STATE AUDIT
OFFICE OF HUNGARY

S U M M A R Y

Findings and Conclusions of the Audit on the Execution of the Budget of the Republic of Hungary for the Year 2010

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László Domokos
President

State Audit Office of Hungary
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Person supervising the audit:

Dr. Pál Becker
Budgetary and Supervisory Director General

Person responsible for carrying out the audit:

Mr. Sándor Horváth
Audit Director

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PRINCIPAL EXPERIENCE

The estimated revenue appropriation of the subsystems of public finances in 2010 amounted to HUF 15,719.3 billion, the expenditure appropriation amounted to HUF 16,779.6 billion, and the deficit was HUF 1,060.3 billion, corresponding to 4% of GDP. The general government deficit was HUF 1,121.5 billion (4.1% of GDP), exceeding the original appropriation by HUF 61.1 billion (5.8%).

The contributions by the components of public finances to the increase in deficit were as follows:

General government deficit in 2010, on a cash basis

HUF million

Description	Original appropriation	Actual figure	Difference
Central subsystem	**-870,346.2**	**-889,474.5**	**-19,128.3**
Comprising			
Central budget	-836,063.0	-853,920.2	-17,857.2
Separated state funds	35,125.1	59,831.9	24,706.8
Health Insurance Fund	-69,408.3	-91,699.0	-22,290.7
Pension Insurance Fund	0.0	-3,687.2	-3,687.2
Local government subsystem	**-190,000.0**	**-231,989.0**	**-41,989.0**
General government total	**-1,060,346.2**	**-1,121,463.5**	**-61,117.3**

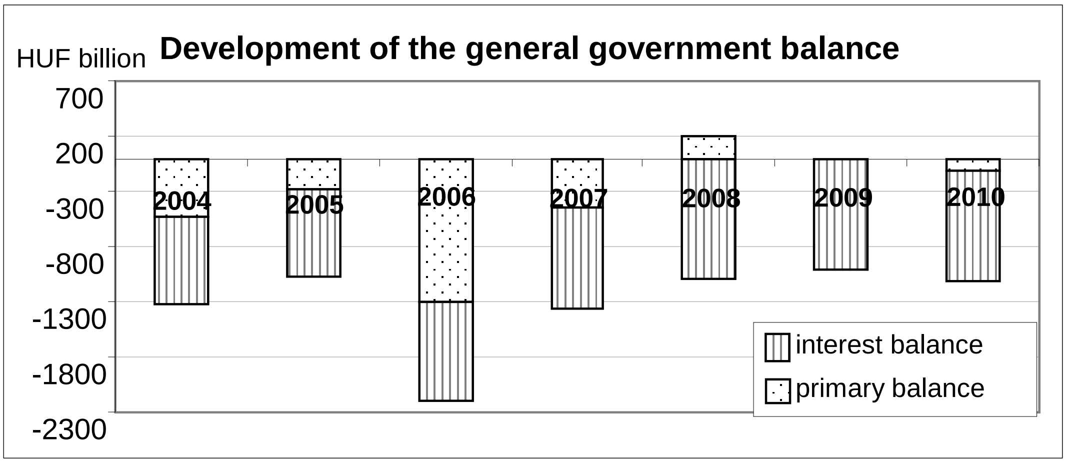
Source: final accounts bill

The fulfilment data exceeded the deficit appropriation originally envisaged in the Act on the Budget. The balance of separated state funds was 70.4% higher than the budgetary appropriation.

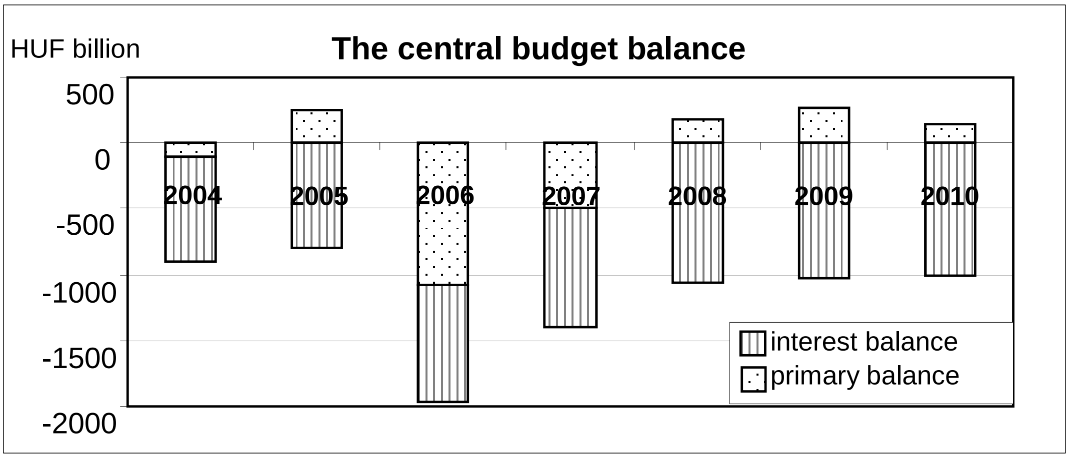
In contrast with the preceding years' differences amounting to several hundred billion HUF, the deficit at the general government level exceeded the originally budgeted figure by a mere HUF 61.1 billion.

As the developments in the planning environment – including those in the global economy – cannot completely be forecast, precise planning and responsible budgetary management are essential for attaining and maintaining the envisaged deficit target. Compliance with the set deficit target is of crucial importance in terms of the opinion formed of the credibility of the Hungarian national economy.

An important indicator in the shaping of budget policy and in the assessment of fiscal sustainability is the so-called primary balance, which expresses the result of the current financial management, and takes into account the expenditures without the interest burden of the debt accumulated in the past. According to its essence in terms of economic policy, it contains those revenues and expenditures where the Government may take measures in order to reduce total debt.



Source: final accounts bills



Source: final accounts bills

With the exception of 2008, no positive primary balance was attained at general government level. On a cash basis, the primary balance of the public finances amounted to HUF -112.9 billion in 2010. The primary balance was improved by the central budget by HUF 152.0 billion and by the separated state funds by HUF 59.8 billion, counterbalanced by the negative impact of local governments (HUF 229.3 billion), the Health Insurance Fund (HUF 91.7 billion), and the Pension Insurance Fund (HUF 3.7 billion).

FINAL ACCOUNTS

The provisions of the bill, its statutory annexes, and its general explanation and the annexes thereto are essentially consistent. There has been a decrease in inaccuracies in various parts of the document. Each year, the general explanation has been providing an increasingly comprehensive account, in both scope and content, of the fulfilment of the mandates provided by the Act on the Budget, also indicating where those concerned had not exercised their mandate.

Apart from a few exceptions, the final accounts document meets the relevant legislative requirements for the bill, which are not comprehensive. The document continues to lack a summary overview of long-term liabilities (Article 12/C (7) of the Act on Public Finances).

The control environment for drafting the bill has remained unchanged. Therefore, the SAO's earlier finding continues to apply that the current presentation system does not provide appropriate support for the constancy of the information content, transparency, comparison between years, and developing an understanding of processes, including the traceability of objectives and their fulfilment.

Several years of audit experience with the bill on the final accounts has confirmed that the quality of presentation will not substantially improve without the comprehensive regulation of drawing up the final accounts and detailed specifications for content and structure. The SAO has been giving indications of the need for separate regulations in this field, specifying the required and sufficient information in an unambiguous way. There have not been any developments of substance in this regard. The SAO's requirement is reinforced by the provision in Article 36 (2) of the Constitution of Hungary: '*All bills on the State Budget and its implementation shall contain all state expenditures and revenues in the same structure, in a transparent manner and in reasonable detail.*'

CENTRAL BUDGET

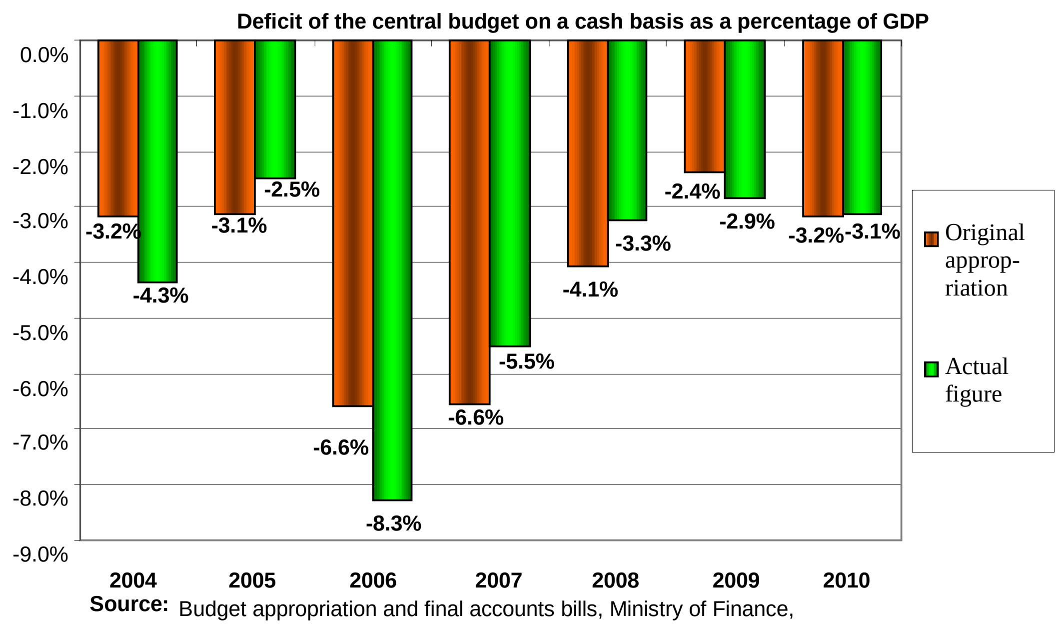
The **deficit** of the central budget was HUF 853.9 billion in 2010, exceeding the amount specified in the Act on the Budget by 2.1%. **The amount of the deficit was higher by HUF 109.1 billion (14.6%) than in 2009.**

The central budget deficit amounted to HUF 608.0 billion as early as March 2010, corresponding to 71.2% of the amount stipulated for the year. During the rest of 2010, the deficit increased dynamically, being HUF 1,021.9 billion (119.7%) in June, HUF 1,282.8 billion (150.2%) in November, and HUF 1,641.3 billion (192.2%) in the first half of December. The unfavourable developments in the current budget deficit called for immediate intervention during the year.

