



STATE AUDIT
OFFICE OF HUNGARY

R E P O R T

on the Professional Activity and Operation of the
State Audit Office of Hungary in 2012

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Article 4 of Act LXVI of 2011 on the State Audit Office of Hungary (SAO) states that in the annual report prepared for the National Assembly, the President of the State Audit Office of Hungary shall provide information on the audit activity, operation and financial management of the organisation in the preceding year, as well as on the measures taken on the basis of audit findings.

With the present Summary, the President of the State Audit Office of Hungary is fulfilling this statutory obligation. In accordance with the above statutory provision, the structure of the Summary was also established to report in a clear, transparent and easy-to-follow manner on how the State Audit Office of Hungary fulfilled its statutory obligations in the year 2012.

1. The role of the State Audit Office of Hungary in the auditing of the public finance system

As a result of the former disorder of public finances and the challenges facing the socio-economic system, Hungary—like the whole of the European Union—is going through a time of profound change. The economic environment has been characterised by unpredictability and uncertainty for years, which is something we must adapt to. The key to effectiveness is the combination of order within public finances and flexibility, innovation, and prompt reaction to changing conditions, the foundation of which is laid down in Hungary by the new Fundamental Law and the cardinal Acts, especially by the 2011 Act on the State Audit Office of Hungary.

One of the key lessons of the economic crisis was that public funds and public assets must be appreciated. This places great responsibility on the system of public finance auditing and its supreme organisation, the State Audit Office of Hungary. The SAO conducted its activities while assuming this responsibility and on the basis of the strategy approved by the National Assembly resolution in 2012 as well. During the course of the year, we utilised 61,856 direct auditor days to conduct audits and made 112 reports public. Our reports provided well-founded, professional and objective answers with regard to the most acute economic and social problems in Hungary.

In Hungary, the auditing of public finances is ensured by a harmonised system comprising elements built on one another, the three pillars of which are external auditing, government auditing and the internal control system of the various institutions. The State Audit Office of Hungary conducting the external audits is the only institution elevated to constitutional rank and wholly independent of the government. Consequently, the work of the auditors watching over Hungarian taxpayers' money and the nation's wealth has strategic and national economy significance. This is reflected in the fact that the Fundamental Law and the new Act on the SAO reinforced the SAO both in terms of its mandate and independence, which has thus become one of the most significant and secure elements of the system of economic brakes and counterweights ensuring the operation of the Hungarian democratic state. The year 2012 was particularly important in the life of our organisation as this was the very first full year when we conducted our activities under the scope of the new Act on the SAO, ensuring that the era of audits without consequences finally came to an end in Hungary.

With the entering into force of the Fundamental Law, last year heralded the dawn of a new era in a public law sense. The Fundamental Law, which represents the foundations of the democratic rule of law in Hungary, now contains a chapter on public finances, while the debt rule, which stipulates the guaranteeing of the responsible utilisation of public funds and the reduction of public debt, has been elevated to constitutional rank. Accordingly, in 2012 the State Audit Office of Hungary paid particular attention to the issue of risks related to the sustainability of public finances and debt. Besides our opinion on the budget appropriation bill and the final accounts report, this was the area our reports on the development of public debt, the financial standing of local governments, the National Bank of Hungary as well as our reports related to the management and operation of national assets and the utilisation of EU funds focused on as well.

Beyond specific and individual addressees, in every case our reports called attention to the fact that in order to overcome economic troubles, Hungary must set off on a growth path that does not entail using up our future or that of our children either. In order to keep growth on a sustainable path, public funds must be utilised not just regularly, but expediently and effectively as well. Besides the quantitative features of the budget, we must also focus on

qualitative aspects, as the transparency, accountability, effectiveness, efficiency and expediency of public fund utilisation are equally as important as the amount of taxpayer's money intended for a given area.

The year 2012 marked a great breakthrough in the operation of the State Audit Office of Hungary as well as the protection of the money and assets of Hungarian taxpayers, namely that pursuant to the new Act on the SAO, the audited entities are now obliged to take measures in connection with the findings of the State Audit Office of Hungary. In its 2012 reports, the State Audit Office of Hungary made 1,117 recommendations to 213 addressees with obligations to take action. Thanks to the Act on the SAO, each one of our reports published last year was accompanied by an action plan outlining specific measures to be taken, which plans were approved by the President of the SAO. This is a great step forward, because our follow-up audits show that before the entry into force of the new Act on the SAO only a little over half of our recommendations led to tangible results, while a large part of them did not trickle down to everyday practice and therefore could not contribute to the establishment of a well-governed state.

The primary area of the utilisation of our reports is legislation, and due to this reason we strived to cultivate a close and intense cooperation with the National Assembly in 2012 as well, the Committee on the State Audit Office and Budget in particular. Last year, the findings of the SAO were mentioned during three quarters of the session days, and the representatives discussed the SAO reports in 54 committee meetings.

Supporting the work of MPs is a priority objective of the SAO as it is our belief that this is the most efficient way our audit findings can help bring about 'good governance' and a well-functioning state with it. All this is in line with our strategic tenet, according to which a modern organisation that meets the challenges of our times must not simply point out deficiencies, but should also support the direction set out to be followed. Rephrasing a classic audit metaphor: we must be more than 'watchdogs', we must be 'herding dogs' as well. This is also supported by the October 2012 amendment of the Act on the SAO, which authorises the SAO to prepare analyses and studies within its remit and, as a professional supporting institution for the Fiscal Council, making them available to the Fiscal Council to promote the performance of its responsibilities. The SAO's obligation to support good governance is a good indication that the audit tasks are not just for their own sake, rather they serve the purpose of ensuring that the institutional scheme maintained by Hungarian taxpayers operate as well as possible, while also ensuring that public funds and public assets are used as regularly, efficiently and effectively as possible.

The Act on the SAO defines the State Audit Office of Hungary as an office, which is therefore not an authority or a court, meaning that it does not issue binding resolutions or judgements and does not have the right to impose sanctions either. In addition to the obligation to take measures as stipulated in the Act on the SAO, our work also exerts its effect indirectly, via various mediators; therefore, in addition to the legislature, the State Audit Office of Hungary considers the academic public, the media and the general public to be important partners. Our work was utilised in 2012 at a number of levels and in a variety of ways. Through our reports, the citizens gained insight into how taxpayers' money was put to use; the audited entities initiated measures to correct the deficiencies uncovered; the financial management and operation of audited institutions improved; our recommendations were integrated into the statutes, and in many cases, when we suspected an infringement of statutes, we notified the Public Prosecutor's Office, initiating legal proceedings.

In 2012, we started renewing our methodology, the purpose of which was to audit the use of public funds more comprehensively but also in a more targeted way. Our new methodology

under development, built on international standards, ensures that our reports give relevant, precise and in-depth answers to well-formulated questions. We continued our thematic audits on several sites under the same audit programme as a means of laying down the foundations of efficient work, and through risk-based selection process we managed to ensure that our audits are held wherever there is the greatest need. By running a monitoring system, the State Audit Office of Hungary is also able to conduct audits that are systematic and holistic in their approach and provide aggregate evaluation. This approach allows for the discovery of systemic errors, which is, in our opinion, one of the key tasks and missions of the State Audit Office of Hungary.

Based on its mandate, the State Audit Office of Hungary has general powers in auditing the financial management of public funds as well as of state and local government assets. The objective of our work is to reinforce legality and order and to create value. Within this framework, the SAO continuously and gradually extends its audits to previously unaudited areas and activities. In Hungary, the users of public funds can take for granted that they will at some point be subject to an audit by the SAO, and if they violate the laws or misuse public funds, they must face the legal consequences of any deficiencies discovered.

The reduction of public debt, retaining the balance of the budget and public finances are the most significant challenges facing the national economy in the coming years and decades. This requires every institution operating on public funds to find areas of more economical operation while maintaining and improving efficiency. In line with this spirit, last year the State Audit Office of Hungary reviewed and rationalised its tasks, their schedule and the use of the available resources already during the course of the year and decided to forgo the use of the HUF 216.6 million chapter-specific equilibrium reserve planned in the year 2012 budget, and HUF 219.3 million in retained residual amounts. Through more efficient operation, in 2012 the State Audit Office of Hungary saved a total of HUF 435.9 million from its own expenditure budget, meaning that we were able to contribute to reducing the central budget deficit and improving the general government balance by over 6 per cent of our total budget.

Our task – as an institution that enjoys citizens’ trust and respect – is to support the National Assembly in terms of its legislative and control function and to contribute to the regular, efficient and effective use of public assets with our recommendations. In light of the recent economic and financial difficulties and the domestic experience of the last decade, there is no doubt that the public financial affairs of Hungary must be put in order. Through its audits and reports in 2012, the State Audit Office of Hungary supported this goal and by complying with the mandates and obligations bestowed upon us by law, we continue to work towards this objective.

2. The professional activities of the State Audit Office of Hungary in 2012

By creating the new Act on the SAO, the National Assembly established the legislative framework for the SAO to generate veritable impact through its work in the field of public finances. The SAO is now placing greater emphasis than ever before on the practical utilisation of the work of its auditors. Using all available tools, it strives to effectively improve the quality of public fund utilisation with its work, by having the audit findings followed by specific and substantial measures and actions. In order to achieve this, we have established an increasingly close cooperation with the National Assembly as well as the organisations that are able to enforce our audit findings.

The present report will approach the professional activities from three different, yet fundamentally related aspects. By reviewing the measures taken on the basis of audit findings, the practical use of the reports, the performance of the audit tasks and the related supplementary advisory role, the core activity of the Office can be described. This also means that the structure of our report had to be changed as well, as a result of which the tasks we carried out during the course of the year and the results we achieved will be easier to follow.

2.1. *Measures taken on the basis of audit findings and the utilisation of audit reports*

Our findings can only support the efficient operation of the state in merit if, through their consequences, they affect the operation of the given institution or organisation. The legal environment established with the new Act on the SAO created this opportunity and launched a change in the approach and behaviour of the users of public funds.

The audit findings with mandatory consequences will increase the responsibility of the SAO in terms of the recommendations issued. That is why communication between the auditor and the audited entity during the elaboration of recommendations is of the utmost importance in order to ensure that the recommendations and proposals drafted are of high quality, feasible and can later become a part of everyday life.

2.1.1. The utilisation of SAO reports in the work of the National Assembly

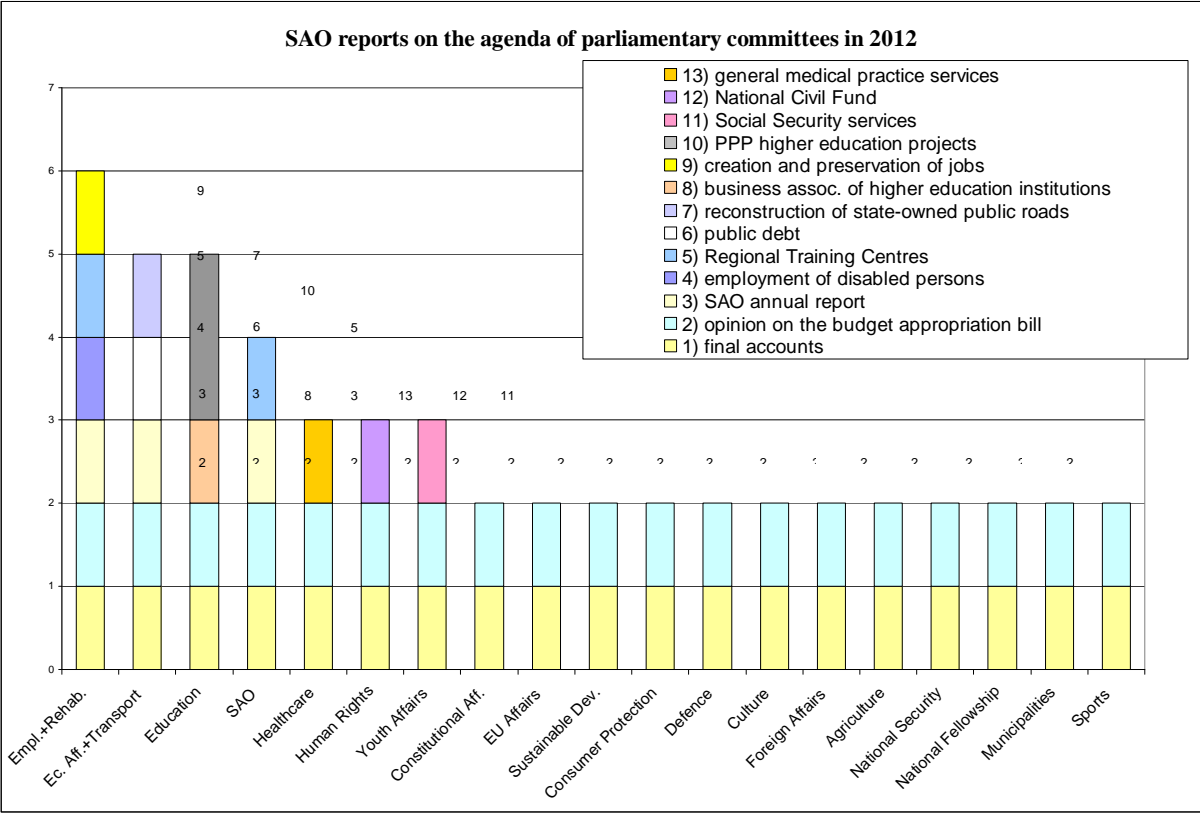
One of the priority areas of the utilisation of the SAO's work is legislation. As a result, in 2012 the State Audit Office of Hungary also went to great lengths to ensure that its reports supported the daily work of MPs and that its audit findings and recommendations, conclusions and observations are effectively utilised in the course of legislation. It is a clear recognition of our work that in 2012 MPs relied increasingly on our reports both during plenary sessions and in their work in the committees and that the National Assembly adopted many laws that also included our recommendations.

It is of paramount importance that the National Assembly passed its decision on the drafting of the Act on the 2013 central budget relying on the opinion, recommendations and observations of the State Audit Office of Hungary. We considered our opinion on the central budget to be a sort of guideline for the Government and the MPs who were tasked with the responsibility to make a decision on the central budget. As a result, we consider it also a fruit of our labour that our recommendations contributed to the adoption of a well-founded and evidence-based Budget Act. During the debate on the 2013 central budget, 30 MPs referred to the opinion of the SAO, which shows that the State Audit Office of Hungary was successful in its advisory and supporting role.

Last year, a total of 89 plenary meetings were held by the National Assembly and the MPs made references to the reports of the State Audit Office of Hungary on 67 session days, meaning that the findings of the SAO were mentioned in three quarters of the session days.

Our documents compiled pursuant to the statutory obligations, carrying a parliamentary document number were also discussed at the plenary meetings of the Honourable National Assembly. In 2012, three such reports—the final accounts report, the 2013 opinion on the budget appropriation bill and the Summary on the 2011 activity of the SAO—were discussed by the plenum. The President of the SAO held an exposé in connection with the debate each time.

In 2012, apart from the three numbered proposals submitted to the National Assembly, further 10 of our reports were discussed at 54 committee meetings. The SAO reports concerning the areas of the National Civil Fund, general medical practice services, job creation, public debt, Regional Training Centres, employment of disabled people, measures aimed at the reconstruction, repair and maintenance of state-owned public roads, the business associations of state-owned higher education institutions, key cultural and higher education projects implemented within the framework of PPP arrangements, and the record systems of the Social Security Funds were all discussed in the relevant committees.



2.1.2. Utilisation of audits in legislation

The utilisation of the SAO’s work—particularly at the legislative and social level—often does not take place in the same year as the publication of the report, but is realised over the following years. Accordingly, in 2012 again there were a number of statutes as well as government and other measures passed that were based on SAO reports published before 2012.

The local government audits of the State Audit Office of Hungary with renewed methodology, which were launched in 2010 and are still in progress, showed outstanding utilisation in 2012. The findings were used by the Government and the National Assembly during the preparation and implementation of the new Local Government Act and the debt settlement programme. The SAO reports published in 2011 and 2012 confirmed that intervention is required in the local government sector as financial difficulties and indebtedness were starting to endanger the operation of the whole of the local government system. We concluded and supported with facts that long-term treatment preventing the regeneration of debt is needed. We called attention of the auditees and the public to the fact that the reason behind the indebtedness of local governments was partly the lack of funds to serve as coverage for development projects completed or still in progress with the help of EU grants, which in turn made long-term fund raising necessary. It became clear that preventing the re-accumulation of local government debt is of common interest, a priority issue of national economy. In the case of state finances, particularly local government finances, a complex audit approach is required. It is for this reason that in the case of local governments, the concurrent and precise mapping of finances, internal control systems, financial situation and future obligations is required. We pointed out that the basic requisite of efficient planning and public fund utilisation is the transparency of public finances, therefore, we have to gradually shift to using the accrual-based accounting system.

One of our priority works related to the local government field was the audit of the Municipality of Budapest completed in 2011 and mainly utilised in 2012. On 10 October 2011, the SAO published its report on the 'Audit on of the Analysis of the Budgetary and Financial Equilibrium of the Budapest Municipality; as well as the 2011 Audit on the Operation of Internal Controls Established in the Budget Planning and Final Accounts Preparation Processes'. The audit uncovered the risks of developments in Budapest, increasingly limited resources, the disadvantages of the PPP scheme, the deficiencies of the operation of internal controls, the inaccuracies of legal provisions related to the record-keeping order of real estate assets as well as the incomplete performance of the disclosure obligation regarding data of public interest. The SAO directed attention to the financial irregularities concerning the building complex constructed on the former 'Közraktárak area' (the so-called CET-project), as well as to the fact that irregularities related to implementation are costing Budapest extra costs amounting to more than HUF 13 billion, regarding which the SAO has filed charges. Furthermore, the auditors also revealed problems in the field of internal control and IT regulations. Called for and recommended by the State Audit Office of Hungary, an independent internal audit department was established within the organisation of the Municipality of Budapest. In connection with the rules on conclusion of agency agreements, based on our report the Municipality of Budapest reviewed all previously concluded agency agreements and established a new procedural order in order to prevent the problems objected to.

