



STATE AUDIT
OFFICE OF HUNGARY

R E P O R T

on the Activities of the State Audit Office of Hungary in 2007

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Introduction

The State Audit Office of Hungary (SAO), the financial and economic audit organisation of the National Assembly, reports on its activities on an annual basis. The activity report is put on the agenda of several parliamentary committees, and is discussed at the plenary sessions each year. After the discussion of the annual activities, the National Assembly passes a resolution evaluating the SAO's activities and setting the future development trends. The SAO compiles its annual audit plan and performs research and consulting activities supplementing the audit activities on the basis of these parliamentary resolutions.

In compliance with the SAO strategy reinforced by the resolution of the National Assembly¹, the reliability of the final accounts was qualified on the basis of concrete audits covering 83% of the total expenditure of the central budget. In 2007, the SAO audited the financial management system of the local governments of five counties, five towns with county rank, of six districts of Budapest, 66 towns, nine large villages and 76 villages based on a modernised audit programme.

In 2007, the SAO published 59 reports². Similarly to the previous year, the parliamentary committees included nine reports in their agenda 51 times. In line with the former practice, a few reports, e.g. the report on the execution of the budget, the SAO's opinion on the budget appropriation bill, and the annual SAO activity report were put on the agenda by several committees. In the SAO reports published in 2007 altogether 895 recommendations were made pursuant on-site audits at 1,082 organisations.

The modernisation of public finances and the concomitant risks affect financial audits, too, and set new requirements for such audits. Today the basic content and objective of SAI audits is to serve and strengthen the security of public funding. This led the SAO to prepare, in addition to the audits, in 2007 – in conjunction with its research and development institute – a summary of theses systemising the changes required for the comprehensive renewal of the public finance system, as well as a study that analysed a few of the major features of the fairness of the 2008 budget appropriation bill.

Due to the nature of the audit activity, the SAO's audit work pertains to the past, but the recommendations and findings published in the present aim at the tasks of the future. Therefore, the SAO annual activity report makes it possible to have a systemic evaluation of audit experiences, review measures taken as a result of the recommendations, and review the influencing factors. Furthermore, the report presents the operation, financial management and development of the organisation.

In compliance with the Act on the State Audit Office, 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.

¹ Parliamentary Resolution 47/2006 (X. 27.).

² Including SAO reports on 55 audits, the SAO annual activity report and three reports signed by Directors General.

Summary

The SAO can evaluate the status, management and operation of public finances based on its audit experiences gained in the previous year. In several aspects, the evaluation is in accordance with the statements disclosed at professional forums and in professional journals.

The audit on the final accounts encountered the problem familiar from the former years, i.e. that the target deficit could not be kept in 2006 either; the financing plan had to be modified five times, the National Assembly modified the budget act twice, and this affected the total amounts and deficit of the state budget. The greater than planned deficit was first of all caused by spending in excess of the expenditure appropriations. Despite the permanent tensions, the structure and regulation of the expenditure side of the budget followed the trends of the former years also in 2006. Expenditures related to the large supply systems of public finances grew not only in 2006, but also in 2007 despite the fact that in the second half of 2006 (revenue increasing and expenditure reducing) measures were taken to improve the balance of public finances. The ratio of distribution of public funds for preliminarily set purposes did not increase.

In terms of employment, the macroeconomic indicators do not reflect the effective utilisation of funds. The number of employees has hardly grown in the past years, the rate of economic activity of the working-age population is low. Attempts to broaden the tax base have yielded few results. The structure of professions is not in harmony with the growth needs. Although some improvement can be witnessed, the level of qualification of the workforce is not adequate.

The modifications that arose from the repeated restructuring of governmental institutions mid-year, which significantly affected the structure of the budget, too, fostered neither the trackability, transparency of the utilisation of public funds, nor the responsible financial management of public assets, nor comparability between the years. The consequences of certain wrong strategic and management decisions (concerning institutional and regional restructuring) come to surface with delay.

In connection with its duty to form opinion on the 2008 budget appropriation bill, the SAO audit was again compelled to point out that there was hardly any sign or result of the further development of the macroeconomic forecasting methodology, which serves as a basis for budgeting, wherefore no reliable governmental prognoses exist. Another deficiency of the budget appropriation bills, according to the SAO, is that the bills did not show the quantified effects of the measures taken within the framework of the convergence programme. Neither the planned impacts, nor the results expected to be achieved due to measures that had already been taken on the basis of the programme and the concomitant processes were presented despite the fact that the Government intended to ensure the sustainability of the budgets for the years 2007 through 2008 by the comprehensive restructuring of the large community supply systems, as well as the restructuring of the systems of taxation and subsidies.

The multi-year experience of the SAO shows that the reform of the local governmental system is long overdue, since the fiscal risks of Hungarian public finances are increasingly concentrating in that field. There is contradiction between the almost full-scale legal independence and the funding or development ability of the local governments (with the latter being “confined” in many aspects), while the significance of this sector is growing, in relation to the utilisation of EU resources. Yet the sector’s finances and asset management are burdened by risks that potentially threaten the entire system of public finances (too). The indebtedness of the sector has sped up to which no real solution can be given without the revision of local governmental tasks and the funding system.

The regular and “well targeted” utilisation of EU funds and subsidies is important for the catch-up process and real convergence, however the possibilities implied could not be fully exploited yet. So far no unified national strategy has been prepared for utilisation, wherefore the synergic effects from the harmonisation of national and EU funds – excluding the development of environmental protection and that of the transport infrastructure – are not really enforced. The institutional system for the management of EU funds has been developed, project preparation and implementation have been well-coordinated lately, however more attention should be paid to the payment and monitoring activity to improve the level of utilisation of EU funds and subsidies.

The SAO audits are repeatedly compelled to point out that the urgently needed structural reforms, the modernisation of the system of taxation and that of the large community supply systems are dragging along, the reform steps have not been properly prepared and they fail to form a consistent system. In many cases only austerity and restricting measures have been introduced – with more or less success – instead of the reforms. Several SAO audits have indicated the lack of long-term, sustainable solutions, development plans and strategies. Task assignments and solutions are usually not preceded by status assessments or feasibility studies. One of the consequences of these deficiencies is that the financial resources are not utilised with adequate efficiency. The work of the enforcing apparatus is hindered by the large number of and occasional conflicts between frequently changing regulations.

Upon reviewing the budgetary system of Hungary, the experts of the OECD and other international organisations emphasised the lack of clear rules of budgetary discipline. The SAO has recently drawn attention to the pressing need for the regulation of public finances in its “Theses on the Regulation of Public Finances”. The SAO’s points were received favourably, and the National Assembly has been submitted a bill package that – although needs thorough discussion, refinement and supplementation at several point – enforces some of the criteria contained in the SAO’s Theses. The reform of the public sector and the modern regulation of public finances are key issues, the solution of which must be based on internationally accepted principles reinforced by national political consensus.

The regulation needed should extend to the entire management of public finances, should ensure the use of the budgeting right of the National

Assembly, the responsibility of the executive power, and it should enforce sustainability and balance. Certain parameters must be identified and observed in the budgeting process. A methodology must be developed on the basis of which macroeconomic analyses and impact assessment studies can be prepared to support legislators in adopting the annual budget acts or in finalising any professional act.

The new, modern regulation must support the transparency of the collection and utilisation of public funds, the dominance of the “value for money” principle. Public finance regulation must be predictable, which makes it inevitable to include the basic rules, requirements and guarantees in the Constitution, too, preferably in a separate chapter.

The operational mechanism of public finances was determined by political compromises that have cemented since 1990 (local governmental and administrative system, social security, system of political elections and related interests). These compromises provided the stability for social and economic operation. However, by today they have made the system rigid and immobile under the current political power relations. Therefore, a new compromise and social dialogue is needed to define the tasks of the state, and to decide about basic issues that affect the fate and future of the country. The realisation of the growth path that provides a chance for catching up requires a strategy based on public consensus, new public policy, the reform of public finances, and requires the modernisation of the economic structure and the mobilisation of the national knowledge base.

1. TASKS OF THE STATE AUDIT OFFICE OF HUNGARY IN 2007

The SAO performs its activities in line with a specific, public strategy. The SAO's objective is to respond to the challenges by maintaining the unity of continuity and adjustment to the changing environment, by weighing the tasks so that the legal obligations could be effectively met by the efficient utilisation of the resources. The fundamental strategic objective of the SAO is to make the audits, analyses and recommendations increasingly foster the regular, efficient and balanced operation of the public sector and public finances, and to initiate and support the necessary restructuring processes with the available tools. The role of the institution is to draw attention to the vulnerable areas of the utilisation of public funds, however progress depends on the decisions of the National Assembly and the government agencies.

The legal conditions and guarantees required for the independent operation and audit activity of the SAO are ensured by the Constitution and other legal regulations. Tasks related to the SAO audit activities are specified by 27 acts. However, the tasks and mandates of the SAO do not only mean direct and exclusive audit obligation and authority, but also activities that enhance the transparency of the utilisation of public funds.

1.1. Execution of the annual audit plan

In 2007, the SAO continued to perform its activities based on the audit plan, which was approved by the President of the SAO after being discussed in the National Assembly's Committee on Budget, Finance and Audit Office.

The audit plan for 2007 included a total of 80 topics. During the year four audits were added to, while three tasks were deleted from the audit plan.³

Two audits that had been planned to be completed in 2006 were carried over to 2007⁴, wherefore in 2007 **as many as 57 audit reports were published.**

In 2007, the SAO fulfilled its audit obligations by using 59,550 direct⁵ auditor days, 5,017 days fewer than in the previous year. This was the consequence of ongoing staff restrictions and the growth in the number of retiring staff members.

Audits that are required by the law to be **performed with certain regularity** (annually, biannually and regularly) represent top priority tasks. The completion of these tasks resulted in the publication of **41 audit reports**, which absorbed **65%** of the audit capacity of the SAO, just like in the previous year.

Audits that must be performed **annually** represent top priority tasks. In the year under review 5 such reports were prepared (opinion on the fairness of the state budget, audit of the final accounts, audit of the operations of the Hungarian Privatisation and State Holding Company and the Hungarian News Agency Corporation, as well as the audit of revenues to be shared between the Municipality and the district local governments of Budapest). Out of the annual audit obligations the task that required the largest capacity was the audit of the execution of the 2006 budget, which absorbed 25% of the annual audit capacity, similarly to the previous year.

³ The plan was supplemented mid-year to include the audit of the accounting of funds used for the by-election campaign in October 2006, the audit of the review of the local governmental decree on the distribution of revenues to be shared between the Metropolitan Local Government of Budapest and the metropolitan district local governments in 2007, the audit of the 2006 financial statement of the Danube Commission, as well as the audit of the utilisation of central budgetary subsidies granted to the Tempus Public Foundation.

Cancelled or postponed audits: Phase I of the comprehensive audit of the Metropolitan Local Government of Budapest, audit of the financial management of Chances for People with Disabilities Public Foundation, as well as the legality audit of the financial management of the Hungarian Justice and Life Party in 2005 and 2006.

⁴ Audit of the financial management of the Hungarian Democratic Forum in the years 2004 through 2005, and the legality audit of the financial management of the Antall József Foundation in the years 2003 through 2005.

⁵ Direct auditor day: capacity used for the audit, as well as the legal, quality assurance and IT support that can be directly charged to the audit.

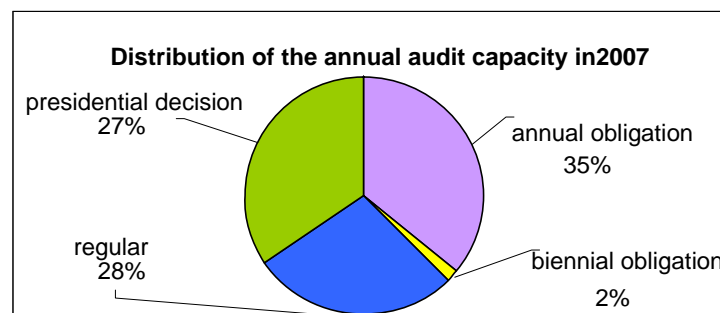
Within the framework of the **biennial** audit obligation, in 2007 reports were prepared on the financial management of five political parties and three party-affiliated foundations.

As many as **28 reports** were published on the completion of **regular** audit tasks.

A major part of regular tasks required by the law was made up by the comprehensive audits of the financial management of local governments. Apart from the report summarising the findings of the comprehensive on-site audits of nearly 600 local governments, as many as 16 separate SAO reports were drawn up on local governments with significant budgets and property (the local governments of 5 counties, 5 towns with county rank, as well as about 6 district local governments of Budapest).

In 2007 the SAO prepared reports on the comprehensive audits spanning several years of two budget chapters (Ministry of Agriculture and Rural Development, Ministry of Foreign Affairs).

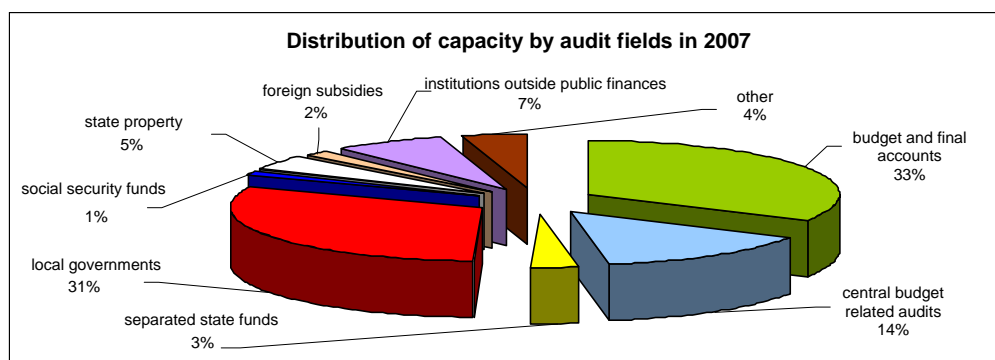
Within the framework of regular tasks, audits were conducted in relation to the Labour Market Fund, the operations of the National Bank of Hungary, the financial management of the Civilian National Security Services, the funds used for the general, local governmental, and national ethnic minority elections, as well as three national minority local governments (Polish, Rusin, Serbian).



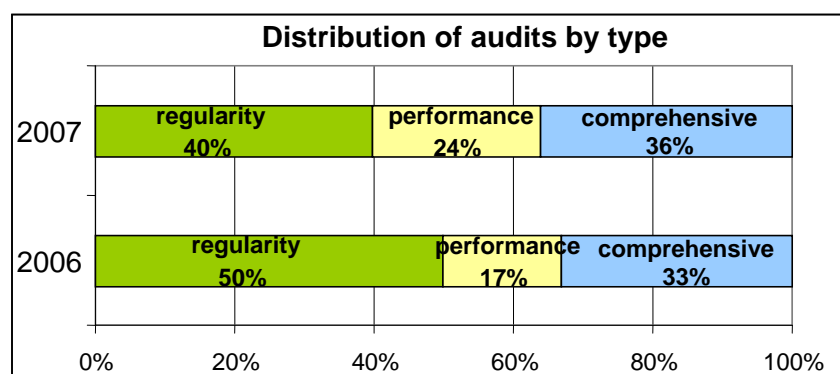
As many as 16 reports were prepared on audits carried out on the basis of the decision of the SAO's President. In 2007, no requests were submitted to the SAO by the National Assembly or the Government, wherefore a larger share of audit capacity could be used for purposes specified by the President (this share totalled 27% in 2006).

In line with its strategic objectives, and based on the decision of its President, the SAO performed audits in relation to the pharmacy management at state and local government owned hospitals, the utilisation of funds used to preserve the working ability and to support public work programmes, the activities of local governments related to basic social services, as well as tasks of local governments related to water management and drainage.

For the efficient utilisation of state development resources and the discovery of risk factors inherent in the novel public private partnership schemes designed to boost investment projects, audits were performed in relation to the electricity supply system, to motorway investment projects completed in 2006, as well as to the higher education investment programme for residence halls.



The SAO classifies its audits according to **three main types**. By paying special attention to the balance requirements of public finances and the modernisation of the large supply systems, the SAO had planned more performance audits than earlier.



1.2. Other tasks of the State Audit Office of Hungary

Other activities of the SAO include several authorisations and tasks that are prescribed by the Constitution, the Act on the State Audit Office and other legal regulations, which authorisations and tasks go beyond the audit obligations and mandates taken in the narrow sense of the word.

The President of the SAO countersigns the contracts related to the borrowings of the central budget, and gives an opinion on proposals aiming to further develop the accounting system and the internal financial control system of public finances. He makes recommendations for the post of chairman of the supervisory board of the state holding company, as well as the chartered accountants of the separated state funds. He comments on the chartered accountants of the National Bank of Hungary and the Hungarian Development Bank, and may form 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 economic organisations where the state is at least a majority shareholder – and where the registered capital exceeds

HUF 200 million – the chairman of the supervisory board is recommended by the SAO upon the request of the head of the economic organisation.

Complaints and announcements of public interest can be lodged by anybody – orally, in writing or electronically – to the agency authorised to conduct procedures in the given subject matter. The legal basis for procedures related to announcements, proposals and requests of public interest is provided by the articles of Act XXIX of 2004 pertaining to announcements, complaints and request of public interest (Articles 141 through 143).

Countersigning and opinion forming authority

On behalf of the Republic of Hungary, the Minister of Finance authorised the chief executive officer of the Government Debt Management Agency Private Company Limited by Shares to sign rollover loan contracts up to the amount of EUR 500 million to ensure coverage for swap transactions. Contracts were signed with four banks for EUR 250, 100, 100 and 50 million, respectively. Furthermore, the contract on a stand-by credit line of EUR 450 million was extended in November 2007. After the documentation related to the loan contracts was checked for regularity, the President of the SAO countersigned all five loan contracts.

In 2007, the SAO exercised its opinion forming authority – given in connection with the changes in the accounting rules – in the proposal titled “On the amendment of certain acts on taxation”, in relation to the amendment of the Act on Accounting contained in the proposal titled “On the Hungarian Chamber of Chartered Accountants, on the activity and public supervision of chartered accountants”, as well as in relation to the amendment of Government Decree 249/2000. (XII. 24.) on the reporting and accounting obligations of public finance institutions, and that of Government Decree 240/2003. (XII. 17.) on the reporting and accounting obligations of treasury accounting.

Authority to make recommendations

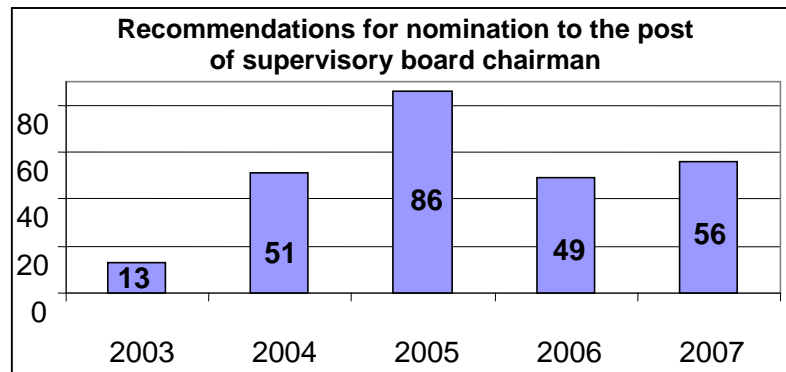
In 2007, the President of the SAO recommended nominees for the chartered accountants of the National Bank of Hungary and the Hungarian Development Bank.

Upon the request of the Minister of Finance, recommendations were made for the post of the chairman of the Supervisory Board of the Hungarian Privatisation and State Holding Company, and then, with regard to the provisions of the act on state property, for the post of the chairman of the Control Committee of the Hungarian National Property Management Plc. – out of turn.

In addition to the above written, the SAO’s Secretary General made recommendations – upon the request of state business organisations – for the posts of chairman of the supervisory board, exclusively from among successful

applicants included in the list of names. (As of 31 December 2007, the number of potential nominees was 680 based on the applications).

In 2007, the SAO evaluated requests submitted by 60 business organisations. After additional information was supplied upon the SAO's request, the Secretary General of the SAO made recommendations on personal nomination for 56 business organisations.



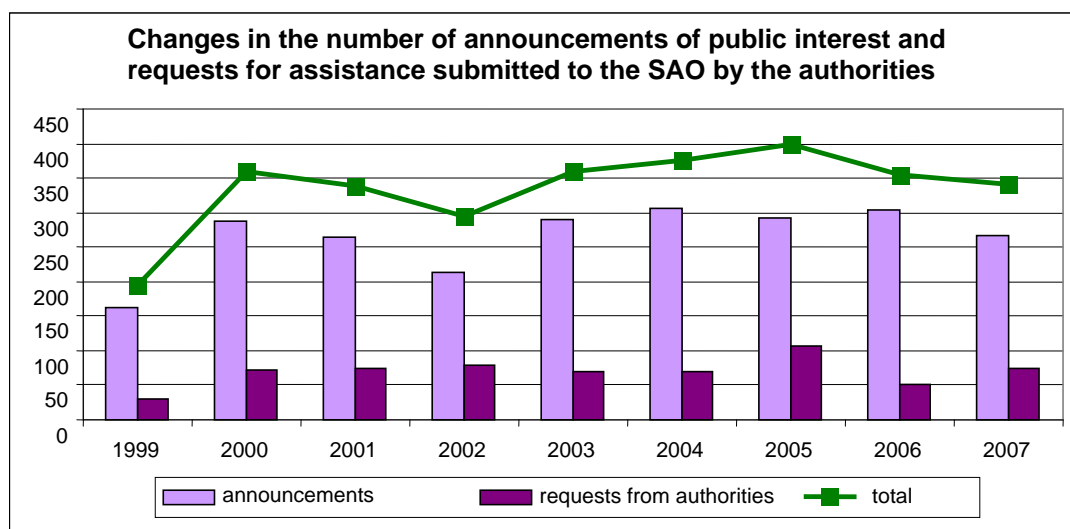
In 2007, no proposal was submitted for the withdrawal of any supervisory board chairman elected upon the SAO's recommendation.

As of 31 December 2007, as many as 135 persons were in position as supervisory board chairmen upon the SAO's recommendation.

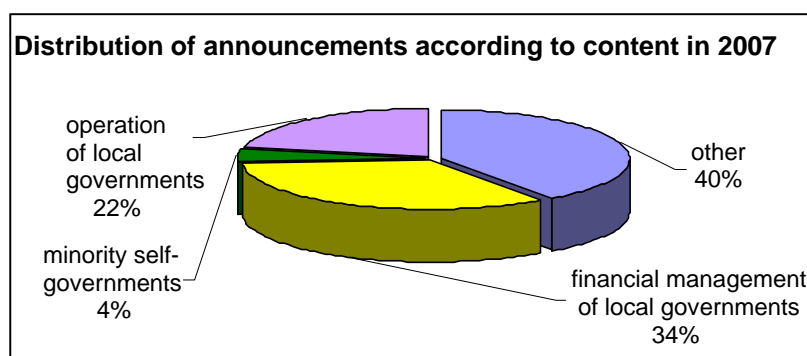
Announcements, proposals and requests of public interest

Apart from cooperation with the central and local organisations of public finances, it is important for the SAO to keep in touch with the citizens and organisations with various mandates that contact the SAO in certain issues. Furthermore, it is important to expand and develop public relations, and activities that may enhance information supply by the SAO. The experiences gained in 2007 show that the citizens are increasingly inclined to use the developing technical opportunities for posting inquiries, recommendations and requests.

In 2007, as many as 267 announcements of public interest were submitted. State and local governmental authorities requested assistance 75 times, and the SAO was contacted via telephone 92 times. Based on the figures of the past nine years it can be stated that with fluctuations though, the number of announcements shows a growing tendency.



56% of the **announcements and requests** were related to the financial management and operation of the local governments, 4% were connected to minority self-governments, and 40% were linked to various issues (housing, district heating, state subsidies, procedures launched by the Government, state institutions or organisations, operations of business organisations, political parties or foundations, associations, as well as requests for opinion, legal interpretation, advice or information). In most cases those who contacted the SAO requested SAO audits or involvement in the arrangement of certain matters.



Out of those who submitted **announcements of public interest**, 14% were representatives or officials of local governments (mayors, notaries), 18% were persons who were unwilling to disclose their names, 44% were private individuals, and 24% of such persons made announcement on behalf of different entities (representatives of organisations, entrepreneurs, employees of state organisations). The number of announcements made by the officials of local governments increased compared to 2006. This growth can typically be associated with announcements made by newly elected officials. The number of requests made by the financial committees of the local governments also rose.

Announcements that can be linked to the subject of audits performed in the subject year or other planned audits are utilised by the audit directorates during the compilation of the audit programmes and performance of the audits depending on their capacities. The SAO is not authorised to provide legal interpretation, legal assistance or opinion. Entities that contact the SAO are duly informed about this fact.

