



STATE AUDIT
OFFICE OF HUNGARY

R E P O R T

on the activities of the State Audit Office of Hungary in 2006

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TABLE OF CONTENTS

1.	Tasks of the State Audit Office of Hungary in 2006	4
1.1.	Audit tasks, areas and focal points	4
1.2.	Other tasks of the State Audit Office of Hungary	7
1.2.1.	Countersigning and opinion forming authority	7
1.2.2.	Authority to make recommendations	8
2.	Audit findings of the State Audit Office of Hungary	9
2.1.	Main findings classified by the subsystems of public finances	12
2.1.1.	Central budget	12
2.1.2.	Separated state funds	18
2.1.3.	Social security funds	20
2.1.4.	Local governments	23
2.2.	Major experiences of audits focusing on the fulfilment provision of state and local governmental tasks	31
2.3.	Utilisation of EU funds	40
2.4.	Subsidies to non-profit organisations outside public finances	42
2.5.	State property	43
3.	Utilisation of the audits	46
3.1.	Discussion of the reports by the National Assembly, resolutions and parliamentary relations	47
3.2.	Enforcement of the SAO recommendations	49
3.2.1.	Recommendations at the level of the National Assembly	50
3.2.2.	Recommendations at governmental level	53
3.2.3.	Recommendations at the level of auditees	59
3.3.	Criminal proceedings initiated by the SAO	60
3.4.	Announcements, proposals and complaints of public interest	62
3.5.	Publicity of the activities of the State Audit Office of Hungary	63
4.	Improvement of the quality of the audit work	66
4.1.	Human resources management and development	66
4.2.	The quality assurance of audits	71
4.3.	International relations	72
5.	Research and advisory activities related to the audit work	76
6.	Institutional operation and financial management	78
6.1.	Budgetary management	78
6.2.	Infrastructural operations and developments	80
6.3.	IT and telecommunication operations and developments	81
6.4.	Internal audit	83

REPORT
on the activities of
the State Audit Office of Hungary in 2006

The State Audit Office of Hungary (SAO), the financial and economic audit organisation of the National Assembly, annually reports on its activities carried out in the previous year. According to the more than a decade-old practice, the report on the annual activities of the SAO 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 containing a brief evaluation of the SAO's activities and the future development trends.

On the basis of the latest parliamentary resolution we compiled our audit plan for 2007, continued our methodological developments, prepared the summary on the audit of the utilisation of EU funds in 2005, and started to elaborate the theses laying the foundations for the Public Finance Act.

In 2006, the SAO published 62¹ reports. The parliamentary committees discussed fewer SAO reports than last year: altogether 9 reports were included in the agenda 46 times. In line with the former practice, a few reports, e.g. the report on the execution of the 2005 budget, the SAO's opinion on the 2007 budget bill, and the SAO 2005 activity report were put on the agenda by several committees. In our reports we altogether made 1,134 recommendations pursuant on-site audits at 1,426 organisations.

Apart from presenting the operations, financial management and development of the organisation, the report on the SAO's annual activities 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. Keeping in mind the continuously growing content of the SAO's tasks, we are trying not to exceed a reasonable size, and trying to comply with the requirements of transparency and comparability.

This report of ours reviews and summarises the findings of audits conducted in 2006 in relation to the subsystems of public finances, the public property, the utilisation of EU funds and task performance by the state and the local governments. The report presents the major features and figures of the

¹ Including 61 audit reports and one report on the annual activities of the SAO.

utilisation of the findings, and points out how the improvement of audit quality serves the balanced and organised operation of the SAO. The report also presents research activities that provide the foundation for the advisory activity, as well as the operation and financial management of the SAO.

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. TASKS OF THE STATE AUDIT OFFICE OF HUNGARY IN 2006

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

Apart from the Constitution and the Act on the State Audit Office, the SAO tasks are specified by another 26 acts. However, the tasks and mandates of the SAO, which are particularly broad even by international comparison, do not only mean direct and exclusive audit obligation and authority, but also activities that enhance the transparency of the utilisation of public funds.

1.1. Audit tasks, areas and focal points

In 2006, the SAO continued to perform its activities based on the annual audit plan, which was approved after being discussed in the National Assembly's Audit Committee.

The SAO fulfilled its audit obligations and eligibilities by performing 86 audits in 2006, including 66 audits that were planned to be completed in 2006. During the year, one audit was added to, and two² were deleted from the audit plan, wherefore the number of audits planned to be completed in 2006 changed to 65 after the amendment of the plan.

Two audits were concluded with a report signed by one of the Directors General instead of the President (SAPARD's certification audit of 2005, and the audit of the system and practice of the management of frauds and irregularities related to grants provided from the EU Structural Funds). The publication of two reports was postponed until 2007³, wherefore **in 2006 as many as 71 audit reports were published.**

² During the year, the audit of funds used for the management of cultural public collections was added to the plan, while the audit of the Ministry of National Cultural Heritage, and the audit of the higher education dormitory investment programme were deleted from the plan.

³ Audit of the financial management of the Hungarian Democratic Forum (MDF) 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.

In 2006, the SAO fulfilled its audit obligations by using 64,557 direct⁴ auditor days, 3,039 days fewer than in the previous year. This was the consequence of staff restrictions introduced mid-year.

Audits that must be performed at certain intervals continue to represent top priority tasks. In 2006, the audit tasks required by the law to be **performed with certain regularity** (annually, biannually and regularly) absorbed **65%** of the audit capacity of the SAO.

Audits that must be performed **annually** continued to represent top priority tasks. In this group **4 reports were prepared** (opinion on the state budget, report related to the final accounts, audit of the operations of the Hungarian Privatisation and State Holding Company and the Hungarian News Agency Corporation). The task that required the largest capacity was the audit of the execution of the 2005 budget, which absorbed 24% of the annual audit capacity, just like in the previous year.

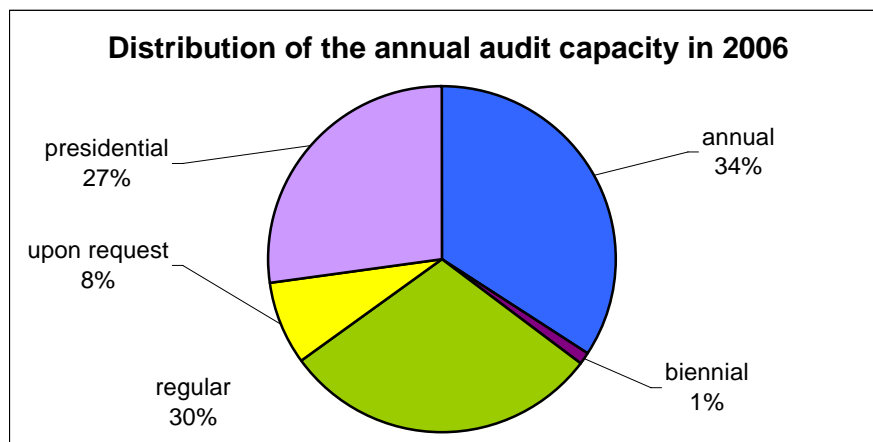
In 2002, **two reports** were prepared on the implementation of **biennial** audits (audits of one political party and one party-affiliated foundation).

As many as **33 reports** were published on the completion of **regular** audit tasks that include the audits of budgetary chapters, local governments, and of the financial management of separated state funds.

A major part of regular tasks 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 500 local governments, as many as 18 separate SAO reports were drawn up on local governments with significant budgets and property (the local governments of 5 counties, 6 towns with county rank, as well as about 1 capital and 8 district local governments).

In 2006 the SAO prepared reports on the comprehensive audits spanning several years of six budget chapters (Prime Ministeriate, Prosecutor's Office, Hungarian Academy of Science, Ministry of the Interior, Regional Development chapter, Ministry of Environment and Water.)

⁴ 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.

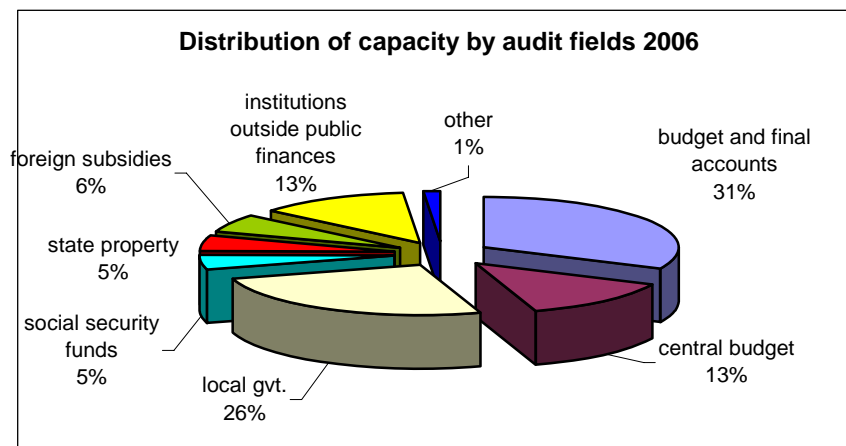


As many as 21 reports were prepared on audits carried out on the basis of the decision of the SAO's President. During the selection of the topics of these audits, preference was given to audits supporting the effective utilisation of EU funds, investment projects implemented in the PPP scheme, as well as the audit of other development purpose funds. In addition, several audits of primary public interest were also conducted.

These include the audit of the implementation of the National Development Plan, the audit of the funding schemes of motorway investments, the audit of the construction and operations of the Palace of Arts, the audit of trends and management of public debt, the audit of the privatisation of specialised healthcare services, the audit of permanently loss-making state-owned business organisations, as well as the audit of the operations of the Hungarian Tax and Financial Control Administration (APEH).

In 2006, four reports evaluated the operational conditions and the implementation of certain tasks of public education: the audit of the system of textbook supply to public education institutions, preparatory courses for school-age children, ensuring the conditions of primary school education in small settlements, the conditions of the maintenance and development of secondary school dormitories, and the audit of the property management of state higher education institutions.

In 2006 one audit was conducted upon the request of the National Assembly. The National Assembly mandated the SAO to audit the application for and utilisation of public utility subsidies transferred from the central government to local governments for road and canalisation projects until the end of 2005 in the Act of 2004 on the Final Accounts. The SAO fulfilled the legally mandated task.



The SAO classifies its audits according to **three main types**. In 2006, 50% of the audit capacity was used for regularity audits (preparing the opinion on the budget, audit of the final accounts, audit of the financial management of parties, certification audits of SAPARD and EAGGF agencies), while 33% of this capacity was used for comprehensive audits. Performance audits accounted for 17% of the annual audit capacity.

1.2. Other tasks of the State Audit Office of Hungary

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

The President of the SAO **countersigns** the contracts related to the borrowings of the central budget, and **gives an opinion** on the proposals for further development of the accounting system and the public internal financial control system of public finances. He comments on the internal audit regulation of the State Holding Company, and **makes recommendations** for the post of chairman of the supervisory board and chartered accountant of the State Property Holding Company, as well as the chartered accountant of the central bank, the chartered accountants of the separated state funds, and **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 business organisations with registered capital exceeding HUF 200 million and where the state is the majority shareholder, the chairman of the supervisory board is **recommended** by the SAO upon the request of the head of the business organisation.

1.2.1. Countersigning and opinion forming authority

On behalf of the Republic of Hungary, on 28 November 2003 the Minister of Finance signed a contract on a stand-by credit line of EUR 500 million. The contract, which was countersigned by the President of the SAO, expired on 24 November 2006. By maintaining the original sum, the Government Debt Management Agency initiated the extension of the contract. The extension was

countersigned after the documents related to the extension of the stand-by credit line were checked for regularity.

The SAO's opinion forming authority – given in connection with the changes in the accounting rules – was exercised in relation to the amendment of Act C of 2000 on Accounting, contained in the proposal titled “On the amendment of certain acts on finances”, as well as in relation to the amendment of Government Decree 249/2000. (XII. 24.) on the specific features of the reporting and book-keeping obligations of public finance institutions, and that of Government Decree 240/2003. (XII. 17.) on the specific features of the reporting and book-keeping obligations of treasury accounting.

1.2.2. Authority to make recommendations

Upon the request of the Minister of Education and Culture, in 2006 the President of the SAO recommended a nominee for the post of chartered accountant of the National Cultural Fund. Preparations for recommending nominees for the same post at the National Bank of Hungary and the Hungarian Development Fund were also in progress, but were carried over to 2007, too.

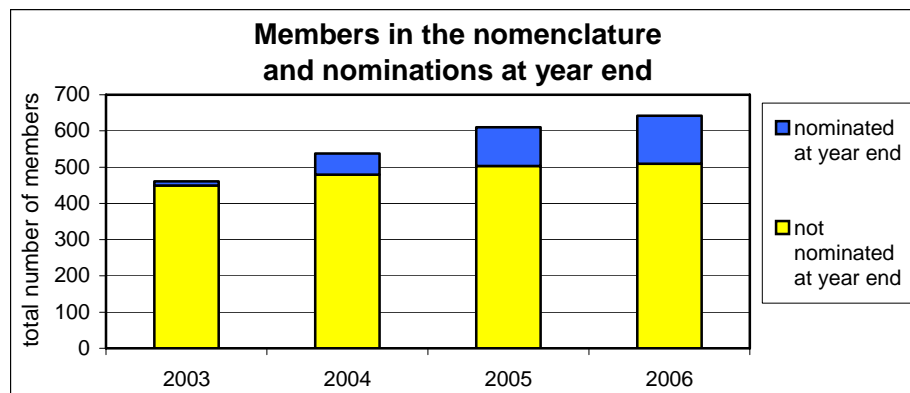
The approximation of the regulation of public procurement processes with the Community law – by further narrowing the exemptions from mandatory public procurement procedures – also affected the practice of formulating recommendations by the SAO's auditors as specified in the different acts (e.g. in the Act on the National Bank of Hungary or the Act on the Hungarian Development Bank). There is no doubt that ordering the services of a chartered accountant is subject to the public procurement act, however the unchanged legal regulations stipulating the nomination right continues to require that an independent chartered accountant selected on the basis of professional criteria should fulfil the audit tasks at the organisations concerned. The SAO created the conditions for this by determining the frameworks of participation in the public procurement procedure with the parties concerned.

Since it affects several acts, we notified the Speaker and the competent committee of the National Assembly, as well as the Ministry of Justice and Law Enforcement about the above legislative problem. Until the review is made, the simultaneous use of the public procurement act and the legal provisions stipulating the eligibility of the SAO to nominate chartered accounts will not cause any interference.

Before the President of the SAO recommends a nominee for the post of chartered accountant, the SAO's staff members contribute to the development of the selection criteria, and also participate in the procedure as observers, which makes it possible to satisfy the professional requirements of the SAO, and enforce the SAO's right to recommend nominees as stipulated in the relevant acts.

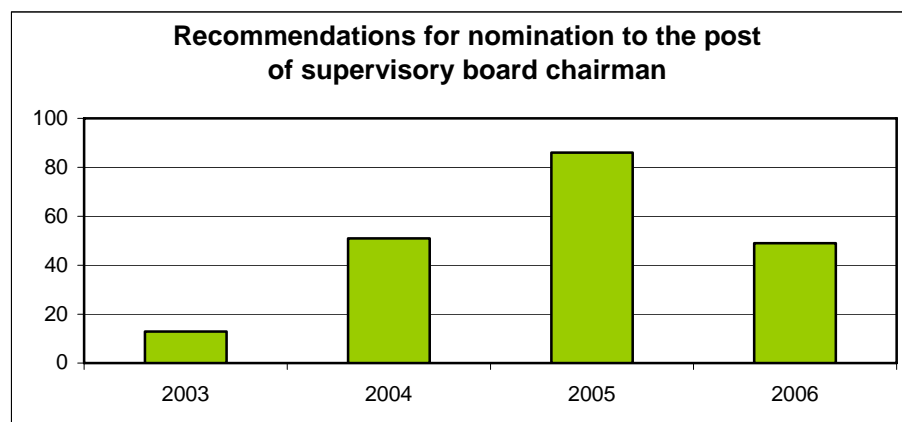
In order to update the nomenclature of the supervisory board (chairman of SB), another application procedure was announced following the former four procedures. Based on the evaluation of these applications, the number of successful applications the SAO manages increased by 32. As of 31 December 2006, the number of potential nominees was 642.

Between the start in 2003 and the end of 2006 as many as 679 applications were evaluated, and 646 persons were included in the nomenclature. Four names were deleted due to death.



In 2006, the Secretary General of the SAO made recommendations for personal nomination for 49 business organisations. As far as the SAO knows, on 31 December 2006, as many as 133 persons were in position as supervisory board chairmen upon the SAO's recommendation.

Between the start in 2003 and the end of 2006 the SAO examined requests from 217 business organisations, and recommended the nomination of 199 persons whose names were included in the nomenclature.



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

During its audits conducted in various fields and topics, the SAO is compelled to face the fact that the institutional reforms focusing on the organisational and regulatory system of the operations and the management of public finances do not evolve along mature and accepted, comprehensive development concepts or well-coordinated strategies. For the lack of a comprehensive strategy, priorities that occasionally interfere or contradict with each other may emerge.

The changes are not supported by preliminary impact assessment studies or other evaluating/analysing documents. The budget information system is not able either to properly support the analysis of the actual costs and impacts of

task performance. The utilisation of the resources is not monitored and evaluated even in cases where utilisation was linked to a specific objective. **Budget security is also weakened by the continuously changing legislative environment.** The SAO has been indicated for years that the information content of the budget and final accounts bills does not foster transparency, and does not provide assistance to sound decision-making.

The elimination of these recurrent deficiencies and their causes requires a new approach in the operations of the public sector, an attitude and problem-solving method that will also contribute to the creation of the conditions for budget security supporting sustainable economic growth, with regard to the future generations, too. This **calls for the immediate system-based review and analysis of public finances, and subsequently the development of new, complete, comprehensive and consistent regulations.**

It is especially to this end that the SAO – in line with the main direction of its strategy, and within the framework of its advisory role – initiates and fosters the renewal of the planning, operational, reporting and audit system of public finances, and in relation to this, the adequate and fully harmonised regulation of the management of public property.

Within the framework of the preparatory work we reviewed the standard international experience, organised professional discussions with the involvement of external experts, and on this basis, as well as by relying on our audit experiences, we prepared several preliminary studies.

We also took into consideration the constitutional and professional/rational boundaries of this initiative role of the SAO, wherefore we formulated our recommendations so that they could be directly utilised in the legislative work as much as possible. Our document titled “**The theses of the regulation of public finances**” – which we will submit to the National Assembly concurrently with our report on our activities in 2006 – contains the most important principles, methods, breakthrough points and the justification of the theses item by item. With this we would like to create an opportunity for the National Assembly to accept the SAO’s initial recommendations as a starting point for further work. We hope that the thesis collection and the related justification will convince the respected members of the National Assembly about the need for change, it will determine the content and direction of modernisation, and will contribute to the acceleration of works aimed at the modernisation of the legal regulation of public finances, and will yield visible results already in the current parliamentary cycle.

The most important “message” of the “theses” is that **the regulation of the management of public funds shall be based on firm theoretical foundations.** These principles shall be enforced throughout the entire regulation. The “theses” set forth these principles and outline the directions of regulation, along which the principles can be enforced. We find it paramount that a professional, political and social consensus be reached about the principles.

The second message of the “theses” is that regulation with a new approach is needed. In the last few years a trend has been evolving according to which organisations outside public finances undertook a growing share of public tasks. On the other hand, the SAO audits pointed out that **public funds are most likely to “melt away” at the meeting point of the public and the private sectors. This danger can be eliminated only with regulation that focuses on the utilisation of public funds instead of the public finance organisation.**

The third important message of the “theses” is that modernisation affected public finances, too. The development of information technology requires that the main rules of the information system of public finances be formulated at legislative level, too. Hungary’s accession to the European Union and other international organisations justify the need to **incorporate the standards developed by these organisations for the public sector in the Hungarian regulation, too.** The techniques of budget planning and management have also developed. The application of these techniques must be given the green light, and shall also be fostered in the Hungarian public finance management.

The “theses” practically start out from the fact that the key issue of the reform of public finances is the modern regulation of public finances, which shall be based on internationally accepted principles confirmed by domestic political consensus; **the cornerstone of regulation is the determination of the state’s tasks.** Such regulation is needed that extends to the entire group of entities managing public funds, as well as to all elements of the management of public funds, that separates the central and local levels of public finances, that **ensures that the National Assembly could practice its budgetary right and assume the responsibility of the legislative power, and that enforces sustainability and balance.** The new, modern regulation must ensure the transparency of the collection and utilisation of public funds, and the dominance of the “value for money” principle. Within the framework of the new regulation management/internal control and (financial) audit will fall into place. Public finance regulation must be predictable and relatively stable, which requires, and therefore it is recommended **to incorporate the basic rules in the Constitution, too.**

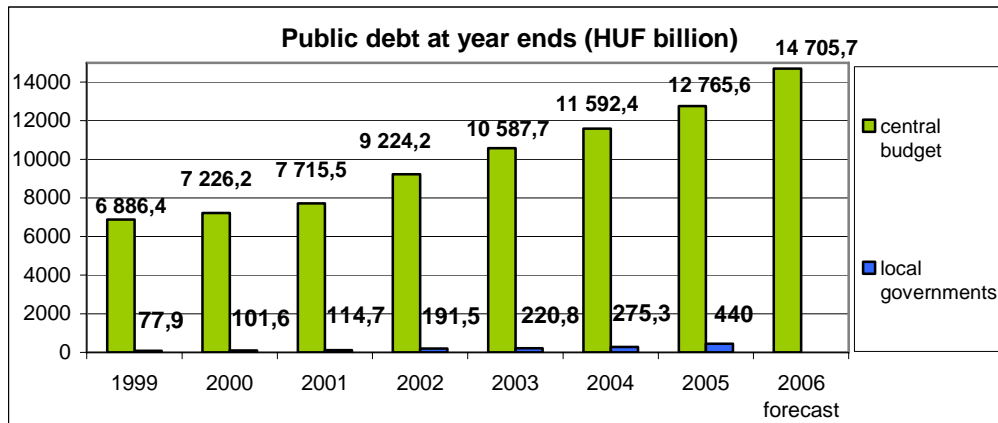
The development of the theses of the new public finance regulation does not mean that the work carried out by the Ministry of Finance for the modernisation of the Act on Public Finances that was adopted in 1992 and has been amended several times since then is no longer needed. On the contrary, the **two efforts supplement each other.**

It is probably not possible to re-regulate public finances with a single act, or by incorporating a few, easily implementable recommendations formulated in the “theses”. Therefore, the “theses” propose – in addition to the renewal of the entire legal regulation – the introduction of system-based regulation for certain blocks of public finance management. However, the recommendations do not extend to issues that belong to the regulatory scope of the property act.

2.1. Main findings classified by the subsystems of public finances⁵

2.1.1. Central budget

In relation to the final accounts, the SAO examines the indicators of public debt and debt service every year. In 2006, a separate report was drawn up about the audit of the management and changes in public debt.

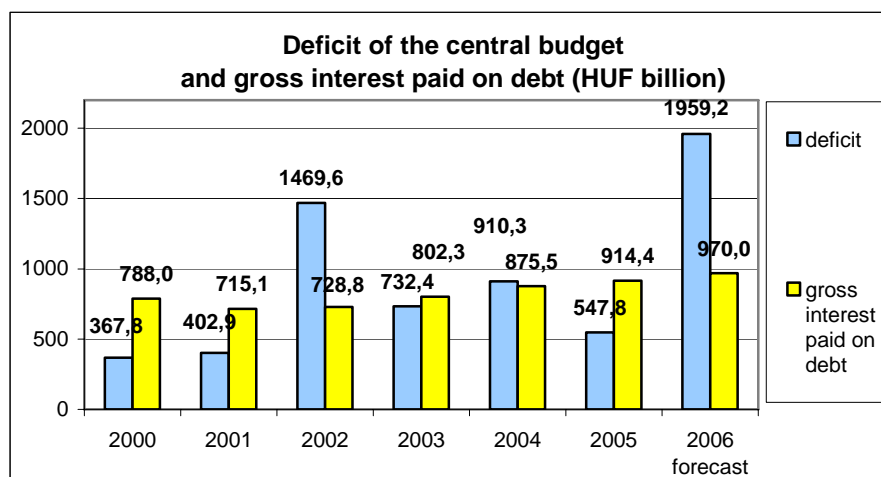


Note: Data about the debts of local governments in 2006 are not available yet.