The new disaster prevention act was drafted using the experience of the SAO audit. The State Audit Office of Hungary published its report entitled 'Audit of the systems set up to prevent and avert natural disasters and to eliminate their consequences' on 20 May 2011. The audit revealed that there are a number of severe deficiencies in the system of national disaster management. Due to the problems and deficiencies uncovered, a new Disaster Prevention Act was drafted, also using the SAO's report, which entered into force on 1 January 2012. In the past, the SAO has already audited organisations participating in the disaster prevention system, such as water management and the fire department. However, there has never been a comprehensive, all-inclusive audit such as the one conducted in 2010, and this was when the sectoral-holistic approach was first employed by the SAO. In its report, the SAO

recommended that the Government transform the regulatory, organisational, operating and financing system, adapt the international systems of regulations, and review the scopes of duty and authorities delegated to local governments as well as the vulnerability classification of settlements. These recommendations provided the foundation for the drafting of the new disaster prevention bill.

With its report on the audit of the operation of and assistance to the National Civil Fund, the SAO contributed to creating the new Civil Code effective as of 2012. The Committee on Human Rights, Minority, Civil and Religious Affairs of the National Assembly discussed the results of the audit and the utilisation of our recommendations as a separate agenda item. The SAO's audit findings were utilised in many respects under Act CLXXV of 2011 on the freedom of association, charitable status and the operation and support of civil organisations, which was passed by the National Assembly. One of the key elements of the new legislation is that the public benefit status can only be obtained based on actual activity based qualifications. By imposing stricter publicity requirements, the act aims to increase transparency through the obligation to place the accounting report and the public benefit report into escrow, or to make them public. The act contains specific provisions on the professional harmonisation of grant programmes, on the possibility of receiving grants for longer term projects and of taking out loans as well as how to resolve the issue of refundable grants. The audit experience of the SAO is reflected in the act in that stricter conflicts of interest rules have been applied to the highest authority, to the way the administrative and representative body passes its resolutions, the composition of the supervisory body and to the person of the auditor.

The State Audit Office of Hungary published its report on the 'Audit on the Financial management of the Hungarian Post Co. Ltd.' on 2 December 2011. One of the most important findings of the audit was that the Hungarian Post Co. Ltd. was late with respect to the preparation for the opening of the market on 1 January 2013. The fact that the organisations responsible for the operation of the postal market had not formulated their concepts in due time and therefore the Hungarian Post Co. Ltd. could not rely on them to provide a basis for its business concepts played a role in the delay. The SAO recommended the Minister of National Development the speedy preparation of the postal market strategy and related regulations taking EU directives into account, in order to allow market players—including the Hungarian Post Co. Ltd.—to have sufficient time to adapt to the changing of the regulatory environment. With its decision of October 2012 of adopting the new act, the National Assembly put our recommendation on the regulation of the postal market to practical use. The findings of the SAO report were accepted and taken into consideration by the management of the Hungarian Post Co. Ltd. Among other considerations, the restructuring of the organisational structure of the company, and as such the elaboration of the most appropriate legal environment and postal market concept can now effectively enhance the competitiveness of the Hungarian Post Co. Ltd.

In 2012, in the bill on the amendment of certain healthcare acts of legislation, the Minister of Human Resources proposed regulations that took the earlier findings of the State Audit Office of Hungary into consideration. According to the justification of the act, the establishment and provision of legal, safe, transparent, adequately funded and professionally sound domestic transplant activity is a key objective, which is supported by the agreement between the Eurotransplant International Foundation and the Hungarian National Blood Transfusion Service, and by the relevant parts of the 2011 report of the State Audit Office of Hungary on the Audit of Organ Transplantation, Donation and Alternative Treatments. The SAO report examined in detail the situation of organ transplantation, donation and alternative treatments in Hungary. The report provided a comprehensive picture on the situation in Hungary and

formulated a number of recommendations addressed to the Minister of National Resources in order to improve it. The topics concerned included the action plan for increasing the number of transplants, the possibility of voluntary organ donations, the basic fees charged for transplant operations, post-surgical care, informing patients, creating a national register, the issue of donated organs which could not be used in Hungary, and the issue of lung transplantation.

In 2012, the Minister of the Interior filed a motion for the amendment of Act CXXXIII of 2006 on the distribution of resources between the Municipality of Budapest and the district local governments. In the report on the Review of the Local Government Decree on Revenues Due to and Shared by the Budapest Municipality and the Budapest District Local Governments in 2010, the SAO made recommendations to the Minister of the Interior with respect to the clarification of the provisions of the Resource Distribution Act. The justification of the act makes references to the findings of the State Audit Office of Hungary stating that ‘the relevant report of the State Audit Office of Hungary discusses the amendment of the Resource Distribution Act’. One of the express purposes of the amendment of the legislation was to amend the act ‘in line with the findings of the SAO’, to create a harmonised legal environment, and to enforce the provisions of the Local Government Act for the purposes of calculating the distribution of resources, with a view to the goal of practical implementation.

The amendment of Act CXXXIII of 2006 on the distribution of resources between the Municipality of Budapest and the district local governments, effective as of 1 January 2013, has greatly simplified the method of calculating resource distribution and rules out the possibility of repeating a part of the errors identified during SAO audits to date. According to the justification of the amendment of the Resource Distribution Act, ‘the changes applicable in the new local government financing scheme as of 2013 will ‘vacate’ the current resource distribution regulatory scheme of the Municipality of Budapest’. On account of the findings of the State Audit Office of Hungary, the minimal adjustment to be implemented by the Municipality of Budapest relative to the resources to be allocated in 2012 represents a risk so low that it does not justify an annual review by the SAO—as stipulated by Article 6(1) of the Resource Distribution Act.

2.1.3. Fulfilment of the obligation to act by audited bodies

The year 2012 confirmed that compared to the previous legislative provisions, the more stringent rules prescribed in the new Act on the SAO are justified in order to be able to hold the relevant parties accountable in terms of their use of public funds in a responsible manner as well as to ensure responsible auditing. As opposed to the previous permissive rules, non-permissive, cogent requirements have gained importance. Due to the option of using criminal sanctions under the SAO’s obligation to take action in connection with the findings of the audit, the audits of the State Audit Office of Hungary have become more effective. While according to previous regulations, it was up to the audited body to decide whether to prepare an action plan to correct the deficiencies identified, the provisions of the new Act on the SAO stipulate this in case the audit findings require. In this context, the deadlines have become tighter for the auditees as well as for the SAO. The State Audit Office of Hungary may verify the implementation of the action plan within the framework of a follow-up audit. During this process, it is possible to audit the measures taken by the audited body on-site. This statutory provision also points in the direction of more consistent utilisation of reports.

Article 33(1) of the Act on the SAO states that the State Audit Office of Hungary shall forward its report containing its audit findings to the head of the audited entity. The head of the audited entity shall develop an action plan in response to the findings in the report and

send that plan to the State Audit Office of Hungary within thirty days from the receipt of the report.

The Act also names the President's reminder as a new tool and also stipulates the rules of its application. In accordance with Article 33(6) of the Act on the SAO, in order to eliminate the practices found to be in violation of the law as well as the improper or wasteful use of assets identified during the audit, the President of the State Audit Office of Hungary may send a reminder of the findings to the head of the audited entity, provided that more serious sanctions need not be imposed under law. The head of the entity shall evaluate the contents of this reminder within fifteen days (a body at its next meeting), take the necessary measure, and notify the President of the State Audit Office of Hungary accordingly.

In 2012, the SAO made 1,117 recommendations to 213 addressees with the obligation to take action in its reports for the subject and previous years. Moreover, it also reviewed the action plans prepared by the audited bodies in response to the SAO's report. It can be established in general that the SAO qualifies an action plan as adequate, if, in its opinion, the plan can be used to eliminate the deficiency, its implementation can be verified and it specifies the person responsible for implementation as well as a deadline for the completion of implementation. The deadline must be foreseeable and suitable for a follow-up audit.

The SAO raised objections in connection with 29% of the action plans sent by the audited entities (only partially accepting the plan or requesting that it be re-drafted or re-worded), calling the head of the audited entity to supplement or amend the action plan. The SAO took its objections to the Prosecutor's Office in one occasion only, due to the breach of the obligation to cooperate related to the failure of the audited entity to forward the action plan to the SAO, as a result of which the investigating authorities initiated proceedings. The SAO initiated the proceedings, pursuant to Article 33 (3) of the Act on the SAO, against the Mayor of one of the local governments.

It can be established in general that the new requirements of the Act on the SAO are taken into consideration by the audited entities; they are increasingly adhering to deadlines and they are taking compliance with the content and the formal requirements of action plans more seriously as well.

In 2012, the SAO notified 50 addressees in connection with 19 SAO reports of 104 findings in the form of presidential reminders. The SAO reviewed 82 of these actions the audited bodies referred to in their responses. Twenty-five of the addressees of the reminders were required—due to their omission—to respond appropriately by the specified additional deadline. The notifications regarding the additionally sent measures were adequate.

According to the provisions of the new Act on the SAO, the SAO may verify the implementation of the measures contained in the action plan drafted in response to the findings of the SAO report within the framework of a follow-up audit. The passing of the new legislation created two possible procedures for the follow-up audits¹, which is expected to determine our work in this regard in the medium term. The implementation of the action plan drafted pursuant to the new statutory regulations applicable to the given topic may be verified within the framework of a separate follow-up audit, or as part of other audits. For the period preceding the entry into force of the new Act, follow-up audits of institutional audits may be conducted on the basis of our recommendations made in our previous reports, in which case the audited entity may decide on how to utilise our recommendations at its own discretion.

¹ For more detailed information, see SAO reports No. 1204, 1209-1272, 1276-1278, 1282, 1284, 1285, 1287, 1288, 1294, 1297, 12109, 12111 and 12112.

In the following section, we will demonstrate the complexity of the system of follow-up audits by presenting a few examples of follow-up audits carried out in 2012 and their findings.

Several follow-up audits were carried out to verify the utilisation of the SAO recommendations made before the adoption of the new Act on the SAO. During the audit on the state subsidy system of railway transport, we revealed that our recommendations made earlier were not fully implemented; the solution for the rationalisation of the discounts in railway passenger transport was still on the agenda when the audit was concluded, which is why we refrained from making a repeated recommendation. During the audit on the effectiveness of the measures aimed at the repair and maintenance of state-owned public roads and on the effect of these measures on the condition of state-owned public roads, we found that the recommendations were only implemented partially and incompletely. The financial conditions necessary for the maintenance of the public road network were not ensured; the preparation and adoption of the public road reconstruction programme was in progress at the time of the closure of the audit. During the audit on the operation of the record systems applied in the eligibility scheme of benefits and services provided from the Social Security Funds and the audit of the debt of the central subsystem of public finances and its commitments for periods exceeding one year, we observed that the recommendations made by the SAO had been utilised.

The year 2012 marked the first time when the SAO scheduled a follow-up audit of certain political parties receiving regular state aid. The Independent Smallholders, Agrarian Workers and Civic Party complied with its reporting and report publication obligation beyond the deadline specified in the Act on Political Parties. The Hungarian Social Democratic Party did not prove that it had complied with the earlier SAO calls or that it had prepared and published its annual reports. The new Act on the SAO was not applicable to the implementation of legality requirements—and the Act on Political Parties does not stipulate any deadlines, or contain any provisions concerning the performance of the obligation of the political parties to prepare and publish their reports—therefore, we were unable to apply the sanctions thereof in this case. The MCF Roma Alliance Party did not comply with its obligation to cooperate as set out in the SAO Act, and therefore circumvented the audit.

We also assessed the utilisation of the recommendations we made during the audits carried out under the scope of the previous Act on the SAO within the framework of the follow-up audits conducted as part of the audits of local governments.

During the 2012 audit of the activities related to enforcing ownership rights over state property in 2011, the follow-up audits of the action plans were conducted in accordance with the new Act on the SAO. Of the five findings requiring action, four have already been completed, while the remaining will be resolved within the framework of the currently ongoing amendment of the Act on State Property, in accordance with the relevant action plan (clarification of the regulations pertaining to business share transfers under the Hungarian Development Bank's right to exercise its ownership rights). Within the framework of the follow-up audit conducted as part of our audit on the implementation and social utilisation of the contracts of cultural and higher education priority projects implemented in PPP schemes, we assessed compliance with the contractual terms of the Palace of Arts project as well as the dormitory projects realised, including their operation and social utilisation. We found that the dormitory projects realised between 2004 and 2011 were disadvantageous for the higher education institutions, thus also for the state and the taxpayers. Pursuant to the contracts, the institutions of higher education bear the majority of the financial risks (exchange rate, interest, inflation), which represents a significant additional burden on the commissioning

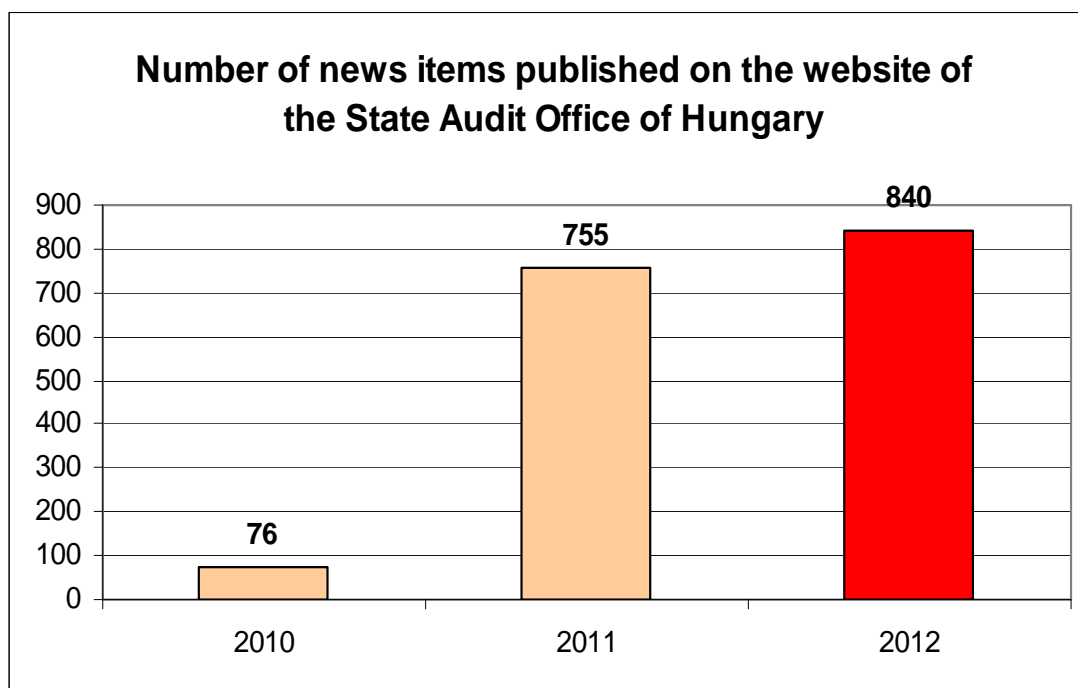
state-owned institutions compared to the planned budget. In the case of the Palace of Arts project, the contractual terms and conditions did not ensure the enforcement of state interests. The contract did not specify the detailed service parameters required for technical operation, which meant that the accountability of meeting these parameters was not ensured. The lump-sum, flat-rate type operating fees make it impossible to assess the economy of sub-tasks. The operation of the facility under a PPP arrangement did not serve the economical use of public funds. The contract did not stipulate the detailed content of the operating services; as a result their contractual performance could not be fully verified. In the case of the Palace of Arts project, the objective of avoiding a budget deficit—one of the main reasons for switching to a PPP arrangement—was not met. The investment increased the deficit of the budget and thus public debt as well. In general it can be established that in terms of the development projects implemented under PPP arrangements, the main objective of conserving budgetary financial resources was not met.

2.1.4. Publicity and utilisation at the social level

Without transparency, there is no well-functioning and well-managed state. The foundation of democracy and accountability is for citizens to know what is happening with their money, who uses the public assets entrusted to them and how they use it. The mission of the State Audit Office of Hungary is to ensure this transparency and our work in 2012 served to this end.

Relying on the spirit of the new Act on the SAO, the State Audit Office of Hungary built a system, whose transparency is outstanding even on an international level. As part of this, in the spring of 2011, we established the SAO News Portal. This is an online platform where anyone at any time can check what phase a given SAO audit is in, what the SAO's plans are and what direction the organisation is looking to take in the future. The detailed presentation of the audit process ensures that information on our work is made widely available. This is important because the SAO is unable to conduct audits everywhere; therefore, it would be a wonderful thing if, after becoming familiar with good practices and audit experience, the users of public funds would put these to use. It shows great progress that thanks to the News Portal, the number of self-published articles dealing with the SAO and our reports has multiplied tenfold, which allows us to provide first-hand information on our work.

With the help of the SAO News Portal, society can continuously monitor the audit process, from planning through the audit itself to utilisation. We report on all significant Hungarian and international news items concerning the SAO; furthermore, the interviews conducted with the audited bodies may also help the general public access original and credible information on the problems of public fund utilisation and how audits contribute to resolving these problems.



In 2012, the renewal of the audit report format commenced with the goal to improve the clarity and transparency of our reports. We prepared brief summaries, understandable for the layman as well, to accompany each of our reports. In 2012, some of our priority reports were also published in this new format. One of these was the report on the 2011 final accounts, published in autumn 2012, which amounted to 120 pages without annexes, in contrast with the hundreds of pages in the previous years.

In our view, the audit process stretches from planning all the way to utilisation, and efficient and conscious communication is crucial for our findings to contribute to ‘good governance’. Real transparency is inconceivable without clarity and communication tailored to target groups; therefore the SAO pays special attention to ensuring that its reports, findings and messages reach all parties concerned in adequately detailed form and breakdown. This is why in the case of certain reports of local relevance, we organised so-called ‘electronic press conferences’, as part of which we provided direct, first-hand information to local media exploiting the opportunities made available by the internet. We paid special attention to our relationship with the National Assembly: we compiled background materials and information for MPs on current issues and regarding bills to be discussed and submitted them to the National Assembly.

By making communication intensive and proactive and developing the News Portal, the SAO has become a public institution that operates in a highly transparent manner.

2.1.5. Domestic relations supporting professional activities

The primary objective of co-operations established within the framework of institutional relations is the development of the audit methodology of the State Audit Office of Hungary, expansion of the professional knowledge of its auditors and supporting the utilisation of its reports. The activities of the SAO can only prove to be useful for the whole of society if the organisation’s work is characterised by constant professional dialogue, high academic recognition and active representation.