2. AUDIT FINDINGS OF THE STATE AUDIT OFFICE OF HUNGARY

2.1. Main findings classified by the subsystems of public finances

The 2007 SAO audit on the final accounts concluded that the 2006 deficit of the central level of public finances stipulated by law totalled HUF 1,545.8 billion. The National Assembly amended the budget act twice during the year, and approved a significantly (by 33%) higher target deficit. The actual deficit of the central level of public finances was HUF 2,042.5 billion, which resulted in a total public finance deficit of HUF 2,199.0 billion together with the deficit of local governments. Consequently, the deficit to GDP ratio grew from 6.8% to 9.3%.⁶

The growth rate compared to the originally approved deficit of public finances equalled 39.1%. Nearly two thirds of this increment could be linked to the unplanned growth of expenditures of the central budget (debt service, funds transferred to the social security funds, compensation for the increase in the price of gas on the world market, as well as expenditures that can be exceeded without the modification of appropriations). The aggregate deficit of the social security funds increased by HUF 99.0 billion, while the deficit of the local governments multiplied by almost five, and exceeded the original target deficit by HUF 121.7 billion. The balance of the separated state funds improved the position of public finances by HUF 32.9 billion.

Expenditures related to the large supply systems of public finances grew in 2006, too, despite the fact that in the second half of the year revenue increasing and expenditure reducing measures were taken to improve the balance of public finances.

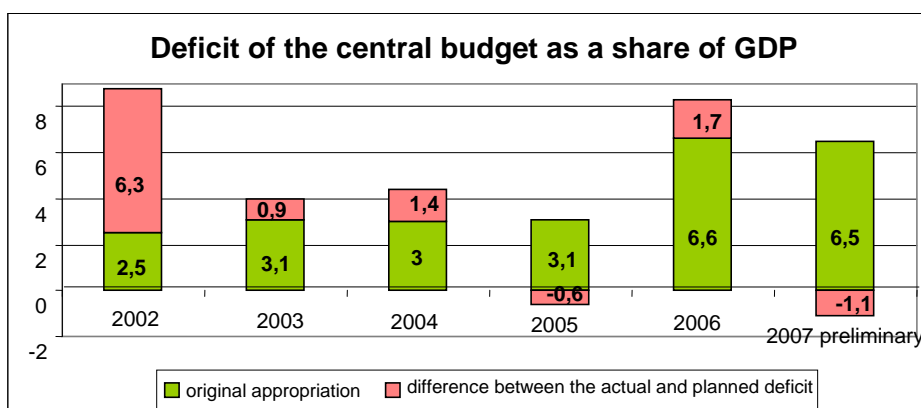
2.1.1. Central budget

Audit of the 2006 final accounts

The 2006 deficit of the central budget exceeded the originally planned deficit by 28.1%, which meant a budget deficit of 8.3% as a share of GDP despite the

⁶ The SAO indicated in the former years and also in the opinion on the 2006 budget appropriation bill that the achievement of the planned deficit of public finances and gross state debt as a share of GDP implied risks.

fact that tax revenue appropriations, which represent a major part of the budget, did not only equal, but also somewhat exceeded the planned amounts.



Source: budget appropriation and final accounts bills, information provided by the Ministry of Finance on 17 January 2008

The amendments of the budget appropriation bill, the significantly higher than planned expenditure and deficit draw attention to the problems of planning. The commitments undertaken in the budget act contributed to the size of the deficit, and thus to the accelerating growth of the debt in the past few years. Furthermore, they show the extremely limited scope of action of the budget policy, and point to the factors that hinder the achievement of a break-even primary balance.

The modification or realisation of certain appropriations well indicates the problems of substantiating the planning process.

The requirement for the regular accounting of certain large expenditure items was also a deficit increasing factor. The budget assumed and repaid a loan of HUF 177.8 billion taken out by the National Motorway Company in 2005 (according to information provided by EUROSTAT, motorway construction related state expenditures could not be accounted out-of-budget in 2005 either). The budget act authorised the Government to assume a further debt of HUF 415.9 billion in connection with the loan taken out by the National Motorway Company for motorway construction, although said expenditures should have been planned in the 2006 budget.

The 'guarantee and contribution to the social security benefits' appropriation was significantly modified (by HUF 112.7 billion) due to the mid-year processes.

The payment, which exceeded the 'central budget special reserve' appropriation by three times, indicates that the downsizing performed in 2006 and the required resources had not been properly considered in the budgeting period.

There is a considerable difference between the 'revenues from the utilisation and management of Treasury assets' appropriation and the actual performance, which is due to the fact that performance has not been based on the planning of this appropriation for years.

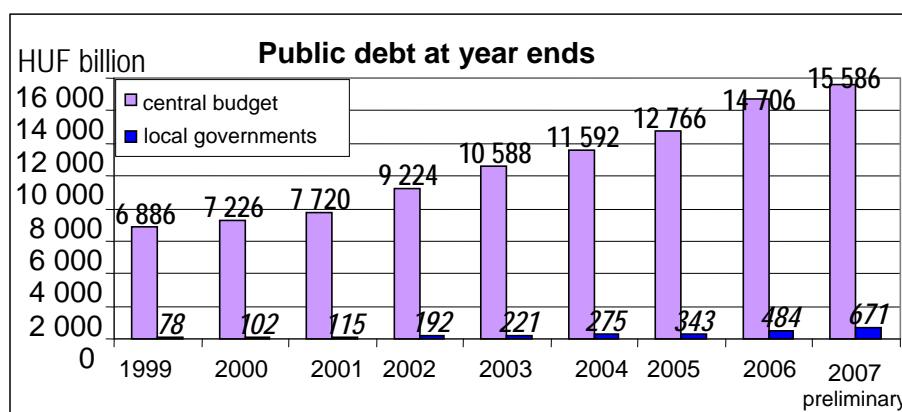
Most of the revenue and expenditure appropriations were realised almost in accordance with the amounts fixed in the amended budget act. However, this

was not the result of balanced planning and disciplined budget management, which that kept in mind the compliance with the size of the deficit specified in the budget act. The amendment of the budget act, which increased the deficit of the central budget by HUF 390.3 billion, entered into force on 22 December 2006. This means that the amendment legitimised the consequences of the mid-year changes of budgetary processes.

Insufficient control over the budget is indicated by the fact that the financing plan, which ensures the solvency of public finances, was modified five times by the Minister of Finance. In the preceding three years the financing plan was not modified so frequently and so significantly.

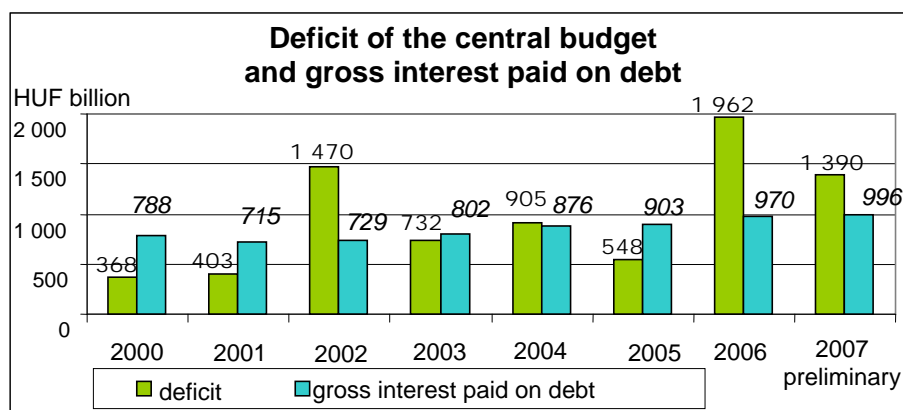
For years, the SAO has repeatedly called attention to the fact that the significant modification of the total revenues and expenditures specified in the budget act, and thus the modification of the deficit around the end of the budget year means that the plan is adjusted to the actual financial processes, which contradicts the essence of planning. No sanctions are envisaged for non-compliance with the budget act, which means that the National Assembly accepts the discrepancies by approving the bill on the final accounts.

The debt of the central budget grew continuously between 2002 and 2006, and the growth rates compared to the preceding years equalled 9 to 15%. By 2007, the growth rate decreased to 6%. While earlier the deficit of the social security funds significantly contributed to the growth of the debt – it amounted to 25% of the debt increment – in 2007 the surplus of the social security funds also contributed to the lower growth rate of the debt.



Source: Ministry of Finance, Government Debt Management Agency

Due to the increasing debt of the central budget, the absolute amount of the interest paid on the debt grew accordingly, by 4 to 10% in the period 2002-2006. The growth rate of gross interests paid dropped to nearly one third by 2007, in part due to the reduction of the growth rate of the debt.



Source: Government Debt Management Agency

Opinion on the 2008 budget

The 2008 budget appropriation bill seems to be executable under the planned macroeconomic trends. The risks implied in the revenues and expenditures can be eliminated by the reserve of HUF 170 billion.

The SAO formulated reservations in connection with certain key elements of the macroeconomic path, which serves as a framework for the central budget. The SAO pointed out that the 2.8% GDP growth planned for 2008 implies a great risk, which is related to the slower reduction of inflation, the modest growth of real wages and household consumption following a significant setback in 2007, as well as the uncertain recovery of the investment activity. The SAO has indicated that the budget appropriation bill does not contain measures that would accelerate economic development, which was extremely modest in 2007.

In 2008, and in the subsequent years, too, the rate of possible debt assumption due to loans taken out by economic organisations managed by governmental organisations or with state guarantee (MÁV Hungarian State Railways Private Company by Shares, Budapest Transport Limited) may imply high risks.

The SAO could not fully evaluate the fairness of the customs and tax revenue appropriations of the central budget in 2008. The auditors could not evaluate 45% of the appropriation, since the calculations required for opinion forming were not available.

Contrary to the former years, the SAO concluded that the deficit contained in the 2008 budget appropriation bill can be maintained. However, **the impacts of governmental measures** (public sector, education, healthcare) that were launched for the reduction of the deficit of public finances and that are also included in the Convergence Programme **can be seen neither from the submitted budget appropriation bill, nor from other governmental sources.** In the case of these systems the results expected to be yielded on the professional and supply side, and therefore the evaluation of the future imply uncertainty. In part for this reason, the SAO has called attention to the fact that the budget policy of the years 2008-2010 are

determined by complex factors showing to different directions, which also indicates the narrow scope of action of the budget policy.

One of the essential guarantee elements for the execution of the budget is the establishment of a stable institutional system. With the continuation of ill-considered downsizing and restructuring in the public administration system, there is still no trace of a stable institutional system that would lay the foundations for the transparent and regular accounting of funds and reporting, thanks to its adequately qualified staff.

Major experiences of the audits of the chapters⁷

The SAO audit on the final accounts affects all budgetary chapters each year. In addition, the SAO audits the financial management and operation of chapters belonging to the subsystem of the central budget at regular intervals, within the framework of comprehensive audits.

Governmental restructuring performed in 2006 fundamentally changed the frameworks of governmental operations, and in certain aspects affected most of the chapters.

Governmental restructuring and reorganisation was not carried out on the basis of a well-developed concept. The regrouping of tasks among the chapters was typically still incomplete at the end of 2006. Consequently, the tasks of the new ministries could not be adequately harmonised with the regulations in all ministries.

The negative trends experienced in relation to the public debts of the central budgetary organisations in the past year (growth in the size of debts, rescheduling of debts with increasing repayment, growth in the number of institutions having debt) continued in 2006, too. In addition to the great share of debts towards suppliers, **the public debt of the institutions grew considerably** despite the measures taken and the debt monitoring system operated in conjunction with the state tax authority. Changes in the volume of debts were associated with the liquidity problems of the central budgetary organisations. These problems are only partially related to compliance with the obligation to form mandatory reserves. The shortcomings in the financial management of the institutions were also to blame, similarly to the former years.

Within the framework of the audit on the final accounts the SAO performed a financial regularity audit, which was concluded with a qualified opinion. In 2006, the number of chapters subjected to such audits significantly increased,

⁷ The findings are based on the experiences gained during the 2007 SAO audit of the final accounts, the audit of the operation of the 'Ministry of Agriculture and Rural Development' chapter, the audit of the 'Ministry of Foreign Affairs' chapter, the financial and economic audit of the Civilian National Security Services, as well as on the audit of the realisation of VAT revenues due to the central budget.

as a result of which **the SAO formed an opinion on the reliability of 83% of the total expenditure of the 2006 central budget.** In addition to the audit of the direct revenues and expenditures of the central budget, as well as the audits of constitutional and single-institution chapters, and budget titles vested with rights similar to the chapters, the SAO performed the reliability audit of all institutions of five chapters. Based on the performed audits **it can be concluded with great certainty that in relation to the central budget the cash flow data contained in the final accounts bill are altogether reliable.** The findings of the financial regularity audits performed in 2006 by the SAO's auditors and the internal auditors of the chapters indicate that the institutions that account for the remaining 17% cannot statistically pose a risk that would influence the reliability of the total of the central budget.

The SAO conducted comprehensive audits on the multi-year operation of two ministries. Within the framework of the audits the SAO examined changes in the tasks of the ministries and those of the institutions subordinated to these chapters. The SAO evaluated the operational conditions of the major tasks, in relation to the efficiency of the use of funds.

The tasks of the institutions of the Ministry of Foreign Affairs were specified – with occasional overlaps – by legal regulations, which were often modified due to the regrouping and re-regrouping of tasks. The legal regulations and the amendments thereof were not supported by impact assessment studies. The dissolution, establishment and merger of background institutions were ordered without due justification. During the time of the SAO audit, the elaboration of a foreign policy strategy that would set the priority tasks was under way.

The basic tasks of the Ministry of Agriculture and Rural Development practically remained unchanged in the audited years, however new tasks were added due to Hungary's accession to the European Union, the development of the related organisational, regulatory and control system, as well as the establishment of a support system relying on financial resources from the EU.

In the audited period a new office was established with the view of the modernisation of the organisation and adjustment to the tasks. The main task of the office was the management of applications for EU funds. The organisational structure and the staff were strongly influenced by the fact that the chapter's staff had to be reduced by around one third due to a government decision made in 2006. The budgetary management of the chapter was restricted by the restraints of the central budget. It was typical that certain subsidies were paid with delay, and that the Hungarian State Treasury, the Hungarian Tax and Financial Control Administration and the Central Administration of National Pension Insurance had outstanding debts of billions of forints.

The possibility of professional support significantly deteriorated at the chapter due to the shortage of funds. Furthermore, certain tasks were not, or were only partially performed. Focus has shifted from national subsidies to EU funds, the share of national subsidies decreased from 95% to 36%, and the titles within the chapter changed, too. Contrary to the legal provisions, no long-term strategy that would ensure the expedient utilisation of funds was prepared. The

most important strategic tasks were specified in the Operational Programme. The economy could not utilise the financial advantage stemming from the EU accession in time because of the delayed establishment of the mechanism responsible for the management of applications. In addition, certain applications were suspended due to the scarcity of national funds.

The comprehensive audit performed at the Civilian National Security Service concluded that after Hungary's National Security Strategy (modified upon the country's accession to the NATO and the EU) was adopted in 2004, no sectoral strategies – specified by the Government – were developed on national security and on the fight against terrorism. The updated draft of the National Security Strategy has been completed, however the Government has not yet put it on its agenda.

The government expectations formulated in 2006 and 2007 in connection with the state reform, as well as in the updated draft of the National Security Strategy, and in the draft proposal for the amendment of the act on national security services all reflected the need for the reconsideration of the activity and structure of the national security services. The drafts encouraged only the functional merger of civilian and military services despite the fact that the Government Decree ordered the simultaneous investigation of other alternative solutions. The motion described above proposed the only solution that was supported with impact assessment, albeit this did not extend to all areas. The amendment of the act was planned to be put on the agenda before a decision was reached about the alternative solutions. (Later the Government deleted the amendment of the act from its tasks.)

The SAO findings made in relation to the budgetary chapters are still valid in that restructuring and changes were not supported by documents that would have unanimously indicated efforts to enhance the efficiency of government work and to reduce costs. The lack of mature, well-prepared government decisions and the risk-increasing effect of changes could also be felt at these three audited organisations.

During the audit of VAT revenues due to the central budget the SAO concluded that in the audited period the Minister of Finance, acting within his scope as a supervisor, regularly made the tax authorities (Hungarian Tax and Financial Control Administration and Customs and Finance Guard) report on the time-proportionate realisation of the revenue appropriations of the budget, on the results of the audits, on the amount of arrears, as well as on the status of liquidation, bankruptcy and voluntary dissolution procedures. The tax authorities provided data and forecasts on the processes and results affecting the fields of their competence on a continuous basis. These data were not used by the Ministry of Finance for the compilation of analyses, evaluations, or for the preparation of legal regulations except for the evaluation of the expected realisation of revenue appropriations.

The SAO concluded that in contrast with the practice applied by most member states, the legal regulation of the registration procedures pertaining to new enterprises does not contain mandatory controls. The Tax and Financial Control Administration has the right to reject the application for registration

due to false or deficient information provided by the tax-payer, however the conduct of such checks is impossible due to the deadlines set by the legal regulations.

In accordance with the findings of the former audits and the practice of the EU member states, the Tax and Financial Control Administration ordered the inspection of tax-payers that try to minimise their VAT payment obligations, tax-payers that fail to submit tax returns, or fail to submit tax returns by the deadline. Furthermore, the Administration ordered the inspection of compliance with the obligation to issue invoices. The Administration conducted an increasing number of preventive inspections following registration, the objective of which is to increase the presence of the tax authority, and thus to foster law abidance by the tax-payers. The tax difference revealed by the inspections conducted by the Tax and Financial Control Administration did not change significantly in 2005 compared to 2004, however it showed considerable improvement in 2006.

2.1.2. Separated state funds

In 2006, the financial position of the funds was balanced both in the individual funds, and in aggregate terms. At the level of the subsystem more revenues were realised than expected, while expenditures were lower than planned, which improved the balance of the entire system of public finances.

In terms of budget size, the **Labour Market Fund** is still the largest among the funds of this subsystem. It fulfils state tasks related to the promotion of employment and the management of unemployment through the national network of labour organisations.

Our audits have indicated for years that some of the changes that have occurred in the internal structure of the expenditures show unfavourable trends: the size and proportions of subsidies serving for the implementation of employment policy goals changed favorably in 2006 in comparison to the previous years, but they are below the 2003 level. **In relation to the active employment policy tools the use of funds has become increasingly non-transparent, and it is difficult to follow the impacts of active tools on employment.**

The resources (fund sections) of the Labour Market Fund identified in the Act on Job Assistance and Unemployment Benefit are not in harmony with the legal titles of expenditures listed in the Annex to the budget act. In addition to the direct expenditures linked to the fund sections, expenditures that cannot be linked to the fund sections play an increasingly important role. The SAO's recommendations made for the review of the planning system, budget relations and legal background of the Labour Market Fund have not been welcome yet. A growing part of funds available for the Labour Market Fund are used to finance the operational costs of its affiliated organisations.

The appropriations of the **Central Nuclear Financial Fund (CNFF)** were implemented according to the requirements. Its **accumulated balance-sheet total** continued to rise, and reached almost HUF 100 billion by the end of

2006. The ratio of operational and accumulation expenditure is more favourable than in 2005. The legal appropriations of the budget of the CNFF were considerably lower in years 2004 to 2006 (and in 2007, too) than the amounts specified in the medium- and long-term professional plans. The lack of resources may cause certain tasks to be cancelled or deferred. The establishment of a storage facility for low- and medium-radioactivity waste products required additional resources already in 2006. (The relevant appropriation was increased by HUF 3.3 billion at the expense of the balance).

The **Wesselényi Miklós Flood and Inland Waters Compensation Fund** started its actual operation in 2004. The SAO's doubts – basically about the expediency and effectiveness of operation – expressed in the reports on the final accounts of the former years seem to be proven by the findings of 2006, too. The off-budgetary resources of the Fund are negligible, they provide coverage for claims for damages only in a small group. **Most of the Fund's revenues come from budgetary subsidies.** In 2006, the number of contracts concluded with the Fund rose, however this number is still a far cry from the number of contracts anticipated when the Fund was set up. The SAO's comments made on the Fund in the previous years are still valid: the reserve cannot be used, operation as a fund is a mere formality.

In 2006, the financial position of the **Research and Technology Innovation Fund** was stable, it closed the subject year with a surplus of HUF 11.2 billion. One third of the payments were made to enterprises, while over 50% of the available funds were paid to budgetary institutions. The cyclicity of the payment of subsidies was similar to that experienced in the previous years: as much as 31% of the annual expenditure amount was incurred in December. The “reserve” of the Research and Technology Innovation Fund is currently used to fund the budget deficit, and cannot be used for the original objectives of the Fund. Thus, the provisions of the budget act restrict operation as a fund, as a result of which the money available for launching new grant programmes shrinks year after year.

The **Homeland Fund** was set up in 2005 as a new separated state fund, with an initial capital of HUF 1 billion. The expenditure appropriation was the same amount in 2006. Based on the support contracts signed, a total of HUF 845.5 million was disbursed. Apart from the budget of the Ministry of Foreign Affairs, the appropriations of other chapters also include appropriations, foundation or public foundation subsidies affecting ethnic Hungarians living outside Hungary. The size of such appropriations and subsidies was by far greater than the budget of the Homeland Fund in 2006, too. The intention formulated in the Government Decree that initiated the establishment of the Fund (i.e. the consolidation of resources designated for similar purposes) has not been realised yet. As much as 100% of the amount transferred to cover the operational costs of the Fund Manager was utilised. Pursuant to the relevant Government Decree, the amount of the appropriation transferred in relation to the management of the Homeland Fund was below 5% of the revenues realised in the subject year.

The **National Cultural Fund** functioned as a separated state fund until 1 January 1999, and has been functioning again as a separate fund since 1

January 2006. The budget act approved identical expenditure and revenue appropriations for the Fund for the year 2006, however the subject year was closed with a surplus. In 2006, the most significant revenue source for the Fund was the cultural contribution. As far as payments from the Fund are concerned, according to company form the largest share was transferred to budgetary organisations (22.7%, including the operational costs of the Directorate of the National Cultural Fund). The funds provided to local governments and the institutions thereof equalled 15.4%, and the list is followed by business organisations, foundations, associations, private individuals, churches and foreign entities. The residue of the National Cultural Basic Programme from 2005 was transferred in full to the Fund. The residue of appropriations of the Fund in 2006 was mostly due to the lower than planned expenditures. The surplus of revenues realised on top of the modified appropriation were negligible.

2.1.3. Social security funds

The consolidated deficit of the social security subsystem of public finances totalled HUF 130.8 billion in 2006. Deficit financing and the fact that the central budget supplemented the revenues of the two insurance funds – under various legal titles – with HUF 964.1 billion means that the social security system contributed to the deficit of public finances with HUF 1,094.9 billion. From this approach, the SAO found the financial position of the funds unfavourable.

The deficit of the **Pension Insurance Fund** was smaller in 2006 than in the preceding year **due to greater direct subsidies transferred from the central budget**. The deficit is caused – just like in the previous years – basically by the fact that the economic processes develop along an unplanned path both on the revenue and expenditure sides, and consequently by the supplementary pension rise and the greater than expected impact of automatism that determine the growth of pension. The equity capital of the Pension Insurance Fund has been in the negative for four years in a row, which is due to the loss of value of outstanding contributions.

According to the Hungarian Tax and Financial Control Administration, in 2006 the Pension Insurance Fund's outstanding contributions exceeded the 2005 level by 92.8%. At the end of the year, a loss in value equalling 47.3% of the outstanding contributions was accounted according to the rules of accounting loss in value, which have been criticised for years in the reports on the final accounts. These accounting rules and the low level of processing of the tax returns submitted yielded values that cannot be evaluated from the perspective of economics.

The amount of actually realised revenues is 0.7% smaller than the amended appropriation, but is 14.9% larger than the revenues yielded in 2005. Within the revenues, the amount of varying and flat rate contribution revenues composed a major share (71.5% of all revenues).

The original expenditure appropriation of pension benefits payable from the Pension Insurance Fund slightly increased due to the amendment of the budget

act, however the discrepancy compared to the original appropriation is significant (5.9%), which proved that pension expenditures had been underplanned. (The SAO drew attention to this in its opinion formed about the budget appropriation bill.)

The daily liquidity of the Fund and the smooth payment of benefits are ensured by the interest-free loan taken from the Single Treasury Account. The Pension Insurance Fund had outstanding loans on each calendar day of the year. Borrowings basically followed the liquidity plan.

The financial position of the **Health Insurance Fund** has been out of balance for years. The balance could not be restored in 2006 either, although the amount of the deficit turned out to be smaller than the modified sum. The decrease in the deficit compared to the former years occurred due to the new budgetary contribution introduced on 1 January 2006, the amount labelled 'national risk community'. The central budget pays contribution to the Health Insurance Funds for citizens that are not or cannot be obliged to pay contribution.