In 2000 and 2001 **the annual growth in the debt of the central budget** was below HUF 500 billion, it tripled in 2002, and has stagnated at around HUF 1,000 billion a year since 2003. As much as 63% of the growth in the debts of the central budget was caused by deficit excluding loan assumption. The deficit was primarily linked to operational expenditures, as a result of which revenues and expenditure savings cannot be expected. The deficit grew despite the fact that the Government has taken several austerity measures since 2003 in order to curb expenditures. However, these measures only temporarily reduced the growth of deficit, because the over-allocation based public finance system practically remained unchanged, and the system of fundable state tasks has not been defined either.

Due to the increasing debt of the central budget, the absolute sum of the interest has been regularly raised. Between 2000 and 2005, interest paid – which forms part of the deficit – equalled 82% of the debt increment of the central budget.

⁵ Due to their nature, the findings of the SAO audits pertain to a longer or shorter period prior to the audits. The reports show the figures of closed financial years. Consequently, our report is based on the experiences of audits inspecting the facts and processes of 2005. However, the trends and conclusions show beyond the given budget year.



The debt of the central budget was also influenced by the fact that the annual deficit of the social security funds grew by more than five times between 2000 and 2005. As much as 25% of the growth in debts was caused by the deficit of the social security funds. Within the funds, the deficit of the Health Insurance Fund was paramount, which was caused by the reduction of contribution rates (revenues), the lack of replacement of lost resources from the central budget, and the fast growth of expenditures (e.g. pharmaceutical subsidies, therapeutic and preventive healthcare services), which exceeded the growth rate of revenues.

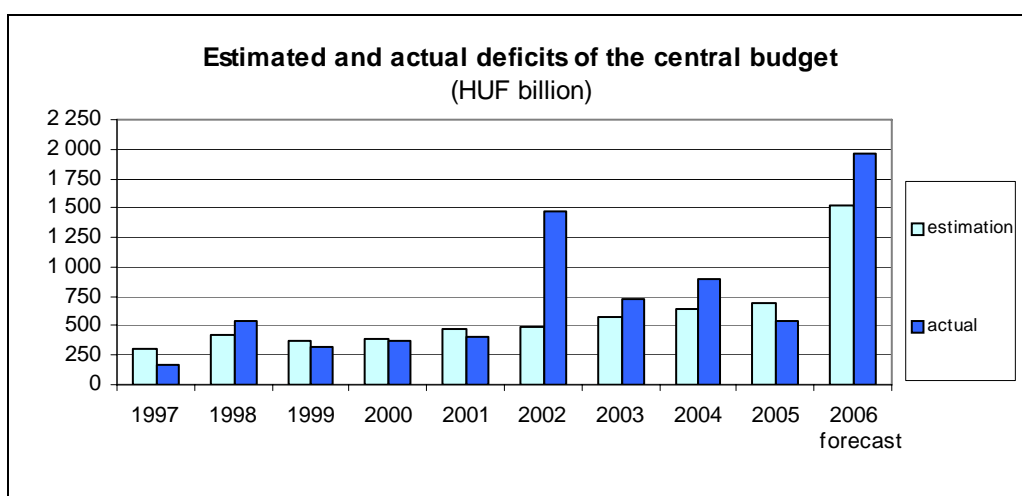
In the audit period, loan assumption increased the public debt by HUF 821.6 billion. A major portion of debt taken over by the Hungarian State from business organisations in 2005 composed of the loan debts of the National Motorway Company (NA Zrt.).

The Government used the one-off, extraordinary revenues from the sale of Budapest Airport Zrt. for the advance redemption and payments on debt.

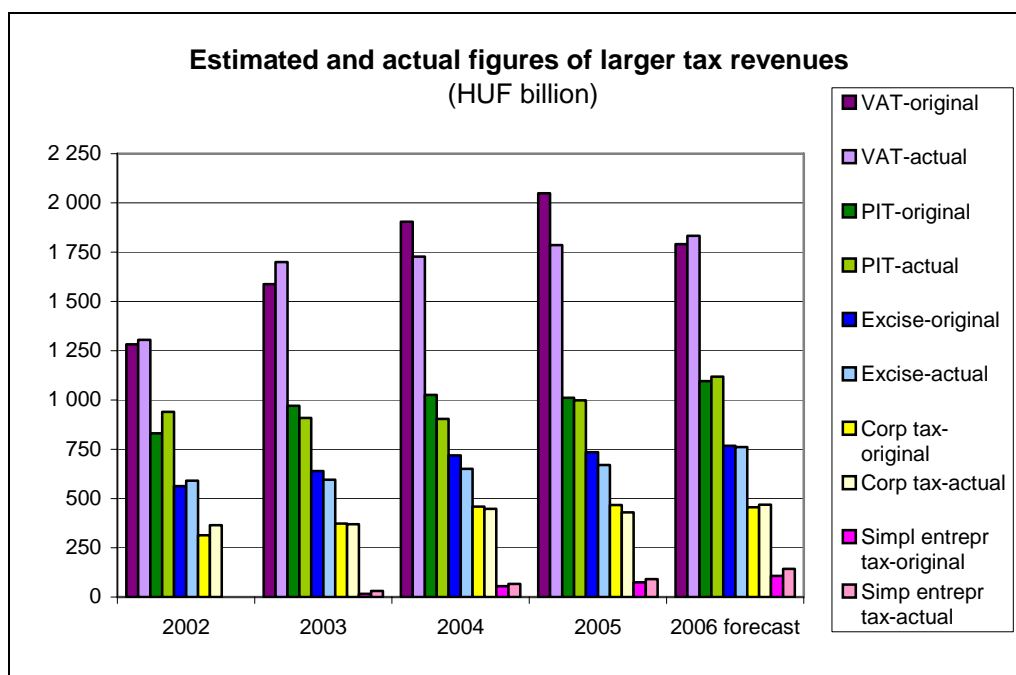
The debt of local governments is increasing, although it does not play a significant role in the growth of public debt. Within the debt of local governments, debts incurred due to developments are a determining factor, however operational debts indicate an unfavourable tendency in the financial management of the local governments.

The further growth of debts, especially if it is coupled with the growth of yields (interests) of debt financing, may lead to the rise in the absolute amount of interest costs, and at the same time **the scope of action of the budget could be reduced even more than today**.

The latest final accounts report issued pursuant to the SAO audit of the execution of the budget for 2005 concluded that **the favourable change in the cash-flow deficit of the central budget** – contrary to the experience of the previous years – **was caused by one-off factors that do not permanently improve the balance of the budget**.



The unrealised **revenues** of the central budget (VAT, corporate income tax, dividend tax, ecotaxes) were only partially offset by certain revenues surpluses (duties, debt service related revenues and other revenues).



From among the **expenditures**, primarily the higher than appropriated expenditures of budgetary organisations and professional chapter managed appropriations, as well as housing subsidies, and additional expenditures related to the debt service and interest payment contributed to the deficit. It is favourable that appropriations that can be exceeded without the modification of the budget were not, or were exceeded to a smaller extent than last year.

The experiences of the audit of the 2005 final accounts still showed that **progress had been achieved neither in the planning method of the revenue appropriations, not in the expenditure structure of the central budget.** The financial and economic effect of restructuring launched in a few chapters could not be quantified. In our audits we continuously

pointed out the lack of harmony between the tasks, the organisational structures and budgetary resources.

It was a strategic objective of the SAO that in a certain group (for nearly 80% of total expenditures) it would **perform final accounts audits to be concluded with a qualified opinion**. We completed the undertaken task. So that the SAO could provide a statement of assurance about the reliability of the report of the audit on the execution of the budget that is submitted to the National Assembly, the final accounts must be audited in a comprehensive manner. In addition to SAO audits this assumes that audits qualifying the institutions are carried out within the framework of the internal audit of the chapters.

With regard to the unfavourable experiences of the former years, no significant progress was made in the field of financial management and reporting discipline in 2005 either. This is primarily due to the not well thought-over restructuring of public administration, which almost continuously ignores the need for reliable accounting of public funds (transfer of assets, closing of financial settlements).

We published a report on the audit of the chapter managed appropriations of the ICSSZEM (Ministry of Youth, Family, Social Affairs and Equal Opportunities) and the GKM (Ministry of Economy and Transport) chapters representing a major share in the central budget with adverse opinion. We found that the financial statement of the NKTH (National Office for Research and Technology) chapter did not present its assets and financial position in a reliable manner. It is noteworthy that the figures of the financial statements of the NKTH and the GKM chapters were unreliable in two successive reporting years (2004 and 2005).

The financial-regularity audits concerning the titles, institutions and chapter managed appropriations concluded with qualified opinion was primarily due to the material problems of the fairness of data pertaining to the assets position shown in the balance, the inadequate operation of the internal control system, the significant errors in the asset balance, and the deviations from the original goals in the utilisation of the funds.

Figures pertaining to the direct expenditures of the central budget were complete and reliable, except for the accounting of housing subsidies with qualified reliability.

The direct revenues shown in the final accounts bill of the central budget were identical with the realised cash-flow amounts both as an aggregate and broken down by revenue types.

When preparing its opinion on the execution of the budget bill for 2007, the SAO repeatedly encountered the lack of efforts for reconsidering the methodology and making the necessary changes in preparing the annual budget plan.

During the preparation of its opinion on the Convergence Programme of September 2006, the SAO lacked the quantification of the impacts of the reforms (measures) presented in the programme. **The budget bill also failed to summarise or deduce the quantified impacts of the planned and already implemented measures and processes.**

Contrary to the former years, **planning was prudent**, which manifested not only in the forecast of macroeconomic processes, but also in the formation of reserves set up with a view to comply with the estimated deficit of the central budget. According to the experiences of the on-site audit, the probability of the realisation of estimated tax revenues of the central budget in 2007 carry lower risks than in the previous years in relation to the value added tax, the personal income tax and the registration tax. In addition, the SAO **drew attention to the risk of the realisation of revenues planned to be yielded from taxes affected by the motion submitted to the Constitutional Court** (the so called minimum tax, which forms part of the corporate income tax and the contribution payable by credit institutions). (The revenues planned to be yielded in 2007 totalled HUF 80 billion)⁶.

The tax changes that serve as a basis for the 2007 central budget (and the Convergence Programme) do not show the direction of a solution for the long-standing problems and modernisation of the tax system. The introduction of tax changes mid-year weakens legal security, and consequently reduces the predictability of the operational conditions of financial management.

In the preparation of the 2007 budget, **priority was given to the planning** of domestic co-financing appropriations ensuring the utilisation of **EU funds and subsidies**. The coverage required for the utilisation of the funds was ensured by the budget bill, however the creation of the guarantees for the use and utilisation of EU subsidies is not primarily a planning task: it rather depends on the expedient and competent activities of the authorities that are responsible for running the programmes.

One of the top priority objectives of the Convergence Programme is **to reduce the expenditures of the institutional system performing state tasks**. The government programme also outlined the major forms of restructuring in relation to the “smaller and more efficient” state. In contrast with this, while the dominant element of the measures described in the Convergence Programme and of the budget bill for 2007 was the **downsizing in the public sector, there was hardly any trace of the review of the performance and organisational frameworks of state tasks, or the**

⁶ There are several motions on the agenda of the Constitutional Court. The expected tax and the petty cash tax were annulled by Resolutions 8/2007 (II. 28.) and 61/2006 (XI. 15.) of the Constitutional Court, respectively.

definition of performance requirements pertaining to state tasks. We saw initial steps in this direction only in three chapters⁷.

Our audit experiences showed that the conditions of public finances cannot be improved in the long run if the governmental staff is reduced without adequate task analysis and differentiation. The experiences gained during the preparation of the SAO opinion about the 2007 budget bill, the lack of preparatory measures concerning the concepts pertaining to the restructuring of the public sector may hinder and delay compliance with the deadlines set in the Convergence Programme.

Major experiences of comprehensive audits of the chapters

The SAO **audits the operations of the chapters at regular intervals.** Last time we conducted comprehensive audits at seven chapters⁸ in relation to the years 2002 through 2005. In the subject period certain chapters were established, others were terminated, and the tasks and institutional system of the chapters were modified several times, primarily due to changes in government. **The restructuring of the government in the middle of the year, as well as the regrouping of tasks and appropriations among the chapters caused problems in the continuous, smooth and quality performance of the tasks.** The risk was augmented by the high level of fluctuation in the management and staff alike.

Restructuring **was not supported by documents** that unanimously would indicate efforts to enhance the efficiency of government work and to reduce costs. It could be sensed that the lack of elaborated, well prepared government decisions, the frequent regrouping of tasks and institutions among chapters, as well as the changes increased the inherent risks. Due to the constantly changing task sharing within the government no stable task and institutional system could be developed in the affected chapters. In fact, the government decrees regulating the operation and organisational structure of such institutions were modified several times during the subject period.

The SAO encountered a positive example in the “Prosecution Service of the Republic of Hungary” chapter, where the growth in legal tasks and compliance with the EU requirements were followed by the development of a generally successful operational system, which led to the establishment of a clearly structured organisation that operates accurately in terms of professional and economic competencies and powers alike.

⁷ According to the SAO’s opinion on the budget bill for 2007, these chapters are: Ministry of Local Government and Regional Development (ÖTM), Ministry of Agriculture and Rural Development (FVM), Ministry of Health (EÜM).

⁸ These chapters are: the Prime Ministeriate, the Prosecution Service of the Republic of Hungary, Ministry of the Interior, Ministry of Environment and Water, the Regional Development Chapter, Ministry of Youth, Family, Social Affairs and Equal Opportunities, and the Hungarian Academy of Sciences.

Restructuring carried out in the subject period – including mid-year restructuring – were not properly well thought-over either for the tasks to be performed, or the economic, financial and accounting processes. Although the agreements contained detailed information about the staff, the jobs, the assets and property, they did not specify the transfer of tasks. The ratio of state and other managers (including executive level managers, too) was significant in the audited chapters, and the number of agency contracts was high.

We concluded that in most cases the monitoring system assisting the decision-making mechanism and the properly managed, updated and controlled database **were not developed.** There was no in-depth reporting system in place, and no emphasis was placed on the evaluation of the effectiveness of the utilisation of resources. System audits were given preference, however the reliability audits of intuitional financial statements were not given due attention, and audits evaluating the internal control systems of the institutions were also nonexistent. The audit capacity allocated for the implementation of the annual audit plans was not always sufficient.

2.1.2. Separated state funds

The subsystem of separated state funds consists of three funds: the Labour Market Fund, the Central Nuclear Financial Fund, the Wesselényi Miklós Flood and Inland Waters Compensation Fund, the Research and Technology Innovation Fund and the Homeland Fund.

In line with the legal regulations, the financial statements of the funds are audited by a chartered accountant. During the evaluation of their financial management in 2005, all funds were given an unqualified opinion. The opinion of the Labour Market Fund was supplemented with an “emphasis of matter” paragraph.

The weight of this subsystem within the state budget grew primarily due to the rise in revenues and total expenditures, however it is still not significant proportionately. The financial position of the funds was balanced in 2005. Their surplus of HUF 30 billion improved the balance of public finances.

In terms of budget size, the **Labour Market Fund** is still the largest among the funds of this subsystem. It fulfils the 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 active and passive employment policy tools changed to the benefit of the latter. **The amount and proportion of subsidies for active employment policy objectives continue to decrease.**

The SAO has reiterated the need for the review of the planning system, the budgetary relations and the legal background of the Labour Market Fund for

years. The Fund still spends more and more on the organisational expenses of organisations that are directly or indirectly linked to the Labour Market Fund (organisations that implement the tasks of the Fund or participate in the distribution of the Fund's financial means).

The **Central Nuclear Financial Fund** is responsible for the establishment and operation of storage facilities used for the permanent or temporary disposal of radioactive waste and spent fuel, as well as for funding the dismantling of nuclear facilities. The Fund's appropriations were practically observed. **Its accumulated balance grew.**

In the years 2004 through 2006 (and also in 2007), the legal appropriations of the Fund's budget were considerably smaller than the amounts specified in the medium- and long-term professional plans. The lack of resources may cause the cancellation of or delay in the fulfilment of certain tasks. The implementation of the long-term objectives and obligations can be significantly influenced by the scope of action of the Fund's budget to be determined for the coming years, including the opening of the budget reserves.

The **Wesselényi Miklós Flood and Inland Waters Compensation Fund**, which was set up to mitigate the damage that the population incurred due to floods and inland waters, started its actual operation only in 2004. However, the findings seem to justify those doubts that we raised already in the report on auditing the 2003 final accounts.

In spite of the expectations, the residents living in the endangered areas have not yet been involved in the damage mitigation procedures on the basis of the insurance principle. **Most of the revenues come from budgetary subsidies.** We believe that this does not satisfy the condition specified in the Act on Public Finances, according to which funds coming from sources outside public finances must also be allocated to task performance when separated state funds are set up. Such funds account for only 1.7% of revenues, which would be insufficient to offset a major loss, even in the current group.

Not even the frequent and serious floods and inland water disasters of the past period could encourage people living in the endangered areas to take out an insurance, which is due to the lack of sufficient demand and the ability of self-support. The operations of the Fund in 2005 reinforced our former position in which we questioned the maintenance of this fund as a separated state fund.

The **Research and Technology Innovation Fund** aims to improve Hungary's economic competitiveness by increasing resources that can be spent on research development. The Fund's two main sources of revenues are the innovation contribution from the business organisations and budgetary subsidies. **The Fund's financial position was stable in 2005, it closed the subject year with a surplus.**

The Government Decree specifying the rules pertaining to the operation and utilisation of the Fund does not provide unanimous guidance regarding the size and group of individual subsidies. The rights and responsibilities related to the Fund were not fully enforced.

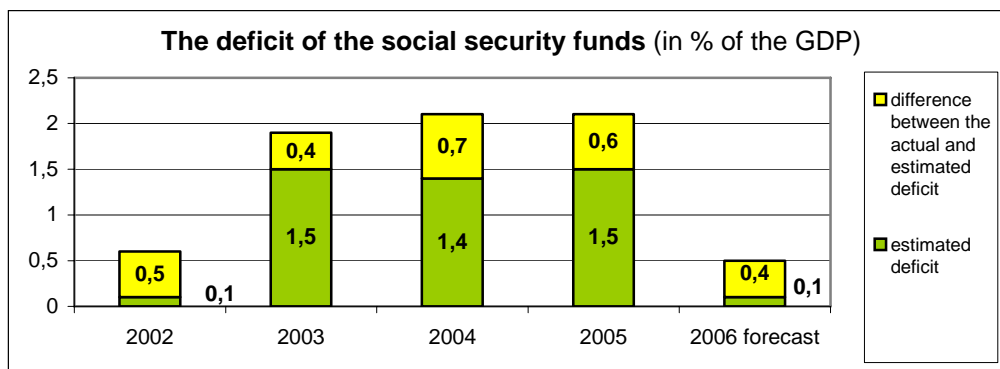
We indicated that **there was no adequate harmony between the different levels of legal regulation**, and that the activities and decision-making mechanism of organisations involved in the operation of the Fund, as well as the operation of the tendering system was not always in line with the legal requirements. During the audit of the Fund's final accounts for 2005 these problems practically still existed.

The **Homeland Fund** was set up in 2005 as a new separated state fund, with an initial capital of HUF 1 billion. 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.

2.1.3. Social security funds

The financial statements of the Health Insurance Fund and the Pension Insurance Fund that form the social security subsystem of public finances were audited by chartered accountants in 2005, too, in compliance with the legal provision. Both funds were granted unqualified opinions, according to which the statements give a true and fair view on the property, financial and earnings position of the funds.

The financial position of both funds was less favourable than planned. As a result, the consolidated deficit totalled HUF 468.8 billion. Within this, the deficit of the Pension Insurance Fund was HUF 93.5 billion, while the deficit of the Health Insurance Fund equalled to HUF 375.3 billion.

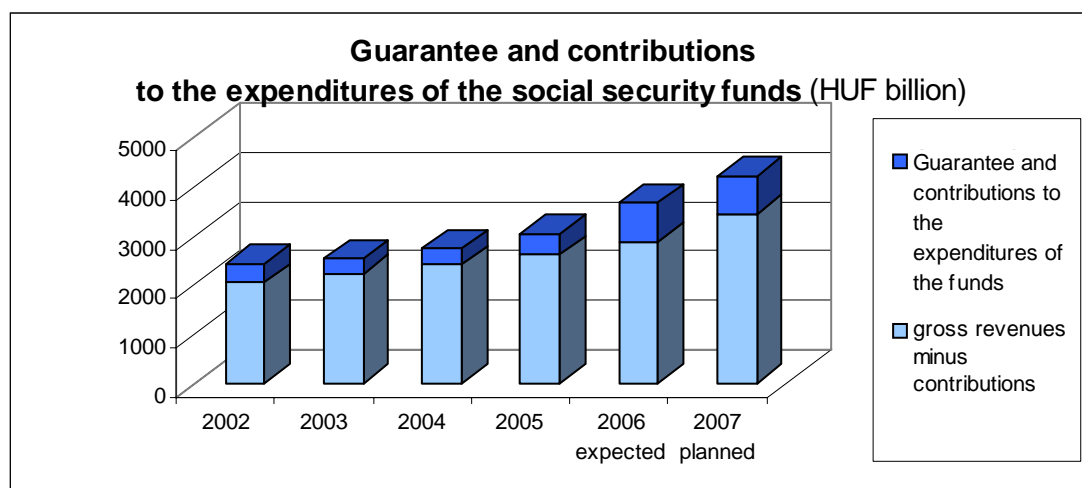


In our reports on the final accounts we have highlighted the problem of the permanent and increasing deficit of the funds and the disturbed balance of revenues and expenditures for years.

The expenditure appropriation for cash **health insurance benefits** and for curative and preventive healthcare services for 2005 were in line with the actual performance figures. The surplus of curative and preventive healthcare services was exclusively used to cover the wage measures, and to equalise and develop family healthcare capacities and capacities accepted in outpatient and inpatient healthcare services.

The efforts made to curb **pharmaceutical expenditures** linked to residential consumption failed again in 2005. This is especially true for contracts signed for the protection of the pharmaceutical fund, where even the significant payments made by the manufacturers (HUF 23 billion) were insufficient to offset excess expenditures. We found it necessary to develop a longer term concept for the pharmaceutical supply system – in harmony with the reform steps of the healthcare reform – which would focus on the review of drugs classified on the basis of pharmacological activity, as well as the development of the subsidy and reception system, which fosters the use of less expensive and more modern drugs and keeps the health interests of the population in mind.

According to the findings of the audit on the operation of the Health Insurance Fund, the steadily growing deficit of the Health Insurance Fund can be attributed to the decreasing number of contribution payers, the increasing use of services by persons not paying contribution, as well as the incommensurate growth of certain service expenditures. The growth of the deficit was primarily due to changes arising from the pay rise in the field of curative and preventive services, and due to fast growing pharmaceutical subsidies.



The growth in expenditures was influenced by the fact that it was not required to fund healthcare services in the most cost-effective manner, based on possible professional procedures, the real costs of services were not known by the organisation that set the charges, and the latest comprehensive cost survey was carried out in 1999. Funding of the specialised healthcare services was more about the maintenance of the existing supply system than funding performances justified by the citizens' state of health on the basis of real expenditures.

The Fund Manager could not really influence changes in and the realisation of revenues. The National Health Insurance Fund Administrator (OEP) could at best influence changes in expenditures by screening illegally provided, used or accounted services when performing funding and audit tasks.

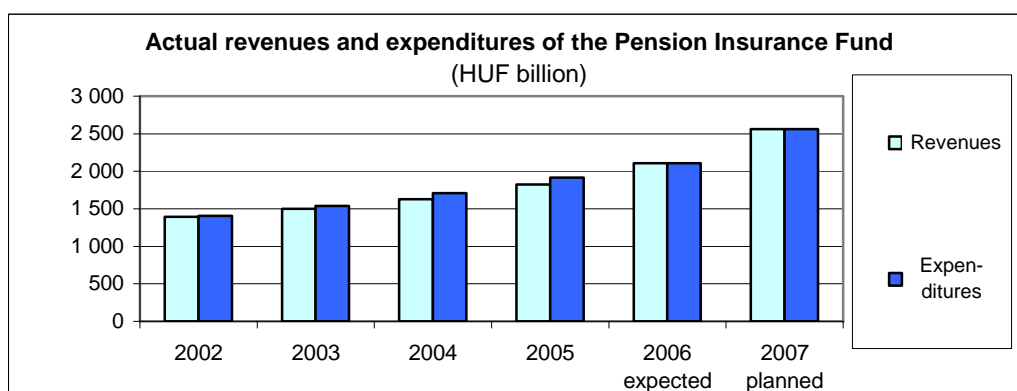
After the introduction of funding specialised healthcare services on the basis of a quantitative limit, the growth rate of the expenditures on curative and preventive healthcare services decreased. The agreements signed with the pharmaceutical manufacturers and distributors did not restrain the growth rate of pharmaceutical subsidies. Measures taken to curb price subsidies on therapeutic equipment stalled.