This is why in 2012, we continued the renewal of institutional liaisons and the expansion of the cooperation framework. One of our goals was to support the work of the legislative and

budgetary institutions with priority events, professional activities, to enhance academic prestige as well as the quality of publications in order to be able to contribute to the implementation of the strategic mission of the SAO.

In 2012, the State Audit Office of Hungary concluded six strategic agreements, and as a result established a network of contacts the width of which is unparalleled among public institutions. The network includes the Office of the National Assembly, 12 leading higher education institutions, nine major professional audit organisations and four academic research workshops. The partnerships and letters of intent in 2012 were hallmarked by such initiatives as the launching of the Financial Literacy Research as a basis of making responsible public finance decisions, the publication of academic materials in support of 'good governance', or participation in the training of public finance budget auditors as well as continuing the internship programme to support the training of the public service generation of the future.

The activity level of co-operations and the role undertaken by the SAO in 2012 far exceeded the practice of previous years. The management of the State Audit Office of Hungary was engaged in discussions, among others, with the Deputy Speakers of the National Assembly, ministers and ambassadors as well as the heads of the local government associations and historical churches. The State Audit Office of Hungary participated in the professional consultations on the development of internal audit standards, the introduction of accrual-based accounting, the anti-corruption activities of state bodies, and the establishment of national key indicators.

The representation activity of the institution in 2012 was characterised by the assumption of a proactive role and the promotion of the utilisation of the SAO's audit activity. As a result, the management and colleagues of the State Audit Office of Hungary primarily responded to the invitations and engagement requests related to the professional activity of the SAO and the development of the public finance system, while we used protocol correspondence to disseminate the results of the SAO's work to serve the purpose of utilising that work. The increasing amount of positive feedback shows us that our domestic co-operation partners and more importantly the audited institutions are increasingly looking to the State Audit Office of Hungary as a supporting organisation.

One of the most important results attained in 2012 in the field of institutional liaising was the deepened co-operation with the Hungarian News Agency, which plays a strategic role in the communication of our reports.

2.1.6. Procedures initiated during audits

In order to ensure that the audits of the State Audit Office of Hungary are planned and conducted, the audited body, as well as its employees, are obliged to cooperate. Pursuant to Article 28 of the SAO Act, in 2012 we drafted our internal regulations determining the rules of procedure applicable to audit tasks and the auditors related to the fulfilment of the cooperation obligation of the audited body.

The audited body is under obligation to cooperate during the full term of the SAO audit. According to Article 28 of the SAO Act, the obligation refers to both availability, providing the necessary information, making the relevant information, data and documents available as well as sending the appropriate action plan by the specified deadline. This section also stipulates that in case the organisation under obligation to cooperate or the colleague thereof fails to fulfil its obligation to cooperate without reasonable justification, or if the fulfilment of said obligation is delayed, the President of the SAO may initiate criminal or disciplinary proceedings against the audited body or request the suspension of the grants and other benefits awarded to the audited body.

The Penal Code in effect in 2012 names as of 1 January 2012 the actual legal circumstances that comprise a breach of obligations related to SAO audits, pursuant to which the SAO may seek assistance from the investigating authorities in relation to the breach of the obligation to cooperate. In 2012, the SAO contacted the investigating authorities on three occasions on account of breaching the obligation to co-operate during the audit phase.

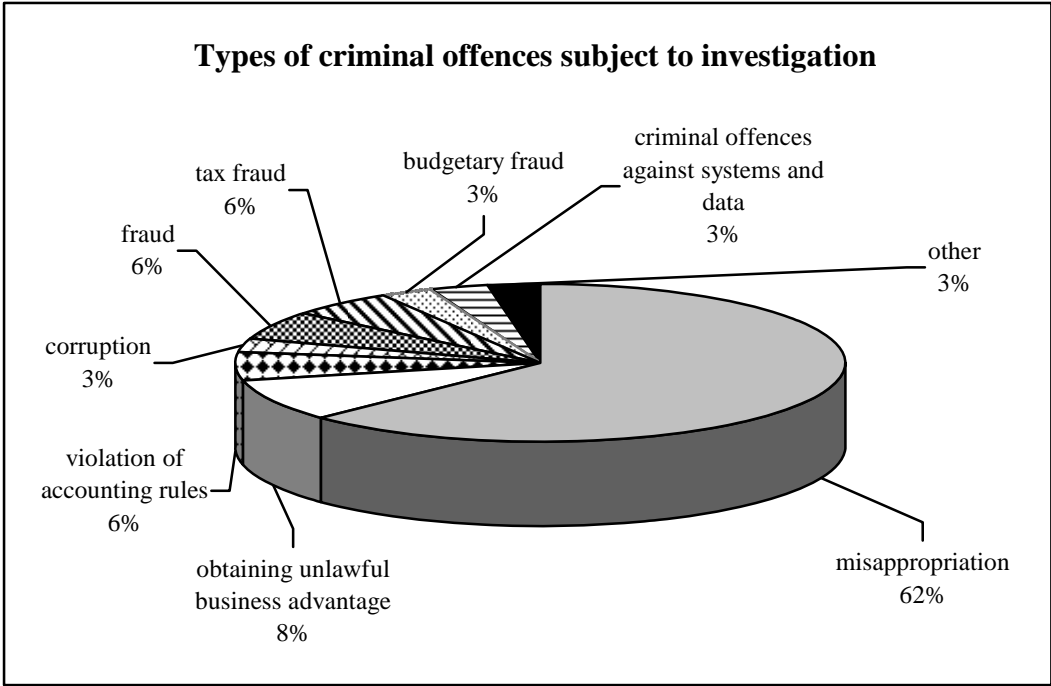
The SAO is not an authority; it does not have direct sanctioning powers in connection with the audit findings. However, it may start the relevant proceedings to enforce the legal consequences at the competent body. The SAO supports the work of the investigating authorities, courts and other authorities by responding to official requests.

Pursuant to Article 1(5) of the SAO Act, based on its findings, the State Audit Office of Hungary may initiate proceedings at the competent organisation against the audited entities and the persons responsible. Article 30(1) of the Act stipulates that if during the audit the State Audit Office of Hungary has grounds to suspect a criminal offence, it shall notify the competent authority of its findings without delay. These statutory provisions enable the SAO, which does not have investigating powers and tools, to indicate to the competent investigating authorities if during any of its audits it discovers circumstances suggesting personal liability. The growing number of audits increased the number of indications the investigating authorities have received. In 2012, the SAO sent indications a total of 11 times, and brought charges on one occasion.

Pursuant to Article 23(2) of the SAO Act and Act CXXIX of 2003 on Public Procurement, the SAO may initiate legal remedy proceedings in connection with the infringements brought to its attention in the scope of its activities. In 2012, the SAO initiated two legal remedy procedures.

Pursuant to Article 23(2) of the SAO Act and Article 71 of Act XIX of 1998 on Criminal Proceedings, the SAO responded to 36 official inquiries in 2012.

There are 10 ongoing investigations after the reports filed and indications made by the State Audit Office of Hungary to the Prosecutors' Office in previous years, and in one instance formal charges were brought against the defendant following the charges pressed by the State Audit Office of Hungary (with respect to a local government).



2.2. Audits performed by the SAO

2.2.1. Selection of audit topics and planning

Even in international comparison, the SAO has wide-ranging audit obligations, mandate and reinforced independence, all thanks to the new Act on the SAO. The Act establishes a framework for the SAO's activities, which must be filled with content by the institution itself, the foundation for which is provided by the institutional strategy. Clear and transparent strategies are needed not just for the utilisation of public funds, but also in terms of its auditing. The provisions and mandates contained in the law are translated into specific audit tasks by the SAO in line with its strategic values and objectives, while acting as an advisor by taking these into account. The audit planning system has been fundamentally transformed following the directions laid down in the strategy, and the development work aimed at comprehensively reforming audit methodologies is underway.

Our renewed institution has produced a number of results recently that have fundamentally determined the SAO's activities and which are in line with our strategy. In order to perform an advisory role, we published a new methodology within our professional competence and applied it in laying the foundation for the opinion on the budget appropriation bill. This, at the same time, also determined the phases of supporting of the work of the Fiscal Council, as well as the tasks to be performed within these phases. We amended the methodology of the audit of the final accounts so that we were also able to conduct an evaluation of the activities as well as the assets and financial standing of certain central budgetary bodies with an outlook of several years. Within the process of audit planning, besides our one-year and two-year mandatory tasks, we focused on risk-based topic selection supporting timeliness and the efficient utilisation of our available resources.

We put our strategy into practice, and this strategic approach has become part of the everyday life of the organisation's staff. The work performed and the measures taken after the announcement of the new strategy all served for the organisation to fulfil its mission and to promote the transparency and orderliness of public finances through a sound professional foundation. The results achieved in the period since the strategy has been published was reviewed in 2012, and we assessed the elements of risk that arose during implementation and defined the manner of dealing with them. In summary, we concluded that the realisation of our strategic system of objectives is on schedule, but we still have a number of tasks to complete.

Today's challenges can only be met with effective responses by an organisation which employs strategic planning and implementation that is flexible and conscious in every respect. The system of objectives of our medium-term strategy, supported by Decree No. 40/2011. (VI. 24.) of the National Assembly, mainly includes goals that we realise on a regular and continuous basis during our everyday work. Carrying a sort of basic value, our objectives are also valid in the long run. The related operating tasks change with time, and are always defined in line with the actual external conditions and serve the realisation of objectives.

The system of the SAO's strategic documents became complete in 2012 with the development of functional strategies. In order to implement the functional strategies that form the basis of the institutional strategy, operating plans are prepared, as set out in the annual action plan, with a two-year outlook beyond the year under review. The annual re-definition of operating plans is an efficient and flexible way of implementing strategic goals, as is projection into a probable future. The internal strategic system of the SAO is, therefore, made up of the unison of strategic objectives based on fundamental values and predictable in the long term and operating plans serving the timely realisation of these objectives. The strategic system, that

has thus become complete, justifies and at the same time ensures the temporal expansion of the range of interpretation of the SAO strategy. Consequently, the institution can conduct its activities in the long run along the stable system of strategic values and objectives as approved earlier by the National Assembly, potentially even throughout the entire duration of the mandate of the President of the SAO.

In 2012, during the process of audit topic selection, the SAO began to apply procedures based on risk analysis. This innovative approach ensured that suggestions on topics, civil complaints and the experience of past audits were evaluated in a regulated, standard and professionally sound manner. In the course of topic selection, we paid particular attention to the likely utilisation of the audit in order for the experience and findings of the audit to substantially contribute to the more efficient and effective functioning of the state. The improvement of the efficiency of the utilisation of public funds came to the foreground, as did the endeavour to ensure that inappropriately utilised public funds do not remain unaudited. The newly applied topic selection system is in line with international practice.

We commenced the development of the uniform risk analysis process of audits, as part of which we gathered and classified the relevant findings and recommendations of audit reports of 2010-2012. We have also completed the risk-based processing of civil complaints and their integration into the selection method. As part of the risk analysis process, the implementation of the management of databases containing financial and asset indicators supporting audits in a unified system, that have until that point been available separately, has commenced. When selecting local governments to be audited, in 2012 we already took risk analysis aspects into account, which we then also expanded to other organisations.

The SAO works on the basis of an audit plan approved by its President. Based on the decision of the National Assembly, the SAO must conduct audits within its statutory competence, and furthermore may conduct audits at the request of the Government as well as in other cases stipulated by law—related to international organisations and contracts. There were no SAO audits conducted on such legal grounds in 2012.

The SAO—in harmony with its strategy—has transformed its audit planning into a rolling planning system, meaning that planning, risk assessment and evaluation represent constant work. In 2012, the compilation of audit plans was performed on the basis of the renewed audit planning system. The primary objective and characteristic of the renewal was the standardisation of planning. The transformation of the planning process is also expected in the future, depending on experience gained. The SAO compiles and publishes its audit plan every six months. By setting a semi-annual planning period, planning and implementation were brought closer, thereby enabling selection of topical issues and flexible resource management.

The audit plan of the SAO for the first half of 2012 contained 38 audit titles of which 15 were carried over from the previous year and 23 were scheduled to be started in the first half of 2012. The audit plan for the second half of 2012 added another 12 audit tasks. When compiling our audit plans for 2012, the audits started before the current year, their completion and the tasks that we are required to fulfil annually and biannually took precedence.

In order to be able to put public finance affairs of the nation in order, one must have a detailed analysis and thorough knowledge of the financial standing of the central budget. Our goal in 2012 was to provide a more realistic, exact and clearer picture of public finances than we did in previous years, in particular through the auditing of final accounts and providing an opinion on the budget appropriation bill.

The auditing of the debt management of the central subsystem of public finances and the debt of local governments is given increased emphasis, as the continuous reduction of public debt

is the primary national economic challenge of the coming years and decades. Hungary must set off on the path to growth without further indebtedness. Our audits highlighted the reasons for the increase of public debt, and we also called attention to its consequences.

Beyond the evaluation of the financial situation of local governments and the compliance of their internal control systems, in 2012 our audits also focused on the asset management of local governments. Furthermore, we also started to audit the way in which the majority-owned business companies of local governments performed their public functions.

In accordance with statutory requirements, we continued the legality audit of the financial management of parties and party foundations. As part of a follow-up audit, in 2012 we audited certain political parties that did not receive regular state aid, and follow-up audit elements were also emphasised in our audits.

Certain audits have special focus being aimed at risk elements and functional problems. These audits are organised around three pillars:

- the audit of internal controls as part of the fight against corruption aims to increase integrity protection;
- the audit of financial standing aims at the elimination of financial exposure;
- the audit of financial situation contributes to resolving problems related to national assets dating back more than two decades.

Accordingly, so-called thematic audits also received emphasis in 2012 as new elements. These are based on the programmes concerned with several audited bodies and which, with slight adaptation, also allowed for comparable audits in many cases. These are, on the one hand, implemented in the case of local government audits, and on the other hand, in the case of the auditing of central subsystem organisations and majority-owned business associations of the state and local governments.

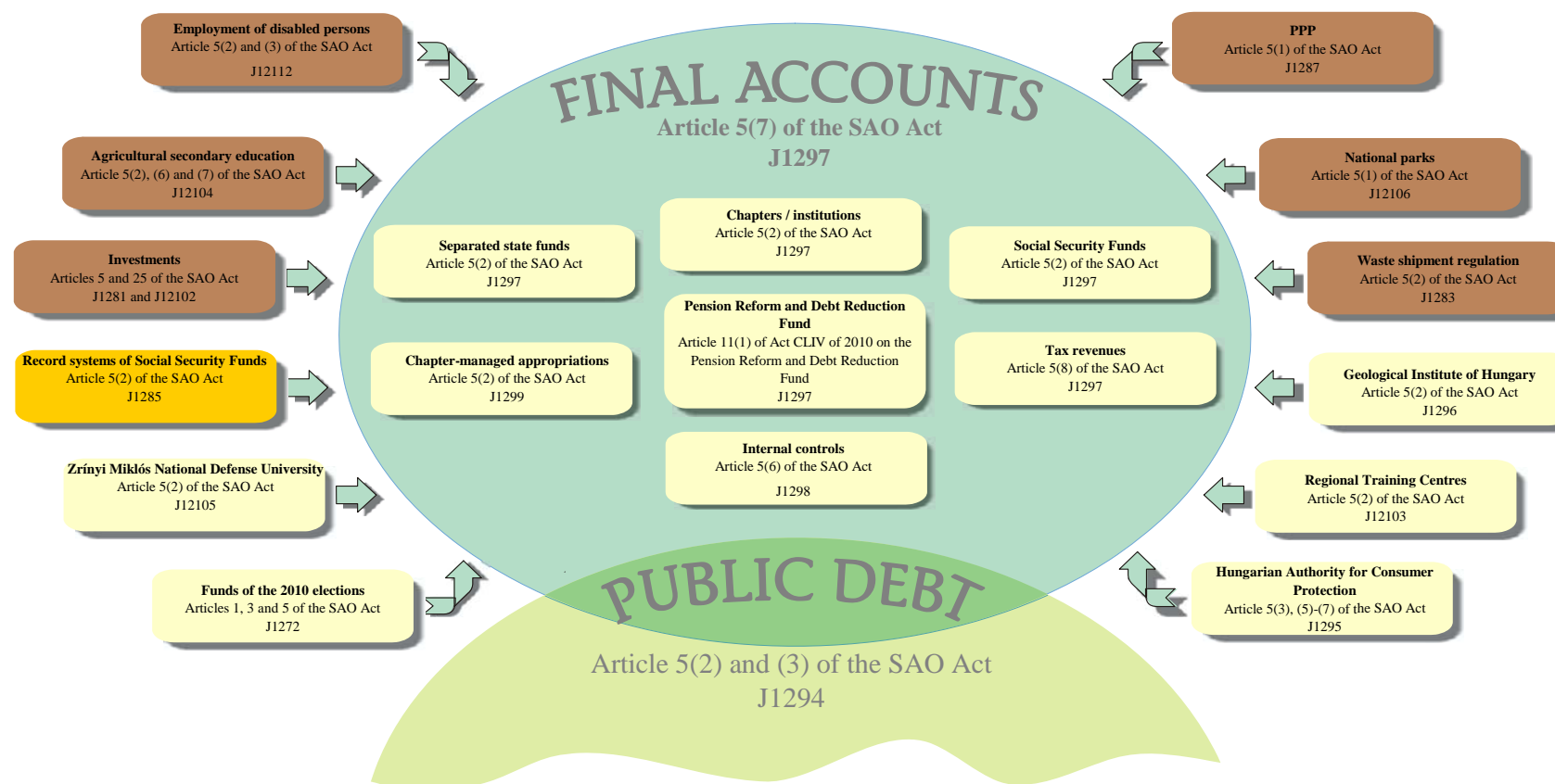
The Treaty on the Functioning of the European Union provides for the cooperation of the European Court of Auditors (ECA) and national supreme audit institutions, and ensures an opportunity for national supreme audit institutions to attend on-site audits of the ECA as observers. Over the course of 2012, the ECA conducted six on-site audits in Hungary in various topics, with data supply without on-site audit on one occasion. Contact with auditors and audited bodies was efficient and effective in all cases. In order to make the cooperation with the ECA smoother, the SAO prepared an internal rules of procedure, pursuant to which it shall in each case decide on participation in the audit and the manner of representation of the SAO on a case-by-case basis. For the sake of retrievability and future utilisation, a negotiation report is prepared on each participation at on-site audits. With respect to audits due in the future, the SAO is in constant contact with the institutions concerned as well as the ECA, which typically gives notice of its current audits four months in advance.

