The repayment obligation mostly arose in relation to the generation of own revenues, rather than in connection with the additional need for normative support, but was also affected by the change of the system of conditions serving as the basis for application in a manner different from the plans. As a result of the increased repayment obligation compared to the previous year, the applications for financial assistance became more substantiated and local governments demonstrated a more law-abiding conduct.

### ***General findings of local governmental audits***

In 2005, the SAO conducted on-site audits at 1,031 local and at 71 local minority governments, i.e. the volume of audits was similar to that of the previous years.

Similarly to the previous year, in 20% of the local governments the mayors submitted the draft budget decree to the council after the legally set deadline. Similarly to the former practice, most of the local governments did not attach the opinions of the financial committees to the submitted drafts. Nearly one fourth of the local governments did not itemise the operational appropriations according to budgetary organisations, did not present the budgets of the minority local governments separately, and did not present the appropriations for tasks with long-term impacts in a yearly breakdown. In violation of the provisions of the Act on Public Finances, they presented the revenues and expenditures of financial transactions for funding purposes as budgetary revenues.

Similarly to the former years, more than half of the audited local governments failed to meet the legal provisions on the frequency, deadline and registration of the amendments of appropriations during the interim amendments of the

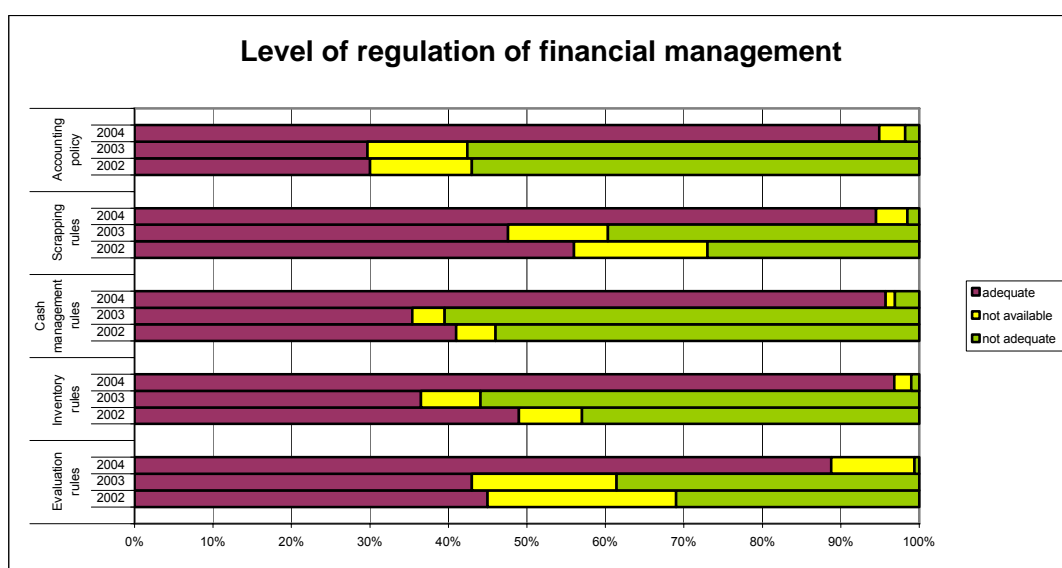
<sup>21</sup> Report on the audit of the execution of the 2004 budget of the Republic of Hungary (0540).

budgetary appropriations. More than two thirds of the local governments did not possess analytical registration on the basis of which the amount of liabilities could be determined. This also contributed to the fact that nearly 50% of the local governments assumed liabilities over the approved appropriation. Local governments did not investigate the causes behind the irregular utilisation of the appropriations, and similarly to the former year, they did not initiate disciplinary measures for exceeding the appropriations.

Most of the audited local governments complied with their obligations to prepare financial statement and provide data prescribed by the law. The chairmen of the county general assemblies and the mayors submitted the draft decree on the final accounts to the general assemblies and the council by the legally set deadline. However, nearly one fourth of the submitted drafts could not be compared with the budgets; there were discrepancies between the original appropriations of the final accounts and the report, as well as between the final accounts and the amended appropriations. Two thirds of the submitted drafts did not contain the balance sheets and statements that should be presented for informative purposes at the submission of the budget and the final accounts in pursuance of the Act on Public Finances.

The book-keeping obligations were fulfilled by 96% of the mandated local governments. The chartered accountants issued a qualified opinion in case of 6% of the financial statements of the audited local governments.

In terms of the **level of regulation of financial management** it can be criticised that half of the mayors' offices did not have Operational and Organisational Rules, and task assignment was incomplete. Within the audited local governments, the **number of local governments that prepared regulations in pursuance of legal provisions significantly grew and the quality of regulation improved** in 2004 compared to the previous years.



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**The decision-making and responsibility levels related to the operative financial management were either not established at all, or were not established in compliance with the legal provisions by more than 40% of the local governments on average.** Half of the audited local governments did not establish the internal order of responsibility for public procurement. They did not announce public procurement tenders despite the fact that the amount spent on the procurement of goods and the purchase of services exceeded the limit stipulated in the Act on budget. The Public Procurement Arbitration Board condemned 20% of local governments that conducted public procurement procedures.

As far as the organisational forms of local governmental task performance are concerned, institutions established by the local governments themselves continued to play a major role between 2002 and 2005, however a rise could be also witnessed in the number of self-employed people, business organisations, public foundations, foundations and non-profit organisations involved. In the amount of around HUF 200 billion, task fulfilment was transferred to entities outside the system of public finances. Due to their size and the number of their staff, the overwhelming majority of the local governments of small settlements cannot meet the requirements of cost-effective and efficient operation. The number of local government run institutions dropped by 22 in the country between 2002 and 2004.

At the audited local governments, the per capita expenditures in the educational and social institutions increased. This growth was mainly attributed to the increase in personal allowances and the contributions thereof due to the centrally approved pay measures.

**The amount of support provided by local governments for a specific purpose – not as social service – to enterprises, non-profit organisations, central budgetary institutions, households and private persons grew by HUF 10.4 billion from 2002 to 2004, and equalled HUF 180.5 billion in 2004.** At the same time, however, only slightly more than one third of the local governments providing purpose specific support prescribed accountability in line with the Act on Public Finances. In the case of these local governments more than one third of the supported organisations and private persons did not give account about the utilisation of the financial assistance they had received. Nearly half of the local governments that provide support violated the provisions of the Act on local governments, too, when making the decision, because the award of support to foundations and public foundations was decided not by the council, but by a committee or local governmental official, or occasionally by the tax-payer by relinquishing the right of disposal over the tax revenues.

As much as 90% of the audited local minority governments established the rules of cooperation with local governments of the settlements, which is regarded as progress compared to the former years. Almost all of the audited local minority governments established their budgets through a resolution approved by the body of representatives, and three fourths of them established their final accounts of their financial management in the same manner. However, irregularities still exist in connection with the operative management

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related tasks and powers (registration of liabilities, remittance, counter signatures).

**Little progress can be perceived in the regulation and implementation of audits conducted at local governments.** The internal auditors were neither functionally, nor organisationally independent in more than one fifth of the local governments. The audits were usually implemented through the civil servants employed in the mayors' offices. Despite the amendments to the legal regulations in 2003, the frameworks of the audit activity were laid down in the form of Operational and Organisational Rules by less than one fifth of the local governments, and the number of local governments that prepared the audit manual was even smaller. The quality of audits incorporated into the work process did not improve compared to the previous years.

**In relation to the transfer of property outside the system of public finances for the purpose of investment** the SAO considered it as a serious deficiency that more than one third of the property management decrees did not contain the conditions under which local governmental property can be transferred free of charge and claims can be relinquished. In nearly 50% of the audited local governments the decrees failed to determine the value limit above which property could be sold, or the right of use or utilisation thereof could be transferred only through competitive bidding. Formal compliance with this requirement is indicated by the fact that in certain local governmental decrees the value limit was set so high that it excluded its application in practice, and made it possible to evade the bidding procedure upon the approval of the council.

***Findings of auditing the utilisation of subsidies and contributions granted from the central budget in relation to the final accounts***

In relation to the final accounts of the central budget, the SAO paid special attention to the utilisation of revenues generated by local governments from the central budget, which amounted to HUF 1,225 billion in 2004. During the past years we continuously encouraged the reinforcement of normativity and the reduction of disintegration in the system of local governmental subsidies, and the simplification of the legal and procedural background that serves as a foundation for the utilisation of subsidies. These recommendations were usually positively received by the ministries responsible for the distribution of the appropriations, however apart from the smaller modifications no significant progress was made. Despite the incessant fine-tuning, the system is complicated, while several components thereof are not regulated adequately, and the rules are not clear about the conditions of eligibility. The shortcomings in the professional knowledge of the local governmental organisations, and the prolonged decision-making process resulted in the fact that the subsidies were transferred with delay in the case of one fourth of appropriations allocated through tendering procedures.

**Normative state contributions and subsidies are determining elements of the resource financing system despite the fact that they undergo minor changes year after year.** In the process of applying for

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and accounting such subsidies the greatest number of deficiencies was revealed in relation to educational, social and child welfare services. It was a typical deficiency that local governments regarded only the concrete conditions of application specified in the annex to the Act on budget as mandatory. They either failed to observe the provisions of other acts and decrees referred in the Act on budget, or observed them only to some extent. It frequently happens that the ministries' standpoints and expert opinions are not in harmony with the legal regulations of the given sector.

Normative contribution under the title "school education" was used by several audited local governments even after students above the maximum allowed number of students per class specified in the annex to the act, despite the fact that they were not authorised to do that. The greatest irregularity in the accounting of normative contribution in 2004 – both proportionately and numerically – was discovered in the provision of care within the framework of special care, under the legal title "education and care to children with special needs". This resulted from the fact that students with special educational needs were admitted to secondary education institutions after they finished primary school without any expert review or review by a rehabilitation committee, or without the modification of the expert opinion, which violated the relevant ministerial decree.

From among the centralised supports, **supports to small regional associations are of utmost importance**. By November 2005 independent regional development associations were established in 5% of the 168 statistical small regions, and multifunctional small regional associations were set up in 93% of them. In order to support the establishment of the associations and the development of task performance, the central budget provided a total of HUF 15.4 billion in 2004 and 2005.

**It is a negative experience in connection with the utilisation of centralised subsidies that under several legal titles** (e.g.: supplementing EU funds or own resources in the case of domestic development projects, support to small regional associations) **the appropriations were partially or fully disbursed to local governments in the last months of the year**, which hampered the utilisation of the funds in the year under review. The state budget keeps pushing for the reduction of personal expenses that make up nearly half of the operational expenses of local governments. As a result, between 2000 and 2004 in nearly two thousand local governments 14,427 persons were made redundant with HUF 11.5 billion in budgetary subsidy.

At the time of auditing the final accounts of the state budget, we also audited the use, utilisation and accounting of accumulation purpose subsidies that were provided to the investment and reconstruction projects of local governments. According to the experience of the audits, **the system of earmarked and targeted subsidies that play a decisive role in the development projects of local governments has become more efficient**. After narrowing the objectives of development that can be subsidised, in 2004 – similarly to the former years – canalisation and waste water treatment development projects that aimed at closing the gap between

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Hungary and the EU's environmental requirements were given special attention. The utilisation of accumulation purpose subsidies was characterised by the coexistence of two trends. While after 2001, the repayment obligation of unlawfully utilised subsidies decreased compared to the previous years, the 35% reserve of the audited accumulation purpose subsidies indicates that the tendencies typical for the former years did not change.

Local governments had to prepare the accounting of the reduction of income differentiation for the first time based on the actual revenues from the local business tax. The accounting of the audited local governments was reliable with regard to materiality. The errors increased the materiality threshold of 2% only in the accounting of three local governments.

**According to the finding of the audit of the final accounts**, the statements made about contributions and subsidies to local governments under the 23<sup>th</sup> title of the Ministry of Interior chapter, which statements pertained to the execution of the 2004 budget, decisions about the contributions and subsidies were made in compliance with the legal regulations, and the transfer thereof to local governments was lawful. The relevant data contained in the bill on the execution of the budget gave a reliable and authentic picture.

According to the audit findings, **local governments accounted the contributions and subsidies provided from the central budget in a reliable manner**. The discrepancies related to the accounting of contributions and subsidies disbursed in the previous years were also settled in line with the legal regulations.

**In pursuance of the provisions of the Act on budget, the award of other subsidies to non-viable local governments was decided by the Minister of the Interior in all cases**. According to the audits, 2% of the awarded other subsidies was not substantiated by a lack of operational funds. Subsidies that were provided to local governments under the title "extraordinary, unforeseeable events" to enable said local governments to repay unlawfully utilised, central budgetary subsidies did not meet the requirements either. Local governments are not encouraged to abide by the law if they receive subsidies under other legal titles for the repayment of budgetary subsidies that the SAO ruled unlawful.

### ***Audits of the accomplishment of the tasks of local governments***

Financial resources handed over to organisations outside public finances for accumulation purposes were basically connected to the **public utility projects of local governments**. Local governments implemented public canalisation projects in cooperation with the public utility companies, as well as the residents and foundations by increasing the total costs of investments to an unexplainably high level, and thus raised the base for state subsidies (subsidies to public utility developments, home savings bank, public utility loan) payable to private persons under subjective right, and reinvested the state subsidies payable to the population to fund local governmental development projects. This is why, due to the cumulative and unlawful utilisation of state

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subsidies and due to implementation of development projects with the exclusion of market competition, the Hungarian State sustained damage.

**The system of state subsidies tied to the total costs of investments is not efficient.** After analysing the specific investment costs of canalisation projects we concluded that the specific costs of projects implemented in a foundation scheme was one and a half higher than the actual price for which the construction companies constructed the facilities specified in the water laws construction permits, based on the technical content. The system of specific costs applied in the case of canalisation projects allowed the construction companies to yield extra profits for many years. At the same time, this system did not prevent the unsubstantiated utilisation of subsidies by maximising the investments costs acceptable for state subsidies.

Based on these audit findings, in § 7 (17) of Act CXVIII of 2005 on the 2004 budget of the Republic of Hungary and on the three-year limits of the system of public finances, the National Assembly asked the SAO to audit the lawfulness of the application for and utilisation of public utility subsidies for road and canalisation projects in the years 2000 to 2005.

**The program of bath and spa development implemented by local governments was also among the development programs that were audited last year.** Local governments acquired bath property in the years following the turnaround the political system, in pursuance of the Act on local governments and the Act on property transfers. Since the tasks and powers are regulated in a framework-like regulation, it is still not clear, to what extent bath services are considered as public services. The legislators left this decision to local governments of territorial jurisdiction. As a result of developments and reconstructions carried out within the bath and spa program, between 2000 and 2003 the assets allocated for this purpose increased by nearly two and a half times – to HUF 52.4 billion – nearly 60% of which was owned by the operating business organisations. The development programs and the strategic objectives of health tourism were not substantiated professionally. The development priorities that would foster the attainment of the set objectives were not defined, the social correlations between tourism and health preservation are not clear, there is no professional coordination that would keep efficiency in mind, and price talks are not carried out on the basis of economic principles.

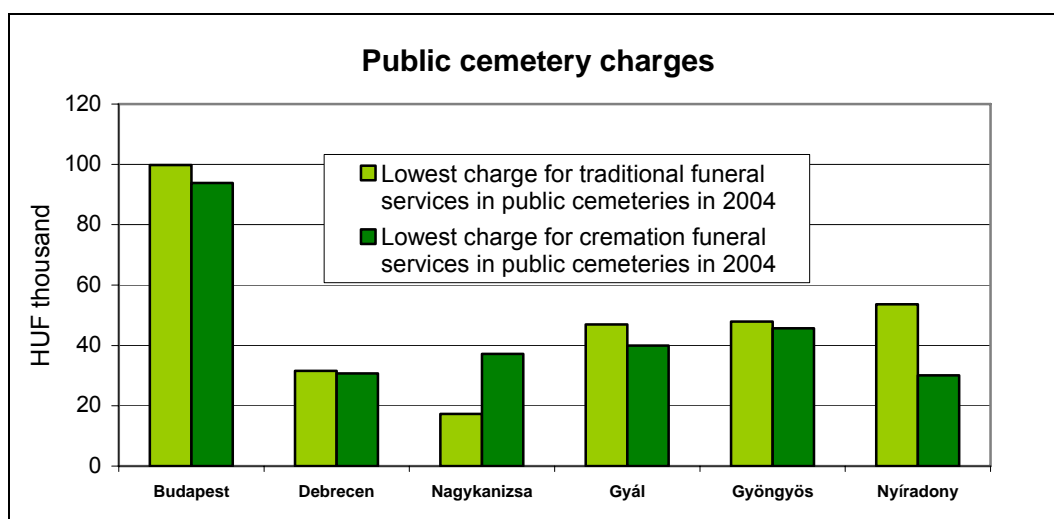
Local governments **rendered library services** by maintaining public libraries by themselves or in association with each other, or by ordering such services. According to the audit, local governments allocate 1.4% of their expenditures on culture on average – independent of the type of their respective settlements – which means nearly HUF 4,000 per resident in the case of the settlement local governments. Over one fourth of this amount is covered from normative state contributions, however, the subsidy is below 40%, even with other types of subsidies. Despite this fact, local governments try to fulfil their mandatory tasks by using the available subsidies and their own resources. Task performance greatly depends not only on the financial condition of local governments, but also on the personal conditions.



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Caring about the deceased is a community task, too, wherefore **local governments must also contribute to the maintenance of public cemeteries**. The SAO audit was extended to local governmental task performance. The act on funeral services stipulated that the construction of the facilities and public utilities in the cemeteries is the responsibility of the owner of the cemeteries, for which they received a grace period until October 1, 2004. This obligation is independent of the number of residents living in the settlement and the size of the cemetery. Although the law stipulated this obligation, local governments could not apply for specific support from the central budget to implement these investments.

The local governments' obligation to issue decrees extends to setting the types and amounts of charges payable for memorial public services in the public cemeteries. The charges vary depending on settlement type and the method of operation. The charges levied in the capital – which were regularly raised at a rate higher than inflation – were three times higher even in the least expensive graves or urn lots than the charges applied in Debrecen, for instance. In cemeteries with many visitors such a large difference in the charges is not justified economically, because there is no measurable difference in the quality of services provided by the cemeteries.



The bereavement public service contracts do not comply with the legal regulations, the elements of bereavement public services and funeral services are mixed, the value of the services and the method of payment are determined in a manner that violates the law, and the supervisory powers that local governments are entitled to are not stipulated in the contract.

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## 2.2. Institutions outside public finances

In the year under review we conducted the comprehensive audit of the financial management of public foundations established by the Government<sup>22</sup>. **Those activities of the public foundations for which they were established were funded by the budget to an extent of 93%.** Therefore, this year's audit findings indicate – similarly to those of the previous years – that the business organisations and the citizens are still reluctant to contribute to non-profit services rendered by public foundations with their donations. The majority of own resources come from the interest revenues of state resources that are temporarily not used and are deposited in various financial institutions.

During our audits we concluded that at two public foundations such changes had occurred in the operational conditions and funding that significantly narrowed the possibility of implementing the objectives set in the deeds of foundation of said public foundations, wherefore in our reports drafted on their audits we recommended the Government to review the need to maintain these public foundations. The Government decided about the termination of one of the public foundations already in the year under review, and about the integration thereof into a new public foundation with several other public foundations so that the assumed tasks would continue to be rendered.

The boards of trustees distributed the financial resources allocated for the public tasks in line with the objectives specified in the deed of foundation. We considered it as a shortcoming of the operation of the boards of trustees that in the case of one public foundation they did not fully enforce the incompatibility rule in decision-making, and in one public foundation the board of trustees transferred the right of decision-making to the chairman of the board of trustees. The public foundations did possess the internal regulations that lay the foundations for lawful financial management, however they did not reflect the specific features of each public foundation, and they were not always updated in line with changes in legislation.