Cash benefits are available to those persons who pay contributions in their own names. The automatic control system that should check the use of services/benefits based on mandatory contribution payment, as well as mandatory contribution payment on the basis of the registration of the legal relationships has not been fully established. On top of that, the operational budget of the OEP only slightly grew, which was not in harmony with the increased tasks.

The financial position of the **Pension Insurance Fund** deteriorated in 2005, which was primarily due to the higher than planned growth of pension expenditures.

The revenues and supply budget plan of the Pension Insurance Fund for 2007 are realistic and justified, and most probably it will require a liquidity loan smaller than in the previous years.

On the revenue side of the Fund, the growth in the rate of contribution payable by the employer will reduce the share of the central budget in funding pension expenditures. Pension expenditures are expected to rise in the long run, but the growth rate may be influenced by the series of measures planned to have a long-term effect.



Due to the scarcity of authorised operational expenditures, the financial management of the Central Administration of National Pension Insurance (ONYF) is still in the “forced orbit” mode. The requirements pertaining to the civil servants’ wage categories can only be met if redundancies are made. We concluded that the shortage of non-personnel expenditures and cumulative expenditures deteriorates the operability of the sector.

The expenditure sides of the 2007 budgets of the social security funds continue to imply several risks. Based on the documents available to us, we found that the revenue appropriations for 2007 were altogether

well-founded in both funds. On the expenditure side we believe that observation of the appropriations for curative and preventive healthcare services, pharmaceutical subsidies and therapeutic equipment carries risks.

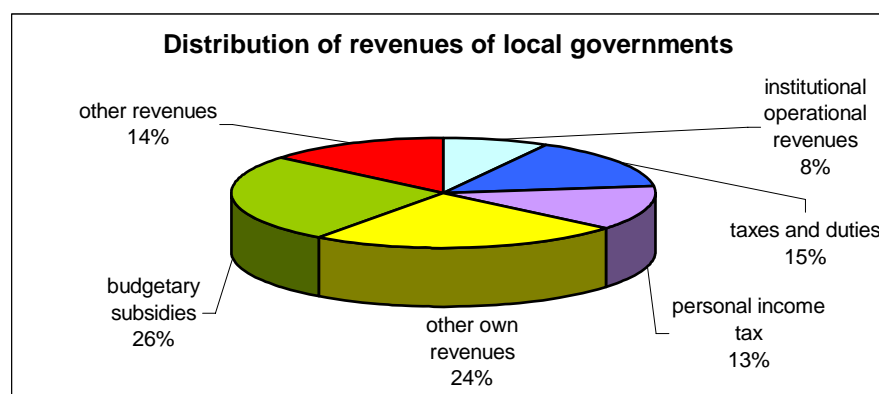
The permanent reduction of expenditures requires the restructuring of the **healthcare, pension and pharmaceutical subsidy systems.** The requirements specified in the Convergence Programme were met on the level of theory in the budget proposals. **In the case of the Health Insurance Fund the precondition for implementation is the consistent implementation of the set objectives and the necessary measures – including the wide range of legislative amendments –, while in the case of the Pension Insurance Fund the precondition is the achievement of the expected macroeconomic indicators.**

The series of measures may launch the restructuring process that forces healthcare service providers to explore their internal reserves, streamline their financial management, perform restructuring by using central incentives, and downsize unnecessary capacities. Results may also be achieved through the regional cooperation of institutions.

From among the factors influencing the development of the curative and preventive appropriation we must point out that the national basic fees introduced in 2006 are expected to remain unchanged in 2007. According to the plans, performance funding based on quantitative restrictions will be maintained in its current form. Technically, the risks of this closed fund can only be reduced if these two factors are used concurrently.

2.1.4. Local governments

The consolidated revenues (HUF 3,365 billion) and expenditures (HUF 3,036 billion) of the 3,187 local governments and 1,825 local minority self-governments that form the local governmental subsystem of public finances were both 10% higher than in the previous year. Within this increment, the amount of loans grew at a considerable rate. The total debts of local governments arising from credits and loans equalled to HUF 385 billion at the end of 2005, i.e. 18% more than a year before, and this growth will presumably continue in 2006, too.



The assets of the local governments presented in the balance sheet totalled HUF 9,861 billion at the end of 2005, and are expected to reach HUF 10,000 billion in 2006. Compared to the previous years, a major change occurred in the stock of securities and the level of liabilities. The stock of securities owned by the local governments decreased, which was typically caused by the sale of government securities received to offset the privatisation of gas public utilities. Liabilities increased due to the repayment obligations related to the growing loans. Within the loans there was a growth in the ratio of short-term liquid loans. Monetary funds were less and less sufficient to cover short-term liabilities⁹.

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

In 2005, the budget was again unable to ease the long-established tension between **the tasks of the local governments and the available resources**. Contrary to the relevant government decrees, the tasks and scopes were not reviewed. For the lack of political and professional consensus, no significant progress was made in the preparation of the funding reform the SAO has encouraged for over 10 years. The mandatory tasks of the local governments were not reviewed, the local governmental tasks and scopes were neither assigned specifically, nor modified in a comprehensive manner, and resource regulation was not further developed in harmony with the aforesaid. It is still typical that the budget does not provide full financial coverage for new tasks local governments are mandated to fulfil (e.g. wage measures in the public sector). The financial conditions of the financial management of the local governments were significantly affected by other factors, too (e.g. baseline reductions, formation of general government reserves, lack of compensation for the effects of price hikes and changes in the VAT rates).

In the resource regulation system operated pursuant to the Act on Local Governments, **the specific amount of normative subsidies is first of all determined by the annual budget planning requirements, professional policy preferences and priorities**. All this hindered cost analysis, the analysis of the ratio of state subsidies and the prime costs of the activities at sectoral level, as well as the treatment thereof in line with its level of importance. **Accountability is made even more difficult by the almost across-the-board lack of a reliable and relevant financial information system, which is a prerequisite for transparency, as well as the development and enforcement of performance requirements**. The general lack of resources is indicated by increasing ÖNHIKI (subsidies for local governments with financial problems through no faults of their own) applications for funds by local governments. At the same time, however, in the past 10 years debt management procedures were launched only at 17 local governments of small settlements that had limited financial conditions for economic independence.

⁹ The liquidity quick ratio (quick assets/current liabilities) was 1.0 and 0.8 in 2004 and at the end of 2005, respectively. Presumably, the trend continued in 2006.

The system of subsidies and contributions to the provision of local governmental tasks is still fractured, and the complexity of related numerous professional, financial, utilisation and accounting rules also implies a major source of error.

In 2005, the local governments were eligible for HUF 884.1 billion as state subsidies and HUF 465.6 billion from the personal income tax revenues, i.e. altogether HUF 1,349.7 billion. The budget act **mandates the local governments to form general government reserves**. The relevant provision contained regulatory contradictions, and disregarded certain provisions of the Act on Public Finances. The expenditure reducing effect of this provision could not be perceived at local level, because the short-term operational loans of the local governments increased by 34% compared to the previous year. Pursuant to our recommendation, the budget act for 2007 does not contain such a provision.

The regular use and accounting of normative contributions was made difficult and the risk of making mistakes was increased by the fact that the relevant legal regulations are significantly modified year after year. The regulation reflected that no significant progress was made in the implementation of the provisions of the government decree on the modernisation programme of public administration services¹⁰. The system of normative contributions available to the local governments did not become more transparent, the frequent changes in the application criteria and the regulatory shortcomings do not allow local governments to predict the size of revenues from the central budget.

For years, the central budget has been striving to achieve the more efficient operation and more rational task performance of public administration by providing significant central appropriations for staff reduction. **However, from time to time staff reductions are followed by staff increases, partly due to the expansion of tasks to be performed by the local governments.**

The use of the large amount of centralised appropriations allocated in a tender-based system would be facilitated by a further shift towards normative support. **The selection criteria for subsidies to multifunctional small regional associations are wide-ranging, complex and complicated, wherefore they are difficult to handle.** In their current form, the application, accounting and audit tasks of supplementary subsidies that belong to this group are disproportionately labour intensive, which fosters neither efficiency, nor expedient utilisation. It must be ensured that resources allocated in the tender-based system should be made available to the local governments within a timeframe that would allow them to utilise the resources in the subject year.

The gradual transformation of the system of normative contributions and subsidies started with the budget bill for 2007. From the 2007/2008

¹⁰ Government Decree 1113/2003. (XI. 11.) on the modernisation programme of public administration services IV. Modernisation of the local governmental system, Section 2

academic year onwards central budgetary support will be provided on the basis of the so called “public education performance indicator”, which is simultaneously able to present the quantity and level of organisation of the tasks, as well as the cost ratios. Task performance by multifunctional small regional associations will be further encouraged in 2007.

A major element of development subsidies in the past few years has composed of earmarked and target subsidies. Within this, since 1999 priority has been given to canalisation and sewage treatment projects, which help reduce the disparities in public utility services and get closer to compliance with the environmental requirements of the European Union. As far as the decentralisation of development decisions is concerned, we regard it as a great step forward that since the enactment of the Act on Regional Development and Land Use Planning, an increasing role was assigned to the regional development councils in addition to the county development councils on regional development. The shift of the decision-making competences to the regional level in relation to local governmental development subsidies under various legal titles may foster the better harmonisation of development objectives, the enforcement of economy of scale requirements for the investment projects, as well as more competent, cost-effective and efficient task performance.

In line with the former SAO recommendations, the amendments of the Act on Earmarked and Target Subsidies for Local Governments in effect since 2005 aimed at the liquidation of the “multi-channel” subsidy system for local governmental projects, and the establishment of a less complicated and more efficient “single channel” system, **the favourable effects of which could be perceived during the SAO audit carried out in 2006.** Other monetary resources – which were smaller in number than before – were available in time for 84% of the projects, and could thus ensure continuous project funding.

The rules for the utilisation of development subsidies granted to the local governments were further clarified. We find it positive that in line with the SAO recommendation made in 2004, a standard regulation was developed for the utilisation of TERKI (subsidy for the reduction of regional disparities) and CÉDE (Earmarked Decentralised Support Scheme) subsidies, on the basis of which **monitoring incorporated into the work process was performed in relation to both types of subsidies** in the county regional development councils.

The SAO performed an itemised audit in relation to contributions and subsidies of HUF 200.6 billion accounted by the local governments. The revealed discrepancy totalled HUF 657 million, the error ratio was 0.33%. The reports of the local governments on subsidies received from the central budget provided a true and fair view with regard to materiality. Subsidies and contributions were transferred to the local government in compliance with the regulations.

We drew attention to the fact that among the centralised appropriations the error ratio was 4.8% in the accounting of public utility subsidies extended to the citizens, 2.7% in case of subsidies transferred to support the implementation of secondary school final and vocational exams, 2.3% in the

case of subsidies extended to support the preparation of secondary school teachers for the implementation of two-level final exams (normative, target-linked supports), and 2.1% in the case of subsidies provided for social further training courses and qualifying exams.

General findings of comprehensive audits of local governments

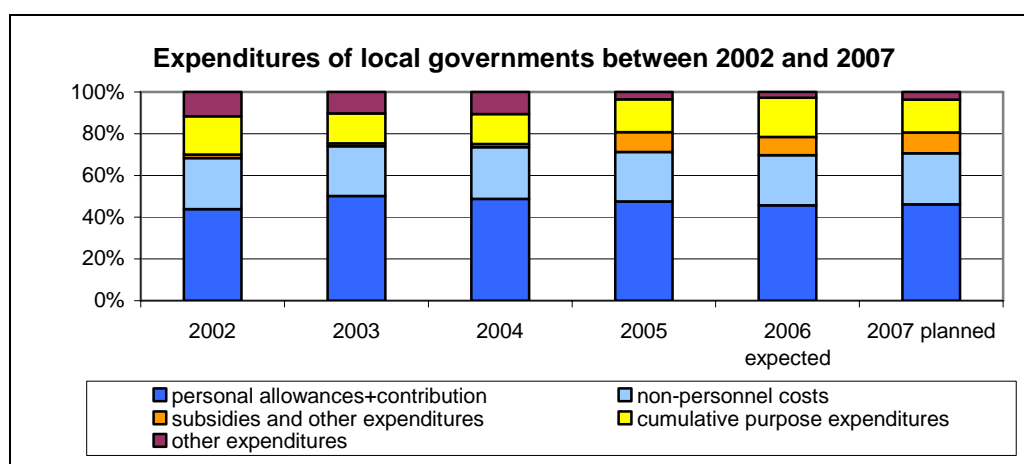
In its strategy for the years 2002 through 2006 the SAO set forth a strategic objective, according to which it would focus its audit capacity on local governments of counties and cities, the metropolitan government of Budapest and the local governments of the districts of Budapest that possess significant budgets or assets, and that it would conduct one comprehensive audit per each parliamentary cycle in this group of local governments. In Resolution No. 35/2003. (IV.9.) the National Assembly approved the formulated objective, and then Parliamentary resolution No. 47/2006. (X. 27.) confirmed the fulfilment of the task. By the end of 2006, the SAO conducted comprehensive and other regularity audits at 2,446 local and minority governments.

Number of local governments subjected to the comprehensive and other regularity audits of the financial management of local and local minority governments

Description	2003	2004	2005	2006	2003-2006 total
Budapest capital	1	1	1	1	4
county	4	6	4	5	19
city with county rank	6	4	6	6	22
metropolitan district	6	6	5	6	23
city	54	64	65	72	255
town	27	22	21	9	79
village	252	268	715	394	1,629
Total:	350	371	817	493	2,031
minority local governments	123	150	71	71	415
Grand total:	473	521	888	564	2,446

Among top priority local governments and town local governments the ratio of local governments having economic programmes increased compared to the previous years¹¹. Nearly half of the local governments violated the provision of the Act on Public Finances, and failed to present the amount of the planned deficit **in the budget decrees**, and considered funding purpose financial transactions as budget revenue and expenditure. A greater proportion of the approved budgets complied with the format and content related legal requirements than in the previous years, however, similarly to the former years, the local governments did not, or only partially determine the local rules related to the execution of the budget. Nearly one fourth of the local governments failed to present the quantification broken down annually and the narrative explanation of decisions with multi-year impacts, and slightly more than half of them did not provide a narrative explanation for indirect subsidies.

¹¹ Pursuant to our recommendation, in 2005 the National Assembly determined the content requirements of the economic programme.



The scopes of authority related to **assets management** were regulated by almost all local governments in their assets management decrees, however the regulations often contradicted the provisions of the Act on Public Finances and in some cases they were not reasonable. The regularity of assets management did not improve compared to the previous years. During the privatisation processes, more than one third of the local governments failed to observe the provision pertaining to the mandatory tendering procedure. The regulatory shortcomings of asset management and privatisation conducted without competitive bidding did not foster the publicity and transparency of the management of local governmental assets. Several local governments transferred the ownership right of water public utilities belonging to the core assets, and thus violated the Act on Local Governments and the act concerning water public utilities. More than one third of the audited local governments purchased, while two thirds sold securities. Nearly one third of the sales and purchases was realised in a manner different from the requirements set forth in the budget or asset management decree of the respective local governments. One fourth of the local governments did not, or did not completely fulfil their publicity obligation set forth in the Act on Public Finances. Claims were abandoned at nearly one third of the local governments, and assets were transferred free in about half of the local governments. Contrary to the relevant provision of the Act on Public Finances, one fifth of the local governments did not specify, in the form of a decree, the method and cases of claim abandonment, and the cases of free asset transfers.

Compliance with the **stock-taking** obligation pertaining to assets presented in the books improved compared to the former years. The need for accounting depreciation was examined by more than 50% of the local governmental offices, however 15% and one third of those local governments failed to account depreciation in the case of outstanding debts and business shares, respectively.

Disregarding the provisions of the Act on Public Procurement, **nearly one third of the audited local governments failed to conduct the public procurement procedure**. The Public Procurement Arbitration Committee condemned one fifth of local governments conducting public procurement procedures for violating the provisions of the Act on Public Procurement.

Compliance with the public procurement rules is regarded as a high risk area in the financial management of the local governments.

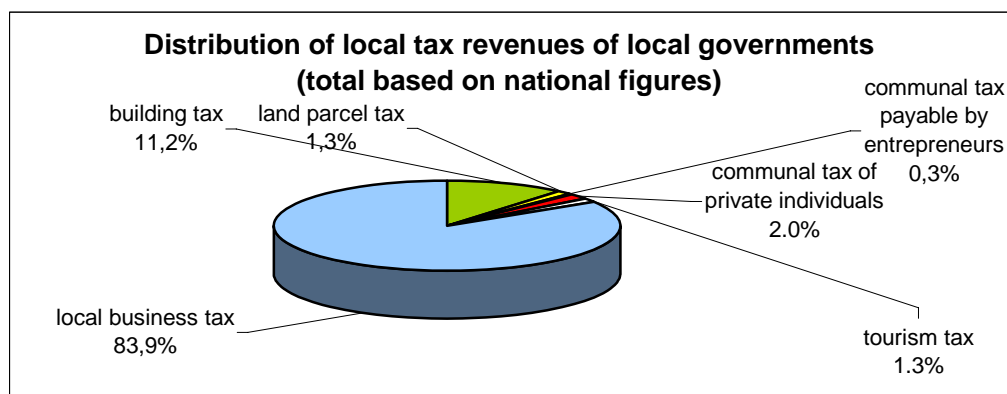
Each year, the local governments transfer increasing funds **as target subsidy** to foundations, public foundations, other non-profit organisations, businesses, households, budgetary organisations others than the local governments' own institutions and to foreign communities for operational and cumulative purposes. The local governments specified the amount of the transferred subsidy, the supported objective, the method and deadline of compliance with the accounting obligation pertaining to the utilisation of the subsidy to a greater extent than in the previous year. Nearly one third of the beneficiaries complied with the accounting obligation with the required content and by the given deadline. **Contrary to the relevant provisions of the Act on Public Finances, the accounts were not checked by one fifth of the local governments, and nearly 90% of them did not check whether the subsidies were used for the designated purpose.**

The regularity of the financial management of the audited local minority self-governments improved compared to the previous years. Similarly to the local minority self-governments audited in the previous years, their tasks primarily included the creation of conditions for the operation of the body of the local government, the representation of the interests of ethnic minorities living in the settlements and the preservation of the traditions of the ethnic minorities.

The **budgetary balance** of the local governments did not improve compared to the previous years. Nearly two thirds of the audited local governments planned budgetary deficits both in the operational and accumulative expenditures, similarly to the former years. Budgetary deficits were partially caused by the irrational organisation of task performance, the low utilisation of institutional capacities, undertaking voluntary tasks over the load-bearing capacity, and planning errors (underplanning of own resources and overplanning of expenditures).

As a result of local governmental measures taken with a view to improve the balance, only one third of the audited local governments had budgetary deficits by the end of the year. The planned deficit was reduced during the execution of the budget by resources obtained in tendering procedures, the surplus own revenues, surplus revenues from the sale of assets, as well as surplus revenues realised due to inadequate planning. With a view to reduce expenditures, two thirds of the local governments initiated various measures, rescheduled or postponed the implementation of certain planned tasks.

Among own **revenues, local tax revenues** represented a significant factor in improving the balance, the rate of which within operational revenues grew from 14.6% in 2003 to 15.8% in 2005 and 2006 at the audited local governments, and is expected to reach around 18% in 2007. On average, the set tax rates reached three quarters of the maximum tax rates specified by law. Under various legal titles the local governments provided further discounts and exemptions in addition to those specified in the legal regulations. Among the local taxes the local business tax continues to be the most significant, which amounted to HUF 334 billion in 2005.



Two thirds of the audited local governments decided to undertake **debt generating liabilities**, most often in the form of loans. The audited local governments complied with their loan repayment obligations for the subject year partly with the help of new loans, which further deteriorated the financial situation. Nearly half of the local governments failed to repay liquid loans taken out during the year by the end of the year, which therefore burdened the budget of the following year.

Contrary to the provisions of the Act on Public Finances, over one fourth of the **draft decrees of final accounts of local governments** were prepared in a manner prohibiting comparison with the budget. Over half of the decrees did not contain the balance sheets and financial statements for information purposes, as specified in the Act on Public Finances. Contrary to the Government Decree on the operational rules of public finances (Ámr.), in over one fourth of the local governments the financial residue was approved during the approval of the final accounts, but it was not presented properly, namely divided by its budgetary organisations.

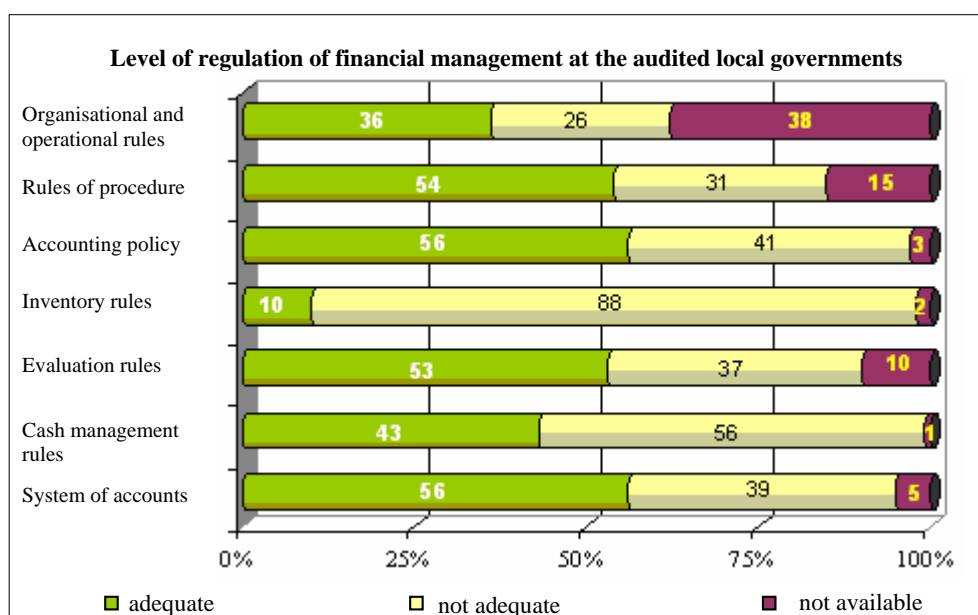
IT supported financial and accounting activities are gaining space in the local governmental offices, however integrated, complex IT systems based on systemised principles have been developed only in a few local governmental offices so far. For the lack of an integrated IT system, computer software applications and manual analytical registrations were also used for the financial and accounting tasks.

At the local governments audited in 2006, expenditures allocated **for social and public education tasks** grew by 11% in three years. In the case of all local governmental tasks, the annual impact of the implemented public employee wage measures, the growth of non-personnel expenditures (among which the changes in energy prices were the most significant), as well as the changes in the VAT rate of public utility services significantly contributed to rise in operational expenditures.

At the audited local governments the performance of mandatory tasks was not threatened by the funding and rate of **voluntary tasks**.

The **regularity of the local governments' financial management improved**, the number of local governments possessing the mandatory

regulations increased. However, the quality of the regulations did not improve at the local governments of villages and large villages.



In the **books** of the local governments, the local governmental offices accounted the overwhelming majority of economic events on the basis of accounting records prescribed by the Act on Accounting, similarly to the previous year. However, in all types of local government the rate of accounting records containing errors in format or content exceeded 50%.

Regulatory deficiencies also contributed to the fact that the quality of **financial management controls** did not improve compared to the previous years. The financial management tasks and the financial management control were not, or not completely fulfilled. Due to the deficiencies found there is a high risk that the internal control system of the local governments will not be able to prevent or indicate major errors or irregularities.

The performance of **internal audit tasks** was more favourable than in the previous year, because progress was made in the development of the internal audit organisation, the raising of resources required for operation, the preparation and approval of internal audit manuals, as well as in the number and professional knowledge of the employed internal auditors. The functional and organisational independence of officials fulfilling internal audit tasks improved. The quality of the implementation of internal audits, the usefulness and utilisation of the audits continue to be unsatisfactory.

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

In the past years we paid special attention to continuing the conceptional, interrelated audits of major public services with a view to assist legislative

work, foster the efficient utilisation of public funds, explore saving possibilities and improve services provided to the population.