2.2.2. Audit of the central subsystem

The tasks stipulated in Article 5(1)-(8) of the Act on the State Audit Office of Hungary have been completely performed by the SAO by pairing expediently selected audits built on the mandatory, fixed-deadline annual final accounts audits concerning the whole of the central subsystem.

The diagram below sums up which of our audits conducted in 2012 within the central subsystem fulfilled our audit obligations set out in the Act on the SAO.

Audit of the central subsystem



During the audit of the execution of the 2011 central budget, we employed a number of innovative approaches made up of several elements, which ensured that our final accounts report was of an appropriate length, clear structure and—through its structured recommendations—of a forward-thinking nature for decision-makers and the public alike.

Using a ‘one-stop shop’ solution for data queries during the audit of final accounts was an important step forward, which improved the efficiency of our work. This enabled us to conduct the audit of the execution of the budget and the operation of related internal controls, as well as that of the planning and mid-year amendment of chapter-managed appropriations with respect to regularity and financial-professional substantiation with the same auditors, and to gather mid-year data necessary for our opinion on the 2013 budget appropriation bill. Besides increasing the efficiency of resource management, our objective with this solution was to avoid creating extra tasks for the staff of the audited bodies.

As part of our audit on the 2011 final accounts, we qualified 96% of the HUF 12,974.2 billion total revenues and 91% of the HUF 14,551.4 billion total expenditures in order to determine whether the execution of the 2011 budget complied with statutory requirements. The detected errors had no substantial effect on the reliability of the final accounts, and the quality of the financial statements improved considerably.

Breaking with previous years’ practice, in our report we made consolidated and structured recommendations, which reflected the complex approach to problems and the true utilisation of our work. According to our audit philosophy, the reports must not only indicate irregularities, deficiencies and problems, our recommendations must also point out in what direction the financial management of public funds should develop. Accordingly, we articulated a total of six recommendations. We recommended harmonising mid-year incremental demands of headings and the utilisation of budget reserves to the Minister in charge of public finances. With respect to state assets, our recommendation to the Minister of Rural Development aimed to establish a closed record-keeping system for National Land Fund contracts. The essence of our recommendation addressed to the President of the National Development Agency regarding the utilisation of EU funds was that, in line with statutory provisions, he should commission the drafting of a single report on the utilisation of all chapter-managed appropriations of the chapter, substantiated with a general ledger statement and inventory consistently with regulations. We addressed the President of the National Tax and Customs Administration two recommendations; one regarding the specification of IT application security levels, and the other on the appropriate development of internal controls for declaring unpaid taxes irrecoverable. The recommendation, addressed to the Minister of National Economy, also dealing with tax revenues, was directed at the harmonisation of procedural fees and revenue collection costs.

Based on our recommendations, the audited bodies prepared action plans. Further to our recommendation regarding reserves, the Act on Public Finances was amended as of 1 January 2013. Pursuant to the contents of its action plan, the National Development Agency shall prepare a single report on chapter-managed appropriations for 2012, supported by a general ledger statement and inventory. In accordance with its action plan, the National Tax and Customs Administration of Hungary carried out the classification of its data assets and IT applications into security classes and identified their necessary levels of defence, thereby building a foundation for the measures ensuring the risk-proportionate protection of IT systems. The development of related IT regulations (business continuity and disaster plans, IT Security Regulations) is in progress. In its action plan, the National Tax and Customs Administration of Hungary undertook—with a deadline of 31 October 2012—to review its internal regulations pertaining to irrecoverability declarations and to review the relevant IT

programmes as well as to establish a uniform practice within the country by creating sample documents. As prepared by the Minister of National Economy, the Act on Duties was amended as of 1 January 2013 based on our recommendation. According to amendment, the procedure for obtaining payment easements has become free of charge for natural persons, whereas in the case of business organisations the rate of the applicable duty has been raised to HUF 10,000. The measures taken by the audited bodies are verified by the SAO within the framework of a follow-up audit.

In our final accounts report we recorded the magnitude of the annual public debt and the facts contributing to its development. Our report on the audit of the debt of the central subsystem of the general government and commitments for periods exceeding one year, went beyond the scope of our final accounts audit, as it went back as far as 2006 in the analysis of the correlations between the development of general government debt, its financing structure and the cause and effect relations tying interest expenditure and long-term commitments together. We established that between 1 January 2006 and 31 December 2011 the debt of the central subsystem of the general government increased by 64.2% to HUF 20,955.5 billion. In addition to the factors that contributed to the increase in public debt such as the extreme deficit of the annual central budgets, individual decisions and exchange rate losses also played an important role.

In accordance with the strategy of the SAO, we expanded the audit of central budgetary institutions, thereby increasing coverage over the audited institutions by number by auditing the central budgetary support scheme of the Zrínyi Miklós National Defense University, the Geological Institute of Hungary, the National Park Directorates, the Institutions of Agricultural Secondary Vocational Training and Consultancy, the Regional Training Centres and the Hungarian Authority for Consumer Protection, as well as the employment of disabled persons. Within the framework of the seven audits related to our final accounts audits, we audited 13 institutional financial statements, of which three received an adverse opinion and three received a qualified opinion, typically on account of the operating deficiencies of accounting controls.

Apart from the regularity audit of the 2011 financial management of the institutions, the audits of the central budgetary institutions also reviewed the regularity of professional task performance and the efficiency of the use of personnel, material and financial resources. Within the framework of our audits we found positive areas that could serve as examples as well as negative areas in need of improvement.

According to Article 5(6) of the Act on the SAO, during its audit, the State Audit Office of Hungary shall evaluate the operation of the internal control system of public finances. The focus of the financial management of central budgetary institutions is on the development and operation of internal controls. Carrying out a more in-depth audit of the final accounts relying on strict compliance criteria (partially compliant qualification from 70%, and compliant qualification from 85%) was justified. The changes in the international and domestic environment were another reason for the audit. The 'in-depth' analysis of 28 central budgetary institutions and the chapter-managed appropriations under 11 chapters recorded an overall compliance of 71% with respect to their internal control systems. Of the five elements of the internal control system, the control environment reached the highest level of compliance, whereas monitoring reached the lowest level, which foreshadowed the apparent need of the internal control activity of the central budgetary institutions for development and expansion.

Another reason why reinforcing internal control activity is desirable is because of the correlation between the internal control system and internal audit compliance. In the case of

institutions where internal audit activity did not function properly, there were also deficiencies in internal controls. In summary, we concluded that the main directions of the further development of the internal control system are to improve the quality of risk management activity, strengthen controls supporting adherence to public procurement regulations, conduct more thorough and frequent audits of the settlement of funds provided through application from chapter-managed appropriations and constantly update internal regulations.

With a view to increasing the role of controls, we provided an opportunity for the heads of the institutions following the completion of the on-site audit to comment on measures already made or planned to correct the control errors revealed, which measures serve the establishment and strengthening of ‘good practices’. Our efforts proved successful as in their declarations returned, the heads of the institutions supervising the chapters undertook without exception to correct the control deficiencies and errors. Based on these declarations, we repeated the assessment, and based on that the aggregate perception of control pillars improved, reaching a compliance level of 92.9 per cent.

The audit on the planning system of chapter-managed appropriations in terms of regularity and financial and professional substantiation covering several years served to increase the depth of the final accounts audit from another perspective. In our report we established that the planning system did not shift from its bargaining position between the ministry in charge of public finances and the ministries in charge of planning; moreover, a gap developed between planned and actual use due to the frequent government interventions.

The audit covered 51 chapter-managed appropriations, above HUF 100 million each, under nine chapters. Within the framework of the audit we discovered that it was necessary for the legislature to work out the legal and methodological foundation of the task-based planning of chapter-managed appropriations in order to ensure more effective utilisation of public funds, and reinforce planned use in the interest of ensuring harmony between the tasks and the funds. In addition, the SAO made a recommendation to standardise the regulations pertaining to chapter-managed appropriations.

The institutional system of the Social Security Funds, which is of key importance within the central sub-system, was reviewed—in addition to the reliability of its reports—from another perspective, namely the reliability of its records systems. We concluded that the organisation and operation of the (core) records of the system fulfilled its function, as they supported the granting and disbursement of benefits. This was also due to the fact that the reliability and up-to-datedness of the data were facilitated by various forms of data reconciliations. In our report we considered the operation of controls for data flows between the various systems to be risky; therefore, in the interest of improving the systems we set the following as the main directions for further development: quality assurance of data flows, harmonisation of IT developments and the elimination of parallel, redundant databases.

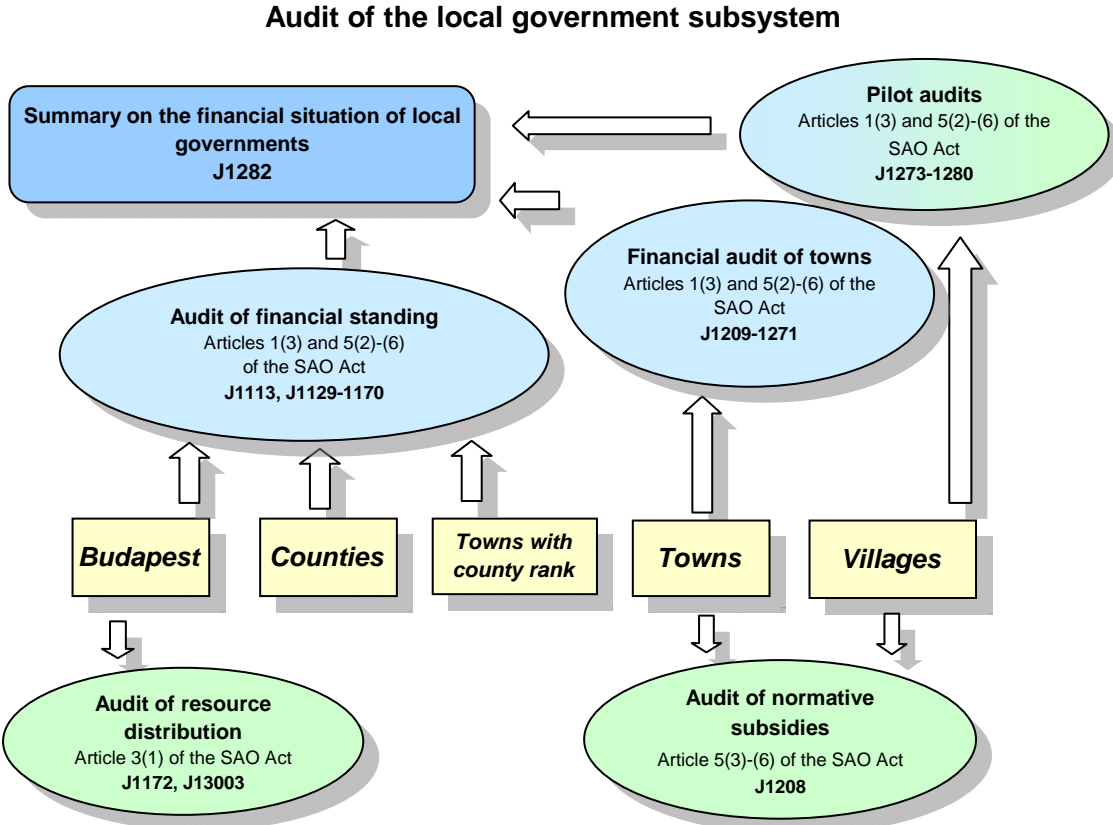
The SAO presented its experience on the auditing of the record systems of the Social Security Funds in the interest of facilitating more efficient utilisation to a larger professional audience; namely the related experience was shared with other audit organisations and were conveyed to institutions of education as presentations, and they were also presented to the Committee on youth, social, family and housing affairs separately, informing the MPs in detail. The presentation of the audit results of the SAO at professional forums was received positively by the auditees as well as the auditing bodies, because in addition to talking about the deficiencies it also appropriately emphasised best practices. All of this had a positive effect on reinforcing the appropriate operating routines.

Based on the authorisation set out in Article 5 of Act C of 1997 on Electoral Procedure as well as in Articles 1(1), 3(1) and 5(2) of the Act on the SAO, the SAO audited the regularity and expediency of the utilisation of funds for the 2010 elections. More than four in five audited electoral bodies failed to budget any original expenditure appropriation related to the parliamentary elections in the state budget for 2010, thereby violating statutory requirements.

2.2.3. Audit of the local government subsystem

Based on the authorisation set out in Articles 1(3) and 5(2)(6) of the Act on the SAO as well as Article 61(2) of the Act on Public Finances, the SAO audits the local government subsystem, in particular the responsible financial management of public funds and assets, the utilisation of subsidies granted from public funds, the compliance with accounting rules as well as the operation of the internal control system.

With respect to the local government subsystem, in the period when SAO audits were conducted in 2012, the public funds utilised at local governments represented revenues of HUF 987.5 billion, expenditures of HUF 906.2 billion and grants of HUF 6.4 billion. In the subject year, we conducted the following audits related to the local government subsystem:



As of 2011, there was a significant change in the auditing of the local government subsystem. We approached our audit tasks with a new methodology and new approach, which primarily focused on detecting financial risks, and thus assessing the financial situation of local governments. Through the 2011 and 2012 auditing of local governments selected on the basis of risk analysis and statistical sampling, the SAO has oversight on the financial situation of the whole of the local government subsystem. Thanks to the new methods of analysis, our information extends beyond the data provided by cash-based accounting; therefore, the SAO has comprehensive information on the financial equilibrium of the subsystem. We revealed

the reasons for the accelerating deterioration of the financial situation as well as for the significant increase of long-term financial commitments, and were thus able to formulate targeted recommendations for local governments and decision-makers in the interest of restoring, improving and preserving financial equilibrium. As part of the audits, we also performed the follow-up audit of the utilisation of the recommendations made during earlier SAO audits.

In 2012, we completed the audit of financial situation at 63 towns and launched such audits at another 13 towns. We processed the data requested from the 241 local governments where no on-site audits were conducted. Based on the 2011 and 2012 audits and the data queries, we prepared a summary report on the financial situation of local governments. We determined the reasons behind the deterioration of the financial situation of local governments being four main financial risks: operating, accumulation and default risks, and risks arising from the operation of business associations in the majority ownership of local governments.

The fundamental reason for the indebtedness of the local government subsystem was the lack of funds to serve as coverage for investment projects implemented with the help of EU subsidies. As a result of debts denominated in foreign currency, the exchange rate losses contributed significantly to the growth of liabilities. The central regulation on limiting the commitment of debt-generating liabilities did not perform its function as local governments committed liabilities that exceeded their financial capacity. Prior to making decisions on long-term commitments, the risks thereof or the realistic possibilities of repayment were not reviewed. The assets belonging to local government key property were also offered as loan collateral on some occasions.

We formulated recommendations for local governments with the aim of eliminating the causes for the deterioration of the financial situation. Our recommendation to manage operating risk entailed measures to increase revenue and cut expenditure, prepare a restructuring programme handling structural problems in a complex manner, establish an institutional structure in line with economies of scale and review the funding of voluntarily undertaken tasks. In order to reduce default risk, our recommendation was to generate reserves that can be used to settle liabilities, to handle overdue trade debtors, and to regularly inform the municipal council of the funds that can be used to finance liabilities. In order to reduce accumulation risk, our recommendation was to review planned investments, assess the possibilities of re-structuring liabilities related to investments in progress and to review the sustainability of the implemented facilities. With our recommendations we contributed to the re-establishment of the financial balance of local governments, the conscious management of financial risk in the future, the appropriate operation of internal controls and regular municipal financial management.

Based on its audit experience, the SAO reiterated at several forums the need to rethink task performance and financing in the local government subsystem. As a result of the financial disequilibrium that evolved, the SAO suggested that immediate central intervention was necessary and also urged that the legal framework be created to prevent the regeneration of debt. All these contributed to the re-regulation of local government task performance and the foundations of task financing being laid down in the interest of ensuring sustainability. With regard to this subsystem, however, one of the most important results of our audit was that the National Assembly passed a decision on the partial consolidation of the debt of local governments. At the end of 2011, the management of the debt portfolio of county local governments became the responsibility of the Hungarian State. The Government facilitated the full repayment of the debts for local governments of settlements with less than 5,000 residents through a specific repayment grant as of 12 December 2012 and any additional

charges outstanding as of 28 December 2012. In case of settlements with more than 5,000 residents, the Government will assume the debts and any additional charges thereof as of 31 December 2012, the date of debt assumption, in a differentiated manner in 2013—taking the revenue generating ability of the settlement into account at a rate of 40-70%. Parallel to the debt consolidation measure, the Government passed stricter regulations on authorising borrowing and liquid loans in order to prevent a regeneration of the debts of local governments.

The size and financial standing of local governments are closely related. Local tax revenues, however, also mean local exposure if a considerable portion of the local tax revenue is collected from a limited number of taxpayers. The success of these businesses has a direct effect on the financial standing of the local government. If the businesses are not profitable, are wound up or move elsewhere, the local government could face financing problems. The taxation and other revenue generating capacities of local governments are limited. During the period under review, the local governments made continued efforts to increase their revenue and they assessed, on a regular basis, the possibilities of levying local taxes and increasing the rate of already existing taxes. As a result of the economic crisis that began at the end of 2008, there was no real possibility to increase their revenue substantially. The local business tax, which is the most important source of local tax revenue for many local governments, was already at its maximum rate in the majority of local governments. The volume of the local business tax revenue had decreased and there was no option to raise it any further.

The operating income of the local governments, according to the aggregate figures of the local governments of counties, towns and towns with county status, was insufficient for debt repayment already in 2010. As a result, operating income was also insufficient to cover the accumulation budget deficit; therefore, external financing was used. The repayment of the latest commitments, however, reduce net operating income even further, creating an unsustainable financial situation.

During the audit on the on-site review system of the Treasury for claiming of and accounting for state subsidies and contributions due to local governments and on accounting for normative contributions due to local governments in 2010, we audited the effectiveness of the review of settlements at the Treasury's headquarters and 11 county public finances offices. The settlement of normative contributions due to local governments in the year 2010 was assessed at 47 local governments (including seven towns and 40 villages) covering all legal titles. Of the HUF 6,356.5 million normative contributions accounted for by local governments, the audit determined HUF 63.4 million of ineligible usage and HUF 54.7 million of additional eligibility. The balance of revealed deficiencies was HUF 8.7 million of ineligible use.

