



STATE AUDIT
OFFICE OF HUNGARY

Audit of companies owned by local governments

6 years of innovation at the
State Audit Office of Hungary

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Motto:

„The State Audit Office of Hungary’s unchanged objective is to make the management of public assets, the operation of public services and the economic management of public funds more transparent, straightforward and effective.”

Strategy of SAO Hungary

Topics

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- ▶ I. Amendment to the Act on SAO passed in 2011 – new competences – companies with majority local government ownership – Audit reports in a new format
- ▶ II. Strengthening international presence – Integrity Project – Integrity Survey extended on companies with public majority ownership!
- ▶ III. Main fields of local government audits – focus areas
- ▶ IV. Audit and analysis of local government-owned companies
- ▶ V. Findings and conclusions, recommendations
- ▶ VI. Utilisation – Self-tests, follow-up, experiences

Results of the previous year

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- Audit reports
 - Legislation support
 - Analytical/advisory activity
 - Initiation of administrative proceedings
 - Information provision to the general public communication
 - Specific events of the previous year: Renewal of public sector management; in focus: large investment projects; integrity – more in depth knowledge transfer

I. General audit mandate of the SAO

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Periodicity of the audits is laid down in Act on the SAO, or failing that by the **Head of the SAO**

Financial management of public finances, among this the financial management of local governments

Use of funds from public finances

Management of public assets

Final accounts prepared in relation to the implementation of the central budget

Taxation and other revenue collection activities of the state tax authority and municipalities as well as the activity of the customs authority.

Financial management of the Central Bank

Financial management of political parties, the utilisation of the contributions to the groups of Members of Parliament

Utilisation of subsidies allocated from public funds to churches as well as to institutions and organisations operated by churches

Within its competence it may prepare analyses and studies assisting the Fiscal Council