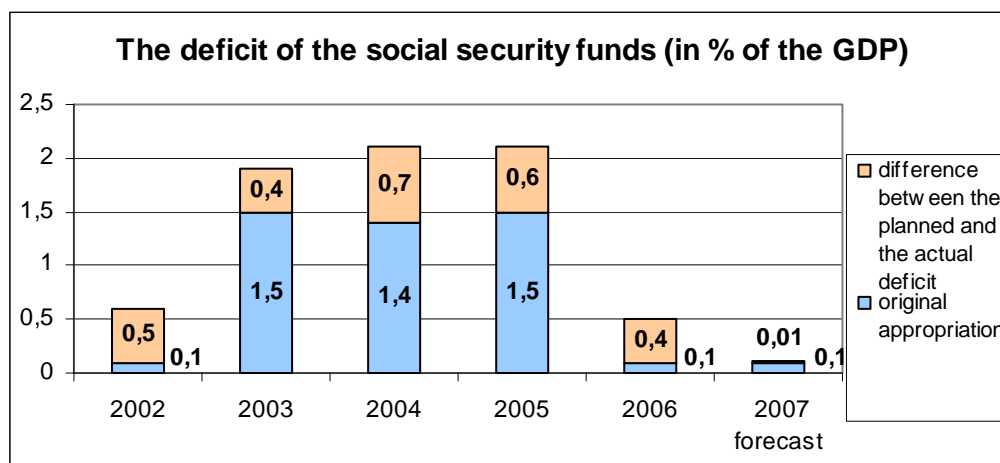
Compared to the revenues realised in the previous year, revenues yielded in 2006 show a performance of 130.1%. The significant growth was caused by the central budgetary contribution paid under the label "national risk community". Without this amount the growth rate on the revenue side is merely 4.9%.

The gradual growth in the budgetary deficit of the Health Insurance Fund, the permanent and growing need for loans reflected the continuous deterioration of the financial situation. In the past six years, the actual deficit has always exceeded the original appropriation stipulated in the budget act. **Despite the 2006 measures aiming to increase revenues and reduce the growth rate of expenditures, the amount of the deficit exceeded the amount set in the original plan.**

The daily liquidity of the Health Insurance Fund and the smooth payment of benefits were ensured by the Treasury by providing interest-free loans pursuant to the budget act. As regards the account turnover corrected for the 2005 deficit, a loan was needed on each calendar day. Borrowings basically followed the liquidity plan.

When forming the SAO opinion on the 2006 budget, the SAO considered the appropriation risky already on the basis of measures known in the planning phase and on the basis of approved measures (in the Government Programme). To maintain operability, internal regrouping was carried out as early as 1 January. Yet, it was evident that the funds available for 2006 would not be sufficient. The deficit was the largest in relation to the expenditures of consolidated specialised healthcare and chronic in-patient care. From July on, the monthly amounts of financing were specified in Government Decrees in accordance with the budget act. It was inevitable to amend the budget act, which increased the original appropriation of the legal title group "curative and preventive healthcare services". Actual spending almost corresponded to this amendment.

The new and considerably effective regulation to curb social security expenditures was adopted at the end of 2006. Measures taken during the year served the purpose of streamlining and the prevention of unnecessary spending. They also decreased the growth rate of the legal title, yet they were not suitable to significantly reduce the 2006 expenditures.

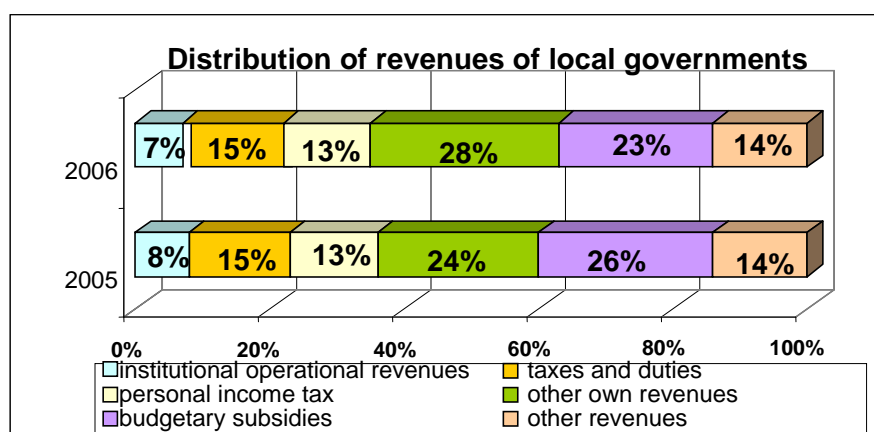


Source: budget and final accounts bills

The 2008 budgetary appropriations of the Social Security Funds continue to imply risks both on the revenue and expenditure sides, however the SAO has found the revenue and expenditure appropriations for 2008 **more fair than in the former years.** The requirements stipulated in the Convergence Programme were in theory enforced in the 2008 budget proposals. In the Health Insurance Fund, compliance with the appropriations for curative-preventive healthcare services, pharmaceutical subsidies and medical aids largely depends on the impacts of the measures taken at the end of 2006 (experienced in 2007). In the Pension Insurance Fund, compliance with the pension expenditure appropriation depends on changes in the expected macroeconomic indicators. The series of measures that have been publicised can launch the restructuring process that may force healthcare service providers to reveal their internal reserves, streamline their financial management, perform restructuring using central incentives, and downsize unnecessary capacities. Results may be yielded by the regional cooperation of the institutions.

2.1.4. Local governments

The revenues and expenditures of the local governmental subsystem of public finances have grown in the past four years. The consolidated revenues/expenditures were nearly 50% higher in 2006 than in 2002, while the annual growth rate was 6 to 12%. During this period coverage for the 50% increase of personnel costs – primarily due to central wage measures –, the 42 to 64% rise in non-personal and cumulative purpose expenditures was provided by the 50% and 38% growth in local tax revenues and personal income tax revenues, respectively, as well as the aggregate increment (46%) of revenues from borrowings.



By the end of 2006, the **assets of the local governments presented in the accounting balance sheet** grew by 60% compared to 2002. The strikingly high growth rate experienced between 2002 and 2003 was primarily caused by the determination of the value of real property that had earlier been registered without indication to its value. It is a positive development that growth experienced since 2003 was typically associated with investment and renovation projects. Unfortunately, in addition to the growing expenditure spent on investment projects, the stock of liabilities at year end also grew, while the rate of current assets that could promote financial solvency has shrunk. The stock of securities owned by the local governments has decreased due to local governmental measures taken to improve the balance of the budget. On the other hand, repayment liabilities have grown due to increased borrowings.

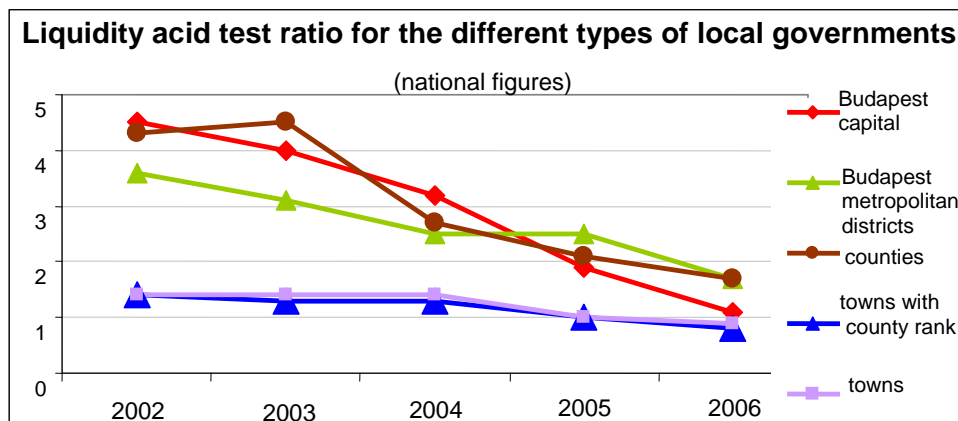
Data in HUF billion

ASSETS OF THE LOCAL GOVERNMENTS AS PRESENTED IN THE ACCOUNTING BALANCE SHEET

Assets	2002	2003	2004	2005	2006
Intangible assets	9	11	16	21	25
Tangible assets	4 350	6 833	7 021	7 238	7 576
Invested financial assets	564	566	575	556	558
Assets transferred for operation, management purposes	930	1 254	1 396	1 482	1 587
CURRENT ASSETS	570	571	610	564	554
TOTAL ASSETS	6 423	9 235	9 618	9 861	10 300
LIABILITIES	490	518	589	697	925
OWN PROPERTY	5 933	8 717	9 029	9 164	9 375

In relation to the annual report, the SAO must draw preliminary attention to the fact that in the past three years **the liabilities of the local governments due to short- and long-term borrowings have dynamically grown**. During 2007, the long-term debts of local governments and multi-purpose micro-regional associations grew by nearly one and a half times according to the figures of the Hungarian Treasury. Last year the year-end stock of long-term liabilities increased by HUF 192.1 billion (46.7%). From

among the different types of credits and loans the local governments gave preference to bond issuance: The stock of bonds hardly totalled HUF 4 billion at the end of 2005, however it exceeded HUF 24 billion at the end of 2006, and HUF 211 billion at the end of 2007.



It can also be concluded from the processed reports of comprehensive audits conducted in 2007 that the debt stock of the local governmental subsystem continued to rise. The liabilities increased in all types of local government, wherefore the economic position of the local governments deteriorated between 2002 and 2006. Deterioration was especially striking at the district local governments of Budapest, the local governments of the counties, towns with county rank, and the local governments of towns.

The liquidity acid test ratio⁸ shows significant differences between the various types of local governments regarding the financial position. However, the difference shrunk in 2006. The acid test ratio indicates that the financial position is deteriorating on a continuous basis: funds, negotiable securities and receivables provide less and less coverage for the short-term liabilities, and one fifth of the local governments that took out liquid loans did not repay the entire amount of the loans at the end of any year, wherefore solvency was maintained by such loans on a continuous basis.

Changes in the regulatory system that affect the financial management of the local governmental subsystem of public finances

The review and precise definition of state and local governmental tasks, as well as the tasks performed by the micro-regions and regions, the modernisation of the financing system, the further development of resource regulation, the significant reduction and simplification of the number of legal titles, the readjustment of the credit limits **were not implemented in 2007 either**. Although the number of the legal titles of normative state subsidies did not increase, the tasks became more detailed within certain legal titles (e.g. social and child welfare tasks), to which specific contribution was allocated.

⁸Receivables+ securities+ funds/ short-term liabilities

Therefore, the accounting had to be prepared on the basis of 156 code numbers. The provisions of the Government Decision on the modernisation programme of public administration services were not enforced, regulations became more detailed, the accounting of normative contributions and the audit thereof required the increasingly thorough knowledge of the task-related professional legal regulations.

Out of the 72 local governments at which normative contributions were audited, five local governments submitted error free accounting reports similarly to the previous year. As much as 15% of the reports had an error ratio of over 2% (this ratio was 3% in 2005, and 9% in 2006). The recent growth in the percentage of reports containing errors over 2%, and the ratio of errors revealed in the reports indicate that the regularity and reliability of the accounting figures are deteriorating.

In local governmental regulation financial means and incentives were used to enhance the efficiency of organisation and improve the quality of public services – in order to improve the balance of public finances – from operational subsidies that are shrinking in terms of real value. **The local governments responded to the reduction of central resources in relation to the improvement of the budget balance by local organisational actions that yielded actual savings, by downsizing, by partially funding the deficit from loans, and thus by increased indebtedness**, which showed contradictions during the approval and execution of the 2007 budget.

The changes of the funding system of public education – in line with the various requirements set in the Act on Public Education regarding the average number of pupils, timeframes and the weekly number of contact hours to be taught by the teachers – encouraged the more rational organisation of public education in a progressive manner.

Following the findings and recommendations of the SAO audits, the modification of the social act and the restructuring of the family support and benefit system gave priority to the enforcement of the principle of need in the award of social benefits, the development of a support and regulatory system focusing on this principle, as well as the transformation of cash transfers in order to encourage benefit recipients to find employment.

Multi-purpose micro-regional associations could apply for contributions to eight different tasks. The conditions and terms for granting such contributions are extremely complex and complicated, wherefore they are difficult to be followed. In 2006, one could witness a growth in the rate of support to which the budget provided centralised appropriations upon call for tenders. The amount and share of normative, special purpose subsidies provided to supplement certain income allowances decreased after the child-rearing allowance was taken out of the funding tasks of the local governments.

The application and accounting system of the majority of appropriations disbursed on the basis of applications, and centralised appropriations disbursed within the framework of tendering procedures is still complicated. In the case of certain legal titles the review of the ex-post accounting of the individual

subsidies awarded upon tendering does not comply, or only partially complies with the requirements, primarily due to regulatory shortcomings. According to the SAO's experiences, this can also stem from the fact that the local government failed to audit the utilisation and accounting of subsidies that had been granted for specific purposes.

A major part of **development subsidies** was still made up of target and earmarked subsidies, however their share continuously decreased as the subsidies provided by the European Union opened up. In 2006, nearly 10% of the subsidies could be used for new investment projects (since 2007, earmarked subsidies cannot be granted to new investment projects). The role of this subsidy was taken over by EU subsidies that replace the national resources and are linked to the implementation of development objectives specified in the Operational Programmes of the New Hungary Development Plan.

When reviewing the local governmental decree on **the distribution of revenues due to and shared by the Municipality of Budapest and the district local governments in 2007** the SAO concluded that the 2006 Act on Resource Sharing does not comply with the Act on Local Governments, since it did not specify the tasks to be considered in calculating the distribution of resources. For the lack of legal provisions it is unclear which operational costs of which tasks must be taken into account on the expenditure side, and which revenues from normative contributions and subsidies – revenues accounted under what processing codes – shall be taken into account on the revenue side. By stipulating the sharing of revenues that the Municipality of Budapest is eligible for at the rate of 47% to 53%, the 2006 Act on Resource Sharing limited the right of the General Assembly to adopt decrees as specified in the Act on Local Governments. The 2007 Decree on Resource Sharing also violates the law, since it stipulates that local taxes collected by the capital districts are the districts' own revenues. In violation of the provision of the Act on Local Government, the 2007 Decree on Resource Sharing did not divide the motor vehicle tax, which belongs to other centrally imposed taxes, between the Municipality of Budapest and the district local governments⁹. The luxury tax, which belongs to this category, and was introduced in 2006, was divided between the Municipality of Budapest and the district local governments.

The deficit of operational expenditures calculated by the Municipality of Budapest, as well as on the basis of the SAO's findings exceeded the sum of dividable revenues, wherefore no resources remained that could be divided according to regulations that consider the specific characteristics of the districts.

The SAO audited the **review of the use and accounting of funds available for the local governments from the central budget**. The

⁹ The National Assembly amended the 2006 Act on Resource Sharing by adopting Act CLXXXII of 2007 – which entered into force on 31 December 2007 - on the amendment of acts affecting certain local governments, wherefore the SAO recommendation for correction formulated pursuant to the review considered all tax revenues collected by the district local governments (motor vehicle tax and local taxes imposed by the district local governments) as the revenue of the district local governments.

2006 review by the Treasury focused on the accounting of state subsidies and personal income tax revenues transferred to the local governments from the central budget in the amount of HUF 1,321.3 billion in 2005, the 2006 application for HUF 1,2893 billion in state subsidies and transferred personal income tax revenues, as well as on the assessment of the indicator related to the 2007 budgeting process.

The staff members of the county directorates of the Treasury have performed this review since 2002, without the staff being increased. Each directorate developed and shaped its databases that assisted the review independently, without cooperation with the other directorates, because there is no uniform, systemised database at the level of the Treasury that would ensure direct access. The timeframe available for the review of the assessment of normative state subsidies and normative special purpose subsidies was insufficient for compliance with the rules of procedures contained in the Act on Public Finances, and the issuance of the written notices in relation to the planning process of the 2007 central budget.

The preliminary review of the use of resources available to the local governments from the central budget was successful, since it prevented the illegal utilisation of state contributions and subsidies. The ex-post review of the use of resources available to the local governments from the central budget was partially successful, because the method of the review, specified by law, did not allow for the complete detection of unlawfully utilised state subsidies.

Nonetheless, the detection of unlawful utilisation by the Treasury directorates pursuant to the ex-post review of subsidies is less effective than the on-site audits, because there are legal titles that can be inspected only by the comparison of documents available on the site.¹⁰

Audit experiences related to the financial management of local governments

The publication of the SAO reports considerably improved voluntary law abidance by the local governments, and made it possible for the management of the nearly 3,200 local governments to learn about those deficiencies – related to the use of regulatory, decision-making or financial management linked powers – that can be regarded typical in the local governmental subsystem.

The SAO has concluded that the ratio of local governments having economic programmes increased between 2002 and 2006 – compared to the previous years. The objectives of the approved economic programmes included the

¹⁰ The ratio of irregular utilisation revealed by the SAO audits conducted in relation to the accounting of normative state subsidies and normative earmarked subsidies within the framework of the 2005 and 2006 final accounts was on average 18.4% higher in each county than irregularities revealed by the Treasury.

promotion of financial stability, institutional restructuring, and the maximum utilisation of calls for proposals.

Violating the provisions of the Act on Public Finances, in more than half of the local governmental offices the town clerks did not, or did not properly ensure **the organisation of financial management control (FMC)**, did not elaborate the rules of risk management, and the **audit trail** was not determined in nearly half of the local governments. Due to the deficient performance of the financial management control stipulated in the Government Decree on the operational rules of public finances, nearly half of the cash-flow accounting records supporting book-keeping failed to meet the content and format requirements of the Act on Accounting. In one third of the local governments liabilities were assumed and amounts were transferred without approved appropriations.

In 2006, the audit of the operation of internal control systems that were found to imply high risks by the previous audits was extended to the subfields of these internal control systems, since due to the absence of financial management controls built into the audit process, and due to full or partial non-compliance with the legally mandated control tasks, deficiencies accumulated on the accounting records. As a result of the extension of the audit, an outstandingly high error ratio was found by the SAO in the operation of the FMC system, compared to the previous years.

Almost all local governments defined the duties related to **asset management**, as well as tasks and duties related to the sale of assets in the form of a decree. However, nearly half of the local governments did not stipulate the requalification conditions of assets that are not completely negotiable. Half of the local governments infringed the requirement of mandatory tendering during sales and property utilisation transactions. Sales transactions conducted without competitive bidding did not make it possible to enforce the publicity and transparency requirement pertaining to the financial management of local governmental assets. By transferring to business organisations the ownership rights of water public utilities that belong to nominal assets that are not completely negotiable, the provisions of the Act on Local Governments and the act on water management were violated by 24 local governments in the period of 2003-2006. Nine local governments sold non-negotiable assets that belonged to the nominal assets of the local governments and had them registered in the Land Register contrary to the severability clause of the Civil Code pertaining to the alienation of non-negotiable real property. Nearly 50% of the local governments sold assets without having the market value of the assets assessed prior to the transaction, or the content thereof was not taken into account when the selling price was set. The number of local governments that provided direct support to political parties by providing premises free of charge or for low rents decreased year after year. Such direct support contradicts the provisions of the Constitution and the Act on Local Governments.

In 2006, the local governments transferred HUF 277.3 billion as **subsidies for special purposes** (other than social benefits) to entities **outside the system of public finances** for special – operational and cumulative – purposes (to

foundations, public foundations, other nonprofit organisations, enterprises, households, budgetary organisations other than their own institutions, and foreign communities). The local governments granted nearly half of the earmarked subsidies for operational purposes, and the remaining amount for cumulative purposes. The amount of the subsidy, the supported objective, furthermore the method and deadline of meeting the accountability obligation pertaining to the utilisation of the subsidy were more often determined than in the previous year. Contrary to the provision of the Act on Public Finances, nearly one tenth of the local governments failed to check accounting, and another 40% of them did not provide for the complete checking of accounting. Nearly eight tenths of the local governments failed to check whether the subsidies were utilised for the designated purposes¹¹.

The **disclosure obligation** stipulated in the Act on Public Finances in relation to subsidies and contracts having a net value of HUF 5 million or more has been violated, or has been met only partially for years by more than half of the local governments. Non-compliance with this obligation did not make it possible to enforce the requirement pertaining to the transparency and publicity of the utilisation of public funds. Abandonment of claims or free transfer of property occurred at nearly one third of the local governments. Nearly 50% of local governments that abandoned claims, and one third of local governments that transferred property free of charge failed to determine in the form of a decree the method and cases of the abandonment of claims and free property transfer, respectively.

The councils of the audited top priority local governments and local governments of towns determined the local rules of **public procurement**, however one tenth of these local governments did not specify the preparation of public procurement procedures, the responsibilities of persons acting on behalf of the tender announcer and involved in the procedure, or the rules pertaining to the documentation of the procedures. Contrary to the provisions of the Act on Public Procurement, one fourth of the audited local governments failed to define the scopes of responsibility in the internal audit of public procurements, and nearly one tenth of these local governments did not compile annual consolidated public procurement plans. In the public procurement procedures that were conducted the persons acting on behalf of the tender announcer had the required expertise. The evaluation of the tenders was in accordance with the provisions of the Act on Public Procurement, the evaluating committees examined the reasons for exclusion in all but three procedures. The contracts were signed by the prescribed deadlines based on the tender documentation, the tender announcements and the tenders.

During the audit, the SAO initiated 21 review procedures for the violation of the Act on Public Procurement. In 19 of these cases the Public Procurement

¹¹ The SAO performed on-site audits regarding the utilisation of transferred funds at 17 subsidised organisations. At six of these organisations the SAO revealed unlawful utilisation.

Arbitration Committee established the violation of law, and imposed a fine of HUF 13.5 million¹².

The **planned balance of the local governments' budgetary revenues and expenditures** has continuously deteriorated in the past years. The planned revenues fell short of the planned expenditures at nine tenths of the local governments. The revenues were not sufficient to cover operational tasks and accumulation tasks at three quarters and half of these local governments, respectively. Part of the deficit growth planned in budget was still partially caused by the uneconomical organisation of task performance, the low level of utilisation of institutional capacities, the undertaking of voluntary tasks over the load-bearing capacity, by planning errors, the under-planning of operational revenues, as well as by the planning of cumulative purpose budgetary expenditures in excess of the cumulative purpose budgetary revenues.

As a result of local governmental measures taken with a view to improve the balance, nearly one third of the audited local governments had **budgetary deficits** in the past two years. During the execution of the budget, the planned budgetary deficit was decreased with revenues realised on top of the plan, extra revenues yielded from the sale of property and from unsubstantiated planning, from funds obtained through subsidies and tender procedures, from the use of the monetary reserve in excess of three times the planned rate (equalling two thirds of the planned deficit), as well as the rescheduling, postponement or possible cancellation of tasks at nearly two thirds of the local governments.

Among own revenues local tax revenues continued to represent a major share; its ratio to all revenues exceeded one tenth. Among the local tax revenues the local business tax continues to be the most significant, by amounting to 84% of local tax revenues. Under various legal titles three fourths of the local governments provided further discounts and exemptions in addition to those specified in the legal regulations.

Two thirds of the audited local governments decided to assume debt generating liabilities, the most frequent method of which was **borrowing**. The loans taken and the bonds issued (the rate of which significantly increased in 2007) were in part used for the repayment of earlier loans. When determining the amount of debt generating liabilities, 96% of the local governments complied with the upper limit prescribed by the Act on Local Governments. The amount and maturity of overdraft credit lines and the liquid loans taken continuously

¹² In 2006, the decisions made by the Public Procurement Arbitration Committee about the termination of the proceedings were in part due to the fact that the Committee considered as the date of obtaining information on the violation of law not the date of availability of all authentic documents supporting such violation, but rather the date of transfer to the auditor of at least one of the documents that indirectly indicate the omission of the public procurement procedure. The Public Procurement Arbitration Committee did not take it into account during its proceeding that during the 15-day term of preclusion available to the SAO pursuant to the Act on Public Procurement violation of the provisions of the Act on Public Procurement cannot be determined with full certainty on the basis of incomplete documentation.

rose in the period of 2002-2006. Three fourths of the county local governments, half of the district local governments of Budapest, one third of the local governments of towns with county rank, and 38% of local governments of towns failed to repay said loans in full by the end of the year.

IT supported financial and accounting activities have become more widespread and modern at the local governments in the past few years, however computer programmes and manual, analytical records were equally used for the performance of financial and accounting tasks. Within the framework of the development of IT assisted processes, the overwhelming majority of the local governments have launched a website. In 2007, nearly two thirds of the audited county local governments, local governments of towns with county rank, district local governments and local governments of towns provided information on the necessary documents in compliance with the 2nd electronic service level specified in the relevant Government decision, and provided for the downloading and completion of forms, in addition to general information provided for administration purposes. In addition, according to the findings of SAO audits performed in 2007, nearly one tenth of the local governments complied with the requirement of the 3rd electronic service level, and elaborated the conditions for initiating electronic administration, which ensures that personal presence is no longer required for starting or arranging certain issues.

The **minority self-governments** did not take over tasks from the local governments, and nor did they establish any institution. Consequently, the majority of their budgets were made up of operational expenditure, within which the share of non-personnel expenses grows year after year.