It was a typical irregularity that apart from the board of trustees other persons had the right of disposal, and in practice they did use this right of disposal over the assets of the public foundations, because the right of representation and the right of disposal over the bank account and the securities accounts were not exercised in compliance with the legal regulations. One public foundation exceeded its operational budget stipulated in the deed of foundation, but despite this fact we did not find any sign of lavish operation. At the audited public foundations the supervisory boards appointed by the Government – as the founder – fulfilled their tasks at all but one public foundation.

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<sup>22</sup> Report on the audit of the financial management of the National Public Foundation of Student Dormitories (0513), Report on the audit of the Apáczai Public Foundation for Hungarian Education beyond the State Borders (0510), Report on the audit of the financial management of the Public Foundation for Nature and Society Friendly Development (0533).

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According to our audit experience gained so far, the majority of interest revenues that the public foundations can account as own revenues comes from the fixed deposits of temporarily unused parts of budgetary subsidies received for the provision of public tasks (nearly 2 to 3% of budgetary subsidies). As a result, the public foundations receive additional budgetary subsidies. The more efficient utilisation of public funds would require a system of state financing that would be adjusted to the schedule of public task provision by the public foundations.

During our audits we objected to the fact that in violation of the equal opportunities of those supported, the boards of trustees of the public foundations provide support without inviting tenders despite the fact that in pursuance of the “Glass pocket” act in effect since June 9, 2003, they are mandated to invite applications if the financial assistance they give for a specific purpose exceeds HUF 1,000,000 per year, except for when an act or Government decree stipulates a different rules of procedure with regard to the public task provided by the public foundation.

**In the year under review we started the legally mandated, biannual audits of the lawfulness of the financial management of public foundations that were established by parliamentary parties and are eligible for budgetary subsidies.** It was typical for the two party affiliated foundations that they used only part (one third and half, respectively) of the revenues they generated. The financial assistance granted by the boards of trustees, as well as programs implemented within the foundations’ own organisational frameworks complied with the objectives stipulated in the foundations’ deeds of foundation. It was a shortcoming of the boards of trustees that they did not determine concrete amounts for certain target activities/supports. The foundations did prepare the financial management regulations, however we objected to the fact that the fund management regulations did not stipulate the tasks related to bank account transactions and the order of electronic bank transfers. In their annual reports the party affiliated foundations complied with the legal requirements.

**The SAO audited the financial and economic activities pursued in the past four years by nearly one third of the ethnic minority self governments operating in Hungary.** The targeted operational contribution to the self-governments’ operation was provided in a degressive manner, proportionate to the membership of the ethnic minorities. The principle of self-governance was enforced in the operation of the self-governments, and financial management was regulated in line with the legal requirements. The utilisation of budgetary resources provided for operational and institutional purposes were duly accounted, and measures were taken to repay unused subsidies into the budget. Apart from the representation of the interests of the minorities, the self-governments maintained successful relations with their “old countries” and mediated the values of ethnic traditions. After the amendment of the act on national and ethnic minorities at the end of 2005, which determines the operation of national minority self-governments, the legal status of the self-governments’ office was clarified. It must become a national budgetary organisation by January 1, 2008. This amendment to the law as recommended by the SAO, too.

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### 2.3. State property

Due to the changes in the Government's philosophy about privatisation, as well as for the sake of profile cleaning and transparency, the rights over the treasury property, the state's entrepreneurial assets and the shareholders' rights over the Hungarian Development Bank are exercised by an organisation/ministry other than the ministry trusted with the supervisory tasks. The Government decided to restart and accelerate privatisation, which determined the privatisation activities of the State Privatisation and Holding Company (ÁPV Rt.). Privatisation gained momentum, and as a result of the new strategy – in the spirit of the standard management of the state's entrepreneurial assets – entrepreneurial assets that used to belong to the portfolio of sector specific ministries, the Treasury Property Directorate (KVI) and the Hungarian Development Bank – were transferred to ÁPV Rt. ÁPV Rt. is no longer involved in governmental investment programs. Through sales and property transfers the ownership rights are now exercised by KVI, ÁPV Rt., the Hungarian Development Bank and other organisations. The ownership structure and the supervising ministry of companies owned indirectly by the state and involved in export promotion have changed.

#### *Treasury property*

According to the data in the property cadastre as of February 2005, the Treasury property is managed by 735 property managers appointed by the law or contracted with the Treasury Property Directorate. The Treasury property is defined neither in terms of content nor concept. Among other things, this is why the data in the different registrations are neither comprehensive, nor reliable. **The registration of state property does not present the actual situation either in terms of in kind property, or in terms of monetary value.** Certain property elements were not entered into the property cadastre, partly due to the problems related to the identification of the property elements, and partly because of the delay in the development of the registration system. The system of registration does not allow for the full enforcement of the ownership interests of the state, and nor does it ensure the full-scale preservation of the treasury property and the provision of asset management tasks. The regulations in force do not make it possible to create the contractual terms and conditions of efficient and effective property management. The minister responsible for the Treasury property did not work out guidelines for the utilisation of Treasury property managed by the Treasury Property Directorate, nor did he determine priorities that would foster the efficient utilisation of property management resources. For this reason, in these years the Treasury Property Directorate had no approved property utilisation strategy for Treasury property. The definition of efficient and effective utilisation was not determined in any document.

The role of the Treasury Property Directorate stipulated in the Act on Public Finances – according to which it represents the state, i.e. the owner – is rather limited. The organisation fulfils real ownership related functions only to a small extent. It exercised the ownership rights only in an ostensible manner, and despite the fact that it used its tools with regard to the legal requirements, it was not efficient. The managed property is rather accounted than managed.

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The Treasury Property Directory formulated the internal regulation of property management and the terms and conditions of property management contracts in line with the legal regulations. For the lack of orderliness in pending property management contracts, and because the contracts are not modified or updated, significant movements of or changes in property are not registered. The property management contracts are mostly formal accessories instead of being an expedient tool in the practice of the management of Treasury property. The lack of the accurate and normative definition of state tasks also hampers cost-effective and efficient property management. The area that enjoys audit priority from among the areas of the use of ownership rights is not defined, the tasks and powers of the minister responsible for the Treasury property are not determined in relation to the supervision of the Treasury property on behalf of the owners.

The Treasury Property Directorate sold its marketable real estates in 2001 and 2002, wherefore its self-funding ability decreased by 2004. No studies or reports were prepared on cost-effectiveness.

### ***Entrepreneurial property of the state***

Pursuant to the asset policy guidelines that were worked out in 2002, property management focused on companies that are of strategic importance for the nation, as well as on the management of state assets of clear profile, on transparent business terms. As a result of accelerated privatisation, the portfolio of the State Privatisation and Holding Company decrease by 39 companies by the end of 2004, however, this was not reflected in the definition of organisational and personal conditions. ÁPV Rt. became a net budgetary contributor. Revenue generation was characterised by measures taken for the alleviation of the budget deficit and the liquidity problems. ÁPV Rt. pursued its activities in a manner stipulated in the laws and the relevant regulations, however in certain privatisation transactions it acted in an objectable manner, and several of its property management decisions led to a loss in property (Bábolna Rt., Budapest Airport Rt., Váltó-4 Libra Rt.).

In relation to the two-round selling procedure of Nemzeti Tankönyvkiadó Rt. (National Course Book Publisher), the tendering regulations of ÁPV Rt. do not fully explain the differences between single-round and two-round tendering procedures. During the sale of MOL Rt.'s shares it was not taken into account how the expected sale of the gas business of MOL would influence the value of the MOL shares. When the bonds of Richter Rt. were issued, ÁPV Rt.'s preparatory process took future changes in the legal regulations granted.

**By separating the book-keeping of dedicated assets and own property, the sale of state property and property management became more transparent within ÁPV Rt.** Apart from the minor changes that were made in the legal regulation of the company's operation in 2004 it is noteworthy that upon authorisation granted by the Minister of Finance, ÁPV Rt. was given the possibility to issue open bonds and to take credits. The internal regulations and instructions were usually in harmony with the legal and other rules that provide the framework for the operation of the company, however, certain harmonisation deficiencies remained in the specific

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accounting practice. ÁPV Rt. managed its own assets in a profitable manner, which required that the amount utilised as operational expenses above the appropriation set by the law could be retained and not paid into the state budget pursuant to the permission of the entity that exercised the shareholders' rights (the Minister of Finance).

The 2002 amendment to the law required the Hungarian Development Bank to operate safely and in a manner typical for banks. The portfolio was practically cleaned by 2003, as a result of which the Bank generated losses, which can first of all be demonstrated in the case of sales to state owned entities. Companies that supplied state tasks were bought up by the Treasury Property Directorate on behalf of the Hungarian State. In 2002 and 2003, the Bank sold ÁPV Rt. 2 and 17 investments, respectively, which meant that the investments remained under state control. The bank losses from the transactions – that are estimated to total dozens of billion forints – cannot be evaluated yet at the level of public finances. This will only be possible after the privatisation of the companies. The Bank no longer fulfils state financing tasks. Since 2002, the ownership rights have been exercised by the Minister of Economic Affairs and Transport. The same rights were formerly exercised by the minister heading the Prime Minister's Office.

### ***State-owned companies involved in export promotion***

The state promotes exports in various ways, the frameworks of which are always specified in the effective budget act. The ownership structure of the Hungarian Export Insurance Ltd. and that of the Hungarian Export-Import Bank has changed. On December 15, 2004, ÁPV Rt. sold the Insurance company's share package representing 75% minus one vote to the Hungarian Development Bank. The Export-Import Bank was directly and fully owned by the state until July 2004. The ownership rights were exercised by ÁPV Rt. from January 18, 2000. After June 2004, the amendments of the law allowed the Hungarian Development Bank to acquire up to 100% of the Export-Import Bank.

According to the explanation of the relevant acts, the ownership structure was modified to make use of the synergies between the companies, however these synergies were not explained in detail. No impact assessment was prepared regarding the future operation thereof, although due to the change in ownership the companies acquired two owners each, and these owners were/are supervised by different ministers. It was not settled who and in what form would mediate export promotion related state interests. As a consequence, the amendments of the law were not substantiated on the side of export promotion. It is paramount that the form of mediation of export promotion related state interests be determined by the Government within the framework of the external economy strategy.

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## 2.4. Main findings classified by topics

### 2.4.1. Healthcare

In order to alleviate the tensions in one of the most significant sectors of state redistribution, which affects the entire society, the healthcare system must be reformed. The major areas of reform are health development and the transformation of public healthcare and the supply system. In the latter, preference must be given to emergency care.

The required fundamental changes have not taken place in healthcare. The healthcare reform has not been implemented. The preparation of the National Health Development Programs was many years behind schedule. The National Assembly decided about the Johan Béla National Program for the Decade of Health in 2003. The resources required for the completion of sector specific tasks were only partially available. The consistent implementation of long-term programs was hampered by the fact that the Government had no approved concept. The long-term program launched for the renewal of the instruments used in the institutions under this chapter was practically shortened to one year for the lack of funds. The deficit of the Health Insurance Fund became permanent, which was partly due to the changing social and economic environment, the unsubstantiated planning and the increase in unpaid contributions.

Based on the findings of the audits of the utilisation of **funds used for the procurement of radiation therapy, radiology, anaesthesiology and intensive care instruments from the central budget** in the period between 1997 and 2003, the radiation therapy centres already had sufficient capacity – compared to 1996 – to provide treatment for the patients in need, wherefore the accessibility of medical treatment improved. At national level, the quality parameters of the availability of X-ray equipment did not improve, however, due to the investments the harmful radiation load on patients and staff alike decreased in said institutions, and the quality of the images improved. As far as the conditions of anaesthesiology and intensive care are concerned, the situation has not improved since the launch of the investment program in 1998.

**According to the audit of the financial management of state and church owned hospitals**, hospitals that function as budgetary institutions are affected by market impacts that are not compatible with the rules of traditional budgetary management. The objective of financial management is not primarily compliance with the pre-planned appropriations, but rather the continuous maintenance of the financial balance. For the lack of sector-specific standards, the management tried to achieve the permanent financial balance with various methods and tools. In general, the hospitals do not evaluate the effectiveness of the applied economic methods, wherefore the subservience and efficiency thereof cannot always be demonstrated. Despite the best intentions, the measures taken by the institutions within their scope of authority cannot yield the expected results if they are not combined with the efficient involvement of the management of the sectors and the entities running said institutions.

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**The audit of the system of pharmaceutical subsidies and consumption** revealed that the state measures aimed at influencing the consumption of pharmaceuticals and at reducing the growth rate of pharmaceutical expenses could not be successfully implemented for the lack of the fundamental regulatory and registration conditions. The activities of the central organisations were not properly coordinated when the prices and subsidies were fixed. Legal regulations did not stipulate unambiguously the prices and the related subsidies. Initiatives were made in all fields of the system of pharmaceutical price subsidies and financing, however no radical change was made in the entire system in the years under review.

**The objective of the managed health care model experiment** was not determined in any legal regulations, and it was not strategically substantiated by the Government programs of the years under review. The professional and financial justification of the model experiment was deficient, because the results expected from the introduction thereof, and the methods of evaluation, as well as the conditions for the expansion of the experiment were not defined. The Ministry of Health did not manage the model experiment from the professional or sector policy point of view. The organisational, management and legislation preparation tasks related to the introduction and expansion of the system were almost exclusively performed by the National Health Insurance Fund. As a result of the inadequate preparations for the model experiment, the lack of coordination of concepts, the indifference manifested by the competent ministry concerning the experiment and the lack of internal rules at the National Health Insurance Fund such processes and practices started both at the care organisers and at the National Health Insurance Fund, whose evaluation and utilisation are important for the entire healthcare system, and can be used for the reform concept of healthcare.

**For healthcare projects local governments** received HUF 184 billion between 1991 and 2004 as earmarked subsidies, the majority of which was utilised for hospital reconstruction. The professional priorities of earmarked subsidies in the healthcare sector were practically the same as before, the programs were too much generalised, and no measurable requirements were set for the reconstruction projects. In contrast with the two to three year long schedule specified in the investment concepts and plans, the schedule of the utilisation of earmarked subsidies was fixed for four to five years, which increased the costs due to the increase in prices, among other things. The lag between the preparation and implementation of the projects was six to ten years, during which both the professional ideas and the technical conditions changed.

Several times in the past years, apart from the major investment projects in the healthcare sector the SAO also audited the factors that influence the operation of this sector. The **financial and operational conditions of local government owned hospitals** improved due to the central measures taken since the completion of the comprehensive audit of year 2000 (increase of the basic fees, 50% increase in salaries, consolidation program), however the factors that generate tensions have not been subjected to a complex, systemised review, and the problems were not resolved either. Shortage and lavishness continue to exist side by side in the healthcare sector. Shortage is indicated by



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the bad state of repair of the buildings, the obsolete instruments, the employees' income level and the inadequate quality of hotel services, while lavishness is caused by the maintenance of a bad structure and the unjustified increase of in-patient care. The Hungarian healthcare system is still hospital-centred. The continuous growth in **out-patient an active in-patient care performance is caused by the institutions' need for increased revenues rather than changes in the need of the population**. The funding organisation could not comprehensively and continuously check the actual content behind the performance accounts, the institutions tried to increase their revenues by enhancing their performance at any price.

#### 2.4.2. Education

Experience shows that the direction of changes that have occurred in education is favourable, however the implementation of the reforms and the financing changes fostering efficiency seem to be behind schedule. Our audits aim at the development of a modern and efficient higher education system in line with the European Higher Education Area.

The continuation of the **higher education integration** that was realised in 2000 is needed primarily in the organisational units within the institutions. In the period under review integration reduced the costs neither in the institutions taken collectively, nor in the individual institutions, and it did not have a synergic effect. The reserves of cost-effectiveness and efficiency primarily lie in the training system, since the training structure of the integrated institutions did not change considerably. The improvement of teacher efficiency can be attributed to the growth in the number of students rather than integration.

The integration triggered no change in the ratio of **higher education research places** that account for 92% of budgetary research places. The resources for research have not been concentrated within the institutions. The management, organisational and support system of research and development within higher education institutions are characterised by excessive disintegration, the lack of the required concentration, and the resulting inadequate efficiency and utilisation problems. Within the funding of the higher education system, the research and development appropriation of the central budget does not express the real importance of the task. The provision of state support is not linked to a performance oriented system of requirements either at the research places within the higher educational institutions, or in the research and development institutions. The performance of higher education research places is less market and practice oriented.

The **system of normative financing** which was developed in higher education, could not be made an efficient tool of the budget despite the elaboration of the introduced and applied norms and the frequent change of certain elements of financing. The initial efficiency objectives faded, the institutions did not become interested in reducing or optimising the training costs. It is necessary to develop a system of indicators that provides for comprehensive evaluation.

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In the period under review, **funds allocated for the performance of higher education tasks** provided additional, supplementary resources for the completion of higher education tasks and the improvement of the operational conditions of higher educational institutions. The funding support to educational and training, IT development and integration related tasks are extremely broken down within the institutions. The system of higher educational task financing is very complicated, and at the same time state funds provided for education and training are not concentrated, and the performance requirements are not established.

### **2.4.3. National defence**

Due to the lack of resources, the development of an army that can be financed in the longer run has seemed to be an unsolvable task. Our audit conducted in 2005 concluded that the concept of the restructuring of the Hungarian Army did not stabilise after Hungary's accession to the NATO either.

The restructuring process of the army almost continuously called for the reduction of troops in the Hungarian Army aiming at the improvement of operational and development resources in the budget of the chapter, especially in the initial phase of restructuring. The unfairness of the ideas for the expansion of resources in this manner only – for the lack of long-term, well-founded concepts – was indicated by the fact that in the period between 2000 and 2004 personal costs and the related contributions grew steadily despite the reduction of the troops/staff (as a result of the more favourable legal regulation affecting the professional military staff and the increased emoluments paid for service abroad).

Hungary's national and NATO commitments, as well as the development of skills required for the completion of NATO's military integration came to the limelight only after 2002, during the elaboration of the Military Integration Program and after a defence supervision was ordered. However, this process came to a halt in 2004. The significant cut (30%) in the chapter's budgetary resources by the Government due to the load-bearing capacity of the national economy and the need to reduce general government expenditures, and then the elimination of the GDP proportionate subsidies provided for defence expenditures radically changed the conditions for military restructuring.

The risks of substantiation and fundability could not be minimised during planning and implementing the concepts of military restructuring. As a consequence, the national answers given to the NATO had to be revised as early as in February 2005. The ten-year plan developed for the period between 2004 and 2013 for the purpose of reaching the "ambition level" specified as a result of the audit lost its reality. The ministry was forced to modify, reschedule, postpone beyond the planning period or cancel certain developments and tasks. The lack of harmony between the national and international tasks, and the budgetary resources could not be resolved despite the fact that the budgetary appropriations were increased year after year. Keeping this in mind we found it fundamentally important to create all conditions required for laying the foundations for planning within the ministry, to work out alternative solutions implying acceptable risks. Furthermore we found that the

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Government should assume responsibility for the presentation of risks inherent in the financing of the restructuring and development of the Hungarian Army, so that the National Assembly would receive sufficient information required for making a proper decision.

#### **2.4.4. Utilisation of EU funds**

In the past four years our strategy focused on the regular audit of the use and utilisation of EU funds. In our annual report prepared on the year 2004, we dealt with the audit findings on the utilisation of EU funds in detail, in a separate section. In pursuance of Parliamentary Resolution 43/2005 (V. 26.), in 2006 we will conduct a comprehensive audit of the practice of the utilisation of EU funds, and within this framework the professional activities and audit findings of Hungarian organisations in charge of auditing the movement of funds related to EU financial resources, which we will present in an informative brochure at the time of the final accounts.

