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SUMMARY

of the Audits on the Financial Situation and Financial Management System of Local Governments in 2011

The finpancial management difficulties, increasing liquidity problems and indebtedness within the local government sub-system directed the attention of the State Audit Office of Hungary (SAO) to the problems arising from the current financial situation of local governments. In auditing local governments, the current SAO strategy, effective as of 2011, placed the main emphasis on revealing financial risks. Through these audit findings, we wished to make a timely contribution to the transformation of the local government (particularly the financing) system.

As of the spring of 2011, we have audited the financial situation of given groups of local governments in five different phases. The situation analysis of the (mid-level) local governments of counties, the capital and towns with county status was followed by the auditing of the financial equilibrium of the local governments of towns. On-site audits were launched at 63 local governments; these were selected from the 304 towns using representative sampling. Our summary findings were made on the basis of the audit of mid-level local governments and data provided by local governments of towns. The audits focused on the period between 2007 and 2010.

In the spirit of preparing for further local government audits, the SAO conducted ‘pilot’ audits at the local governments of five towns and seven villages, selected on the basis of risk analysis. The objective of these pilot audits was to identify financial management areas with the highest risk, to develop and test methodologies and to assess the resource and time requirements of audits.

The objective of the local government audits

The objective of the audit of mid-level and town local governments was to asses (1) what factors came into play in the development of the financial equilibrium and debts of local governments; (2) what kind of financing problems local governments faced with; (3) what effect the changes that have taken place in the organisational frameworks ensuring the performance of mandatory and voluntary tasks as well as in the mode of task performance have had on the development of the financial situation of local governments.

The objective of 'pilot' audits was to present the findings, yields, main lessons and experience of a number of closely linked audit areas (assessments of financial situation, the establishment and operation of the internal control system, the exercising of ownership rights and the utilisation of earlier SAO recommendations).

The financial equilibrium of local governments

The financial equilibrium of local governments deteriorated in 2007-2010. Financial risks (operating, accumulation and default risks, as well as risks arising from the operation of majority-owned business associations) increased. The financial equilibrium indicators changed unfavourably both jointly and individually for the various local government types. The balance of the current budget has been declining steadily since 2008, dropping from HUF 172 billion in 2007 to HUF 76 billion in 2010 (a 55.8% drop). The unfavourable development of the balance of the current budget indicates structural (financing and task performance) problems requiring central as well as local government measures. The change of those responsible for task performance will be unable to resolve financial problems if the content and financing of the given task remain unchanged.

The unfavourable development of the financial situation was impacted by the relatively high proportion of voluntary tasks. From 2007 to 2010, that ratio of voluntary tasks within operating expenditures increased from 17.1% to 18.9% in the case of towns with county status, and dropped from 24.5% to 23.2% in the case of local governments of towns. A possible way to restore financial equilibrium, apart from rationalising the institutional structure which does not reflect the principles of economies of scale, is to narrow the scope of voluntary tasks. Business associations began to play an increasingly prominent role in the mandatory and voluntary task performance of local governments. By outsourcing public tasks to business associations, the risks of the financial management of local governments have been removed from the local government sub-system; however, the problems arising in the operation of companies may still represent indirect risk for local governments mandated to perform tasks.

With respect to the mandatory/voluntary classification of performed tasks, local governments interpreted applicable legal provisions differently. Local governments are only able to comply with legal regulations if legal provisions comprehensively stipulate the content and extent of the performance of mandatory tasks. According to the provisions of the Local Government Act, effective as of 1 January 2013, the financial regulation of local governments will have to specify the funds and expenditures related to mandatory and voluntary tasks separately.

In 2007-2010, mid-level and town local governments generated a total operating income of HUF 599 billion, from which HUF 268 billion remained available to finance the HUF 902 billion accumulated deficit after debt service expenditures were effected. As a result, further external funds were required to finance capital expenditures, which in turn led to the increase of the debt portfolio. Based on the aggregate data of county local governments, the balance of the current budget did not cover debt service expenditures in any of the years, which resulted in further indebtedness.

The total revenues of mid-level and town local governments dropped by 4% in total, from HUF 2,328 billion in 2007 to HUF 2,235 billion in 2010. The absolute value decrease (16.9%) of the revenues of county local governments was primarily due to the central withdrawal of funds that constitutes particular risk to task performance. All types of local governments were affected by the reduction of the funds from budgetary relations aimed at improving the central fiscal equilibrium, which was accompanied by an increase in the own resources of local governments. In the case of some local governments, it also contributed to the loss of financial equilibrium as they were unable to keep up with increasing financing requirements using own funds. For mid-level local governments, the drop in duty revenues further weakened financial capacity. The 6.1% increase in the aggregate revenues of the Budapest Municipality, the local governments of towns and towns with county rank also dropped in real terms. Exposure to external factors could represent risk for local governments in terms of their financial situation if: a significant portion of their tax revenues are collected from one or two taxpayers, they have no options to impose new local taxes or tax rates are already at maximum levels.