Compared to the former years, progress was made in the fulfilment of **internal audit** tasks in relation to the development of the internal audit organisation and the personal conditions, the creation of conditions required for operation, and the level of regulation of task performance. Most local governments created the organisational frameworks of internal audit, however more than half of the towns, and nearly four fifths of the large villages and villages failed to regulate the legal status and tasks of persons in charge of internal audits. Four fifths of the local governments ensured the organisational system of internal audits within the framework of an internal audit association. Progress was made in relation to the functional and organisational independence of the internal auditors, since at almost nine tenths of the local governments the internal auditors were directly subordinated to the town clerk. Nine tenths of the local governments had internal audit manuals, however the audit plans were still not properly substantiated. The working plan of the associations and the needs of the local governments were out of harmony in nearly one third of the affected entities. Three quarters of the audits were completed with reports with adequate content. The councils continued to pay little attention to the annual result of the internal audit activity.

2.2. Major experiences of audits focusing on the fulfilment of state and local governmental tasks

Audit of infrastructure development and operation

In line with its strategic objective – the SAO audited the **motorway investment projects that were completed in 2006**, using the results of former and related audits. The costs of the 137.2 km long expressways – 117.7 km motorway and 19.5 km highway – opened in 2006 totalled HUF 143.4 billion. In the case of motorway sections constructed under concessional agreements, the construction costs stipulated in the contract (HUF 136 billion) will be paid by the Hungarian State as a stand-by fee by 2030.

For the lack of uniform legal regulation on state investment projects, such projects are not coordinated at governmental level. Implementation is subject to alteration under the effects of the market conditions, it depends on the organisations concerned, and is more financing than system based.

According to the legal regulations in force, the audited expressway sections should have been opened to traffic by the end of 2006. In the concluded implementation contracts the completion deadline was brought forward by nine months, which was not professionally substantiated. Furthermore, the actual status of the preparation of the projects and the time needed for implementation were not taken into consideration when the new deadline was set. As a consequence, the set deadlines were either missed, or completion of the work was done in stages, or the technical contents that caused additional costs were modified. During the investment projects only the deadlines were given priority: economy issues were neglected and the enforcement of quality requirements implies risk factors. The invitation to tender announced for the selection of contractors limited the group of potential enterprises. This, as well as the volume of expressways planned to be opened to traffic in 2004 through 2006 led to the fact that the number of road sections to be built exceeded the number of potential contractors on the Hungarian market, which led to the segmentation of the construction market, and the potential contractors did not have to count with “competition pressure” when working out the tender prices. These phenomena did not encourage the candidates to reduce the costs of implementation.

The SAO did not audit the **system of electricity supply** before. The topicality of the issue was given by the fact that the electricity market had to be fully liberalised by 2007, in line with the EU requirements. The regulatory and support system first of all fostered the establishment of small power plants, and no large power plant able to generate extra electricity was built. Consequently, the controllability of changes in load and that of breakdowns has been less and less ensured since 2005. According to the 2007 analysis of MAVIR Hungarian Transmission System Operator Company Ltd., i.e. the system operator, the system fails to meet the security requirements of quality supply for about 40% of the year. Network loss is high (10%), reduction of this cost is not sought, since the loss constitutes costs that can be accounted in the electricity bill. The price of electricity has considerably grown in the past four years due to changes

in the prices of energy resources, producer prices or changes in the system of pricing. For example, household electricity price has grown by 45%. The prices were also increased by the high take-over price of electric power, the take-over of which is mandatory, however they were favourably influenced by the less expensive electricity generated by the Paks Nuclear Power Plant. However, this ensured cross financing for higher prices, as a result of which high-cost power plants could also stay in competition.

In line with the EU Directives, the dual market model was introduced on 1 January 2003¹³. Pursuant to long-term contracts concluded during the privatisation of power plants in the mid 1990s, nearly two thirds of the required electricity was secured, however this narrowed the scope of action of this market segment. Since the competitive market was restricted, it could not significantly influence the prices. The critical approach to the dual market model is indicated by the fact that the European Commission launched three independent proceedings. Full market opening, which the EU expected to see in the middle of 2007, was postponed, since state management was behind schedule both in the elaboration of regulations and in taking the necessary measures in connection with the long-term contracts.

The SAO revealed the problems and results of regulation and task performance within the framework of the **audit of tasks of local governments** related to **water management and drainage** with a view to taking measures that ensure long-term and sustainable solutions. Water management and drainage belong to the mandatory public service tasks of the local governments, however the legally prescribed tasks to be performed within the framework of water management in the administrative areas of the individual local governments were not specified in legal provisions with regard to the different property relations. No complex water management plans were drawn up, and developments within and outside the municipality boundaries were not coordinated. Cooperation among the local governments was not typical despite encouragement. The local regulation of task performance partially complied with the legal regulations, 26% of the local governments did not even define water management in the local regulations. As much as 29% of the local governments ensured harmony among the local rules of water management and drainage tasks approved by the councils, the programmes, the concepts, the local spatial plans and the water management plans for the different parts of the settlement. Contrary to the provisions of the relevant Government Decree, the natural and value data pertaining to water bodies and water facilities indicated in the cadastral register of real property were still not accurate at one third of the local governments.

In the period of 2001-2006, the central budget provided the local governments with a total of HUF 23.9 billion in subsidies for the performance of water management development and reconstruction tasks (within the framework of earmarked subsidies, subsidies to equalise regional disparities, earmarked decentralised support, and the water management appropriation). However,

¹³ The so called public utility and the newly opened competitive markets functioned side by side.

according to the survey conducted by the Ministry of Environment and Water, the local governments would need a total of HUF 224 billion – at national level and at 2003 prices – for water management reconstruction and development projects. The local governments could obtain funds for the repair and maintenance of the settlements' water drainage systems and facilities within the framework of employment assisting subsidies, as well as public benefit, public purpose and public work schemes.

The lack of separation of “multi-channel” subsidies for water management within municipality boundaries and the related water management expenditures adversely influenced transparency. The applications for cumulative and maintenance purpose subsidies did not reflect the real needs of the local governments, since the applications were linked to several objectives, and the selection of the objectives, and thus the submission of the application was influenced by the approach of the local governments, and the order of priority of task performance set up in accordance with the population's scale of values. However, it was a positive development that in contrast with other objectives, the decentralised resources supported water management within municipality boundaries at a rate of 100%. The local governments spent less funds than needed on task performance. Such expenditures accounted for only 1.9% of their budgets on average. As much as 66% of the water management tasks were financed from the central budget. 44% of the audited local governments performed a few, less cost-intensive tasks without state subsidies, in the value of HUF 1.3 billion.

According to the findings of the audits conducted on 84 sites, the local governments' level of preparedness for water management within municipality boundaries has improved since the 1998 SAO audit – primarily due to developments – however only little progress was made in the continuous maintenance of the water facilities and the preparation of the water defence plans. Only five local governments prepared a comprehensive strategy for the prevention of water damage, and the endangered areas were mapped on 25 settlements. The mandatory defence plan was prepared by 41 local governments, however non-compliance with this regulation did not entail any disadvantage in the funding of defence and the elimination of water damage from state subsidies.

It was characteristic of the **local governmental investment projects** that while the support system that is funded from national resources and basically serves decentralised regional development objectives continued to favour the projects of the former years, it also focused on increasing the competitiveness of the regions, on job creation projects not subsidised by the EU, as well as on local governmental, in part tourist development projects. The decision-making process of development purpose budgetary subsidies was restructured, the decision-making power related to the different levels of development purpose subsidies concentrated at regional level, which fostered the coordination of development objectives and enhanced the efficiency of the utilisation of resources. In parallel with this, the resources about which the county regional development councils are authorised to decide have dropped to a minimum level.

The professional and technical preparation of investment projects launched by the local governments with the help of development purpose subsidies was adequate at only around 50% of the projects due to shortcomings in the technical documentation, plans, construction permits, technical planning, as well as due to the delayed availability of technical documentation. In more than half of the investment projects various extra works were performed and accounted in part due to the above written, and in part due to technical necessities that occurred in the implementation phase. The local governments failed to call the implementing contractors and technical supervisors to account for deficiencies that could in part be associated with the need for extra work.

Most local governments applied the provisions of the Act on Public Procurement in the selection of project suppliers, however nearly half of the contracts concluded as a result of the public procurement procedures were modified. The modification of the contracts, and the amendment of the contractual terms and conditions that also formed part of the evaluation criteria of the public procurement procedure violated the requirement of fair competition. In the course of these modifications the local governments stipulated higher contract prices on the basis of extra work, longer deadlines for implementation, and more favourable auxiliary contractual obligations for the contractors. Altogether 30% of the local governments complied with the provisions of the Act on Public Procurement.

The utilisation of earmarked and target subsidies was effective in the audited investment projects, since the investment objectives were achieved and the facilities are used for the purpose that the subsidies were provided for. The investment projects have led to the expansion and improvement of the public utility, healthcare, educational and cultural infrastructure of the settlements concerned.

The 2007 audit of the **higher education investment programme for residence halls** focused on the performance audit of implementation in the framework of the PPP scheme. Developments were encouraged by the problems of residence halls in higher education – lack of vacancies, bad state of repair of the buildings, lack of quality services, number of students without dormitory services. The Government Decisions that were adopted in 2003 and 2004 on the construction of residence halls and reconstruction programmes contained only quantitative objectives. The development of the objectives was not preceded by the compilation of a residence hall development strategy and a higher education level feasibility study. For the lack of budgetary resources, developments were carried out in the PPP scheme.

The developments were not backed by regional education policy plans, longer-term training concepts and demographic forecasts. The legal environment fostering the cooperation of the public and private sectors was not sufficient. Uniform state procedural rules stipulating the organisation of PPP projects, and the methodology for the calculation of the cost-efficiency of the projects are still nonexistent. The Ministry of Education and Culture did thorough preparatory work when elaborating the risk and guarantee elements of the PPP scheme. The

preliminary cost-efficiency calculations performed by the higher education institutions justified the advantages of the PPP scheme.

The higher education investment programme for residence halls was implemented only partially and later than planned. In the case of the completed residence hall construction projects the present value of service purchase exceeds the net construction costs by more than two times, while the nominal value thereof is nearly three and a half times higher than the net construction costs in the long run, typically at the end of the 20-year maturity period.

In the short run, the implementation and operation of the residence hall projects are effective, economy and efficient. The specific project objectives were achieved by lowering the operational expenses, improving the quality and utilising full capacity. The long-term cost-efficiency of the residence hall investment programme cannot be unanimously determined due to the size of the dormitory and service fees and the risk factors influencing changes in these fees – changes in the EUR/HUF exchange rate, rise of the public utility fees, changes in the normative subsidies to dormitory and other accommodation costs, changes in the student body population, determination of the residual value when the dormitories are transferred into state ownership.

Healthcare, social care

Several SAO audits have already focused on the use of pharmaceuticals by the hospitals. In 2007, the SAO audited the **medicine management of state and local governmental hospitals** as an independent topic. In the past years the growth of publicly funded pharmaceutical expenditures seemed unstoppable. The proposed solutions and the measures taken concentrated on the doctors' prescription writing, the patients' medicine taking habits, as well as on contracts with pharmaceutical companies. The use of law related to the medicine management of the hospitals was not facilitated by the large number, the occasional disharmony, incessant modification or lack of modification of legal regulations. The audit of compliance with the provisions and possible sanctioning were not fostered either.

The regular data collection activities of the sector aim to ensure that the sector manager is properly informed, however the conflicting data are not suitable to provide information about the processes, and prepare and justify the decisions due to the existing parallelisms, the lack of uniformity in the system as well as non-compliance with the data supply discipline. The results of sectoral data collection are influenced by the fact that the institutions' medicine management data are neither accurate, nor uniform (e.g. the legal regulations pertaining to the institutional registration of the procurement of pharmaceuticals are deficient and conflicting).

The lack of continuous supervision of the minimum requirements set for the operation of pharmacies within the institutions does not serve the safety and security of patient care. Based on healthcare interests, the institutions received temporary, and then final exemption from compliance with the minimum requirements set by the law as soon as the relevant legal regulation took effect.

The hospitals strove to create the harmony between the professional and financial management tasks of the use of pharmaceuticals. The internal regulations emphasised continuous adjustment required for maintaining the operability of the institutions, and in general complied with the legal provisions. The procurement of pharmaceuticals by the hospitals is subject to the Act on Public Procurement, yet a large number of the institutions ignored this requirement. The reasons cited included the extra tasks and costs implied in the public procurement process, the satisfaction of need out of line, the loss of use of discount offers, and the similarity between the conditions that can be achieved with or without public procurement. The omission of the public procurement procedure was not criticised by the supervisory audits either in any but one case.

Pharmaceutical manufacturers and distributors are engaged in considerable marketing activity in the hospitals, which has unanimously yielded cost savings. The effect of this marketing activity on medicine consumption by out-patients (on the pharmaceutical fund) was inspected neither by the sector manager, nor by the funding entity. The increase of pharmaceutical expenditures does not play a significant role in the indebtedness of hospitals.

The gap between the need for social care and support and the possibilities continues to grow, wherefore the more efficient and effective utilisation of the scarce resources is a social interest. On this basis, **the SAO audited the implementation of mandatory basic services stipulated by the social act in 333 settlements** (mostly villages).

The preparation of Act III of 1993 on Social Administration and Social Services (social act) was not preceded by the assessment of the social status and needs of the population, and no medium- or long-term concept was elaborated for the transformation of benefits. For the time being there is no registration system that would provide up-to-date information on the type of the existing services, the number of recipients, and the need for the different services. The figures of the statistical reports become accessible subsequently, with a delay of at least two years. Due to the high number of social basic services, the supply system is fragmented and regulation is complicated. The local governments and the district local governments of Budapest are mandated by the social act to provide meal services and home help services as basic services. The supply of other basic services is mandatory depending on the number of permanent residents on a settlement. In many cases the local governments violate the law by omission, i.e. by not providing all personal care services within the framework of mandatory social service supply. Non-compliance with the legally mandated requirement does not entail real sanctions for the local governments.

Service provision is different in the different regions of the country: the local governments perform their tasks by providing services that differ both in terms of quantity and quality, which is caused by the fact that the minimum service indicators are not specified, and the capabilities of the local governments (population, financial position) are not identical. The normative state subsidy appropriation linked to the benefits was not maximised until 31 December 2006. The growth in the capacity of basic services and specialised residential

care was largely determined by access to the normative subsidy, since the accepted applications were not coordinated in terms of service needs. Consequently, while service provision increased at national level, regional disparities could be observed in terms of service supply. The growth of financed capacities was not restricted. Therefore, in 2007 a system of managed regional equalisation was introduced concerning non-public proprietors for the reduction of regional disparities. Task performance within the framework of multi-purpose micro-regions expanded as a result of complementary normative state subsidies.

Labour market regulation, subsidies, public work

In addition to the audits related to the budget and the execution thereof, the SAO conducted a comprehensive audit of the operations of the **Labour Market Fund** in the years 2004-2006, as well as in the first half of 2007. The long-term distribution of expenditures among the different fields of the Fund significantly changed, and in relation to the individual objectives costs were incurred outside the corresponding Fund sections, too, under an increasing number of legal titles (e.g. co-financing of EU employment programmes, normative contribution allowances, transaction fee). Regarding the professional content of the expenditure items, the rate of passive expenses covering the benefits paid to job seekers dropped from 57% in 1999 to 33% in 2003. In parallel with this, the rate of active expenses spent on the training and employment aid of job seekers grew from 28% to 40%. The proportions of passive and active expenditures changed by 1 or 2% between 2003 and 2006.

The labour market organisation took several measures under the changing operational conditions to improve the efficiency of task performance. The institutional system that was set up in the course of the reorganisation of the county network of labour centres was simplified based on the experiences. During the mandatory downsizing processes the differences in the workload of the centres were taken into account. The IT risks of operation did not decrease despite the developments launched since 2004, and the computer systems did not support the application of all employment policy tools in 2007 either. The development of the IT system that would include the figures of the different centres and would cover the financial and controlling processes has been overdue for ten years. The number of staff members engaged in granting subsidies and the supervision of the legality of use of such subsidies decreased further contrary to the SAO's recommendation.

In order to liquidate the permanent structural disparities on the labour market (regional, age and educational disparities) the Government made decisions that primarily modified professional regulation, which realised the expected impact only partially. Linking eligibility for benefits to compliance with the requirement of actual job search fostered the activity and job seeking efforts of the unemployed. However, this requirement could not be met especially in regions that are hit the hardest by unemployment. Mainly higher income citizens were affected adversely by the twofold reduction of benefits during the disbursement period, wherefore they were most of all encouraged by the measures to find a job. The application of employment tools that focus on the

supply side of the labour market and yield short-term results was not sufficient to offset the trends affecting the labour market and other measures. No considerable improvement can be shown in the labour market position of the disadvantaged groups (e.g. new entrants to the labour market, citizens over 45 or 50 years of age, citizens near the retirement age).

The audit of the utilisation of funds spent on the preservation of the working ability spanned the years 2004 through 2006. The SAO monitored the processes until the end of the audit, and paid special attention to the restructuring of the complex rehabilitation system, which was carried out simultaneously with the audit.

In the early 1990s, the number of employees decreased by 1.5 million in Hungary, but only a fraction of this figure contributed to the rise of official unemployment. The regulations then in force provided much scope for gaining eligibility for disability benefits, which allowed the disadvantaged groups of the society (that became disadvantaged on the labour market, too) to obtain benefits. These benefits were rather small, yet sufficient for subsistence. Making use of the lax regulation was also made possible by the population's bad state of health, as well as the underdeveloped nature of the institutional system of medical and employment rehabilitation. As a result of this process, the state has been forced to undertake an increasing role in the field of passive benefits. The number of working-age citizens receiving disability benefits totalled 454,000 in 2006. Between 2004 and 2006, as much as HUF 1,103.9 billion was disbursed to working-age people with reduced working abilities in the form of benefits payable on the basis of reduced working abilities – excluding regular social benefits. Out of this sum HUF 954.6 billion was disbursed to people that were not entirely incapacitated for work.

Governmental and EU objectives and measures clearly intend to foster the social reintegration of people with reduced working abilities. In the audited period no major changes were introduced to medical rehabilitation. The rehabilitation in-patient capacity significantly increased in March-April 2007, however neither the personal, nor the material minimum requirements were specified for rehabilitation services. The Ministry of Health did not provide documents on the professional distribution of capacity growth, or the substantiation of the decision for the SAO audit. The reorganisation of the subsidy system of employees with reduced working abilities was completed during the audit. Implementation of the objectives is assisted by monetary funds, most of which come from the European Social Fund (ESF) within the Structural Funds, and from the European Regional Development Fund (ERDF) to a smaller extent.

The system determining the level of disability from the medical point of view contributes to the rehabilitation of people with reduced working abilities neither in principle (legal authorisation), nor in practice. In relation to medium-term task performance it implies a risk that as much as 51% of the evaluating physicians working in the institution are above the retirement age, another 16% of them will reach the retirement age in five years, and their replacement seems to be an unsolved problem. The National Medical Expert Institute has an obsolete IT system.

The demand has grown for the greater involvement of the different social layers in the world of work, for the organisation of **public work programmes** that enforce the principle of “*provision of work instead of social benefits*” and at the same time provide a framework for the implementation of public services that have been neglected for the lack of funds in regions that are disadvantaged in terms of employment. A total of HUF 24.9 billion was available for public work (including non-budgetary external resources and the co-payment by the applicants), which provided coverage for the employment of some 15,000 people on average each year in the period of 2003-2006.

Low economic activity increases the social burden of the local governments, however only few local governments set tasks to actively influence the local employment conditions. Instead, they expected the employment organisations to take the appropriate intervention measures.

The elaboration of a conscious local governmental concept that would consider all forms of public employment was not thought to be important by the local governments, and therefore the application thereof was not typical either among local governments audited for the utilisation of funds spent on public work programmes. Although the regional incentive elements were incorporated in the public work programme related grant system, in the implementation phase the local governments failed to exploit the advantages inherent in small regional cooperation, and the settlements’ strive for independent actions was strong. Typically, the local governments organised public work in those fields of the management of settlement operation that had been neglected for the shortage of funds.

Despite the former SAO recommendations and the specified employment policy objectives, the system of public work has not been standardised, rationalised and its elements have not been harmonised. In the history of public work programmes 2005 was an outstanding year, when a total of HUF 6,479 million was granted to 352 applicants in the course of the consolidated grant procedure. During the seven-month timeframe of the programme, which affected every third settlement of the country (altogether 1,024 settlements) wage-earning employment was ensured for 24,550 people. The primary objective of the grant system was the alleviation of employment and social tensions, with regard to the social and mental impacts thereof. However, inadequate attention was paid to the efficient and effective operation of the grant system, to the definition of the performance requirements of the value creating work, to compliance with the undertaken obligation to further employ the people involved, and to the evaluation of the effectiveness of the training programmes. This would have required the uniform management of funds available in the budget, the conversion of professional and financial figures into a database that would make comparisons and analyses possible.

Information supply

The primary objective of **the audit of the performance of public services specified in the Act on the National News Agency and in the Act on Radio and Television Broadcasting (media act)** was to investigate the

regulation, professional supervision, funding frameworks and the provision of public services specified by these two acts. The maintenance and operation of the organisational system set up by the media act and the Act on the National News Agency – the system designed to fulfil ownership, control and professional tasks – required HUF 550 billion in the period of 1997-2006. Within this amount, direct and indirect subsidies amounted to HUF 404 billion. The initial assets of HUF 30.4 billion linked to task performance decreased to HUF 29.7 billion in ten years, despite the fact that a total capital allocation of HUF 32 billion was made in several stages.

The justification and effectiveness of the use of significant resources could not be unambiguously evaluated due to the shortcomings and contradictions of the two acts. Public service task performance and the coordination of task related resources are defined inadequately. The relationship between the participants of the organisational structure is contradictory. The public foundation form of organisation – which is not independent of politics, contrary to the original intention of the founder – hindered the fulfilment of tasks by the boards of trustees. The activity of bodies operating with a large staff was of low efficiency, primarily due to protracted decision-making. Checking and controlling the implementation of the measures were either formal, or non-existent. Social control was hindered by the fact that civil trustees were elected for a term of one year, i.e. a period that is too short for enabling them to actually contribute to decision-making. Regulatory problems were further aggravated by the fact that the bodies were not striving for consensus, and the National Assembly did not pay enough attention to tackling the problems either. All this would require the system-based reconsideration of the regulatory and the organisational structure, and in line with this, the development of a financing system that would also take into account the recommendation of the European Commission regarding competition free operation. The SAO has called the legislators' and the Government's attention to these issues on a continuous basis since 2003.

The SAO concluded that funding was not implemented on a normative basis, but rather from resources approved in the annual budget acts and the Broadcasting Fund managed by the National Radio and Television Commission on the basis of preliminarily decided allocations, and through tendering. The funding of the public media was adversely affected by the fact that the state budget took over usage charges from the population, the rate of which was much smaller than the growth of the inflation rate. The resulting funding deficit was made up for by the National Assembly with one-off subsidies. The subsidies that were distributed unequally under different legal titles were typically granted to organisations other than those having an expedient and effective financial management. The SAO found that the financial management of all three public foundations was balanced in general. The preservation, restoration and digitalisation of documents that represent important elements of the cultural heritage and are stored in the archives of said companies should deserve more attention. This activity requires adequate regulation and predictable funding.

Electronic public administration

According to the audit of the development of e-government services, the developments carried out in the audited period resulted in major progress primarily in the communication interfaces of the services. Furthermore, the establishment of the e-government public utility network was on the right track with extremely dynamic development. The basic components of the system (e.g. Electronic Government Backbone Network, Government Portal, Client Gate) have altogether functioned effectively since the middle of 2005. The level of utilisation of e-government services is still low, especially in terms of utilisation by the citizens. The underlying causes included the insufficient skill of the user side of the system (digital illiteracy affects nearly 60% of the population), such as the aversion of public administration to computerising, or the novelty of e-signature and e-payment in the case of transaction services.

Several shortcomings were revealed in the definition and prescription of the practical methods serving the implementation of the objectives. Within the scope of the Ministry of Information and Communication, and the Prime Minister's Office such a shortcoming was the absence of requirements affecting the funding rules, monitoring and IT security, certain recommendations and the interoperability framework system¹⁴. In fact, the coordinated and mutually supporting approach of the implementation of the public administration reform and e-government appeared in the New Hungary Development Plan only. The regulatory environment created for the implementation of the strategic objectives showed contradictions. The SAO found that the lack of regulation of the budgetary aspects of e-services implied especially many risks.

In general, institutions affected by e-government developments failed to perform cost-efficiency calculations and risk analyses, and the deficient documentation of the projects entailed unclear responsibility issues in all but a few cases. Immature concepts, which implied legal obligations, led to certain steps that resulted in expenses that were later ruled unnecessary, e.g. the investment project for chipcard based identification launched by the Hungarian Tax and Financial Control Administration, which had been planned for a longer term, yet was utilised for only one year.