##### ***International subsidies disbursed from EU funds***

The Council of the European Union launched the **ISPA program** in 2000, providing the candidate countries with a short time to prepare. Similarly to the other ISPA countries, Hungary created the regulatory and institutional system required for the implementation of the program in parallel with the development and submission of the applications. **The overall performance and efficiency of the national institutional system of the program was weakened by the changes that occurred in the institutional development concepts and the division of labour in governance.** Due to the delays in project implementation by one and a half to two years, the subsidies were actually drawn and utilised later than scheduled. The lag between the planned and actual payments of the projects did not reduce. Changes in EU and domestic regulations of implementation adversely affected the implementation of the projects. For example, the repeated modifications of the regulation pertaining to public procurement required the reformulation of the procurement bidding documents again and again, which delayed the implementation of investment projects. The completion of the planning and authorisation processes of the projects was delayed by the prolonged reconciliation of the EU and Hungarian standpoints in the interpretation of the requirement for environmental impact assessment. The inefficient operation of the institutional system was indicated by the fact that during the preparation of the realisation of the projects approved by the EU Commission, the schedule of technical planning and authorisation was not observed, no measures were taken for the immediate comprehensive legal, technical and environmental preparation of the project proposals, or for the acquisition of the required licences.

It can be considered as a progress in this area and as the realisation of our audit recommendations that these problem areas were already regulated in connection with the submission of applications under the Structural Funds and the Cohesion Fund.

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During the audit of the execution of the 2004 budget we concluded that the National Development Office, which is responsible for governmental coordination in relation to EU funding (except for agricultural subsidies), and which is also involved in the development of the national development plan, established an excessively fractured internal system to perform its tasks. The efficiency of this system is seen differently by the different players. Positive statements are also accompanied by critical remarks, which resulted from the deficiencies of cooperation, and the lack of adequate professional experience. Among other things, this can be regarded as a cause for the lengthy process of the award of the subsidies.

The managing authorities of operative programs implemented with support from the Structural Funds announced the call for applications at different times, wherefore the time available for the applicants of the different operative programs was not equally long, and in several cases was not sufficient for successful application for funds already in the year under review. The time required for the processing of the applications (data registration, checking and evaluation) also differed from Managing Authority to Managing Authority.

According to the statistics of applications that were positively evaluated, on average nearly 3 months passed from the submission of the application until the decision of the Management Authority, and on average 42 more days passed from decision-making to the conclusion of the contract. The entire period of processing the applications exceeded five months, which – taken the time of announcement into account – a priori restricted the possibility of drawing down the subsidies in the year under review. This practice led to the continuous violation of the law<sup>23</sup>.

**In the case of the operative programmes the applicants were not adequately prepared for drawing down the new resources, therefore many applications were rejected** due to content or format related deficiencies. Assistance to inexperienced applicants required additional resources, which slowed down the evaluation process even more. It can be attributed to unpreparedness that in the case of several appropriations payments were either not made at all, or only a few million forints were paid in 2004 compared to the planned utilisation of funds.

The appropriations containing subsidies funded by the European Union from the Structural Funds or the Cohesion Fund are included in the EU integration and other chapters in the 2006 budget. According to the original ideas, all such appropriations should have been included in the EU integration chapter of the central budget, however in the budget act, those appropriations that are professionally handled by the managing authorities under the different chapters, are included in the budget of the chapter responsible for the

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<sup>23</sup> According to the decree on the general rules of procedure on the utilisation of the Structural Funds and the Cohesion Fund, the organisation in charge of the procedure must notify the applicant in writing about the decision made about the support within 60 days from the receipt of the complete application, and in case the support is granted, it must send the applicant the draft support contract.

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implementation of the given program, priority or measure. However, the law delegates the right of disposal over these appropriations (planning, appropriation modification, utilisation, accounting, etc.) to the minister without portfolio in charge of EU affairs. **Appropriations supervised by the minister without portfolio in charge of EU affairs are contained in ten budget chapters.** The presentation of the central budget in this manner is not in line with the interpretation of the general right and power of disposal, since the powers are defined in a manner different from the general definition. This solution contradicts the presentation practice that the Government formerly supported. In addition, separate regulations and audits may be necessary to ensure compliance with the funding and reporting obligations. The other appropriations that include EU funding, too (the appropriations of PHARE programs and transitional subsidies, the Schengen Fund, SAPARD, and the National Rural Development Plan) are listed by the budget act under the different specific chapters, and stipulate that they are under the supervision of the minister competent in the given field.

The financial agreements signed with the European Union for the budget period lasting until 2007, as well as the liability commitments pertaining to the different subsidies based on these agreements represent the maximum funding need for which the authorities announcing the programs may sign contracts for. According to the n+2 rule, in the case of the Structural Funds the utilisation of EU funds within the contracted frameworks (assumption of liabilities) is allowed for two more years after 2006. **Ensuring the utilisation of EU subsidies is not primarily a planning task, its efficiency depends on the work of the authorities that run the programs.** This is why we must emphasise that although it facilitates the utilisation of EU funds, the relatively flexible procedure of the modification of appropriations does not guarantee that the funds are actually utilised.

The appropriations of the Structural Funds can also be evaluated on the basis of how much they reflect the utilisation of EU funds available for a period of several years. Before the next seven-year budget period of the EU, the 2006 budget year is the last one in which the utilisation of funds allocated for several years can be ensured with different commitments. After that we will have two more years to draw down the EU subsidies. The unused, estimated amount of over HUF 316 billion can be drawn by December 31, 2008 if the contracts are signed by the end of 2006. According to the relevant estimates of the National Development Office, by that time the liabilities will exceed the amount available for a three-year period by HUF 60 billion, i.e. the draw of the subsidies will not be hindered. This calculation is mostly based on estimates, the realisation of which does not only depend on changes in the expenditure appropriations, but also on future liabilities, on the schedule of program implementation, on the status of accountability (regularity) and on the availability of domestic resources for co-financing.

### ***Audits performed on the basis of agreements***

In pursuance of the work agreement concluded with the National Program Authorising Officer acting on behalf of the Competent Authority for the completion of the duties of the **SAPARD Certifying Body**, the SAO has been

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continuously performing the annual certification audit, since 2003. By September 15 we prepared an interim report, and by April 15 following the year under review we prepared an annual report and audit certificate, which the National Program Authorising Officer forwards to the EU Commission.

All funds available for SAPARD purposes were appropriated, and are continuously utilised. By December 31, 2005 as much as 70.6% of the total available sum was utilised. During the financial and the compatibility audits neither the EU Commission, nor the European Court of Auditors or the SAPARD Certifying Body detected any errors or deficiencies that would have required a financial correction by the end of 2005.

For the performance of the duties of the Certifying Body responsible for certifying the utilisation of subsidies financed from the **Guarantee Section of the European Agricultural Guidance and Guarantee Fund (EAGGF)** the SAO signed an agreement with the Ministry of Agriculture and Rural Development. The Certifying Department of the SAO – acting as the Certifying Body of EAGGF's Guarantee Section – conducted the audit of EAGGF for the financial year 2004, and issued the Certificate and Report on the certification audit of the Agricultural and Rural Development Agency, which acted as the Paying Agency for programs financed from EAGGF's Guarantee Section.

Our audit concluded that during the payment of community support paid under the title "Supply of dairy products to students" the structure and procedures of the Agency did not fully meet the accreditation criteria and the rules of the EU Commission. We could not determine whether the Agency conducted a posteriori audit of the quantity of the required milk and the price thereof, as well as of the accuracy of the computation of community support. The EU Commission asked our department being the Certifying Body to audit the measures taken by the Agricultural and Rural Development Agency upon the findings and recommendations attached to the audit certificate of „C" qualified opinion with limitation on scope, and to issue a new audit certificate reflecting our final standpoint. As a result of the completed a' posteriori audit, we drew up a report containing supplementary information on the activities of EAGGF's Guarantee Section in financial year 2004, and issued an audit certificate of "A" opinion without qualification.

We completed the report on the audit of the Agricultural and Rural Development Agency, which acted as the paying agency for programs financed from EAGGF's Guarantee Section in the 2005 financial year by the deadline, and issued the Certificate, which we then forwarded to the Competent Authority on January 1, 2006. In the Report we also had to draw attention to a few things. We found that the Agricultural and Rural Development Agency should pay greater attention to a few special areas so that the financial interest of the EU would not be violated, the utilisation of support financed from EAGGF's Guarantee Sector would be in line with the EU and national regulations, and so that the authenticity, accuracy and completeness thereof could be insured. In the financial years 2004 and 2005, most payments from EAGGF's Guarantee Fund were made by the deadlines set by the EU requirements. The EU Commission did not apply any major financial corrective measure by the end of 2005.

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### 3. UTILISATION OF THE AUDITS

The result of the SAO audits greatly depends on what amendments to legal regulations are made at the level of the National Assembly, the Government, the chapters and local governments pursuant to the utilisation (realisation) of the findings and recommendations, and on what measures the auditees initiate. The SAO is not an authority; it cannot impose sanction, and cannot enforce the realisation of its recommendations and proposals either.

#### 3.1. Discussion of the reports by the National Assembly, resolutions and parliamentary relations

The SAO met its reporting obligations provided by the legal regulations in 2005, too, and submitted to the National Assembly its opinion on the budget appropriation bill, the final accounts bill, as well its reports on the annual activities of the Hungarian News Agency and the State Privatisation and Holding Company. The SAO facilitated the audit and legislative work of the National Assembly with altogether 71 audit reports<sup>24</sup>.

The number of SAO reports published between 2002 and 2005 exceeded the number of reports issued in the previous years by nearly 50%. In this period, the **committees placed the SAO's reports and studies on their agenda 308 times.**

The reason behind such a considerable growth in the number of reports was primarily due to the publication of reports published about the comprehensive audits of local governments with large budgets, property or local governments with high budgetary risks, however the committees have not yet discussed these reports.

The 23 committees discussed the final accounts bill and the budget appropriation bill in cooperation with the related SAO report and opinion. On top of that, 9 to 14 committees discuss SAO reports and studies annually. Most reports were discussed in 2003 and 2005 (22 reports each year). 3 to 12 committees discussed the SAO's annual activity reports. Apart from the Audit Committee, mostly the Economic Committee, the Committee on Health Affairs, the Budgetary and Financial Committee, the Environmental Committee, as well as the Committee on Cultural Affairs and Press relied on the SAO reports in their work. Similarly to the previous parliamentary cycle, the Economic Committee discussed most of the reports (nearly 30). The committees included six studies of the SAO's Research and Development Institute (RDI) in their

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<sup>24</sup> The SAO has adjusted to the so called electronic parliamentary system introduced in the National Assembly in September 2004, as result of which the members of Parliament can have access to the full texts of the reports via several electronic channels, as well as to the letters – sent to the members of Parliament – summarising the findings, conclusions and recommendations of the reports. The hard copy of the reports are also forwarded to the executive officials of the National Assembly, the Audit, the Economic, the Budgetary and Financial Committee, as well as other competent committees, however, by reducing the number of hard copies we put increasing emphasis on electronic circulation.

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agenda, and twice they discussed reports signed by one of the Directors General.

In 2005, 22 reports and two RDI studies were on the agenda of the standing committees or joint subcommittees either independently, or in connection with the discussion of bills, reports or statements. On top of the SAO documents discussed by every committee, other SAO reports and RDI studies were discussed by 14 committees and joint subcommittees. 7 committees discussed our annual report.

Similarly to the practice of the former years, in 2005 all reports submitted to the National Assembly (except for the report on the State Privatisation and Holding Company /ÁPV Rt./) were included in the agenda of the plenary sessions. The SAO report on the audit of the activity of ÁPV Rt. were discussed only at committee level – similarly to the former years of the parliamentary cycle<sup>25</sup>. The preamble of the resolution adopted when discussing the report of the Hungarian News Agency, and the SAO audit report cited the recommendation that the SAO had repeatedly made in connection with the amendment of the Act the National News Agency. In 2005, the President of the SAO took the floor four times during the parliamentary session in connection with the reports being discussed.

During the parliamentary cycle, on 70% of the session days over 1,200 parliamentary interventions referred to the findings and recommendations of the reports and studies. A significant part of the references cited audit findings (studies) related to the financial management problems of local governments, the funding problems of healthcare and education, and audit findings (studies) related to the funding of political parties, privatisation, and PPP projects. Off the agenda, as well as in relation to interpellations and questions, the members of Parliaments who took the floor referred to the SAO over 170 times.

The SAO maintained continuous working relationship with the General Secretariat of the National Assembly and the committees. Prior to making his decision about the draft audit plan, the President of the SAO asked for the opinions and suggestions of the senior officials, committee chairmen and the Audit Committee every year. Some committees drew up a work plan for each session, which was then forwarded to the President of the SAO. According to the established practice, in the form of thematic lists, the President of the SAO drew the committees' attention to reports that could be linked to certain subjects of the work plans or the Government's legislative program.

The President and senior managers of the SAO also maintained regular relations with the Speaker, officials and senior staff members of the National

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<sup>25</sup> After the submission of the report the National Assembly held a political debate, the main topics of which included privatisation issues. As many as 10 parliamentary intervention referred to the SAO reports and studies on privatisation issues. In one meeting the Agricultural Committee discussed the SAO reports on the audit of the State Privatisation and Holding Company between 1997 and 2002 together with the Government's reports. Upon the committee's request the SAO prepared a summary for this purpose.



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Assembly, as well as with the groups of members of Parliament. Similarly to the former years of the parliamentary cycle, the President of the SAO was invited to the meeting of the committee chairmen in 2005, too. The Speaker and Deputy Speaker of the National Assembly, and several members of the Audit Committee regularly attended the events organised by the SAO.

The Audit Committee plays a crucial role in our ties with the National Assembly, since in addition to the reports linked to the agenda of the plenary sessions, it discussed the SAO's draft Audit Plan, our draft budget, several studies of the Research and Development Institute every year, and regularly supported the SAO's intentions in its draft amendments to bills, and in its draft parliamentary resolutions submitted for the approval of the SAO's annual activity report. The managers and experts of the SAO attended 80 of the committee's meetings and assisted the work of the members of Parliament with oral information, too. In 2005, the committee paid special attention to resolve the regulation problems arising from the funding of public utility projects implemented by local governments in the ÖKÖTÁM system.

### **3.2. Enforcement of the SAO recommendations**

During the audits performed in the previous years, the SAO recommended several amendments to the legal regulations in order to prevent deficiencies and irregularities, and enhance the transparency and efficiency of the utilisation of public funds. These recommendations were positively received by the auditees. **Most of the chapters and local governments affected by the audits included the SAO's recommendations in their action plans.**

Our a' posteriori audits and the information requested in relation to our annual report indicate that our recommendations pertaining to the internal regulation, registration and accounting systems, our recommendations aiming at the introduction of measures that improve expediency and efficiency, as well as our proposals that recommend the elaboration of programs and action plans are usually implemented, however, our proposals aimed at the modification and harmonisation of the regulation system being in force are realised only to a smaller extent.

The utilisation and implementation of the recommendations formulated in the different audit reports can be followed on the SAO's website.

#### **3.2.1. Recommendations at the level of the National Assembly**

The National Assembly and the Government regularly took into account the findings and recommendations formulated in the SAO reports in the past four years during the discussion of bills in the committee meetings or at plenary sessions, and the preparation of bills, respectively.

In addition to the annual final accounts and budget appropriation acts – both of which incorporated several of our recommendations – **our audit findings were utilised in the amendment of 28 acts between 2002 and 2005.**

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The recommendations formulated in the report on the audit of the financial process of the M3 motorway construction were utilised in the Act on the public interest and development of the motorway network of the Republic of Hungary.

The content of our report on the audit of the utilisation of subsidies to promote employment was incorporated in the amendments related to the establishment of the Single Hungarian Labour Database.

Our recommendation made to facilitate the collection of unpaid duties was utilised during the amendment of acts on taxes, contributions and other payments into the budget.

The new Act on Public Procurement was elaborated in line with the SAO's relevant audit findings and recommendations. (With its proposals, the SAO participated in the development of the concept of the new Act on public procurement from the autumn of 2002.)

The National Assembly formerly approved the amendment to the Act on higher education. Pursuant to our recommendation, the labour law regulation part of the amendment makes a distinction between the appointment of university or college teachers and the establishment of employment relationship or civil servant relationship.

Several articles of the Act on the National Bank of Hungary were supplemented in line with our recommendations.

The National Assembly acknowledged the need to secure the operational conditions of civil organisations and foundations with state guarantees by adopting the Act on the National Civil Fund. Pursuant to former SAO recommendations, the Fund ensures exclusivity for civil organisations that have won the legal status of non-profit organisations, except for a few objectives.

In addition, the findings and recommendations formulated in the SAO reports were utilised in the Act on political parties, in the Act on motion pictures, in the amendments of certain social welfare related acts, as well as in the budgets of the Hungarian Television, Duna Television and the Hungarian Radio.

Our recommendation for the correction of the high level regulations of national defence upon the audit of the utilisation of the funds serving the operation of the land troops of the Hungarian Army, and the audit of the public procurement system of the Hungarian Army were in line with the topical harmonisation of the legal background of national defence, wherefore major elements of our recommendations could be incorporated into the Act on the amendment of the Constitution of the Republic of Hungary and the Act on the Hungarian Army.

In line with our recommendations formulated in the report on the audit of the utilisation of state funds spent on research and development from the central budget, the Act on research and development and technological innovation specifies the frameworks of the state tasks promoting the production of research and development and technological innovation results and the utilisation thereof by the economy and the society. The act also stipulates the most important legal regulations pertaining to the utilisation of publicly financed subsidies, and facilitates the utilisation of the results of budgetary research places by the economy.

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Partly upon our recommendations for the elimination of differences in the interpretation of law, certain provisions of the Act on the rules of taxation and of the Act on personal income tax were harmonised.

The Act on the rules of taxation was amended upon our initiative. The amendment left the upper limit of the default penalty untouched, however it made the definition of the upper limit of the default penalty more accurate. In determining the upper limit, the tax authority has a greater scope of action for differentiation in determining the sanctions.

Our recommendation made in the report on the audit of the operation of the National Radio and Television Commission (ORTT) and Broadcasting Fund was also realised: the bill on the execution of the 2004 budget of ORTT submitted by the Budgetary and Financial Committee presented the utilisation of the Broadcasting Fund already in line with the SAO's recommendation. The National Assembly accepted the bill.

The Act on mandatory health insurance was supplemented with the System of Managed Health Care.

In 2005, a large proportion of our recommendations made in connection with the **audit of the execution of the 2004 budget** of the Republic of Hungary was realised in the legislative work.

The over-the-year liabilities of certain separated state funds were regulated in the Act of 2006 on budget. This act settled this issue in relation to the employment sub-fund and training sub-fund of the Labour Market Fund. In connection with the National Cultural Fund the regulation was included in an amendment of an act; they plan to issue the enforcing decree in the first quarter of 2006.

The Act of 2006 on Budget stipulates the transfer of care organisers involved in the managed health care model experiment into the system of managed health care. Furthermore, it stipulates the frameworks and certain conditions of the system of managed health care.

The recommendation for the repayment of some of the subsidies provided to local governments was incorporated into the Act on the final accounts.

According to the information provided by the Hungarian Regional Development Office under the "Regional development" budget chapter, the TERKI appropriation (regional equalisation development subsidy) of HUF 4,800,000, which was unlawfully locked up, was withdrawn pursuant to the SAO's recommendation.

Our recommendations made in our **opinion on the 2006 budget** appropriation bill of the Republic of Hungary were taken into account, and the necessary amendments were made to the Acts on public education, social administration and social welfare benefits, and on the child protection and guardianship administration realised in connection with the modifications related to normative contributions and supports.

**In the report on the audit of the integration of the network of higher education institutions** we recommended that the Act on higher education be amended so that Hungary could successfully participate in the European Higher Education Area, and so that it would foster the more efficient

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operation of the institutions and the transformability of the training structure and the internal organisational units. We also recommended the elaboration of a medium-term development plan up to the year 2010, including the determination of the state development resources.