In line with its strategic objective, the SAO decided to perform the comparative audit of the **funding solutions of motorway investment projects**, relying on the experiences of former audits, too. Since 1997, each Government has determined the medium-term programme for the development of expressways in Hungary. However, long-term funding programmes adjusted to the motorway developments, and supporting cost-effectiveness calculations have not been prepared. Each Government could select the form of funding at its own discretion. Changes in the forms of funding have been related to the current status of the budget and the decided schedule of motorway developments. The primary aspect in funding was the application of funding solutions that are gentle to the budget of the current year. This approach has become stronger and stronger since Hungary's accession to the EU. Consequently, while the construction of the network of expressways has implied growing expenditures at the level of the national economy, the direct role of the budget has decreased.

From 1990 through 30 June 2006 altogether a 603 km long expressway (27 sections) opened to traffic. Of these sections, one section was constructed in the PPP scheme, 8 pursuant to concessional agreements, and the construction of 18 sections was funded by the state. In the case of the latter funding form, funds were provided in part directly from the central budget, and in part from loans taken out with state guarantee.

The elaboration of the Act CXXVIII of 2003 (Aptv) on the Public Interest and Development of the Expressway Network in the Republic of Hungary had a favourable effect. However, in the two and a half years that have passed since its enactment the act has been amended 8 times. Amendments affected funding as well as the tasks of organisations involved in motorway construction. Such frequent modifications of the law do not foster the predictability of the legal regulation of motorway developments, and also increase the risks inherent in task performance.

In addition to the funding solutions applied, the costs of the development of the network of expressways in Hungary were also influenced and increased by the conditions of construction. The scarcity of funds, the shortening of the time period available for construction, the limited nature of construction capacity appeared as price raising factors in the construction of motorways ordered by the state. Accelerated motorway construction also resulted in the fact that on certain sections there were no detailed working drawings, for instance, which implied the risk of price rises. **The funding of motorway developments have always, but especially since the turn of the millennium reflected the problems with the balance of public finances.** The lack of funding plans for the different motorway sections, the primary aspects of the reduction of current budget expenditures, the preferences related to the starting date of construction and hand-over did not foster cost-efficient funding.

The audit of the maintenance of state-owned public roads extended to state-owned non expressway roads and the entities maintaining such roads. In

2005, acting as the owner, the Ministry of Economy and Transport merged the county public benefit associations into ÁKMI Kht (Technical and Information Services on National Roads Public Benefit Association) – but maintained the Road Management and Coordination Directorate. This restructuring was not preceded by a preliminary impact assessment study of the organisations and their tasks. Furthermore, the expected cost-efficiency objectives and the financial impacts could not be evaluated due to the shortage of time that has elapsed since then.

With the exception of the Széchenyi Plus Programme, there was no comprehensive development concept in the subject period. Within the framework of on-site audits we examined 33 projects. Indicators to assess target achievement were specified only in development projects implemented under the Environmental Protection and Infrastructure Operational Programme. **Indicators were also specified** for “purely national” development projects, however **their implementation was not traced**.

While the development of public roads was given utmost attention – partly due to the available EU funds, resources designed to maintain and improve the condition of the existing road network were not increased. Consequently, in relation to the state of repair of the public roads, only the performance of minimum, “C” level works was set as a basic requirement. **As much as 30% of the roads needs immediate repair**. With the exception of one indicator (load-bearing capacity) all other indicators (changes in the state of repair, unevenness, surface intactness) deteriorated. Due to unrealised maintenance work, the length of road sections affected by annual repair works decreased from 2,000 km ten years ago to 400 km, while the average time lapse between two interventions has nearly doubled compared to the former cycle time of 20 years. On the other hand, it is a favourable measure that after a delay of nearly 8 years, the value based property registration of state owned public roads has been completed. However, the registration is not yet complete in relation to the ownership rights of landed property.

The Palace of Arts was built in cooperation of the public and the private sectors (in a PPP scheme). The project and the state’s role therein were not properly well-considered. Neither an impact assessment study supported with economic calculations, nor a cost survey was prepared. The project was mainly carried out according to rules set during the building phase. **In the subject period the level of regulation of cooperation between the public and the private sectors was not satisfactory. There were no legal regulations and standard procedural rules in place for PPP projects.**

In the final part of the investment process the public partner initiated some changes in the PPP scheme in order to postpone contractual payment obligations and to account with the investments outside the central budget. **Eurostat qualified the development as public investment**, wherefore the growth in the budget deficit could not be avoided. Based on the comparable figures, at nominal value the **new version** resulted in **surplus spending** by the central budget compared to the original scheme.

The facility was constructed within the maximum development funds set forth in the business plans: the increase in floor space was offset by a parallel decrease in technical contents. The average costs of the concert hall that represent nearly half of the development costs, are acceptable by international standards, in fact they are lower than the European average. Altogether, the partnership of the public and private sectors resulted in a high quality, multifunctional cultural facility. However, the not well considered preparations and the resulting change in functions and the funding scheme adversely affected the cost-effectiveness and efficiency of implementation. The maintenance and operation of the facility for 30 years will cost the budget HUF 335.2 billion at nominal value, without VAT.

The state is a major player on the textbook market, in the procedure of textbook approval and price setting due to the financial assistance it provides for the production and purchase of textbooks. **According to the audit of textbook supply to public education institutions**, the enforcement of professional management, i.e. textbook approval was a costly and therefore price-raising regulatory procedure, and due to the great number of institutions, experts and bodies involved in the process, it was complicated and slow. Changes in the approval requirements had contradictory effects on the enforcement of professional quality requirements. The professional and economic requirements of the sectoral management of public education textbook supply can be enforced via the textbook list, however, the gradual withdrawal of discounts since 2003 have made the publishers less and less interested in having their publications approved as textbooks.

Budgetary support to textbooks used in public education was provided via two channels: through the normative support to students and through direct subsidies to the publishers. The principle, system and extent of normative subsidies were modified several times, and normative subsidies were transformed from a subjective right into a right granted on the basis of needs. The changes were not supported with detailed, well-founded background calculations, and impact analyses or assessments were not performed either. The production of low-circulation textbooks is costly, the payback period is long, wherefore publishers did not take the financial risk of publishing such textbooks. In the case of the reprint of textbooks produced originally with state subsidy it generated an unfavourable situation that the rights were assigned to the publishers.

The book value of the real estate properties managed by state-owned higher education institutions make up 10% of the real estate property of the Treasury. **During the audit of the real estate management of state-owned higher education institutions** we concluded that state management and regulation basically but not comprehensively ensured the conditions of real estate management for higher education institutions. Similarly to other budgetary institutions, the problem of compensation for depreciation is not solved. The maintenance element of the normative subsidy granted for education and maintenance depends on the number of students, and not on the composition and technical conditions of the managed real estate property.

The strategic foundation for the provision of central funds – as a source of integration developments – was provided by the Higher Education Development Programme 2002-2005, which was not fully adjusted to the approved institution development plans. **There were no standard institutional real estate management practices in the institutions.** The institutions **did not elaborate a real estate management strategy** covering all subfields of real estate management (development, maintenance and preservation) and including effectiveness and cost-efficiency criteria. The lack of geographical and organisational unity of the institutions hindered the proper utilisation of real estate property and that of the benefits of integration.

Within the framework of the audit of the financial management of the local governments and the mandatory community tasks to be performed by the local governments, the SAO has examined certain fields of public education and social services for years. With the SAO audits we aimed to foster the modernisation of public finances, and found it important to audit areas in which significant changes were carried out, or would be carried out in the near future in terms of organisation and content.

Our audits of public education especially focused on the problems of economy of scale, cost-effectiveness, the compensation of the children's disadvantages arising from their place of residence and other living conditions, and the audit of the impact of equal opportunity measures. Within this framework we examined the conditions of primary school education in settlements with fewer than 1,000 permanent residents, as well as the maintenance and development of secondary school dormitories.

Despite the fact that the number of the beneficiaries of public education services has been continuously declining since the mid 1980s, the ratio of expenditures spent on funding such tasks from public finances has grown compared to the total expenditure. In 2005, the local governments spent HUF 594.8 billion, i.e. 18% of all of their current expenditures on the current expenditures related to the maintenance of public education institutions and other public education tasks, compared to the HUF 286.0 billion in 2000, which represented 15% of the total current expenditure.

In small settlements children and students are educated and taught in scattered institutional networks, in institutions with a low headcount of students. Small settlements do not have professionals that are adequately trained to fulfil the management tasks on the part of the maintaining entity. In the scattered education management there is a weak relationship between the various management levels, as well as with the public education management and the regional development of the area.

In the past few years the legislative environment, education management and financial regulation did not coerce structural reforms that would have reduced the funding needs of the education sector, while improving – or at least maintaining – the quality and effectiveness thereof. In relation to public education, the local governments are mandated to provide tasks, and not to maintain institutions. Despite this fact, we found that small settlements strongly insisted on maintaining their local

institutions, often under the excuse of the wrongly interpreted independence, and their roles in population retention and identity preservation.

Before the establishment of multifunctional small regional associations it was not generally typical for small settlements to perform tasks in conjunction / partnership, it was not initiated to perform tasks that can be efficiently performed within the framework of coordination among more local governments (professional forums, teacher substitution system, assessment/evaluation, control, dormitory services). The establishment of multifunctional small regional associations and the extra subsidies that can be received in the incentive based funding system played a crucial role in the expansion of joint task performance. The associations got into contact with the local governments and their institutions typically through the transfer of funds available upon tendering. Experience shows that – in hopes of getting additional subsidies, **the local governments support task performance by the association as long as it does not jeopardise local education.** This resulted in the fact that task performance by associations mostly increased the number of member institutions, but there was no perceivable change in average expenditures.

Average expenditure drastically rose as the number of children declined, while almost all nursery school children and one fifth of primary school students attend undivided classes, despite the better overall supply of teachers. In 77% of primary schools operating with high average expenditures the number of students was below 50. Consequently, **the current system of public education is wasteful**: on one side it has excess capacities for the tasks to be performed, and therefore unjustifiably high operational cost, and lack of fund, or occasionally inadequate professional competence on the other. The development of capacities that occasionally exceed the needs was also fostered by the central budget policy of the former years, which was not properly well thought-over and was not based on the preliminary assessment of the conditions. The reduction in the number of beneficiaries could not be offset by the significant increase in normative subsidies. The drastic growth in average expenditures and the operation of the institutions required more and more local governmental subsidies and the realisation of own revenues.

The amendment of the Act on Public Education enhanced compliance with the plans and regulations on all levels of public education. The Ministry of Education prepared a medium- and long-term strategy. The enhancement of the management and cost-effectiveness of public education included in the objectives and priorities; however the elements of being disadvantaged, the circumstances threatening quality education, and the tools for compensating disadvantages were not defined.

The basic task of secondary school dormitories is the compensation of disadvantages and the provision of talent programmes. Although the Ministry of Education declared the creation of opportunities as a top priority area, the provision of dormitory tasks was not included in the medium-term strategy of public education, and for the lack of financial resources, the line ministry has no development plan either. One of the areas of implementation for the equalisation of opportunities is the Arany János Talent

Programme, which affects less than 5% of students despite its continuous growth. Due to the low number of students utilising this form of opportunity equalisation, as well as due to the deteriorating living conditions, the number of students living in dormitories continuously dropped. Even this low level of utilisation could not coerce the integration of capacities and coordination among the maintaining entities, which led to the declining cost-effectiveness of this activity. The personal conditions of dormitory services were characterised by high fluctuation, and the tangible assets may appear as a factor hindering operation in the longer run. The local governments did not encourage the renovation or reconstruction of the dormitories from local governmental funds. This was especially true if they only operated, but not owned the dormitories. The existing problems collectively hindered the actual compensation of disadvantages, and thereby the enhancement of the quality of education.

In the previous years we audited the status of the **social and child welfare services of municipal local governments**, nursing homes from among institutions that provide permanent residential care, as well as child welfare and child protection tasks. The SAO completed the audit of the system of institutions caring for the homeless in 2006, and then it audited the status of basic social services provided by the local governments in more than 300 small settlements. The on-site phase of this audit has been completed.

The supervisory organisation of this field and its affiliation was modified several times in the past few years, (once it was a separate ministry, then was put under the Ministry of Health with varying organisational frameworks) as a result of which, and for the lack of long-term concepts, the processes that had been launched either slowed down or were modified.

The line ministry does not have up-to-date, reliable data and information about the supply system. The data of statistical reports on social benefits and services become accessible subsequently, usually with a delay of one year. The professional statistics related to child protection services are incomplete, they do not categorise services provided by non-state organisations, broken down by entities maintaining such organisations.

The development and amendment of legal regulations specifying social and child protection services was not preceded by impact assessment studies, no concepts were prepared for the development and transformation of services, and occasionally the legal regulations were not used consistently. The professional tasks and operational conditions of social institutions providing personal care, as well as the special rules of caring for the homeless are regulated by a ministerial decree. The act and the ministerial decree have been amended several times since they entered into force. Yet, the tasks of caring are not in line with the needs and the services provided in practice.

The tasks of the different forms of caring specified in the social act and the child protection act are almost identical (family assistance and child welfare services, home assistance services, alarm supporting housing service and supporting services), and are difficult to separate. In families with children the child's problems can only be solved within the family. Therefore, the concurrent organisation and provision of the two services mean parallel care.

The local governments fulfil their tasks by providing services of different quantity and quality, the basic reason behind that is **no minimum quantity and quality requirements are set for the services.**

The basic services (meals, home assistance services), day-care for children, which necessarily represent the first phase of social and child protection services, have been cut back, or have not been established at all. These services are substituted by more cost-intensive services, wherefore this form of care contains both squandering and shortage. It cannot be determined what criteria (number of places) need to be met by the metropolitan or county local governments to comply with their task performance obligations. In the case of local governments the provision of access to specialised care to those in need and the relevant requirement can be interpreted in several ways.

For the lack of a professional and financial information system indispensable for well-founded decisions, the SAO encountered difficulties in analysing and evaluating the composition of resources for the different types of caring, and in auditing the expedient and efficient utilisation of normative state subsidies.

The **development of the services and institutions of caring for the homeless** is not coordinated, since the ministry has no long- or medium-term concept determining the objectives and development trends of caring for them. For the lack of a long-term strategy no concrete tasks were formulated in connection with the prevention of homelessness either, albeit this is the most efficient and least expensive way of handling of the problem of homelessness, even according to international experience.

The legal requirements and tasks of caring for the homeless are not defined unanimously either, and are **not in harmony with the needs.** It is not clear what belongs to the tasks of caring for the homeless, and the ways out of homelessness are not defined. The amendments of the law are not coherent, indeed they are contradictory in certain cases. Due to inadequate financial regulations, social institutions that assist the homeless can cover the additional healthcare costs from professional grants awarded upon application and normative state contributions that can be used for other types of service supply.

To fulfil their tasks, the social institutions receive normative state contribution from the central budget, while the ministry provides grants available upon competition from chapter managed funds. Normative funding is higher than average for church run institutions that play a special role in caring for the homeless. Changes in normative funding, as well as in the amount of chapter managed appropriations are primarily determined by the current status of the central budget, and not by the professional needs. The current system of funding is not flexibly adjusted to the real needs of the supply system, and thus makes the continuous provision of several services uncertain.

One of the specific features of **local governmental investments** is that the local governments are not able to implement their local projects by themselves, since they do not have enough own resources. Taking all this into account, the implementation of the investment projects of the local governments, and the funding of public utility projects can also be linked beside state subsidies to

special discount loans provided for water public utility associations, various home saving bank schemes, etc. Capitalising on the resource crunch of local governments and the almost obscure and complicated regulation, foundations emerged to initiate and organise funding and investment schemes for the unauthorised utilisation of state subsidies.

In 2005, the SAO revealed and presented in detail the funding elements of **ÖKOTÁM and other similar water public utility investment projects**, the violations of law revealed in the operation of the system, the statutory deficiencies that made such abuses possible, the detrimental effects thereof on public finances, as well as concluded that in 2004 public utility development subsidies worth HUF 620.2 million were granted unlawfully. Within the framework of the Act on the Final Accounts for 2004 the National Assembly requested that the SAO should audit the lawfulness of the utilisation of public utility subsidies by all local governments that implemented projects in the ÖKOTÁM and other similar systems between 2002 and 2005.

The SAO performed on-site audits at 298 local governments. Furthermore, we asked 554 local governments to review the lawfulness of the application for and utilisation of public utility subsidies based on the detailed criteria provided by the SAO. The **audit of the utilisation of public utility subsidies for road construction and canalisation projects** gave far more information than determining that HUF 3.68 billion worth public utility subsidies were used unlawfully. It confirmed the experiences of former audits, and provided wide-ranging information about the unfavourable trends that developed in the funding of local governmental investment projects by the state, the deficiencies of legal regulation, the inaccurate and wide-ranging regulation, as well as the significant lack of law-abidance.

During the implementation of projects funded in the ÖKOTÁM and other similar systems violations of law were committed by the local government, by the water public utility associations, as well as by the foundations that were set up with a view to evade tax-paying and legal regulations.

In the audit the SAO presented that in the implementation of public utility projects of public interest the operations of the organisational and funding method of ÖKOTÁM and similar systems had a negative effect on the deficit of the central budget, since if the public utility projects had been implemented from the state's own resources – from deficit financing loans or from state bond revenues – the costs would have totalled merely 75 to 85% of the sum that the users of the ÖKOTÁM system requested from the central budget – by using multiple subsidies. In the case of public utility projects implemented within the framework of ÖKOTÁM and similar systems, the state's share of the costs more than tripled – when implementing public utility projects of the same technical value. However, despite our commitments made towards the European Union, not those projects were realised with state support that would have been necessary based on the order of priority set forth in the National Municipal Sewerage and Sewage Treatment Programme.

The fractured allocation system of development purpose state subsidies, the lack of harmony in the system, as well as the lack of control over credits for water public utility associations ensuring the local governments' own resources resulted in the fact that in 14% of the local governments subjected to the audit the public utility projects were over-funded – even on top of the total investment costs unjustifiably increased with the local governmental revenues.

2.3. Utilisation of EU funds

Several years ago the European Union raised the demand that the European Court of Auditors and the national audit institutions should prepare summary evaluations about the audit findings related to the utilisation of EU funds. In line with this, in its 2004 Activity Report the SAO summarised the audit findings of the utilisation of EU funds in a separate section. The National Assembly called for the review of the utilisation of EU funds in Parliamentary Resolution 43/2005. (V. 26.).

In accordance with the resolution of the National Assembly, as well as in line with the principles agreed by the EU Contact Committee in its Stockholm meeting held in December 2005, in 2006 the SAO reviewed the entire practice of the utilisation of EU funds, and within this framework the professional work of Hungarian organisations auditing the financial transactions related to EU funds, and the experiences of the audits. The SAO published the Summary of Audit Reports on the Financial Management and Control of EU funds in Hungary in 2005 concurrently with our report related to the final accounts. The Summary was forwarded to the national audit institutions of the member states and the major EU institutions.

The Summary presents the institutional, legal, audit and registration system of the utilisation of EU funds, and the actual utilisation of the different funds in 2005, relying on audits performed by the actors of the intermediary institutional system on the basis of EU requirements, and on audits performed by the European Commission and the European Court of Auditors. Although the audits carried out in 2005 altogether concluded that the multi-actor institutional system suitable for the reception and distribution of EU funds was set up in accordance with the EU requirements and the Hungarian legal regulations, its operations need further development in some fields.

The Summary – planned to be issued annually from this year onwards – will soon cover the entire scope of the utilisation of EU funds, and will be suitable for identifying trends and changes.

In the course of 2006, the SAO audited the implementation of the National Development Plan in terms of the time-proportionate development of the set of objectives, which serves as a basis for the utilisation of the subsidies. It was concluded that the **implementation of the National Development Plan**, which implied intense activity by the applicants, fostered and accelerated the national development processes in the areas belonging to the objectives. Despite the improving trend, the ratio of announcing winning bids, the assumption of contractual liabilities and ratio of the actual payments made

was smaller than the time-proportionate utilisation of funds stipulated in the annual budget acts.

In the selection process the evaluation focused on the project selection criteria only, and the impact of supported projects on the realisation of programme level objectives was not assessed. As a result, for example, in terms of the regional distribution of the awarded amount, the greatest sum was granted to the most developed Central Hungarian region, which hindered the achievement of the objective of the elimination of regional disparities. The efficiency of the selection of tender application for funding was not adequate due to the shortage of time, since in the case of all operational programmes the actual time required for the selection process was longer than the timeframe prescribed by the law for decision-making.

The efficiency aspects of the utilisation of subsidies were given less emphasis than the measures taken for the acceleration of financial performance. It was not monitored to what extent the supported projects contributed to the implementation of programme level physical objectives, and neither was it investigated how effectively the projects corresponded to the planned utilisation of resources. As a result, in certain programmes the portfolio of supported projects that would meet the planned objectives was not developed. No full conformity was created between the set of objectives and the contracted sources of support.

The specific and general objective related macroeconomic effects of the implementation of the operational programmes could not be perceived during the on-site audit due to the time-proportionate delay of the implementation of the National Development Plan, the ratio of advance payments and the expected growth in the number of completed projects in the next two years.

Audits performed on the basis of agreements

In pursuance of the work agreement concluded with the National Programme Authorising Officer acting on behalf of the Competent Authority for the completion of the duties of the **SAPARD Certifying Body**, the SAO has performed the annual certification audit since 2003. We prepared interim and annual reports, as well as an audit certificate, which the National Programme Authorising Officer will forward to the EU Commission.

As a result of the SAPARD certification audits carried out in 2005, the SAPARD Certifying Body – the Certifying Department of the SAO – concluded in its certificate that the financial accounts prepared and sent to the Commission by the Agricultural and Rural Development Agency about the disbursement of SAPARD subsidies in 2005 were fair, complete and accurate.

For the SAPARD Certifying Body the 2006 certification audit proved to be more complex than in the former years, since actual payments from the sources approved during the expansion of funds in 2004 were practically made in 2006. Therefore, the utilisation of such funds was audited according to different rules, too. In addition to the different disbursement procedure, the complexity of the audit task was increased by the fact that 2006 was the last year of the

SAPARD Programme. The Certifying Body had to prepare its summary report on the final accounts of EU funds used for the implementation of the objectives of the SAPARD programme since the beginning of the programme, as well as the certificate about the financial procedures of the Agricultural and Rural Development Agency by 15 April 2007.

The increased funds allocated for SAPARD objectives are fully contracted, and are utilised on a continuous basis. During the financial and the compliance audits neither the EU Commission, nor the European Court of Auditors or the SAPARD Certifying Body detected any errors or deficiencies that would have required a financial correction by the end of 2006.

The duties of the Certifying Body responsible for certifying the utilisation of subsidies financed from the **Guarantee Section of the European Agricultural Guidance and Guarantee Fund (GS EAGGF)** were performed by the SAO pursuant an agreement with the Agricultural and Rural Development Agency.

The Certifying Body of GS EAGGF drew up its report on the EAGGF financial year of 2006, and issued an "A" audit certificate, i.e. an opinion without qualification. It concluded that reports forwarded to the EU Commission about the EAGGF financial year of 2006 were fair, complete and accurate. The Certifying Body made a few major remarks and recommendations in connection with the management of guarantees, debtor management, computer data security, payments of Direct Subsidies, Intervention Measures and Accompanying Measures.

The agreement concluded by the SAO and the Agricultural and Rural Development Agency for the performance of the duties of the Certifying Body responsible for certifying the utilisation of subsidies financed from **GS EAGGF** was terminated by mutual consent as of the end of the EAGGF financial year of 2006, i.e. 15 October 2006.

2.4. Subsidies to non-profit organisations outside public finances

State subsidies for non-profit purposes increased by HUF 30 billion on average between 2003 and 2005. As a result of this dynamic growth, state resources in the funding system of the non-profit sector increased to 40% to 60%, similarly to the developed countries. State subsidies totalled around HUF 400 billion in 2006.

The SAO conducted the audit of the utilisation of budgetary subsidies granted to civil organisations from the National Civil Fund on the basis of documents submitted by 127 foundations and 226 social organisations. Regularity audits and the audits of utilisation for the designated purpose were conducted at 40 foundations and 61 social organisations on the spot. Despite the modern regulation, the **Fund did not eliminate overlapping state funding, and neither did it foster the strengthening of smaller organisations.** During its two-year operation, civil organisations were granted subsidies of HUF 12.3 billion. Operational subsidies did not reflect the quality of task

performance. **There were no suitable performance indicators and funding normatives** on the basis of which the social usefulness of the professional support could have been assessed. The audit of the utilisation of subsidies was not in line with the regulations, and the monitoring process planned by the ministry did not function.