2.3. Subsidies to organisations outside public finances

In accordance with the development of the civil society in Hungary, state resources in the funding system of the non-profit sector increased to over 40%, i.e. to the level characteristic for EU countries. As a result of the dynamic growth of development subsidies, state subsidies in 2006 totalled HUF 429 billion, and are estimated to have reached HUF 500 billion in 2007. Due to their increased and extended role in the society, the number of non-profit organisations grew to 75,000. The SAO's audit experiences show that this dynamic growth was not accompanied by the modern regulation of the regular

¹⁴ A catalogue of organisational, semantic and technical standards, requirements, recommendations, methods and other tools to be observed for maintaining the ability to cooperate.

authorisation and utilisation of budgetary subsidies in the framework of acts and decrees. The grant of greater budgetary subsidies to civil organisations did not trigger quality changes: the “*value for the general public in return for subsidies*” principle was not enforced, and the auditing and monitoring system guaranteeing utilisation for the designated purpose was not set up either.

During the audit of the legality and expediency of the financial management of public foundations performed in the reporting year, the SAO concluded that the boards of trustees of the public foundations utilised the received state and other subsidies, as well as the public foundations’ own revenues in a regular manner, for the implementation of the objectives specified in the Deeds of Foundation. The public foundations complied with the legal obligation of publicity specified in the legal regulations as a precondition for the transparency of the utilisation of public funds. The public foundations did possess internal regulations that lay the foundations for lawful financial management, however the accounting rules were not fully regulated, and were not regulated with regard to the special features of public foundations. The supervisory boards that were asked to control the boards of trustees by the Government (founder) fulfilled their tasks. The public foundations’ financial management control was incomplete in relation to the certification and transfer of basic accounting documents, as well as in relation to the management of petty cash.

In pursuance of the legal regulations pertaining to the audit of political parties, the SAO completed the legality audit of the financial management of four parties in 2007 (as scheduled). Furthermore, the SAO completed by the deadline the audit of the accounting of funds used for the general elections of 2006 and the by-elections. The SAO’s experiences have again confirmed that it is indispensable to modernise the operation and financial management of the political parties, and to renew the legal regulations of the election procedures. The provisions of the latter regulations, which have been in force since 1998, did not ensure the transparency and controllability of the origin and utilisation of campaign funds neither in the third election cycle. In 2006, the Government unsuccessfully submitted Bill No. T/237 on the amendment of the act to the National Assembly, since no consensus was reached among the factions, wherefore the required two-third majority was not achieved.

In parallel with the audit of the political parties, the SAO conducted the legality audit of the financial management of foundations that were set up by the parties and are eligible for budgetary subsidies. The boards of trustees of the two audited party affiliated foundations operated legally, the subsidies they provided and the programmes that were implemented within their respective organisational frameworks were in line with the objectives specified in the Deeds of Foundation.

The SAO audited the financial and economic activity of the national minority self-governments at three local governments. The audits revealed that the execution of the amendments of the act on national and ethnic minorities, which took effect at the end of 2005, can be evaluated in a conflicting manner. The resources available for the preservation of the national identity and

traditions are shrinking, nearly 80 to 90% of the budgetary resources were spent on office operation instead of the performance of national tasks.

2.4. State property management

The SAO audits the financial management of the Hungarian News Agency Corporation, as well as the operation of the Hungarian Privatisation and State Holding Company and its activities related to the execution of the central budget annually.

Due to its specific legal environment, the risks implied in the operation and financial management of the **Hungarian News Agency Corporation** for deficient regulation have existed since the Agency's foundation. The significant loss that the Company incurred in the first three years of the past five-year period was turned in the past two years into minor profits due to cost-saving measures, more expedient human resource management and state subsidies, the amount of which is growing year after year. The share of own revenues that used to form over 50% of the sales revenues continuously decreased. The missing amount was replaced with state subsidies.

The current system of operational subsidies is not in harmony with the EU regulations. The definition of public service activities and the amount and utilisation of the required state subsidy are not sufficiently transparent, and no control guarantees exist. The SAO's former recommendations that aimed to find a solution to the problem have not been realised in the legal regulations, and have been only partially realised in the corporation's deed of foundation.

The opening balance of the dedicated state assets of the **Hungarian Privatisation and State Holding Company** at the beginning of 2006 was HUF 760.7 billion, while the closing balance at year end was HUF 825.2 billion. At the beginning of the year dedicated assets included 245 companies, including 178 business associations and 67 state-owned companies. By the end of the year the number of such companies decreased to 221. The Hungarian Privatisation and State Holding Company implemented its revenue plan related to the dedicated assets and the filling of reserves in accordance with the prescribed requirements.

The activity of the Hungarian Privatisation and State Holding Company usually complied with the provisions of laws and regulations, however it could be criticised in a few cases. The greatest privatisation transaction was the sale of the shares of MOL Hungarian Oil and Gas Company, in which over HUF 5 billion less revenue was realised than envisaged due to the fact that insider contracts had not been banned. At Forrás Trust and Investment Company, which was set up to retire compensation notes, the return was HUF 4 billion smaller compared to the invested assets of HUF 15 billion. The operation of the Csepel port owned by MAHART Freeport Company was privatised instead of being transferred on the basis of a concession agreement, which would have created a more definite legal situation and clearer terms and conditions. During the privatisation of MALÉV Hungarian Airlines an expert was employed in a manner conflicting with the Act on Public Procurement.

The unsuccessful reorganisation of the Bábolna Group, the contradictory decisions, the lack of calling those responsible to account and the absence of process monitoring increased the state's losses. With a view to reduce these losses, the Government subsequently approved the decisions. To share responsibilities, the Hungarian Privatisation and State Holding Company made the Government approve issues that otherwise belong to its own competence. The new privatisation strategy, which was devised after dissolution was terminated, and which is unsubstantiated and contains risky elements, further increases the state's losses.

Deficiencies were revealed in the case of a few payments made from the privatisation reserve: a resolution on Exercising Shareholders' Rights hindered the return of a guarantee of nearly HUF 15 billion; based on a court ruling more than HUF 300 million was paid to a local government as default penalty. The balance of the privatisation reserve totalled HUF 98 billion on 1 January 2006, and dropped to HUF 82.3 billion by year end.

2.5. Utilisation of EU funds

In line with the provisions of Parliamentary Resolution 43/2005. (V. 26.)¹⁵, the SAO prepared a **Summary** of Audit Reports on the Financial Management and Control of EU funds in Hungary for the second time. The Summary presented the financial relations of Hungary within the European Union and the experiences of the 2006 audits on subsidies. It analysed the utilisation of these funds, i.e. Hungary's absorption ability, according to which with a rate of 37% Hungary is in the vanguard of countries in terms of payments from the Structural Funds (among member states that joined the EU in 2004), and occupies a favourable position in relation to the Cohesion Fund, too with a rate of 25%.

Since the EU closed its budgetary period of 2000-2006 (2004-2006 for the new member states) in relation to the commitment of resources, the Summary summarised the experiences of this period, too: the system of institutions in charge of the utilisation of EU funds was established, the system operates on a continuous basis, and the preparation and implementation of projects comparing to the new member states can be regarded satisfactory. However, special attention must be paid to the payment and monitoring activities so that Hungary could sustain the relatively good position it has achieved in the next budgetary period (2007-2013) of the EU.

The audit of the operation of the national monitoring and control systems of EU funds concluded that the systems were set up and are operated in accordance with the requirements set for these systems for the

¹⁵ "...the State Audit Office of Hungary shall give an overview on the practice of the complete utilisation of EU funds, within this framework it shall review the work of national institutions performing the audit of financial flows related to EU funds and present the audit findings".

draw-down and utilisation of EU funds, however the effectiveness and efficiency of operation differed from subsidy to subsidy.

The differences in terms of the effectiveness and efficiency of monitoring activities stemmed from the lack of uniform operational standards of monitoring, problems related to the distribution of the different subsidies, the difference in the timeframe required to reveal discrepancies from the plan, as well as the different consequences of intervention decisions. No standard national strategy was prepared for the coordinated utilisation of EU funds, wherefore the synergic effects of the harmonisation of national and EU funds were less apparent.

In the course of planning, the balance of financial and natural planning was not created, the project and programme level indicators of monitoring were not harmonised, and such indicators had to be subsequently redesigned in several cases. The national monitoring activity adequately facilitated the achievement of the subsidy objectives by tracking the financial processes, but the monitoring of the natural objectives of the individual subsidies was performed to differing extents. The audit concluded that no standard reporting system was developed to monitor the utilisation of subsidies, however it appreciated that the analysing activity had strengthened.

Audits performed on the basis of agreements

In relation to the certification audit of SAPARD and the Guarantee Section of EAGGF, in 2007 the SAO exclusively performed tasks related to the closure of year 2006.

The SAO concluded in its Certificate – that it issued in its capacity of a **SAPARD Certifying Body**, and supported with a report – that the financial accounts prepared and sent to the Commission by the Agricultural and Rural Development Agency about the disbursement of SAPARD subsidies in 2006 were fair, complete and accurate.

The European Commission accepted the Report and Certificate of the SAPARD Certifying Body for the 2006 financial year, and thus Hungary's SAPARD financial accounting for 2006. The Commission declared the SAPARD Programme closed – regarding the SAO's activities as a SAPARD Certifying Body – but it formulated tasks to be completed after the closure of the Programme (monitoring obligation for five years following implementation, audit of cash flow processes undertaken during this period and the audit of the after-life of recommendations made in the previous year). Since 2007, these tasks have been performed by the audit company acting as the Certifying Body of EAGGF.

The European Commission accepted in its Decision C/2006/6047 dated 10 December 2007 Hungary's final Implementation Report on and the financial accounting of the 2000-2006 SAPARD Plan, on the basis of which the final cash flow accounting and disbursement will be carried out.

In the capacity of the **Certifying Body of the Guarantee Section of EAGGF** the SAO concluded that the financial accounts submitted to the Commission on the 2006 financial year of the Guarantee Section of EAGGF were fair, complete and accurate.

The SAO and the Ministry of Agriculture and Rural Development terminated – with mutual consent – the agreement on the provision of tasks to be performed by the SAO as a Certifying Body in connection with the utilisation of subsidies financed from the Guarantee Section of EAGGF as of the end of the EAGGF financial year 2006. Since the financial year 2007, this task has been performed by an audit firm selected through a public procurement procedure.

3. UTILISATION OF THE AUDITS

The parliamentary deputies, the heads of the audited organisations and other entities showing interest may get to know the findings of the audits from the published SAO reports. The National Assembly has a major role in the utilisation of the audit results, since the recommendations and statements formulated in the SAO reports can be realised in practice indirectly, via the legislative activity of the National Assembly.

Due to the implementation of the reforms announced by the Government in 2007, the activity, reports and studies of the SAO were given increasing attention. Bill No. T/4319 on public finance responsibility and on the Legislative Budget Office, the planned implementation of the governmental district, as well as the bill on health insurance funds represented topics that called for a SAO opinion, which is regarded credible in professional circles.

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

The SAO met its reporting obligations stipulated by the legal regulations in force. In addition to the opinion on the budget appropriation bill, the audit of the final accounts, the report on the activity of the SAO, and the annual reports on the financial management of the Hungarian Privatisation and State Holding Company, and the Hungarian News Agency Corporation, the SAO submitted the National Assembly the summary of audit reports on the financial management and control of EU Funds in Hungary for the second time in 2007.

The President of the SAO informed in detail the Committee on Budget, Finance and Audit Office about the audit plan – outlining the framework of the SAO's activities in 2007 – in December 2006. Out of the topics mentioned in the audit plan, **nine SAO reports** and **one SAO study** were included in the agenda of the parliamentary committees. Out of those nine reports **five were also discussed in the plenary sessions of the National Parliament** (the SAO activity report 2006, the audit of the final accounts, the opinion on the budget

appropriation bill, as well as the reports on the financial management of the Hungarian News Agency Corporation in 2005 and 2006).

The SAO activity report 2006 was discussed and proposed for general debate by eight selected committees. The report on the audit of the execution of the 2006 annual budget and the SAO opinion on the 2008 budget appropriation bill were discussed by all committees but the Committee on Immunities.

Pursuant to Parliamentary Resolution 43/2005. (V. 26.) the summary of audit reports on the financial management and control of EU Funds in Hungary was referred to by the parliamentary deputies both at the committee and the plenary meetings, however the report required neither plenary discussion, nor voting.

The Committee on Budget, Finance and Audit Office discussed the study titled "Theses on the Regulation of Public Finances" together with the SAO activity report 2006. An evaluating study was prepared in connection with the opinion on the 2008 budget appropriation bill, which presented a few correlations of the macroeconomic foundations of the budget appropriation bill.

In 2007, SAO reports were included in the agenda of 51 meetings of 17 committees. The staff members of the SAO attended nearly 70 committee meetings. **The President of the SAO was actively involved in almost 20 committee meetings, and presented 5 exposés** at the plenary sessions of the National Assembly. In February 2007, the parliamentary deputies asked two questions from the President of the SAO, who submitted his response by the deadlines in both cases.

Parliamentary Resolution 112/2007. (XII. 19.) **called the SAO** to examine the lawfulness of the contract on the sale of a building located at Budapest VIII., Köztársaság tér 27., which forms part of the assets of the State Treasury, and to determine whether the sale caused any property loss for the Hungarian State. The President of the SAO indicated during the committee discussion of the proposed resolution that in case the proposal is accepted, information on the audit results will be provided within the framework of the final accounts.

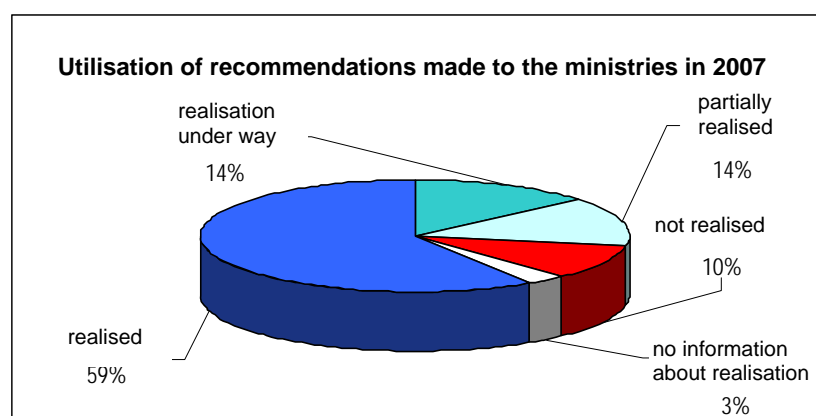
3.2. Enforcement of the SAO recommendations

During its audits the SAO makes all efforts to help in revealing and eliminating the risks of the audited organisations, systems and processes, in enforcing regularity and enhancing efficiency through its substantiated recommendations. In addition, the SAO recommendations aim to amend, harmonise and enforce the legal regulations.

SAO audits focus on tasks and processes. Utilisation of the findings and recommendations often starts already during the audit, wherefore some of these recommendations are not included in the final SAO reports. The audited organisations summarize their tasks in action plans that are sent to the SAO for information purposes. The recommendations raised are often implemented through the reconsideration of the legal regulatory environment and the amendment of the legal regulations.

The SAO follows the utilisation of its former findings and recommendations, as well as measures taken in relation to the audit recommendations. To this end, the SAO **asked the Government and the heads of the ministries for information on the utilisation of recommendations in 2007, too, similarly to the former years.** All parties contacted responded to the request, and the answers given by the ministries have become more comprehensive year after year.

Based on experience obtained during the years it can be said that the SAO recommendations on corrective actions, or recommendations pertaining to regulatory issues that can be implemented separately are typically realised. Recommendations pertaining to the internal control systems, as well as recommendations aiming at enhancing expediency and efficiency were also received positively. On the other hand, SAO recommendations for financial security **and recommendations requiring system-approach changes are realised on a lower scale.**



3.2.1. Recommendations at the level of the National Assembly

Similarly to the former years, most of the SAO recommendations addressed to the National Assembly, or affecting the legislative operations of the National Assembly were realised in 2007.

In line with the recommendations formulated on the basis of the audits, several articles of the legal regulations on public finances were amended or supplemented, the state property act was adopted and the elaboration of the new package of public finance regulations, one element of which is the bill on the legal status and financial management of budgetary organisations, has also come within reach.

Based on the recommendation formulated in the report on the **audit of the execution of the 2006 budget** of the Republic of Hungary, and the proposal of the Minister of Finance, the discrepancies revealed during the audit of the transfers to local governments were incorporated in the Act on the Execution of the 2006 Budget.

During the amendments made at the end of 2007, the provisions of the Act on Public Finances were supplemented with the rule prescribing the mandatory on-site audit of the accounting of budgetary transfers given to the local governments.

At the same time, it was stipulated in para (9) of Article 64 of the Act on Public Finances that the local governments shall supply information on the application for, mid-year renouncement of or additional need for normative state support electronically from 31 July 2008 on.

In line with the SAO recommendation, para (1) c) of Article 36 of the Act on Public Finances was amended so that medium term budgeting should have an adequate legal background (a three-year outlook instead of the two-year outlook stipulated in the act).

Based on the experiences of the audit of the **financial management of the local governments**, the SAO made one recommendation to the Government and forty recommendations to the ministries between 2003 and 2007. As a result, the National Assembly specified the content requirements of the economic programme, set a uniform upper limit for mandatory tendering, specified the rules of locally centralised public procurement projects, the requirement for the publication of non-normative, targeted operational transfers. Furthermore, the National Assembly made the rules of the financial audit system more comprehensive and supplemented the content requirements of agreements to be signed with minority self-governments.

A bill on the amendment of the Act on Local Governments regarding the modification of the regulation of the borrowing limit (debt limit) has been submitted to the National Assembly. The Minister of Finance has indicated that during the next amendment of the Act on Local Governments the ministry will initiate the more precise definition of legal requirements pertaining to the right of disposal of not fully negotiable assets.

The amendment of the Act on Public Procurement is under way in order to review the proceedings for legal remedy. Within the framework of this review, the deadlines left open upon the request or initiative of the Public Procurement Arbitration Committee were reviewed, in part due to the mandatory transposition of Directive 2007/66/EC of the European Parliament and of the Council.

The Ministry of Environment and Water is currently working on the preparation of the so called "*water public utility act*", which aims to tackle the problem raised by the SAO, according to which the current act concerning water management stipulates clearly that the ownership right of water public utility assets belonging to the nominal assets of local governments can be exclusively exercised by the local governments, and can be transferred only for operational purposes.

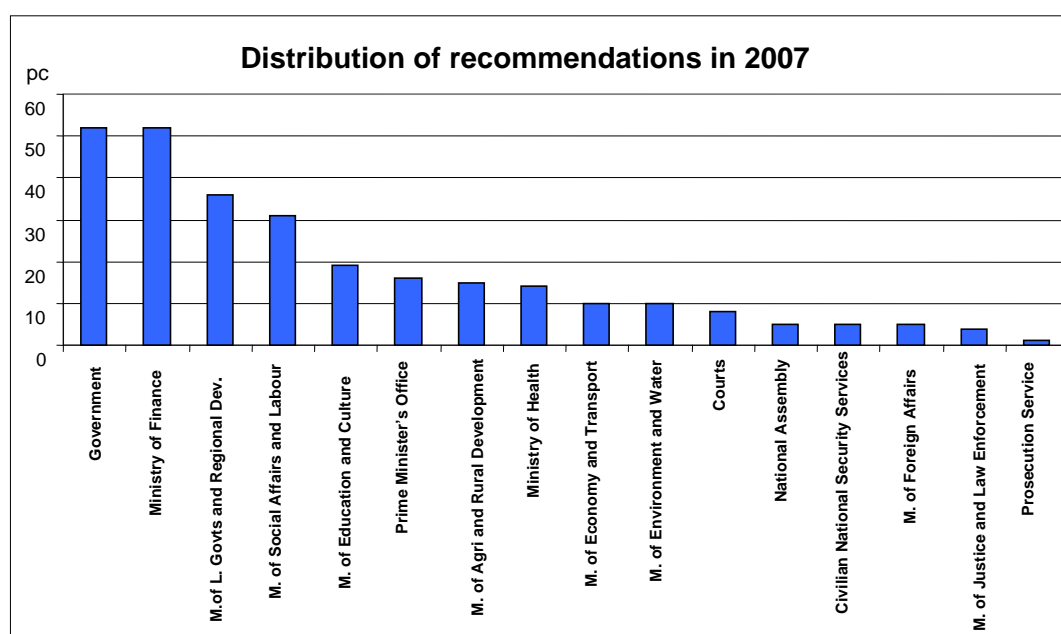
In order to enhance the transparency of transfers to **entities outside public finances**, the National Assembly adopted Act CLXXXI of 2007 on the transparency of transfers from public funds on 17 December 2007. This act is designed to ensure the transparent operation of the institutional system deciding

on the granting and utilisation of development subsidies based on the lawful demand that “*development projects implemented with public funds shall be protected both from party politics related disputes and the cyclical governmental changes*”. In accordance with the Act, the Government issued Government Decree 21/2008. (II. 7.) on the amendment of Government Decree 160/2003. (X. 7.) enforcing Act L of 2003 on the National Civil Fund, which amendment also utilised the findings and recommendations of the SAO audits.

With regard to the SAO recommendations formulated upon the audit of political parties, and in accordance with the intentions of the Government, Bill No. T/4190 was submitted to the National Assembly with a view to making party funding more transparent. The separate motion, submitted by a parliamentary deputy, would restrict party and campaign funding to ensure corruption free political life, it would impose stricter sanctions on the parties’ illegal financial management practices, campaigning. Furthermore, the motion would significantly enhance the scope of authority of the SAO audits, and would create harmony with the Act on Accounting in force, in line with our recommendations. The Ministry of Finance indicated that it reduced state subsidies provided to the Hungarian Democratic Forum in 2007 by HUF 1.3 million.

3.2.2. Recommendations at governmental level

Information from the ministries on the utilisation of the SAO recommendations is important for the SAO, since apart from the initiation of the restoration of lawfulness there is no general legal requirement for the realisation of the SAO recommendations. In their replies, several ministries indicated that the SAO had largely contributed to their professional task performance and financial management with recommendations made during the audits, and on the basis of the SAO’s work they achieved progress in several areas in terms of regularity, level of regulation and efficiency.

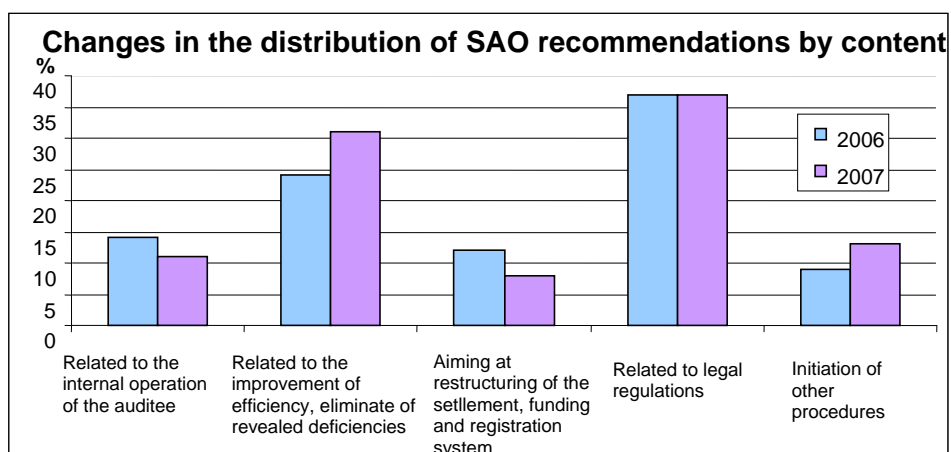


Just like in 2006, the SAO recommendations were received positively in 2007, too. **As much as 87% of the recommendations reached a certain level of realisation.**

Following the trend of the previous year, the ratio of SAO recommendations for measures aiming to improve expediency, efficiency and effectiveness, as well as to eliminate the revealed shortcomings and deficiencies increased.

The share of SAO initiatives for the amendment of legal regulations was similar as one year earlier, however more of them were received positively and more of them were given substantial attention.

The share of other SAO recommendations that pertained to the regulation of organisation and operation decreased, however this type of recommendations continued to be received favourably.



As much as 54% of the SAO recommendations aiming at **legal regulation** were realised. 15% of the recommendations (typically those pertaining to the amendment of acts and other existing legal regulations) were rejected. In a few cases the existing regulation was regarded adequate, in others the ministries did not feel competent. Almost all SAO recommendations aiming at the enforcement of legal regulations were realised.

As much as 87% of the SAO recommendations aiming to improve **expediency, efficiency and effectiveness**, as well as to eliminate the revealed shortcomings and deficiencies were received positively, and 74% of them have already been realised.

Concrete measures were taken in connection with 88% of the recommendations aiming at the review and further development of the **internal control system**, and that of the chapter and internal audit system, or the entities concerned have started to prepare the utilisation of the recommendations. SAO recommendations belonging to this type were never rejected, however 13% of the respondents failed to give unanimous information on the realisation of the recommendations.

Based on the responses received in connection with recommendations aiming to eliminate accounting and registration irregularities, and to modernise **accounting, financing and registration systems**, 30% of such recommendations have already been realised. The other recommendations are being realised, or have partially been realised.

Other recommendations that can neither be classified, nor included in the former categories due to their uniqueness, accounted for 13% of the recommendations. Over 92% of such recommendations were accepted, and 62% were implemented by the time this report was compiled.