During the review of the local government decree on revenues due to and shared by the Municipality of Budapest and the Budapest district local governments in 2012, we determined that the Mayor's Office complied with the procedural rules and deadlines pertaining to the audit of the base year reporting data serving as the basis for resource distribution calculations and to the consultation with the Budapest district local governments. When establishing the operating expenditures by district, the Budapest Mayor's Office, disregarding the Government Decree on the Rules of Operation of Public Finances, also included expenses not linked to normative contribution and the distribution of tourism revenues also failed to comply with the statutory regulations.

The SAO participates in the fight against corruption and fraud, the identification and application of the efficient and effective means of fight against corruption risks and corruption, and in the dissemination of their use as well as in establishing an integrity-based

administrative culture. The audit started in 2012 on the development of the internal control systems of local governments and the operation of certain controls, as well as of the operation of internal auditing served these objectives.

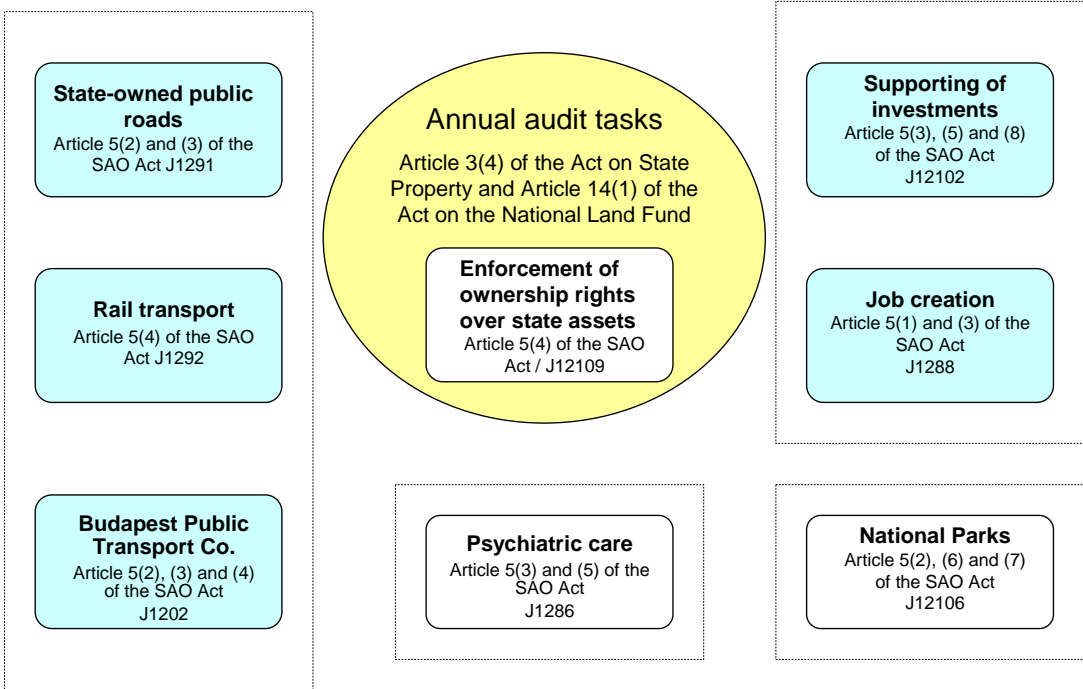
As added value, one of the potential results of the audits is that the level of regulation of the internal control system and the compliance of operation of audited local governments improves, thereby allowing for the achievement of statutory objectives through the operation of the internal control system. Another possible impact is that by promoting ‘good practice’—something we wish to take an active part in—unaudited local governments will also adopt the good examples. Another result is the deterrent effect with respect to irregularities of the number of audits proposed as a result of risk-based sampling.

As a result of the audit, a well-founded conclusion could be drawn from the audits of an adequate number of local governments on whether the—current and undifferentiated—statutory requirements applicable to the development and operation of the internal control system are setting realistic requirements for the local governments of villages and large villages.

2.2.4. Audit of the management of national assets

Pursuant to the provisions of Articles 1(3) and 5(4) of the Act on the SAO, the SAO audits the management of state assets. All SAO reports published in 2012 concerned—with varying gravity—national assets. The majority of reports also contained the evaluation of expediency aspects.

Audit of the management of national assets



Of the activities related to the management of national assets, the auditing of the activity related to exercising proprietary rights over state property, performed annually by the SAO pursuant to a relevant statutory requirement, should be highlighted. The experience gained during our audits performed on a regular basis was sent to the Ministry of National

Development to be used in the course of renewing the act on state property, which we hope will be appropriately utilised.

The fact that property registration data are not reliable or complete has been a long-standing problem with the exercise of ownership rights over state property. The assets constituting the results of the investments carried out by the National Infrastructure Development Co. Ltd. are not featured in the records. Through the transfer of the concerned assets of the Hungarian National Asset Management Inc. (HNAM) to the National Land Fund Management Organisation (LFMO), the earlier problems of the Land Fund's record-keeping—which until that point existed only within the organisation of the HNAM—were brought to the surface. Due to the significant deviation between the asset record data and real estate registration data handed over, the LFMO conducted the legal audit of all parcels of land belonging to the Land Fund. The auditing of state assets is not fully resolved; most importantly available capacity is insufficient to carry out property audits. Several recommendations were formulated in connection with the final accounts audit of 2011. In its action plan the National Land Fund Management Organisation made a commitment—with a deadline of 30 September 2013—to establish a closed integrated contract registration system enabling the retracing of contracts.

The tools of increasing and preserving assets are investment and renovation. Our audits revealed the problem that in the case of projects implemented with EU funds, local governments as well as public institutions assume a maintenance obligation of up to 15-20 years, while their operation fails to generate coverage for the depreciation required for continuous improvement. The investments were financed from domestic funds and in the manner stipulated in the Act on Corporate Taxes, while EU grants were considered to be the funding source to achieve the objectives defined in the National Development Policy Concept adopted in 2005. This also contributed to the fact that the rate of investment decreased between 2005 and 2010 despite the fact that the Concept had forecasted a significant increase in investments.

Significant domestic and EU funds were available for job creation and protection. Through our assessment of the grants we illustrated that in the 2004-2010 period HUF 1,850 billion were available for job creation; however, the results did not improve the already unfavourable employment situation, and the geographical differences were not significantly reduced either. The labour market position of those participating in the programmes only improved in the short term.

Special mention should be made of our reports in two areas of the transport industry. The 2005-2007 reorganisation of the organisations involved in public railway services did not improve the liquidity of the companies. In the 2008-2011 period, the state subsidy system of rail transport was only able to ensure the operation of public services related to railway passenger transport and of the track network with an increase in operating loans, with occasional subsequent state intervention and a decline of service quality level. During our audit we again pointed out that the settlement the assets of the Hungarian State Railways has not taken place since 1993, the real estate records of the company differ from the land registry records. The assets originating from the investments carried out by the National Infrastructure Development Co. Ltd. (NIF Co.) were booked as inventories in the books of the NIF Co.

The main transport concepts did not attach appropriate importance to the renovation of the road network other than expressways between 2006 and the first half of 2011. Most sources available in the Road Fund were spent on the construction of expressways, and renovations were financed based on the residual principle. As a consequence, the technical depreciation of state assets continued. Renovation cycle time was around 35 years instead of the 10 years generally accepted in the industry. The length of road sections with speed limits due to road

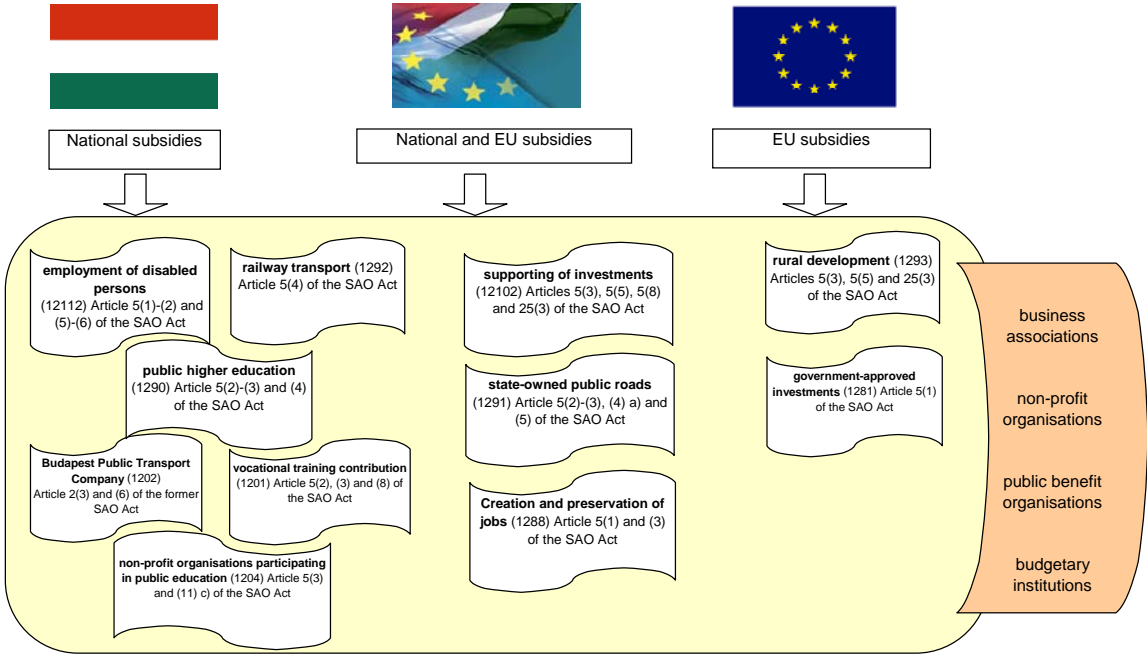
defects increased by nearly 10%. The renovated assets worth approximately HUF 56 billion are still included in the books of NIF Co, their transfer and depreciation failed to materialise.

Due to the complexity of the tasks undertaken by local governments and as a result of the proportion of local government assets, in 2012 the SAO started a regularity audit on the property management of local governments as well as of the performance of public tasks of companies owned by local governments. The regularity audits contribute to our ability to point out regulatory deficiencies and the options that can provide systematic protection for the local governments in their asset management and for the performance of their public functions and also increase the local governments’ ability to protect themselves against risk.

During the audits planned for 2013 we will pay special attention to auditing the asset value protection and asset value increasing activities of business associations held by the state as well as on auditing the asset management activities of public institutions. We will continue to audit the public function performance of business associations in majority ownership of local governments and also assess their asset management activities.

2.2.5. Audit of subsidies granted from public funds at the beneficiary organisations

The SAO audited the use of public finance pursuant to Article 5(3) of the Act on the SAO and in accordance with its strategy, thereby contributing to the ability to judge the transparency of the use of subsidies extended to public benefit organisations, business and non-profit organisations in order to ensure their task performance. Our audits also covered a wide range of public function performance and the use of domestic and European Union subsidies.



The subsidies extended from public finances amounted to approximately HUF 5,687.2 billion with respect to the beneficiary organisations in the period and fields concerned by the SAO audit in 2012.

Over the last year, among others, we assessed the subsidies provided for the employment of disabled persons, non-profit organisations involved in public education, entities involved in the performance of public tasks related to rail transport and public transport in Budapest as well as the renovation and maintenance of public roads. When auditing the use of European

Union subsidies we put special emphasis on grants provided for the purpose of job creation and for enterprises.

The budgetary support provided to the beneficiaries contributed to the performance of public functions. However, the audited support schemes could not always ensure effective and efficient use of the subsidies. For instance, the subsidy system was only able to ensure the operation of public services related to railway passenger transport and of the track network with an increase in the operating loans of the railway companies, with occasional subsequent state intervention and with a decline of service quality level. Between 2007-2011, the support system of disabled employees did not ensure the increased participation of such persons in employment, and did not contribute to the efficient and effective utilisation of resources. Regarding more than half of the HUF 270 billion for vocational training objectives, it was impossible to determine what part of it was spent on accomplishing vocational training and vocational training-development goals. Furthermore, the regulation of the vocational training contribution made it possible to use the financial resource for purposes other than vocational training development.

During our audits it was discovered that the quantifiable targets that were to be achieved through the central budgetary support were not always defined. No measurable requirements for the use of the support were set in the grant agreements, rules of procedure or legislation. On occasion, the substantiation of subsidy amounts and the offsetting of the justified costs of public service not covered by revenue were not clearly documented. The reporting and accounting system of the grants, and the available information did not ensure complete transparency and accountability. The SAO discovered illegally used development tax benefits, a HUF 40 billion minus in contribution returns on the part of the obligors in 2009-2010 and HUF 1.9 billion in illegally drawn support.

Several SAO audits were conducted in 2012 to assess the utilisation of European Union funds, playing a very important role in terms of developments and investments. Based on our reports, our assessment was that the efficiency of committing European Union funds was high. The lack of focused strategic planning, however, was striking. During the audit of funds with a rural development objective, the SAO revealed that the modification of the financial framework of the New Hungary Rural Development Programme (NHRDP) was contrary to the objective set out in the economic development programme of the NHRDP intended to strengthen micro-enterprises operating in rural settlements and improve local employment. According to our findings, EU subsidies have difficulty in reaching beneficiaries and do so slowly, which has a negative impact on effectiveness. For instance, at the end of 2011 the ratio of payments made for the purposes of rural development was 20.4%, while the time required to process grant applications regularly exceeded the statutory deadlines by an average of 394 days. In addition, in the course of the utilisation of EU funds, long-term effects and consequences were not always taken into consideration or the extent to which these developments could contribute to the objectives set.

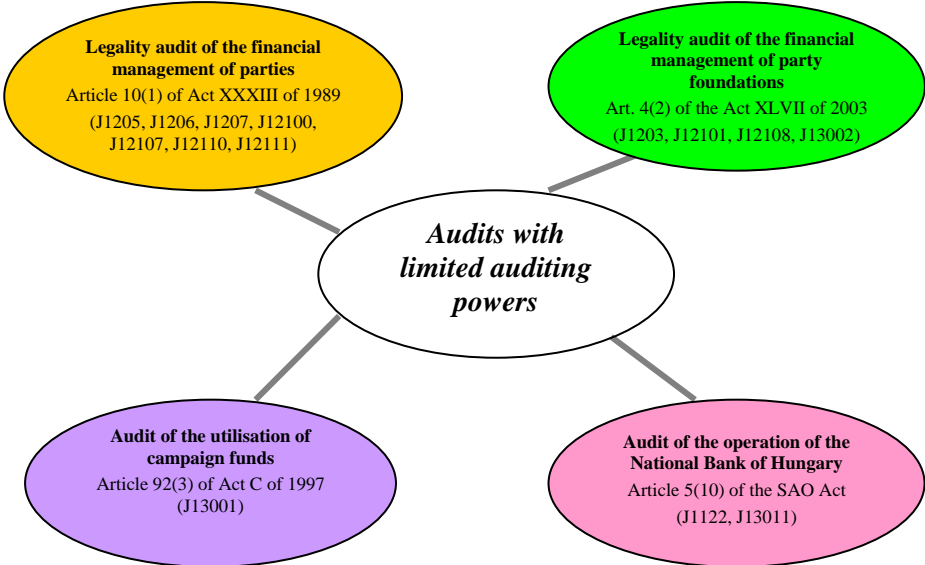
Although the subsidies provided to enterprises contributed to job creation, we pointed out that the job creation programmes in effect between 2004 and 2010 were operated in parallel; they were not harmonised and therefore it was difficult to measure their results. Despite the grants provided within the framework of the New Hungary Rural Development Programme, demographic indicators and employment failed to improve, and the per capita GDP did not increase in rural Hungary. Creating a business-friendly environment and improving the targeting of the various grants are key issues in addition to the quantity of the tax benefits and grants provided to enterprises.

The audits of the State Audit Office of Hungary highlighted the strengths and weaknesses of the audits conducted by the organisations providing support and exercising proprietary or supervisory rights. For instance, in the course of our audit of the Budapest Transport Company (BKV), it was discovered that the Municipality of Budapest failed to request reports from the committees with ownership rights, and it only partially fulfilled its auditing obligations and only took partial measures to ensure the utilisation of the audit findings. Of the operators of non-profit organisations participating in public education, 35% did not perform their quadrennial audit obligation as stipulated in the Act on Public Education. The external audits conducted in this field failed to reveal the shortcomings related to operator’s management tasks and disclosure obligation. The Regional Development and Training Committees either did not or only partially complied with their statutory obligation to monitor the utilisation of vocational training levy in the region and to assess the efficiency thereof. During the audits they failed to evaluate whether the performance attained with the help of the financial funds was proportional to the expenditures.

The SAO contributed to the transparent, regular and effective use of public funds transferred outside the system of public finances by auditing the central budgetary grants provided to 30 non-profit organisations involved in public education. Due to the lack of a medium-term public education development plan for the 2007-2010 period, the county-level development plans did not specify quantifiable targets to be attained by the non-profit operators. The medium-term public education development plan will be drafted in line with the recommendation of the SAO and in accordance with the provisions of the new Public Education Act. In our audit report, we emphasised that the accreditation system for performing public education tasks failed to provide the required guarantees for the regular and effective task performance. Of the audited operators, 25 non-profit organisations complied incompletely with the operators’ tasks stipulated in the relevant legislation. The concerned government offices will report on their related experience as well as on the measures taken by June 2013.

2.2.6. Audits with limited auditing powers

With respect to audits with limited auditing powers, in the 2012 period the public funds utilised represented revenues of HUF 5.5 billion, expenditures of HUF 18.6 billion and grants of HUF 3.9 billion in the audited areas.



The irregularities found in the course of the regular legality audits of political parties repeatedly point out the basic deficiencies of the Act on Political Parties. Specifically, they call attention to the untenability of the annual reporting obligation, which runs contrary to the Act on Accounting, ensuring neither transparency nor comparability. There are no provisions on mandatory audits, the employment of a certified accountant or the consequences of failure to comply with the publication obligations, which would serve the provision of reliable information to the public.

In connection with the annual reports of the political parties, the SAO has been reporting for over a decade that the content of the annual reports may differ depending on the accounting policy employed by the parties, emphasising that the template report required by the Act on Political Parties does not comply with the balance sheet and profit and loss account requirements stipulated in the Act on Accounting. In response to the amendment bills included in the reports published by the SAO, the Minister of Public Administration and Justice stated that the Government considers the establishment of party financing and financial management rules in line with the Act on Accounting important. The amendment of the Act on Political Parties and the utilisation of the recommendations of the SAO may be realised within the framework of the cardinal legislative process.