The operations of public foundations established by the Government continued to be funded almost entirely by the central budget. The boards of trustees of the two public foundations we audited distributed the funds for public tasks in public tender procedures. During our audits we criticized that the foundations had no standard, comprehensive regulations for the process, terms and conditions of tendering, the selection criteria and contracting. In some cases the boards of trustees failed to comply with the provision of the “Glass Pocket Act” according to which subsidies exceeding HUF 1 million can only be granted upon the call for tenders.

Within our mandate we also conducted the legality audits of the financial management of 4 parties and 2 party-affiliated foundations, 4 national minority local governments, as well as the audit of the financial and economic activities of the National Secretariat of the Hungarian Red Cross.

Our experiences gained during the party audits still confirm the need for the amendment of the Act on Political Parties, including the need for regulating financial reporting regulations in harmony with the Act on Accounting.

The financial management of the party affiliated foundations was in line with the objectives set forth in the deeds of foundation. The foundations prepared the financial management regulations mandated by the Act on Accounting; however these regulations did not contain specific provisions for the party affiliated foundations.

By utilising budgetary subsidies for the designated purposes, the national minority local government not only represents national interests, but also nurtures ties with the homeland, and fosters the transfer of national values and cultural education in the mother tongue.

2.5. State property

Apart from the audit of annual financial management of the state owned Hungarian News Agency Corporation, which is regularly audited by the SAO, the operations of the Hungarian Development Bank and the annual operations and activities of the State Privatisation and Holding Company (ÁPV Rt.) related to the execution of the central budget, the SAO’s audit plan for 2006 also included the audit of the financial management of state-owned, permanently loss-making business organisations.

In our reports on the audit of **the financial management of the Hungarian News Agency Corporation (MTI Zrt.)** was out of date at several points, and that the ownership structure and the operational solution we have annually proposed – for eight consecutive years – that the special ownership rights established for the operation of the Hungarian News Agency

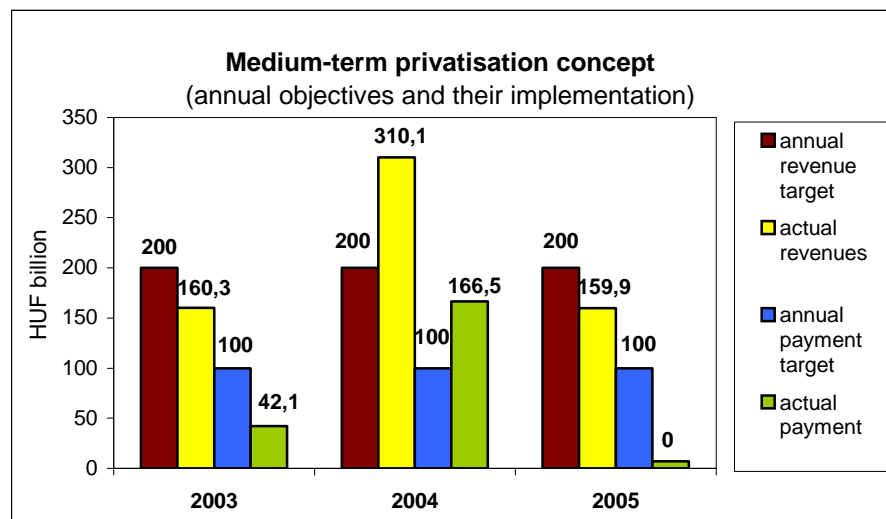
in 1996-97, the Act on the National News Agency, and the corporation's deed of foundation should be revised in a comprehensive manner due to inaccuracies in the tasks and scopes of the managing and supervisory bodies and organisations. The SAO emphasised that neither the public service activities, nor the size and application procedure of the necessary state subsidies were determined. Application for and utilisation of state subsidies for public service tasks are not transparent.

In 2006, the SAO also stated that the Foundation Deed of MTI Zrt. was out of date at several points, and that the ownership structure and the operational solution do not foster profit-oriented financial management, and loss-making financial management is not sanctioned by the owners. The National Assembly – i.e. the founder of MTI Zrt. and the entity exercising the rights of the general meeting – does not maintain day-to-day relationship with the corporation, it passes decisions neither about the strategic, nor about the annual business plans.

MTI Zrt. incurred losses in 2002 for the first time, and also in the subsequent years. Losses incurred in three years exceeded HUF 460 million. In 2005, the corporation forecasted a profit of HUF 5.3 million according to the balance sheet, but the profits actually yielded totalled HUF 6.5 million. The corporation fulfilled its financial plan for 2005. The downsizing of 111 employees yielded cost reduction in the years 2005 and 2006.

The Hungarian Development Bank is responsible to ensure the development resources required for the economic development objectives specified in the Government's medium- and long-term economic strategies. Apart from the Government's programme for the years 2004 through 2006, which contains the economic development objectives of the Government, **no approved economic development strategy was prepared**. Therefore, the concrete tasks of the Bank are determined by Government decisions. Implementation of these tasks was not possible without the amendment of the Act on the Hungarian Development Bank. The act was modified five times in the past few years. The operations of the Bank complied with the expectations formulated in the founder's resolutions issued by the minister exercising the ownership rights, as well as with the legal requirements in force. The Bank's financial management was cost-effective between 2003 and 2005. In 2004 and 2005 it paid the Hungarian State a dividend of HUF 6 billion and HUF 11 billion, respectively.

Within the framework of the **comprehensive audit of the 2005 operations of the State Privatisation and Holding Company (ÁPV Zrt.)** the SAO concluded that the Company pursued its privatisation activities in 2005 within the framework of the implementation of the last phase of the three-year asset policy guidelines elaborated in 2002. The main objectives of the asset policy guidelines was the sale of state assets worth more than HUF 700 billion, spread evenly over three years.



In the three years of the medium-term privatisation concept, the revenues and payments to the budget on the basis of ÁPV Zrt.'s dedicated assets were realised and made in a different time schedule than planned. The privatisation of dedicated state assets was not evenly realised, the total payments made to the budget were less than envisaged. Unrealised payments to the budget were offset by revenues from the lease of rights of use related to the privatisation of Budapest Airport Zrt., which revenues were received by the Treasury Property Directorate (KVI).

The execution of the privatisation of Budapest Airport Zrt. was supported by amendments of the law. Two acts amended exclusive state ownership, and removed the airport from the scope of the concession act. The assets management agreement concluded with KVI on the utilisation of the asset element of the fully state-owned airport was also amended. During the preparation of Bábolna Mg. Rt. for privatisation such ownership decisions were made that accelerated the significant reduction of the company's market value, and the owners failed to take measures that could have reduced losses. Due to the unmade decisions, the launch of the voluntary dissolution procedure caused damage to the company, and the owner further increased the state's losses with the final settlement fees and by waiving claims.

During the audit of the financial management of permanently loss-making, state-owned business organisations the SAO concluded that the concept of state ownership and the related rights were not unanimously defined. In state-owned business organisations **the ownership rights are not exercised in an harmonized manner**, the content, depth and formal tools thereof differ from entity to entity exercising the state's ownership rights. **The accounting of state property is not performed in a closed manner.** Registration provides a real picture neither about in kind assets, nor about the money value of assets. Indeed, such value cannot be accurately determined even by cross-checking the different systems of registration.

In the 97 permanently loss-making companies with significant state ownership that the SAO audited, the book value of state ownership was HUF 503 billion in 2005. This meant that on average 99.86% of the registered capital was owned

by the state. In the years from 2000 through 2005, the audited companies realised a total revenue of HUF 6,309 billion, incurred a total operational loss of HUF 478 billion, and a total pre-tax loss of HUF 290 billion.

The losses of fully or partially state-owned companies can partly be attributed to **external causes**. State-owned companies receiving regular state subsidies are loss-making partly because of the deficiencies of the relevant regulations, and partially due to the public services they provide and the insufficient revenues they realise. It is a multiple problem that the state legally stipulates the tasks to be performed by its companies, however it provides only a fraction of the countervalue for such tasks.

In about 20% of the companies the **internal causes** of loss-making include the lack of an asset management strategy, and ownership or management decisions that subsequently turn out to be wrong. In one third of the companies efficiency declined due to obsolete technical and technological solutions. The scarcity of financial resources limited the implementation of cost- or staff-reducing investment projects in one fourth of the companies. Changes in the management and restructuring contributed to declining efficiency in one tenth of the companies. The number of staff, as well as problems with the professional composition thereof, and the loss of assets in the investment projects all contributed to the losses.

The 97 companies that the SAO audited received HUF 1,116 billion as capital and other subsidies in the years 2000 through 2004. Subsidies were granted through increasing the capital or profit reserves, or as operational, investment, redundancy, environmental and other specific – e.g. development, reconstruction, vocational training, etc. – subsidies. A major portion of the subsidies was awarded to 15 of the companies subjected to on-site audits. As far as the subsidies granted to the companies are concerned, they were typically smaller than requested. Basically, this had two reasons: on one hand, there is no normative funding system for public tasks (with the exception of price supplements), and on the other, the load-bearing capacity of the budget limits the satisfaction of the needs.

3. UTILISATION OF THE AUDITS

The activity of the State Audit Office is realised in the published reports. The results and findings of the audits, as well as the recommendations are available and publicly accessible not only for the political players, but also to the general public. The utilisation of the audits, the parliamentary and public “after-life” of the reports after publication represents one of the effectiveness indicators of the SAO’s work. The public life of published reports is reflected in the press coverage of the SAO audits. The parliamentary utilisation of the SAO’s 2006 reports is indicated by the committee and plenary meetings and events dealing with the reports.

The result of the SAO audits greatly depends on what amendments to legal regulations are made at the level of the National Assembly, the Government, the chapters and local governments pursuant to the utilisation (realisation) of the findings and recommendations, and on what measures the auditees

initiate. The SAO is not an authority; it cannot impose sanctions, and cannot enforce the realisation of its recommendations and proposals either.

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

The SAO met its reporting obligations provided by the legal regulations in force – acts and resolutions – in 2006, too (audit of the execution of the budget, the final accounts, the activity of the SAO, the Hungarian Privatisation and State Holding Company, the Hungarian News Agency Corporation).

2006 was the year of the general and local governmental elections, the effects of which affected the “after life” of the SAO reports in the Parliament and the committees.

In the new parliamentary cycle that began in May, the National Assembly set up 18 permanent committees instead of the former 25 committees. The Audit Committee ceased to exist, the former Budget and Finance Committee was re-established under the name Committee on Budget, Finance and Audit Office in the new cycle, which includes the Audit Office subcommittee.

Due to the elections fewer reports could be submitted to the committees than in the previous years, and due to the restructuring of the committees fewer committee events were associated with each report.

Out of the 62 reports published in 2006, **nine** were included in the **agenda of the committees**, and **three** of them were discussed in the **plenary sessions** of the National Assembly. The largest number of reports was discussed by the Committee on Environmental Protection, which dealt with SAO reports on five occasions.

From among the reports submitted to the National Assembly, the report on the audit of the execution of the 2005 budget, as well as the SAO opinion on the budget bill for 2007 were discussed by all committees but the Committee on Immunity, Incompatibility and Mandate.

The SAO activity report 2005 was discussed and proposed for general debate by six committees (the Committee on Budget, Finance and Audit Office, the Economic and IT Committee, the Local Governmental and Urban Development Committee, the Committee on Education and Science, the Committee on Human Rights, Minorities, Civil and Religion affairs, as well as the Committee on Employment and Labour).

Apart from the report on the final accounts and the opinion on the budget, the Committee on Environmental Protection discussed the SAO report on the audit of the operations of Ministry of Environment and Water, the report on the audit of the application for and utilisation of subsidies for public utility projects (local government managed road and sewage system projects) in the ÖKOTÁM system in the years 2002 through 2005, as well as the report on the audit of the operations of the Hungarian Privatisation and State Holding Company in 2005.

In 2006, a total of 46 committee events (meetings, discussions) were related to SAO reports.

The **SAO's audit plan for 2007** was discussed by the Committee on Budget, Finance and Audit Office upon being presented by the President of the SAO.

The SAO maintains well functioning professional relations with the National Assembly and certain organisational units and committees thereof. With a view to strengthen these working relationships, the senior management of the SAO met with the leaders of all the five parliamentary faction leaders after the elections, and the President of the SAO was invited to attend the Meeting of Committee Chairmen several times.

In 2006, the **President of the SAO attended 18 committee meetings**, and was asked by the National Assembly to express his views at **four plenary sessions**. The staff members of the SAO attended nearly **60 committee meetings**¹².

In the Act on the Final Accounts for 2004 the **National Assembly asked** the SAO to *“audit the lawfulness of applications for and utilisation of funds transferred from the central budget to the local governments for road and sewage system projects until the end of 2005, with special regard to projects implemented in the ÖKOTÁM and similar systems”*. In response to this request, in October 2006 the SAO published its **report on the audit of applications for and utilisation of public utilities development support for local governmental road and sewage system projects in the years 2002 through 2005**.

Full EU membership requires Hungary to internally audit the utilisation of EU funds. According to **Parliamentary Resolution 43/2005. (V. 26.)**, the National Assembly *“finds it justified and supports that the State Audit Office would provide a comprehensive description about the practice of the utilisation of all EU funds, and within this framework it should inspect the professional work of Hungarian organisations involved in the audit of money movements related to the EU funds, and should present the audit findings.”* **The summary of the audit of the utilisation of EU funds in 2005** was submitted by the SAO to the National Assembly concurrently with the report on the final accounts.

Upon the Prime Minister's request, the SAO formulated an opinion on the draft convergence programme of the Republic of Hungary updated as of September 2006. The opinion was forwarded to the Prime Minister's Office at the end of August, and was uploaded onto its website to make it accessible for those interested.

¹² Attendance at the committee meetings is not linked to published reports only. Therefore, occasionally the SAO may represent itself at committee meetings where SAO reports are not included in the agenda, or where the SAO is only indirectly affected by the subject.

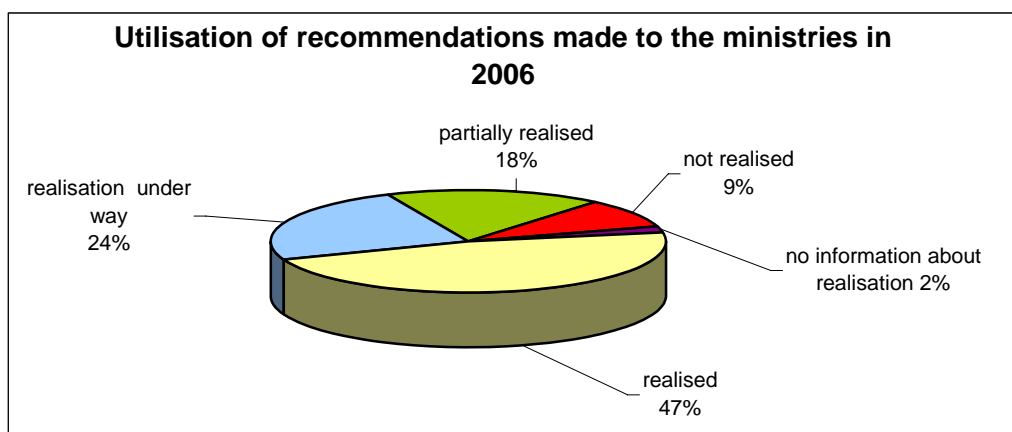
3.2. Enforcement of the SAO recommendations

During the audits performed in 2006, the SAO continued to help the discovery and elimination of risks inherent in the audited organisations, systems and processes, the enforcement of regularity and the enhancement of efficiency with well-founded proposals. The SAO also made proposals for the amendment and coordination of, and compliance with legal regulations.

In 2006, the SAO continued to pay attention to the utilisation of former SAO findings and recommendations, as well as to the audit and monitoring of the execution of the measures taken. **We followed the measures taken in relation to our audits' recommendations** in this aspect, too.

Both the action plans of the chapters concerned and the information requested in relation to the annual SAO report indicate that **our recommendations were received positively**. However, the most comprehensive account about the fact and impacts of the realisation of the recommendations can only be obtained in the framework of audits focusing on special purpose or ex-post audits.

On the basis of experience accumulated for several years it can be stated that the SAO recommendations made as direct impacts of financial audits for correctional amendments or certain independent regulatory issues are typically realised. The SAO recommendations pertaining to the internal regulatory, registration and accounting systems, as well as measures improving expediency and efficiency are also received positively. On the other hand, **SAO recommendations for financial security and requiring system-size and system-approach changes are realised on a lower scale**. However, it can be regarded as a success when analyses evolve aiming at the reconsideration of the economic correlations of the areas and processes "targeted" by the recommendations, and at the development of plans and programmes.



The recommendations of the individual audit reports, as well as the utilisation and realisation thereof can be followed on the SAO's website.

3.2.1. Recommendations at the level of the National Assembly

Most of the SAO recommendations addressed to the National Assembly based on our audits, or recommendations that affect the legislative operations of the National Assembly has been either realised, or is incorporated in the legislative work.

Several SAO recommendations were realised in the Act on the execution of the 2005 budget, the act on the 2007 budget, and in relation to them, in Act CXXI of 2006 on the amendment of certain acts that lay the foundation for the 2007 budget of the Republic of Hungary, as well as in other acts.

In order to **ensure the transparency of budget related accounting**, in 2006 several SAO audits concluded and proposed that the content of data to be presented in connection with the budget, and the structure of related tables must be updated. In the light of this, Act CXXI of 2006 on the amendment of certain acts that serve as a basis for the 2007 budget of the Republic of Hungary

- updated – by amending the Act on Public Finances – the balance sheets and statements that must be presented during the submission of the budget and the final accounts,
- amended the provisions of the Act on Public Finances dealing with debts. The amended Act on Public Finances specifies the different debt categories, prescribes an obligation to publish data on public debts and public finance debts with contents specified in a government decree on a quarterly basis. (The content of debt related data to be published, and the content of data required for the consolidation of the different debt categories will be specified in a government decree on the rules of procedure of public finances, the amendment of which – as far as we know – is still under way.)

In order to have more comprehensive knowledge about Hungary's relationship with the European Union, and to enhance the transparency of the settlement of accounts, upon the SAO's recommendation, and on the basis of bilateral consultations, the finance minister modified the structure of the table summarising the EU budgetary relations and the table presenting agricultural subsidies in detail already in the bill on the execution of the 2005 budget, and also in the 2007 budget bill. These tables are included in the annexes of the explanatory memorandum. Therefore, with a view to present budgetary relations in full, agricultural subsidies that otherwise fall outside the budget and the final accounts acts are also presented.

During the **audit of the operations of the Health Insurance Fund** (one of the social security funds), the SAO's recommendation for the elimination of contradictions in the legal regulations specifying the legal status of the fund manager was realised by the amendment of Act LVII of 2006 (on legal status) (Act CIX of 2006 on the amendment of acts related to governmental restructuring), as well as by the development and enactment (1 January 2007)

of a new government decree (No. 317/2006. (XII. 23.)), which specifies the tasks and scope of the National Health Insurance Fund.

Measures taken upon SAO recommendations for the operations of the **Pension Insurance Fund** indicate that the recommendations have been partially realised. The amendments of the act on social security pension benefits and of the related acts as of November and December 2006 specify the missing procedural rules of the operation of the pension system after 2006 (e.g. the expansion of the indexation of incomes to the years immediately preceding retirement, calculation of the pension base up to 2012). Although the modernisation of the pension with age allowance eligibility rules did not take place by the set deadline, i.e. end of 2006, the eligibility conditions for pension with age allowance will be specified by a separate act beginning in January 2011. The accepted amendments first of all improve the financial position of the Fund (e.g. the reallocation of contributions for the benefit of the Pension Fund, the reduction of the group of people receiving benefits, and the modification of the computation of the pension base).

Upon our recommendation, the Minister of Health proposed the **more rational regulation of medical aids** that can be claimed within the system of public health benefits. The act on the safe and cost-effective supply of pharmaceuticals and medical aids, and on the general rules of the distribution of pharmaceuticals came into force. This act contains, in harmony with the SAO's recommendations, the revision of the regulation on medical aids supplied within the public health benefit scheme.

In relation to the audit of the financial management of permanently loss-making, state-owned business organisations, as well as in relation to the audit of the operation of the Hungarian Privatisation and State Holding Company in 2005, and its activities related to the implementation of the central budget, we recommended to the Government to take measures to ensure the harmony of financial management related to certain groups of state property by **preparing the act on the state property**, furthermore, to standardise the rules of managing state claims related to the entrepreneurial and treasury property of the state. The elaboration of the act on the state property is under way. It is expected to be submitted to the National Assembly in the spring parliamentary session.

Utilising the experiences of regular party audits, in mid 2006 the Government submitted to the National Assembly its proposal number T/237 on the amendment of Act XXXIII of 1989 on the **operation and financial management of political parties**, Act C of 1997 on **the election procedure**, as well as on the amendment of other related acts. The SAO supports the approval of the proposal for legislative amendment, since it enhances the transparency and accountability of party and campaign funding. In accordance with the SAO's efforts and social expectations, the approval of the proposal would provide a growing scope of authority for the constitutional task revealing deeper correlations and would more strongly penalise irregularities. The National Assembly held a detailed discussion about the proposal, but no voting took place. Until the approval of the proposal, the SAO will continue the audits of the financial management of political parties and

the lawfulness of election funding in line with the effective provisions. Applying the law, the SAO is not entitled to expand the scope of audits.

In relation to the audit of the operations of the Hungarian Tax and Financial Control Administration (Tax Authority) the SAO initiated the amendment of Act LVI of 2005 so that no legal regulation would allow for the **assignment of the Tax Authority's claims** against organisations under voluntary dissolution. Pursuant to Act LXV of 2002 on the Tax Authority, and Act XCII of 2003 on the Rules of Taxation, from 1 January 2007, the Tax Authority can assign its claims only against organisation that are undergoing liquidation proceedings, but not voluntary dissolution.

Based on the SAO's recommendations made **pursuant to the comprehensive audit of the financial management of local and local minority self-governments**, the Act on Public Finances was supplemented with the content requirements of the agreement between the local and the local minority self-governments, and the obligation of publication also pertains to the beneficiaries of non-normative, operational subsidies provided for special purpose. Pursuant to the SAO's initiative, legislators set the fundamental rules of public procurements centralised locally by local governments in the Act on Public Procurement.

In accordance with recommendations made in relation to **appropriations for special purpose**, significant progress was made in subsidising the maintenance and renovation of ferries and harbours in the accounting for 2005 and the establishment of the eligibility conditions for 2006. The accounting system of operational subsidies is already properly specified in the regulation for 2006. In order to eliminate overlaps, the appropriation supporting internal audit associations was eliminated from 2007. Applications for this subsidy can only be submitted within subsidies for multi-purpose micro-region associations. The repayment of subsidies carried over from 2004 to 2005 despite the prohibition laid down in the act on environmental protection, was mandated by the Act on the Final Accounts. In the accounting of normative support repayable by the professional fire services of local governments, the revenues and expenses of fee paying services supplied as a business or auxiliary activity can no longer be taken into account from 2007 on.

The rules pertaining to the draw-down and utilisation of **social normative subsidies** changed in the social and budget acts.

After the audit of the application for and utilisation of **public utilities development support for local governmental road and sewage system projects in the years 2002-2005**, Section 7 (18) of Act XCIX of 2006 stipulated that public utilities development supports used unlawfully in the years 2002 through 2005 should be repaid, and Section (19) stipulated a new regulation to prevent the unlawful use of subsidies.

Pursuant to the SAO's recommendation, Section 101 (10) of the Act on Public Finances was amended. With a view to prevent abuses, the amendment described in detail the rules for the proportionate repayment of development

subsidies – due to funds received by the local governments directly from the contractor or indirectly through other organisations.

Based on the recommendations formulated in the report on the audit of the execution of the 2005 budget, in the 2007 Budget Act the distribution of **personal income tax revenues due to the local governments** was regulated in accordance with the real objective and the relevant provision of the Act on Public Finances, and no obligation to create general government reserves was stipulated therein.