After several years of preparation and serious professional debates, the National Assembly approved the new Act on higher education at the end of 2005. The new act specifies the tasks of higher education within the higher education system of the European Economic Area, stipulates the training structure and institutional frameworks of the higher education institutions.

As a medium-term plan for the years 2005 to 2008, the Government approved a Universitas Program with a total appropriation of HUF 175 billion. The top priority task of this program is the development of the infrastructure of the higher education institutions, as well as the implementation of dormitory investments and renovations – not primarily from state funds, but rather in the framework of PPP projects.

Pursuant to our recommendation formulated during the audit of the operation of the “**Ministry of Employment Policy and Labour Affairs**” chapter, the Act on adult education was amended. The Ministerial decree related to the enforcement of the act has been issued. A Government decree was passed on the transformation of the system of normative subsidies to adult education. Reporting on and auditing of the utilisation of resources are included in the audit plan of the Ministry of Employment Policy and Labour Affairs for the first half of 2006.

Pursuant to **several recommendations** made for the National Assembly, or pertaining to the legislative activity thereof, the review of the relevant acts and regulations, etc. started **in 2005**, however changes are expected only in the next parliamentary cycle (e.g. in case of the Act on radio and television broadcasting or the Act on the National News Agency).

**The SAO’s recommendations regarding the concept of the Act on public finances have not been realised.** According to the information received **they will be implemented within the reform of the system of public finances.**

### **3.2.2. Recommendations at governmental level**

In order to track the utilisation of recommendations and proposals made during the audits, the SAO, **in line with the practice of the former years, requested information from the Government and the heads of the ministries about the utilisation of the recommendations in 2005, too.** The entities affected responded to the request, and the answers given by the ministries have become more comprehensive year after year.

Based on the measures taken for the elimination of the discovered deficiencies, all in all, our recommendations are received and utilised favourably. We must note, however, that a more complex picture about the implementation of the

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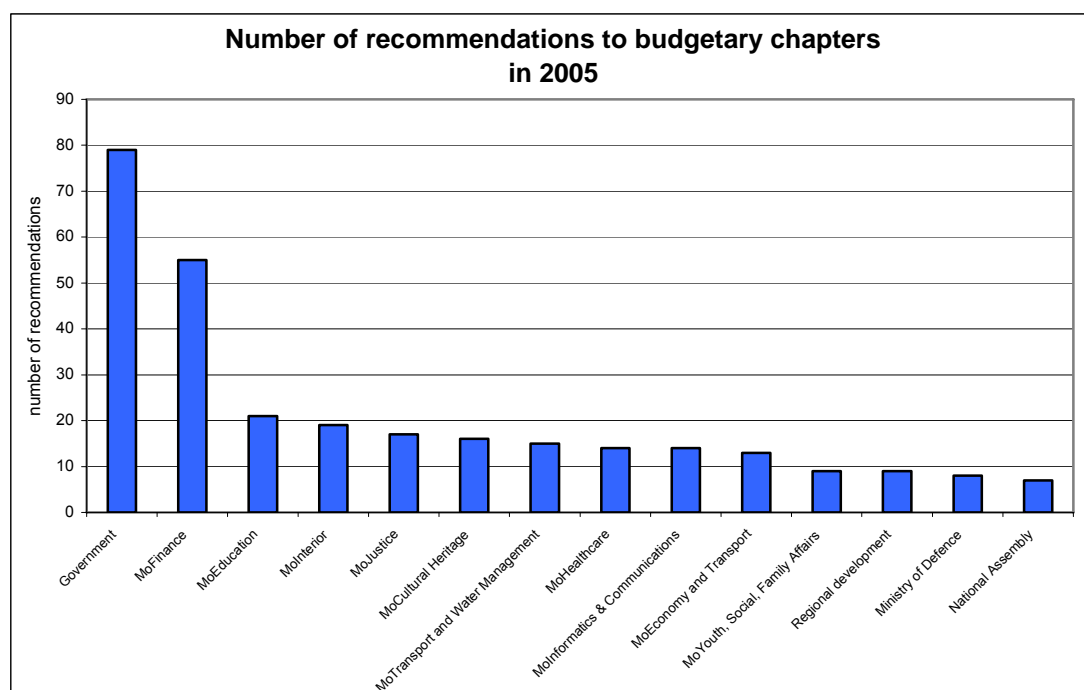
recommendations and the effects thereof can be provided only through audits focusing on special purpose or a' posteriori audits.

Several ministries responded that we had greatly assisted them in fulfilling their professional tasks and in their financial management with our recommendations made during our audits, and that they had made progress in several fields in relation to regularity, regulation and efficiency as a result of our work.

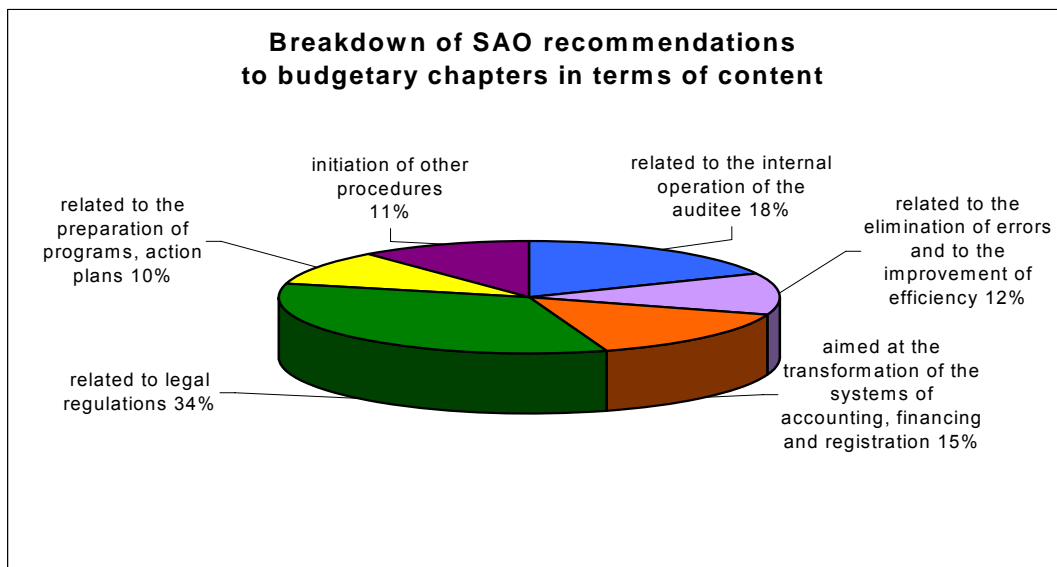
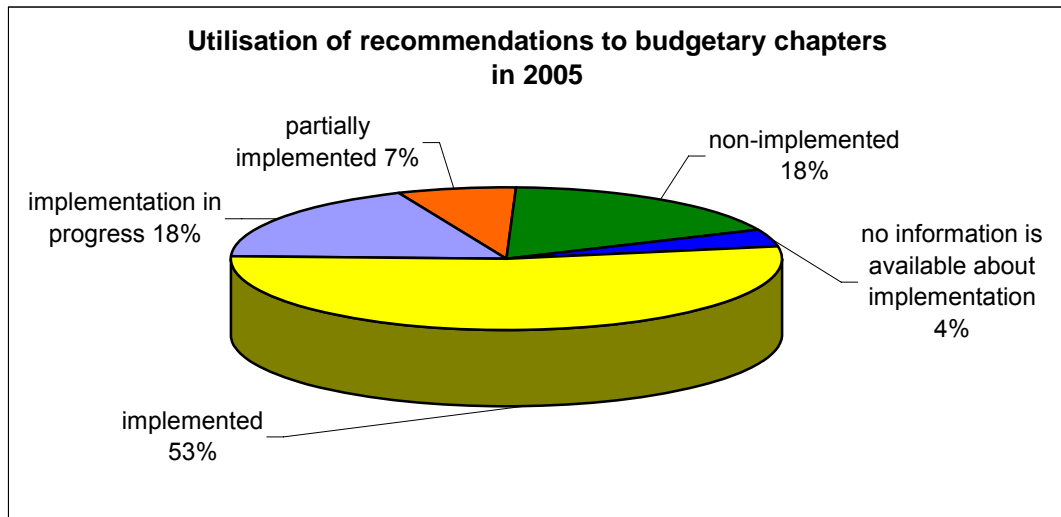
It is worth noting that **on certain occasions the utilisation started already during the audit.**

The feedback about the utilisation of our recommendations is all the more important for the SAO, since apart from initiating the restoration of legality there is no generally accepted legal provision for the consideration of the recommendations of the State Audit Office of Hungary.

The SAO selects the addressees of its recommendations on the basis of which organisation (the head of which organisation) can take considerable steps for the realisation of a given recommendation due to its (his) competency or scope of authority.



According to the information received, nearly 80% of the recommendations addressed to the ministries were either implemented, or are being implemented.



According to the responses received in connection with our recommendations aimed at **legal regulation**, 42% of such regulations were implemented, in 17% of the cases measures are either in progress, or are expected to be taken in the future. Altogether 33% of our recommendations were rejected. These recommendations typically called for the amendment of the legal regulation. In some cases the current regulation was found suitable. The responses did not give any feedback in connection with the remaining 8% of our recommendations.

As many as 18% of the recommendations aimed at the review and further development of the **internal control systems** of the auditees, as well as that of the operation of chapter managed and internal audits, and initiated efficiency and streamlining measures. Based on the responses received, concrete measures were taken pursuant to 94% of these recommendations, or the audited organisations concerned started preparations for the utilisation of the recommendations. Six per cent of the recommendations they are planning to implement only in the future.

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Based on the responses received in connection with recommendations aimed at the elimination of accounting and registration irregularities, and at the modernisation of **accounting, financing and registration systems**, the entities concerned agreed with 79% of such recommendations, and the realisation thereof is either under way, or has been completed. In the rest of the cases either no feedback was provided, or the responses did not unambiguously give account of the implementation of the recommendations.

Altogether 86% of the SAO's recommendations aiming at **enhancing expediency, efficiency and effectiveness**, or eliminate the revealed errors, deficiencies were received positively.

Ten per cent of the recommendations called for the elaboration of **programs or action plans**. According to the responses, 100% of these recommendations were received positively: 52% of them have been implemented, and 48% are being implemented.

In addition to the adoption of particular laws and amendments to the law, the **Government's report on the utilisation of the SAO's recommendations** can be summarised as follows.

After being evaluated by the SAO, the managed health care model experiment launched in 1999 was evaluated in detail by the group of experts of the Ministry of Healthcare and the National Health Insurance Fund. The findings were submitted to the Committee on Health Affairs of the National Assembly and –for the specification of future tasks– the Government. Taking all this into consideration, the decision was made according to which the model experiment should be terminated and the managed health care system should be established on the basis of the experiences gained from the model experiment. In pursuance of Act LXXXIII of 1997 on the Benefits of Mandatory Health Insurance (hereinafter: Ebtv) and in pursuance of Act CLXXXII of 2005 amending Act XXXIV of 2001 on the Specialist Health Services, further more on the Amendment of Various Laws, the Articles 38/C and 38/D of the Ebtv were supplemented with the System of Managed Health Care. Upon authorisation provided by the amendment to the act, Government Decree 331/2005 (XII.29.) on managed health care was issued, which contains the detailed rules for the invitation for and evaluation of tenders, the regulation for the calculation of per capita subsidy and the rules pertaining to the utilisation of surplus revenue thus generated. Furthermore, the government decree specifies the rules pertaining to the liquidation of the organiser of services, as well as the rules of withdrawal from the managed health care system, and the supervision of such withdrawals.

Upon the recommendation of the Minister of Education, the Government issued Government Decision 2153/2005 (VI. 27.), which terminates the independence of the National Public Foundation of Student Dormitories, and orders that the activity of the foundation be pursued by its legal successor, the Public Foundation for Education, which functions as an priority non-profit organisation, and incorporates several other public foundations.

The most important tasks recommended to the Government by the SAO in its report on the audit of the operation of the Hungarian Export-Import Bank were summarised in the annex to Government Decision 2169/2005 (VIII. 3.) on Hungary's medium-term external economy strategy. With its resolution No. 1095/2005 (IX. 22.), the Government approved that the medium-term strategy of

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the Hungarian Development Bank be supplemented with the cooperation involving EXIMBANK and MEHIB Rt. (Hungarian Export Credit Insurance Ltd.) at group level. As the entity exercising the founder's rights over the Hungarian Development Bank, the Minister of Economic Affairs and Transport specified in detail – in the annex to the Founders' resolution No. 34/2005.(IX. 30.) – the most important objectives related to the activities of EXIMBANK and MEHIB Rt.

Pursuant to our recommendation made in our report on the operation of Hungarian Export Credit Insurance Ltd., Article 12 and the temporary provisions of Government Decree 303/2005 (XII. 25.) specify the new regulation on the special reserve for the so called not yet served fees. This regulation replaces the regulation pertaining to the provisions for expected liabilities.

Pursuant to our report on the audit of preparation for the prevention of natural disasters, the Government decree on the rules of stay in free water bodies was amended. For the prevention and mitigation of serious industrial accidents the risk-analysis has been prepared, and the Act on the management and organisation for the prevention of disasters and Government Decree 2/2001. (I. 17.) were amended. Within the organisation of the National Directorate for Disaster Management under the Ministry of the Interior, the Working Committee on the Mitigation of Serious Industrial Accidents was set up.

Pursuant to our report on the expedience of the financing system of water and canalisation projects by using funds handed over by local governments to organisations outside public finances, the Government issued Government Decree 244/2005 (X. 31.) to amend Government Decree 12/2001 (I. 31.) on state subsidies for housing purposes. The amendment tightened the rules of interest subsidies on water and canalisation loans in order to prevent the provision of state-subsidised loans for investments with artificially inflated costs.

The amendment also modified the rule on the basis of which the amount of the loan is determined, wherefore the definition of the total cost of investment became unnecessary. The rule pertaining to the reduction of the reimbursement obligation was incorporated in the government decree.

The application for interest subsidies of water public utility companies loans is regulated in detail in the contract concluded by the financial institutions concerned and the minister without portfolio responsible for the development of the regions and the reduction of regional inequalities.

During the amendment of Government Decree 249/2000 (XII. 24.) in 2005, the Government took into consideration the SAO's recommendation, according to which the requirements of the accounting principle of separate evaluation should provide for the collective evaluation of receivables subjected to a simplified evaluation procedure (Article 5 of Government Decree 319/2005 (XII. 26.) made the accounting regulation more accurate).

In the course of its subsequent audits, the SAO monitors the implementation of the measures taken by the heads of the ministries, and gives a brief summary thereof in its reports.

In addition to the annual summaries prepared about the utilisation of our recommendations, the following specific measures were implemented **in the past four years** upon our recommendations. The SAO's recommendations



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and findings, or part of them were taken into account during the elaboration of several new or amended government decrees:

The SAO regularly conducts audits in the field of **national defence**. The following achievements can be pointed out as the utilisation of our recommendations made in the past four-year term.

The introduction of the New Ministerial Defence Planning System (TVTR), and the continuous updating of the databases of the Defence Planning Support Information System (VTTIR) allow the Ministry of Defence to present its draft defence budget appropriations based on the 10-year plan devised for the period between 2006 and 2015 (and the underlying resource, cost and expenditure plans). During the discussion of the 2006 budget of the Republic of Hungary, the budget submitted by the Ministry of Defence and its parliamentary presentation were based on this 10-year plan.

After organisational restructuring, the Ministry of Defence continuously reviewed and renewed its internal regulations in order to streamline logistic supplies (typically public procurements) with the aim of developing and maintaining skills, of eliminating parallelisms, and of making procurements in the spirit of efficiency.

Within the framework of the organisational modernisation of 2005, an organisational unit was set up to elaborate the strategy underlying the development of the IT infrastructure, comprehensive regulations and documents suitable for security accreditation.

In 2005, the rules related to exercising the ownership and professional supervisory rights as well as the rules of setting professional requirements were revised in the favour of the efficient operation of share companies and non-profit companies that are required for the maintenance of military skills, but were not explicitly established for the fulfilment of military tasks.

The entities concerned tried to eliminate or prevent deficiencies that were indicated in the annual qualified opinion of the SAO (but which deficiencies did not influence acceptance) by issuing several internal regulations, by enhancing the efficiency of the financial management control, by updating the system of accounts and the accounting policy of the chapter, by adjusting the internal audit rights to the new organisational structure. At the Ministry of Defence, the reliability audits may be extended to the entire chapter after the completion of the approved organisation development plans.

In relation to the **major healthcare related SAO recommendations**, the following can be stated based on the past four years. The Government submitted the Johan Béla National Program for the Decade of Health to the National Assembly, which it subsequently approved. The monitoring system aimed at facilitating the efficient utilisation of funds in the health sector was developed. However, audits related to the utilisation of chapter-managed appropriations and the preparation of the related documents continue to fall short of the expectations. The Government's concept on the development of emergency care was adopted. The Ministry of Health undertook to prepare

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proper registration about the utilisation of chapter-managed funds. The ministry also undertook to utilise the professional documents related to the preparation of the healthcare reform, and took measures to make the institutions prepare missing regulations and stop employment without work contracts.

Among other things, the SAO recommended that the Government should evaluate the implementation of the provisions contained in Parliamentary Resolution 60/1991 (OGY) on the concept of the renewal of the social security system and on short-term tasks, and that it should elaborate the long-term concept on the transformation of the system of health insurance and submit it to the National Assembly. The recommendations were supported, but they have not been implemented yet.

Several major amendments of legal regulations were made pursuant to the audits of the budgetary relations of **local governments**, as well as the comprehensive and other audits thereof.

Major amendments were adopted in relation to the provision of subsidies supplementing personal income tax incomes in order to reduce the difference in revenues of different local governments. Based on the SAO recommendations aimed to reduce income differences, the Act on the 2004 budget determined the method of distribution of surplus funds generated from the tax ability related withdrawals and the financial statements at year-end.

Upon our repeated recommendations, the distribution of the personal income tax was modified in 2003. The ratio of the personal income tax that can be – in theory – freely used by local governments of all settlements increased from 5% to 10%.

For years, the SAO had recommended the central regulation of the normative method for the distribution of resources among local governments of the capital and of the districts based on several audits. After amending the Act on local governments, which contains the principles and frameworks of the distribution of resources, the National Assembly adopted the Act on the normative methods for distribution of resources.

In connection with the audits of target and earmarked subsidies, progress has been made in the enforcement of the VAT deduction right, too, since 2002. As a result of the modification of the regulation, the beneficiary of the central subsidy cannot be changed during the implementation of the project, and only the host local government can submit to the financial institution the unpaid and reviewed invoice certifying the completion of the project.

Pursuant to our recommendations pertaining to the establishment of the professional requirements for local governmental audit tasks, Government Decree 193/2003 (XI. 26.) on the internal audits of budgetary institutions was issued, which also covered local governmental budgetary bodies.

The Act of 2003 on the budget accepted – as a centralised legal title – the recommendation for promote and support the operation of internal audit associations from the central budget.

Since the Act on regional development and country planning had entered into force it has been a major progress in the decentralisation of development related

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decisions that pursuant to our recommendations, more and more tasks are assigned to the regional development councils in addition to the county regional development councils.

In the system of normative contributions, supplementary contributions were introduced in 2005 to foster the development of efficient and cost-effective institutional network in the field of public education. In the field of social and child welfare benefits some of the normative supports determined on the basis of the number of residents were replaced with contributions linked to actual task performance indicators, wherefore these resources are allocated proportionately to those local governments that actually perform the relevant tasks. Compared to the Act of 2004 on the budget, the Act of 2006 on the budget contains fewer legal titles for normative support for certain public education related tasks, since such subsidies were incorporated into the normative state contributions.