In the case of the parties that are no longer represented in Parliament, having fully or partially lost their government funding, the act includes no provisions on the handling of serious irregularities or the application of sanctions. One of the deficiencies of the Act on Political Parties is that currently there are no rules governing the management of debts accumulated in the course of the financial management of these parties nor is there a procedure in place to handle the resulting insolvency and outstanding public debt payment obligations. In addition to requiring the audited entity to pay the ineligible revenues discovered by the SAO into the central budget—due to the termination of the organisation’s right to receive government funding—there is no way to reduce the government funding by the same amount. The guarantees aimed to ensure the intended use and the preservation of the value and condition of the real properties of the state purchased with the help of several hundred millions of Hungarian Forints disbursed through the Act on State Assets are not defined, which poses a high risk.

For understandable reasons, the scope of the legality audit tasks of the SAO do not cover the obligations of expedient financial management of political parties. The Act on Political Parties does not assign any requirements or expenditure restrictions on revenue use. The government funding provided to the political parties and the revenue generated from the use of the free of charge asset transfer received from the state can be used freely.

The Act on Political Party Foundations does not stipulate any sanctions on failure to publish the annual reports and divergence from the intended purpose of funding is only ‘penalised’ if a payment is made from central budgetary grants. There were occurrences when the expedient use of funds by political party foundation funded by several tens of millions of Hungarian Forints was subsequently unascertainable.

The effective provisions of the Act on Election Procedures do not yet ensure the conditions for auditing the complete transparency of the origin and utilisation of campaign funds. The mandate of the SAO only allows it to audit the use of funds intended for the election of Members of Parliament at the nominating organisations.

In accordance with the provisions of the Act on the SAO, pursuant to a statutory mandate, the SAO has audited the financial management of the National Bank of Hungary (MNB) every year so far. One of the key goals of the SAO’s audit is to support more efficient and transparent task performance by the MNB and a more economical use of public funds.

As a result of our 2011 report on the audit of the 2010 operation of the MNB, the sections of the MNB Act related to the transfer of corporate decision-making powers and the exercising of powers were amended as per our recommendation; furthermore—retrospectively for the year 2011—the balance of the HUF exchange rate and the foreign currency securities equalisation reserve must be evaluated aggregately. The legislative amendment effective as of 2011, requiring the consolidation of equalisation reserves mitigates the risk of the central budget incurring a payment obligation to the MNB.

The 2012 audit relied upon the methodology that was updated in accordance with the international standards. Apart from auditing the management and decision-making system of the MNB, the regularity of the MNB's bank operations in 2011, the enforcement of cost-efficiency considerations, and the utilisation of the recommendations of the previous year's SAO audit, the SAO audited, for the first time, the MNB's exercising of ownership rights over the Hungarian Banknote Printing Co. and the Hungarian Mint Co., both fully owned by the MNB as well as the central budget-related accounting statements of these companies.

The document handling practice of the MNB did not comply with the statutory requirements as of December of 2012, as the Bank's document handling software did not have the required certification. Between 2008 and 2010 the MNB disclosed data, qualifying as a business secret to the IMF without authorisation. During the audit the MNB acknowledged that it had in fact reported data qualifying as a business secret to the IMF and added that it had taken action to find those responsible and investigate any procedural errors.

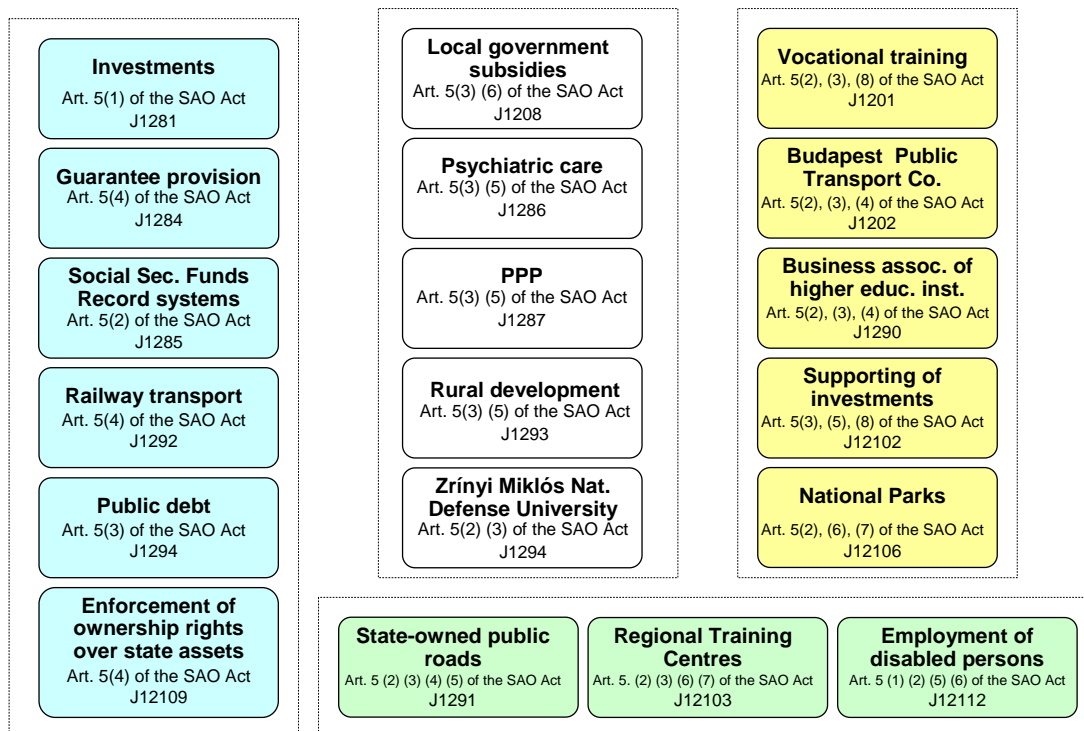
2.2.7. Performance audits

According to Article 43(1) of the Fundamental Law of Hungary, the State Audit Office of Hungary, within its statutory competence, shall audit the implementation of the State Budget, the financial management of public finances, the utilisation of funds from public finances and the management of national assets. The State Audit Office of Hungary carries out its audits against the criteria of legality, expediency and efficiency. The National Assembly reinforced the application of performance audits that make assessments along the lines of considerations of economy, effectiveness and efficiency by the SAO earlier in its resolution no. 72/2008 (VI. 10.).

Every economically active organisation, citizens as well as the government must manage their finances within a certain, pre-defined financial framework that becomes even more restricted in an economic crisis. It also follows from this that public funds must not only be used regularly, but expediently and effectively as well.

In terms of the financial management of public funds, the SAO primarily audits the actual implementation of expediency and efficiency considerations within the framework of performance audits, but in many cases it evaluates expediency aspects during regularity audits as well. In 2012, the SAO published 19 reports of performance audits conducted in a variety of different areas. These audits generally covered periods of four to five years.

Performance audits



The general experience of the audits is that there are problems related to efficiency and effectiveness, which can be traced back to the deficiencies of regulation and the implementation of controls. The performance audits published in 2012 showed that in terms of public fund use, efficiency and effectiveness in the course of task performance did not improve in the majority of cases during the audited period (our audits typically concerned periods before 2011); positive developments only happened in a few cases.

The audits shed light on the fact that the audited entities typically did not formulate any efficiency or effectiveness objectives, nor did they define any indicators for them. This does not facilitate accountability in that if the objectives and criteria are missing, the audited entities cannot be held accountable in terms of the expediency and effectiveness of their use of funds, rather only in terms of their spending. In cases where objectives were in place, they were too general in their wording and did not include any partial objectives, priorities, focal points or any measurable expectations.

For the majority of the audited areas, no evaluation procedures had been established and the extent of the implementation of the strategic objectives and whether the results achieved were proportional to the expenditures were not evaluated. All of this does not encourage economical and efficient task performance, utilisation of funds and financial management.

A system of indicators was established to monitor the result of EU subsidies. The availability of the data, however—despite the continuous developments—enabled only a limited comparison of the results achieved to the set objectives.

The audit experience of the SAO confirms that public spending could be more efficiently curtailed and the objectives could be better reached if success criteria were defined and applied to public fund spending. The recommendations of the SAO are also aimed at this.

To illustrate our typical experience with performance audits, we would like to highlight the following from our 19 reports.

Based on public health and financial figures (indicators), the transformation of psychiatric care resulted in reduced the efficiency and effectiveness of the system, and the costs of operation were not lowered either. The closing of the National Institute of Psychiatry and Neurology was professionally unprepared and inexpedient. Several government initiatives were announced for the reorganisation of healthcare in the period 2006-2011, but they did not specifically determine the tasks and size of the various components of psychiatric care. (Audit report No. 1286)

During our audit of the central subsystem of public finances and its commitments exceeding one year we concluded that the Minister of Finance and the debt management system were unprepared to handle the risks described in report no. 0604 of the SAO on the audit of government debt management and debt development between 2000 and 2005 (down-grading of the external debt ratings and increasing financing costs), which then materialised in the next audited period (2006-2011). The activities of the Government Debt Management Agency Co. did not support the establishment of a cost-efficient debt structure, which was set as the objective of debt management. The costs and effectiveness of the individual financial and financing operations were not assessed or evaluated. (Audit report No. 1294)

The effectiveness of the Garantiqa Credit Guarantee Co. Ltd.'s guarantee commitment activity deteriorated as the result of the vigorous expansion of the guarantee portfolio and the deteriorating quality thereof. The Company engaged in wasteful financial management in the course of its operation, establishing and operating its subsidiaries, in its personnel expenses, as well as regarding services used. The management and supervisory bodies that were in office at the company until August 2010 failed to uncover deficiencies in regulation, inexpedient and wasteful financial management and failed to take action to eliminate these. The Government specified indicators for measuring the achievement of the goals marked in the SME development strategy adopted in 2007. These, however, only measure the achievement of goals at an overall SME level and thus fail to reflect the type of facilities used to accomplish goals and the degree to which they contributed to these goals. (Audit report No. 1284)

Our report on the audit of business associations in which public higher education institutions have an interest pointed out that between 2006 and 2010, it was not precisely measured how the professional and economic activity of companies contributed to the task performance of the institutions; necessary professional and other indicators and their target values were not determined. The business shares did not generate any substantial direct profit to institutions. The yield rate of funds invested by institutions in companies barely exceeded half of the central bank base rate in the audited period. (Audit report No. 1290)

2.3. *Activities performed in the advisory function of the SAO*

The State Audit Office of Hungary has been exercising a certain advisory role since its inception in 1990, which is unique even by international comparison, through providing opinion on the central budget appropriation bill, which is currently prescribed in Article 5 (1) of the Act on the SAO. In the process of providing an opinion on the central budget appropriation bill, the SAO functions as an advisor to the National Assembly, which has become even more prominent with the entry into force of the new Act on the SAO. This also means that the legislators had a very keen sense of the fact that the scope of activities of a modern supreme audit institution can be supplemented by an advisory role in addition to the traditional auditing roles. This line of thought is indisputably justified and forward thinking in that—apart from the Government—no other central budgetary or market organisation possesses the amount and quality of information accumulated at the SAO in the course of carrying out the audits. By playing an advisory role we do not allow already obtained

information and the special expertise needed to evaluate them to go to waste, rather we publish them for further use in the interest of the country even at the highest, parliamentary level. In its resolutions no. 43/2005 (V.26.) and no. 72/2008 (VI.10.), the National Assembly considered it necessary to reinforce the advisory role of the SAO and to ensure that the SAO can continue and make its advisory activities regular.

2.3.1. Opinion on the budget appropriation bill

When providing an opinion on the budget appropriation bill of 2013 of Hungary, we assessed the legality, substantiation and support of the bill, and we also identified the risks. The SAO provided opinion on 88% of the total expenditure of HUF 15,477 billion and 82% of the total revenue of HUF 14,799.7 billion. This was the first time we used the new methodology created for the analysis of the relevant appropriations of the budget appropriation bill.

The 2013 budgetary planning process differed significantly from previous practice in that the National Assembly already decided on the key budget figures during its spring session. Accordingly, in June 2012 the SAO prepared and handed over to the National Assembly its opinion on the draft budget. In this opinion we emphasised the importance of reserves as well as the deficiencies and risks that needed to be handled in connection with the revenue and expenditure appropriations.

The National Assembly approved the 2013 Budget on 11 December 2012. The gross sums in the central budget—especially in order to keep the deficit below 3% of the GDP—were changed on several occasions, and multiple measures were taken to mitigate risks. In doing so, the indications emphasised in the SAO report about the importance of reserves, income and expenditure risks and legislation were taken into consideration. The regulations that were missing according to the SAO have been completed (tax regulations), and the National Assembly adopted a significant portion of the related bills, within the framework of which the Stability Act was amended in order to ensure smoother decision-making. Progress was also made in terms of creating substantiated and well-grounded plans. Further adjustments were accepted on the revenue and expenditure side of the budget, keeping economisation in mind. A number of motions for amendment supported by the Government were submitted to the budget appropriation bill. Measures were taken to keep the 2012 budget under control. The planned amounts of reserves, including the Country Protection Fund, were increased.

Yet, in spite of all this, risks still exist (for instance with respect to the realisation of the macro-economic forecast); risks that make disciplined financial management necessary on both the part of the Government and local governments, and necessitate comprehensive implementation of the measures of the Convergence Programme and the Széll Kálmán Plan 2.0.

At the ‘Good Practices’ conference held in November 2012, the SAO provided an opportunity for the concerned parties to become familiar with the exemplary planning practices made public during the provision of the opinion, thereby supporting the development of planning work and the dissemination of utilisable good examples.

2.3.2. Supporting the task performance of the Fiscal Council

In line with the provisions of the Act on the SAO, the President of the SAO performed his tasks as member of the Fiscal Council (hereinafter: Council) as set out in the Stability Act. The primary ambition of the SAO was to integrate the results of its budget-related audits into the Council’s decision-making process. In the interest of the professionally sound execution of this new task, the SAO took three important measures.

1. It established a monitoring system that allowed the systematic observation and evaluation of budgetary processes in the given year.
2. In order to provide an opinion on the budget appropriation bill, the SAO developed a new methodology ('Methodology for the audit establishing the opinion on the bill on the Hungarian budget') which was also available for utilisation when the SAO prepared its analysis for the Council on the draft of the 2013 budget appropriation bill.
3. It compiled a methodological guidance for the audit on the compliance with the debt rule. With the help of this guidance, it was possible to check whether the public debt indicator was in line with the rate of public finances deficit planned for in the budget appropriation bill, whether the exchange rate equivalence was realised with respect to debt data and whether the consolidation between the various subsystems had been carried out.

The above measures allowed the SAO to help the Council with independent analyses.

The SAO assessed the statutory amendments for the 2012 budget, submitted five times during the year, from the aspect of the development of public deficit and public debt. It prepared an analysis for the Council for the evaluation of the budgetary processes of the first half and three quarters of 2012. It pointed out the risks of the not time-proportionate execution of certain budgetary appropriations and indicated the extent of these risks.

The SAO prepared an analysis for the Council on the draft of the 2013 budget appropriation bill. In this analysis, it qualified the substantiation of the appropriations set out in the draft budget. During the parliamentary debate phase, the SAO evaluated the impact of Government-supported motions to amend, submitted to the budget appropriation bill, on the public finances balance as well as the statutory substantiation and legal compliance of the appropriations to be amended within a short deadline. It provided an opinion on whether the rate of public deficit in the draft is in compliance with the debt rule.

Prior to the final vote on the 2013 budget appropriation bill, the SAO systematically audited the factors affecting the development of the actual 2012 public debt and the public debt planned for 2013, as well as the completeness of the assessment of public debt.

The 2012 amendment of the Act on the SAO further strengthened the SAO's tasks related to the Council, as it set out that 'in connection with the tasks of the President laid down in subsection 13(2)l), the State Audit Office of Hungary prepares analyses and studies and by the provision thereof it assists the Fiscal Council with the performance of its tasks'.

Through its analyses, the SAO contributed to the fact that the Fiscal Council made all its decisions by consensus in 2012 and that the Government and the National Assembly took several Council recommendations into consideration in their budget-related decisions. The SAO's work supporting the Council, therefore, also served the goal of the National Assembly passing a well-founded, substantiated budget that manages risks and enables the reduction of debt, and that these criteria may also be enforced at the mid-year amendments of the budget.

2.3.3. The promotion of the development of public finances

In the interest of ensuring the academic foundation of its work and enhancing the professional reputation of the organisation, the SAO conducts active academic-professional activities. As part of this activity, it publishes the *Public Finance Quarterly* periodical and operates the *Public Finance Quarterly Online* portal, and also organises seminars in order to promote forward-thinking financial management solutions and good practices. In its Decrees No. 43/2005. (V. 26.) and No. 35/2009. (V. 12.), the National Assembly considered it necessary to

stipulate the publication of a modern financial periodical by the SAO, and concurred with the conducting of advisory and opinion-shaping activity as well as the nurturing of the *Public Finance Quarterly*.

The fact that in 2012 the articles of the *Public Finance Quarterly* became available in the world's leading economic database, the periodical received an impact factor and that the PhD tender announced by the periodical was successfully completed were all significant breakthroughs. The beginning of the year also saw the launch of the *Public Finance Quarterly Online* website as well as the social media pages supporting the portal. The *Public Finance Quarterly* has grown into a renowned and well-known scientific brand, one of Hungary's defining workshops that provides a sound foundation for building the academic credibility and enhancing the reputation of the State Audit Office of Hungary. In 2012, the *Public Finance Quarterly* joined in supporting the work of the State Audit Office of Hungary at an institutional level as well, as the fundamental editorial principle of both the periodical and the online portal is to promote the utilisation of SAO's work.

In 2012, the periodical published four issues; the topics in focus were crisis management and sustainable development, the financial affairs of local governments and the challenges facing financial literacy and public accounting. The selection of topics was related to and in line with current SAO reports and strategic objectives.

It is a strategic task of the State Audit Office of Hungary, as the guardian of public finances, to improve financial literacy, which assumes the surveying and analysis of finance-related knowledge, attitudes and habits.