In order to adhere to the budgeted deficit, the Government adopted a number of measures. It drew up its first action plan of 29 points (budgetary savings, introduction of the bank tax), followed by the second action plan (introduction of a crisis tax, reallocation of private pension contributions), accompanied by decisions in June and December to block and reduce appropriations.

Developments in the central budget deficit were more unfavourable than planned in five out of the past nine years (between 2002 and 2004, in 2006 and in 2009).

In 2004, the central budget deficit exceeded the estimated amount by 32.6%. In 2005, it fell short of the appropriation by 32.6%, while it again exceeded the budgeted appropriation by 2.1% in 2006 and by 12.5% in 2009. In 2007 and 2008, it was 16.6% and 22.2% lower than the budgeted amount, respectively.



Source: Budget appropriation and final accounts bills, Ministry of Finance, Hungarian Central Statistical Office

In addition to the new taxes introduced in the second half of 2010, the deficit in 2010 was influenced by the fact that certain appropriations of decisive significance in terms of the equilibrium of the budget differed from the fulfilment of such to a lesser or greater extent.

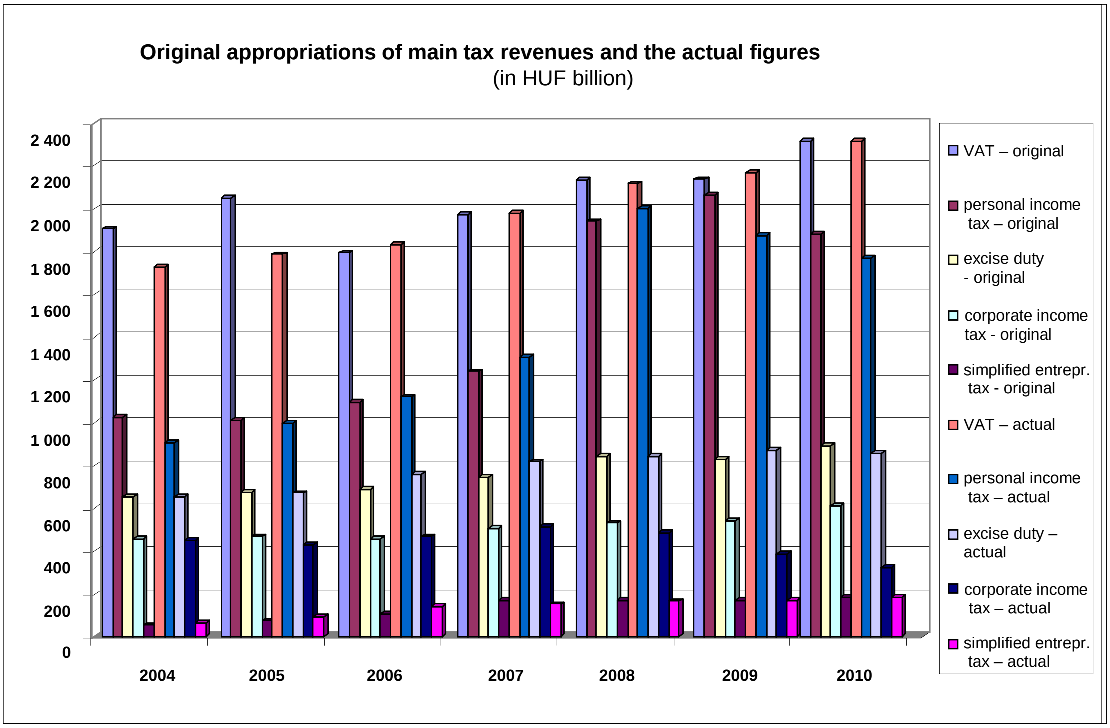
Tax revenues (consumption-related taxes and payments by economic entities and private individuals) were a total HUF 235.8 billion below the amounts envisaged in the act (HUF 6,422.2 billion) despite the introduction of several new taxes during the year in order to meet revenue targets. The deficit was increased by a HUF 30.0 billion shortfall against budgeted revenues related to state property. The macroeconomic processes on which planning was based were volatile in 2010.

> Rather than the envisaged 0.9% fall, the GDP increased by 1.2% (HUF 820.0 billion); however, owing to excessive planning and despite the introduction of the new taxes, payments by economic entities exceeded the legislative appropriation by a mere 0.1% (HUF 0.8 billion). The special taxes introduced during the year generated revenues of HUF 334.0 billion. Without these taxes, the shortfall would have been HUF 569.8 billion.
>
> The shortfall in revenues was the greatest in the case of payments by households, as income subject to consolidated taxation increased by only HUF 96.6 billion against the estimated increase of HUF 1291.0 billion.

The shortfall in tax revenues was partly offset by the surpluses originating from other revenues (HUF 83.2 billion), subsystems of public finances (HUF 30.5 billion) and the revenues related to debt service (HUF 20.4 billion). With regard to the introduction of the title ‘other budget revenues’, it should be noted that most of the surplus payments were collected from the amounts paid by pension funds (HUF 64.8 billion) after taxpayers reverting to the social security pension system from the private pension system.

Surplus revenues of budgetary institutions and chapter-managed appropriations amounted to HUF 573.1 billion, but the expenditures of these appropriations, which were HUF 721.1 billion higher than planned, resulted in a HUF 148.0 billion overall growth in the deficit. The deficit was increased by an excess of HUF 97.6 billion in certain expenditure appropriations (individual and normative grants, subsidies to subsystems of public finances, enforcement of guarantees, contributions to the EU budget and expenditures related to state property). The deficit was reduced by an underspending of HUF 27.3 billion on certain expenditure appropriations (subsidies to families, social benefits, interest costs).

In its opinion on the 2010 budget, **the SAO called attention to the risks of macroeconomic trends and the uncertainty of the realisation of the budgeted tax revenues.**



The SAO had no means to assess the substantiation of the draft appropriations (budgeting) for the tax revenues of the central budget in 2010. The feasibility of budgeted tax revenues and, with a few exceptions, the risk involved could not be assessed in the absence of certain data and detailed calculation materials which are required for adopting an opinion.The SAO indicated risks with the achievement of the targets for corporate income tax, VAT and credit institutions' allowance. The shortfall in revenues from the taxes deemed to involve feasibility risks amounted to HUF 289.2 billion compared to their appropriations, which could only partly be mitigated by surplus revenues totalling HUF 68.0 billion from mining rents, company car tax and other payments. The surplus from mining rents (HUF 61.9 billion) was generated by an increase in the price of crude oil in the world market, a rising average annual rate of mining rents, as well as by the early exploitation of so-called cap gas by MMBF Natural Gas Storage Ltd. Tax revenues falling short of plans were partly counterbalanced by the special taxes (levied on certain industries and on financial organisations) introduced during the year.

Based on data from the National Tax and Customs Administration, **arrears** in 2010 amounted to HUF 1989.3 billion, a 15.5% increase from the closing accounts for 2009. The increase in arrears was coupled with a continuous deterioration in composition: according to the accounts of the tax authority, 70% of the outstanding amount was attributable to non-operating taxpayers in 2009, the same figure rising to 75.4% in 2010.

In recent years, there has been a significant increase in the amount of tax arrears, which in 2010 was nearly double the HUF 989.8 billion in 2007. At the end of 2010, tax arrears amounted to HUF 1890.2 billion, 15.2% higher than in 2009.

43.8% of the arrears is related to VAT, 5.4% to personal income tax and 3.6% to corporate income tax.

Arrears of duties amounted to HUF 75.1 billion, which was 7.1% less than in 2009 (HUF 80.8 billion), owing primarily to an increase in derecognised amounts.

The tax authority used all means available (a progressive increase in the number of acts of enforcement, expansion and development of IT systems, derecognition due to assignments and means other than assignment) to curb the increase in arrears, but its efforts were sufficient only to slow the rate of the increase.

Based on the records of the tax authority, **overpayments** in 2010 amounted to HUF 756.4 billion, which was 3.2% higher than in the previous year. Also in the year under review, a majority of overpayments was neither necessarily, nor in full amount a payment obligation to taxpayers. In 2010, overpayments continued to accumulate owing to payments of reclaimed VAT being carried over to the next year, advances paid on taxes, and errors made by taxpayers.

Balances of arrears and overpayments*

Description	2007		2008		2009		2010	
	HUF billion	2007/ 2006	HUF billion	2008/ 2007	HUF billion	2009/ 2008	HUF billion	2010/ 2009
Arrears	1,079.7	113.7%	1,410.4	130.6%	1,722.9	122.2%	1,989.3	115.5%
Overpayments	836.5	108.3%	766.9	91.7%	733.3	95.6%	756.4	103.2%

* based on data supplied by the National Tax and Customs Administration

In the 2010 final accounts bill the fulfilment data of the direct revenues of the central budget – with the exception of data related to state property (on which the SAO issued a limited qualification) **– are reliable**. In the case of the revenues under review, the Hungarian Tax and Financial Control Administration and the Hungarian Customs and Finance Guard (which realise 71.8% of the revenues of the central budget) performed all material taxation, duty collection, customs administration and excise activities in conformity with the relevant regulations and their own internal rules.

Internal controls were adequate at the Hungarian Customs and Finance Guard and generally adequate at the Hungarian Tax and Financial Control Administration, although the review identified deficiencies at the latter in certain cases. In connection with the qualification of unpaid taxes as irrevocable, the **deficiencies** revealed by the SAO's audit **are related to the fact that the internal controls used by the tax authority** in these fields (such as corporate income tax, arrears of duties, overpayment and payment preferences) **are not comprehensive in scope**.