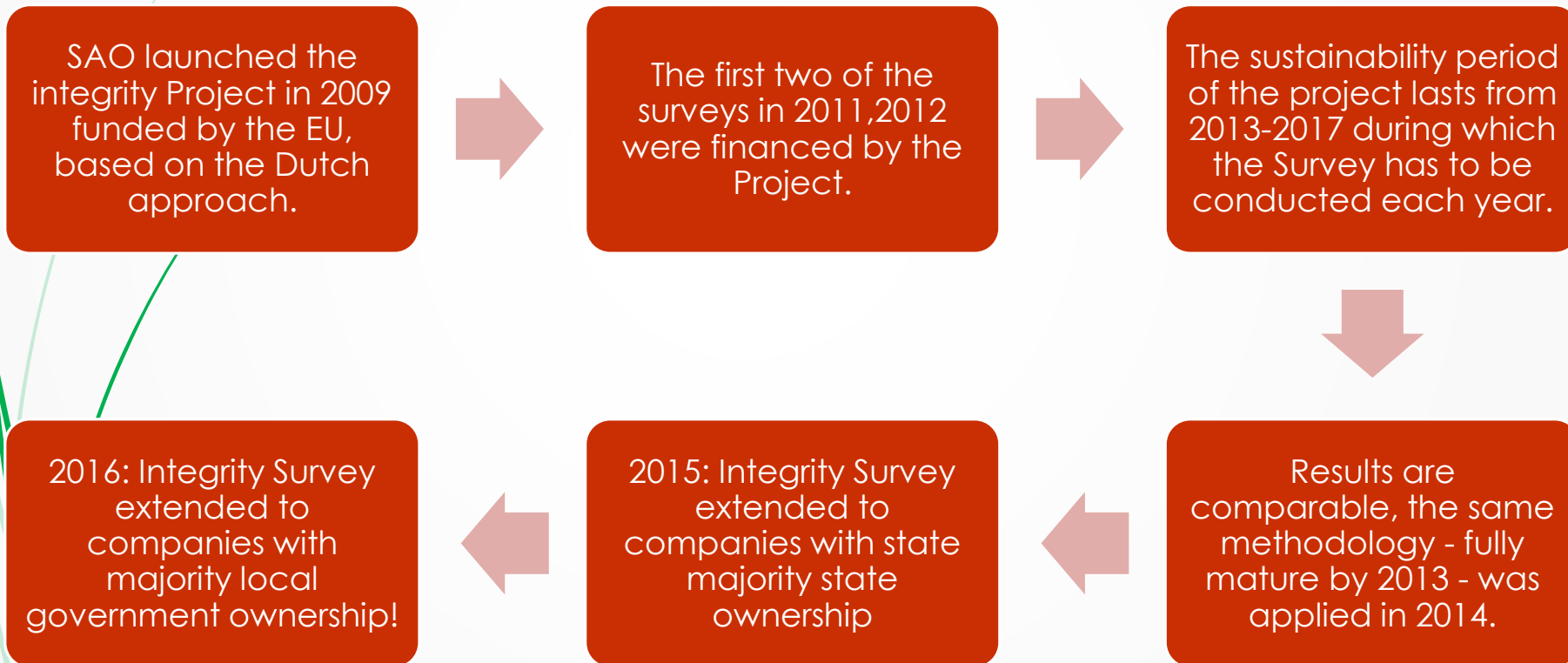
II. International presence

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- INTOSAI (methodology)
- EUROSAI (leading Goal Team 1 on Capacity Building, innovation) - Conferences, seminars to promote new methods and projects – even more potential for the future
- EU Contact Committee, V4+2
- Bilateral relations, IDI
- EURORAI
- Integrity project

Goals and methods in of the Integrity Survey

GOAL: To assess risks of corruption and existing level of controls.



Integrity vs internal control

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Not easy to make
clear distinction

Internal control:
system of hard
control measures

Integrity: combined
system of hard and
soft control
measures

Pointing in the same
direction (properly
regulated operation,
transparency,
accountability,
prevention of fraud and
corruption)

Objective: to ensure
consistency between
assessment of the two
control systems

Local government audits

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Local governments form a separate sub-system within the general government. Their potential financial deficit and debts exert an impact on the deficit and debt of the government sector. Moreover, the property of local governments is part of the national assets.

Since 2011 the SAO conducted its audits of Local Governments through a **thematical and comprehensive** approach - on areas most exposed to risks such as asset management, financial situation, internal controls. The audits conducted on the basis of a new risk-based monitoring system represent a new approach, which is intended to improve the efficiency of the audits.

SAO audits assist Local Governments in the following ways:

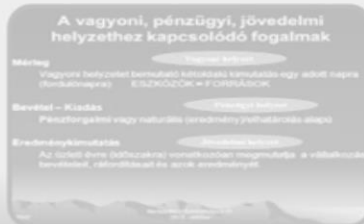
To ensure financial equilibrium

Improving the quality of fiscal management,

Explore the occurrence of manifest or hidden indebtedness

System of auditing local governments

Among its strategic goals SAO of Hungary defined:



evaluation of the financial status of local governments;



detection of the related risks;

