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ÁLLAMI  
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**Summary**  
**of the Audit on the Financial Situation of the Local**  
**Government of Town Érd with County Status (1133)**

**Relevance of auditing the local governments of towns with county status**

The actual economic difficulties of Hungary can be attributed mainly to the disorder of public finances in former periods and the high total debt. The year 2010 demonstrated that part of the risks is not connected to the central budget, but to the local level of public finances. Due to the financial management difficulties, the increase in the deficit on a cash basis, as well as the dangers resulting from indebtedness in the local government system, the State Audit Office of Hungary (SAO) decided to audit the financial situation of local governments. The risk analysis carried out by the State Audit Office of Hungary showed that firstly the audit of local governments operating at the middle level – mainly those of counties and towns with county status – is justified.

The audit objective was to evaluate whether the local governments of towns with county status ensured long-term financial balance, whether the recommendations concerning regularity and expediency aiming to improve the financial balance, made in the course of the former audit of the financial management system were utilised. The audit covered the period of 2007-2010 and, if possible, we also tried to include the period until the last quarter before the on-site audit.

**The financial equilibrium of the local government of town Érd with county status**

The debt of the local government increased significantly in the audited period. The total debt increased from HUF 1.1 billion to HUF 10.6 billion between 2007-2010, of which the foreign exchange difference – which also had an impact on liabilities due to the evaluation of liabilities amounting to CHF 36.9 million – was HUF 2.9 billion.

The current budgetary balance showed a deficit in terms of operating resources between 2007-2010 – except for 2009 –, amounting to a total of HUF 1.7 billion. Due to the repayment obligations amounting to HUF 1.2 billion between 2007-2010, the financial capacity (net operating income) of the local government was a deficit of HUF 2.9 billion. In the audited period, the cumulative expenditures of

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the local government amounted to HUF 7.5 billion, of which HUF 6.8 billion was spent on renovations and investments until the end of 2010. The balance of the cumulative budget of the local government was negative between 2007-2010, which resulted in a lack of cumulative resources amounting to altogether HUF 4.8 billion. The total financing deficit of the local government amounted to HUF 7.7 billion in 2007-2010.

The preservation of the budgetary balance could be ensured with the involvement of external resources. The deficit in operating resources was funded by means of current account credit, as well as bond issuance used for repaying current account credit. The lack of development resources was managed by means of long-term development credit and the revenue from issuance of bonds for development purposes. The local government undertook commitments pursuant to decisions of the General Assembly; however, the resources of repayment, as well as the interest payment and capital repayment obligation to be expected throughout the repayment term were not presented in the proposals. With the continuous increase in its outstanding loans, also the interest costs burdening the local government escalated.

The bank liabilities of the local government at the end of 2010 originated from the issuance of bonds for development and operational purposes amounting to HUF 8.2 billion (77.3%), the borrowing of long-term credits for development purposes amounting to HUF 1.5 billion (14.2%), as well as outstanding current account credits amounting to HUF 0.9 billion (8.5%). As a result thereof, the local government has to repay capital and pay interest in the amount of HUF 1.3 billion and CHF 3.8 million in 2011-2013.<sup>1</sup> The local government's arrears to suppliers amounted to HUF 1.5 billion at the end of 2010. The local government planned to finance its outstanding liabilities mainly from its own revenues envisaged in its current budget; however, this is not supported by the negative trend in the operating income. The sale of tangible immovable assets and the resources resulting from the collection of receivables provide a cover only for approximately 38% of the total liabilities. Out of the bank liabilities known at the end of 2010, the resources for the payment of HUF 1.9 billion and CHF 39.6 million due from 2014 were not known.

The total of liabilities of the development tasks of the local government in progress was HUF 3.9 billion at the end of 2010, of which HUF 3.3 billion and HUF 0.6 billion were planned to be financed from EU subsidies and the revenue of former bond issuance, respectively. As a result of the active tendering activity,

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<sup>1</sup> Taken the extent of the interest of the first quarter of 2011 as a basis.