The selection system of the tax authority selected 2,537,702 tax returns for review before payment and for public debt review in the major taxes (corporate income tax, VAT, personal income tax). Out of the tax returns selected, 89.8% were filtered out and 8.1% were dispensed by auditors. **The rest of the selected tax returns (47,926 returns) were reviewed by the tax**

authority. The amount reclaimed in the tax returns reviewed accounted for 28.6% of the **amount reclaimed** in all selected tax returns. Consequently, **HUF 1,243,778.0 million was refunded to taxpayers without any review**, which is worthy of special attention.

The fulfilment data of the direct expenditure appropriations of the central budget – with the exception of other housing subsidies and the expenditures related to state property (on which the SAO issued a limited qualification) **– are reliable**.

> With respect to other housing subsidies, the SAO found every year since its audit of the 2005 final accounts that payments were made against the appropriation in the case of six credit institutions in the absence of signed new contracts. This irregularity continued to exist in 2009 and 2010 in the case of three credit institutions, which were the same in both years.

In the field of the Hungarian State Holding Company's financial and economic activities, there has been an improvement compared with 2009 in terms of the daily level of processing revenues. In 2010, revenue payments were generally made on the basis of invoices previously issued by the company, which predominantly ensured that revenues were identified in compliance with the law. As a result of IT development implemented in 2010, the identification of the legal title of revenues and their accounting under the appropriate legal titles became more accurate than in 2009.

Records related to state property continued to be **based on predecessors' records which were not fully documented.** The property register maintained by the Hungarian State Holding Company failed to comply with the provisions of the Act on Accounting at the time of drawing up the 2010 interim balance sheet.

Revenues related to state property (HUF 71.0 billion) were significantly lower than the budgeted amount (HUF 101.4 billion). This was due primarily to the fact that the call for proposals concerning the sale of frequency use rights was not launched, resulting in lost revenues of HUF 20.0 billion. Within revenues from sales, a major shortfall of about HUF 9.0 billion in the sale of arable land was caused by the circumstance that the National Land Fund, despite the legislative conditions having been provided, failed to carry out full acceptance of the agricultural property from the Hungarian State Holding Company in 2010. As confirmed by the SAO's audit, the reason for such failure was that the organisation was prevented from engagement in economic activities generating budget revenues in 2010 for lack of space, staff, assets and resources. In 2010, like in previous years, the SAO was of the opinion that there was a lack of harmony between the envisaged revenues from sale of real estate and the fulfilment thereof.

Expenditures related to state property were 17.2% higher than the original appropriation (HUF 81.4 billion) and 3.3% higher than the revised appropriation (HUF 92.3 billion). This overspending was due primarily to expenditures required for the acquisition and recapitalisation of MALÉV Ltd.'s stake, which did not involve any cash flow.

The accounts were not in conformity with the content of the revenue or expenditure with respect to an amount of HUF 366.5 million in total. The

SAO's audit found two instances of payment without performance (HUF 441.6 million).

In 2010, a **payment** of HUF 26.0 billion was made **in connection with MALÉV Ltd.** (capital increase).

In 2010, the **funding[1] requirement for the central subsystem of general government was unfavourable in comparison with plans**, excepting the financing plan for October 2010.

In 2010, the net funding requirement of treasury institutions[2] amounted to HUF 871.9 billion, with the total net funding requirement[3] being HUF 966.9 billion. The amounts specified in the financing plan of January 2010 were exceeded by HUF 34.1 billion in the case of the total net funding requirement, and by HUF 1.5 billion in the case of treasury institutions. The reason for this is that the amounts specified in the financing plan of January 2010 were exceeded by HUF 1.7 billion for the state budget deficit, HUF 26.2 billion for social security deficit, and HUF 26.5 for the balance of extra-budgetary funds.

The additional funding need of the central subsystem of general government was met by a total net issue[4] of HUF 513.3 billion, the utilisation of HUF 324.4 billion out of the foreign exchange deposits made using the loan granted by the IMF/EB (subsequent calls were not made), and the utilisation of mark-to-market deposits in the amount of HUF 109.3 billion.

In 2010, funding continued to be provided for the central budget, the social security funds and the separated state funds.

At the end of 2010, the **gross debt of the central budget** amounted to HUF 20,041.0 billion, **exceeding the plan** (HUF 19,509.5 billion) **by 2.7%** and the corresponding figure for 2009 by 5.7%.

> The growth rate compared to the previous year was 10.1% in 2005, 15.2% in 2006, 6% in 2007, 16.2% in 2008, 4.8% in 2009 and 5.7% in 2010.

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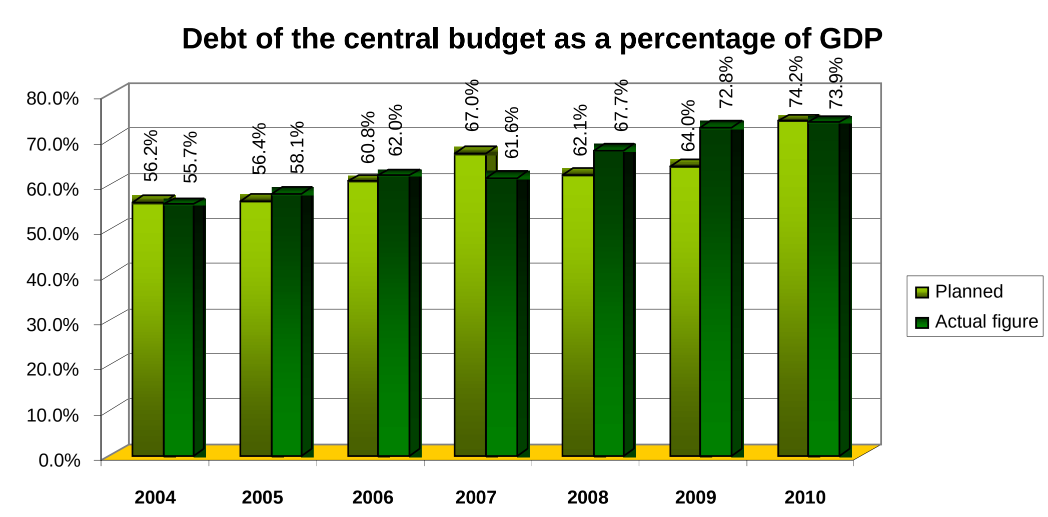
1 The annual funding need is determined by the renewal requirement of expiring debts, as well as the prevailing deficit of the central budget, the social security funds and the separated state funds. Furthermore, the funding requirement may be modified by changes in the Single Treasury Account balance and the equalisation reserve of the National Bank of Hungary, the granting of advance and liquidity loans specified in the Act on Public Finances and the share of advance payments related to EU funds and of privatisation revenues affecting the budget.

2 The combined balances of the central budget, the financial funds of social security, and separated state funds.

3 The amount of the balance of the state budget deficit, the funding need of social security funds, the funding need of separated state funds, the reserve accumulation of the National Bank of Hungary as well as of the pre-financing and reimbursement of EU agricultural subsidies, excluding debt assumptions.

4 The total of the balances of issuances in forint and foreign exchange, borrowings and repayments as well as foreign exchange deposit transactions.



Source: Budget appropriation and final accounts bills, Hungarian Central Statistical Office

Gross debt for 2010 amounted to 73.9% of the GDP, up 1.1% from the previous year.

Last year's increase was the result of a higher net issue owing to favourable market demand in 2010, the devaluation of the forint, and an increase in mark-to-market deposits placed with the Government Debt Management Agency following swap transactions[5]. A 2.5% increase in the exchange rate of the forint against the euro from 272.1[6] to 278.8[7] also added to the gross debt of the central budget.

There have been no major changes in the composition of the total debt in comparison with the previous year. The ratio of foreign exchange debt was 44.1%. At the end of 2010, the total foreign exchange debt of the central budget was worth HUF 9,062.8 billion, coupled with a debt of HUF 10,978.2 billion in forints, representing an increase of 6.8% and 4.8% compared to the end of 2009.

The negative balance of HUF 49.5 billion of the advance payments of the EAGF subsidies from the Single Treasury Account contributed, even if only to a small extent, to the increase in total debt in 2010.

The **financing position of budgetary institutions continued to be characterised by debts which were high** throughout 2010 **and increased significantly**. Notwithstanding the high amounts, the debt can be considered temporary and of liquidity in nature.

> Total annual debt amounted to HUF 41.1 billion at the end of 2010, HUF 11.3 billion higher than in the previous year. Average annual debt (HUF 28.3 billion) increased by 50%.

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5 To manage the risks in foreign currency debt, the Government Debt Management Agency opens swap transactions.

6 The exchange rate envisaged at the time of planning the 2010 budget.

7 Official rate of exchange on 31 December 2010. Source: National Bank of Hungary

The average value of qualified debts (i.e. 3.5% in excess of the original budgetary appropriation or HUF 50.0 million) amounted to HUF 6.6 billion, which was HUF 4.4 billion more than in the previous year. Qualified debt amounted to HUF 12.4 billion, corresponding to 3.2 times the closing amount of 2009.

> Two-thirds of qualified debt is concentrated in only three institutions: the State Health Centre (Military Hospital, HUF 3.1 billion), the Central Office for Administrative and Electronic Public Services (HUF 2.0 billion), and the University of Pécs (HUF 3.1 billion).

The composition of total debt by types of debt has not changed significantly. While other trade accounts payable continue to be decisive both in terms of their quantity and proportion, as a result of measures taken earlier and the functioning of the debt monitoring system jointly operated with the Hungarian Tax and Financial Control Administration as well as the introduction of the net financing order of the Treasury (which prevents the arising of new public debt), institutions' tax and contributions debts have essentially been eliminated.

Enforcement of guarantees and counter guarantees undertaken by the state was 64.6% higher than the 2010 appropriation of HUF 20,379.0 million.

In one case (HUF 3,628.8 million), **EXIMBANK Ltd.** and the **Hungarian Export Credit Insurance Pte Ltd. failed to apply the appropriate weighting in the assessment of risks** when approving the transaction **as part of the allocation and coverage of a loan** involving a guarantee by the state. In our judgement, the risks identified **should have been considered more prudently**. In connection with that case, guarantees worth an **annual HUF 3.0 billion (HUF 20.0 billion in total)** under the loan agreement are expected to be redeemed **until 2016** against the central budget. **The amount of recovery is estimated at 40.7% of the net present value of redemptions.**

As a result of the SAO's audit, both EXIMBANK Ltd. and the Hungarian Export Credit Insurance Pte Ltd. reviewed and modified the relevant procedures.