In the course of its subsequent audits, the SAO monitors the implementation of the measures taken by the heads of the ministries, and regularly comments on the implementation thereof in its reports.

The utilisation of the SAO recommendations is indicated by – among other things – the implementation of the following concrete measures:

In its report on the **audit of the execution of the 2006 budget of the Republic of Hungary** the SAO formulated 122 recommendations for the Government and the heads of the individual budgetary chapters. Some of the recommendations aimed at the amendment of existing legal regulations and the preparation of bills, while others called for the elimination of shortcomings and deficiencies revealed in the field of financial management and financial reporting. The SAO made several recommendations for the increased consideration of efficiency and expediency requirements, too. The heads of the different budgetary chapters responded to the SAO recommendations either by submitting the completed action plans, or in part by informing the SAO in writing about the direct measures.

As much as 77% of the measures taken in response to the SAO recommendations can be regarded acceptable. Measures that are deemed partially acceptable or not acceptable were related to recommendations on regulation, legislation or budgeting in the case of which the heads of the affected budgetary chapters did not share the SAO's standpoint.

When auditing the 2006 budgetary revenues related to the management and utilisation of treasury property, the SAO did not find any of the registration irregularities that were revealed earlier.

The SAO had already objected to the content and format, and documentation of government proposals prepared in connection with the general reserves of the central budget based on the resource needs, since they contradicted to the relevant provisions of the Government Decree on the operational rules of public finances in a significant number of cases. The government decree was amended as of 1 January 2007.

Pursuant to the SAO recommendations formulated in relation to the **audit of the Civilian National Security Services**, action plans were elaborated by the minister heading the Services, as well as the services affected (Managing

Authority, National Security Office, Special Service for National Security). Measures taken for the modernisation of the organisational structure foster efficient operation and strengthen supervision.

The national security services were not restructured or merged on 1 January 2008 as envisaged in the state reform of 2006–2007. At the end of 2007 the Government annulled its resolution pertaining to the reorganisation of the national security services (Government Decision 2010/2007. (I. 30.)) without specifying any further tasks (Government Decision 2236/2007. (XII. 15.)). The national security services perform their activities in the former organisational structure.

Based on the findings of the **audit of the operation of the “Ministry of Agriculture and Rural Development” chapter** the SAO recommended the Government to review the privatisation of the research institutes, and to manage the funding issues of priority tasks. Furthermore, the SAO recommended the competent minister to reinforce the control system and the network of village clerks, as well as to give priority attention to subsidies to animal husbandry farms. After the report was published, the Minister of the Prime Minister’s Office informed the SAO about the fact that the Government took the privatisation of agricultural research institutes off its agenda.

Upon the SAO’s recommendation for the issuance and amendment of government decrees ensuring the enforcement of Act LXXXVI of 2007 on **Electricity**, five government decrees and seven ministerial decrees came into force on 1 January 2008 that took the elements of the recommendation into account, in order to make the Hungarian electricity market reorganised from 1 January 2008, in accordance with the EU requirements.

Government Decree 182/2007 (VII.10.) was issued pursuant to the SAO recommendation to fully establish the legal environment for **e-government developments** and services (establishing rules pertaining to electronic payment, as well to the use of the client gate by persons having limited legal competency). Para (1) of Article 18 of said decree is related to the SAO recommendation.

Most of the recommendations formulated in the report on the audit on the Treasury’s reviewing activity on the practice of obtaining and accounting for funds from the central budget, by local governments and local minority self-government bodies were realised. Government Decision 2146/2007 (VII. 27.) provided for a staff increase of 335 at the Treasury for the on-site audits of state contributions.

According to the information given by the Minister of Finance, the amendment of Decree 16/2002 (IV. 12.) issued by the Minister of Finance is under way due to the incorporation of detailed rules related to the mandatory on-site audits. Simultaneously, the “*minimum*” requirements of the preliminary review of subsidies from the central budget are being elaborated pursuant to the SAO’s recommendation.

The Ministry of Finance proposed the Minister of Education and Culture to create the possibility of comparison of the normative state subsidies and the statistical data of the Public Education Information Office, and proposed to have this implemented by the Treasury in the first quarter of 2008.

Pursuant to the SAO recommendations made in relation to the **audit on special purpose appropriations**, the malfunctions related to the **public utility subsidies** provided to the population decreased as a result of the amendment of legal regulations and the SAO audits. The modified form of application for subsidy reflects the changes in the regulatory system. Most of the SAO recommendations made in connection with the system of subsidies for the operation of the professional **fire departments** of the local governments were realised, since the size of the stand-by staff has been in part reviewed, the funds required to cover the costs of staff increase in lieu of overtime and extra service have been ensured within a year, and measures have been taken to provide the funds for benefits and other costs related to the extraordinary retirement of firemen. The technical parameters of the **IT equipment** of public education institutions have been issued, certain rigid requirements pertaining to the objectives were lifted pursuant to the SAO's recommendation, which made it possible to utilise subsidies in a more flexible manner. Based on the SAO's recommendation, measures were also taken to eliminate the problems revealed during the audit of the pavement reconstruction of **hard cover residential roads of local governments**.

Pursuant to the SAO recommendations formulated in **the report on the audit on the utilisation of funds granted for the support of public work programmes**, the competent ministry elaborated the new concept for the rules of employment in public work in order to create the uniform system of public work programmes and the uniform practice of resource coordination. Furthermore, the audit of the organisations responsible for financial implementation and monitoring was standardised, the database of the available information was set up, and the comparability of performance requirements was prescribed at the level of micro-regions.

Based on the recommendations made during the **audit of the water management and precipitation water drainage tasks of the local governments**, the action plans and tendering schemes serving the implementation of the operational programmes of the New Hungary Development Plan included local water management development projects. The utilisation of budgetary resources available for the development and renovation of water management and precipitation water drainage facilities through applications, as well as the expansion of the required system of incentives for local governmental applications appear in the specific decisions on a continuous basis. The ministry responsible for water management proposed that plans and schedules for tasks related to the prevention of water damage, and compliance with the relevant legal regulations should be taken into account when evaluating the applications for subsidies. Pursuant to the SAO's recommendation, the National Directorate General for Disaster Management subjects the water defence plans of the local governments to more thorough inspection. The local water management tasks of the local

governments are expected to be defined upon the review of mandatory local governmental tasks.

More than two thirds of the SAO recommendations made **on the basis of the audit on the provision of basic social services by the local governments** were completely realised. The development and operation of a national registration system containing the data of social care institutions and services was mandated by a government decree. The financial information system of the local governments is still unable to ensure the transparency of task performance, to reveal data about the expenditures of services specified in the social act, and to make substantiated cost estimates. The elaboration of the new service act is under way, which will ensure that in the legislative activity the same terminology will be used in all legal regulations on social issues, and the existing contradictions will be eliminated. The ministry determined the main directions for the restructuring of social services, partly in accordance with the SAO's recommendations.

During the 2005 audit on the system of institutions caring for the homeless, the SAO recommended that a long-term concept should be elaborated in this issue. Somewhat in connection with this, the Government approved the seven-year strategy aiming at the development of care for the homeless. The strategy covers all phases of the problem, from prevention through enhanced care to giving up the life of the homeless, and to establishing an independent life. One of the priority objectives of the strategy is to reduce the number of homeless people in the streets by 3,000 (some 50% of the estimated number of people living on the street) by 2013, and to ensure independent housing for 3,500 people undertaking employment.

In relation to the subsidies provided to organisations outside public finances, Government Decision 2233/2007 (XII. 12.) called for the coordination of the support systems of civil organisations for the efficient utilisation of public funds, for increasing the transparency of the awarded subsidies and the utilisation thereof, and for making the support criteria for civil organisations more exact. Taking the former SAO recommendations into account, the Government decided to review again the continuing operation of public foundations it had founded. Pursuant to the SAO's audit recommendation the Government amended the Deed of Foundation of the Public Foundation for the Rights of Patients, Benefit Recipients and Children by passing Government Decision 1073/2007 (IX. 26.). In its resolution No. 16/2007 (III. 7.) , the National Assembly earmarked measures to respond to critical remarks on the situation of national and ethnic minorities, with regard to the deficiencies revealed in the financial and economic activities of the national minority self-governments that have been functioned as budgetary organisations since 1 January 2008.

Pursuant to the SAO's recommendations made during the audit on the financial management system of the local governments the Government amended the provisions of the Government Decree on the operational rules of public finances and the Government Decree on the reporting and accounting obligations of public finance organisations, raised the professional qualification requirements for entities fulfilling enforcement

tasks, and specified detailed rules for the submission of indirect subsidies to the councils. The Ministry of Finance supplemented the sample internal audit manual with uniform criteria for the audit of earmarked subsidies. No measures have been taken with the view of specifying the mandatory tasks of the local governments, and of determining how the loan repayment obligation should be taken into account during the calculation of the deficit.

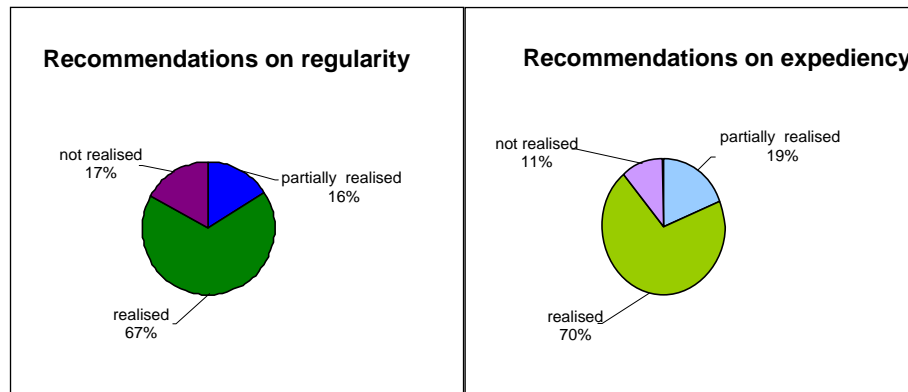
Pursuant to the SAO's recommendation, during the amendment of the Government Decree on the operational rules of public finances at the end of 2007 it was included in para (3) of Article 134 that records pertaining to liabilities of less than HUF 50 thousand must at least include the subject, amount and date of liability assumption, and the name of the person who assumed the liability. It was included in para (2) of Article 135 that professional performance must be certified by indicating the date of certification, compliance with the certification obligation, and with the signature of the authorised person

The Minister of Local Government and Regional Development issued the Decree No. 7/2008 (I. 28.) on the normative costs, cost items, and the accounting and internal audit rules related to the referendums held in 2008 pursuant to the SAO's recommendations made on the basis of the **audit on the funds used for the organisation of the general elections of 2006, as well as the election of local government councillors, national and ethnic minority representatives**. The Minister brought the importance of full compliance with this decree to the attention of the Head of the Central Office for Administrative and Electronic Public Services. He also emphasised that during the performance of election tasks, liabilities should be assumed in accordance with the provisions of the Act on Public Finances.

3.2.3. Recommendations at the level of the auditees

SAO audits were performed at each **local government**¹⁶ in the period of 2003-2006. **The SAO formulated nearly 50,000 recommendations during the comprehensive audits of the financial management of the local governments.** The local governments utilised nearly three fourths of these recommendations, as a result of which improvement could be experienced in relation to compliance with the provisions of the Act on Public Finances and the Government Decree on the operational rules of public finances in the course of budgeting, appropriation modification and the compilation of the final accounts. As a result, the level of regulation of budget management improved, locally and centrally set requirements were more respected, and audit tasks built into the work process were ensured to a larger extent than before.

¹⁶ Compliance with this requirement is stipulated in para 2. b) of Article of Parliamentary Resolution 47/2006. (X. 27.) on the approval of 2005 activities of the SAO.



It is favourable that the SAO's recommendations made for the county local governments, towns with county rank, as well as capital district local governments affected by the comprehensive audit of the financial management system were soon utilised. Recommendations pertaining to compliance with the legal regulations, the performance of economic activities, the transparency and expediency of financial management were accepted and action plans were devised for the realisation thereof. In 2007, the SAO often experienced that the audited local government corrected the revealed irregularities and deficiencies during the on-site audit, and although the report stated that the irregularity/deficiency existed in the past, the condemning statement was no longer valid. It happened several times that having read a SAO report published on the internet, the management of a local government explored and corrected the typical irregularities before the start of the SAO audit (since the audit programme is standard, and the President of the SAO selected the local governments to be audited in the next four years in advance).

Public foundations, party affiliated foundations, political parties and national minority self-governments operating outside public finances and audited since they receive regular state subsidies have realised some of the legality and regularity measures recommended by the SAO, and have included the other measures in their approved action plans. Utilising the findings of on-site audits, they typically eliminated the operational, accounting regulation deficiencies, corrected the material mistakes of book-keeping and the annual reports by means of self-audit, and gave instructions on compliance with the data supply obligations. The national minority self-governments made a resolution at the level of the general meeting to set up the office organisation – by 1 January 2008 at the latest – and to reinforce the internal control system required by law (financial committee, internal auditor, chartered accountant).

In relation to **budgetary chapters affected by the audit of the 2006 final accounts**, the SAO made 30 recommendations with a view to create regular financial management, closed financial processes, and up-to-date accounting and other legal regulation.

A former SAO audit of the final accounts concluded that in the case of payment facilitation benefits provided by the Tax and Financial Control Administration it sometimes happened that the prescribed payments were not made by the required deadline, yet the benefits were not withdrawn – despite para (9) of Article 133 of the Act on the Rules of Taxation – in accordance with

the relevant resolutions of the tax authority. In connection with this, the Administration prepared an action plan and inspected the possibilities for the automatic withdrawal of payment facilitation benefits in case of non-payment. Consequently, the development of an IT system that would enable the immediate and automatic withdrawal of benefits is under way.

Despite the recommendations of the SAO, in 2006 the Tax and Financial Control Administration did not conduct targeted inspections spanning several years at the credit institutions – regarding the special legal title of the disbursement costs of housing subsidies – however for 2007 it set the inspection of these costs as a priority inspection target within the entire period of limitation.

Pursuant to the recommendations formulated in the report on the audit of the execution of the 2005 budget, certain measures were taken by the Customs and Finance Guard. The professional directorates expanded their audits at the account keeping unit of the Customs and Finance Guard. The SAO concluded already during the audit of the final accounts for 2004 and 2005 that at the Hungarian Customs and Finance Guard documents used for the accounting of revenues (requirement, payment sheets, correction records) are not handled as documents subject to strict accounting, despite the relevant provisions of para (1) of Article 168 of the Act on Accounting. A partial measure was taken in 2007, when Instruction No. 9/2007 (VI. 13) of the Accounting Command Unit of the Hungarian Customs and Finance Guard ordered that correction records and the validating insertion sheets should be subjected to strict accounting.

During the 2006 audit of the operation of the Hungarian Privatisation and State Holding Company, the SAO recommended the Minister of Finance to investigate the circumstances of the loss of revenues that occurred due to the error made in the course of selling the shares of MOL Hungarian Oil and Gas Company, to explore the grounds for the loss of assets entailed by the recapitalisation and privatisation of Forrás Plc., to call to account those persons that were responsible for payments made in connection with the unnecessary voluntary dissolution of Bábolna Plc., to review unsubstantiated payments made from the privatisation reserve and own assets, as well as to investigate the causes behind the growth of payments made by omitting public procurement procedures. Only some of the SAO recommendations have been utilised. The Minister of Finance commissioned the Supervisory Board of the Hungarian Privatisation and State Holding Company to conduct an investigation in accordance with the recommendations.

Pursuant to the recommendations made during **the audit of the operation of the monitoring and control system of EU funds**, planning and regulatory tasks have been completed. As far as institutional tasks are concerned, the institutional system has been set up, the funding contracts have been signed with the Intermediary Bodies, and a schedule has been drawn up for the compliance audit of the institutional system. The implementation of the tasks can be continuously monitored on the basis of the work plans of the Government and the National Development Agency. Pursuant to the SAO recommendations, procedural novelties have been introduced to the audit manual in connection with the monitoring and audit tasks, as well as the harmony of the professional content of human resources in order to strengthen

risk analysis. Consequently, the audits focus on high risk areas and have become more flexible on lower risk areas. The Training Programme has been developed for the staff members of the affected organisations on the procedural novelties. Furthermore, external experts are involved in the performance of internal audit tasks that require special expertise.

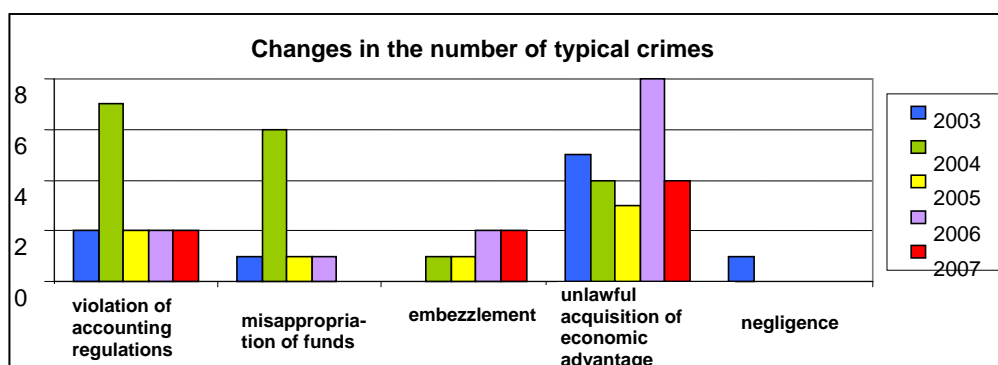
The operational costs of the Intermediate Bodies have been assessed in detail, funding has been made single-channel, as a result of which the costs of Intermediate Bodies that had operated with higher unit costs than other bodies were reduced. In its contracts signed with the Intermediate Bodies, the National Development Agency stipulated that the costs related to the intermediary tasks should be recorded separately and in a sufficiently detailed manner.

3.3. Criminal proceedings initiated by the SAO

By auditing the utilisation of public funds, the SAO provides the society with data and indicators regarding the regularity of utilisation. The primary objective is not to lay the foundations for criminal proceedings, however when there is (reasonable) suspicion of a crime, the SAO shall file charges in accordance with para (2) of Article 25 of Act XXXVIII of 1989 on the State Audit Office, as well as para (2) of Article 171 of Act XIX of 1998 on Criminal Proceedings.

In 2007, the SAO **filed eight charges**, against **22 known perpetrators**. The damage caused by criminal conduct totalled nearly **HUF 322 million**, almost all of which was related to the crime identified as **'unlawful acquisition of economic advantage'**. The size of the amount can be explained by the high costs of sewage and public utility development projects – and hence the large subsidies required – as well as the subsidy accumulating effect of the system. In the eight charges, **criminal liability was raised** on the basis of facts and findings revealed during **four SAO audits**, and charges affected the financial management of the local governments. The eight charges altogether qualified as three types of crimes (unlawful acquisition of economic advantage, violation of accounting regulations, embezzlement).

During the audit **personal liability was raised in 16 cases**.



Note: A charge may pertain to the serious presumption of several crimes, wherefore the number of charges submitted and the number of crimes committed in a year do not necessarily correspond.

In relation to charges pressed due to the suspicion of committing the crimes identified as ‘violation of accounting regulations’ and ‘unlawful acquisition of economic advantage’ – which represent the majority of crimes revealed by the SAO – the criminal proceedings are conducted more expediently and efficiently than before, and accurate and up-to-date information is available for the SAO on the afterlife of the charges. The investigation authority has launched investigation already in seven out of the eight charges pressed in the reporting year. In one case the charge is being evaluated for admission. The investigation authority terminated investigation in three cases, however, the prosecution service ordered the continuation of investigation in two of these cases upon the SAO’s successful complaint. One proceeding launched after the SAO reported a crime has already reached the stage of judicial procedure after formal charges were filed.

In the subject year, the SAO was **contacted by the investigation authorities 16 times** in relation to ongoing criminal proceedings. In part due to its service supplier function, in most cases (14 cases) the SAO could meet its data supply obligation by forwarding documents that contained facts that had come to its knowledge in the course of the audits. In two cases – for the lack of SAO audits – the SAO was unable to provide the requested information.

In addition to the above, the SAO forwards the **announcements of public interest** related to criminal liability to the competent investigation authority, for the SAO itself lacks investigative authority. In the reporting year three such announcements were transferred, each of which related to the financial management of local governments. In one of these cases investigation has already been ordered.

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

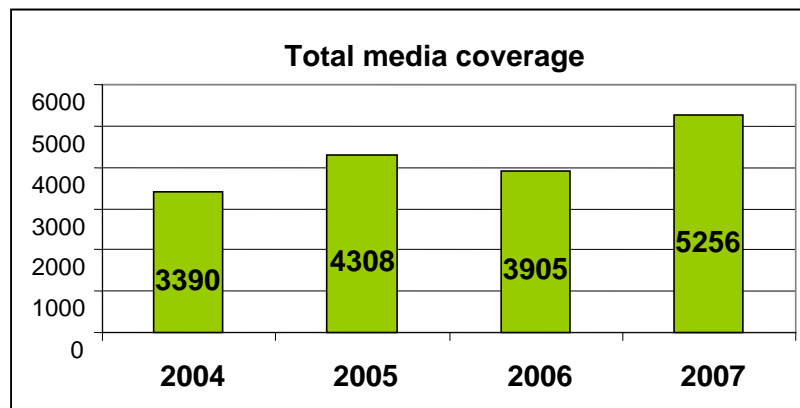
Publicity contributes to the enhancement of the effectiveness of the audit activity, it may help the SAO convince the audited entities and may prevent irregularities. Apart from giving information to the National Assembly, the SAO finds it important to inform the general public, maintain a dialogue with financial audit professionals, and encourage cooperation with higher education institutions. The basis of the SAO’s communication, as well as the broad dissemination of its activities and results is that the SAO’s reports and professional publications are public and accessible for anybody in full length.

In 2007, similarly to the former years, one of the SAO’s main tasks was to inform and support the control and legislative work of the National Assembly. The members of the National Assembly received – primarily electronically – the SAO reports, as well as letters summarising the major statements and recommendations of the reports. These documents are accessible on the SAO’s website already on the day of their publication. The SAO staff members regularly attended the meetings of parliamentary committees.

Maintaining close relations with the media, editorial staffs and journalists **is an integral part of the SAO’s communication activities.**

The press summaries of the SAO reports were directly forwarded to the press and the National News Agency Corporation. Press releases were issued about the major events affecting the organisation.

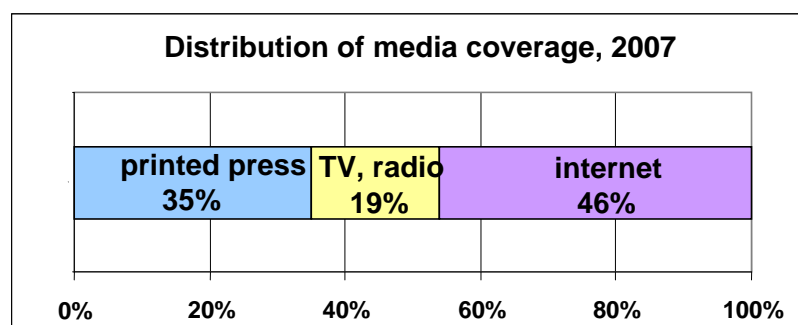
In 2007, an outstandingly high number of publications were issued in connection with the SAO: according to the information given by the Observer Media Monitoring Ltd., as well as the SAO's own media processing, over **5,000 SAO related news items, interviews, articles and references** appeared in 246 different media outlets.



The SAO organised five presidential press conferences, and the Directors General held three press conferences in Budapest. In addition, the SAO organised joint press conferences with the county local governments and towns with county rank.

In January, journalists could ask questions about the SAO Audit Plan for 2007, while in March questions could be raised about discussions on public finances. The presidential press conferences focused on the SAO activity report and the public finance theses in April, on the report on the final accounts in September, on the SAO opinion on the 2008 budget appropriation bill, as well as on the SAO study on the macroeconomic foundation of the bill in October.

The Research and Development Institute of the SAO presented to the representatives of the media its study titled "International and national experiences on PPP projects" and its study titled "The public sector and economic competitiveness" in May and June, respectively. In July, representatives of the media could ask questions about three reports of the Local Governmental and Regional Audit Directorate.



In line with the practice of the former years, the summaries of the SAO reports and personnel news of the SAO were published in the Official Bulletin of the Hungarian Gazette.

The SAO **restructured its website** in accordance with its renewed image. Within the framework of these efforts, user friendly developments were realised to facilitate application and to make information more easily accessible. The customer satisfaction form, which was included in the website in 2005 with the primary objective of receiving feedback on the services of the website, was also renewed. With the help of the new form, respondents can evaluate the SAO's activities, reports and findings thereof.

People interested in the SAO's work downloaded reports from the SAO's website **100,580 times** in 2007 (from external IP addresses). The English version of the SAO's website is getting more and more popular, too: in 2007 as many as 1,339 English language summary reports were opened compared to the 380 in 2006.