Upon the SAO's initiative, since 2005 the Act on the budget has determined the limit of value above which local government owned property can be sold, or the right of use or utilisation thereof can be transferred only through tenders.

It is considered as a step forward that the affected ministries in the form of decrees have determined the rules of application for central appropriations since 2005.

It is considered as an achievement in relation to the audit of local governmental subsidies granted from non-public sources that in line with our recommendations, the rules of interest subsidies granted for state sponsored public utility loans have been made more stringent.

In 2005 pursuant to the recommendations made during the audit of the development potentials of local government run baths and spas, the National Tourism Development Strategy 2006–2016 was completed. This program includes the intention to coordinate bath developments within the health tourism concept, and sets professional priorities. The approval of the concept of the Act on tourism is included in the Government's work plan for the first half of 2006. The development of health tourism will be also included in the 2nd National Development Plan.

In line with the recommendation made during the audit of healthcare investment project financed from earmarked subsidies, the Healthcare Development Concept was completed in 2005. The amendment of the Act on the earmarked and target subsidies to local governments – which has been submitted to the National Assembly, and is pending approval – aims at the reinforcement of the elements of tender procedures and of the publicity.

Pursuant to the recommendation made in relation to the audit of public cemeteries, the 2005 amendment to the Act on cemeteries and funeral services allows local governments with no public cemeteries to fulfil their public funeral service related tasks within the framework of supply contracts.

The performance of public education/cultural tasks by local governments is facilitated by the ministerial decree on professional supervision, which was issued in 2005.

As a result of the amendment of the Act on national and ethnic minorities (which determines the operation of national minority local governments) at the end of 2005 – which amendment was also recommended by the SAO – the legal

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status of the office of local governments will be clarified, and it will be transformed into a budgetary institutions by January 1, 2008.

The utilisation of the recommendations made for the review of the Act on political parties, the adjustment of the Act on accounting and the regulation of the transparency and accountability of electoral campaign funds was hindered by the lack of political consensus necessary for the amendment of two-third majority acts.

### **3.2.3. Recommendations at the level of auditees**

**When auditing the execution of the 2004 state budget, and when commenting on the 2006 budget**, the SAO formulated recommendations for the heads of all chapters. These recommendations pertained to the preparation and updating of the operational, financial management and accounting regulations, the proper operation of internal audits, and to taking the necessary measures. In pursuance of the recommendations made in relation to the internal regulation system of the auditees, as well as the findings and recommendations pertaining to the operation of the chapter managed and internal audits, the concrete measures were taken.

In relation to the **audit of the “Ministry of Education” chapter**, in 2005 we started to screen the operation of the background institutions of the Ministry of Education on the basis of calculations and analyses, as a result of which two ministerial orders have been issued. The implementation of these orders, as well as the screening of the Ministry by an external consultancy company continued well into 2006. If all goes to plan, the proposal regarding the new organisational structure will be elaborated in the first half of the year.

In pursuance of the SAO’s recommendations made during the audit of the operation of the **Hungarian Customs and Finance Guard**, the Minister of Finance took the necessary measures to amend the decree of the Minister of Finance on setting the sales price of flats to be sold, and ordered the comprehensive investigation of infringements revealed in the financial management of the Customs and Finance Guard. Based on the findings and recommendations of the audits of the realisation of excise tax revenues and the operation of the Customs and Finance Guard, the Minister of Finance elaborated action plans, however the SAO has not yet conducted a’ posteriori audits in relation to the implementation of these plans.

In relation to preparation for the **prevention of natural disasters**, the Governmental Coordination Committee and the ministries with regard to our audit findings and recommendations have prepared action plans. The contents of these plans were harmonised, however the deadlines for the major tasks were extended, wherefore we cannot report on the actual benefits thereof.

The recommendations made to the Government called for the establishment and operation of a **centralised payroll system**, the review of the experiences thereof, and upon the evaluation of the experiences the creation of the conditions for reasonable and efficient operation. The findings we had indicated several times were utilised during the preparatory work of the

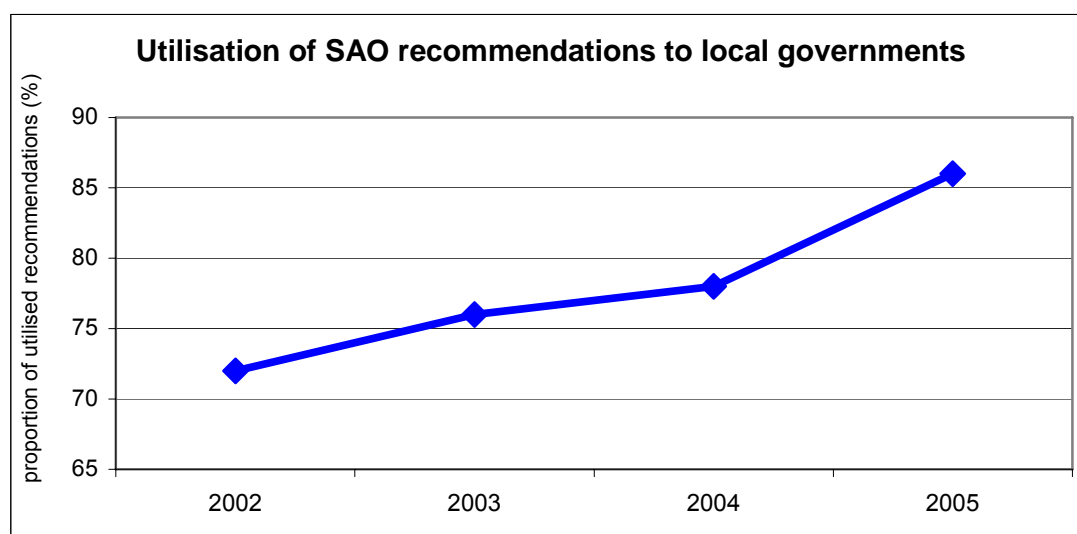
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government decree on centralised payroll. The system of programs was standardised, and the task related responsibilities were unambiguously defined.

The audited organisations took several measures based on our recommendations made for the Minister without portfolio in charge of EU Affairs and the Minister of Economic Affairs and Transport during the audits of **transport development programs implemented with ISPA support**.

Pursuant to our recommendation, the Government decided about the establishment of appropriations for the preparation of a project worth HUF 27 billion, which not only covers the costs of the potential EU projects, but also the quality assurance of the preparatory documents. The fund provides HUF 10 billion and professional assistance for the preparation of 17 large projects in the field of transport. In order to create and ensure the coordinated operation of an expert team in the long run for the quality assurance, financial and technical review of current projects implemented with support from the Cohesion Fund, the National Development Office, the Ministry of Economic Affairs and Transport, and the Ministry of the Environment and Water Management announced a joint call for public procurement tenders. The related contract was signed in December 2005. Under the contract, the experts are available until mid 2007. The management of the utilisation of support from ISPA/Cohesion Fund was developed so that the original schedule of the program and the related projects could be maintained.

During **the comprehensive audit of the financial management of local governments** in 2005, the SAO examined the implementation of recommendations made for the elimination of deficiencies revealed during various audits carried out from 2002 until 2004. Nearly two thirds of the recommendations aimed at ensuring the regularity of financial management, and one-third at the improvement of the expediency of financial management. Most (nearly two thirds) of the recommendations were fully, while one third were partially or not at all implemented by local governments.



As far as the realisation of the recommendations is concerned, there are deficiencies in the regularity of financial management, which are mostly related to the financial management and control system, the public procurement procedure and cooperation with local minority governments. The councils of local governments several times passed decisions that did not fully meet the transparency requirements.

**It is positive that the SAO recommendations made for local governments of counties, towns with county rank and the districts of Budapest** affected by the comprehensive audits of the financial management **were implemented within a short time.** Several local governments took measures to eliminate deficiencies detected and defaults already during the on-site audits. They accepted the recommendations related to compliance with the legal regulations, the performance of economic activities, as well as the transparency and expediency of financial management, and prepared action plans for the realisation of such recommendations.

### **3.3. Initiated criminal procedures and announcements of public interest**

#### ***Criminal procedures initiated by the SAO***

Similarly to the previous years, in 2005 the SAO complied with its obligation specified in the Act on the State Audit Office of Hungary and in the Act on criminal procedures, according to which it must inform the investigation authority about any audit findings that support the suspicion of a crime. Therefore, a criminal procedure can be based on any data representation that supports – with documents – the suspicion of a crime at the level of probability.

#### **Number of charges filed in the different years**

Years	Number of audits resulting in the initiation of criminal procedures	Number of persons against whom charges were filed	
		Total	unknown persons out of that
1993 to 2000	25	45	3
2001	3	3	1
2002	12	22	-
2003	8	8	6
2004	13	22	6
2005	5	7	2
<b>Total:</b>	<b>66</b>	<b>107</b>	<b>18</b>

Since its establishment, the SAO has initiated criminal procedures altogether in 66 cases, out of which 5 in 2005, which meant that a total of 109 suspicions of criminal acts have been reported, out of which 7 in 2005. Similarly to the

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previous years, in 2005 the most frequent suspicion was the **violation of accounting rules**.

In the period of 1993 to 2005, the SAO initiated criminal procedures in 33 cases due to the suspicion of the above crime, 2 out of which in 2005. The second most common type of criminal act is the acquisition of **unjust economic benefit**.

The SAO discovered such crimes in 21 cases, out of which three in 2005. For the suspicion of **misappropriation** the SAO has initiated criminal procedures in 18 cases so far, out of which one in 2005. We have filed charges for the suspicion of **embezzlement** in four cases, only ones in 2005.

### **Distribution of charges according to the type of crimes (1993–2005)**

Violation of the accounting discipline and the accounting rules	33
Acquisition of unjust economic benefit	21
Misappropriation	18
Negligence	10
Fraud	7
Forgery of private documents	7
Embezzlement	4
Abuse of authority	2
Other (tax, social security frauds, violation of secret, etc.)	7
<b>Total:</b>	<b>109</b>

We initiated criminal procedures in connection with the financial management of local governments more often than in any other fields audited by the SAO. This is explained by the fact that in most fields affected by the SAO audits there are several state organisations authorised to perform audits, while the audit of the financial management of local governments is the exclusive right and responsibility of the SAO. It happens that local governments submit applications by declaring bogus funds, accounting deficiencies are also often revealed; the rules of cost reimbursement are irregular, etc.

The major audits conducted last year included the so-called ÖKOTÁM audit, upon which a criminal procedure was launched, too. The ÖKOTÁM system is a specific, multi-pillar method for funding local governmental road construction and canalisation projects. Pursuant to our report, the National Assembly requested the SAO – in the Act of 2004 on the final accounts – to examine the legality of the application for and the utilisation of public utility development subsidies transferred to local governments for road and sewerage construction, with special regard to projects implemented within the ÖKOTÁM and similar systems. In pursuance of the request, the national audit is under way.

It happens more and more frequently that in criminal procedures initiated by other entities (private persons, authorities) the investigation authority wants to

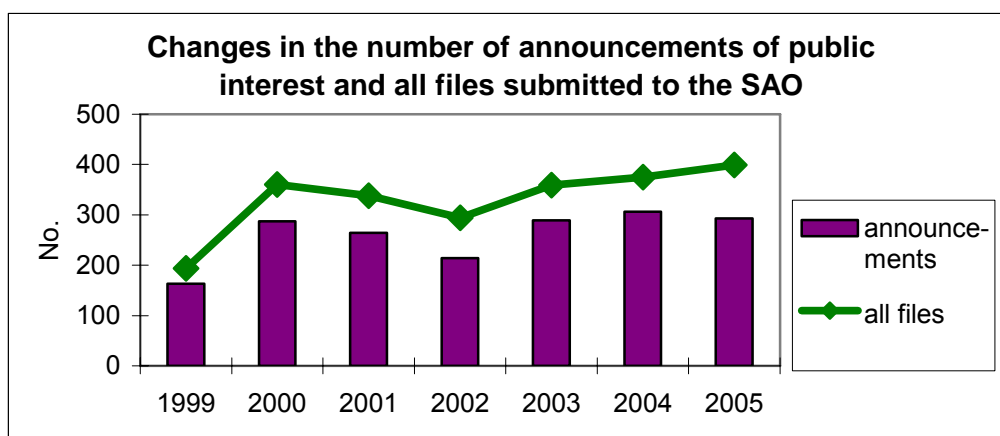
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get to know the findings of the SAO audits. In 2005, the SAO was contacted in 33 such cases. The amendment of the Criminal Code in 2005 is an important development – the preamble of the amendment also cites the findings of the SAO audits –, accordingly the violation of the accounting rules is punishable even if the violation is the result of negligence, if that prevents the review (audit) of the economic condition.

In order to support the work of auditors engaged in on-site audits, in 2005 we prepared a **field manual on criminal prosecution** for internal use, which analyses in detail – using the experience accumulated so far – the conditions for substantiating the suspicion of crimes frequently revealed by the SAO audits. The aid is also designed to further develop the practice of initiating criminal procedures by the SAO.

### ***Announcements of public interest***

The number of announcements of public interest, proposals and complaints (hereinafter: announcements), as well as the number of requests for assistance made by authorities, reached its peak in 2005 after many years: in that year 399 announcements (out of which 293 were announcements and 106 were requests) were made.



Although they usually contain specific requests, the **announcements** submitted to the SAO provide a sensitive “feedback” about the practice of utilisation of public funds in Hungary, the anomalies of such use, about the conditions that determine the atmosphere in the given environment (settlement, region, area of expertise), about the enforcement of certain rules, and at the same time they also demonstrate a certain trust in our work and audits. The **requests for assistance** were primarily requests for the SAO reports, for SAO’s opinion in different issues, and for the performance (launch) of SAO audits.

In 2005, too, nearly three quarters of the announcements were complaints about residents related services rendered by local governments, the demands, possibilities and limits influencing everyday life, the financial management of local governments, or the presumed or real abuse incidents involving local governmental executives. Compared to the past four years, 2005 saw a



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significant increase in the demand for audits of the operation **state organisations and institutions**. In 2002 no such request was lodged, while in 2003 and 2004 such audits accounted for 4% and 6% of all audits, respectively.

Compared to the average of the past six years (18%), in 2005 nearly 11% of the announcements were **transferred** to the SAO from other authorities (Hungarian Tax and Financial Control Administration, public prosecutor's office, police). The trend in which the authorities immediately – without a more in-depth investigation into the scope of audit authority – transfer announcements pertaining to the financial management of local governments, as well as to the state and central public administration organisations seems to diminish to some extent.

The distribution of entities filing complaints is almost the same as before. However, in the past six years it could be perceived that while the number of announcements made by **anonymous** persons (27%) and **private persons** has been slowly decreasing, the ratio of announcements made by member of Parliament, councilors, mayors or public notaries of local governments (16%), as well as announcements received from the staff members (executives) of local governmental institutions, and mostly from the representatives of business organisations, trade unions, associations, foundations, etc, are slowly rising (12%). The number of anonymous announcements has been similar for several years (80 to 90). These announcements are used according to their contents: they are either forwarded to the competent organisations, or to the audit directorates of the SAO to raise awareness of the issues.

An increasing portion of the announcements (20%) can be investigated within the framework of one of the audit programs. In addition, the number of announcements that the SAO has transferred to a competent body for investigation (one of the budgetary chapters or local governments) has grown. The organisations thus contacted later informed the SAO about the measures they took or the results of their investigations.

### **3.4. Publicity of the activities of the State Audit Office of Hungary**

The publicity of the activities of the SAO is ensured by the publication of reports and studies, the provision of information about the events of international audit community, and information about cooperation with the state, social players or institutions, about the dialogues, about participation in the professional audit events, as well as about the characteristics of the financial management and operation of the SAO<sup>26</sup>.

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<sup>26</sup> The concerted developments, which were carried out in the past ten years and affected external image elements, too, resulted in a traditional and authoritative appearance. For the implementation of our strategy, we are developing our institutional image by systemising the rules of application of the image elements while relying on the results we have achieved so far.

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We considered that supporting the audit and legislative activity of the National Assembly was a top priority task in 2005, too. We forwarded the reports and audit programs to the members of Parliament both in printed and electronic formats. In line with the multi-year practice, the President of the SAO drew the attention of the members of Parliament to the most important findings and recommendations in separate letters sent together with each report.

We informed the general public through the press, but most often we used the opportunities provided by our website. We increased the ratio of electronic circulation to publicise our reports, methodological publications and press materials.

In order to use the communication methods in a differentiated manner, and to lay the foundations for the communication tasks in the period between 2006 and 2010, we commissioned TÁRKI Social Research Institute to conduct an opinion poll about how much the SAO is known by the general public. The survey showed that the population receives most of the information about the SAO's work from the radio and the television.

**Maintaining media relations** is one of the most important parts of the SAO's communication activities. We have sent our reports to the different editorial staffs, too. In line with our multi-year practice, we have also published the summaries of the reports in the Official Bulletin of the Hungarian Gazette, and provided information on a regular basis about the audits of local governments in the Local Governmental Circular – which is received by every local government – and in local governmental professional journals.

We have also invited the representatives and heads of the press to our events, and organised “**background discussions**” with the President of the SAO for them. We have organised presidential press conferences on a quarterly basis, as well as every time when reports of great public interest have been published, during top priority events related to the operation of our organisation. In 2005, the Director Generals held four press conferences in Budapest on the professional experiences of audits. The members of professional committees of the National Assembly regularly attended the press conferences<sup>27</sup>.

We held thirteen press conferences in cooperation with local governments on audits conducted at local governments of the counties and towns with county rank.

According to the information given by the Observer Media Monitoring Ltd., as well as our modernised media processing, the number of SAO related publications grew from 1,408 in 2002 to 4,275 in 2005<sup>28</sup>.

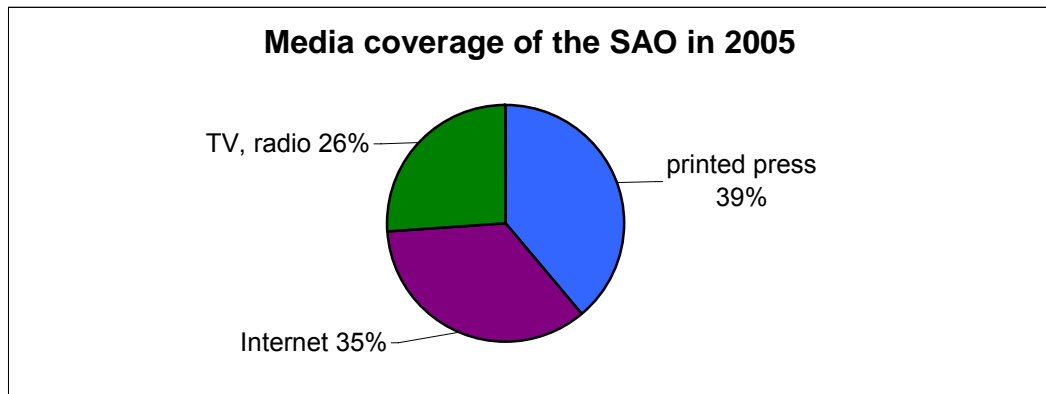
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<sup>27</sup> Since last year, the parliamentary press conferences can be followed live or replayed later on the SAO's website.

<sup>28</sup> In 2002 we did not yet register articles that appeared in Internet publications, and the comprehensive monitoring of articles in local publications was only started in 2004.