Pursuant to a decree by the Ministry of Finance, remittance duties involved in guarantees redeemed by the Hungarian Export Credit Insurance Pte Ltd. and EXIMBANK Ltd. are discharged by the Ministry of Finance/Ministry of National Economy, without reviewing the contents of the transaction. **Remittance without any review of contents poses risks.**

In 2010, the Hungarian Tax and Financial Control Administration continued to have the procedures in place concerning which the SAO raised objections years ago. The SAO report No. 0928 on the on-site audit of the implementation of the 2008 Act on the Budget found that **in the course of redeeming guarantees related to various housing loans (public officials and staff, *'Fészekrakó'*), the procedure for issuing resolutions to bind debtors was not consistent** within the Hungarian Tax and Financial Control Administration in cases where borrowers were also joint and several debtors. In a majority of such cases, the procedure **did not follow the relevant authorities** and as a result, it lacked legal and regulatory compliance.

Following the findings and warning resulting from the SAO's audit, the Hungarian Tax and Financial Control Administration continued to apply the unlawful procedure for two and a half years, including 2010.
The circular to establish consistent procedures was issued by the Tax Department of the Hungarian Tax and Financial Control Administration only on 12 November 2010. The competent vice-chair of the Administration issued the relevant procedures on 6 December 2010. Neither the relevant instruction by the President of the Hungarian Tax and Financial Control Administration, nor its draft was available for the purpose of the SAO's audit.

> In June 2009, the Hungarian Tax and Financial Control Administration provided the following written communication:*'The IT system to ensure the consistency of currently different practices within the Directorate is being developed.'*When the review was commenced, the elaboration of procedures was already in progress for the transitory period until the system was completed.

The original legislative appropriation of the **central budget reserves** (general reserve, special reserve, stability reserve) for 2010 amounted to a total of HUF 188.9 billion. Following two legislative adjustments to the appropriation of the general reserve during the year, the total was modified to HUF 285.1 billion. During the year, HUF 150.5 billion were reallocated to the chapters, HUF 0.6 billion of which was restored in 2010. Taking this into account, the total utilisation of reserves amounted to HUF 149.9 billion (52.6%), while the year-end residue was HUF 135.2 billion.

In consistence with the audit experience of the previous years, **the reallocation of the appropriation of the general reserve was not justified in a number of cases** (amounting to 26% of the reallocated appropriation of HUF 118.4 billion for the year), and claims failed to comply with the provisions of the Act on Public Finances.Regarding certain tasks, the need for additional resources which occurred at specific chapters could have been anticipated and planned for and cannot be regarded as unexpected funding needs generated by unavoidable revenues lost.

The reallocation of HUF 32.4 billion amounting to 21.1% of the annual appropriation of HUF 153.5 billion was carried out in the second half of December 2010 (between 15 and 27 December).

From the HUF 33.0 billion appropriation of the **special reserves**, HUF 32.0 billion were reallocated as coverage for various payments set forth in Article 6 of the Act on the Budget; HUF 0.6 billion of this amount was restored during the year on the basis of the accounting and reimbursement obligation. Accordingly, the fulfilment of the appropriation amounted to HUF 31.4 billion, while the year-end residue was HUF 1.6 billion. Under two out of the seven legal titles specified in the Act on the Budget, appropriations were not utilised.

The Act on the Budget provided for an appropriation of HUF 98.6 billion in **stability reserves**, which was not utilised. The year-end residue equals the amount of the appropriation.

Measures have been taken in response to certain **recommendations** concerning the deficiencies revealed by the SAO in the course of its previous audits. However, certain problems recurring over several years continued to exist in 2010 as well.

As in previous years, some of the 2010 fulfilment data for **revenues and expenditures related to state property** remained inconsistent with the appropriations. Over the past years, no progress has been made in terms of taking a fair and complete inventory of state property. In 2010, as in 2009, the Hungarian State Holding Company continued to perform its tasks relating to the state property that was entrusted to it without having orderly, precise and complete property records confirming actual state property with an itemised inventory containing the updated value of the shares of the state. In several cases, the time limit for the action plans responding to recommendations extended beyond the period of on-site audit, as a result of which such action plans could not be assessed.

Settlement has been reached concerning the legal aspects of the utilisation of the real estate that became the property of the Hungarian State as a result of the sale and purchase of the property of the National Horseracing Company in Dunakeszi-Alag. However, the circumstances of the tender procedure for property management and security services, and the agreement concluded with the Ministry of Defence Electronics, Logistics and Property Management Private Company Limited by Shares MoD ED Co. were not reviewed.

In 2010, no measures were taken concerning the harmony between the Act on Exchanging Compensation Notes for Life Annuity and the Act on Public Finances. In its comments, the Hungarian State Holding Company indicated that it had *'initiated measures for legal harmonisation'*.

The SAO's audit recommended that manually performed tasks, which pose risks, should be replaced by electronic processes at the Hungarian Customs and Finance Guard. An action plan was developed to achieve this, but its time limit in several cases extends beyond the period of the on-site audit, as a result of which the actions could not be assessed.

The results of actions specified in guidance and instructions issued for the further implementation of the action plan (reduction of claims outstanding, derecognition of lapsed debt, and a uniform interpretation of bad debt) are not reflected in the data stated in the current account on 31 December 2010.

Based on the findings of the 2009 audit of the final accounts, a risk analysis methodology was added to the system of auditing IT security management at the Hungarian Customs and Finance Guard. In 2011, the recommendations made concerning electronically submitted excise returns were incorporated into the IT system operated by the customs authority to process returns.

On the recommendation of the SAO, the Ministry of National Economy developed its action plan, which requires that the SAO's recommendations should be taken into account in the development and national implementation of intergovernmental agreements involving the remission of **foreign claims by the Hungarian State**.

Based on the SAO's recommendation, **Garantiqa Creditguarantee Co. Ltd.** reviewed its portfolio of guarantees and in 2010, it cancelled guarantees undertaken at its own risk. Owing to their nature, additional measures planned by the company provide an ongoing task.

No measures have been taken in connection with the findings and recommendations concerning the allocation and revision of appropriations for the **general, special and stability reserves**, the substantiation of claims, accounting for and reimbursement obligations related to reallocated appropriations, and the date of annual updates to the recording system of adjustments to budgetary appropriations.

The assets procured as part of the development of the **K-600 communications system** are still not recognised in the balance sheet of any of the organisations despite continuous indications by the SAO, since the audit of the 2007 final accounts, regarding the need for settlement.

In 2010, a **signed new contract** conforming to Government Decrees 12/2001. (I. 31.) and 134/2009. (VI. 23.) was still not in place at all credit institutions involved in the disbursement of **housing subsidies**. The other recommendations made by the SAO concerning housing subsidies have been implemented.

The recommendations made to the President of the **Hungarian Tax and Financial Control Administration** (with respect to the procedure to be followed upon the more frequent use of **grants** and the authorisation of one-off grant advances) were implemented following the procedures issued by the President of the National Tax and Customs Administration.

Based on the SAO's finding related to the application of the **remission code** *'Other'*, the Hungarian Tax and Financial Control Administration revised its procedures in 2010. Accordingly, the Administration applied the revised procedures to reviews carried out in 2010, and reduced the number of remissions on 'Other' grounds in comparison with 2009.

As in previous years, the internal audit of IT systems remained unresolved in 2010 within the organisation of the **Treasury**. The organisation continued to lack essential IT regulations.

BUDGETARY CHAPTERS

In 2010, structural changes in government had a major impact on the operation and financial management of the chapters controlled by the Government. The new structure is aimed at streamlining, reducing the number of ministries and as a result, making public administration cheaper. 8 ministries have been created instead of the previous 13; nevertheless, the scope of duties to be discharged remained the same despite the reduced number of organisations.

The Act defined the grounds for restructuring, specified the legal successors of the ministries, and provided for the reallocation of certain tasks among the ministries, as well as the procedures and documentation of transfers between predecessors and successors.

> The Act contains detailed specifications for the contents of records on ministry-level transfers and those of IT systems, and requirements for the documentation of the same. Transfers between institutions and other administrative organisations were documented in annexes to the records.

The records of ministry-level transfers were completed in the required form and contents within the time limit available, and were accompanied by letters of representation by the transferring parties.

The procedure of transfers involving central administrative bodies, budgetary institutions, economic entities and foundations was not fully consistent with Decree 2/2010. (VI. 8.) issued by the Ministry of Public Administration and Justice.

> With respect to the procedure, the audit found formal deficiencies and that information content in records was more limited than required.

In accordance with the new structure of ministries, the rearrangement of duties as provided for in Government Decree 212/2010. (VII. 1.) required transfers not only between appropriations, but between the professional organisations of the ministries, as well as of the assets used for the discharge of the duties.

> Organisations have been rearranged; however, problems were identified with implementation in terms of the assessment of personal allowances, the transfer of assets and the availability of documentation.

Several government decisions contain provisions for the implementation of the Act. The Treasury appropriately rearranged the appropriations according to the new structure, based on data supplied, with delays in certain cases, by the ministries. In 2010, in implementing the government decisions on the further allocation of duties, the ministries concerned either did not conclude all the required agreements, or failed to fulfil them within the time limit applicable.

The ministries and other organisations affected by structural change were required to draw up new statutes and Operational and Organisational Rules, as well as to make arrangements for registration.

The ministries met their obligation to draw up statutes, issued temporary Operational and Organisational Rules for the transitory period, while keeping the regulations of their predecessors in effect. The new Operational and Organisational Rules were issued by the end of the year, the audit of which identified deficiencies in the case of the **Ministry of Rural Development** and **Ministry of National Resources**. Rules of procedure and job descriptions were not fully updated.