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following the year 2010 the local government undertook commitments in the amount of HUF 0.3 billion, which were planned to be funded by EU and domestic subsidies. Having a 78% ownership in the Local Government Association of Érd and its Region for Sewage Disposal and Wastewater Treatment, the local government undertook a guarantee in the amount of HUF 5.4 billion for the repayment of bond series to be issued and current account credit to be borrowed in order to finance the own resources of the canal construction project of net HUF 31.4 billion, implemented from EU subsidies.

In two of the four business associations in qualified majority ownership of the local government, the value of own capital did not reach the value of subscribed capital at the end of 2010; of the outstanding liabilities, leasing obligations of HUF 5.4 million and arrears to suppliers of HUF 29.3 million had to be paid from 2011.

In the period of the on-site audit, the local government and its institutions were involved in 70 pending legal proceedings. The amount in dispute revealed and to be paid by the local government is HUF 4.0 billion, 96% of which originates from three legal proceedings involving high amounts. The local government did not set up reserves for the reduction of the financial risk of the significant disputed amount revealed and to be paid.

The local government did not examine what kind of obligations the replacement of depreciated assets might cause. In the years 2007-2010, the local government accounted for a depreciation of HUF 1.9 billion after the tangible assets, while it spent only 42.1% thereof, i.e. HUF 0.8 billion, on renovation.

In order to improve the current financial situation, the local government took measures increasing its revenues and reducing its expenditures (lending out real estates and other assets, increasing fees, reorganising the institution and its tasks resulting in staff cut-backs). The simultaneous impact of these measures improved its financial situation by HUF 1.7 billion.

The two recommendations concerning regularity, aiming at the improvement of financial balance, made in the course of the former SAO audit, were utilised only after the date specified in the action plan.

**In summary**, it can be concluded that the current revenues of the local government did not ensure the financing of current expenditures and the debt service in 2007-2010, and the local government could not counterbalance these liabilities with its measures to reduce expenditures and increase revenues. The balance of the cumulative budget of the local government showed a lack of cumulative resources amounting to altogether HUF 4.8 billion between 2007-

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2010. The total financing deficit of the local government amounted to HUF 7.7 billion in 2007-2010. The financing of investments following 2010 might be jeopardised by the additional expenses of pre-financing EU funds.

The financing of the local government's expenditures for operational purposes caused tension, as it ensured operation only by drawing current account credit continuously, as well as by utilising bond resources and the interest revenue originating from the investment of bond resources. The long-term bank liabilities of the local government increased, the financing thereof is insecure in the following three years in the light of the receivables, the real estate collateral, and the available operating income, which is mainly negative. As regards the further years' long-term commitments, based on the data provided by the local government, the funding resources are not ensured.

Consequently, financial risks jeopardise the financial management of the local government, and immediate measures need to be taken in order to rapidly restore the financial balance and maintain its long-term sustainability.

### **Recommendations for the Mayor**

- To take measures for the elaboration of an action plan to rapidly restore the financial balance of the operation and ensure the long-term sustainability thereof. The action plan should contain the exploration of possibilities increasing revenues, the comprehensive review of the investments planned and other expenditure obligations, as well as the overview of the structure of debt service.
- To present to the General Assembly every half year the current financial situation of the local government and its business associations in qualified majority ownership, as well as a financing plan on the whole scope of liabilities for at least three years with the quantified indication of resources.
- To examine the availability of internal and external resources necessary for the developments in progress and those planned by the local government and from this aspect evaluate the investments of the local government, provide for the inclusion of resources ensuring the operation of facilities established by means of investments in regulations on the budget.

### **Recommendations for the town clerk**

- To ensure that in the future the resources of the commitments generating debt, as well as the interest rate and foreign exchange risks thereof are

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presented during the preparation of decisions. To follow continuously the commitments of business associations in qualified majority ownership and the influence thereof on the local government's liquidity, financial situation and equilibrium.

- To take measures to earmark the cover necessary for the fulfilment of obligations of the Mayor's Office and its budgetary institutions arising from the legal proceedings.