Pursuant to our strategy, in order to increase the efficiency of public administration, we make good practice public property and transfer the information and knowledge obtained as a result of audits to the users of public funds. In the course of its audits, the State Audit Office of Hungary not only reveals shortcomings, but also encounters innovative financial management policies and best practices. Through the widespread presentation of these practices, the SAO attempts to facilitate the improvement of the quality of the Hungarian public finance system, to make the operation of organisations more efficient and to make the utilisation of public funds more economical.

On a related note, the SAO organised two 'Good Practices' seminars in 2012. An international seminar was held in April with the participation of the Financial Inspectorate of the Canton of Valais from Switzerland and the Audit Office of Galicia from Spain, the central theme of which was the indebtedness of local governments. In the month of May, we supported the work of the Fiscal Council and contributed to the National Assembly's activities in preparing the budget appropriation bill through a conference presenting the domestic and international experience of public debt management. In November, with the participation of high-ranking officials of the Ministry of National Resources, the Ministry of Public Administration and Justice, the Ministry of the Interior, the Ministry of Defence and the National Tax and Customs Administration, the SAO organised a conference entitled 'Good Practices! Focus on the Central Budget'. Besides renowned international lecturers, the seminars supporting the work of local governments and central budgetary organs also featured officials from more than 100 Hungarian local governments and the main managing authorities.

2.3.4. Providing opinion on draft legislation

Pursuant to Article 6(1)-(2) of the Act on the SAO, the President of the SAO participates in the preparation of legal regulations concerning the legal status and competence of the State Audit Office of Hungary, regarding the operational rules of public finances and the internal

audit of budgetary institutions, and those related to the accounting rules of the public finances. These draft legislations shall be forwarded to the SAO, which shall be provided adequate time-limits to provide its opinion on such drafts. As part of the fulfilment of the obligation set out in Article 6 of the Act on the SAO, the SAO provided opinions on draft statutes pursuant to external requests in 2012 as well. The formulation of the official opinion of the SAO was realised with the utilisation of audit experience and knowledge related to the given topic.

In 2012, the SAO performed the review of its process related to opinion provision powers based on practical experience. As a result, new procedural rules pertaining to deliberation were drafted with regard to the acts and other documents within the purview of the SAO that play a key role in terms of the operation and core function of the SAO and also pertaining to the motions that concern the deliberation functions of the Fiscal Council. The new rules of procedure may be followed within the context of regulatory environment changes experienced by the organisations even if no external inquiries are received. Pursuant to the new rules of procedure, the tasks that result from the deliberation rights and obligations of the SAO are performed by expert colleagues—among traceable lines of responsibility—that have audit experience in the given topic, according to their field of expertise, either in accordance with general rules of procedure or fast-track rules of procedure in cases that require an immediate response.

In accordance with Article 5(6) of the Act on the SAO, during its audit, the SAO shall evaluate compliance with the accounting rules of public finances. The extensive experience gained during the audits help the organisation provide a well-founded opinion on the legislation relevant to the accounting rules of public finances.

The new draft government decree on the accounting of public finances was a high priority in our legislation deliberation work in 2012, which originally scheduled the transition to accrual-based accounting by 1 January 2013 at the latest. In our opinion we explained that we considered the direction of the regulation to be good; however, special attention should be paid to the transition and the optimisation thereof. As a result of our negotiations with the concerned parties and decision-makers in the interest of introducing accrual-based accounting, Government Decree No. 4/2013 (I.11.) on the rules of the accounting of public finances will enter into force as of 1 January 2014.

The audit of the financial situation of local governments pointed out that the prerequisite of establishing long-term financial equilibrium is the renewal of the IT and accounting order of budgetary institutions. The audit revealed that cash-based accounting does not provide a true picture of assets and financial standing. In order to provide a fair presentation of the efficiency and effectiveness of public tasks performed, accrual-based accounting must be introduced in the public sector as well. We agree with the legislative intention that the public finance, budgetary and reporting system must be renewed and made more transparent in line with Council Directive 2011/85/EU on the requirements for budgetary frameworks of the Member States. We found the objectives of the new system of accounting supportable, according to which if the systems of accounting are established in a uniform manner, planning, financial management and reporting will all become more auditable; the quality of planning could significantly improve in the medium-term along with the measurement of medium and long-term determinations.

During our audits on compliance with the accounting order, we revealed several accounting deficiencies.

Regarding the central subsystem, based on separate audit programmes related to the audit of 2011 final accounts, we qualified the reliability of financial statements and evaluated compliance with accounting regulations in the case of several institutions. In more than one

case, the audits revealed that the balance sheet in the financial statement was not backed up by a comprehensive inventory, the tangible assets were not capitalised at the date of their commissioning and that the discrepancies between the data in the treasury and institutional reports were handled in a consolidated manner, thereby revealing a breach of the basic accounting principles of gross settlement and clarity and exceeding of priority expenditure appropriations. In the case of three institutions, we determined ineligible commitments and related payments, as a result of which the financial statements received adverse opinions.

During the audit of the internal control system of local governments, the auditees were selected on a risk basis. Based on the pilot audits, we can determine that our risk analysis system is effective and may be utilised in the future as well. However, the findings made during the evaluation of risk-based sampling painted a picture that was more unfavourable than the actual situation. With respect to the selected local governments, the experience of the audits of the internal control system confirmed the correctness of our risk analysis and at the same time also reassured our assumptions through the audit results. During the audits of local governments operating with weak internal control systems, of the 16 local governments, there were only two where the SAO did not observe regulations deviating from the provisions of the Act on Accounting or the Government Decree on the Specificities of the reporting and book-keeping requirements applicable to public finance organisations (hereinafter: Government Decree), or other book-keeping deficiencies. In the case of two local governments, the audit uncovered the absence of accounting regulations stipulated by the Act on Accounting or the incomplete content thereof (with respect to accounting policy, inventory, evaluation and fund management regulations). Despite the provisions of the Government Decree, three local governments failed to prepare a system of accounts, and four had no regulations on accounting documents. In the case of four local governments, inventory obligations were set out in inventory regulations at intervals different from the period set out in the Government Decree. In the case of 11 local governments, the audit determined non-compliance with the provisions on the content of account classes as contained in Article 9(11) and Annex 9 of the Government Decree. As a result of the inadequate designation and settlement of accounts in book-keeping, the basic accounting principles of authenticity and the priority of content over form were not observed, and in one case the principle of gross settlement was breached as well.

2.3.5. Fight against corruption and fraud

With respect to the topic of the fight against corruption, the SAO's tasks are set out in Decree No. 35/2009. (V. 12.) OGY and Decree No. 72/2008. (VI. 10.) OGY. In line with these resolutions, the SAO has set as its strategic goal that it 'facilitates the creation of integrity-based, transparent and accountable utilisation of public funds', and furthermore, '... plays a role in the fight against corruption and fraud. It participates in the identification and application of the efficient and effective means of fight against corruption risks and corruption and in the generalisation of their use as well as in formulating an integrity based administrative culture.' A single organisation cannot successfully fight corruption; the cooperation of all organisations concerned is required. Recognising this, on 18 November 2011, the President of the SAO signed a joint declaration with the Minister of Public Administration and Justice, the President of the Supreme Court, and the Chief Prosecutor, in which they declared their commitment to battling corruption. Therefore 2012 proved to be an important phase for the SAO in the fight against corruption. The utilisation of this activity was the creation of Government Decree No. 50/2013. (II. 25.) on the integrity control system of central administrative bodies and the order of acceptance of interest enforcers, which

extends to central administrative bodies under the control or supervision of the Government and their employees.

The strategic objectives serving the strengthening of integrity are primarily achieved by the SAO within its own organisation. For this reason, in 2012 it developed its internal regulations and actual operation to comply with the requirement of transparency and accountability. The SAO, guided by international standards, develops its methodology on a continuous basis, making its organisation more up-to-date and efficient and more resistant to corruption.

The development of the methodology also enables the SAO to act more effectively against corruption during the planning and implementation of audits. As part of the methodological renewal, the SAO commenced the selection of audit topics on the basis of risk analysis. During this selection, besides the risks arising from financial situations, it also takes corruption vulnerability into account, based on the audits of previous years, the data of the survey conducted as part of the Integrity Project and the summary and classification of risks uncovered and identified during civil complaints. The SAO submits civil complaints and complaints to risk analysis and takes these into account when planning audits.

During all its audits, the SAO examines compliance with regulations concerning audited activities. If during the audit the auditor has grounds to suspect a criminal offence, they shall notify the competent authority of their findings without delay. In this sense, all SAO audits reduce the possibility of corruption.

Besides the external audits (also) performed by the SAO, the basis of the successful fight against corruption is the establishment and efficient operation of internal control systems as well as strict and thorough internal auditing. This is why in 2012 the SAO treated the audit of internal controls as a priority audit task. The contents of the programme approved with Government Decree No. 1104/2012. (IV. 6.) on the government measures against corruption and the approval of the Public Administration Corruption Prevention Programme, served as guidelines during the planning of the audit programme concerning the internal control of local governments.

The implementation phase of so-called Integrity Project, launched by the SAO, was completed at the end of April 2012, which is followed by a five-year maintenance period ending in April 2017. The objective of the project implemented with EU subsidy is to assess the operation of budgetary institutions with respect to corruption vulnerability, to identify risks and to improve Hungary's auditing practice and public administration culture with integrity in mind. Through the Project, the SAO became the number one workshop for Hungarian anti-corruption thinking. This is well reflected by the fact that based on SAO experience, the resolution on government measures against corruption, approved by the Government in April 2012, launched a pilot project to introduce the integrity-control system at state institutions. In the interest of the implementation of the government resolution, the SAO participates in the work of the anti-corruption expert working group coordinated by the Ministry of Public Administration and Justice. In the course of this participation, the SAO provides its experience gained in the fight against corruption and in the establishment of an integrity-based public sector.

3. The operation and development of the organisation

As the supreme institution auditing the use of public funds, the constantly changing environment as well as professional and social expectations pose a constant challenge for the SAO. The need to meet the challenges carries the dichotomy of striving for continuous renewal and stability at the same time. The auditing and advisory functions of the SAO have recently come to the foreground in response to the combined need for accountability and the prevention of excessive indebtedness in the current economic environment.

Only an organisation tailored to our mandate enables us to carry out our mission; therefore, when we reform our internal operations and transform our organisational structure it is a fundamental objective to establish a well-functioning and efficient organisation fully capable of meeting the challenges of our time. With a view to setting up an optimal organisational structure in line with the tasks we need to execute, we have further reduced the number of organisational units, and improved the efficiency of the SAO's operations by consolidating the organisational units and existing tasks. By doing so, the SAO clearly demonstrated that even a public sector organisation and institution can operate cost-efficiently.

As part of our restructuring, between May 2011 and the end of 2012, we reduced the number of organisational units by nearly two thirds. We have also rationalised management levels. As a result, the hierarchy of the organisation was 'streamlined'; as regards the professional areas, the department structure was partially eliminated and replaced by a matrix-type organisation. In this environment, all work is performed on a project basis. We set up a controlling and monitoring system to track internal processes and we fully reformed our internal regulations. Thus we succeeded in increasing the external/internal responsiveness of the SAO, enabling it to become a flexible organisation that is based on systematic processes and generates added value. In order to tailor resource management to the tasks at hand, we started to develop competence-based resource allocation, which leverages auditors' work to maximum advantage. The organisational renewal allows the institution to progress continuously while meeting the challenges of a constantly changing legal and economic environment.

After developing and elaborating the sub-strategies, the State Audit Office of Hungary found that the medium-term strategy adopted by the National Assembly is suitable to define the operations of SAO for the next ten years.

3.1. Results supporting SAO's professional operations

The activities of the State Audit Office of Hungary is supported by a multi-level strategic document system. This system is well structured both in terms of substance and purpose. The institutional strategy is located at the top level of strategic documents. It includes the fundamental strategic goals and tasks of the SAO defined on the basis of the institution's mission, vision and organisational values. The institutional strategy defines goals and tasks in three main areas (development of audit activity, the operation and development of the organisation and external/internal communication), which are then detailed further as the specific functional strategies of supporting areas, namely: organisational development, methodological, communications, international relations and IT strategies. These functional strategies are located at the level directly underneath the institutional strategy. Individual sub-strategies fit the organisational strategy while at the same time being consistent with each other. In addition to the strategies described above, separated from the organisational development area a new, independent functional strategy emerged: the strategy of the human resources area. With the sole exception of the communications strategy, the functional strategies were adopted in 2012.

As a tool of management and control, the internally used annual action plan includes key tasks concerning the performance and development of audit activity aimed at the public sector and the 'professional infrastructure' assisting the audit work. The SAO has completed all the tasks defined in the internal action plan for 2012.

Based on the experience gained during the implementation of the action plan for 2012, the SAO revised the function and content of the action plan for 2013. The action plan was given an active role in setting up the entire organisational culture and supporting the renewal of the institution. The new action plan was defined in the context of a consciously devised and sound task structure. Accordingly, it includes twice as many tasks as last year, which reflects the increasingly intensive internal activity of the office.

The year 2012 saw the launch of the review and reform of the audit procedures of the State Audit Office of Hungary. The objective of the enhancement was to achieve a higher quality auditing process to ensure more reliable audits. Based on our professional experience, in the course of 2012 we compiled and started to apply the internal regulations setting out the guidelines for the tasks to be performed in individual phases of audit work. The guidelines regulate the audit process in accordance with the requirements of international standards. They include the detailed rules of the workflow of individual audit phases, ensuring the transparency and quality assurance of the audit process. The application of these rules allows for a better division of work between specific organisational units, making the assessment of the completed tasks easier. Appropriately designed and scheduled processes contribute to improving the quality of human resource management and thereby enhancing the utilisation of the resources available.

As of 2012, the SAO divided the audit process into six phases in its internal regulation. Effective as of 1 January 2013, Article 3 (9) of the SAO Instruction No. 4/2012. (XII. 29.) on the Rules of Organisation and Operation of the State Audit Office of Hungary sets forth the following provision: 'the audits of the State Audit Office of Hungary are divided into six fundamental phases: preparation of the preliminary study; preparation of the audit programme; preparation of the auditor working papers; compilation of the draft audit report; preparation of the audit findings; consultation with audited bodies on the draft audit report, finalisation and issuance of the audit report; monitoring of the audit report's utilisation. The auditor's responsibility is enforced in each phase'.

We performed our 'one-stop shop' audits within the a given organisation with audits built on each other in time, designed for the purpose of examining different topics, which is an example of the cost-efficient utilisation of our resources. These audits significantly contributed to reducing the audit-related workload of the audited bodies.

The professional rules of auditing the public sector involve a continuously changing and expanding professional information base, which is also significantly influenced by the periodically changing international auditing rules. The International Organization of Supreme Audit Institutions (INTOSAI) is constantly enhancing and renewing the framework of professional standards (International Standards of Supreme Audit Institutions – ISSAI) pertaining to the auditing of the public sector.

The SAO performs its methodological development in line with the standards elaborated, adopted and issued by INTOSAI (ISSAIs). In line with its methodological strategy adopted in 2012, the SAO commenced the review of the fundamental principles of operation and the professional rules of auditing which, considering the high resource-intensity of the task, is still in progress.

The SAO has elaborated and published on its home page its own framework for the Professional Rules of Auditing. The professional auditing rules of the SAO can be classified under three levels built on each other.

Level I: The fundamentals of auditing the public sector

The fundamentals of auditing the public sector are outlined in the Lima Declaration adopted by INTOSAI in 1977.

Level II: The fundamental principles of SAO's operations:

- the items guaranteeing the independence of the State Audit Office of Hungary;
- the SAO's fundamental principles of transparency and accountability;
- the SAO's fundamental principles on ethics;
- the SAO's fundamental principles of quality-driven operation.

Level III: The fundamental principles, standards and guidelines of SAO audits, the reform of which continues into 2013

In the context of the professional review, the existing system of professional rules and the documents addressing methodology are being constantly revised. The new professional auditing rules of the SAO and the methodological documents will be developed on the basis of INTOSAI's professional standards (ISSAIs), providing content to the professional framework.

The State Audit Office of Hungary actively participates in the activities of the working groups, committees and other cooperation forums belonging to the international relations network of the SAO (INTOSAI, EUROSAI, EU Contact Committee, EURORAI, NATO, V4+2), and is engaged in bilateral and multilateral cooperation with its partners. These contacts and involvement ensure the transfer of knowledge and provide an opportunity for the sharing of knowledge, the mutual exchange of good practices and international communication. All this contributes significantly to improving the quality of the audit culture and the audit practice within our institution.

In the context of activities concerning methodology and auditing, in 2012 the staff of the SAO attended a number of foreign and domestic events. In the framework of our activities performed within the aforementioned international organisations, we have maintained an active membership, among others, in the working groups addressing VAT, auditing independence, professional standards and the IT dimensions of auditing. In addition, in the context of presidential meetings, we focused on key professional subjects such as the fight against corruption, the latest developments in economic governance and the role of auditing in promoting environmental awareness. At the expert level, we sought information in the context of bilateral discussions about the different aspects of risk analysis, the indebtedness of local governments and the auditing of the banking sector. In addition, coordinated audits served as important tools for international information exchange. In 2012, the SAO was involved in three such audits as a participant (enforcement of the EU's Waste Shipment Regulation; utilisation of funds allocated to the development of the cycle route network; simplification of the Structural Funds Regulations) and in one audit as an observer (adjustment to climate change).

The SAO continuously gives account of its international activities on its news portal, and reports on priority events on its English language home page. Interviews with foreign invitees are also posted on the English language home page. Consequently, anyone interested can obtain information about international events, domestic and foreign professional meetings and visits, as well as their main results in a transparent and easy-to-follow manner.

In the framework of international cooperation, the State Audit Office of Hungary formed an opinion on the significantly modified draft text of public sector auditing principles located at Level III of the INTOSAI's professional framework ('Fundamental Auditing Principles'). The documents will be adopted at the XXI INTOSAI Congress in October 2013.