Regulations required for the financial management of institutional and chapter-managed appropriations were mostly issued in the second half of 2010. With respect to chapter-managed appropriations, the procedures of predecessors were followed.

Our findings of the financial regularity audit of the financial statements suggest that structural change and its impacts also influenced the reliability of the statements. In financial statements given a qualified opinion, some of the detected errors may be attributed to deficiencies in regulation, records and accounting which are related to structural change.

Constitutional and uni-institutional chapters, budgetary institutions with chapter rights, as well as the Hungarian Central Statistical Office and the Hungarian Academy of Sciences were not affected by governmental change. The structure and duties of these organisations essentially remained the same, their financial management was subject to the same control environment, and their operations were not hindered by additional tasks related to change and the temporary difficulties involved.

> Out of the financial statements by organisations which continued their operations without any change, the ratio of those deemed reliable was approximately the same as in the previous year, whereas with organisations affected by change, the ratio of financial statements deemed reliable fell from 75% to 66%. With organisations affected by change, the ratio of statements given qualified or adverse opinions increased (from 19% to 26%, and 6% to 8%, respectively), while with organisations which continued their operations without any change, the ratios remained the same.

Approving opinions were given to the 2010 statements for **titles 1–4 of the National Assembly**; the administrative titles and chapter-managed appropriations for the chapters of the **Presidency of the Republic**, the **Constitutional Court**, the **Parliamentary Commissioners' Office of Hungary**, the **Prosecution Service**, the **Ministry of Public Administration and Justice**, the **Prime Minister's Office**, the **Ministry of the Interior**, the **Ministry of National Economy**, the **Central Statistical Office** and the **Hungarian Academy of Sciences**; the administrative titles of the **Ministry of National Development**; the chapter-managed appropriations for the chapters of the **Courts of Justice** and the **Ministry of Foreign Affairs**; and to those of the institutions of the **Hungarian Archives of the Hungarian State Security**, the **Fiscal Council**, the **Office of the Fiscal Counci**l, the **Hungarian Financial Supervisory Authority**, the **Hungarian Patent Office**, the **Government Audit Office**, the **Hungarian Atomic Energy Authority** and the **Prime Minister's Office**.

Owing to deficiencies identified in the course of the audit which did not affect the reliability of the statements concerned, emphasis of **matter paragraphs were included in the SAO's approving opinions** on the chapters of the **Parliamentary Commissioners' Office of Hungary** and the **Prosecution Service**; statements on the administrative titles and chapter-managed appropriations for the **Ministry of Public Administration and Justice**, the **Ministry of the Interior** and the **Ministry of National Economy**; the administrative title of the **Ministry of National Development**; the institutions of the **Hungarian Archives of the Hungarian State Security**, the **Fiscal Council**, the **Hungarian Financial Supervisory Authority** and the **Prime Minister's Office**; and the chapter-managed appropriations for the chapters of the **Ministry of Foreign Affairs** and the **Hungarian Academy of Sciences**.

The external chartered accountant attached an approving qualification to the statements of the **SAO**.

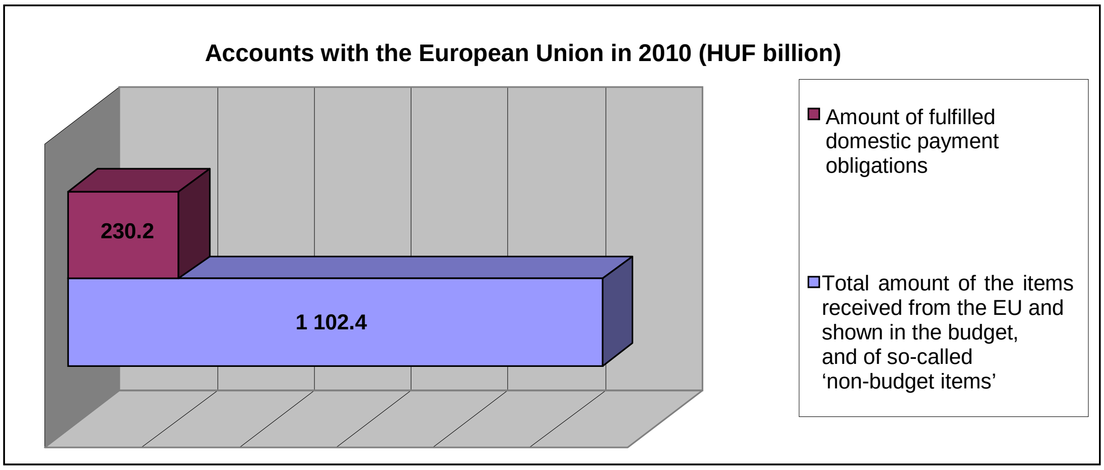
The SAO gave **limited qualifications** on financial statements concerning certain appropriations and balance sheet lines in the case of the Courts title of the **Courts of Justice** chapter; the **Hungarian Competition Authority** chapter; the administrative title for the **Ministry of Foreign Affairs**; the administrative titles and chapter-managed appropriations for the chapters of the **Ministry of Defence**, the **EU Developments** and the **Ministry of National Resources**; and the chapter-managed appropriations for the **Ministry of National Development**.

Adverse opinions were attached to the 2010 financial statements on the administrative title and chapter-managed appropriations for the **Ministry of Rural Development** chapter.

In the course of its on-site audit, the SAO found positive changes in comparison with the previous year in certain areas of the operations and financial management of the organisations under review, and stagnation in other areas. However, in addition to recurring problems related to the structural change in government, errors also occurred which had not been detected previously.

THE UTILISATION OF FUNDS FROM THE EUROPEAN UNION

Although its contributions to the EU budget have been increasing over the years, **the amount of assistance granted to Hungary in 2010 was still higher than its contribution to the EU budget.** In 2010, the total amount of HUF 1,102.4 billion of the **items received from the European Union** (EU) and **shown in the budget and so called 'non-budget items' was approximately five times the amount of the fulfilled domestic payment obligations** (HUF 230.2 billion).



EU funds shown in the budget (exclusive of subsequent recovery of EU grants) exceeded the planned amount by 26.7% (HUF 171,506.8 million), coupled with a 20.6% excess (HUF 38,678.8 million) in national co-financing shown in the central budget. The latter is a risk to meeting budget targets as it increases the deficit. Due to the combined effect of revenues from the EU and expenditures from the domestic budget both exceeding plans, the realisation of the appropriations including the EU funds exceeded the planned amounts by 23.7% (by HUF 198,000.3 million). Out of the so-called 'non-budget' agricultural subsidies, direct subsidies to producers accounted for HUF 247,412.0 million and agricultural market subsidies accounted for HUF 49,748.7 million.

In the programming period of 2004–2006, the managing authorities and intermediate bodies, with a few exceptions, observed the time limit for closing the operational programmes financed from structural funds, and submitted their final reports on each operational programme to the EU Commission in due time.

Out of the 43 projects financed from the Cohesion Fund, closing financial statements were submitted to the EU on only seven projects in 2010. The closing of eight projects has been postponed until 2011–2012. With the remaining 28 projects, physical closing had been completed, but the closing financial statements were not prepared in due time.

Cumulated expenditures for 2007–2010 under the operational programmes of the New Hungary Development Plan (in respect of EU and national funds) amounted to HUF 1,354,465.9 million, including expenditures of HUF 724,116.4 million[8] for 2010. Of the payments made in 2010 and in previous years, the Transport Operational Programme (TOP), the Social Renewal Operational Programme (SROP) and the Economic Development Operational Programme (EDOP) had the greatest share. In view of the budgets for 2007–2013, the implementation of the New Hungary Development Plan is much slower than it should be on a pro rata basis.

Except for the Central Hungary Operational Programme (CHOP), Social Infrastructure Operational Programme (SIOP) and TOP, the contracted grant amount remained below 60%. In the case of the Environment and Energy Operational Programme (EEOP) and the Implementation Operational Programme (IOP), payments corresponded to 5% and 26% of the respective budgets, while the same ratio was 20% with the rest of the OPs. Interim amounts approved and paid by the EU remained below 20% of the respective budgets with all operational programmes except IOP (27%).

In the case of OPs, there is evidence of delays in announcing grant programmes and the fulfilment of commitments as a result of the temporary measures implemented within the powers of the Governments and the Presidents of the National Development Agency. For instance, with relevance to the EDOP, submissions were suspended for seven tenders in the first half of 2010, the action plan for the EDOP was revised in the second half of 2010, some tenders were withdrawn and the scheme was cancelled.

Following the structural change in government, 32 projects of the New Hungary Development Plan were removed from action plans in order to launch new grant programmes and rearrange funds within OPs in connection with preparations for the New Széchenyi Plan. Owing to deficient records, the SAO has not been able to monitor the measures related to the above decisions, including the settlement of commitments, the method of reclaiming grants, and repayments by beneficiaries.

The deadlines set for individual phases of grant processes were not fully observed by managing authorities and intermediate bodies, which may lead to delays in the payment and utilisation of grants. The 75-day time limit allowed between the submission of bids and the adoption of grant decisions was exceeded with almost a half of the projects under review (EDOP, EEOP, and the Regional Development Operational Programme [RDOP]). Among two-tier programmes, the two tiers spanned almost a year in the case of RDOP.

In the case of the items under review, the periods between grant decisions and contracting (35 to 194 days) were unnecessarily long. The maximum length of the period between the approval of drawings and payments was observed in the case of the EDOP. However, with the EEOP, the time limit set was exceeded in all of the cases.

8 In its comment, the Ministry of National Economy indicated that according to its calculations, expenditures were made in 2010 in the amount of HUF 729,080.1 million.

The funding needs of agricultural subsidies and national co-financing were provided in 2010. There is lack of regulation in the management of funds temporarily available from the Agricultural and Rural Development Agency, and in the institutional utilisation of such funds.