Those interested may ask questions through the "**SAO Forum**" and the "**Meet the President Hour**" pages of the website. The "SAO Forum" receives questions and comments on a continuous basis, and the answers appear on the website within maximum 8 days. The "Meet the President Hour" provides an opportunity for visitors to the website to have a live dialogue with the head of the SAO about issues of interest.

Last year 69 questions were submitted to the "SAO Forum". The most frequent topics included the internal audit of local governments, the elaboration of operational and organisational rules and the budget of the local government, sewerage construction, multi-purpose micro-region associations, normative school support. Several abuses were reported, and the SAO was also contacted in connection with the interpretation of certain legal regulations. The "Meet the President Hour" was organised twice last year. The column was opened one week prior to the Meet the President Hour on both occasions. Questions could be uploaded from that time on, and answers were provided at the previously announced time.

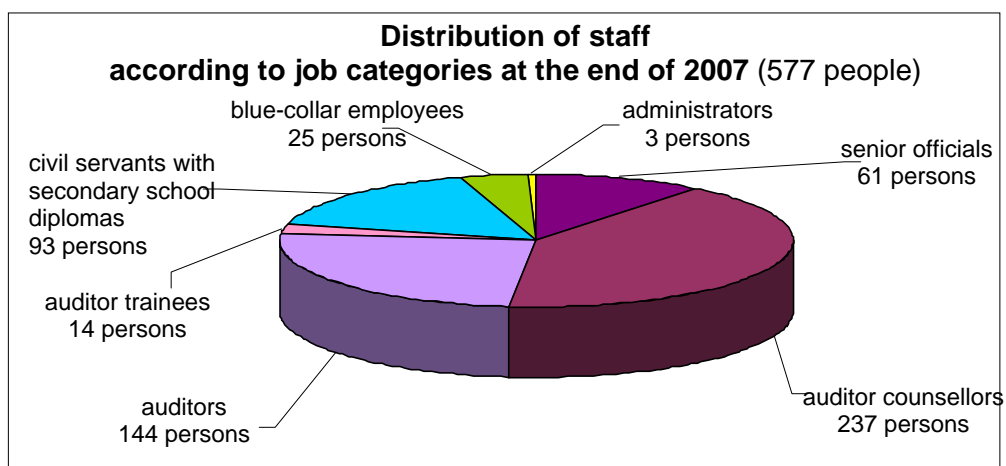
In the former two cases both the questions and the answers are public. In case questions are sent to the **central e-mail address of the SAO**, the answers are available only to the askers. Last year as many as 282 e-mails were received by the SAO. It can be stated in connection with all three communication channels that the number of persons that contacted the SAO grew in 2007.

4. IMPROVEMENT OF THE QUALITY OF THE AUDIT WORK

4.1. Human resources management and development

Personal conditions

As of 31 December 2007, the SAO had 577 employees. During the year the employment relationship of 34 staff members was terminated, and since not all jobs that became vacant were occupied, only 24 new staff members were hired by the organisation.



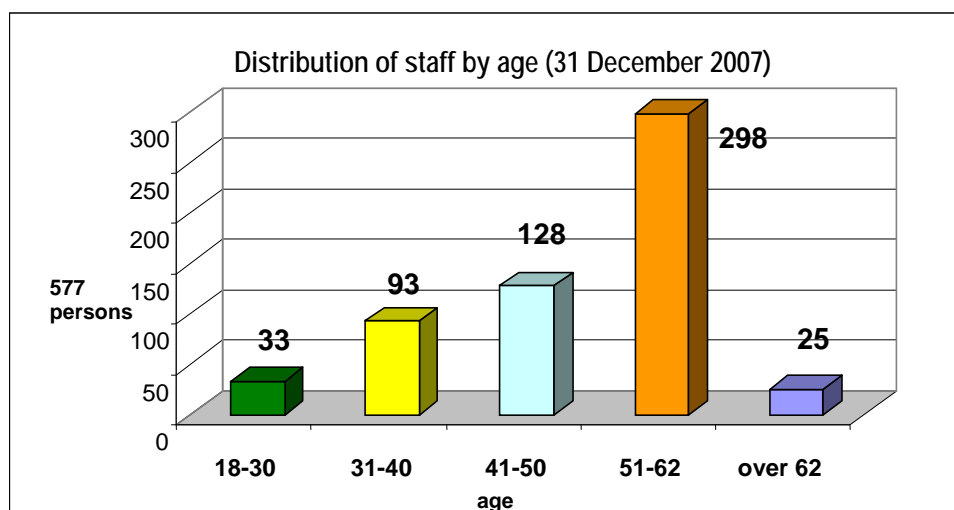
Similarly to the previous year, large-scale retirement continued, and 19 auditors retired. Another four persons were dismissed, the service relationship of seven people was terminated with mutual consent, but it also happened that civil servants resigned or were transferred to other positions. The employment relationship of two working age colleagues was terminated due to death. Out of the new employees 17 persons were appointed to auditor positions, five were hired as civil servants with secondary school education, and two blue-collar workers were hired on the basis of work contracts.

The replacement of executives and senior staff members who retire after a longer period of time spent as auditors – which period may often be identical with the length of existence of the SAO – requires special attention. The SAO requires a staff who possess modern economic and financial knowledge, up-to-date IT and foreign language skills, and at the same time show adequate sensitivity to understanding and managing the social, community and human aspects of the audits. During the personal interviews the in-house recruitment committee evaluates the candidate's professional and educational background, as well as the personal skills and characteristic features. The progress of adjustment is measured through the performance evaluations carried out after each audit: it happens every year, as it happened last year, too, that an auditor has to be dismissed.

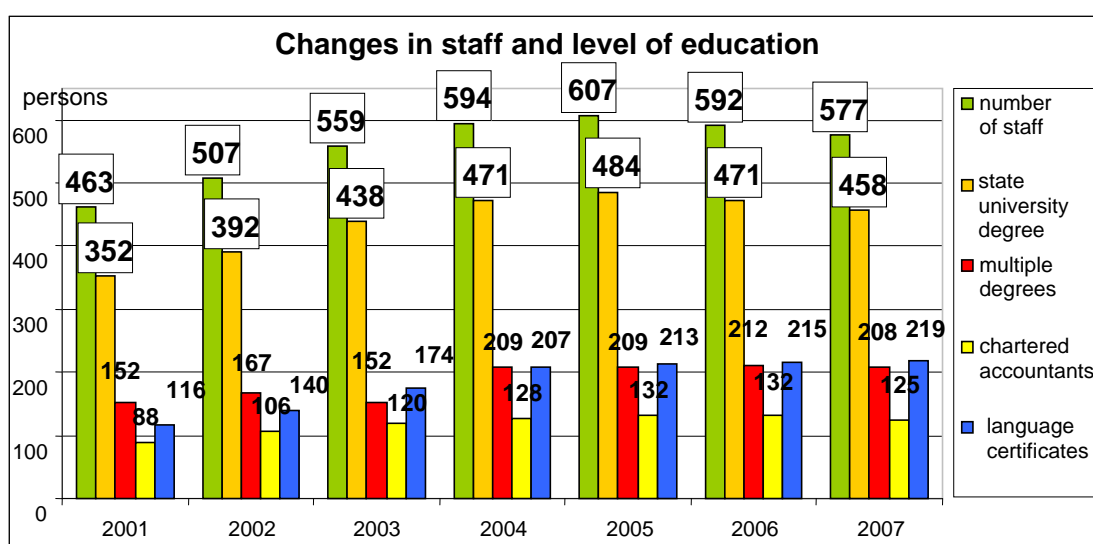
The SAO has a stable staff of professionals. (Staff and wage restricting measures that affect the entire system of public administration are sufficient to reduce the desire for changing jobs and for professional mobilisation.) The scarcity of funds for wage hikes does not foster the chances of promotion. The speed of progress of the 100 to 120 – mostly younger – auditors who were hired during the accelerated staff inflation four or five years ago lags behind the opportunities that were available to former generations of professionals. The SAO is seeking those methods and resources that can provide a predictable professional and income path for auditors of 30 to 50 years of age, currently forming the backbone of the staff (38%), or staff members under 30 years of age.

In an expert-type audit organisation that carries increased professional responsibility, the relatively higher average age must be regarded natural,

wherefore it is deemed acceptable that 59% of the staff members are older than 50 years. As many as 150 staff members have already reached or will soon reach the legal retirement age. Measures taken in the initial phase of the pension reform accelerated retirements in 2007, and since one must count with the reduction of pensions due to the further regulations, the retirement intentions will grow within the SAO.



After the older, more experienced auditors retire, the percentage of employees with multiple degrees, the highest accounting and audit qualifications, as well as the percentage of chartered accountants remains almost the same. By the natural rejuvenation of staff the number of employees with foreign language skills is rising on a continuous basis.



Pursuant to the organisational and operational patterns of the service and the competitive sector, public sector organisations are increasingly striving for the regular evaluation of individual work performances, and the introduction of

the corresponding income incentives. In accordance with the specific organisational features of the SAO, individual performance is evaluated after the completion of the audits in the case of auditors, or on an annual basis in the case of non-auditor staff members. The evaluation of the auditors' work is in part fostered by the fact that the different audits are directly evaluated by different senior auditors (objectivity). On the other hand though, changes and trends in the personal attitudes can be less perceived and evaluated by a larger number of senior auditors. Naturally, each senior auditor has his/her own system of criteria. Despite its weaknesses, the evaluation system is an important indicator, especially in the case of extreme (best and weakest) performances. Performance evaluations are more or less in concert with the individual qualifications spanning a longer work period of several years.

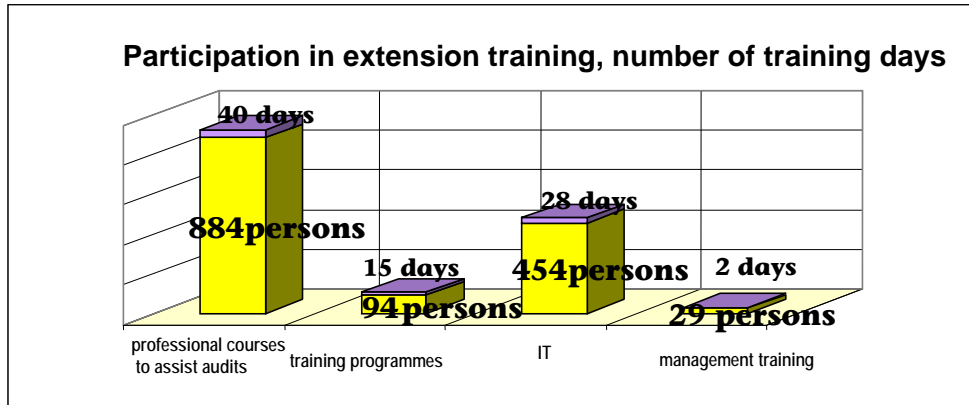
Extension training

The content of the 2007 Training Programme of the State Audit Office of Hungary followed the strategic objectives and the human policy planning trends. It took into consideration the increasing or changing professional requirements, the Annual Audit Plan, the specific changes in personnel, as well as the limitations of the available funds. **Internal professional training courses that directly assist the auditors' work** were the most significant and popular of all courses. **Last year courses were organised in 34 subjects on 46 occasions on 85 training days.**

The academic year started with lectures presenting the changes in the acts on taxation rules, social security regulations and accounting. These lectures are attended by an increasing number of SAO staff members year after year. The topic "Internal control system in public finances. The audit of control systems", which deals with the audit of the public sector, risk assessment and control audits in the EU, turned out to be a successful element of training. Another novelty was the lecture presenting the operation, audit methods and experiences of the European Court of Auditors. The heads of the audit teams prepare the auditors for efficient audit work within the framework of lectures providing practical skills prior to, or in the initial phases of the audits.

The SAO's training programmes are also popular. Such programmes have recently included the topic "The school of persuasion – present-day intensive communication", which is based on the formerly introduced topic "Efficient verbal and written communication", and also proves to be useful in audit related cooperation. Year 2007 saw the continuation of the training course on fast reading, which teaches how the reading speed can be increased while improving the comprehension skills by using special techniques. The SAO organised a course for the administrative staff on the application of the modernised document and file management regulation, during which the templates prepared in accordance with the new image of the SAO were also presented.

In the field of computer science and information technology there is typically greater demand for learning about IT applications that support special fields of work, as well as for refreshment courses. The use of the IDEA programme is indispensable in the case of certain audits, and based on a survey of training needs the topic of "questionnaire compilation" was reinstated in the Training Programme.

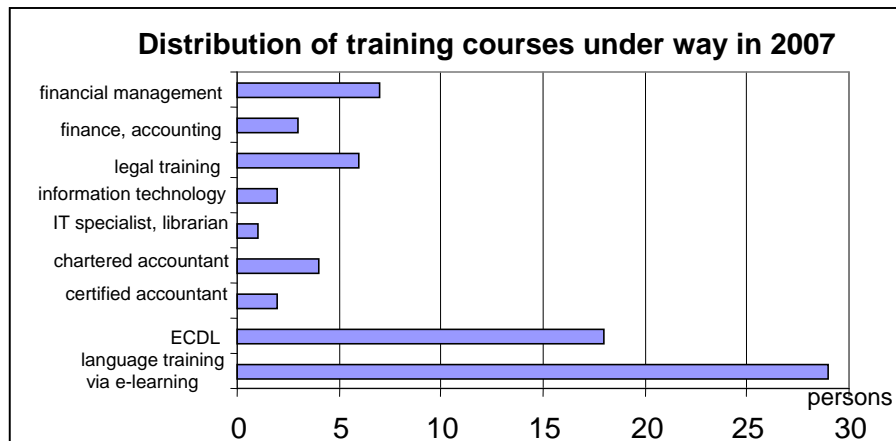


In accordance with the practice of the former years, staff members are encouraged to attend language training courses organised for civil servants by external language institutions (Goethe Institute, Alliance Française). In 2007, funds available for language courses were significantly increased (from HUF 1.6 million in 2006 to HUF 3.4 million in 2007). This is in part related to the SAO's participation in Government sponsored English language training, as well as to the fact that despite the continuously rising costs, the SAO can support the technical language training of staff members participating in EU audits.

The SAO maintains professional relationship with the Government Personnel Service and Public Administration Training Centre, as it did with the Hungarian Institute of Public Administration before. The SAO follows the educational programme of this centre, and this is how it could join its e-learning language teaching project. Within this framework, the SAO signed study contracts with 31 staff members who enrolled in language courses.

Year after year, a large number of staff members attend various professional days, conferences and other external educational and extension training events. (In 2007 nearly 100 such events were attended.) However, for audit capacity and cost saving purposes the management of the SAO supports only professionally justified applications.

In order to improve job aptitude and the level of preparedness, the SAO supports professional extension training for its staff members as much as possible.



In 2007, the existing distant learning teaching materials of the SAO were supplemented with the electronic teaching material of performance audits, wherefore the general theory and methodology of this topic became accessible for all members of the profession. The electronic teaching materials of the SAO are getting more and more popular, and permanent access is ensured for those interested.

Delegations of foreign audit institutes that visited the SAO during the year talked about the system and the teaching material with appreciation, and they inquired about the possibility to access the English version of such materials.

The SAO maintains continuous cooperation with the Hungarian Chamber of Auditors. As a result, in 2007 the Chamber found that the auditors of the SAO can obtain 50% of the credits required for mandatory extension training in 13 topics within the internal training courses of the SAO.

The SAO is trying to choose lecturers for the internal training courses from among its own staff, and conducts the courses in its own buildings as much as possible. However, there are special fields that require the professional experience of external lecturers and senior trainers, as well as the use of external venues.

4.2. The quality assurance of audits

The Presidential Decree regulating the quality management system of the SAO audits, which entered into force on January 1, 2006, was enforced in full in 2007. The quality management system, which 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 which highlights and provides a standard system and a regulation framework for those elements that are vital for high quality audits and reports, functioned adequately.

The **internal quality control and quality assurance system** proved to be efficient for the reliability of the audit opinions of the SAO, as well as the substantiation of audit findings, conclusions and recommendations in 2007, too. The users of the reports, or the audited entities submitted no criticism regarding the quality of the reports.

The financial management control during the whole audit process and the professional supervision conducted at the end of each work phase kept the audit activities of the auditors and the auditor's reports on the results of the on-site audits under continuous control. Each draft audit report was subjected to a double review (from the perspective of the audit and legal profession), and in the meantime discussions were conducted with the audited organisations. Those draft audit reports that raised personal responsibility, were subject to substantiation review – and were modified if modification was deemed necessary – before they were forwarded to the persons named in the reports.

The SAO reports were signed by the President of the SAO only after the Quality Assurance Department – which is independent from the directorates

conducting the on-site audits – issued certificates certifying the effective completion of the audits. This practice is unprecedented in the international arena and can be regarded a pioneering action.

The independent Quality Assurance Department, which is directly supervised by the President of the SAO, evaluated the entire process of the audit activity (in all the three main audit types) by performing an ex-post quality assurance review of one seventh of the audits that were closed in 2007. Evaluation extended to the process lasting from the preparation of the audits to the compilation of the SAO reports, and focused on compliance with the professional requirements, and the achievement of the expected high level audit certainty. Altogether, the ex-post review was closed with comforting results, and it certified compliance with the professional requirements.

4.3. International relations

While developing its system of international relations, and in line with its strategic objectives, the SAO strived to encourage the development of efficient forms of cooperation among the audit institutions in 2007 by fully completing the management tasks undertaken within the international audit community, and – at expert level – to actively contribute to the modernisation of audit methodologies and techniques, and to apply such methods and techniques.

In 2007, the main arena of the SAO's bi- and multilateral cooperation continued to be the International Organisation of Supreme Audit Institutions (**INTOSAI**). The President of the SAO filled the post of the Chairman of the INTOSAI Governing Board between 2004 and 2007, and in accordance with the Statutes of the organisation, he transferred this function to his Mexican counterpart at the INCOSAI organised in November 2007.

The joint activity of the national supreme audit institutions of the EU Member States and the European Court of Auditors (ECA) continues to have great significance both at the presidential level, and within the working groups set up for the different professional fields.

The President of the SAO as the Chairman of the INTOSAI Governing Board (2004-2007)

In accordance with the INTOSA's Rules of Procedures, and as the host of the 18th INTOSAI Congress held in Budapest in October 2004, the President of the SAO filled the post of Chairman of the world organisation for the subsequent three years. In said period several processes were launched that are of importance for the future of INTOSAI, wherefore it is justified to review the results of these three years of chairmanship.

Filling the post of chairman was of utmost significance for two reasons. During the more than 50 year long history of INTOSAI it happened for the first time that chairmanship was fulfilled by an Eastern-Central European country, within a relatively short time following the political and economic transformation in the region. On the other hand, the significance of

chairmanship was increased by the fact that this period coincided with the practical launch and initial phase of the implementation of the Strategic Plan (2005-2010), which had been approved at the INTOSAI Congress in Budapest, and is regarded as a milestone in the life of the organisation.

The SAO played an active, initiative role in the elaboration of the organisational framework of the Strategic Plan, which was approved at the 18th INTOSAI Congress. In doing so, in conjunction with the General Secretariat of INTOSAI the SAO worked out a draft methodological guideline, which summarised the tasks of the persons in charge of the different topics, outlined the requirements of the new communication policy of INTOSAI, and the possible relations of INTOSAI with international financial sponsoring organisations. In the capacity of Chairman of the INTOSAI Governing Board, the President of the SAO attended the inaugural meetings of the new committees set up pursuant to the strategy (Professional Standard Committee, Capacity Building Committee).

Within the possibilities of the tight international event calendar, the Chairman of the Governing Board made sure to represent the INTOSAI community at important regional events, such as the EUROSAI-ARABOSAI and EUROSAI-OLACEFS conferences, which were pioneering ventures in the cooperation among the regional working groups of the organisation.

As the Chairman of the INTOSAI Governing Board, the President of the SAO was invited to several protocol events in the past three years. Such events included the anniversary events of the Turkish, Spanish or Kazakh audit institutions, or the meeting of the Executive Council of the heads of the supreme audit institutions of the Commonwealth of Independent States.

Apart from fulfilling the tasks of chairmanship, the SAO played an active role in the newly established organisational units of the INTOSAI at institutional and expert level. The organisation is continuously involved in the work of the Privatisation Working Group, the Professional Standard Committee and the Subcommittee on Internal Control Standard.

During the term of chairmanship, close, harmonic and smooth working relations were maintained with the General Secretariat of INTOSAI (Austrian Court of Audit), and personally with the Secretary General, Dr. Josef Moser.

In the initial phase of the renewal of INTOSAI, the new organisational structure was set up under the guidance, and with the cooperation of the Hungarian chairmanship. Furthermore, the personal conditions were created that serve as a firm foundation for INTOSAI's intentions to successfully respond to the financial, economic and audit challenges of the 21st century.

Multilateral professional cooperation

The SAO undertook initiative and leading roles in the activity of the European regional working group (**EUROSAI**) of INTOSAI. The next Congress of the organisation will be organised by the SAO's Polish partner institution in Krakow, in June 2008. The Chair of the 1st Theme of this event (Establishing an

Audit Quality Management System within a Supreme Audit Institution) will be the President of the SAO, upon the request of his Polish counterpart. The SAO contacted other institutions to assist in the thorough preparation of the 1st Theme of the Congress (the staff members of the Danish, Maltese and Russian Supreme Audit Institutions and those of the European Court of Auditors), who supported the work of the SAO responsible for the elaboration of the theme related documents. The SAO completed the undertaken tasks; based on the Country Papers received from 33 EUROSAI member SAIs it compiled the Discussion Paper, and sent it to the Polish organisers in due time. Work will continue after the Congress, since the working group is going to elaborate a guide relating to the topic of the 1st Congress Theme.

The SAO increased the intensity of its involvement in the professional working groups of EUROSAI (e.g. IT, environmental auditing). Furthermore, it organised a successful seminar in Budapest on the quality requirements of audits for the staff members of the EUROSAI member SAIs of Eastern European and the West Balkan countries.

A SAO staff member held a talk at the Congress of **EURORAI** (European Organisation of European Regional Audit Institutions) in Switzerland about the topical issues of public private partnership (PPP).

The **Contact Committee**, which is the cooperation network of the Heads of the Supreme Audit Institutions of the European Union, focused on the exchange of professional experiences on the audits of EU funds and other issues linked to the operation of the Community both at its annual presidential meeting and in the working groups in 2007, too. The SAO was involved in the activities of all working groups engaged in top priority tasks (audits related to Structural Funds, VAT, public procurement, etc.). Concurrently, the evaluation of the activity of the working groups was started. The SAO feels honoured and appreciated that the representative of the SAO can also participate in the activity of the small evaluating team. This work aims to map how the national SAIs can utilise the professional results presented by the working groups. Since the **Contact Committee will meet in Budapest in 2009**, preparations have been started by mapping the possible venue and the technical conditions.

The SAO attended the meeting of the International Board of Auditors for **NATO** held in Brussels, at which the representatives of the national audit institutions of the member states discussed the annual report of the Office.

The President of the SAO gave a talk at the 2007 International Conference of the International Consortium on Governmental Financial Management (**ICGFM**) in the United States.

The President of the **Inter-Parliamentary Union** invited the President of the SAO to attend the seminar held in Geneva on Parliament and the budgetary process, including from a gender perspective. The seminar paid great attention to the importance of accountability and transparency in the budgeting process. The presentation of the SAO's President discussed in detail the relevant priorities of INTOSAI, as well as the major international and national

experiences gained in connection with the enforcement of accountability and transparency. All costs related to this trip were born by the host organisation.

The Heads of the Supreme Audit Institutions of the **Visegrád countries** met in Slovenia in 2007, where they approved the schedule and programme of a parallel audit that would focus on the internal control system of national institutions affected by the utilisation of the EU's Structural Funds, and which is implemented by the national audit institutions of four countries. The Contact Committee will be informed about the results of the work led by the SAO and the audit experiences in 2008.

Bilateral international relations

From among the bilateral relations maintained in 2007, the presidential meetings offered an opportunity to lay the foundations for expert level cooperation in the different fields of audit, occasionally on the basis of bilateral, written agreements. In 2007, the President of the SAO signed such an agreement with his counterparts in Moldova and Albania. Within the framework of agreements signed with the National Audit Office of the UK and that of Estonia, the possibilities of tripartite cooperation are being outlined regarding the audit of the restructuring of the large supply systems (healthcare, education). Last year the SAO received presidential delegations from Norway, Columbia, Poland, Spain and Germany.

At expert level, the SAO gave presentations on performance audits to the representatives of the Bosnian audit institution among others, and on human resource management to the staff members of the Ukrainian audit institutions. The SAO had an exchange of experiences on legal issues with the Slovak counterparts, and provided information on the issues of budget planning and the audit of budget planning to a Chinese delegation.