Given the distribution system, the supplementary subsidies serving to maintain the viability of local governments failed to improve long-term financial equilibrium and in some cases did not help create equilibrium in the short-term either. The fact that of the 304 local governments of towns 51 local governments received ÖNHIKI subsidies (available for local governments with financial problems through no fault of their own) in a total amount of HUF 1.9 billion in 2010, and 156 local governments received ÖNHIKI funds of HUF 9.2 billion in 2011 indicates a problem in the financing system of local governments. When assessing eligibility for support, the number of voluntary tasks undertaken by the local government, and whether it had any development projects that could increase its operating deficits further were not considered reasons for exclusion. The ÖNHIKI subsidy did not exclusively serve to assist near-bankrupt local governments as part of individual debt management; furthermore, it did not encourage local governments to take reorganisation measures ensuring long-term financial equilibrium.

Liquid loans taken out to bridge the difference between the time required to collect trade receivables and pay trade payables began to play an increasingly important role in the long-term financing of the financial equilibrium. The majority of local governments favoured taking out current account credits and liquid loans as the borrowing limit did not apply to these and interest conditions were also favourable. The average daily volume of current account credit facilities increased from HUF 47 billion in 2007 to HUF 61.8 billion in 2010, which augmented the financial risk of operation. Liquid loans were primarily used to finance long-term operating and capital deficits. As a result, the exposure of local governments to banks increased, and due to insufficient funds, it became common practice to renew these liquid loan framework agreements annually, mostly out of necessity and in increasing loan amounts.

The increasing tendency of trade accounts payable, overdue debts in particular, posed a risk, just as the high level of non-personnel expenses compared to a monthly average. Due to the limited availability of bank loans, local governments typically considered suppliers instruments of external financing. The year-end portfolio of trade accounts payable — with the exception of 2008 — exceeded the two-month level of non-personnel expenses. With respect to the risk of non payment, the management of overdue debts is of particular significance. Total trade payables increased from HUF 85 billion in 2007 to HUF 105 billion in 2010 (by 23.5%), while overdue debts increased at an even greater rate, up from HUF 26 billion to 44 billion (69.2%). In the case of mid-level local governments of the sub-system, 50% of overdue trade accounts payable was made up of debts accumulated by hospitals financed by the National Health Insurance Fund. The items resulting from the financing of the trade payables of EU grants have not been separated from the overdue trade payables, which would be justified by the EU subsidy system. As a result, the outstanding trade payables recognised on the balance sheet do not provide an accurate picture of the actual trade payables of the local government. When subsidies are granted directly to suppliers, the obligant is not the local government, but rather the state. Providing the funds required for the subsequent financing of projects implemented with the help of EU grants caused liquidity problems for the towns, which makes it necessary to rethink the financing of programmes implemented with the help of EU grants.

In spite of the unfavourable tendency, local governments failed to pay adequate attention to manage their debts separately according to due dates or to take advantage of the opportunity to reschedule. They failed to take measures to eliminate late payments that allow the launching of debt settlement procedures and, furthermore, did not take potential consequences into account.

In the case of all local government types, the balance of capital income and expenditure had a deficit every year, the primary reason for which was the intensive investment activity related to EU tenders. The rules of managing indebtedness due to the negative balance of capital income and expenditures (one-off consolidation) have not been established. In addition to the EU grants, domestic government grants and their own revenue, town and mid-level local governments would need an additional HUF 217 billion in external funding to be able to finance the HUF 1,154 billion still due on investment projects in progress as of 31 December 2010.

When taking development decisions, high ratios of financing were given priority over requirements concerning the rate of return, the developments necessary to perform mandatory tasks, the improvement of return on total assets and the preservation of the condition of existing equipment. Hidden debt originating from the wear and tear of equipment and delay in complying with replacement obligations is considerable. Furthermore, the subsequent financing of these debts is doubtful. There were no legal provisions obliging local governments to generate a replacement fund equivalent to the depreciation, which also reflects returns requirements. The operation, maintenance and future sustainability of tangible assets created through developments poses a further risk factor, as typically during operation, no additional supplementary revenues or considerable cost savings are generated.

Outstanding liabilities to financial institutions in 2010 increased in every type of local governments — by 8.8% in the capital, 143% in county local governments, 100% in towns with county status, and 92% in towns — by a total of 77.7% compared to 2007. 84.6 percent of the HUF 1,247 billion debt of the local government sub-system, as of 31 December 2010, was generated in the aforementioned local government sector. The primary reason behind the indebtedness of local governments was the lack of funds to serve as coverage for development projects completed or still in progress with the help of EU grants. Due to interest and exchange rate conditions prevailing in 2007-2008, foreign currency-denominated bond issue offered a better solution than long-term loans. With respect to maintaining current solvency, the distribution of payment burdens over a longer period was a more favourable financing solution. Eighty-five per cent of the bond and loan repayment obligations of local governments outstanding at the end of 2010 will have to be settled in the period starting in 2014, which constitutes a risk in light of the current volatility of exchange and interest rates. In the case of bonds, beyond the unfavourable developments of the exchange rate, pre-term reconversion initiated by the financial institution or conversion into forint could also cause unexpected expenses.