Out of the 31 partial statements issued for individual operational programmes and budget lines on the utilisation of chapter-managed appropriations under the chapter ‘EU Developments’ in 2010, 13 were given approving opinions, of which emphasis of matter paragraphs were attached to 8 partial statements and 11 partial statements were given limited qualifications (environmental projects supported by the Cohesion Fund, projects implemented using grants from the TOP, SROP, TIOP, EEOP, Central Transdanubia Operational Programme, North Great Plain Operational Programme, CHOP and Human Resource Development Operational Programme as well as the European Territorial Co-operation, the EEA and the Norwegian Fund). Material errors were found in 7 partial statements, as a result of which adverse opinions were given on the partial statements concerning projects implemented using grants from the State Reform Operational Programme, Electronic Public Administration Operational Programme, West Pannon Operational Programme, South Transdanubia Operational Programme, South Great Plain Operational Programme and North Hungary Operational Programme and the Swiss Fund.

The total value of errors leading to limited opinions and adverse opinions was HUF 16,410.9 million. The errors detected amounted to 1.87% of the expenditures total of HUF 875,892.3 million of the consolidated statement on the chapter-managed appropriations of the chapter ‘EU Developments’. On that basis, the SAO issued a limited opinion on the consolidated statement on the chapter-managed appropriations of the chapter ‘EU Developments’.

The majority (88.9%) of the errors were detected during the audit of balance sheets. The errors detected had an impact on the fairness of the balance sheets as well as the accuracy of the data presented therein, and will also impact the cash-based accounting of subsequent years. Errors concerning the fairness and adequacy of individual balance sheet lines, amounting to a total of HUF 14,584.2 million, correspond to 2.75% of the HUF 530,193.5 million balance sheet total of the consolidated statement on the chapter-managed appropriations of the chapter ‘EU Developments’. With closing operations, the errors detected are attributable to the deficiencies of in-process controls, deficiencies in the operation of internal controls related to IT systems supporting accounting (EMIR SA Single Monitoring Information System, EMIR New Hungary Development Plan, IMIS Monitoring and Information System, IMIS2, Source SQL), and, in the case of OPs under the New Hungary Development Plan, a delay in the launch of the claims management module of the EMIR system.

The findings of the SAO’s audit concerning the whole process of managing EU grants also show the deficiencies in the system of management and controls. In its cash-based audit of expenditure items, the SAO found that the first-level reviews conducted by the managing authorities and intermediate bodies were, with a few exceptions, essentially adequate. In the field of on-site audits preceding payments, deficiencies were found in terms of regulation and the conduct of reviews.

In 2010, the Treasury spent 3,931 expert days with reviews concerning EU grants, which falls short of its plan of 5,500 days. Reviews conducted by the Treasury found that the time limits for responses to irregularities were often not observed, and that the documentation of irregularity decisions was insufficient in several cases. Quality assurance reports were often not prepared or only with delays.

Following the structural change in government in 2010, the National Authorising Officer's Office (Paying Authority/Certifying Authority) underwent a number of organisational changes.

Within the audit system of EU grants, internal audit also comprises multiple levels. The Internal Audit Department of the National Development Agency is adequately regulated and operates in compliance with legal provisions. However, its resources allocated to audits on the utilisation of EU funds are limited, particularly because the scope of its duties also include other tasks such as record keeping, data supply, risk management, etc., which could be mitigated by the use of external auditor capacities.

In the case of subsidies for agricultural and rural development, the Certifying Body conducting the external audit established in its certificate for the financial year 2010 that the EAGF and EAFRD statements to be submitted to the EU Commission were competent, complete and accurate, and that the operation of internal audit procedures were satisfactory.

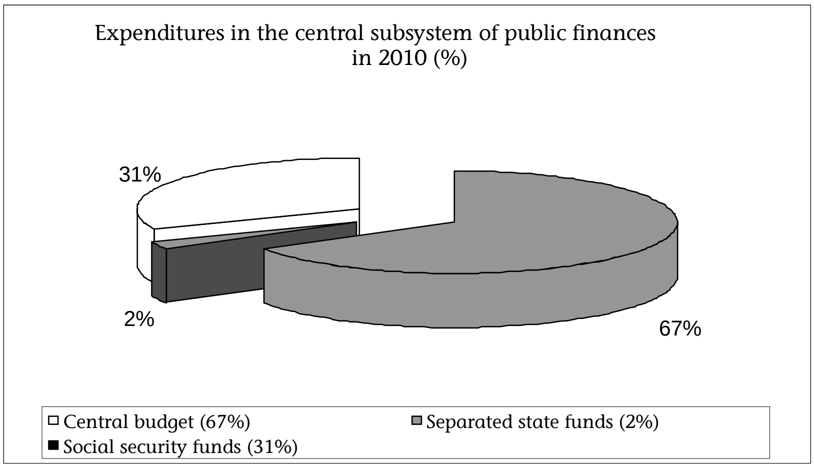
SEPARATED STATE FUNDS AND SOCIAL SECURITY FUNDS

As in previous years, the separated state funds and social security funds (**the funds**) constituted a separate chapter of the state budget, but **became part of the central subsystem** as of 1 January 2010. Consequently, based on the common methodology followed in audits and similarly to the audit of chapters, the funds were audited in a thematic manner for the purpose of a joint analysis of revenues collected for the funds by the Hungarian Tax and Financial Control Administration (National Tax and Customs Administration).

Under the Act on the Budget, separated state funds comprised six funds in 2010: the Labour Market Fund, the Homeland Fund, the Central Nuclear Financial Fund, the National Cultural Fund, the Wesselényi Miklós Compensation Fund for Flood and Inland Waters Protection and the Research and Technology Innovation Fund.

The social security funds comprised two funds: the Pension Insurance Fund and the Health Insurance Fund.

In 2010, the funds collected revenues of HUF 4,707,287.0 million in total, against expenditures of HUF 4,742,841.3 million, with a consolidated deficit of HUF 35,554.3 million. Expenditures of the funds in 2010 account for 33% of the expenditures of the central subsystem (2%+31%), in a breakdown as shown in the figure below.

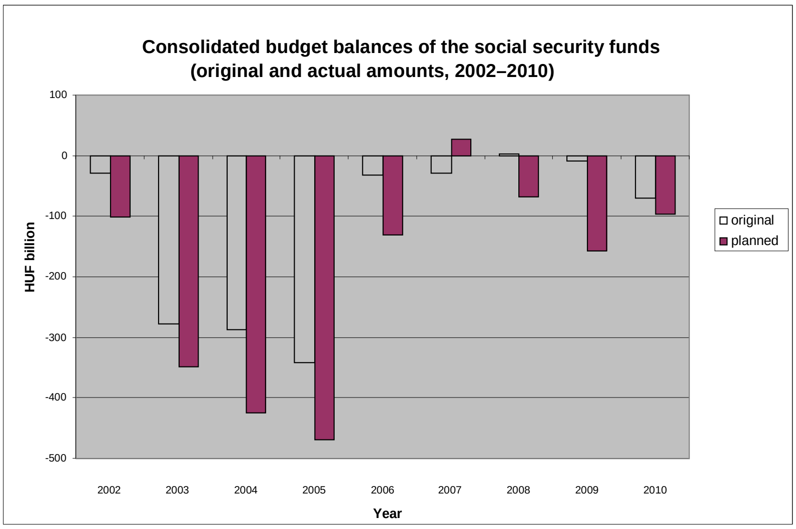


In terms of the financial equilibrium of the funds, **the balance of separated state funds** (HUF 59,831.9 million) **improved the financial situation of public finances**. The funding of separated state funds remained stable in 2010.

Their financial management, except for the Wesselényi Miklós Compensation Fund for Flood and Inland Waters Protection[9], increased savings.

The consolidated deficit of the social security funds (HUF –95,386.2 million) **negatively influenced the financial equilibrium of public finances.** Among the social security funds, the 2010 deficit of the Pension Insurance Fund (HUF –3,687.2 million) exceeded the budgeted amount by a negligible 0.1% of its expenditures, whereas the deficit of the Health Insurance Fund (HUF 91,699.0 million) exceeded the budgeted HUF 69,408.3 million by HUF 22,290.7 million.

The deficit of the social security funds is shown in the figure below.



Funding for the Pension Insurance Fund and the Health Insurance Fund required the use of the Single Treasury Account.

Article 11 of the bill on the implementation of the 2010 budget of the Republic of Hungary provides for the approval of the deficit of the social security funds, and for the remission thereof against the Single Treasury Account as of 30 December 2011.

A residue was accumulated in the operating budget of the social security funds, owing primarily to government action provided for in Article 1 of Government Decision 1268/2010. (XII. 3.) on the measures required for the achievement of the 2010 budget balance. The bill (Article 14 for the Pension Insurance Fund and Article 16 for the Health Insurance Fund) recommends that the National Assembly take note of the amounts (HUF 7,151.3 million in total).

The 2010 deficit of the Pension Insurance Fund (HUF –3,687.2 million) exceeded the budgeted amount (0), but corresponded to only 0.1% of its expenditures. The deficit

9 In the aftermath of the floods in 2010, the Fund paid compensations worth HUF 74.2 million, the highest amount in its history. In order to satisfy compensation claims, HUF 6.4 million were reallocated, in compliance with the law, against budgeted operating expenses, and HUF 67.8 million were reallocated against residues from the previous years.

was caused by lost revenues of HUF 19.8 billion, mitigated by expenditures remaining below the appropriation (HUF 16.1 billion).

The excess deficit of the Health Insurance Fund for 2010 was due to overspending, mitigated by revenues exceeding the appropriation by 0.6%. The equilibrium of the Health Insurance Fund was improved by HUF 57,776.9 million in the previous year, financed by the surplus of funds transferred from the central budget in contributions (HUF 298,130.0 million higher than in 2009).

In terms of expenditures, the **weight of the Pension Insurance Fund is the greatest among the funds.** Within the total expenditures of the funds, a share of over 61% is represented by the expenditures of the Pension Insurance Fund (its expenditures amounted to HUF 2,918,253.7 million in 2010), followed by the expenditures of the Health Insurance Fund (HUF 1,476,691.2 million), corresponding to about 31% of the total expenditure of funds. The expenditures of **separated state funds** accounted for the approximately 8% remaining of the total expenditures of the funds, among which the **Labour Market Fund** is **outstanding** in terms of appropriations with an expenditure of HUF 297,787.7 million in 2010. In terms of the proportion of their appropriations within the budget, **the remaining separated state funds** are not significant but, in view of their function, they **play an important social role**.