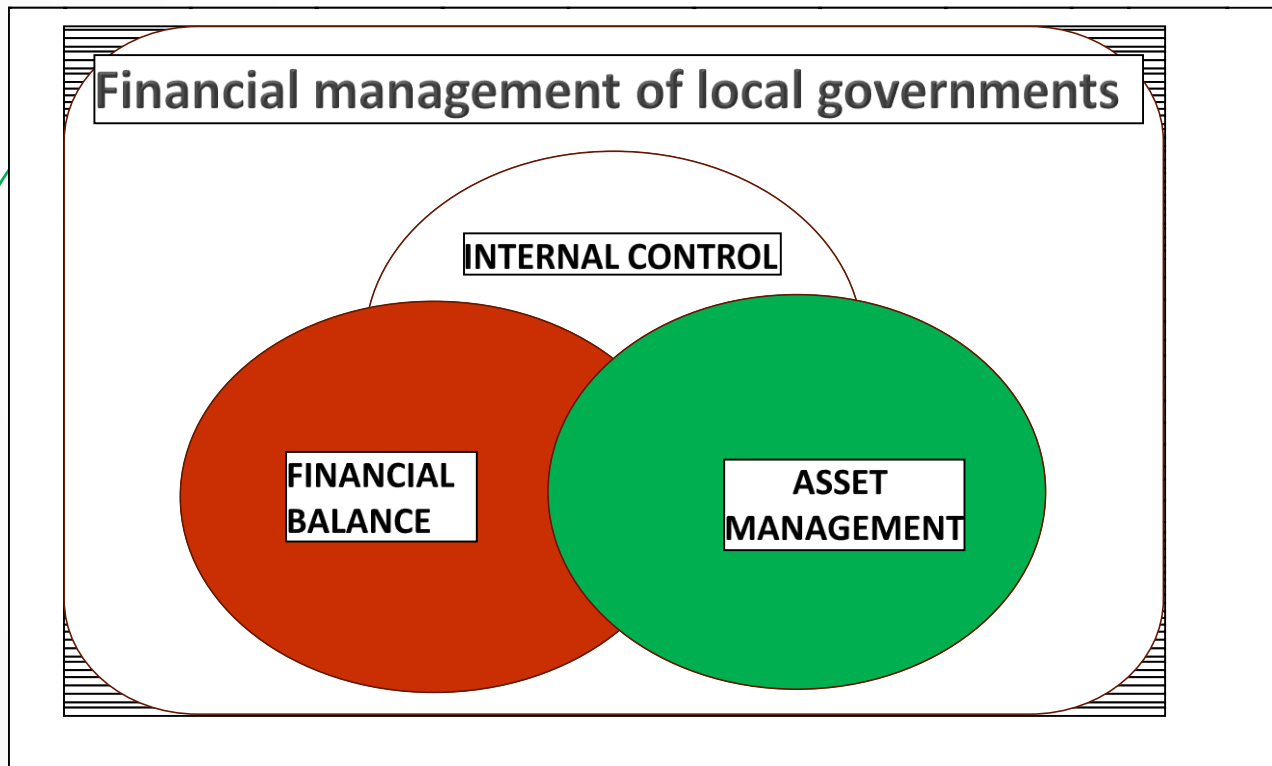


selection of audit sites on the basis of risk assessment.

III. Main fields of auditing local governments

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Auditing the fiscal sub-scheme of local governments is accomplished by auditing each of the three pillars below



Thematic group audits – an audit arrangement

Thematic group audits enable the audit of local government operations covering the most important areas, enabling comparison in many aspects. These are audits performed on the basis of uniform programmes, the methods applied ensure the efficient performance of the audits



Audit of the most risky areas: asset management, financial status and internal control systems, minority local governments, local government associations



Companies with majority local government ownership – enabled by the Act on the SAO since 2011

Innovative methods – CLF- ÖKOMER

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New ways of organising audits



- Theme group audits
- Intertwined audits
- Distance audits

New methods of sampling and analysing

- Sampling adjusted to goals set
- CLF financial analysis
- Comprehensive analysis



Audit competences - asset management

- ▶ According to the Act LXVI of 2011 on the SAO of Hungary as part of its audit of the management of national assets, the SAO shall audit the management of assets belonging to the scope of public finances; the financial management of such assets; such activities of economic organisations owned in full or in part by the state, **or owned for the most part by local governments**, that are aimed at preserving and increasing the value of such assets
- ▶ The SAO is not an administrative authority: it does not enact binding resolutions and decisions
- ▶ SAO audits are not a substitute for internal controls of the audited entity, merely a complement to that

IV. Audit and analysis of local government-owned companies

Objective

A **key objective** of the State Audit Office of Hungary is **to ensure**, by uncovering the financial risks inherent in the financial management of local governments, and by auditing the state subsidies provided outside the state budget and the free grants of assets and the task performance systems operating outside the state budget, **that public funds are used by the organisations transparently and in a regulated manner.**

Motives

In Hungary, institution-oriented task performance is typical, but **extra-budgetary task performance is increasingly gaining ground. Local government-owned companies are important players in this process.**

Products

In 2017 the SAO **continued to conduct audits** among the companies majority-owned by local governments in the context of thematic audits, focusing on their financial management in the periods of 2011–2014 and 2012–2015. In 2017, the SAO published **two studies** analysing the financial management, operational and asset management risks of business associations in majority local government ownership and the owner local governments.