3.2. Organisational results supporting operations

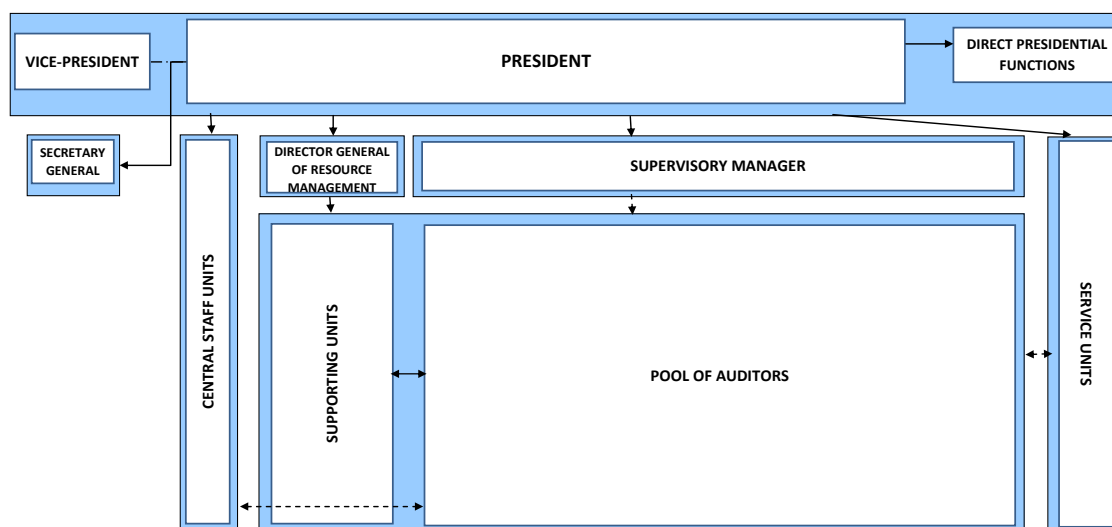
In an effort to resolve the previous organisational and operational problems, we have partially eliminated the department-based organisation and replaced it with a matrix-type organisation, where tasks are performed on a project basis. The operation of the organisation has become transparent, with a reduced number of management levels. Tasks are performed by establishing the foundations of a uniform resource allocation system, on a competence basis.

The duties of the departments (risk analysis, audit planning, legal, coordination of auditors' work) supporting auditing tasks have been changed, and links to the audit process have been strengthened. The application of the internationally prescribed operating principle, the 'four-eyes principle' makes it possible to guarantee the higher-level, maximum support of the audit process and the improved quality of reports. With the transformation of resource management activity we can ensure a task-centred and performance-oriented system with optimal employment. The SAO strives to facilitate the efficient, effective and cost-efficient use of public funds even in its own operations.

The main areas of the new structure include:

- units fulfilling central staff functions (responsible for strategic governance, direct support to management, secretarial and organisational administrative tasks, quality control and monitoring, tasks related to HR activities and strategic planning, theoretical and methodological duties, tasks related to international and institutional relations, communications tasks);
- unit fulfilling supervisory functions (management and control of audits, representation tasks, utilisation of reports);
- unit fulfilling the function directly related to on-site audits (execution of audits);
- unit fulfilling the audit support function (tasks related to HR management, audit planning, applied methodology, risk analysis and legal support);
- units fulfilling supplementary audit functions (these departments are responsible for tasks related to institutional budgeting and financial management, asset management, operations and IT).

Simplified organisational function chart



In line with its strategy, the State Audit Office of Hungary performed its tasks and activities throughout 2012 with a view to quality-oriented operation and developed, applied, continuously reviewed and enhanced its processes and procedures accordingly.

Throughout nearly the entire year of 2012, quality assurance tasks were carried out by an independent department functioning as final control. In parallel, we commenced preparations for and transition to quality-driven operations aimed at more complex and higher level quality requirements and approach. As a part of these efforts, we defined the guidelines to be applied, as well as the related control points.

Last year, the SAO reviewed and utilised the quality control values, experience and good practices obtained in the international arena, thereby commencing the implementation of an organisational operation that is open to learning and building on others' experience. In this context, the President of the State Audit Office of Hungary adopted the document entitled 'The SAO's principles of quality-driven operation', the tenets of which were elaborated with regard to the 'Quality Control for SAIs (ISSAI 40)', the international standards issued by INTOSAI.

As from December 2012, quality assurance is not a separate part of the audit process but quality control, as a quality requirement, is integrated into every element of the SAO's auditing activity and the process of reporting. Consequently, in each operating area of the SAO, employees are expected to enforce, within their own scope of competence and responsibilities, the principles of quality-driven operation as well as the requirement of prudent planning and consistent implementation, and the requirement of controlling the implementation and performing the necessary adjustments accordingly.

For each element of the audit process, the State Audit Office of Hungary has defined clear responsibilities and the rules pertaining to the quality-oriented supervision and review of the work performed. Before publication, the SAO's reports are always subject to rigorous quality review.

Elements of the internal control system have also been integrated into the audit process. Risks arising during audits are identified, assessed and addressed as part of the risk management system.

The performance of the SAO can be measured on the basis of intellectual property, reports and implemented audits. To this end, it is essential to have high-quality human resources and the adequate professional capital possessed by our well-trained staff. We continue to develop the professional expertise of our staff in line with our workload and the challenges of our time.

Although the State Audit Office of Hungary is a constitutional chapter and, pursuant to the Act on the SAO, the organisation can be given a mandate by the National Assembly only (set forth in legislation or parliamentary resolution), in consideration of the good practices of recent years and the fact that the vocational training system for public officials is governed consistently by the Ministry of Public Administration and Justice (KIM), each year, the organisation prepares and forwards its annual training plan to the competent background institution of KIM. The cooperation is mutually beneficial: on the one hand, it assists KIM in planning vocational training; on the other hand, SAO staff have access to high quality knowledge transfer.

As is the case with all organisations, the SAO also experienced a certain level of workforce mobility (in 2012 the number of entries was 78 and the number of exits was 77), and made career building opportunities available to everyone. For this reason, there is a constant need for human resources in a certain quantity and quality, which must be ensured.

In order to ensure the availability of an adequate workforce, the SAO continuously develops its recruiting system which, at present, is based on bidding and a three-round selection process. A training package has been put together for new entrants to ensure their fast integration and to achieve sufficient work value.

Our basic expectations of auditor trainees and auditors are independence, responsibility, objectivity, accuracy, thoroughness and writing skills. Our competency system provides a point of reference in the application process as well. Job competencies defined for each position indicate the professional skills required to fill the specific position beyond the basic expectations.

In the context of corporate social responsibility, the SAO introduced an internship system which helps new graduates to acquire their first workplace experience. As part of the programme, 30 young graduates were recruited in 2011 and following the annual revision and assessment, we increased the staff by 17 new entries in 2012. The SAO ensures that the potential of young talents is leveraged to maximum advantage through targeted training programs and professional workshops.

The objective of the internship system is to ensure the utilisation of young experts' knowledge and to lay the grounds for good work practices among those opting for the auditor profession. Another primary goal of the programme is to put the theoretical knowledge obtained at the university into practice and to gain professional experience.

The former library of the SAO went through a significant overhaul in 2012. The transformation of its physical appearance and the modification of its name were accompanied by stepping up the information management and e-library functions, while also partially retaining the previous library functions. During the transformation process we commenced the review of the library stock and the stocktaking of more than 30,000 documents on file. Parallel to this, we rationalised our databases.

We are convinced that the transparency of public sector auditing does not only involve the legal declaration of the public availability of reports, but also the provision of actual and easy access to the findings of public sector audits. With that in mind, in 2012 the audit reports

prepared before 1996 were digitised, which allowed us to publish older reports on the SAO's home page.

The Training and Information Service Centre has been adjusted to the expectations of the modern age with expanded functions. This ensures that the knowledge underlying the auditor work is collected and made available by means of the most up-to-date tools and techniques. Besides brand new workstations, the Training and Information Service Centre now features a modern training and conference room, which gives home to the internal training programmes of the SAO.

The SAO has developed its equal opportunity plan for the next two years. The SAO continuously monitors the prevailing equal opportunity regulations and adherence to equal opportunity considerations; in respect of its employees, it does not discriminate on the basis of gender, race, age, etc.

In order to ensure equal treatment and equal opportunity, in the area of employment the SAO has defined different objectives, programmes and measures as regards responsibilities at home and on the job, in order to facilitate the development, improvement and maintenance of working conditions and health, equal access to training programmes and equal opportunity for employees with disabilities, and in relation to the termination of employment and retirement.

3.3. *Transparency of the organisation*

In addition to ensuring the transparency of the use of public funds, in line with INTOSAI recommendations, the State Audit Office of Hungary must lead by example and demonstrate transparency in its own operations. The new Act on the SAO adopted in 2011 establishes the basis for this. Besides strengthening the powers of our institution, the Act also represented a significant step forward in the area of transparency.

The Act stipulates that all SAO reports are public, thus, while the independent State Audit Office of Hungary determines the audit methods applied, all Hungarian taxpayers have the right to learn about the findings of the audits. In the spirit of total transparency, besides making all SAO reports and audit plans public and accessible to anyone, in keeping with the expectations of the 21st century, the reports can be searched and downloaded on the SAO's home page at www.asz.hu.

The transparency of our work also adds value to our anti-corruption commitment. The fight against corruption is a strategic objective of the State Audit Office of Hungary and the transparency of our audits and other work processes visibly reduces corruption risks. Where all activities are performed in front of the public, there is no room for bias or favouritism; thus transparent operation is the basis for the integrity of our own work.

Initiated by the SAO in the spirit of transparency, the National Assembly created a new menu item on its home page, a new platform designed to keep MPs informed. Members of Parliament are increasingly provided with information through a wide array of platforms; we regularly compile background materials and briefings for their use in relation to current topics and draft legislation submitted to Parliament for debate. As these compilations may be of interest to the general public as well, most of them are available on the SAO's home page or News Portal.

4. Financial management of the State Audit Office of Hungary in 2012

The SAO compiles its proposal for its own budget and its report on the implementation of its budget itself, which is then submitted without any changes by the Government to the National Assembly as part of the central budget appropriation bill and its implementation. The financial management of the State Audit Office of Hungary is audited by an independent chartered accountant selected and appointed by the Speaker of the National Assembly in a public procurement procedure.

According to the chartered accountant's report, the SAO managed its financial resources within the limits prescribed by the Act on the Budget, in consideration of the range of appropriations and in compliance with regulations and internal policies. The annual financial statement for 2012 provides a true and fair view of the assets and financial standing of the budget heading for the State Audit Office of Hungary. The independent audit report prepared on the budget heading of the State Audit Office of Hungary is presented as an annex to this report.

In line with the practice of previous years, during the financial management of the SAO the cost-efficient utilisation of resources and the most efficient possible use of existing capacities represented a critical task in 2012 as well. The SAO considered the cost-efficient management of public funds binding to itself. Beyond immediate savings, the review and renewal of the organisation resulted in more efficient operating conditions capable of reducing costs even over the long term.

In the Act on the Budget, the National Assembly allocated HUF 7,240.5 million for the discharge of the SAO's duties in 2012, of which HUF 7,220.5 million was covered from subsidies and HUF 20.0 million from the SAO's own revenues.

During the year, key budget appropriations and their performance were as follows:

(data in HUF million)

	Original appropriation	Amended appropriation	Performance	Index (Performance/ amended appr.)
Personal allowances	4,670.7	4,921.5	4,736.9	96.2
Contributions payable by employers	1,247.3	1,385.8	1,336.4	96.4
Non-personnel and current expenses	951.0	941.4	855.6	90.8
Other operating expenditures		433.4	433.4	100.0
Institutional investment	133.0	472.7	236.6	50.0
Renovation	21.9	64.4	5.1	7.9
Chapter reserve	216.6	216.6		
Other non-operating expenditures		7.6	7.6	100.0
Lending		7.6	7.6	100.0
Total expenditures:	7,240.5	8,451.0	7,619.2	90.2
Operating revenue	18.0	18.0	6.0	33.3
Non-operating revenue	2.0	2.0	5.3	265.0
Revenues equivalent to funding		113.3	113.3	100.0
Loan repayment		7.6	7.6	100.0
Budget subsidy	7,220.5	7,447.4	7,447.4	100.0
Residue from the previous year		862.7	862.7	100.0
Total revenue:	7,240.5	8,451.0	8,442.3	99.8

Based on the statements prepared in accordance with the provisions of Government Decree No. 249/2000 (XII.24.), the expenditures of the SAO in 2012 amounted to HUF 7,619.2 which, reduced by HUF 50.2 million of financing expenditures (pending, carry-over) amounted to a total of HUF 7,569.0 shown in the audit report.

Budget revenues of HUF 8,442.3 are reduced by (pending, carry-over) financing revenues of HUF 58.0 million, thus the total revenue shown in the audit report is HUF 8,384.3 million.

Pursuant to adjustments during the year, the original appropriation was increased by HUF 1,210.5 million, comprising

- HUF 862.7 million for the use of the appropriations residue from 2011,
- HUF 7.9 million in compensation paid pursuant to Government Decree 371/2011. (XII. 31.),
- HUF 199.8 million stemming from the change in the auditor's base remuneration pursuant to the Act on the SAO,
- HUF 19.2 million in reimbursement of employer costs related to the 'prime years' programme,
- HUF 113.3 million as the amount of amendment related to the project entitled 'Mapping Corruption Risks...',
- HUF 7.6 million in housing loans disbursed against repayment instalments collected.

Actual expenditures amounted to HUF 7,619.2 million, i.e. 90.2% of the amended appropriation. The combined amount of personal allowances and contributions payable by employers (HUF 6,073.3 million) accounted for 79.7% of expenditures, with 11.2% spent on non-personnel expenses, 3.4% on non-operating expenditures and 5.7% on other operating expenditures.

Overall, the appropriations available provided the operational conditions required by the SAO for the uninterrupted discharge of its basic duty. The organisational and operational transformation significantly improved the SAO's efficiency. It was due to the improved efficiency that, after reviewing its tasks and their schedule and in consideration of Hungary's interests, the SAO was able to forgo at its own discretion the utilisation of HUF 216.6 million chapter reserve and HUF 219.3 million saved as per presidential decision during the year, thereby contributing to the maintenance of fiscal balance.

The SAO's residue available from 2012 amounted to HUF 15 million. In 2012, in total HUF 823.1 million was accumulated in residues, of which HUF 14.7 million is the residue of the funds provided, with accounting obligations, for the change in the auditors' base remuneration which, as a payment obligation, constitutes the centralised revenue of the central budget. The remaining, available appropriation is HUF 808.4 million (corresponding to the figure indicated by the auditor), of which HUF 357.5 million were committed already—to cover the tasks and payments rescheduled and carried over to 2013—while HUF 435.9 million is the sum offered by the SAO for the maintenance of the fiscal balance.

Owing to the organisational and operational transformation commenced in 2011, conditions for efficient work have also improved. In Budapest, the SAO continued its efforts to reduce the size of leased office space and centralise the sites of the institution. As part of our cost-cutting measures, in respect of the offices required for the operation of county audit offices, we proposed to the operators of the buildings concerned to replace the existing lease arrangements and hand over the buildings for asset management or grant free use of the space.

The Training and Information Service Centre was opened in July, providing the SAO with a suitable venue for internal training programmes, various professional events and press conferences.

In line with our decision made in the second half of the year, the four floors of the office building in Lónyay Street were transformed into open-space offices; a heating and cooling system was installed for the Club Room and the Training and Information Service Centre at the headquarters in Apáczai Csere János Street; moreover, a public procurement procedure was commenced for the construction of the conference room on the fourth floor.

In order to renew the vehicle fleet as planned, five vehicles were replaced.

In the field of IT, our primary goals were to maintain the technical level achieved, to prepare for the developments to be implemented in the context of the IT strategy in the 2013-2015 period, and to define requirements.

The procurement of security software and the renewal of the relevant licenses (firewall, intrusion prevention, spam filter, web security and content filter, Symantec virus protection, etc.) enabled us to ensure the integrity and confidentiality of data generated and stored at the SAO. As a result of updating the Novell Zenworks Configuration licenses and installing the application, and owing to the application of state-of-the-art software distribution, remote supervision, up-to-date hardware and software inventory-making technologies, the SAO's IT efficiency has improved.

We have commenced the upgrading of the IT network of sites with more than 100 employees and launched the IP-based modernisation of the SAO's telecommunications system. The required equipment was purchased in 2012 for both projects.

Over the past year, 96 desktop computers and 185 notebooks were procured. The replacement of the equipment was on schedule and continuous.

We ensured remote access to IT services for 400 employees, allowing them to reach our databases, the electronic mail system, e-learning materials and the examination system from anywhere in the country. This has been implemented in a secure environment, relying on efficient technical and technological solutions.

As a supreme audit institution, within the framework of its own internal audit system, the SAO operated an organisationally independent internal audit system under the direct supervision of the SAO's President. Functional independence was ensured and was not violated throughout the entire reporting period. The internal auditors organised their activities independently, free of any outside influence, discharged their duties impartially and objectively, and compiled the audit report containing their findings, conclusions and recommendations in the structure and content stipulated by law.

In respect of internal audit activities in 2012, the Annual Internal Audit Report prepared with the contents prescribed for budgetary institutions was approved by the President of the SAO. Heads of central public administration bodies falling outside of the management and supervision of the government are required to report to the Minister responsible for the state budget on certain internal audit issues of the budgetary organisation. As the Annual Report of the SAO covers the prescribed topics, the SAO has no further reporting obligation in this respect pursuant to Article 54 of Government Decree 370/2011 (XII. 31.) on the Internal control system and on the internal audit of central public administration bodies.

The independent assessment by internal audit facilitated compliance with the required level of SAO internal regulation and supported efficient internal operations and the maintenance of quality through reassurance provided in respect of the scheduled tasks and by offering

proposals and recommendations for improvement. The proposals and recommendations have been utilised by the implementation of the measures scheduled in the action plans approved by the SAO's President.

The internal audit assignments were implemented in accordance with the annual audit plan—prepared on the basis of risk assessment and approved by the SAO's President—with the consistent utilisation of the available internal auditor capacity. No external experts were involved and capacities were not supplemented through external sources.

The objectives of the annual work plan were accomplished; the implementation of one internal audit was carried over to the year following the reporting period. In addition to internal audits, advisory activity became more emphatic than initially planned, in the context of which internal auditors mainly provided opinions on the SAO's financial management-related draft regulations.

The independence of internal auditors' task performance was fully enforced with no conflict of interest. In the interest of ensuring and maintaining internal auditors' appropriate level of expertise, we provided access to the required trainings. In 2012, no compulsory further training was required to retain registration.

The regulatory frameworks and detailed rules ensuring the conditions for high quality internal audit activities were developed and revised during the reporting period (Rules of Procedure, Strategic Internal Audit Plan, Risk Management documentation, Internal Audit Manual); in addition, the document management and registry system was transformed.