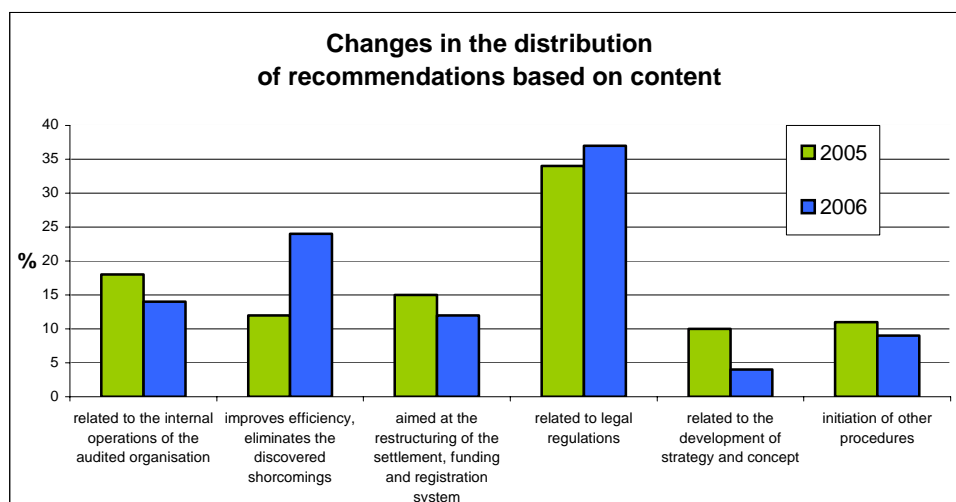
Upon the Finance Minister's initiative, measures intended to **eliminate the discrepancies** revealed during the audit of the subsidies to local governments were incorporated in the act on the execution of the 2005 budget.

In relation to the audit of the maintenance of state owned **public roads** the SAO asked the Government to initiate the inclusion of requirements necessary for the maintenance of the good state of repair of the public road network at all times within the framework of the act on transport. In 2006, Act I of 1988 on road transport was amended with a view to preserve the state of repair of the public road network, and to ensure traffic organisation commensurate with the level of development and the load-bearing capacity of the pavement.

3.2.2. Recommendations at governmental level

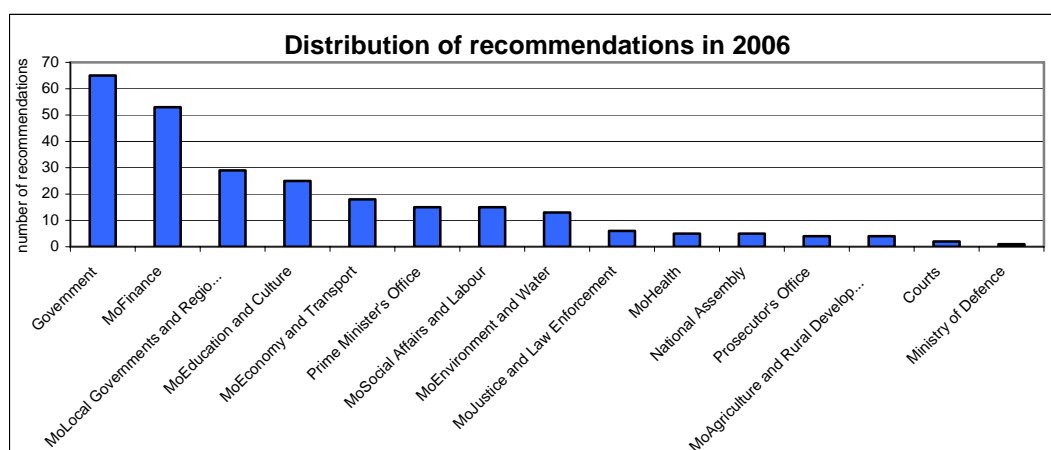
Compared to 2005, the SAO's recommendations were received more favourably in 2006: **the ratio of recommendations that had been implemented, had been partially implemented, or were being implemented grew from 80% to 89%.**

From 2005 to 2006, the ratio of SAO recommendations aiming at measures improving expediency, efficiency and effectiveness, as well as recommendations aiming to eliminate discovered errors, shortcomings **doubled**. A greater portion of such recommendations was received positively than before. The share of SAO recommendations initiating the amendment of legal regulations slightly grew, and such recommendations were received more positively than in the previous year. The rate of implementation is almost the same (41-42%), however the straightforward refusal of such recommendations dropped considerably (from 33% to 10%). The ratio of other SAO recommendations on the level of regulation of organisational operation declined. These types of recommendations are continued to be received positively, i.e. 80 to 90% are accepted.



In order to monitor the utilisation of recommendations and proposals made during the audits, the SAO **asked the Government and the heads of the ministries for information on the utilisation of recommendations in 2006, too, similarly to former years.** All parties contacted responded to the request, and the answers given by the ministries have become more comprehensive year after year. Information on the utilisation of the SAO recommendations is all the more important for the SAO, since there is no general legal provision for the realisation of SAO recommendations other than the initiative of legal realisation aimed at the restoration of lawfulness.

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 our work they achieved progress in several areas in terms of regularity, level of regulation and efficiency.



As much as 41% of the SAO's recommendations aimed at **legal regulation** were realised, while 10% of the recommendations were rejected. The latter typically called for the amendment of legal regulations. In some cases the existing regulation was found suitable.

Altogether 90% of the SAO's recommendations aiming at **enhancing expediency, efficiency and effectiveness**, or eliminate the revealed errors, deficiencies were received positively. As many as 61% have already been implemented.

In relation to 83% of recommendations aiming to revise or further develop the **internal control systems**, as well as the operations of chapter managed and internal audit systems, concrete measures have been taken, or the audited organisations concerned started preparations for the utilisation of recommendations.

Based on the responses received in connection with recommendations aimed at the elimination of accounting and registration irregularities, and at the modernisation of **accounting, financing and registration systems**, 43% of such recommendations were realised. The realisation of other recommendations is under way. As many as 10% of the responses did not unanimously report on the implementation of the recommendation.

As many as 100% of recommendations aimed at the development of **strategies or concepts** were received positively; 45% have been implemented, and 55% are being implemented or have been implemented partially.

Other recommendations that can neither be categorised, nor included in the former categories due to their uniqueness, accounted for 9% of the recommendations. Over 90% of such recommendations were accepted, and 41% have already been implemented.

In the course of its subsequent audits, the SAO monitors the implementation of the measures taken by the heads of the ministries, and comments on the implementation thereof in its reports. **In addition to the annual summaries prepared about the utilisation of the SAO's recommendations, the following specific measures were implemented in the past year:**

Pursuant to the comments of the SAO, Government Decree 217/1998. (XII. 30.) on **the rules of operations of public finances** was modified, because the Summary issued by the Ministry of Finance in 1997 on the data supply and registration rules pertaining to the planning, modification and expected implementation of budgetary appropriations of entities in the treasury system became obsolete, and could no longer serve its original purpose, i.e. forecasting and planning.

Pursuant to the SAO's recommendation – after the amendment of the government decree on the rules of operation of public finances at the end of 2006 – proposals for the utilisation of **general reserves** can no longer be submitted without the Finance Minister's consent, wherefore only joint proposals, or proposals made by the Finance Minister can be submitted to the Government.

The Government did not support the SAO's recommendations about the justification of the further operation of the **Wesselényi Miklós Flood and Inland Waters Compensation Fund**, and about the review of the planning system of the **Labour Market Fund**.

In the report on the audit of the management and development of the debts of the system of public finances the SAO proposed that the Government should develop and submit to the National Assembly a proposal for creating the **all-time financial balance of the Social Security Funds**. Governmental measures taken in the fields of pension reform, healthcare reform and contribution regulation (e.g. increase of contributions, regulation of the national risk community, expansion of the contribution base) are designed to improve the financial balance of social security. Year 2007 will see the continuation of the pension reform, the modernisation of care services and the development of further measures serving the expansion of the healthcare reform.

From among the major **healthcare** related recommendations of the SAO, the Government is working on a comprehensive healthcare policy issue, which determines the possible role and professional fields of private capital and private enterprises, the fundamental principles of state subsidies, and which regulates the system of operation of healthcare services with regard to the aforesaid.

The SAO report on the audit of the execution of the 2005 budget of the Republic of Hungary proposed that the Government should have a comprehensive, well-considered, long-term strategy for the entire system of **pharmaceutical supplies**, in harmony with the restructuring of the healthcare system. Furthermore, it should determine the financial, professional and social priorities of implementation. In this issue, the acts on the safe and cost-efficient supply of pharmaceuticals and medical aids, the act on the general rules of the distribution of pharmaceuticals, as well as the related statutory implementation decrees have already been enacted.

In the report on the audit of the operations of the Regional Development chapter the SAO recommended that the Government should take measures for the elaboration of the **National Housing Programme**. Pursuant to Section 5 (b) of Government Resolution 1139/2002. (VIII. 2.), the government commissioner set up the National Housing Policy Advisory Board, which acts as an opinion forming and advisory professional and social forum.

During the audit of the implementation of construction and operation of the Palace of Arts the SAO recommended to the Government to develop appropriate legal background regulations and a standard state procedure for **PPP schemes**. Pursuant to the SAO's recommendations, in February 2007 the Government prepared a draft decision on the amendment of Government Decision 2098/2003. (V. 29.) on the application of the novel forms of PPP, and elaborated a draft decree on certain rules pertaining to the undertaking of long-term liabilities (the public administration conciliation of the drafts is under way).

The SAO recommendations made to the Government and the line ministers in relation to the audit of various fields of the **financial management and task performance by the local governments** were mostly taken into account during the amendment of the regulations.

The long-term restructuring programme of **care for the homeless**, which contains employment, social and healthcare elements alike, has been completed. It is a significant change that housing for the homeless is intended to be provided by enlarging the capacity private rented accommodation rather than establishing new shelters.

The Government took measures pursuant to the SAO's recommendations made after the 2005 audit of the **expediency of the use of subsidies and funds provided by the local governments outside the system of public finances especially for the purpose of accumulation**. The Government Decree on state subsidies for housing purposes maximised the amount of water public utility loans at HUF 200,000 per natural person. This move intends to prevent the use of unjustifiably large loans with subsidised interest rates. Furthermore, it was required that revenues generated from the investment should be used for the repayment of the water public utility loan. The changes in the legal regulations will presumably terminate the operation of ÖKÖTÁM and similar investment organisation and funding schemes.

From 1 January 2007 onwards, the auxiliary annex to the budget report of the local governments must contain a separate summary table about the central budgetary subsidies used for the different investment projects, which table must also indicate own resources and the revenues realised by the local government in addition to the state subsidies.

In November 2006, the Finance Minister asked the Hungarian Tax and Financial Control Administration to audit the lawfulness of the use of water public utility loans with subsidised interest rates provided by the state, and preliminary loan saving subsidies on saving deposits held in housing saving banks. The audit is still under way.

In relation to the comprehensive audit of **the system of financial management of the local governments**, the amendment of the Government Decree on the rules of operation of public finances at the end of 2006 stipulated the content requirements of the statement of indirect subsidies to be presented concurrently with the submission of the budget and the final accounts. Furthermore, beginning on 1 January 2008, validation tasks at the local governments can only be performed by employees having the professional qualification specified in the law, and the agreement between the local and the local minority self-governments must include the rules of implementation of the financial management of the local minority self-government, and the appointment of the persons authorised and mandated to perform the related tasks. The internal audit manual sample prepared for the local governments was supplemented with certain aspects of the audit of subsidies provided for special purpose. The recommendation, which stipulated that the notary should decide about the extension of the accounting policy and the related rules to budgetary organisations that are attached to the office of

the local government, but are independent in terms of financial management, and have partial scope of authority, was also realised. The obligation of publication specified in the Act on Public Finances also applies to operational purpose subsidies provided by the local governments.

Pursuant to the recommendations made during the audit of **the maintenance of residential halls for secondary schools, in** the 2nd National Development Plan, the Regional Operational Programmes already include the concept of public education institutions as beneficiaries, which includes student residential halls, too. The regional public education strategies already contain the directions and areas of residential hall developments, which are decided locally.

Based on recommendations made by the SAO pursuant to the former audit of the application for and utilisation of subsidies available to **regional development councils** and their work organisations, the proposal for a standard system of resource decentralisation has been incorporated into the budget acts. It is a requirement that continuous monitoring should be carried out during the implementation of the action programmes. In the Operational Programmes of the New Hungary Development Plan the development and funding of underdeveloped regions is given priority from among the interventions aimed at balanced regional development.

Pursuant to the SAO recommendations made in relation to the audits of the **social and child welfare services of the local governments**, the Government specified the conditions for admission to the so called “system of managed regional equalisation”, the procedural rules, as well as the professional aspects underlying the decision about admission. In 2007, non-state providers are eligible for normative support for social, child welfare and child protection services and capacities that are regarded as new services in terms of funding, if the minister responsible for social affairs has accepted such services in the system of managed regional equalisation.

For social justice and the more efficient utilisation of the available resources, in line with the agreement concluded between the National Family and Social Policy Institute and the Ministry, through the allocation of resources, working groups were set up that will prepare professional proposals required for determining the eligibility criteria for each type of service.

The eligibility criteria for other basic services (home care, alarm supporting housing service, supporting services) were determined. Such criteria must already be validated in the case of applications submitted in 2007, and the fee calculation rules have also changed.

Complex programmes aimed at solving the gravest labour market and social problems have been worked out. The implementation of these programmes will commence in 2007 with EU support.

The Government issued Government Decision 1069/2006. (VII. 13.) on the **review of governmental public foundations** upon considering the SAO’s former recommendations.

3.2.3. Recommendations at the level of auditees

The recommendations made for the different ministries have typically been realised, or realisation is in progress. The heads of the ministries prepared action plans, formulated recommendations for budgetary organisations in their scope and updated ministerial decrees. In certain cases utilisation of the recommendations started already during the audit.

During the audit of **the execution of the state budget for 2005, and when forming an opinion on the budget for 2007**, the SAO made recommendations for the heads of all chapters in relation to the preparation and updating of regulations on operation, financial management and reporting, appropriate internal audits, as well as the necessary measures to be taken. Concrete measures have been taken in relation to the findings and recommendations related to the internal regulatory system, and the operations of the chapters and internal audits of the auditees.

In the report on the audit of the execution of the budget for 2005 we recommended that the minister heading the Prime Minister's Office should require from the head of the National Development Agency the full development of the accounting module of the **Unified Monitoring Information System**, which will ensure compliance with the legal requirements. This recommendation has been realised.

In the report on the audit of the operation of the **"Prosecutor's Office of the Republic of Hungary"** chapter we recommended the chief prosecutor to define the domestic prosecution and other authorisations for the national member of EUROJUST, and develop the rules for the utilisation of this institution. In addition to two proposals for the amendment of rules of law, the Chief Prosecutor's Office elaborated the draft of the new and detailed Chief Prosecutor's decree for EUROJUST.

In our report on the audit of operations of the **"Hungarian Academy of Sciences"** chapter we drew the Government's attention to the fact that it should monitor and regularly evaluate the cooperation of state organisations with the Hungarian Academy of Sciences in the state management of research and development, and that it should comprehensively regulate the operational conditions of the specific financial management of budget supported research places that conduct research as a core activity. According to the information received, the Government continuously cooperates with the Academy of Sciences in developing its medium term (up to 2013) scientific and technological innovation political strategy. The Prime Minister's Office called the Ministry of Finance to take the governmental measures required for this specific financial management task.

In our report on the audit of the operation of the **Hungarian Privatisation and State Holding Company in 2005 and its activities related to the implementation of the central budget** we recommended the Finance Minister to regulate the consistent enforcement of liabilities and claims undertaken in the sales and management contracts related to the entrepreneurial and treasury asset of the state by standardising registrations

and accounting. The bill on the standard legal regulation and organisational system of state property – the elaboration of which is in progress – will presumably result in changes in this area, too, in case the new holding organisation will work out new internal registration, audit, IT, etc. systems and new internal regulations. Naturally, the experiences and findings of the audits may be utilised in the meantime. In general, we expect that as a result of the standardisation of the organisation, the company responsible for the management of state assets will be able to function much more efficiently than the current system, as well as in line with standard legal regulations, standard principles and requirements for the entire group of state assets.

Some of the recommendations made during the **audit of the financial management of the Hungarian News Agency Corporation in 2005** have been utilised. The review of the Act on the National News Agency was started by the subcommittee of the Committee on Culture and the Media of the National Assembly, however no rules have been formulated yet.

In the past four years **the SAO conducted audits at all local governments**. During these audits we formulated nearly 3,000 recommendations, three quarters of which were utilised by the local governments. This resulted in the better regulation of the financial management of the budget, progress has been made in compliance with the local and central requirements during implementation, and the provision of audit tasks incorporated in the work process was ensured in a broader circle than before.

It is favourable that the SAO's recommendations made for the local governments of counties, cities with county rank, as well as metropolitan and district local governments affected by the comprehensive audit of the financial management system **were soon utilised. In several cases, measures were taken already during the on-site audit to eliminate the revealed deficiencies and to make up for the missing parts.** The establishment of law-abiding patterns of behaviour, the adoption of the best practice is facilitated by the fact that the comprehensive reports on top priority local governments are public and can be accessed by anybody via the Internet.

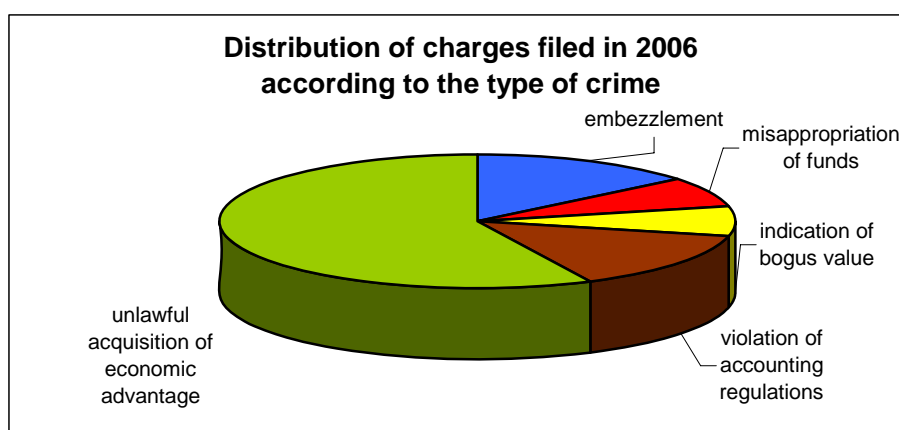
3.3. Criminal proceedings initiated by the SAO

Criminal sanctions imposed in relation to the abuse of public funds are in the interest of the entire society. Within its investigative competence, the SAO plays a major role in supporting such abuses with evidences. This is especially true in the local governmental sector, wherefore the SAO is almost the only organisation that can provide information – based on concrete audits – about the quality and practice of the financial management of the local governments.

Similarly to the previous years, in 2006 the SAO complied with its obligation according to which it must inform the competent investigation authority about any audit findings that support the suspicion of a crime. In relation to the initiation of criminal proceedings, the SAO continues to keep in mind the principle of fairness.

In 2006, the SAO **filed 14 charges**¹³, against **22** known and **other unknown perpetrators**. In the 14 charges, criminal liability was raised on the basis of facts and findings revealed during **four SAO audits**. The damage caused by criminal conduct in the case of all 14 charges totalled over **HUF 1 billion**.

The 14 charges altogether qualified as **five types of crimes**.



In the subject year crimes qualifying as '**unlawful acquisition of economic advantage**' were committed at an exceptionally high rate. The reason behind this was the great number of charges pressed pursuant the findings of SAO audits that served as a foundation for the 2006 **ÖKOTÁM report**.

The most important indicator of the efficiency of legal realisation related activities – and also the fairness of charges filed – is the number of proceedings launched by the competent investigation authority, indictments and judgements. On the basis of resolutions passed by the authorities and other feedbacks, the investigation authority has launched investigations into nine cases from among the 14 charges filed. It terminated investigation in one case, and the evaluation of four charges is still under way.

Pursuant to the act on criminal proceedings, state organisations (including the SAO) must fulfil the **requests** of investigation authorities for the disclosure or transfer of information, data or documents by the given deadline. In the subject year the SAO was contacted by the investigation authorities 20 times in relation to ongoing criminal proceedings. In most of the cases the SAO could comply with its data supply obligation by forwarding the documents containing facts that it obtained knowledge about during the audits. It was stated in the responses to five requests only that no SAO audit had been conducted in the issue specified in the request for information.

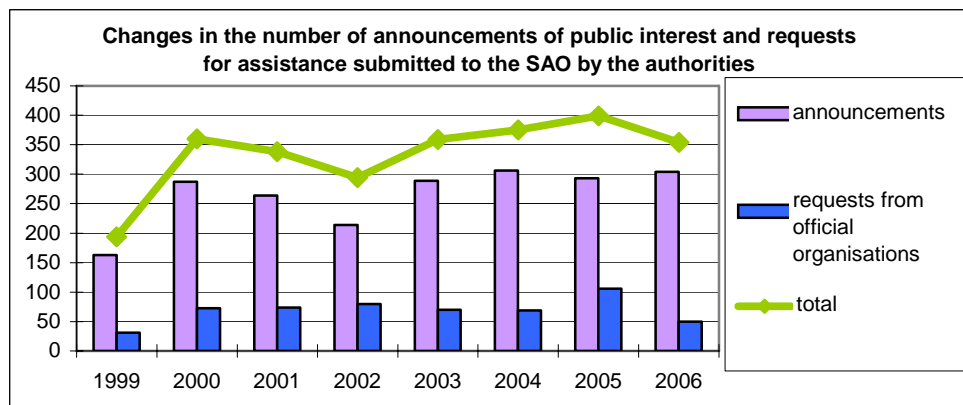
Apart from raising the possibility of criminal liability, pursuant to the Act on Public Procurement, the SAO is authorised to initiate review procedure **for the**

¹³ In 2005, the SAO filed charges 5 times in relation to 5 audits. The charges affected 7 persons.

violation of public procurement regulations. In 2006, the SAO initiated review procedure before the Public Procurement Arbitration Committee 21 times. It was determined in 17 cases that a violation of law occurred. The proceeding was dismissed in three cases, and one proceeding is still under way. The total value of contracts affected by review procedures due to the unlawful omission of public procurement procedures equalled **HUF 781.9 million**. In this relation the Public Procurement Arbitration Committee imposed a total fine of **HUF 14.5 million**.

3.4. **Announcements, proposals and complaints of public interest**

In 2006, as many as 304 announcements, complaints, proposals and other requests were submitted to the SAO, and authorities requested assistance 50 times.



With minor fluctuations, the number of announcements shows a growing tendency. Citizens, civil organisations, natural or legal persons representing certain cases most often requested a SAO procedure (usually audit), as well as legal information for solving their problems. The issues raised were taken into account by the audit directorates as much as possible within the operational audit programmes.

As many 170 announcements affected the scope of operation of **local and minority self-governments**. An increasing number of announcements were submitted by local governmental representatives and officials. Most audits were requested by the opposition representative of the body of representatives, and the chairman of the finance committee. For the first time, audits were requested to reveal abuses related to the utilisation of EU funds.

As many as 28% of citizens making announcements were **not willing to disclose their names**. Most of them lived in small settlements. Their announcements typically contained charges based on mere suspicion, assumptions and hearsay lacking evidence.

After the **local governmental elections** held in the autumn of 2006, the newly elected executives of municipal local governments contacted the SAO 12 times asking for the extraordinary audit of the financial situation of their

settlements. The SAO could not fulfil these requests for the lack of capacity, however the requests contain valuable information for the preparation of the audit plan for the next period.

The number of announcements **transferred** to the SAO has slightly grown. State organisations (typically the public prosecutor's office and the public administration office) often claim the SAO's wide scope of authority when transferring cases they receive to the SAO.

The number of announcements in which measures, advice, legal interpretation or opinion was requested from the SAO in issues outside its competence remained steady. In letters addressed to the SAO citizens often complained about the failure of their initiatives at other organisations. In such cases we strove to provide maximum theoretical assistance to lay citizens in need, taking into account the scope of authority and possibilities of the SAO. The citizens expressed their thanks in their replies (55 letters), and sometimes they informed the SAO about the development of their cases.

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

One of the basic pillars of the SAO's activities is that our reports, publications, papers written by our staff are public and accessible by anybody in their entirety. It is on this basis that we organise our communication, support the audit and legislative activity of the National Assembly, as well as our relationship with the media.

Year 2006 was characterised by the duality of **continuity** and **change**. On one hand, the SAO continued the long-established and proven communication towards the National Assembly, the media and the citizens, while on the other hand we renewed our image, introductory publications and our strategy.