Municipality-owned enterprises

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- ❖ SAO has general authority by the law to audit local governments. Property management of municipality-owned enterprises can be audited by the SAO.
- ❖ **Usually compliance audits are carried out. The scope of audit can be:**
 - budget execution,
 - use and management of local assets including exercising the owner's rights in municipality-owned enterprises,
 - debt consolidation,
 - internal control system,
 - integrity and anti-corruption measures.

Municipality-owned enterprises

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The SAO also pays particular attention to local government decisions on the organization of public service tasks, the regularity of its preparation and supervising of the performance and operation of public companies, **application of ownership rights.**

The **SAO classifies the economic management of the companies according to uniform criteria,**

- assets management activities,
- reporting obligations,
- revenue and expense accounting,
- establishing public service charges.

Experiences of the audit of company with local government ownership

- - Weaknesses in the exercise of the right of ownership
- - They did not have the Business policy approved by the local government
- - The shortcomings of the accounting rules of the companies and their lack of updating,
- - The companies did not record the accounting separation rules in their accounting rules, thus transparent and non-cross-subsidized accounts, they did not have an assessment of the receivables and the assessment required for impairment.

V. Findings and conclusions, recommendations

exercise of proprietary rights over the companies

- at 90% of the local governments was regular
- Deficiencies: accountable requirements, evaluation criteria or indicators for the performance

the occasional absence of ownership control contributed to increasing the operational risks of the companies

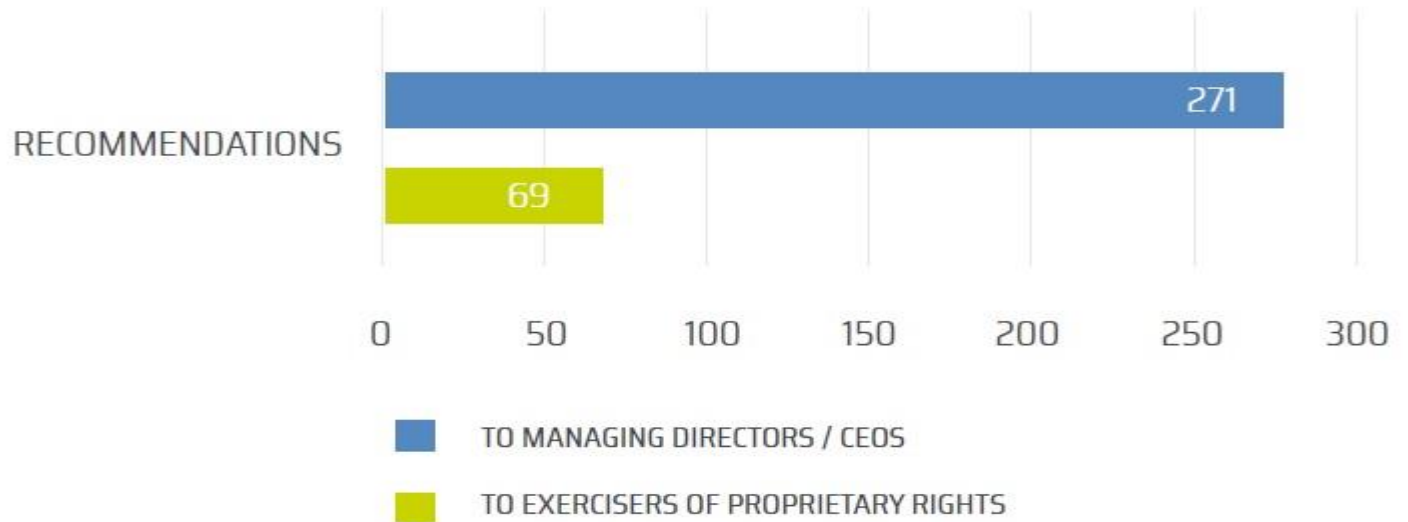
Companies

- Deficiencies:
 - regularity of accounting (82%)
 - Inventory taking (44%)
 - Cost accounting rules (48%)

- a need to improve the protection of national assets and to strengthen ownership control
- clear requirements, criteria should be set for the management of the companies

Recommendations

DISTRIBUTION OF RECOMMENDATIONS BY ADDRESSEE, 2017



Action plans

Analysis I.