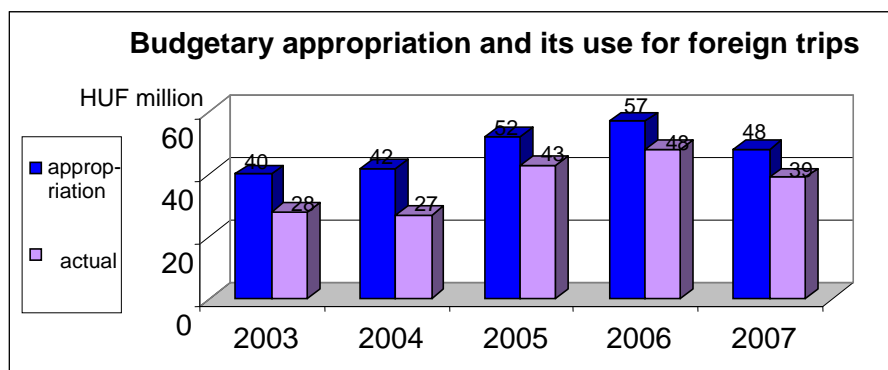
With support from the Ministry of Foreign Affairs, the SAO established an expectably close and regular relationship with the Vietnamese partner institution. A one-week seminar was held in Budapest for the representatives of the Office of the State Audit of Vietnam on the audit of budget planning. Upon the request of the Vietnamese counterparts, SAO staff members spent one week in Vietnam, where they again presented the practical procedures of the audit of budget planning to the competent staff members of the supreme audit institution of Vietnam.

Within the framework of the EU supported twinning agreement, the RDI processes the actual questions of the anti-corruption fight with the involvement of the staff members of the Netherlands Court of Audit.

The budgetary aspect of the SAO's international relations

According to the objective of the International Relations Plan, in 2007 the amount spent on foreign trips could not exceed the actual costs incurred a year before, i.e. HUF 48 million. Altogether, the SAO envisaged HUF 40 million for travel, accommodation and insurance costs, and HUF 8 million for per diems in

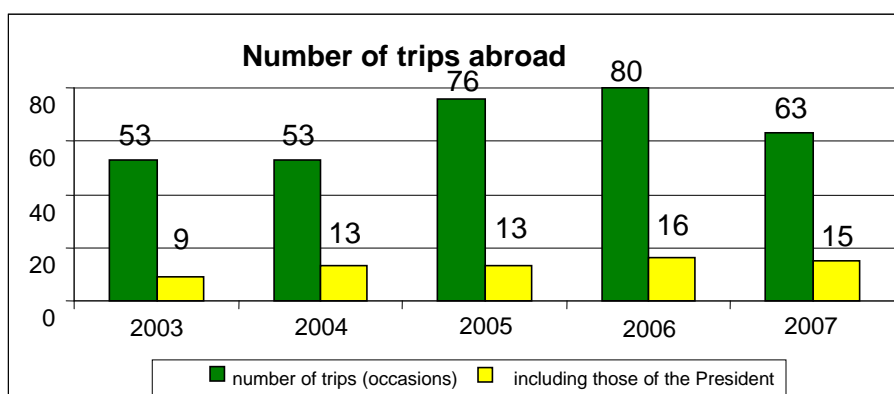
relation to the foreign trips. The actual costs of the trips abroad were in line with the expectations. During the year a total of HUF 39 million was paid for such purposes, which equalled 39% of travel costs incurred in 2006.



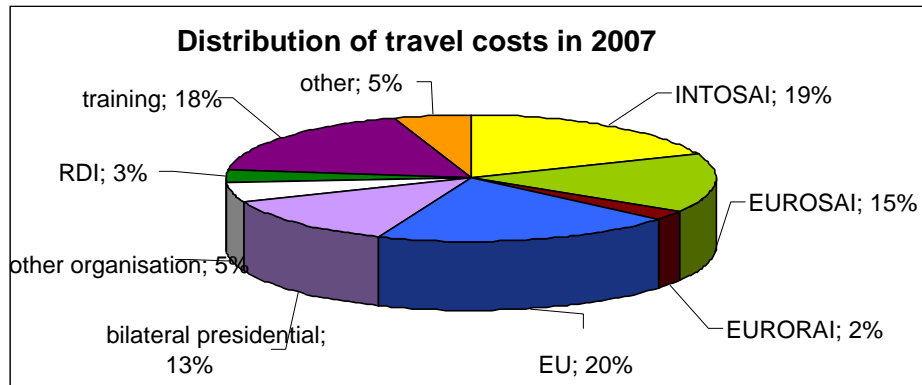
In 2007, the staff members of the SAO participated in 63 trips abroad. This meant that 124 delegates spent 440 days outside the country. (The plan envisaged 66 trips for 137 delegates.) Two foreign trips were linked to participation in a longer training course, for a total of 204 days. On average, each business trip abroad lasted for four working days, not including the long-term training courses. The average cost for a working day spent on a business trip abroad totalled HUF 136,000 in 2007 (compared to HUF 131,000 in 2006).

There were 25 trips above the plan, the costs of which totalled HUF 8 million. These trips were funded from the reserves that were accumulating during the year due to cancelled trips.

In 2007, the President of the SAO had 15 official visits abroad for a total of 62 days. Six of these trips were realised as the Chairman of the INTOSAI Governing Board for a total of 32 days. The average costs of a presidential trip in 2007 equalled HUF 490,000, and the average daily costs totalled HUF 104,000 (versus HUF 550,000 and HUF 149,000, respectively in 2006) The striking reduction of the costs of presidential trips was in part due to the fact that travelling by car was consistently preferred, as well as due to the discounts that can be received if airplane tickets are booked well in advance.



The size of the costs is largely influenced by trips overseas. Last year the SAO could again delegate a staff member to the five-month-long training course organised by the supreme audit institution of the United States. The costs of the course, which lasted for 171 days, totalled HUF 6.7 million, i.e. 17% of all travel costs. In 2007, another seven trips were made overseas, with the involvement of 16 staff members. The SAO spent 25% of all travel costs, i.e. HUF 9.8 million on these business trips (compared in HUF 17.8 million in 2006). Two of these trips were related to the chairmanship of the INTOSAI Governing Board (with six participants).



5. RESEARCH AND ADVISORY ACTIVITIES RELATED TO THE AUDIT WORK

In line with the SAO's strategic objectives, in 2007 the **Research and Development Institute of the SAO** continued to make all efforts to promote the preparation of comprehensive evaluations on the utilisation of public funds, the modernisation of audit methods in harmony with the international standards, and to promote the creative adaptation of the international best practice. In accordance with the above, the RDI **conducted research in several topics** in 2007.

The major research topics were: The status and tasks of the development of the knowledge based society and economy in Hungary; The directions of the financial reform of public finances in the late 20th, early 21st centuries; The competitiveness of the public sector and the economy; International and national experiences on public-private partnership; Analysis of the efficiency of utilisation of subsidies provided since the political transformation for the research of the region of Lake Balaton from the perspective of the tourist industry; The financial risks of the Hungarian local governmental system; Size and efficiency of subsidies provided since the political transformation for improving the status of the Roma population of Hungary.

The preparation and start of implementation of the project titled "Encouraging further development of anti-corruption measures and the implementation of the anti-corruption government strategy" under EU Transition Facility Unallocated Institution Building Envelope proved to be a new type of task for the RDI.

The work done for the **elaboration of the public finance regulatory theses** deserves special attention. In line with its strategic objectives, and within the framework of its advisory activity, the SAO undertook to define the theses that would lay the foundations for an act concerning public finances with new approaches and content. With a view to realise this task, the RDI prepared several preliminary studies. After the discussion of these studies internally and at expert level, the final study describing the major features of the regulatory concept of the new Act on Public Finances was prepared. The “Theses on the Regulation of Public Finances” were developed in this basis. The President of the SAO submitted the theses to the National Assembly in April 2007, which approved them in the form of a resolution and asked the Government to utilise them in its work aimed at the modernisation of public finances.

After the approval of the theses by the National Assembly, the work of the Government aimed at the preparation of legislation for the modernisation of public finance regulation gained momentum. Following large-scale consultation, the SAO formed an opinion on the working material that had been prepared in the Ministry of Finance. The main points of the opinion are: in the first step the budget policy related professional requirements must be elaborated. Then it must be decided what type of elements and to what extent should restrict the budgeting activity of the Government if necessary. Finally, the institutional condition must be modelled based on the scopes and powers.

The SAO working group, which was set up to assist the preparation of public finance regulation, became a full right participant of the conciliatory process: in conjunction with the experts of the National Bank of Hungary and the Ministry of Justice and Law Enforcement it could foster efforts made for the enhancement of public finance security, and the transparent and more efficient utilisation of public funds.

Since the SAO’s tasks can be directly affected by the regulation, in addition to commenting on the theoretical approaches, the SAO also formulated detailed, concrete comments while forming opinion on the draft texts of the bills. Furthermore, the SAO elaborated a basic document, a bill that would ensure long-term regulation and would guarantee the enforcement of collective responsibility by supplementing the Constitution with a new chapter on public finances. This document – which was submitted to the developers themselves, the experts of the parliamentary parties and the competent committees of the National Assembly – presented the most important requirements in concert with the entire Constitution, and in a much more detailed manner than the current rules, while complying with the European norms and giving sufficient weight to the topic. According to the SAO, this proposal should be the starting point of the future legislative actions.

In parallel with this, the working group modelled – in part relying on the basis of international experience – the impact of the planned regulation on the future activity of the SAO, the inherent tasks and the related possible solutions.

With regard to the proposals pertaining to the modernisation of the regulation of public finances, among other things, the **RDI prepared an separate analysis on a few correlations of the macroeconomic substantiation of the 2008 budget appropriation bill**, which the President of the SAO submitted to the National Assembly as an attachment to the SAO opinion on

the 2008 budget appropriation bill of the Republic of Hungary. In addition to analysing the budgetary processes, the study contained a new methodology for the analysis of macroeconomic risks and impacts. With the help of this methodology the study drew attention to several risks and undesired effects related to economic growth, changes in prices and wages, the indebtedness of local governments, the utilisation of EU funds, the tax burden and the recent healthcare measures.

The fundamental goal of the SAO's **methodology development activity** is the further development of the applied audit methodologies, aids, inspection methods and procedures on the basis of international development achievements and its own practical and development experiences. Within the framework of the development of the internal methodological regulation, the SAO started to review and modernise the internal regulatory document titled "Basic Rules on Auditing", which was issued in 2004. This work will continue in 2008, too. In parallel with the review of the document that defines the fundamental principles and requirements of the SAO audits, the SAO worked on the modernisation of the methodologies of the main types of audit (prepared in former years), and on the review of the related aids.

The National Assembly continues to find it important and supports that the SAO should exercise influence on the general opinion of the profession within the framework of its evolving **civil relations**. In line with this, and in accordance with its strategy, the executive officials and staff members of the SAO attended several professional events and conferences, where they presented the audit experiences and conclusions, as well as the professional achievements of the research workshop of the SAO. Papers written by the staff members of the SAO and its RDI were published in different professional journals. The SAO itself organised several conferences, in cooperation with the Hungarian Economic Association, the Hungarian Lawyers' Association, as well as the government commissioner of the "New Order and Freedom" programme, just to mention a few.

The SAO edits and issues a bilingual (Hungarian-English) **public finance journal** within the framework of its professional public life activities. In 2007 as many as 43 studies, professional papers and 10 book reviews were published in the Public Finance Quarterly, which focused on – among other things – on the modernisation of the system of public finances, the convergence programme, as well as the interactions of the society, politics and the economy. The exchange of professional ideas designed to promote the balance creating and catch-up processes was fostered by the fact that the editorial staff organised a symposium in conjunction with the Hungarian Economic Association, during which the study titled "How did we get here: Hungarian budget 2000-2006", published in the thematic issue on the budget served as a starting point for discussion. The journal, which is getting increasingly known outside Hungary, too, and which offers publication opportunities for foreign expert writers, too, also contributed to the fact that the President of the SAO was asked to analyse the modernisation of Hungary's system of public finances and competitiveness. This analysis was published in issue 1/2007 of the OECD Journal on Budgeting.

The **President's Advisory Board**, which is a consultative work organisation assisting the management activities of the SAO's President, functioned in accordance with its annual meeting plan in 2007, too. It met at regular intervals and in general complied with its programme by processing and discussing written motions, analyses and (partial) studies. It paid special attention to tasks related to the development of the Hungarian system of public finances, the modernisation of SAO audits, the inherent methodological development, the analysis of the legislative environment related to the operation of the public sector and the SAO audits, as well as to tasks inherent in the preparation of the modernisation of certain elements of the SAO audits.

6. INSTITUTIONAL OPERATION AND FINANCIAL MANAGEMENT

6.1. Budgetary management

Since the Act on the State Audit Office of Hungary was amended in 2004, the SAO compiles the drafts on the central budget chapter "State Audit Office" and the execution thereof. The Government submits this proposal to the National Assembly – without making any changes – as a part of the budget appropriation bill and the bill on the final accounts.

The independent chartered accountant appointed by the Speaker of the National Assembly upon a public procurement procedure audited the financial report of the "State Audit Office" chapter of the central budget with an accounting date of 31 December 2007. The audit was completed on the basis of the Hungarian National Audit Standards and other legal regulations on audits by using the Financial Audit method of the SAO. The audit included the sampling based audit of documents supporting the factual figures of the annual budget report, as well as the evaluation of the applied accounting principles and that of the annual budget report. **According to these documents, the annual financial report gives a true and fair picture of the financial position of the "State Audit Office" budget chapter as of 31 December 2007.**

Due to the greater responsibility arising from legal authorisation, the SAO found that the chapter's budget appropriation bill should present the SAO's basic strategic objectives in detail, the professional tasks arising from these objectives, focusing especially on audits that are contained in the Annual Audit Plan of the SAO, and are legally required to be performed at regular intervals. Furthermore, audits to be performed on the basis of presidential decisions and upon the request of the Government were designed. In addition, the SAO presented – in the form of a separate programme – those professional and operational tasks that can be classified as distinct groups, and determined the resources required for implementation.

Based on all this – through the Ministry of Finance – the SAO prepared a detailed, transparent, and thoroughly conciliated draft budget plan for the National Assembly. During the preparation of this plan the SAO took into

consideration the planning guidelines of the Ministry of Finance, the provisions of acts that basically affect audit and other tasks, and the relevant resolutions of the National Assembly. It strove to ensure that the SAO should comply with its legal obligations – to the greatest possible extent – in a prudent and cost-efficient manner, and with regard to the economic conditions of the country.

In the budget act the National Assembly approved HUF 7,616.4 million for the SAO to perform its tasks in 2007, HUF 7,596.4 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 reduction of more than 1%. The scope of action in utilising budgetary resources was again reduced by the fact that 65% 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.

All this required that while fulfilling professional, institution maintenance and operation tasks the SAO should enforce austerity measures and observe economic aspects. To this end, the SAO strove to make use – as much as possible – of the saving possibilities provided by public procurement procedures conducted centrally or within the SAO's own competence.

From the total amount of expenditures the appropriations for personal disbursements amounted to HUF 4,747.5 million, the contributions payable by the employers totalled HUF 1,483.7 million, the non-personnel expenses equalled HUF 955.9 million, the institutional investment costs totalled 161.9 million, the renovation appropriations totalled HUF 13.7 million, and the chapter's general government reserves equalled HUF 253.7 million.

The approved appropriation was increased by HUF 778.3 million due to the interim modifications, including HUF 565.4 million used as the residue of the previous year's appropriation; HUF 18 million was spent on the additional appropriation provided pursuant to Government Decision 2117/2007. (VI.25.) ; HUF 10.9 million was earmarked to cover extra costs incurred in relation to the national expert employed in the EU institution; HUF 1.0 million totalled the instalment of the grant provided by the OTKA Fund in the subject year; HUF 1.9 million was provided by the EUROSAI Governing Board in support of the seminar organised by the SAO; HUF 16.6 million came from revenues realised from audits performed for material compensation, the preparation of studies and the sale of assets; HUF 0.7 million was used to support programmes included in the Training Plan; and HUF 3.0 million was due to housing loans provided from the repaid instalments.

After the modifications as much as HUF 8,394.7 million was available.

Altogether HUF 8,040.3 million was utilised, which accounted for 95.8% of the modified expenditure appropriation. Personal disbursements and contributions payable by the employers totalled 81.1% of the expenses (HUF 6,519.9 million). Non-personnel expenses and expenditures for cumulative purposes accounted for 14.4 % and 4.5%, respectively.

In contrast with the planned revenues of HUF 20 million, the SAO realised HUF 35.9 million in revenues. More than 30% of the extra revenues was made up of expert fees and cost reimbursements payable to the SAO for cooperation with the British partner institution in Tajikistan in 2006. The rest came from the fees for studies prepared by the Research and Development Institute (RDI) of the SAO, the fulfilment of audit tasks, and the sale of unnecessary equipment.

The amount of the reserve totalled HUF 354.7 million, within which HUF 354.3 million came from expenditure saving, and HUF 0.4 million from extra revenues. The rest of the reserve (92.8%) comes from the rescheduling, postponement of committed tasks, performances and invoices to 2008 (primarily due to the obligation to create a mandatory reserve). The free reserve amounted to HUF 25.6 million.

Due to the considerable thoughtfulness and austerity measures, the available appropriations altogether ensured the operational conditions required by the institution to perform its tasks smoothly.

6.2. Infrastructural operations and developments

In 2007, in addition to ensuring adequate working conditions, maintaining or improving the state of repair of the existing office buildings, and enhancing the availability of equipment, it was a priority task for the SAO to install security systems (entry systems, fire alarms and CO detectors) in the main and branch offices.

The greatest development in 2007 was the completion of the roof insulation, the construction of stairs leading to the roof and that of the green roof in the SAO's Headquarters in Apáczai Csere János Street. This eliminated roof leakage problems, and at the same time provided a solution for heat insulation.

Furthermore, some of the windows/doors of the SAO's Headquarters in Apáczai Csere János Street were replaced and renovated, shutters were installed on the windows looking onto the courtyard, a canopy was installed over the entrance to the building, and on the flat roof the air conditioning units were rearranged according to the requirements of the Office for Cultural Heritage Protection.

In the office building in Lónyay Street the automation of the heating and air conditioning system was completed, just like the renovation of the electrical system, and the paintworks in the offices on the 8th floor.

With a view to the modernisation of the parking garage in Garibaldi Street, the entrance doors were replaced, electrical wiring was fully reconstructed, and fire alarms and CO detectors were installed.

The detailed architectural plan was prepared for the complete renovation of the office building in Bécsi Street.

Phase I of the renovation of the County Audit Office in Miskolc was completed by the replacement of electrical wiring, lighting fixtures, the reconstruction of

the floor slab and the finishing, the completion of paintwork and the complete renovation of the sanitary premises.

In the subject year the SAO spent a total of HUF 164.9 million on building renovation and reconstruction.

In order to provide high-level support to the audit activity, the SAO spent HUF 55.0 million on the procurement of Xerox machines, printers cutting machines and furniture.

In 2007, vehicle parts and accessories were purchased for a total of HUF 16.5 million, and within the framework of the planned renewal of the vehicle fleet one vehicle was replaced.

6.3. IT and telecommunication operations and developments

The main objective of the SAO's IT activities is to support the implementation of the SAO's strategic mission and tasks in a versatile manner. Similarly to the former years, IT and telecommunication developments in 2007 were carried out 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 training room and a standard network telecommunication system that can flexibly respond to the changing communication needs. The IT budget approved for 2007 ensured the implementation of projects and development tasks specified in the annual plan.

The **top priority IT project of the SAO** was the development of the electronic system designed to support the documentation of the audit work, and to file and store the documents produced or collected during the audits, for which the SAO submitted a successful application for EU Transition Facility. The project was approved on 3 July 2006 by the Phare Management Committee. The first phase of programme implementation includes software development, for which the CFCU conducted an open public procurement procedure in 2007 with the involvement of the SAO, in accordance with the rules pertaining to the EU Transition Facility. The tender was won by **Bull Hungary Ltd.**, and the costs of development totalled EUR 195,836 (HUF 50 million). The contract was signed by the CFCU, Bull Ltd. and the SAO on 21 January 2008. The deadline for project completion is the end of February 2009. System development expects to entail the improved efficiency of audits – especially that of preparation –, the reduction of time spent of the preparation of audits, and improved efficiency of executive quality control and quality assurance due to the on-line accessibility of audit evidence.

In 2007, the SAO introduced an on-line **HelpDesk system** for the reporting, documentation and management of errors and problems related to the SAO's IT services. As a result, the SAO is able to ensure that problem management and error correction are documented and performed expediently. The system efficiently supports the performance evaluation of staff members engaged in operation. The system was linked to the network based active device

management software, wherefore error messages from the network monitoring system and the management thereof are also documented.

The SAO has been using a computer assisted **tracking and filing system** since 2000 to support document management. In 2007, the accredited version of the electronic tracking and filing system (OFFICE.GOV) was prepared and introduced in pursuance of Decree 24/2006. (IV. 29.) issued jointly by the Ministry of the Interior, the Ministry of Informatics and Communication, and the Ministry of National Cultural Heritage on document management software used by organisations providing public service, in accordance with the document management regulation approved by the National Archives of Hungary.

Last year major developments were performed on the **SAO's website** in terms of functions, structure, content and format. The operation of the website has considerably changed, and its appearance was modified to fit the image of the SAO, which was renewed in 2007. The services of the SAO's website were extended in accordance with the Act on Freedom of Electronic Information. Documents and information specified by the law are shown in full under a separate menu point¹⁷. Pursuant to the relevant legal regulations, documents stored in the **Public Data Search** system operated by the Ministry of Economy and Transport are also automatically updated on a continuous basis.

In parallel with the development of its website, during the improvement of the SAO's **Intranet** system new thematic databases were set up to enhance the efficiency of information management. Consequently, the documents will no longer need to be printed, similarly to the Electronic Presidential Meeting system introduced in 2005. The new system, which will be gradually introduced in 2008, will have a structural navigation interface and a search engine that will support quick searches through the various, ever-growing documents.

The **SZEKRETER audit registration and monitoring system**, which has included all material information about the SAO audits from planning through the resources spent on the audits to the realisation of recommendations since 2002, is developed on an on-going basis and is modified according to the management's needs. From this system the Audit Plan of the SAO, the recommendations formulated in the reports and the responses thereto can also be accessed on the Internet website of the SAO.

Within the framework of **infrastructure development**, all SAO sites were connected to the Electronic Government Backbone in 2006. In 2007, band widths were further expanded at the individual sites. The complex network provides services that are of much higher quality and have more contents at each site, while the costs of services did not rise. The logically separate and classified virtual private network (VPN) is monitored by the SAO's experts.

¹⁷ The Eötvös Károly Foundation rated the SAO's website and the informativity thereof exemplary in its study analysing the practice of the freedom of electronic information.

Another important element of the IT infrastructure is the construction and continuous development of the SAO's hardware units at the required level, the provision of hardware components – first of all desktop computers and/or notebooks – for the staff in order to enable them to fulfil their tasks in an efficient manner. In line with the SAO's strategic objectives, the rate of notebook users increases year after year among employees involved in on-site audits.

In 2007, a total of **88 desktop computers and 35 notebooks** were purchased through a centralised public procurement procedure. Within the framework of the scheduled replacement of equipment, 20 medium, and one colour, medium capacity printers were installed in various branch offices of the SAO. To serve the dynamically growing computer services, **one new server computer was purchased**. This move was first of all justified by the larger hardware resource needs of the SAO's new, self-developed portal system (website). In addition to the procurements, significant progress was made for the optimisation of resources by reorganising the functions of the server computers.

In the first half of 2007 the SAO conducted an open public procurement procedure for the use of **mobile telecommunication services**. As a result, the monthly costs could be reduced by 35% on average. During this procedure the SAO could negotiate a price that is even more favourable than that available through centralised public procurement procedures. As a result of the public procurement procedure announced for **wire telephone services** in October 2007, the monthly service fees are expected to drop by 40% on average from 1 December 2007.

In 2007, the SAO spent HUF 66.1 million on software procurements, and HUF 60.2 million on the purchase of IT and telecommunications devices and equipment. The value of devices and equipment ordered in December appears as residue subject to liability in 2007, and will be accounted and paid in 2008. Said devices and equipment will also be commissioned in 2008.

6.4. Internal audit

In 2007, one internal auditor performed the internal audit tasks of the SAO, in line with the relevant legal regulations and the Internal Audit Manual of the SAO, on the basis of the strategic and annual work plan approved by the Secretary General. The tasks envisaged in the annual work plan were completely implemented.

The personal and material conditions for the internal audit were adequate during the year; functional independence was fully maintained in the internal auditor's work.

In the reporting period the internal auditor made the following major findings:

- Similarly to the previous years, the financial management of the SAO was in line with the legal and internal requirements, as well as the austerity measures in the audited fields;

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- In the course of the audits there was no suspicion of any act, negligence or deficiency that would have served as a ground for criminal, misdemeanour or disciplinary proceedings, or actions for damages;
 - In order to eliminate minor deficiencies revealed during the audits, and to further mitigate financial management related risks, the internal regulations need to be supplemented and updated regarding certain details.

Half of the recommendations made in the internal auditor's reports was realised by the end of 2007, and the rest will be implemented by mid 2008 as scheduled by the approved action plans.