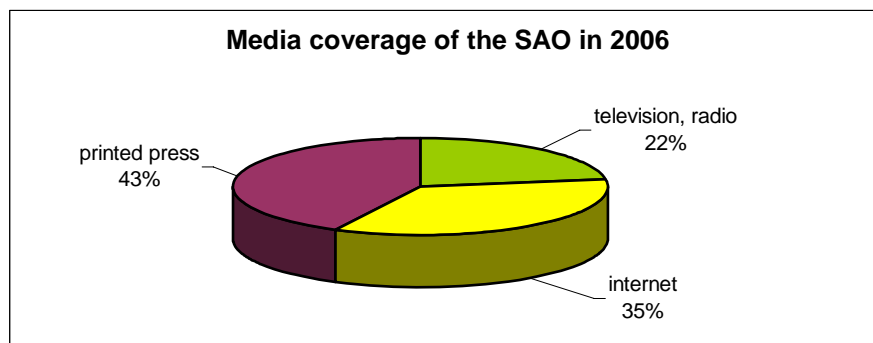
Similarly to the former years, **one of our main tasks is to inform and support the work of the National Assembly**. We forwarded to the new members of the National Assembly our renewed, updated introductory publication, as well as our strategy for the years 2006 through 2010. Similarly to the former years, the members of Parliament were notified about our reports in separate letters of notice ("distribution" of the letters to the members of Parliament and of the reports is primarily effected electronically). We continuously monitored the work of parliamentary committees, our staff members attended their meetings as necessary. Furthermore, we facilitated the work of the members of Parliament with our professional comments, and by sending them our reports and publications in printed format.

Maintaining relations with the media, editorial staffs and journalists is one of the most important parts of the SAO's communication activities. In 2006, we organised three presidential press conferences, and held nine press conferences in different parts of the country in conjunction with the county local governments and the local governments of cities with county rank. In 2006, the Directors General held two press conferences in Budapest: we presented the study of the Research and

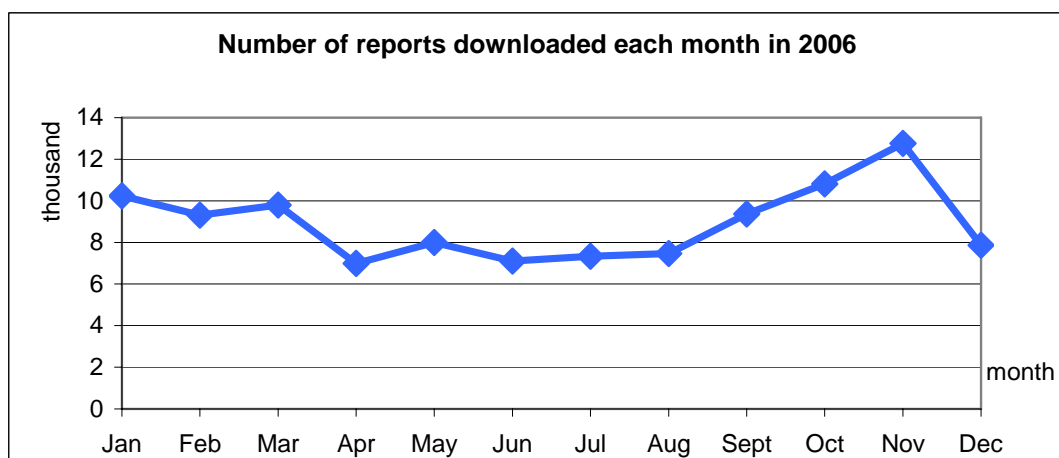
Development Institute (RDI) of the State Audit Office of Hungary titled “Environment conscious economic activities and sustainable development in the light of regulation and audit experiences” to media professionals, and then we provided information about the audit experiences related to the financial management systems of local and local minority self-governments.

We forwarded the press summaries of our reports directly to the national news agencies, editorial staffs and journalists. In line with our multi-year practice, we also published the summaries of the reports and personnel news of the SAO in the Official Bulletin of the Hungarian Gazette.

The broad interest in our work is indicated by the fact that according to the information given by the Observer Media Monitoring Ltd., as well as our own media processing, nearly **4,000 SAO related publications** appeared in about 200 different media outlets **in 2006**. The trend is growing year after year.



Our internet website has provided information about the rate of downloading detailed information, reports and other documents (letters of representatives, English language summaries of the reports, etc.), as well as about the number of visitors to the different menu points since May 2005. It was then when we installed a customer satisfaction form on our website.



Our experience shows that our website is a popular source of information for entities interested in our activities and reports: in 2006, there were more than **97,000 visitors to our homepage**. External visitors downloaded reports on a total of 107,033 occasions¹⁴, opened cover letters and English language summaries 4,066 and 380 times, respectively.

The primary goal of setting up the customer satisfaction form was to get feedback about our website services. In 2006, a total of 71 visitors used this possibility to express their views about the SAO's website. The answers received provide information about the level of visitor satisfaction with the usefulness of information available on our website, about the user friendliness of the website, the quantity and the freshness of information. We evaluate the data obtained from the completed forms in detail every six months. In relation to 2006 it can be stated that those who filled out the form used the SAO's website primarily for their job. The most frequently visited columns were the "Reports" and the "Audit Methodology" columns. The respondents were satisfied with the amount of information available on the website.

Our website offers several possibilities for those interested to establish direct contact or dialogue. The column titled **Forum** provides two ways for asking questions or making comments: either through the "SAO Forum" or the "Meet the President Hour".

The "**SAO Forum**" receives questions and comments on a continuous basis, and the answers appear on the website within maximum 8 days. Last year 66 questions were received: most of the askers asked for legal assistance or an opinion related to the solution of a concrete problem.

The "**Meet the President Hour**" was organised three times last year. The column was opened one week prior to the Meet the President Hour on each occasion. Questions could be uploaded from that time on, and answers were provided at the previously announced time. The "Meet the President Hour" provides an opportunity for visitors to the website to have a live dialogue with the senior officials of the SAO about issues of interest. The announced topics included: SAO audits conducted in 2006, the SAO's strategy for the years 2006 through 2010, the SAO activity report 2005, the SAO opinion on the budget bill for 2007, the audit of the maintenance of state owned public roads and that of the utilisation of EU funds in 2005.

In the former two possibilities 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 183 questions were asked via this channel.

¹⁴ It often happens that external visitors download more than one report.

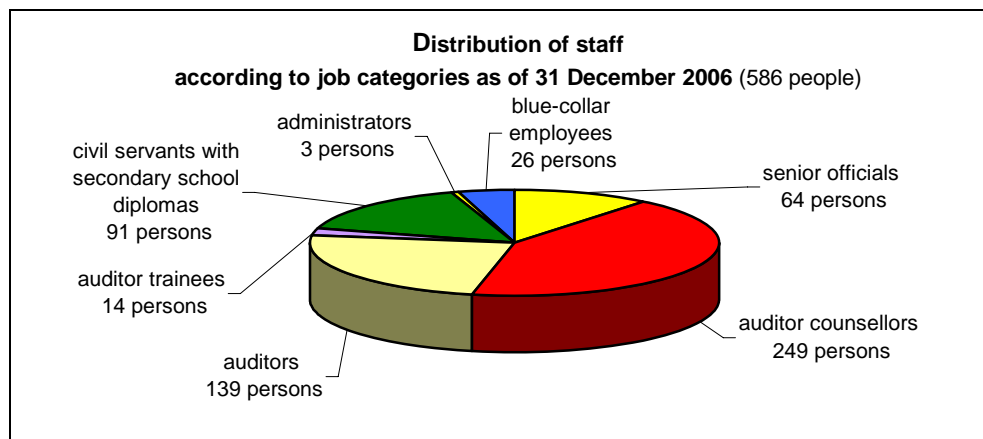
4. IMPROVEMENT OF THE QUALITY OF THE AUDIT WORK

4.1. Human resources management and development

Personal conditions

In 2006, the human policy objectives and measures were developed in harmony with the SAO's strategy and the general requirements of public administration development. The harmony between the audit tasks and the available capacities had to be created with consideration of the central staff and wage restrictions that affect our organisation, too. We reviewed the characteristics of our staff (age composition, qualifications, task sharing between the different jobs), and with minor organisational adjustments we could maintain efficient operations and the implementation of the audit plan.

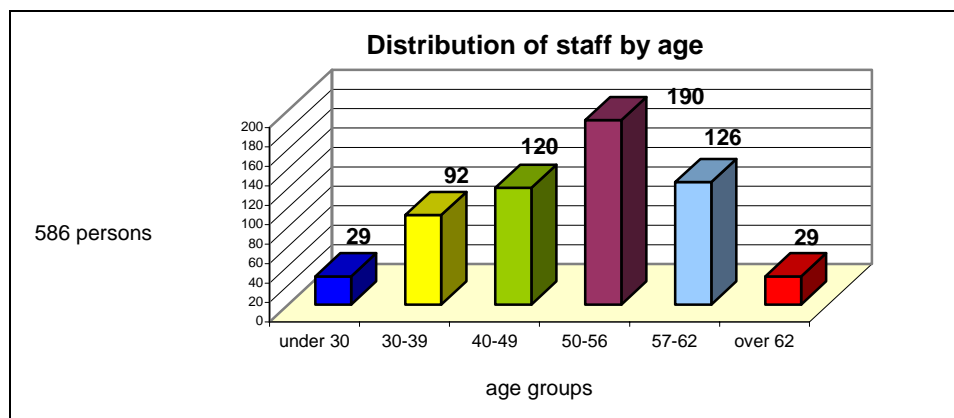
Due to the relatively high average age, we examined the possibility of retirements as a natural way of downsizing. We prepared a retirement plan for two to three years, the concrete schedule of which was discussed by the employer's senior officials and the staff members affected in the course of personal meetings. The action plan and the implementation thereof are not automatically adjusted to pension entitlements, since the special features of the jobs and personal conditions – first of all individual performance – must also be considered.



The SAO's approved staff number in 2006 was 618, including the 8 public employee jobs in the Research and Development Institute (RDI). We earmarked to reduce the staff by 20 persons by the end of the year, which we implemented in a sustainable manner. As of 31 December, the SAO had 586 employees.

A formerly formulated staff-strategic objective was to reduce the average age of staff members, and to approximate the age indicators of the different employment groups. Due to retirements, the average age is 48 years. There are reasonable boundaries for rejuvenation among auditors, especially senior

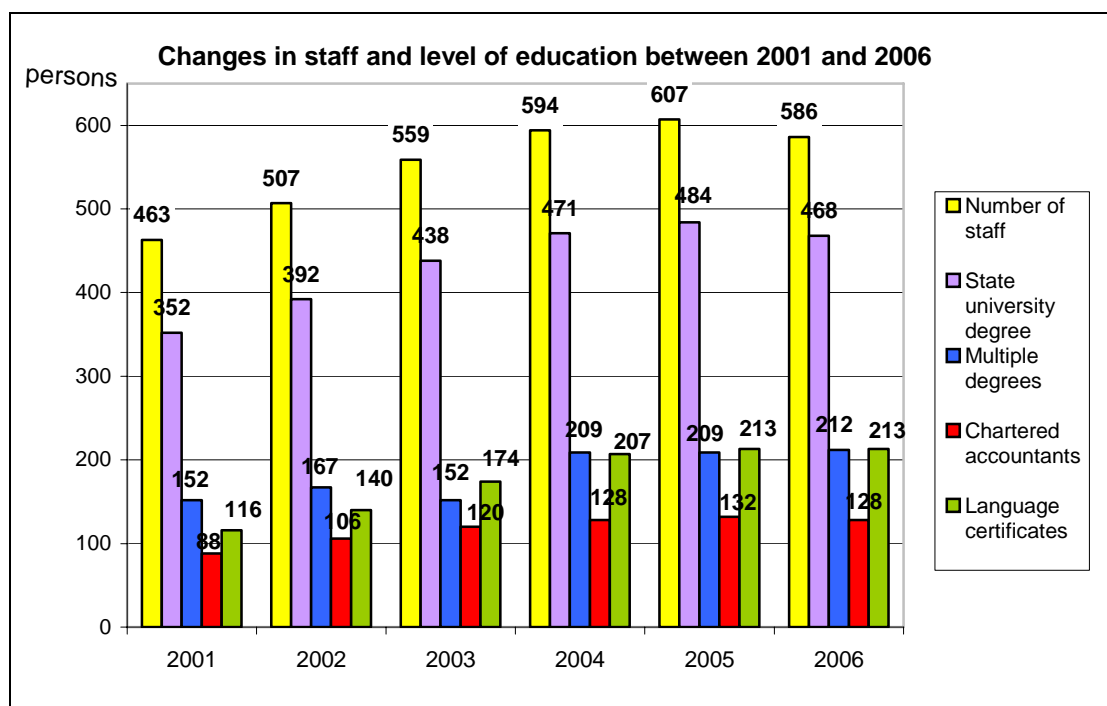
auditors, since due to the responsibility to be assumed for the findings, the audit tasks require greater than usual professional knowledge, which means that longer experience must be obtained in the given job.



Similarly to the former years, staff fluctuation in our organisation was negligible in 2006, too: 37 staff members left and 15 persons were hired. For reasons of actual status management the ratio of those leaving and new hires turned around compared to the tendency observed in the previous medium-term period, and in the foreseeable future the number of new hires cannot exceed the number of those terminating their public service relationship.

Since due to the retirements several experienced audit experts left the world of work, we paid increased attention to the professional and ethical requirements of hiring and employment in order to maintain professional quality and efficiency. In the job advertisements and hiring process preference is given to professionals who – in addition to the standard degrees in finances or economics – have postgraduate qualifications, possess two or more diplomas or specific higher level qualifications in finances.

The continuous generation shift goes together with changes in professional qualifications and knowledge. Younger staff members that replace (or work under) auditors with longer audit experience and higher qualifications bring with them more up-to-date professional basic knowledge, broader knowledge of foreign languages, better IT skills and more flexible skills for further education.



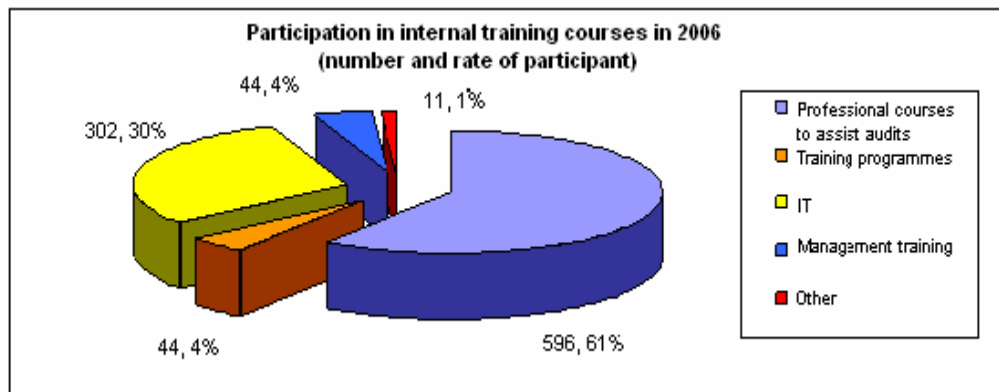
Apart from professional expertise, the efficiency of organisational activity is greatly influenced by the staff's attitude. The work of auditors directly involved in audits is evaluated by the project leaders after the completion of each audit. The aspects of evaluation are linked to the audit objectives, and the phases of implementation (preparation, on-site work, report writing, justification of the findings, deadlines, etc.). Last year 563 evaluation reports were prepared about the auditors' activities. The senior official exercising the employer's rights prepares a qualifying report based on the performance evaluations and the career development trend every four years. In 2006 as many as 78 qualifying reports were prepared.

Due to the scarcity of funds available as incentives for the auditors, year 2006 was characterised by the slowdown of promotions and the compulsory withholding of due career steps.

Extension training

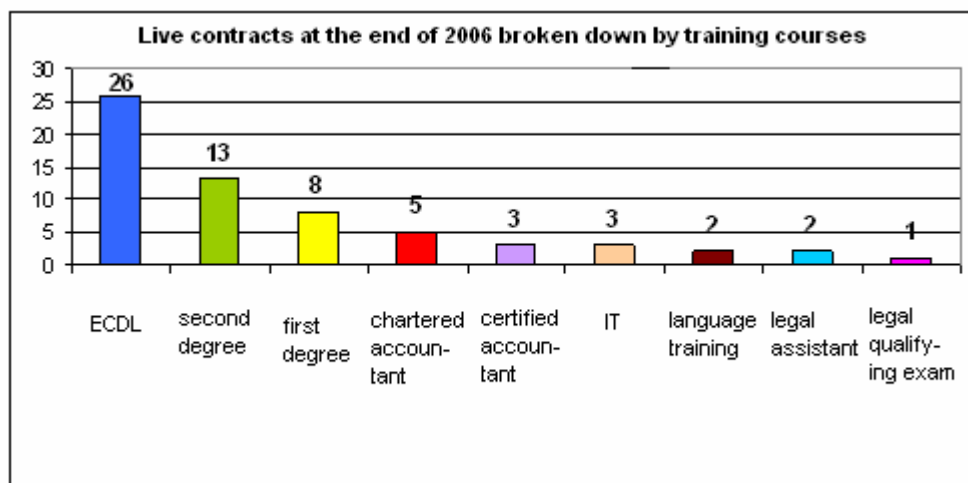
As far as internal further training is concerned, **courses that directly assist the auditors' work** are the most popular among our staff. In 2006, we paid special attention to lectures teaching the different types of audits, as well as accounting and legal courses offering up-to-date information. As a new form of training we make our staff familiar with the rules of the quality management system, and the objectives of its development. There was continuing demand for professional presentations organised by the senior auditors to support the preparation of auditors involved in the given audits. We also paid special attention to the transfer of modern, ever-changing IT skills, and since the

technical and data protection security of information management is of utmost importance, we strive for the development of security-conscious user behaviour.



Around 50 senior officials and auditors working for the SAO are involved in higher level education and vocational training – in different classes in each semester – especially in the fields of public finances, audit organisation and audit methodology. For people interested in higher level professional training we organised an education methodological training course in conjunction with the Central European University.

In order to improve job competence and the level of preparedness, we provide working hour reduction and financial means to support the professional and language training of our staff members as much as reasonable and depending on the financial possibilities – often by building on the experiences of qualifications and personal performance evaluations. In 2006 as many as 15 persons completed their SAO-supported studies successfully, and 16 new study contracts were signed. Currently we have 63 live study contracts.



Within the human policy and education system supporting the SAO's strategy priority is given to the development of the electronic organisational and educational methods of extension training. By **testing the elements of the**

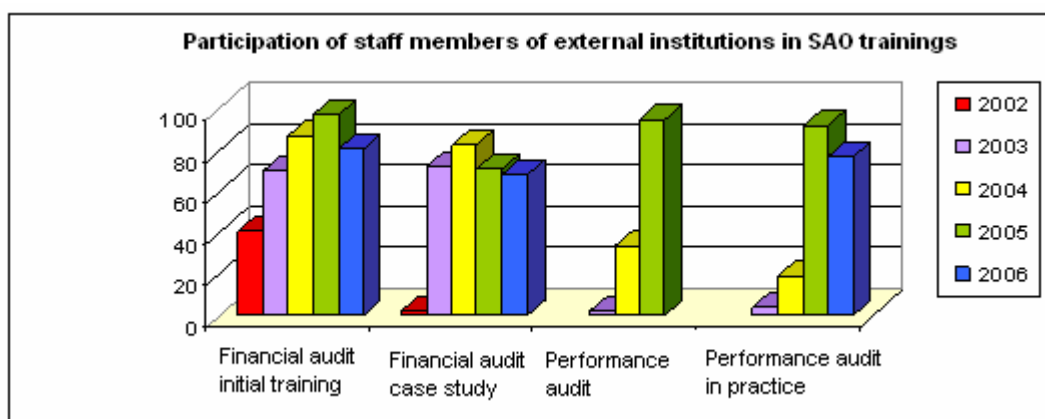
e-learning (distant learning) project, and then by commissioning the system, the SAO obtained a leading position in public administration.

In 2006, the following electronically available teaching materials could be used with the help of the distant learning framework system and the management system supporting and monitoring the learning process: CD Legal Database teaching material, CD Legal Database exam material, ECDL start package, basics of financial audit (with IDEA examples), language teaching software in various languages and at various levels.

There has been great interest in our financial audit (FA) distant learning teaching material. Last year the number of registered users grew to 312 after 55 new authorisations to access were granted. In the meantime, in addition to the FA material, the performance audit (PA) teaching material was also prepared, and since it is included in the accredited teaching materials of the Hungarian Institute of Public Administration, it becomes nationally accessible for public administration professionals.

The SAO methodologies are supplemented with electronic teaching materials, which can also be used instead of in-person training courses, for preliminary preparation and ex-post information updates not only for the SAO's staff, but also for auditors working in the public sector, utilising state-of-the-art training assisting technologies and the benefits of the Internet. Following preliminary registration, auditors conducting supervisory and chapter audits can access interactive teaching materials on audit methodologies via the Internet, after entering their passwords.

The SAO has conducted traditional (classroom based, in-person) training courses in the fields of **financial and performance audits** for the internal controllers of ministries and institutions, auditors and other financial audit professionals since 2000. A large number of applications were submitted for such courses in 2006, too. We organised FA training courses four times for a total of 149 participants, and the three PA lectures we gave were attended by 77 people.



The SAO planned a similar educational budget for 2006 as for the previous year, which proved to be sufficient for achieving the training objectives. What is more, due to reasonable austerity measures and the better utilisation of the

tools available for education organisation, the funds actually used were less than the available amount.



4.2. The quality assurance of audits

In order to ensure the reliability of the SAO audits, as well as the fairness of audit findings, conclusions and recommendations, the **internal quality control and quality assurance system** was efficiently operated in 2006, too. The management supervision built in the audit process, and the professional reviews performed at specified points, provided continuous control over the auditors' audit activities, as well as the auditor's reports prepared about the findings of the on-site audits. All draft audit report was subjected to a double professional and legal review parallel to the contradictory procedure with the audited organisations. Furthermore, those draft reports that raised personal responsibility, were checked for fairness before they were handed over to the people concerned.

The SAO reports could be signed by the President only after the Quality Assurance Department, functioning independently from the directorates responsible for the audits, issued certificates certifying that the reviews were successfully completed.

The process of one sixth of audits completed by the two audit directorates in 2006 were subjected to a quality assurance review. Evaluation covered the entire process from preparations for the audit to the drafting of the audit report, compliance with the professional requirements and the envisaged high-level audit certainty, and on the whole it yielded satisfactory results.

The presidential decree regulating the quality management system of the SAO audits entered into force on January 1, 2006. The quality management system 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 it provides a standard system and a regulation framework for those elements of the professional principles and requirements contained therein that are vital for high quality audits and reports. In connection with the audit activity the quality management system focuses on those aspects, requirements and procedures that must necessarily be met in order to ensure good quality on a continuous basis. The presidential decree stipulated that

Organisational and Operational Rules, the rules of procedures, the Audit Manual, the methodologies and the teaching materials should be brought into harmony and supplemented with the regulations of the quality management system of SAO audits. The major part of this task has been implemented and the job descriptions have been updated.

4.3. International relations

The SAO has been being an active and – according to the feedbacks – accepted and acknowledged member of the international audit community. We achieved and further developed this position of ours in 2006 by striving to adopt and modernise new audit techniques and methodologies in line with our strategic objectives, as well to learn about and apply in practice the forms of efficient cooperation with audit institutions.

In addition, it can be regarded as a breakthrough in international cooperation that in 2006 the SAO undertook an active role in the transfer and practical implementation of modern audit and institution development principles within the boundaries of its possibilities and capacities, in well chosen regions, and occasionally in partnership with our more experienced foreign counterparts.

In 2006, the priorities of the SAO's bi- and multilateral international cooperation were determined by the functions of the Chairman of the Governing Board of the International Organisation of Supreme Audit Institutions (INTOSAI) and the increasing cooperation between the national Supreme Audit Institutes of EU Member States and the European Court of Auditors (ECA).

Multilateral professional cooperation

2006 saw the acceleration of the execution of **INTOSAI's** Strategic Plan (2005-2010), which had been approved in Budapest, and the implementation of the goals contained in the document. In relation to the further development of the audit standards the SAO participated in the completion of the tasks of the Professional Standard Committee, and was involved in the harmonisation of the audit guidelines of INTOSAI and the International Federation of Accountants (IFAC). We also actively contributed to the innovative activity of the Sub-committee on Internal Control Standard, aiming to flexibly respond to the changing external and internal conditions.

In relation to the knowledge and information sharing processes of the audit institutions, we contributed to the development of modern audit principles in several fields of professional importance, e.g. money laundering, fight against corruption, or the utilisation of funds set up for the mitigation of damages caused by tsunamis. We had the opportunity to share our experiences on privatisation related audits, too, with our counterparts at many forums.