As regards the supervision, operations and organisational structure of the funds, the structural change in government taking place in 2010 led to personal changes among the ministers disposing of the separated state funds who, in the case of the social security funds, exercise the Government's powers of control. At the same time, only three separated state funds were subject to changes in the structure of fund management.

In the case of the Labour Market Fund, technical supervision and the right of disposition were separated in respect of the rehabilitation segment of the fund[10].

In the case of the Innovation Fund for Research and Technology, pursuant to Articles 73 (q) and 85 (m) of Government Decree 212/2010. (VII. 1.), regulations modified in connection with the change in government in 2010 led to the separation of supervision and the right of disposal in respect of the Fund and the fund manager, which were previously under single control. Since 1 January 2011, the new fund manager of the Innovation Fund for Research and Technology (the National Development Agency succeeding the National Office for Research and Technology), has been supervised by the Ministry of National Development.

The Homeland Fund was discontinued as of the end of the year and was replaced as of 1 January 2011 by the newly established Gábor Bethlen Fund, managed by a new fund manager.

The audit of funds by professional accountants is required by law.[11]. With separated state funds, professional accountants are appointed by the

10 Pursuant to Articles 65/A and 81 (1) of Government Decree 212/2010. (VII. 1.) on the duties and powers of individual ministers and the Secretary of State heading the Prime Minister's Office.

11 Article 57 (3) of the Act on Public Finances for separated state funds, and Article 86/A (2) of the same for social security funds.

President of the SAO. Similarly to the social security funds, audits by professional accountants are to be conducted following the methodology issued by the SAO[12]. In the course of audits by professional accountants, **the methodology of the SAO was not fully applied in every case**.

Professional accountants qualified the statements on the Labour Market Fund, the Central Nuclear Financial Fund and the Innovation Fund for Research and Technology according to the SAO's methodology. Audits by professional accountants on the rest of the funds were not fully compliant with the methodology; for instance, other revenues were not qualified, or audits complied with the methodology only in their form.

In 2010, the **engagement of professional accountants** for the audit of statements on the funds **was severely delayed[13] in two cases** despite the statutory requirement[14] that professional accountants should be engaged upon approval of the statements for the previous year.

In the opinion of the professional accountants auditing the funds, the 2010 statements, with one exception[15], **provide a true and fair view** of the assets and financial standing of the funds as at 31 December 2010.

Based on the financial regularity audit following the SAO's methodology, **the SAO issued approving opinions in respect of every fund concerning the reliability of data on the revenues collected by the Hungarian Tax and Financial Control Administration (APEH)**. **However, in the case of four funds, the opinions** issued **included emphasis of matter paragraphs** owing to a variety of minor regulatory issues.

An approving opinion was issued concerning the data on the revenues of the Innovation Fund for Research and Technology from innovation contributions collected by the Hungarian Tax and Financial Control Administration.

In the case of the Labour Market Fund, the Health Insurance Fund and the Pension Insurance Fund, an emphasis of matter paragraph was attached to the opinion concerning the reliability of data on the revenues due to the funds and collected by the Hungarian Tax and Financial Control Administration/National Tax and Customs Administration. The reason for that was the absence of data on split tax categories from the statement of overpayment and arrears (these are presented in the balance sheet of the Treasury).

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12 Methodology for the financial regularity audit of social security funds and extra-budgetary funds (November 2009).

13 The professional accountants were engaged for the audit of the 2010 statement and balance sheet on 4 May 2011 for the National Cultural Fund and on 5 May 2011 for the Innovation Fund for Research and Technology.

14 Article 155 (6) of the Act on Accounting requires that the professional accountant be appointed upon approval of the annual statements for the preceding business year. Act XCVIII of 2010 on the implementation of the 2009 budget of the Republic of Hungary was promulgated on 28 October 2010.

15 The professional accountant attached an adverse opinion on the financial statements of the Innovation Fund for Research and Technology for 2010.

The SAO's opinion raised objections to the calculation method for default charges and penalties due to the Pension Insurance Fund and the Health Insurance Fund. Consequently, a recommendation was made to review the regulation for the method of settling and allocating revenues from sanctions. The SAO also warns that the tax authority did not fully meet its obligations to supply balance sheet data to the managers[16] of the funds concerned. Although changes to the legislative environment were initiated by the Hungarian Tax and Financial Control Administration/National Tax and Customs Administration, the law was not amended before the opinion was issued.

In the case of the National Cultural Fund, the opinion includes an emphasis of matter paragraph because the SAO found that the tax authority, at the request of the manager of the National Cultural Fund, did not pay the revenue from the gambling tax for November 2010, payable to the Fund in December (HUF 678.1 million).

In the course of auditing the operations of the funds and the utilisation of their appropriations, typically neither irregularities affecting the final accounts for 2010, **nor utilisation for other than the intended purpose** were **found**. Most of the minor errors and irregularities occurring in a small percentage of the cases were corrected during or after the on-site audit in accordance with the action plan. Legislative settlement is required for some problems with cost rationalisation, and regulatory deficiencies and inconsistencies identified in connection with the Wesselényi Miklós Compensation Fund for Flood and Inland Waters Protection, and social security funds.

The Wesselényi Miklós Compensation Fund for Flood and Inland Waters Protection was not able to achieve the efficient fulfilment of its objective of encouraging self-support. Its regular contracted revenues were even insufficient to cover operating costs. The SAO recommended that the manager should encourage self-support, ensure consistent application of legal regulations relevant to floods, and positively discriminate those contracting the Wesselényi Miklós Compensation Fund for Flood and Inland Waters Protection in the event of damage.

The SAO has recommended rationalisation of the costs associated with benefits disbursed from the Pension Insurance Fund in small amounts[17] or to foreign accounts, as the growing number of pension benefits had led to a 27.3% increase in the cost of bank charges. The costs of foreign payments are significantly higher than those of domestic payments. To date, the organisation disbursing foreign payments has not joined the preferential system of fund transfers.

With expenditures from the Health Insurance Fund in treatment and prevention benefits, no adequate and up-to-date data were available for the accurate and fast administration of one-off wage supplements. The closure of the Managed Care

16 The Labour Market Fund is managed by the LMF Department of the Ministry of National Economy; the Pension Insurance Fund is managed by the Central Administration of National Pension Insurance; and the Health Insurance Fund is managed by the National Health Insurance Fund.

17 Examples of payments in small amounts disbursed from the Pension Insurance Fund include the Hungarian subtotal of pensions due on grounds of rights acquired in multiple countries, and the charges (agency fees) of judicial execution in the event of garnishment.

System (IBR)[18] involves problems: the conditions are lacking for the enforcement of law-abiding conduct and the submission of final accounts.

In its assessment of the operations of the system to review support granted from the funds, the SAO found that fund managers had introduced the controls for the review of payments, and that such controls, although not with all of the funds, fully covered the review of benefits, support and other payments.

In its audit for 2010 as well as for previous years, the SAO found that with the Homeland Fund and the Labour Market Fund, the review of support was not comprehensive in scope. With regard to the discontinuation of the Homeland Fund at the end of 2010, the SAO has not repeated its recommendation of previous years based on the latest audit experience.

In its audit of the **Labour Market Fund**, the SAO paid special attention to the review of payments made against the training segment of the Fund by the National Institute of Vocational and Adult Education (NIVE), a regional unit of the Fund. The reason for that was the **failure to utilise the SAO's recommendation[19] made to the Government in its report on the audit of the operations of the Labour Market Fund** concerning the assignment of authority to auditors at NIVE. Audit operations where examined in the context of grant agreements where, in accordance with the 2010 audit plan, beneficiaries were subject to on-site audits. As part of that, grant agreements concluded in previous years[20] with the Public Foundation for Education ('Public Foundation') were also reviewed. **Audit findings suggest that**, owing to the possibility to manage the irregularities encountered while auditing the utilisation of grants, **it is still appropriate to review the rights and powers related to auditing**, and, based on the review, to regulate the same within the process of rearrangements in the system of vocational education.

In 2010, among other reviews, the Government ordered a review of the efficiency of discharging the duties assigned to the Public Foundation[21]. A separate SAO audit[22] was also launched on the subject. Based on that review, the Government adopted a decision on 18 May 2011[23] to discontinue the Public Foundation for Education with

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18 Discontinued as of 1 January 2009 by Act CVI of 2008 on the amendment of certain acts concerning healthcare.

19 Report on the Audit of the Operations of the Labour Market Fund (0750), p. 21, Recommendation 3 to the Government

20 As part of its audit of the 2010 final accounts, the SAO reviewed the documentation of the following grant agreements between NIVE and the Public Foundation: FKA-KT-11/2007 (HUF 162.8 million), FKA-69/2007 (HUF 1,070.4 million), FKA-KT-72/2007 (HUF 280.3 million) and FKA-KT-14/2008 (HUF 1,100.0 million). Under those four agreements, a total of HUF 2,613.5 million had been paid.

21 Pursuant to Article 2 of Government Decision 1159/2010. (VII. 30.) on urgent action concerning the public foundations and foundations established by the Government.

22 Under the SAO's audit plan for 2011, a separate audit was launched in January 2011 under the title 'Audit on the regularity and effectiveness of the 2009–2010 task performance and property management of public foundations set up by the Government'.

23 According to Article 4 of Government Decision 1152/2011. (V. 18.) on the discontinuation of the Public Foundation for Education, the Government appointed Wekerle Sándor Alapkezelő to take inventory of the assets of the Public Foundation.

immediate effect in order to ensure that the same public duties are discharged more efficiently in other organisational arrangements. With a view to the elimination of the deficiencies found, the SAO put forward a recommendation concerning the review of the duties discharged by the Public Foundation, the grants received under the grant agreements, and accounts.

In its follow-up to the audit, the SAO found that most if its recommendations made in previous years had been implemented.

The structure of expenditures from the Labour Market Fund was streamlined and became more transparent[24]. The SAO's recommendation on the Central Nuclear Financial Fund[25], made as part of the opinion on its 2011 budget, was implemented: the National Assembly passed the amendment to Act CXVI of 1996 on Atomic Energy (Atv.)[26].