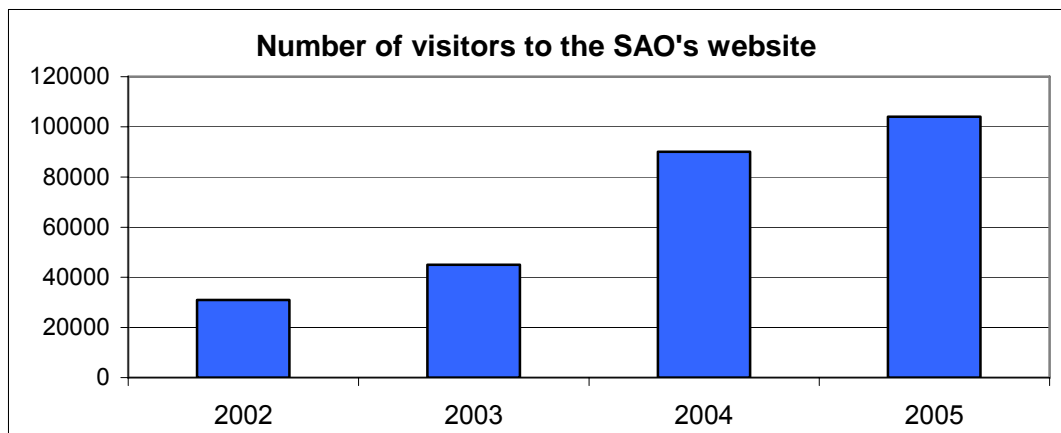
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From the communication point of view, the 2004/2005 year differed from the former years in that there was a considerable growth in the number of SAO reports on the comprehensive audits of local governments with significant budgets, and this consequently increased the media coverage of the SAO, especially in the countryside.



Our **website** enjoyed the greatest popularity. The number of visitors to the homepage more than tripled in four years, and reached 104,000 in 2005 (which meant 285 visitors on average on each day of the year). The website provides access to the full reports, the awareness raising summaries addressed to the members of Parliament, as well as information and data of public interest related to our organisation and its operation.

Since our visitor counting system was installed, reports were downloaded nearly 63,000 times, cover letters have been opened over 2,700 times, and English language summaries have been downloaded 374 times.



We placed the greatest emphasis on the development of public relations through the Internet. Currently, we provide three opportunities to receive questions and comments from the citizens electronically, via the Internet. Within the Forum column on the SAO's website questions and comments can be sent to either the "The SAO Forum" or the "Meet the President Hour".

Feedback can be provided through the **central e-mail address** (szamvevoszek@asz.hu), which was launched in February 2004, or the **website**

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**satisfaction form** introduced in 2005. Experience has shown that these methods of communication are popular among the citizens.

Most comments sent to our **Internet forum** pertained to the financial management of local governments. Most of the questions sent to the “Meet the President hour” – which was organised two times – also related to the operation of local governments and the audit of their financial management. In several cases the comments recommended SAO audits and called for the greater utilisation of the audit findings and recommendations.

We increasingly focus on making university and college students familiar with the financial audits. We already have cooperation agreements with five higher education institutions, in which the managers and staff members of our organisation hold classes on a regular basis. We have hosted students on parliamentary scholarship in the last three years now to make them familiar with the operation of the SAO.

**Our library** is a professional library compiled with scientific rigour, which serves as a professional information centre of the SAO. It serves internal and external needs by providing limited access to the general public. In response to the challenges of the information society, we have continuously expanded the databases and electronic services of the library (the proportion of electronic documents grew from 12% in 2002 to 30% in 2005).

## **4. IMPROVEMENT OF THE QUALITY OF THE AUDIT WORK**

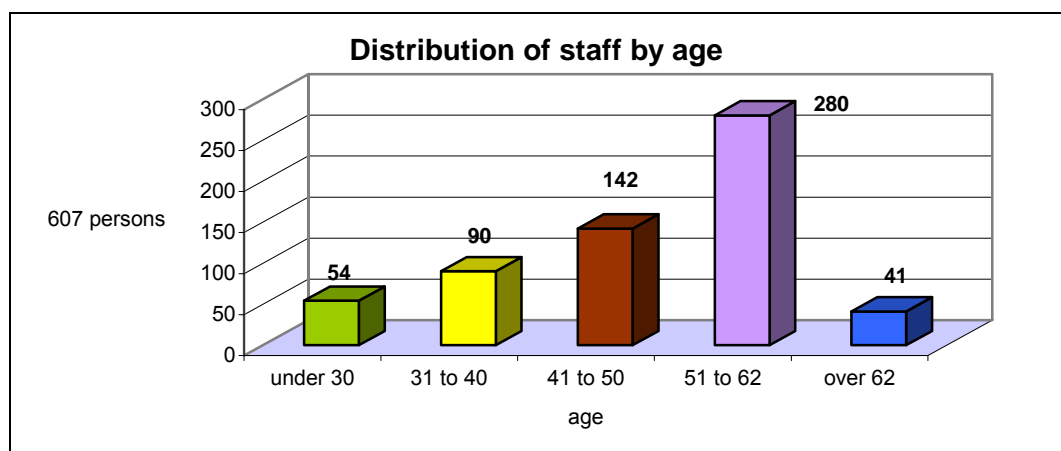
### **4.1. Human resources management and development**

#### ***Personal conditions***

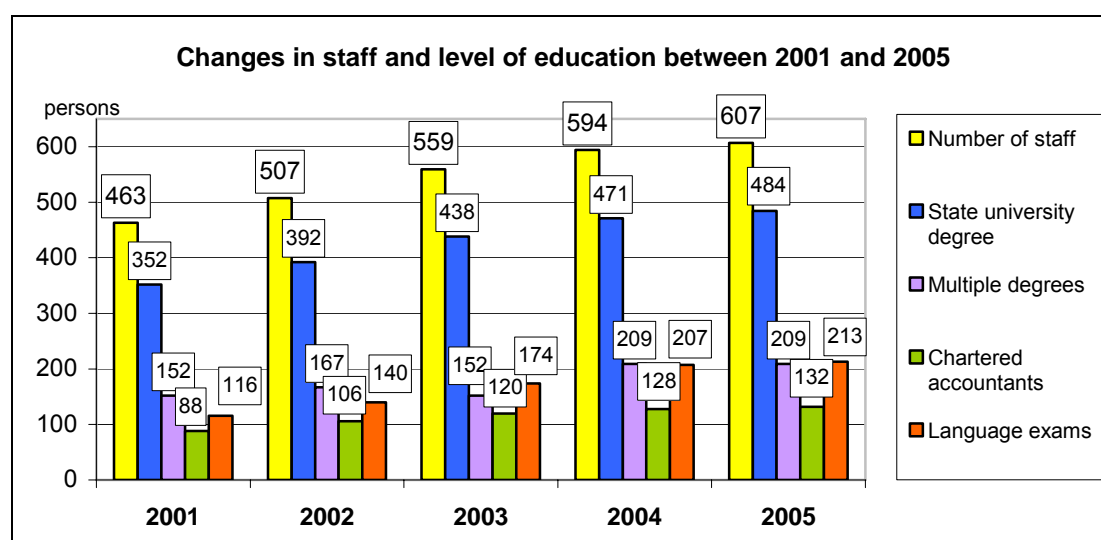
The SAO works in a dynamically changing international and domestic economic, financial, professional and organisational environment, which has become perceptible through changes in requirements, internal organisational and personal movements, as well as changes in the direction and speed of trends. During the change and renewal of the staff we considered as a basic requirement the continuity and stability of the performance of task. Our staff had to prepare for adaptation to and application of the “best audit practice” regarded as a standard requirement in the EU, taking national circumstances into account.

In the past five years major personal and organisational changes occurred in two directions. One was related to the growth in the number of auditors due to the restructuring of the tasks, while the other was related to the significant changes in the distribution of the staff by age. The National Assembly approved to increase of the audit capacity gradually, in several steps. The new order of audit tasks and the management–control functions has been developed with significant restructuring. At the same time, we started to rejuvenate the auditors’ staff, the average age of whom was 51 years. In order to have a healthier age distribution, we encouraged the hiring of younger experts – and young people at the beginning of their careers – during the staff expansion and to vacant positions. As a result, the average age of the auditors

significantly dropped. In 2005, the average age of the SAO employees was 48.3 years. Within that, the average age of senior auditors was higher (53.8 years), while the average age of lower rank auditors was lower (47.2 years).

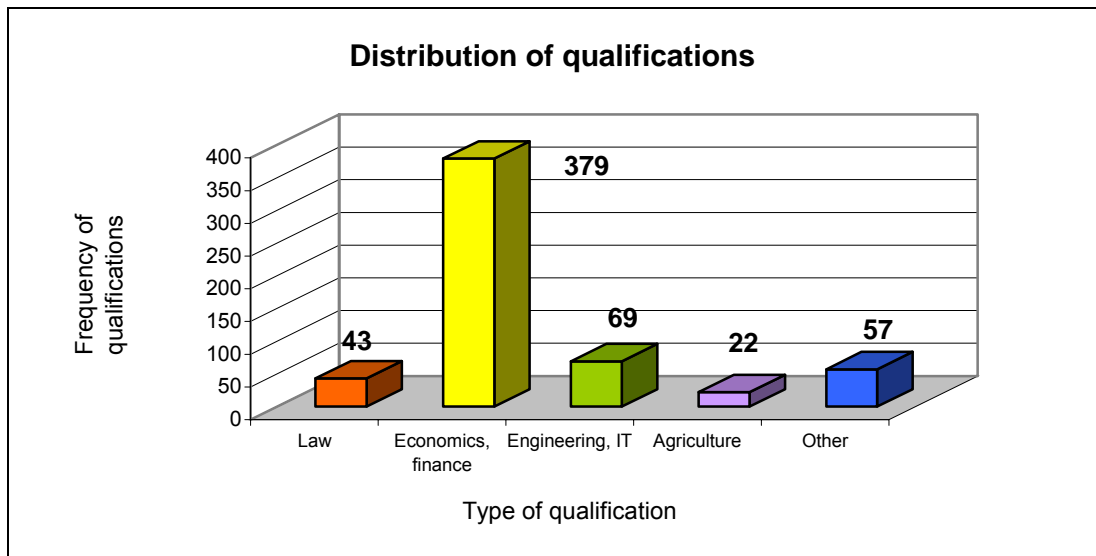


From 2001 to 2004 the staff of the SAO grew by nearly 30%, in correspondence with the expansion of tasks, and it reached the maximum allowed number of 618 (which includes the civil servant posts of the Research and Development Institute of the SAO) The number of staff was not expanded in 2005, and in 2006 either, and as we indicated in Section 1.1, the staff included 607 employees as of December 31, 2005, including seven temporary employees. Vacant posts were filled. Due to personal, but on the whole insignificant fluctuations (retirement, quality shifts in positions) posts were vacant only temporarily. The stability of the permanently hired workforce is demonstrated by the fact that fluctuations (resignations, new hiring) have affected only 6 to 8% of the positions in the recent years.

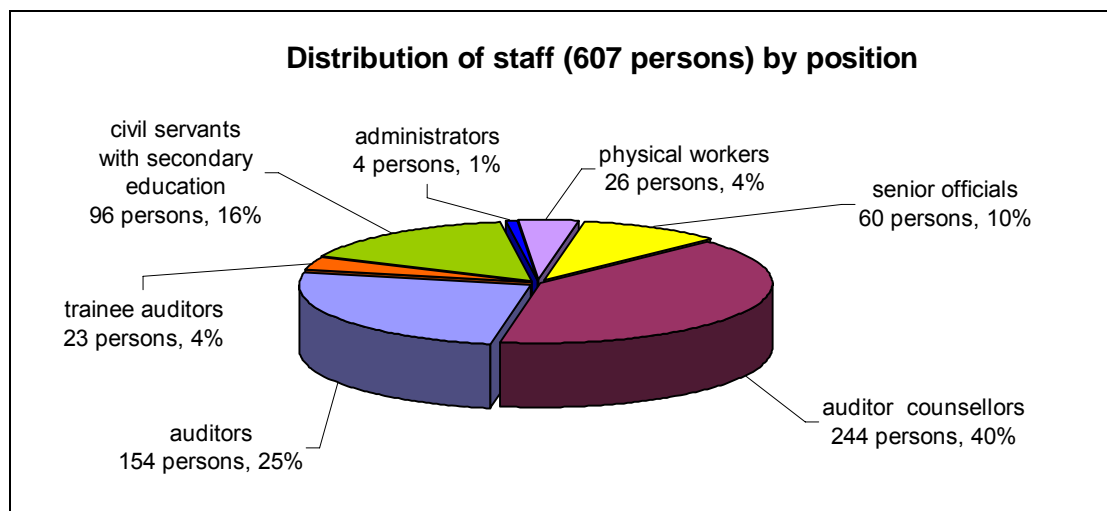


From among the figures related to the qualifications we accentuate that our auditors include 132 chartered accountants and 125 certified accountants. As many as 209 staff members have two degrees, and 30 employees have more than two degrees. For the time being 202 employees have passed state

language exams in at least one major language of the EU (English, French, German).



Apart from the President, Secretary General, Directors General and other senior officials, the SAO's staff includes auditors, civil servants with at least secondary education, administrators and physical workers. During the staff expansion and task restructuring mentioned above we aimed at increasing the direct audit capacities. We increased the number of auditors by eliminating certain administrative and blue-collar posts, too.



Promotion is directly linked to performance and age (term of office). Adequately firm and consistent auditing assumes not only up-to-date knowledge of economics, finance and accounting, but also sufficient workplace and audit experiences, as well as moral firmness, therefore the rejuvenation of the team of auditors has reasonable constraints. The number of trainee auditors is relatively low partly due to their restricted hiring (they cannot audit by themselves), and partly because they are promoted to work as independent auditors in 3 or 4 years. The experts that play an important role in the day-to-

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day audit tasks are mostly middle-aged people in the “auditor counsellor” position. Counsellors demonstrating outstanding individual performance may be promoted to the post of advisor or senior advisor by the President of the SAO. In 2005 there were 43 advisors and 66 senior advisors at the SAO.

The promotion opportunities of auditors have decreased compared to the rate witnessed in the 1990s. To offset this tendency, the institution has introduced a more differentiated system of promotion. During the medium-term program of generation shift, the waiting period for promotion has lengthened for younger auditors and trainee auditors that were hired in greater numbers. This is partly due to the lengthening of the training period in compliance with EU standards, as well as to the limited resources required for regular and reliable promotions. The significance of the monitoring and realistic evaluation of individual performance has grown, therefore we shape the rules and practice of our internal qualification and evaluation accordingly.

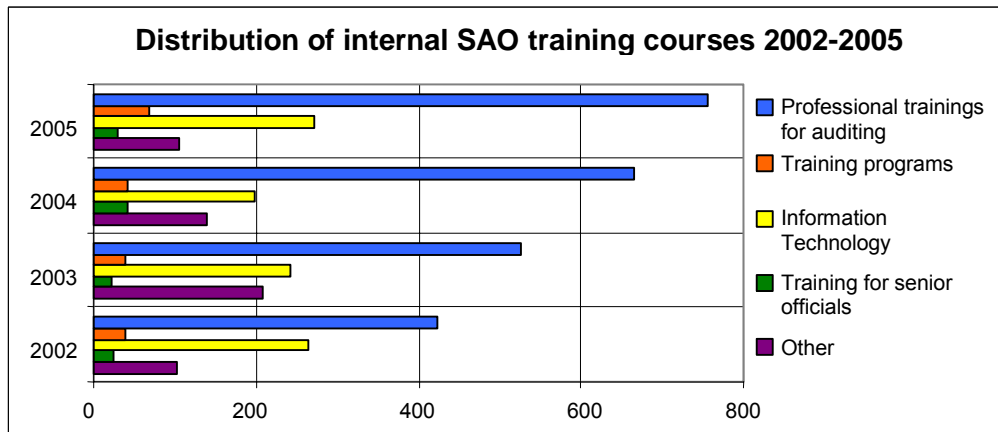
In line with the social and professional expectations, we require the senior officials and auditors of the SAO to comply with stringent moral and ethical requirements. The strict rules related to the conflict of interests are examined during the recruitment process and are monitored continuously afterwards. The property declaration obligation imposed on the civil servants is applicable to most of our employees. The declarations are managed and checked within the organisations (except for the property declaration of the President of the SAO). In 2003, in the spirit of the ethical requirements formulated in the Lima Declaration of INTOSAI, we prepared and published our Code of Ethics, the presentation and interpretation of which is continuously included in our training programs. There has been no ground for disciplinary action at our organisation for years.

The auditors’ work – especially if that involves travelling to farther places – requires not only constant intellectual preparedness on the auditors’ part, but occasionally serious mental and physical endurance. The office workers spend most of their working time in front of computer screens. To protect the state of health of our employees, we continuously develop occupational health services. Since 2005, members of our Budapest staff has been taken care of by an excellently equipped service provider, the 2nd Department of Medicine of the Semmelweis University of Medicine, which also makes it possible for the members of our county offices to undergo thorough screening on an annual basis. We have installed modern, eye-friendly monitors, we ensure that the adverse effects of computer work are controlled, and provide compensating and protective glasses to the extent of the available funds.

### ***Internal training***

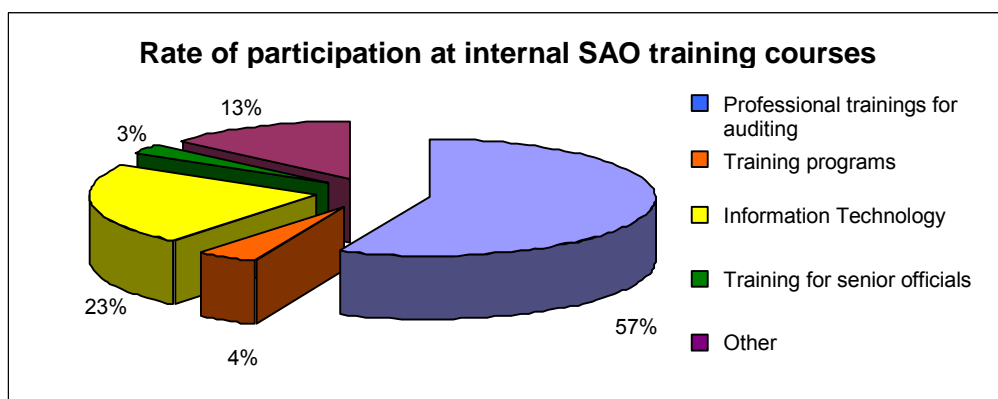
In the 1990s the SAO developed the organisational framework of internal training that meets the specific professional needs and demands. From the year 2000 we faced new challenges: we had to prepare our auditors to learn the EU compatible professional standards and the “best practice”, and apply the methods accordingly. Within the framework of the twinning agreement signed with our British counterpart (NAO), apart from the adoption of the theoretical and methodological knowledge, we developed the possible ways of adaptation

of the modern audit standards, tools and techniques by analysing the findings of joint audits. Since not only the auditors' knowledge and approach had to be renewed, but also that of other national audit experts, the organisation of internal education and training within the program was assigned increased responsibility and workload. Almost all audit units were actively involved in the operation of the mechanism of training, which created the close unity of theory and practice, teaching and learning, internal and external training courses.



Since 1998, the most important training objectives have been set in the form of medium-term plans, during the elaboration of which we consider the provisions of the SAO's audit strategy, the educational principles of INTOSAI and EUROSAI, as well as the main objectives of the development of the Hungarian system of public administration. The medium-term training objectives are specified in annual plans.