Our effective work was largely due to the harmonious cooperation with the general secretariat of INTOSAI, as well as the president and staff of the national Supreme Audit Institution of Austria.

We played a leading role in the cooperation between EUROSAI and ARABOSAI also institutionalised within the framework of cooperation among the regional working groups of INTOSAI, in addition to the long-standing cooperation between EUROSAI and OLACEFS.

We ourselves increased the intensity of our involvement in the working groups of **EUROSAI** (e.g. IT, environmental auditing). In 2006, the SAO became a member of the training committee of said organisation. Almost concurrently, we started the preparations for organising the seminar on the quality requirements of audits. This event was hosted by the SAO in March 2007. Similarly, we started preparations, and the elaboration of the required documents for the next EUROSAI Congress to be held in Poland (Krakow) in 2008.

Last year again, the SAO had the opportunity to be involved in the activities of **EUORAI**, the umbrella organisation of European regional audit institutions. The events of this organisation, the topics of which included the audit of state debts and risk based audits, were attended by SAO officials both as speakers and participants.

The SAO continued to play an active role in the cooperation network (Contact Committee) of the supreme audit institutions of the **European Union**. This forum focused on the exchange of professional experiences on the audit of EU funds and other issues linked to the operation of the Community.

The audit institutions involved in the work of the Contact Committee aim to provide a comprehensive evaluation about the utilisation of EU funds at national level. In line with this intention, it was in 2006 that the SAO compiled a document on the audits of the utilisation of EU funds at national level for the first time. The publication was forwarded to the major domestic and foreign partners of the SAO.

Since Hungary joined the European Union, the SAO organised the meeting of liaison officers of said cooperation network for the first time. The meeting was attended by the representatives of nearly 30 national audit organisations, including those of the candidate countries. During the event we reiterated our intention to host the meeting of the Contact Committee in 2009.

At various international events we continued our fruitful cooperation with the **International Board of Auditors for NATO**, as well as **SIGMA**, which is a joint initiative of the OECD and the European Union. The head of SIGMA, who is also the co-chairman of the Working Group on Audit Manuals and Methods, specifically mentioned the continuous and extremely active participation of the SAO's staff when closing the activity of the working group.

The SAO participated in, and its President gave a talk at the regular forum organised by the International Consortium on Governmental Financial Management (**ICGFM**).

The heads of the national supreme audit institutions of the **Visegrád countries** met in Hungary in 2006. Based on the proposal of the SAO's

President made when signing a joint report on a former parallel audit performed in the field of environment protection by Austria, Slovenia and Hungary, the participants outlined the possibility of a new parallel audit. This work will presumably focus on the internal control systems of national institutions affected by the utilisation of EU Structural Funds. The Supreme Audit Institutions of all Visegrad countries will participate in the planned parallel audit.

Bilateral international relations

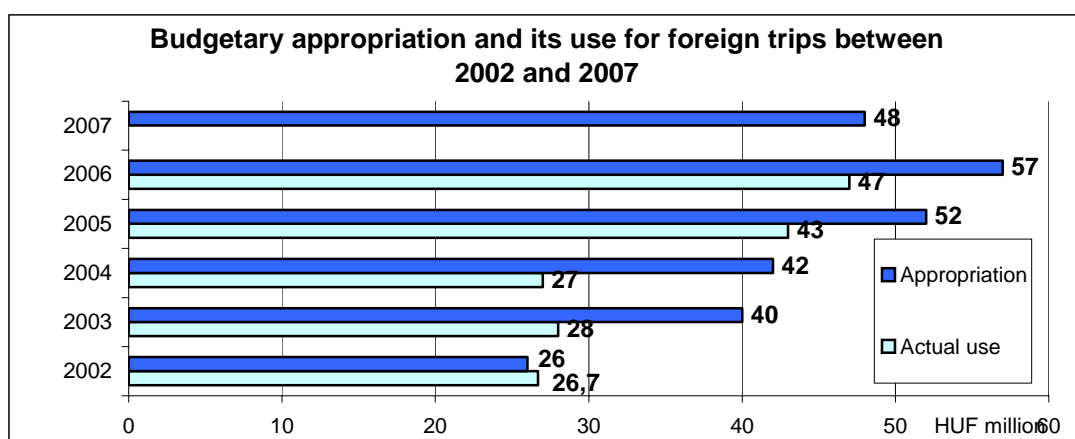
In the framework of bilateral relations maintained in 2006, we discussed certain fields of the professional work (audit of local governments, quality management system, IT audits, PPP schemes, etc.) in agreement with our partners. Our relations were especially intense with the national supreme audit institutions of the Central and Eastern European region (Visegrád countries, Baltic countries), but we also established extremely useful cooperation with partner institutions in Israel, Switzerland or Liechtenstein.

The SAO regularly received delegations (e.g. from Vietnam and Tajikistan) in order to present different fields of the Hungarian audit methodology (first of all regularity audit methodology), approach and activities.

We maintain longstanding, excellent and regular professional cooperation with the National Audit Office (NAO) of the UK, which has been our strategic partner since 1999. Pursuant to the agreement between the two national supreme audit institutions titled "Support to the development of an independent external audit function in the public sector of the Republic of Tajikistan", a SAO staff member assisted the work of the SAO's British counterpart as an instructor in a several weeks long training programme.

The budgetary aspect of the SAO's international relations

Due to the international acknowledgement of the SAO, the number of requests for involvement in international events is growing. Furthermore, foreign partner institutions demonstrate keen interest in the SAO's activities. In 2006, the SAO spent HUF 47 million on trips abroad.

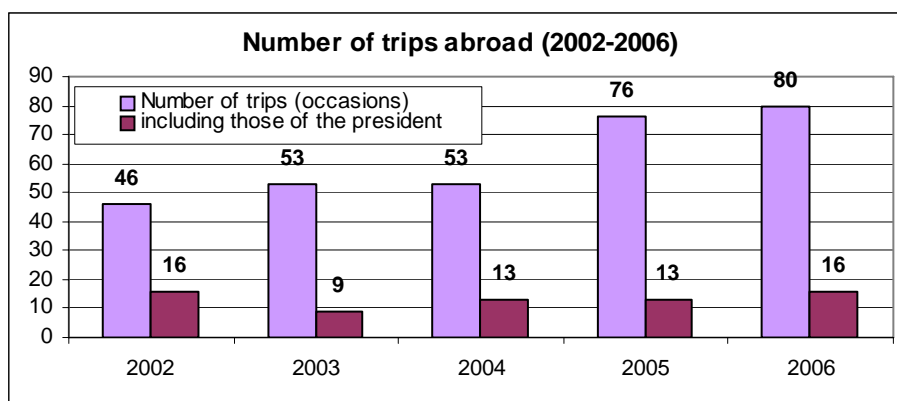


In 2006, the staff members of the SAO participated in 76¹⁵ trips abroad. This meant that 147 delegates spent 343 days outside the country. One foreign trip involved participation in a training course for a total of 29 days. (On average, each business trip abroad lasted for four working days.) The average cost for a working day spent on a business trip abroad totalled HUF 131,000 in 2006.

Out of the total actual expenditure HUF 35,979,000 (75%) was spent on pre-planned trips. The pre-planned and completed trips were realised within the framework of the preliminarily calculated budget, at 98.6% of all planned costs. In terms of the realisation of the business trip plan it is an unfavourable phenomenon that in 2006 as many as 18 events were cancelled. These events were included in the SAO's plan on the basis of the hosts' intentions and the experiences of the former years, although without having concrete invitations or knowing the exact dates. Plans cannot be made in relation to the growing number of requests for the delivery of speeches either.

The costs are largely influenced by the fact that the President of the SAO is the Chairman of the INTOSAI Governing Board until 2007, and this position requires several presentations abroad.

In 2006, the President of the SAO had 16 official visits abroad (compared to the 10 visits realised in 2005) for a total of 59 days (versus 38 days in 2005). Eight of these trips were realised as the Chairman of the INTOSAI Governing Board for a total of 32 days (versus 4 trips in 2005 for a total of 13 days). The average costs of a presidential trip equalled HUF 550,000, and the average daily costs totalled HUF 149,000.



During the trips the austerity requirements are fully met. The senior officials and staff members of the SAO do not use the services of interpreters when travelling abroad, and neither do they ask remuneration for talks given at various professional conferences. In such cases the registration fee, and in certain cases the travel and accommodation costs are borne by the foreign partner. In the field of international relations the SAO does not provide catering on the basis of reciprocity. It pays for the travel costs of its own delegates, and consequently, it does not account the travel costs of visitors as

¹⁵ Not including trips in relation to which no costs were incurred.

“catering for foreign visitors”. To reach destinations within Europe, the delegates either travel by car, or use the services of the least expensive airlines, and always as economy class passengers. On a few occasions we also used the weekend discounts offered by the airlines. The cost-efficiency of such trips, similarly to that of travelling by car, was preliminarily examined on a case by case basis.

A trip report specified in the internal regulations was prepared about each trip and their useful experiences. All trip reports are publicly accessible in the SAO’s library.

5. RESEARCH AND ADVISORY ACTIVITIES RELATED TO THE AUDIT WORK

In line with the SAO’s strategic objectives, in 2006 the **Research and Development Institute of the SAO** continued to make all efforts to contribute to the modernisation of audit methods in harmony with the international standards, to the creative adaptation of the international best practice, and to promote the preparation of comprehensive evaluations on the utilisation of public funds.

In accordance with the research programme, the Institute conducted scientific and methodological research in several topics, including the status and tasks of the development of the knowledge based society and economy, the directions of the financial reform of public finances, on the competitiveness of the public sector and the economy, on the methodological issues of decisions related to the involvement of private partners, on the analysis of tax subsidies, on the possibility to shift to programme budgeting, as well as on the possible role of SAO audits in the fight against corruption.

In most countries of the world, audit institutions are responsible for revealing corruption risks and for fighting against corruption. In 2006, several national audit institutions (Columbia, Serbia and Ukraine) organised international conferences and seminars on what audit institutions may do in order to prevent and detect corruption. Within the bounds of possibility, the SAO attended these events, its representatives presented the Hungarian experiences, and aimed to learn about the latest international results.

During its audits the SAO evaluates the transparency of operations and the accountability of financial management, and thus identifies and indicates the risks and possible acts of corruption, and makes recommendations to prevent errors and irregularities. In justified cases it initiates criminal proceedings. In addition, the SAO prepares summary studies that analyse the reasons behind corruption and highlight the risks and trends.

In 2006, the SAO applied for funds from the Institution Building program under the EU Transition Facility Funding under the title “Fostering the further development of anti-corruption measures and the implementation of the anti-corruption government strategy”. The application was approved by the Commission of the European Union. The implementation of the project is the responsibility of the Research and Development Institute (RDI). The contract is expected to be signed in the first half of 2007. As a result of the project, we will

develop analysis methods – in conjunction with the leading European partner organisations – that help us identify the risks of corruption and areas especially exposed to corruption during the preparation and realisation of the audits.

In the 2006 activities of the RDI special emphasis was placed on the development of the regulatory concept for the Act on Public Finances. Within the framework of its advisory role, the SAO undertook to develop a concept 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.

Continuous methodological development that is aligned with the environmental changes and the international trends, and that supports practical audit work is indispensable for the activities performed by audit institutions. In 2006, the SAO completed and introduced the new methodology of performance audits, which also contains an electronic teaching module. The SAO continuously modernises, updates and expands methodological tools that support the concrete audit work.

In relation to the development of the internal control system of the public sector – which receives great attention both at international and national level – we continued the adaptation of approaches and principles of the “best international practice” and the development of the related methods. This work also extended to cooperation carried out in the INTOSAI Sub-committee on Internal Control Standards, to cooperation with the Ministry of Finance responsible for the coordination and harmonisation of the internal financial control system of public finances, as well as to the elaboration of the risk assessment of internal control systems, and working documents and drafts required for the methodological development of external reliability audits. Said documents are partially related to the methodology of comprehensive audits.

Our methodological work included the elaboration and further development of various teaching materials, and training itself. The latter was carried out in the framework of internal extension training courses at the SAO, as well as lecture sessions in domestic educational institutions specialised in the given field.

We participated in the methodological work of certain partner audit institutions. Within this framework, the SAO staff members actively participated in the implementation of the development programmes of Macedonia and Tajikistan as instructors.

In 2006, supporting the development of the Hungarian system of public finances, and the development of the SAO’s strategy for the years 2006 through 2010 specifying the main directions and volumes of SAO audits formed the backbone of the activities of the **President’s Advisory Board**, which is a consultative work organisation assisting the management activities of the SAO’s President. Within this framework, the Advisory Board carried out several professional consultations about the SAO’s strategy, first of all about principles and values, strategic directions, the development of organisational

management, the development of contact systems, as well as about the principles of the regulatory concept of the new, comprehensive act on public finances, which came to the limelight in connection with the modernisation of public finances and the convergence programme. In addition, the Board paid attention to the annual report evaluating the SAO's activities in the previous year, the activities of RDI, and reviewed the major content related issues of editing the Public Finance Quarterly.

The SAO met the needs of the finance profession and fulfilled its tasks mandated by the parliamentary resolution by issuing the bilingual (Hungarian-English) public finance journal regularly, on a quarterly basis in 2006. The authors of the renewed **Public Finance Quarterly** include regular and correspondent members of the Academy of Sciences, university lecturers, senior professionals working in the public sector, experts and Ph.D. students. Relying on the activities of the Editorial Committee, too, the content followed the main direction of financial and economic processes that belong to the scope of this professional journal. The thematic range of the journal focuses on the analysis and evaluation of the operations of public finances, the reform of public finance, the convergence programme and the underlying background correlations. Last year the journal focused on national economic and corporate aspects of competitiveness, the maturity of Hungary's economy for integration, the development of cooperation between the public and the private sectors, and the vision of the European Union. It also paid special attention to the domestic employment situation, the inflation-targeting system of the National Bank of Hungary, and the change of paradigm in the fight against money laundering. The journal was favourably received in foreign, university, OECD and EU circles alike.

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 bill and the bill on the final accounts. The financial management of the chapter is audited by an independent chartered accountant appointed by the Speaker of the National Assembly upon the submission of applications. The report evaluating the SAO's activities in 2006 is expected to be completed by the end of April.

Due to the greater responsibility arising from legal authorisation we found that the chapter's budget appropriation bill should continue to present the SAO's basic strategic objectives in detail, the professional tasks arising from these objectives, focusing especially on audits contained in the SAO's audit plan, and legally required to be carried out at certain intervals. Furthermore, we 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 – we prepared a detailed, transparent, and thoroughly conciliated draft budget plan for the National Assembly. During the preparation of this plan we took into consideration of 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. We strove to ensure that the SAO should comply with its legal obligations – as much as possible – 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 7,719.6 million for the SAO to perform its tasks in 2006, HUF 7,699.6 million of which was granted in the form of subsidies and HUF 20.0 million was provided from the SAO's own revenues. Compared to the original appropriation of the previous year, this meant a growth of less than 1%. The scope of action in utilising budgetary resources was again reduced by the fact that more than 75% 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 the SAO should pursue plan-based investment, renovation and procurement policies, making use 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 4,568.1 million, the contributions payable by the employers totalled HUF 1,424.0 million, the non-personnel expenses equalled HUF 1,122.1 million, the institutional investment costs totalled 321.6 million, the renovation appropriations totalled HUF 123.8 million, and the chapter's general government reserves equalled HUF 160.0 million.

The approved appropriation was increased by HUF 548.9 million due to the interim modifications, as a result of which HUF 8,268.5 million was available. Within the modifications, HUF 542.4 million resulted from the approval of the residue of the previous year's appropriation, HUF 2.8 million resulted from the contributions provided for research conducted with support from the OTKA Foundation, and for extension training courses pursuant to an agreement with the Ministry of Interior, and HUF 3.7 million resulted from the repayment of housing loans provided to employees.

Altogether HUF 7,698.3 million was utilised, which accounted for 93.1% of the expenditure appropriation. Personal disbursements and contributions payable by the employers totalled 78.8% of the expenses (HUF 6,065.3 million). Non-personnel expenses and expenditures for cumulative purposes accounted for 14.0 % and 7.2%, respectively.

Compliance with the expenditure appropriation was influenced by the observance of the obligation to create mandatory reserve, for the sake of which payment obligations for only 2007 could be fulfilled from the selected appropriations.

In contrast with the planned revenues of HUF 20 million, only HUF 15.9 million was realised. Most of the revenues came from the fees for studies prepared by the Research and Development Institute (RDI) of the SAO, the sales of unnecessary equipment and vehicles, the lease of premises, as well as services the costs of which were transferred to other parties through invoicing. The SAO realised revenues of HUF 2 million as expert's fees and cost reimbursements for cooperation with its British counterpart in Tajikistan.

As much as 13.6% (HUF 77.0 million) of the reserve (totalling HUF 565.7 million including the HUF 4.5 million unrealised revenues) was offered to improve the balance of public finances, and will be deducted during the accounting of the appropriation residue. The rest of the reserve (86.4%) entirely comes from the rescheduling, postponement of tasks, performances and invoices fully bound by undertaking obligations to 2007 (primarily due to the obligation to create a mandatory reserve).

With the planned austerity measures and expedient procurements the available appropriations altogether ensured the operational conditions required by the institution to perform its tasks smoothly.

6.2. Infrastructural operations and developments

In year 2006, too, it was a priority task to ensure the adequate level of working conditions, to maintain or improve the state of repair of the existing office buildings, and to enhance the availability of equipment.

The greatest development in 2006 was the reconstruction of the lifts in the SAO's Headquarters in Apáczai Csere János utca, which included the replacement of the passenger lift cabins, the expansion of the lift tower, and the installation of a safety glass cover combined with wrought iron elements to preserve the monument-like appearance of the building.

We prepared the technical plans for the heating modernisation of the headquarters in Apáczai Csere János utca.

2006 saw the continuation of the reconstruction of the electrical networks in the Budapest based premises of the SAO, and the renovation of the offices according to the plans. In the headquarters located in Apáczai Csere János utca, as well as in the office building in Lónyay utca, the lighting system of stairways and corridors was separated from the power supply of the offices during the electrical reconstruction project. As a result, the lighting of common premises can now be regulated depending on the power of incoming light.

In both office buildings the reception desks in the entrance areas were rebuilt using modern furniture befitting the functions of the office buildings.

In order to improve the working conditions, minor renovation and reconstruction projects were carried out in six county offices of the SAO.

In the headquarters in Apáczai Csere János utca we expanded and restructured the intrusion detection system.

With a view to save heating energy, all windows on the street façade of the office building in Lónyay utca were replaced with modern windows with excellent noise and heat insulation, and external blinds.

In order to reduce rents, we purchased the office space rented in the Dunaház Office Building to the benefit of the Hungarian State. The asset management of the offices is provided by the SAO. For austerity reasons, we terminated the rent of several office premises, whereby we can reduce our annual operational costs by HUF 30 million in the coming years.

In the subject year we spent a total of HUF 320.9 million on building renovation and reconstruction.

In order to provide high-level support to the audit activity, we spent HUF 73.9 million on the procurement of a colour printing-machine, on the refurbishment of older models, on the procurement of Xerox machines and other office equipment, as well as on the replacement of worn office furniture.

For the gradual renewal of the vehicle fleet, two vehicles, each older than six years, were replaced at a cost of HUF 13.1 million (which also included the purchase of other vehicle parts).

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 with the help of IT and telecommunication tools. Similarly to the former years, IT and telecommunication developments in 2006 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, standard network telecommunication system that can flexibly respond to the changing communication needs. This is also due to the fact that the SAO's professionals keep the developments under continuous and reliable control, and applicants submit their bids being aware of this. Competition and fair professional behaviour keep costs under control, which therefore do not put a disproportionate burden on development appropriations.

During the year we developed new application software and continuously develop systems that were introduced formerly.

In 2003, the SAO introduced a computer aided electronic education organising system, which can be used not only for the management and registration of internal training courses, but also for running and administering standard electronic teaching materials. In the past years we incorporated several electronic materials in the system, including the ECDL material designed to teach the application of Microsoft Office programmes, the programme teaching the application of the Complex CD legal database, as well as the distant learning material on financial audit methodology developed by the SAO. In

2006, we completed the development of the distant learning material on performance audit methodology.

After a preliminary study and detailed status assessment, the project plan of the Electronic Audit Documentation Management System (EADMS) was completed in 2005. Within the framework of this project, the SAO intends to develop an electronic system to support the documentation of the audit work, to file and store the documents produced or collected during the audits. For the implementation of the development, in 2006 the SAO submitted a successful application for EU Transition Facility through the National Development Agency. In accordance with the approved project plans, the Central Finance and Contracts Unit and the SAO will launch a public procurement procedure for system development in 2007, in compliance with the rules pertaining to the EU Transition Facility.

Each year, the SAO pays utmost attention to the further development of its website in terms of content and format alike. In 2006, we started to develop the image of the website based on the SAO's new image plan. Development will be completed in 2007. In parallel with the website, we developed new thematic databases for the efficient management of information by the continuous development of the SAO's Intranet system. Our application system titled "Electronic Presidential Meeting" (3E) has been functioning since January 2005. In this system information about the management meetings, the letters of invitation, the documents to be discussed can be electronically accessed and retrieved by those affected right from the preparatory phase. Another benefit of the system is that it can be used for storing the decisions made at the meetings, the assignment of tasks and the monitoring of task performance. The memoranda compiled about the agenda items discussed are electronically available for all SAO employees. Since 2006, the meetings of the Secretary General have been administered in a similar system.

In 2006, we expanded our case tracking and filing system introduced in 2000 with the archiving function. As a result, computer assisted file management became comprehensive. We further developed our SZEKRETER audit registration and monitoring system, which has included all material information about the SAO audits from planning to realisation of recommendations since 2002. 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.

We set up a computerised helpdesk system for the reporting, documentation and management of errors and problems related to the SAO's IT services. The system will be introduced in 2007, as a result of which problems can be managed and errors can be eliminated faster and in a documented manner. In addition, the executive officials have up-to-date registration about the failure notices, the current status of error mitigation, about the schedule of professionals providing such services. The introduction of the system will make it possible to measure the performance of employees involved in the operation of the IT system. The system was connected with the network based active asset management software, wherefore error messages from the network monitoring system and the management thereof is also documented.

With a view to reduce the security risks of IT services, in 2006 we installed new hardware and software to filter incoming e-mails (spams) and kill computer viruses. This system automatically deletes unnecessary e-mails and marks e-mails that may be spams. We ensured safe access to the different IT services by SAO employees by updating our firewall software.

Within the framework of infrastructure development, after several months of preparatory works we implemented network development at national level in 2006. All SAO sites were connected to the Electronic Government Backbone. The use of the complex network reduce the monthly costs by at least 10%, while the services are of much higher quality and provide more contents than before. The system also meets the requirements stipulated in the SAO's Security Regulations that call for the independence of the SAO.

In 2006, we completed the development of a network based, active device monitoring system, which allows system administrators to continuously monitor the status of devices connected to our computer network, which significantly reduces the time required for trouble shooting. We fully introduced remote management tools in the SAO's network. As a result, system administrators and technicians can solve most of the software problems without travelling to the site. Consequently, the travel costs of IT professionals to SAO offices outside Budapest could be reduced by around 50%.

Another important element of the 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 or notebooks – for the staff in order to enable them to fulfil their tasks in an efficient manner. In 2006, a total of 116 desktop computers and 51 notebooks were purchased through a centralised public procurement procedure. As many as 18 of these computers are so called Power PCs that support secretarial tasks in the county offices, and also function as central servers. Within the framework of the scheduled replacement of our equipment, four medium, two large and two colour, medium capacity printers were installed in various SAO branches. To ensure adequate central computer services and to enhance availability, one new server computer was purchased.

In 2006, the SAO spent HUF 89.9 million on software procurements, and HUF 58.2 million on the purchase of IT and telecommunications devices and equipment. The value of devices and equipment procured in December appears as residue subject to liability in 2006, and will be transferred in 2007.

6.4. Internal audit

In 2006, one internal auditor performed the internal audit tasks of the SAO.

The internal auditor performed his tasks in line with the relevant legal regulations and the Internal Audit Manual of the SAO, on the basis of the strategic and annual work plans 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.
- In the course of the audits **there was no suspicion** of any act, negligence or deficiency that would have served as a ground for **calling anybody to account**.
- 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.
- **Further measures need to be taken by the management** with a view to improve the efficiency of the system of financial management control.

The recommendations made in the internal auditor's reports are implemented as scheduled by the action plans approved by the Director of Finances. Half of the recommendations was realised by the end of 2006, and the rest will be implemented by mid 2007.