The SAO's recommendation to the Minister of Public Administration and Justice[27] concerning the review of the Act on the General Rules of Administrative Proceedings and Services has been implemented. As of 1 January 2011, Article 13 (2) of the Act was appended with the new point (i)[28].

The SAO's recommendation to the Government[29] concerning the review of the regulations pertaining to the audit of the funds has not been implemented.

The SAO's recommendation made to the Minister of National Economy during the 2009 audit[30], concerning the review of the system of data supply on split contributions, was not implemented as the control environment of split revenues remained unchanged.

24 A reference to this was made in the last paragraph on page 23 of the SAO's report on the 2011 budget appropriation bill, 'Opinion on the 2011 Draft Budget of the Republic of Hungary (1025)'.

25 Opinion on the 2011 Draft Budget of the Republic of Hungary (1025), p. 36, Recommendation 8.

26 Act LXXXVII of 2011 amending Act CXVI of 1996 on Atomic Energy and Act CLIX of 1997 on Armed Security Guards and Environmental Protection and Rural Guards.

27 Report on the audit of the implementation of the budget of the Republic of Hungary for 2009 (1016), p. 54, Recommendation 36.

28 Pursuant to Article 86 (3) of Act CXXVI of 2010 on Metropolitan and County-level Government Offices and Legislative Amendments Pertaining to the Establishment of Metropolitan and County-level Government Offices and to Territorial Integration.

29 Report on the audit of the implementation of the budget of the Republic of Hungary for 2009 (1016), p. 50, Recommendation 7.

30 Report on the audit of the implementation of the budget of the Republic of Hungary for 2009 (1016), p. 51, Recommendation 15.

BUDGETARY RELATIONS OF LOCAL GOVERNMENTS

In the Act on the Budget, the appropriations of subsidies and contributions payable to local governments, minority local governments and multi-purpose micro-regional associations were set out in Annex 1, Chapter IX 'Subsidies and assigned personal income tax to local governments'. On that basis, local governments were entitled to HUF 1,164.4 billion in 2010, which was HUF 125.5 billion (9.7%) less than in 2009.

The appropriation amendments took place in governmental and chapter competence and **in compliance** with the provisions specified in the Act on Public Finances and the Act on the Budget. By the end of the year the appropriation changed to HUF 1,202.6 billion. The modified appropriation of local governments' subsidies and assigned personal income tax exceeded the original appropriation by 3.3% (HUF 38.1 billion). The actual figure amounted to HUF 1,259.4 billion, which is 8.1% higher than the original appropriation and 4.7% higher than the modified one.

The National Assembly allocated **state subsidies for a specified purpose as centralised appropriations** for the fulfilment of duties listed in Annex 5 to the Act on the Budget by local governments, settlement- and regional-level minority governments and multi-purpose micro-regional associations. Based on the Act on the Budget, the aggregate original appropriation for the 20 titles under centralised appropriations was HUF 124.1 billion. The amended appropriation equalled HUF 134.8 billion, while its actual utilisation was HUF 126.0 billion. Actual fulfilment was 1.5% above the original appropriation and 6.5% below the amended one.

The HUF 10.7 billion increase in the original appropriation was owed to adjustments to the appropriations of two titles: (1) Subsidies of additional expenditures associated with local organisational measures; and (2) Subsidies for pavement reconstruction on residential roads maintained by local authorities.

The Act on the Budget provided for the adoption of 17 decrees[31] concerning Chapter IX, 'Subsidies and assigned personal income tax to local governments'. **The deadline for adopting the decrees**, which was set forth in the Act on the Budget, **was not adhered to by sector ministers in 14 cases**. (In 2009, the deadline for adopting the decrees was not adhered to in 24 out of 26 cases.) Owing to a delay in the promulgation of the decrees, local governments had **less time available for the preparation of their tenders**.

Out of the HUF 4,500 million available from Appropriation 2, 'Subsidies for communal water and sewage services' of Title 5, 'Centralised appropriations', the

31 16 decrees concerned Title 5, 'Centralised appropriations' and one decree concerned Title 7, 'Subsidies for performing organisations maintained or supported by local governments', Appropriation 2, 'Subsidies against the central budget for orchestras and choirs in category I'.

Ministry of Environment and Water authorised utilisation of HUF 3,500 million, the remaining HUF 1,000 million being allocated for the funding of protection against water damage. However, the appropriation had not been modified either within the competence of the Government, or within that of the chapter. **No documentation was made available** to the SAO's audit **to support and justify 'blocking' HUF 1,000 million out of the appropriation**. **The appropriation should not have been reduced by HUF 1,000 million without a legal mandate.** In its comment of 22 June 2011, the Ministry of National Economy indicated that '*the solution was needed in order to protect public funds and meet the general government deficit target'*.

Within centralised appropriations, support for wage policy measures for 2010 was claimed pursuant to Government Decree 316/2009. (XII. 28.). However, the Decree did not specify the healthcare institutions funded in the secondary category the National Health Insurance Fund. Consequently, the classification of budget activities had to be corrected and the allocation of support had to be settled. Except for HUF 2.8 million, the distribution of coverage for the 2010 wage settlement support was settled in 2010 between Chapter IX, 'Subsidies and assigned personal income tax to local governments' and the Health Insurance Fund. In 2011, the settlement of the remaining HUF 2.8 million is in progress.

The actual fulfilment of the year 2010 subsidy appropriation of HUF 10,000.0 million for the construction of **Budapest Metro Line 4 (between Kelenföld Railway Station and Bosnyák tér)** amounted to HUF 6,271.4 million, falling short of the planned amount by 37.3%. The reason for underspending against the appropriation was that project implementation was behind schedule. The deadline for the completion and handover of Stage I is Q2/Q3 2013 according to the report of February 2011 prepared by the Ministry of National Economy for the Government.

In 2010, the Treasury sent information to the Ministry of the Interior on the payments effected in the given period on a quarterly basis. As the information was not available to the Ministry of the Interior on each day when there was a payment transaction, an up-to-date matching of the remittance notes against the payments was not carried out.

The management and performance audit of the appropriation of the Budapest Metro Line 4 investment have to be shown among the liabilities of the chapter that is responsible for the professional implementation of the investment. However, an amendment to the act on the financing of the Metro Project ('Metro Act') would be required for the change. The SAO has been giving regular indications of that since the audit of the 2006 final accounts. However, the Act was not amended until the audit of 2010 was closed.

Within the meaning of Article 2 (2) of the Metro Act, the State may utilise a maximum amount of HUF 50.0 million against the state subsidy for the use of expert services to assist exercise of the control position. Similarly to previous years, this allocation was not used in 2010 either. According to the written advice of 25 May 2011 by the Ministry of National Economy, a majority of Stage I of the Metro 4 investment project is financed using EU funds, and the strict controls of the EU's institutional system are applied. The General Assembly of the Budapest

Municipality ruled against the implementation of Stage II of the project for the time being. As a result of the circumstances prevailing at the time of closing the audit, the position of the Ministry of National Economy was that the involvement of a 'government expert' was not required. The SAO accepts the position of the Ministry of National Economy.

Pursuant to Article 9 of Government Decision 1059/2005. (VI. 4.) on the state subsidy for the construction of the Budapest Metro Line 4 (between Budapest Kelenföld Railway Station and Bosnyák tér) the Government entrusted the president of the Government Control Office with controlling the implementation of the investment and reporting on it to the Government once a year. In Article 10 the Minister of Finance and the Minister of Economy and Transport were requested to inform the Government on the progress of the Budapest Metro Line 4 project biannually. In 2010, the Minister of Finance/Minister of National Economy fulfilled their reporting obligations required by law. According to the written advice of 26 May 2011 by the Ministry of National Economy, the Government Control Office did not investigate the subject of Metro Line 4 in 2010, which has been confirmed by both the Treasury and the Ministry of the Interior.

As of 15 May 2008, the Ministry of Economy and Transport was divided into two legal successors: the Ministry of Transport, Communications and Energy, and the Ministry of National Development and Economy. As it already indicated in respect of the final accounts for 2008 and 2009, the audit of the SAO found that clarification was required in Article 10 of Government Decision 1059/2005. (VI. 4.), which specifies the successor ministry responsible for reporting on the metro investment. Pursuant to the Act and Government Decision 1136/2010. (VI. 29.), the Ministry of National Development and Economy is succeeded by the Ministry of National Economy, and the Ministry of Transport, Communications and Energy is succeeded by the Ministry of National Development. The issue of responsibility remains unresolved at the time of closing the on-site audit.

Pursuant to the contract between the Municipality of Budapest and the Budapest Transport Company on attending to the investor's tasks of the section between Budapest Kelenföld Railway Station and Budapest Keleti Railway Station of the Budapest Metro Line 4 concluded on 19 January 2004 and amended on 17 August 2005, the Budapest Transport Company is obliged to commission an *'Independent Control Engineer'* to check the investment decisions taken during the investment and the implementation of the investment. Point 6.09 of the financial contract concluded between the Municipality of Budapest and the European Investment Bank on 18 July 2005 also requires the employment of *'an independent engineer with international experience'*. The *'Independent Control Engineer'* would perform his tasks in accordance with the conditions specified by the Budapest Transport Company in agreement with the Municipality of Budapest, but – similarly to the previous years – until the closure of the audit by the SAO no engineer was employed for this task. In order to ensure attendance to the tasks of the *'Independent Control Engineer'*, a call for proposals was published in the Official Journal of the European Union on 1 February 2011. The public procurement procedure was cancelled as of 6 July 2011: pursuant to Article 92 (b) of the Act on Public Procurement, the procedure was declared invalid as only invalid bids had been submitted.

In the course of drawing up the final accounts for 2009, the SAO recommended that the Minister of the Interior should review the terms of contracting with respect to the grants disbursed under the new titles established within the powers of the Government. The Ministry of the Interior reviewed the terms of contracting, and in 2010, grants to local governments were not disbursed without the conclusion of the corresponding contracts.