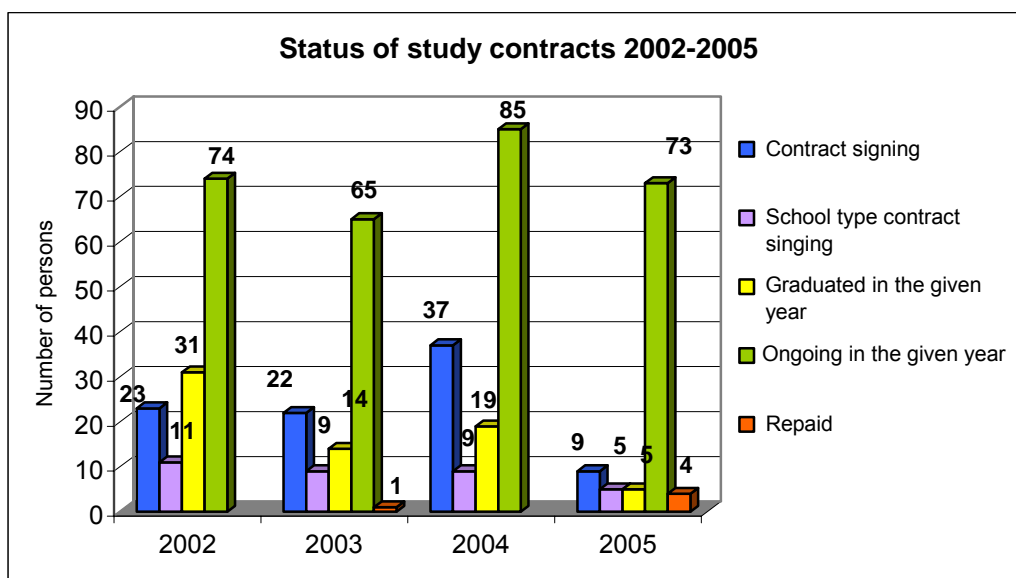
From professional point of view, the *internally organised training courses* – taken in the narrow sense of the word – are the most important, during which we transfer the knowledge required for the completion of the daily tasks, and for audit development, and we develop the skills indispensable for auditing and reporting.



If certain knowledge contributes to the completion of position related tasks at a higher level, the SAO supports the continuation of studies under a *study contract* in line with the relevant legal regulations and internal rules, by



contributing usually 50% of the tuition fee. Between 2002 and 2005 we concluded study contracts with 91 employees, of which 73 were “live” contracts last year, which can be regarded as the average figure. The conclusion of new contracts and the expiration of the old ones practically offset each other in the medium run.



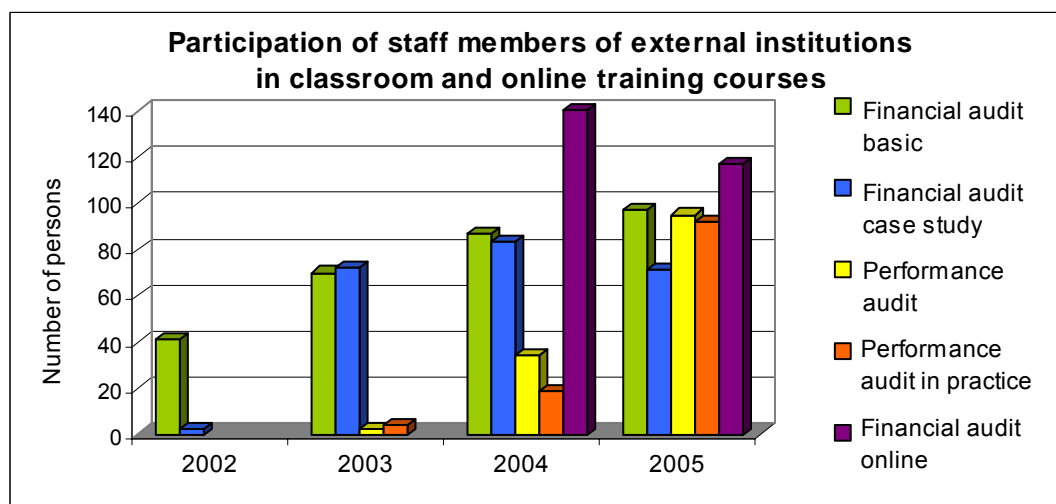
The study contracts are first of all designed to support the acquisition of second degrees (e.g. law-economics, engineering-economics) that facilitate the accomplishment of audit tasks, as well the broadening of IT skills. Due to the rapid increase in the knowledge required in administrator positions, staff members with secondary education will also need to obtain degrees.

Hungary’s accession to the EU, as well as the SAO’s international professional working relations made the knowledge of English and French, as well as the development of the command of foreign languages and the general development of language skills especially important. The basic form of support to language learning is given by computer software that is accessible by all employees and that communicates at different levels. However, a significant number of staff participates in various language courses: in the period between 2002 and 2005 altogether 113 employees were enrolled into language courses to develop their language skills.

The most efficient way for our staff members to develop auditing (professional) and language skills is obtaining experience abroad upon invitation or by participating in secondment upon application. Cooperation with foreign partner institutions often takes a complex shape: apart from scholarship based and other shorter training courses and study tours, it also includes joint audits, audit analyses and the exchanges of experiences. In the past four years we delegated 21 staff members to the various events of international professional cooperation. We have received repeated opportunities to participate in the training courses of the Government Accountability Office (GAO) of the United States, the European Court of Auditors (ECA), the International Centre for Information Systems and Audit (iCISA) in India, and more recently in the training courses of IDI. In order to ensure that our staff members could increase

their number and success in applying for international training courses within the rapidly expanding bi- and multilateral international professional relationships, we set up a target group of 22 in 2002 primarily with the aim of training younger colleagues. The number of such colleagues grew to 66 in 2005.

In addition to the training of its own employees, since 2000 the SAO has been involved in the professional training of internal auditors of ministries and their institutions, as well as in the training of auditors and other audit professionals in the framework of external education. The number of applicants to these training courses is growing year after year. At the beginning of the course we transfer basic information and later practical, complex auditing skills in accordance with the thematic and visual system we have developed. The financial audit course is now listed among the accredited programs of the Hungarian Public Administration Institute.



**The educational and training costs of the SAO  
in the period 2000 to 2005**

	2000	2001	2002	2003	2004	2005
costs (HUF million)	11.2	17.6	24.6	23.9	29.3	30.4
per capita cost (HUF thousand)	26.1	38.1	49.0	43.1	49.7	50.6

*Note: The table shows the direct costs that do not include organisational or working time expenditure.*

The greatest increase in costs was experienced in 2001 and 2002 due to the fact that all cost-increasing factors underwent considerable changes in the mentioned period. The restructuring of the SAO meant the beginning of a multiyear program aimed at gradual staff expansion. We launched the professional training courses required for the EU accession, and the IT and technical developments reached a new stage, which required preparation within an extremely short time. Our organisation gave away its training centre

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in Velence due to the low level of its utilisation. Since then the supply costs and technical expenses of the several day-long courses have appeared as direct costs. Although the lecturers at the internal professional training courses are mostly our own employees, in parallel with the expanding programs the remuneration of external lecturers and course leaders is continuously rising.

However, there are certain circumstances that slow down the pace of cost increase, as a result of which the training costs have not grown considerably since 2002. The structure of annual training courses (which can be efficiently planned and operated) has been finalised, and our external partner relations have stabilised, too. More and more classroom lectures are replaced with online training courses.

We have prepared the distant learning material of the financial audit course, and the development of a similar material for performance audit is under way. The younger generation of auditors possess up-to-date IT and communication skills, knows languages spoken in the European Union, therefore in this field we gave preference to cost-efficient, special forms of training. Furthermore, we make use of all those discount training opportunities with which our foreign partner institutions, as well as institutions participating in the development of the Hungarian system of public administration support our work.

## **4.2. The quality assurance of audits**

In line with the expectations of the National Assembly, in order to ensure the reliability of the audit opinion of the SAO, the fairness of audit findings, conclusions and recommendations, the **internal quality control and quality assurance system** was efficiently operated in 2005, too. The management supervision built in the audit process, and the professional supervision carried out at certain points, provided continuous control over the auditors' audit activities, as well as the auditor's reports prepared about the findings of the on-site audits. Every draft auditor's report was subjected to a double professional and legal review parallel to the contradictory procedure with the audited organisations. Furthermore, those draft reports that raised personal responsibility, were checked for fairness before they were handed over to the people concerned.

The SAO reports could be signed by the President only after the issuance of the certificates certifying that the audits were successfully completed, and the reports raising personal responsibility could be handed over only after the necessary corrections were made. The certificates are issued by the Quality Assurance Department, which is independent of all directorates responsible for the audits. This two-level quality assurance is not a usual procedure at national audit institutions. Financial audits qualifying the reliability of annual settlement and statement of budgetary accounts within the framework of auditing the final accounts, while the post-audit quality assurance reviews aimed at the preparation for and performance of audits of local governments, political parties and social organisations evaluated compliance with the professional requirements and whether the defined high audit assurance was achieved or not.

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In accordance with the plans, the presidential order that regulated the quality management system of the SAO audits entered into force on January 1, 2006. The quality management system describes and regulates in a comprehensive manner factors and conditions that directly influence the audit activity. It is closely linked to the professional regulation system of the State Audit Office of Hungary (Code of Ethics, Audit Principles and Standards, Audit Manual, and methodologies), and of the professional principles and requirements contained therein, it provides a standard system and a regulation framework for those elements that are vital for high quality audits and reports. In addition, the quality management system also covers conditions that directly affect quality, such as human resources management or external relations. In line with this, in connection with the audit activity the quality assurance system focuses on those aspects, requirements and procedures that must be fully taken into account, met, and followed respectively in order to continuously ensure high quality. The summary of the regulation (in Hungarian and English) is publicly available on the SAO's website.

### **4.3. International relations**

In terms of our relations with the players of the international audit community we have formulated clear and unanimous objectives for the past four year period, including the year 2005. The representation of our institution at the professional events abroad, as well as the preparation and organisation of national events aimed to make the SAO employees familiar with the internationally accepted and applied professional requirements, practical procedures, and to make them contribute to such requirements at different forums, and – through such activities – to make them contribute to the development of the professional work of the SAO, and to the national audit culture in general.

The bi- and multilateral international relations of the SAO have been long based on two significant cooperation networks, i.e. the International Organisation of Supreme Audit Institutions (INTOSAI), as well as the cooperation between the national Supreme Audit Institutes of EU Member States and the European Court of Auditors (ECA). In addition, in close connection with the above, we demonstrated our willingness and ability for practical cooperation in several parallel audits performed in the past four or five years.

#### ***Cooperation with international professional organisations***

Last year, our international activities performed within the framework of **INTOSAI** were largely determined by the fact that the State Audit Office hosted the 18th Congress of INTOSAI in 2004. As a result, the President of the SAO also acts as a Chairman of the Governing Board of INTOSAI until the next Congress (2007).

The Strategic Plan of INTOSAI (2005-2010) approved in Budapest, as well as the start of implementation thereof further increases the importance of the SAO's international presence. The reform of INTOSAI established over 50 years

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ago, and the adjustment of its activities to the requirements of the 21st century pose a great challenge for the national audit institution of each member state. Breaking with the traditions, being the Chairman of the INTOSAI Governing Board plays an active managing role in the implementation of the reform process. We have actively contributed to the development of the three strategic target areas (the further development of audit standards, the development of the institutional capacity of national audit institutions, as well as the development of new, modern forms for the exchange of knowledge and experience between national audit organisations) through different presidential statements and recommendations, and we will continue to do so in the future, too.

Within the framework of INTOSAI, working groups implement the goals of the Strategic Plan and carry out the practical work. In 2005, similarly to the previous years, the SAO participated to a limited extent, although very efficiently, in the activities of several working groups of INTOSAI. It must be emphasised that we played an active role in the Sub-Committee on Financial Audit Guidelines of the INTOSAI Professional Standard Committee, which continued to harmonise the audit guidelines of INTOSAI and the International Federation of Accountants (IFAC). We contributed to the continuous adjustment of internal control standards elaborated by INTOSAI Internal Control Standard Committee to meet the changing conditions, which work receives great international attention from professionals. We focused on the presentation of general conclusions of the Hungarian practice at the events of the Working Group on Privatisation, and we expressed our opinion about the possibilities and achievements of the fight against corruption at several forums.

Our institution is also a member of **EUROSAI**, the European regional organisation of INTOSAI. In May 2005, we participated in the 6th Congress of the organisation, which focused on auditing the planning of budgetary revenues. We also attended the Conference of the European and the Central and South American national audit institutions (EUROSAI-OLACEFS) in Lima, the topics of which included the external audit of the financial conditions of public representatives, as well as the methodology for auditing the utilisation of Community resources.

At the Lima Conference the President of the SAO – as one of persons in charge of the first topic – presented a paper about the legal regulations guaranteeing the independence, lawful and impartial activity of civil servants, as well as about the system of property declarations.

We actively participated in all three working groups of EUROSAI. Within the framework of the IT Working Group, our institution carried out the IT self-evaluations and then participated in the working group's seminar on the same topic. One of the currently most important tasks of the Training Committee of EUROSAI is the development of a standard European training strategy. In 2005, the second meeting of the Committee was organised by the SAO.

The Environmental Working Group prepared an information leaflet for the Bonn Congress about the national and international audits performed during the six years of its activity, to which the SAO contributed, too. At the September

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meeting of the Working Group we presented the strategic objectives of the Hungarian environmental policy in the field of waste management, and the findings of the SAO in connection with the implementation of these objectives. Upon the invitation of the Supreme Audit Institution of Ukraine, we attended the inaugural meeting of the subgroup in charge of auditing the consequences of natural and man-made disasters and radioactive waste management.

The objective of the institutional and regular forum of cooperation, i.e. the Contact Committee set up by the Heads of national Supreme Audit Institutions of EU Member States and the European Court of Auditors is to provide a forum for the exchange of professional experiences in relation to auditing the utilisation of EU funds and other issues related to the operation of the Community. In 2005, the Contact Committee focused on the improvement of national and community internal control systems related to the utilisation of EU funds. The relevant Contact Committee resolution, in the elaboration of which the SAO also was involved, contains many future tasks in the subject.

Being a member of referred cooperation network, the State Audit Office of Hungary has undertaken to contribute to the success of the activity through the active involvement of its representatives in various working groups (general methodological issues, VAT audits, public procurement audits, audit of EU Structural Funds, etc.). It can be recognised as a significant professional success that the Working Group on Audit Manuals and Methods held its meeting on auditing EU Structural Funds in Budapest, in September 2005.

By the conscious and coordinated planning and implementation of audits related to EU funds (with the involvement of national and international partners) we started the implementation of our main objective, i.e. to provide the National Assembly, the Government, the EU institutions and the national audit institutions of other EU Member States with a reliable and realistic picture about the utilisation of EU funds in Hungary, based on the summary of experiences gained from EU related audits.

In 2005, the relations between the International Board of Auditors for NATO (IBAN) and the SAO exceeded the level of the previous years. Apart from attending the Brussels meeting of the Competent National Audit Bodies (CNABs) discussing of the annual report of the Board, we also participated in the on-site audit aimed at the implementation of IBAN's first Hungarian program known as NATO Security Investment Program.

We continued our fruitful cooperation with SIGMA – which is a joint initiative of the OECD and the European Union – at different forums, and we consider it as a recognition of our work that a SAO employee is also on the OECD Board of Auditors.

### ***Bilateral international relations***

In the past four years, bilateral relations established with national audit institutions of other countries focused on the learning of audit practices, methods or aspects in a comprehensive manner or in detail, and on the operative exchange of experiences. The bilateral relations were intense primarily with the Supreme Audit Institutions of some of the Western European

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countries, but mainly with those of the Central and Eastern European region (Visegrád and Baltic countries). The latter have followed a similar development path as the SAO: they were also involved in the EU accession process and before that in the transition to audit institution type audits.

Apart from the countries mentioned above, more active cooperation was launched with the countries of the former Soviet Union and the Baltic region (Russia, Ukraine, Macedonia, etc.). The SAO regularly received/sent experts from/to these countries, primarily for the detailed presentation of segments of the Hungarian audit methodology (primarily financial audit), approach and activity. The SAO's relations with the Supreme Audit Institutions of the old EU Member States (the EU-15) are mostly maintained in the form of professional discussions and exchange of experiences within the framework of EU forums. Bilateral relations are not too typical. An exception to this is the highly respected National Audit Office (NAO) of the UK, which has been the SAO's strategic partner since 1999. In the past years the NAO's staff members have provided valuable methodological assistance several times, primarily in relation to the audits of public and private partnerships (PPP).

The frequent consultations with Polish colleagues (on organisational and operational issues, local government audits, IT solutions at the audit institutions) and the professional seminars held biannually with the Swiss partner institution deserve a special note. Due to the similar scope of audit authority, the SAO exchanged professional experiences with the Supreme Audit Institution of Israel several times (local government audits, audits of political parties and the cultural heritage).

The multilateral professional cooperation of the Supreme Audit Institutions of the Visegrád countries, enlarged with the participation of Austria and Slovenia, represents an informal, independent opinion forming group at regional level, the members of which regularly discuss their professional views in various EU and other international audit issues. The Visegrád cooperation first of all means presidential meetings and opportunities for consultations. Expert level cooperation was implemented once, in relation to the enforcement of the INTOSAI standards. A separate comparative study was prepared by the SAO's Research and Development Institute about the pre-accession development of the four Visegrád countries (and the three Baltic states).

Significant development could be witnessed in the field of parallel audits. In the period between 2002 and 2005, the SAO prepared and published five, internationally acknowledged audit reports in cooperation with national audit institutions of other countries.

The subjects of the above mentioned parallel audits were:

1. construction of the Marie-Valerie Danube Bridge (2002, with Slovakia);
2. construction of the Zalalövő – Bajánsenye – Hodos – Murska Sobota common railway line (2003, with Slovenia);
3. nature protection of the area of Lake Fertő (2003, with Austria);
4. flood control preparedness of the Upper Tisza region (2005, with Ukraine);
5. Danube Bridge at Szekszárd and Lötschberg Base Tunnel, comparative audit (2005, with Switzerland).

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At international level the joint reports were always forwarded to the entities concerned (EU officials, national audit institutions, international organisations, etc.) with a joint cover letter – based on the proven practice – and usually we could evoke significant professional and media response.

Active cooperation was launched between the SAO and the GAO through the joint activities in the different organisations of INTOSAI, as well as through a performance audit seminar held in Hungary.

The relations between the Hungarian and US Supreme Audit Institutions include the SAO's participation in high level professional forums organised by the International Consortium on Governmental Financial Management (ICGFM), which is a US led international organisation involved in the development of the financial management of the public sector. Since 2002, the SAO has been a so called "organisational member" of ICGFM's Board of Directors. By delivering lectures at the annual conferences, summits and other events the president of the SAO actively participates in the organisation's work, which is primarily aimed at seeking for interrelations at international level related to the management of public funds.

Our professional development and international recognition are well indicated by the fact that while earlier, for many years the SAO – as a recipient organisation – concentrated on the adoption and implementation of the internationally accepted audit practice, by 2005 and 2006, upon special request, we have become capable of conducting audit training courses on our own (Macedonia) or in cooperation with our partners (Tajikistan).

## **5. RESEARCH AND ADVISORY ACTIVITIES RELATED TO THE AUDIT WORK**

In line with the research plan, the **Research and Development Institute of the SAO** prepared several summarising-evaluating and background studies in 2005. The summarising-evaluating study titled "From research to innovation – the status of the R & D activity in Hungary and certain efficiency and finance issues thereof" was published last year. The study draws attention to the fact that Hungarian research and development, as well as innovation need a significant progress, or rather breakthrough, in terms of both quantity and quality. It is a fact that in the past few years important measures have been taken in legislation, institutional development and in the improvement of the relevant conditions, however the change of concept was only partially followed by a change of practice. The study was discussed by a professional body, and was included as an independent item on the agenda of the joint committee meeting of the Education Committee of the National Assembly in charge of research and development.

The summarising-evaluating study titled "Environment-conscious financial management and sustainable development in the light of regulation and audit" started out from the fact that in parallel with the implementation of social and economic tasks the environmental problems must be solved, too. The study gives an insight into the international and national status of the



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regulation and audit of environmental protection and sustainable development; with special emphasis on the constitutional requirements, the *acquis communautaire*, and presents the SAO's environmental protection related audits and international activities. The study was presented to the representatives of the media at a press conference.