The local governments failed to create the reserves required to repay the liabilities to financial institutions. The funds serving as coverage for repayment were typically not identified. The fact that assets belonging to local government key assets were also offered as loan cover is another risk.

In the audited period, the central regulation on limiting the assumption of debt-generating liabilities did not perform its function, and local governments took on liabilities that exceeded their financial capacity. It would be justified to rework debt settlement regulations in order to improve the situation of local governments, which are likely to encounter grave financial problems as of 2014 due to debt service burdens. Stabilisation programmes need to be developed that take the unique characteristics of various local governments into account, and allow for the long-term sustainability of the financial equilibrium established during the procedure.

Business associations in which local governments are majority shareholders have accumulated significant debts. Local governments failed to pay sufficient attention to preventing their business associations from becoming indebted and, furthermore, failed to present the financial risks of local governments and business associations to the representative council. Liability as owners — if certain conditions are met — for the debts of business associations constitutes financial and consolidation risk.

Information on the on and off-balance sheet liability items arising from the contractual relationship of business associations performing public service tasks and the proprietor local governments (support, loans, guarantees and warrants), and the obligation of the local government to assume liabilities owed to third parties arising from its status as proprietor are not directly or fully available from the current reporting system. In the case of the local governments of towns with county status, liabilities owed to financial institutions of qualified majority-owned business associations in 2010 amounted to HUF 57 billion; trade accounts payable were HUF 21 billion. Until 31 December 2010, the liabilities of the business associations of town local governments resulting from loans and owed to financial institutions were HUF 151 billion, while their trade payables reached HUF 102 billion, with overdue debts of HUF 15 billion. The guarantees and absolute guarantee provided for the current account credit and other loans of qualified majority-owned business associations of mid-level local governments tripled (up from HUF 15.8 billion in 2007 to 47.8 billion in 2010). The liabilities of town local governments arising from the bank guarantees and absolute guarantee undertaken on the loans of their business associations increased from HUF 8.1 billion in 2007 to HUF 14.6 billion in 2010 (by 80.2%).

In order to improve the financial equilibrium, the SAO recommended various measures to the local government groups created on the basis of identified financial risks, treating separately local governments that require the immediate restoration of equilibrium, those that require medium-term measures and local governments where financial equilibrium is ensured in the short and medium-term, thus its maintenance must be ensured in the long-term.

The audits identified the problems of the accounting and information system. The current system does not meet the requirement of transparency. It fails to comprehensively present financial risks. The fair presentation of the efficiency and effectiveness of public tasks performed can only be ensured through accrual-based accounting. The current rules of accounting do not make it possible to recognise reported depreciation in the expenditure of individual tasks or to take them into consideration for financing.

Due to the high level of risks identified, the continuation of the audits of towns following risk-based selection is justified. Data that is not directly available in the accounting and information system can only be quantified properly as part of on-site audits. The systemic and consolidation risks justify extending on-site audits to majority-owned business associations of local governments as well as hospitals maintained by local government.

Pilot audits

The so-called pilot audits conducted in 2011 at local governments of five towns and seven villages confirmed the preliminary risk assessment, which supports the opinion that the selection of audited local governments should be risk-based. There were 12 local governments, where problems adversely impacting financial situation were increasingly frequent. In their case, the State Audit Office of Hungary pointed out the deficiencies of measures aimed at managing financial risks — including procedures of the preparation and substantiation of decisions — which contributed to the development of unfavourable financial processes, the significant decrease of financial capacity, the increase in indebtedness, the lack of liquidity and the drop in reserves.

SAO also pointed out that the regulation of asset management processes was deficient, and as a result internal controls did not function. Due to the deficiencies revealed, the risk of irregular revenue collection and irregular expenditure performance was a possibility. With the audit, the State Audit Office of Hungary directed attention to the risky financial and economic processes of audited local governments and their business associations, as well as the fact that the absence of basic ownership controls poses a risk to the financial equilibrium of local governments. The failure to utilise earlier recommendations made by SAO also contributed to the deficiencies revealed once again in connection with the operation of internal controls.

The experience gained during the audits served as basis for identifying areas of risk and for determining the focuses and topics of future local government audits.

Summary of the audits about the financial situation and financial management system of local governments in 2011

We have prepared a Summary about the audit experience and findings. This presents the financial risks of the whole of the local government system as well as the financial situation of the various local government types. The Summary has no specific addressee; through the publication of the Summary the State Audit Office of Hungary would like to contribute to good governance.