From among the background materials we must mention the one written about the theoretical basis of program budgeting, and the experiences of the international application thereof. In order to evoke professional comments, this material was also published on the SAO's website. The study can contribute to the expansion of the aspectual frameworks of the reform of public finances, and the chapter budgeting within the SAO as well.

The background study on the (draft) regulation concept of public funds is designed to lay the professional foundations for the SAO's intention, according to which the finances of the public sector should have a standard and consistent regulation, which would provide adequate frameworks for the transparent, regular, efficient and responsible financial management of public funds. The draft concept puts the Hungarian regulation and practice first of all against the financial decree of the EU, the provisions of the German law on public finances and the British accounting standards.

As part of its professional services, the Institution prepared background analyses for the SAO audit of the final accounts for 2004, as well for the SAO's comments on the budget appropriation bill for 2006. Based on the time series budgetary and macroeconomic figures the background analyses pointed out the macroeconomic relations and problems of the budget, the lack of fairness in planning, the changes in public debts and debt service expenditure, as well as to the risks of the 2006 budget.

As a result of the research and development activities of the Research and Development Institute (RDI), several methodological studies were written in 2005. The Institute was directly involved in the works aimed at the further development of the professional regulation system of the SAO. A methodological study was prepared, among other things, on the evaluation system prescribed for programs financed from the EU Structural Funds, the knowledge of which is indispensable during the audits of such grants. The study was incorporated into the SAO's further training program on performance audits. The study on sustainable development and environment-conscious financial management also contributed to the internal training of the SAO, which contributed to the development and implementation of the further training program launched for the first time last year.

The year 2005 saw the completion and publication of the Audit Terminology (Dictionary and Glossary), which – according to the feedback information – gives considerable assistance to the acquisition and use of the international audit terminology.

In 2005, the **President's Advisory Board** first of all focused on the evaluation of implementation of the audit strategy for 2002-2006, as well as on

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laying the information and professional foundations for the medium-term strategy for the parliamentary cycle 2006-2010.

It discussed and approved the analyses of the facts and the underlying driving forces that affect the scope of action of the strategy to be drawn up for the upcoming parliamentary cycle, the national economy, including the status of the public sector and public finances, as well as internal materials outlining the principles and target groups pertaining to the different fields of the strategy.

In addition, the Advisory Board meetings – following the long-standing practice – functioned as special professional workshops, executive discussion forums to exchange opinion on the system of public finances, the changing role of the state, the reform of public finances, state accounting and on the theoretical regulation concept of a public finances act to be passed on the basis of our audit findings, frequently relying on the studies prepared by the Research and Development Institute of the SAO.

The Ministry of Finance could not ensure the continuous publication of the **Public Finance Quarterly**, which goes back over 50 years, wherefore the SAO took over the founder's rights in June 2005 with the approval of the Minister of Finance, and has since edited, as the owner, the journal of public finances – which has renewed both in content and appearance – in cooperation with the Hungarian Official Journal Publisher.

The aim of the publication issued in Hungarian and English (Public Finance Quarterly) under the guidance of an editorial board consisting of outstanding professionals who occasionally represent different views in the large range of values is a realistic and to give a realistic and authentic picture about the Hungarian financial system both within and outside Hungary, and on the major trends of the operation of the public sector and the national economy, on the efforts to close the existing gaps and on the related professional discussions – in the light of the most important financial correlations.

All this is in compliance with the strategic objectives of the SAO, and with the provisions of Parliamentary Resolution 43/2005 (V. 26.) OGY evaluating the SAO's activities performed in 2004, under which the National Assembly finds it necessary that the SAO should issue a modern financial journal within the framework of its advisory activities.

## **6. INSTITUTIONAL OPERATION AND FINANCIAL MANAGEMENT**

### **6.1. Budgetary management**

In pursuance of the 2004 amendment of the Act on the State Audit Office of Hungary, the financial management of the chapter is audited by an independent chartered accountants appointed by the Speaker of the National Assembly upon the submission of applications. The main audit findings can be summarised as follows:

“The audit included the sample-based audit of accounting records supporting the actual figures of the annual financial statement, as well as the evaluation

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of the accounting principles applied and that of the presentation of the annual financial statement. “

During the audit, the annual financial statement of the State Audit Office of Hungary, the parts and items thereof, the underlying book-keeping practice and the accounting records were reviewed in compliance with the provisions of the Hungarian national standards on auditing in force, on the basis of which we could conclude upon collecting sufficient and reliable evidence that the annual financial statement was prepared in pursuance of the provisions of the Act on accounting and Government decree 249/2000 (XII.24.) on the characteristics of the accounting and book-keeping obligations of organisations of public finances, as well as in accordance with the general accounting principles.

We believe that the annual financial statement gives a true and fair picture about the property and financial conditions of the “State Audit Office of Hungary ” budgetary chapter.

The budgetary management of the SAO reflected a high level of regulation and organisation in 2005, similarly to the previous years. Last year and in 2006 (up to the time of the audit) 26 such internal regulations were updated or were issued anew that affected the operation and financial management of the SAO.

The audit concluded that the SAO interpreted financial management control (FMC) – rightly – as the sum of controlling activities integrated into each component of the complex financial and economic processes, i.e. those of financial management. In accordance with this, the SAO prepared the audit trail representing the basic pillar of FMC at a high professional level.

The internal audit fully completed the 2005 internal audit plan approved by the Secretary General of the SAO. At the same time the development of new methodological standards continued for the public internal financial control system, and the application thereof within the SAO.

The budgetary management of the SAO was characterised by compliance with the external legal provisions and the internal regulations, as well as expediency and strive for cost-efficiency.

The improvement of the efficiency of financial management can be deduced from the specific (performance) indicators related to the financial management or the basic tasks, such as costs per audit days or changes in the real and running expenses per staff member. This includes the continuous reduction of interim modifications of budgetary appropriations, which means that the reliability of budgetary planning gradually improves, too.”

As a result of the amendment of the Act on the State Audit Office of Hungary, it was during the planning of the budget for 2005 that the SAO could independently prepare its proposal regarding the budget of the “State Audit Office of Hungary” chapter and the implementation thereof for the first time. The Government submits this proposal – without any modifications – to the National Assembly as part of the bill on the central budget and on final accounts.

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Due to the greater responsibility arising from the authorisation we found that the chapter's budget appropriation bill for 2005 should present the professional tasks of the SAO in more detail than before, focusing especially on audits prescribed by the law and on the required resources. In addition, we presented in the form of a separate program those operational tasks that can be classified as distinct groups, and determined the resources required for implementation.

All these methods represented the first step in parting from baseline budgeting. Through the Ministry of Finance we prepared a much more detailed, transparent, and much more thoroughly conciliated draft budget plan for the National Assembly than in the previous years. This draft budget plan included the major tasks of the SAO in 2005, and presented that the SAO made all efforts to fully comply with its legal obligations in a prudent and cost-efficient manner, with regard to the economic conditions of the country.

In the Act on the budget the National Assembly approved HUF 7,654.6 million for the SAO to perform its tasks in 2005, HUF 7,734.6 million of which was granted in the form of subsidies and HUF 20.0 million was provided from the SAO's own revenues. Compared to the original appropriation of the previous year, this meant a 4.4% growth. The scope of action in utilising budgetary resources was again reduced by the fact that more than two thirds of the professional tasks of the SAO are determined by legal provisions or parliamentary resolutions, and as a concomitant, by the mandatory nature of personal disbursements, public dues and non-personnel expenses.

From the total expenditure the appropriations for personal disbursements amounted to HUF 4,44.5 million, the contributions payable by the employers totalled HUF 1,399.5 million, the non-personnel expenses equalled HUF 1,284.1 million, the institutional investment costs totalled 367.6 million, while the renovation estimates totalled HUF 158.9 million.

HUF 499.0 million due to the interim modifications, as a result of which HUF 8,153.6 million was available, increased the approved appropriation. Within the modifications, HUF 581.6 million resulted from the approval of the residue of the previous year's appropriation, HUF 11.0 million resulted from the deferred costs of the audit tasks of EAGGF's Guarantee Section connected to our status as a certifying agency and pre-accreditation tasks as well (from December 2004). As much as HUF 3.6 million was required for certain tasks (interpreting and translation costs of the seminar organised for the staff members of the State Audit Office of Macedonia, contribution to running the electronic distant teaching program of the "Financial Audit" audit methodology in pursuance of an agreement signed with the Hungarian Institute of Public Administration, contribution to support training in pursuance of an agreement concluded with the Ministry of the Interior). In addition, HUF 0.8 million was resulted from the repayment of housing loans disbursed to staff members. The withdrawal of the 1% reserve appropriation generated in pursuance of the Act on the budget, and the amount transferred to the Ministry of the Interior for the purchase of motor vehicles for upper managers meant a total reduction of HUF 98.0 million.

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Altogether HUF 7,611.4 million was utilised, which accounted for 93.4% of the expenditure appropriation. Personal disbursements and contributions payable by the employers totalled 77.5% of the expenses. Non-personnel expenses and expenditures for cumulative purposes accounted for 14.8% and 7.7%, respectively.

Compliance with the expenditure appropriation was influenced by the observance of the obligation to create mandatory reserve, for the sake of which payment obligations for only 2006 could be fulfilled from the selected appropriations.

As much as 11% of the reserve (totalling HUF 542.1 million) comes from the different than planned implementation of the contracts signed in 2004, while the rest of the reserve (89%) entirely comes from the rescheduling, postponement of tasks, performances and invoices fully bound by undertaking obligations to 2006 (primarily due to the obligation to create mandatory reserve).

On the basis of the above written it can be concluded that the available appropriations altogether ensured the operational conditions required by the institution to perform its tasks cost-efficiently but smoothly.

## **6.2. Infrastructural developments**

In year 2005, too, it was paramount to ensure the adequate level of working conditions, to maintain or improve the state of repair of the existing office buildings, and to enhance the availability of equipment.

The greatest development in 2005 was the reconstruction of the large conference room in the SAO's Headquarters in Apáczai Csere János utca, the installation of equipment required for an audiovisual conference system. As a result of the development, the SAO now has a conference room meeting the international technical standards, suitable for lectures, conferences and multilingual presentations. In addition, the hallway between the library and the club was widened to make room for glass cases to display various articles. The reconstruction of the club on the ground floor was also completed.

An open public procurement procedure was conducted for the renovation of the elevators in the Headquarters in Apáczai Csere János Street. The contract with the selected contractor was signed in January 2006. According to the schedule, renovation will be completed by June 30, 2006.

To prepare the modernisation of the heating system of the Headquarters in Apáczai Csere János Street, the contract with the designer selected upon a public procurement procedure was signed in December 2005.

In 2005, the planned refurbishment of the offices continued, and we also contributed to the reconstruction works of the buildings of the county local governments (by providing funds proportionately to the area we use).

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In the year under review a total of HUF 235.2 million was utilised for the renovation and reconstruction of the properties.

In order to provide high-level support to the audit activity, we spent HUF 32.6 million on Xerox machines and other office equipment, as well as on the replacement of worn office furniture. We spent HUF 39.7 million on furniture for the refurbished conference room.

Within the framework of the planned renewal of the vehicle fleet, three vehicles over 6 years old were replaced, which cost HUF 14.3 million together with the cost of other car accessories.

### **6.3. IT and telecommunication developments**

The main objective of the SAO's IT activities is to support the implementation of the SAO's objectives in a versatile manner with the help of IT and telecommunication tools. IT and telecommunication developments were carried out in 2005, too, in accordance with the project plans specified in the SAO's annually updated, detailed IT strategy, approved by the presidential meeting.

Due to the dynamic developments carried out in the past years, today the SAO possesses a modern, standard network telecommunication system that can flexibly respond to the changing communication needs. There is a local network at each site, connected to the server located in the Apáczai Csere János utca building of the SAO either via rented line or microwave equipment. The SAO centre is connected to the Electronic Government Backbone (EGB), through which access to the Internet is provided. We provide IT and telecommunication services to each organisational unit through this infrastructure.

In 2005, as much as HUF 65.7 million was spent on the purchase of software, and HUF 196.1 million on the purchase of telecommunication tools and equipment in order to implement the following tasks.

In the past four years, the active tools of the computer network were modernised at the Budapest sites of the SAO, which significantly enhance the speed and efficiency of communication among the users' local computers and the servers in the individual buildings. At the SAO's offices outside the capital cable-work and other telecommunication tasks related to the refurbishments were carried out.

Another important element of the infrastructure is the construction and development of the SAO's hardware units at the required level, the provision of hardware components – first of all desktop computers or notebooks – for the staff in order to enable them to fulfil their tasks in an efficient manner. We have achieved considerable progress in this area, too, in the past years. In 2005, a total of **180 desktop computers and 111 notebooks** were purchased through a centralised public procurement procedure in order to replace obsolete computers. Within the framework of the planned replacement of our equipment, six medium capacity printers were installed. The printing function of the multifunctional equipment purchased for the county offices was

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incorporated into our existing system. In order to meet the needs of the dynamically growing computer based services, four new server computers were purchased.

In September 2004, a conference and training room equipped with multimedia and IT tools for 20 workstations were installed in the Headquarters in Apáczai Csere János utca. As a continuation of this project, during the refurbishment, **a multifunctional conference, interpreting and audiovisual system was installed** in the glass hall of our main office, which seats 120 people. The hall is equipped with an amplifier system of speech and other program sources, wireless microphones, interpreting booths for simultaneous interpreting between two languages, a projection screen for presentations, as well as with a video and computer system. The equipment of the two rooms can be connected in case a joint conference is to be organised.

The IT Safety Regulations of the SAO were reviewed in 2003. Based on the action plan prepared as part of the system, separate projects were launched last year in order to enhance the safety of the SAO's electronic data and systems.

Apart from developing the infrastructure, new applications were developed and systems introduced earlier are continuously developed, too.

In 2005, we switched to the new version of our **case tracking and filing system**, and further developed our **SZEKRETER audit planning, registration and monitoring system**.

The SAO pays utmost attention to the further development of its **website** each year in terms of content and format alike. The website includes a statistical program that keeps track of not only the number of visitors to the site, but also of the downloaded documents, which provides us continuous information about the number of readers of our reports per day and per month.

In parallel with the development of our website, we continuously developed the internal information network (**intranet**) of the SAO to ensure quick, efficient and simultaneous access to the SAO information, to support team work, as well as the use of a secure mailing system from all computer workstations, independent of the location of the given SAO office. For the efficient management of information, new thematic databases were developed, which are continuously integrated into the Intranet system.

In 2005, the project plan of the **Electronic Audit Documentation Management System** (EADMS) was completed. Within the framework of this project, the SAO intends to develop an electronic system to support the documentation of the audit work, to file and store the documents produced or collected during the audits. For the implementation of the development the SAO submitted an application to the National Development Office for EU transition facility.

Our user system called **Electronic presidential meeting** has been in place since January 2005. This system allows those affected to access and retrieve information of the presidential meetings, the invitation cards, and the

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documents to be discussed. A further function of the system is the storage of decisions passed at the meetings, task assignment and monitoring. All SAO employees can electronically access the memos about the agenda items discussed.

In 2003, the SAO introduced an electronic educational framework system, which is capable of the management and administration of internal training courses, as well as of running and administering standard developed electronic teaching materials. In 2004, several electronic teaching materials were incorporated into the system, such as the ECDL material teaching the use of Microsoft Office programs, the educational program teaching Complex Jogtár (collection of legal regulations), as well as the distant learning material teaching the financial audit methodology developed by the SAO. In 2005, we started the development of the **distant learning material** teaching the methodology of performance audits. Auditors responsible for supervisory and chapter audits can gain access to the financial audit teaching material with a password – upon prior registration – from the website of the Hungarian Public Administration Institution (MKI).

In the past three years the SAO provided the IT and telecommunication background for the **18th INTOSAI Congress** and the related events. The website of the congress will be active until July 2006.

In 2005 the library system of the SAO was also modernised by the introduction of the **HunTéka integrated library system**. Apart from the fast management of library tasks, the new system provides access to the central library databases and has laid the foundations for the borrowing of library materials electronically.

#### **6.4. Foreign study tours**

In 2005, the SAO employees participated in 82 foreign study tours, within the framework of which 142 delegates spent 380 days abroad. Two missions involved participation in a training course for 59 days altogether. (The average number of working days per foreign study tour was 4 days/tour, not counting the long training courses.) The number of participants has been growing from 91 in 2002, however the number of longer, even several months long foreign courses has dropped.

The costs of the study tours totalled HUF 43.0 million, which equalled 89% of the amount earmarked for the year. The costs of foreign study tours exceed the costs incurred a year before by nearly 60%. This is greatly influenced by the fact that the President of the SAO is the Chairman of the INTOSAI Governing Board until 2007, and this position requires several presentations abroad (thus, in 2005 six overseas missions were organised compared the two missions organised in the year before), which increased our airplane ticket costs. Due to the increased international role and recognition of the SAO, our leaders are invited as lecturers at an increasing number of international events.

In 2005, the President of the SAO had 14 official visits abroad, (including 4 visits as the Chairman of the INTOSAI Governing Board) for a total of 51 days.



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An average presidential tip cost HUF 481,000, and the daily costs totalled HUF 132,000.

The executives and staff members of the SAO do not use interpreting services during their missions abroad, and nor do they receive remuneration for their presentations held at various professional conferences. In such cases the foreign partner pays the registration fee, and sometimes the travel costs.

A report is prepared on each mission and the lessons learnt in accordance with the provisions of the internal regulations. All reports are available in the library of the SAO.

## **6.5. Financial Management Control**

The management of the SAO ensured the organisation and efficient operation of the financial management control (FMC) in pursuance of § 97 of Act XXXVIII of 1992 on public finances. It determined the audit trail representing the basic pillar of FMC by interpreting FMC as set of control activities built into each component of the financial management. The trail specifies the diagrams and the related narrative descriptions of the following major financial management processes: appropriations and financial management within the framework of the available funds, commitments, financial performance, accounting and budgetary reporting, salary management and payroll calculation, property management and stock-taking, investment and renovation tasks.

The SAO determined the procedure to manage irregularities in the framework of which it developed: the definitions used in connection with irregularities, measures, tasks and scope of authorities, the rules of procedure related to irregularities and the prevention thereof, as well as the rules pertaining to the tracking of procedures, the administration of measures and the fulfilment of reporting obligations regarding irregularities.

The audit trail and the rules of procedure related to irregularities are contained in the SAO's Operational and Organisational Rules as an annex, and the provisions thereof are enforced in the day-to-day operation.

From among the documents prescribed by the FMC, the preparation of the risk management regulations and the internal audit manual is under way.

The responsibilities are well delineated within the organisation. Information about financial management activities is available through the managers' reports, and the evaluation of the processes is ensured.

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## 6.6. Internal audit

One internal auditor performed the internal audit tasks of the SAO in 2005.

The internal auditor performed his tasks in line with the relevant legal regulations and the internal instructions of the SAO, under the direct supervision of the Secretary General, and on the basis of an annual work plan. The personal and material conditions for the internal audit were adequate during the year; functional independence was maintained in the internal auditor's work. In the reporting period the internal auditor made the following major comments:

- In the audited fields the financial management of the SAO was in line with the legal and internal requirements, and was reasonably cost-efficient.
- In the course of the audits there was no suspicion of any acts, negligence or deficiency that would have served as a ground to launch a criminal, misdemeanour, indemnification or disciplinary procedure.
- The audits revealed – not significant – deficiencies primarily in the area of internal regulation. In order to eliminate such deficiencies, the internal instructions and regulations need to be made more accurate and need to be supplemented regarding certain details.
- The utilisation of the findings and recommendations of the internal auditor continued to improve compared to the previous years.

The recommendations made in the internal auditor's reports have been mostly implemented in line with the action plans approved by the Director of Finances, or implementation is under way.

Budapest, 11 May 2006



*Árpád Kovács*  
Dr. Árpád Kovács  
President