Objectives

- In January 2017, a study was published exploring the possibilities of addressing the deficiencies identified during the audit of waste management companies in majority local government ownership.
- These companies are especially vulnerable from the perspective of economies of scale.

Motives

The standard of the activities performed by waste management companies fundamentally affects **the quality of life for the population** consuming the service.

Ensuring **uniform public service price levels** is a key factor in fostering the **equal opportunities of citizens**.

The expedient, effective and economical functioning of companies is therefore one of the most important social goals, and one that the SAO also intended to contribute to with its own tools. To this end, the State Audit Office of Hungary audited a total of 29 companies between 2014 and 2016.



Conclusions of Analysis I.

the compliance of financial management has declined in proportion with the size of companies (smaller companies were less regular)

Typical non-compliances and the resulting risks at the vulnerable companies:

The company reports did not provide the owners with a full and reliable view of the company's finances, nor did they provide a sufficient basis for decision-making.

The vast majority of the companies did not establish a system of criteria capable of measuring their public service activities

A significant number of companies violated regulations on the protection of personal data and on access to public information

Conclusions of Analysis I.

- In every report, the State Audit Office of Hungary called attention to the obligation **to segregate the revenues and expenditures related to public services and to the importance of sound cost accounting.**
- To remedy the problems observed in the workout area, in 2016 the National Waste Management Coordination and Asset Management Ltd. was established.

Analysis II.



The “Analysis II. on the experiences of the operation of local government-owned companies” published in May 2017 was based on the experiences of the audits conducted between 2011 and 2014 at a total of 106 companies majority-owned by 178 local governments.

Objectives

The analysis separated local governments into four groups, based on the number of citizens, and reviewed the audit experiences, findings and contexts in four risk areas; Summed up in a total of 19 aspects and systematised based on the audit reports over the municipal services of the local governments and the operation of enterprises in their majority ownership.

Hypothesis

The hypothesis of the analysis was that operation of the enterprises owned by the local governments are determined by the operation of the local governments, and the risks derived thereof. Thus, **the risks assumed by the local governments directly affect the operation of their enterprises. This assumption has been confirmed by the results of the analysis.**

Conclusions of Analysis II.

the risks to financial management and operational risks at the companies can be significantly reduced by strengthening the setup and operation of internal controls

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- * financial stability of local governments showed definite improvements in 2013, however the risks are increasing
 - * some of the local government-owned companies already belong to the government sector and as such, they are required to develop a system for monitoring the implementation of the objectives

an increase in the number of suggestions per report.

Conclusions of Analysis II.

- The increase in the risks associated with the operation of local governments and their companies and ultimately, the risks to public service provision, was inversely proportional to the decline in the number of the population.
- **The analysis showed that the SAO helps local governments and their enterprises the most by focusing on realistic risks, both in its findings and its suggestions.**

VI. Utilisation of audit results

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Obligation of the audited entity to act:

- ▶ 1 July 2011: the era of audits without consequences has come to an end

Direct value added:

- ▶ internal controls of audited entities/municipalities is better regulated and operated
- ▶ goals set by law can be achieved

Indirect value added:

- ▶ entities/municipalities not subject to an audit take on the „best practice“ → voluntary compliance
- ▶ The fact that SAO is strongly committed to audit internal controls
- ▶ The dissuasive effect of the number of thematic group audits as a result of risk based selection

Further value added:

In the possession of great numbers of audits of companies owned by local governments - more than 260 in last 6 years - the SAO may initiate an amendment of legislation

Utilisation of Audits – Self tests – follow-up - experiences



Proactive Communication

SAO Newsportal
E- Press
Conference



Best Practices

SAO – Ministry of
Justice: Joint
Training
Programmes
20 locations



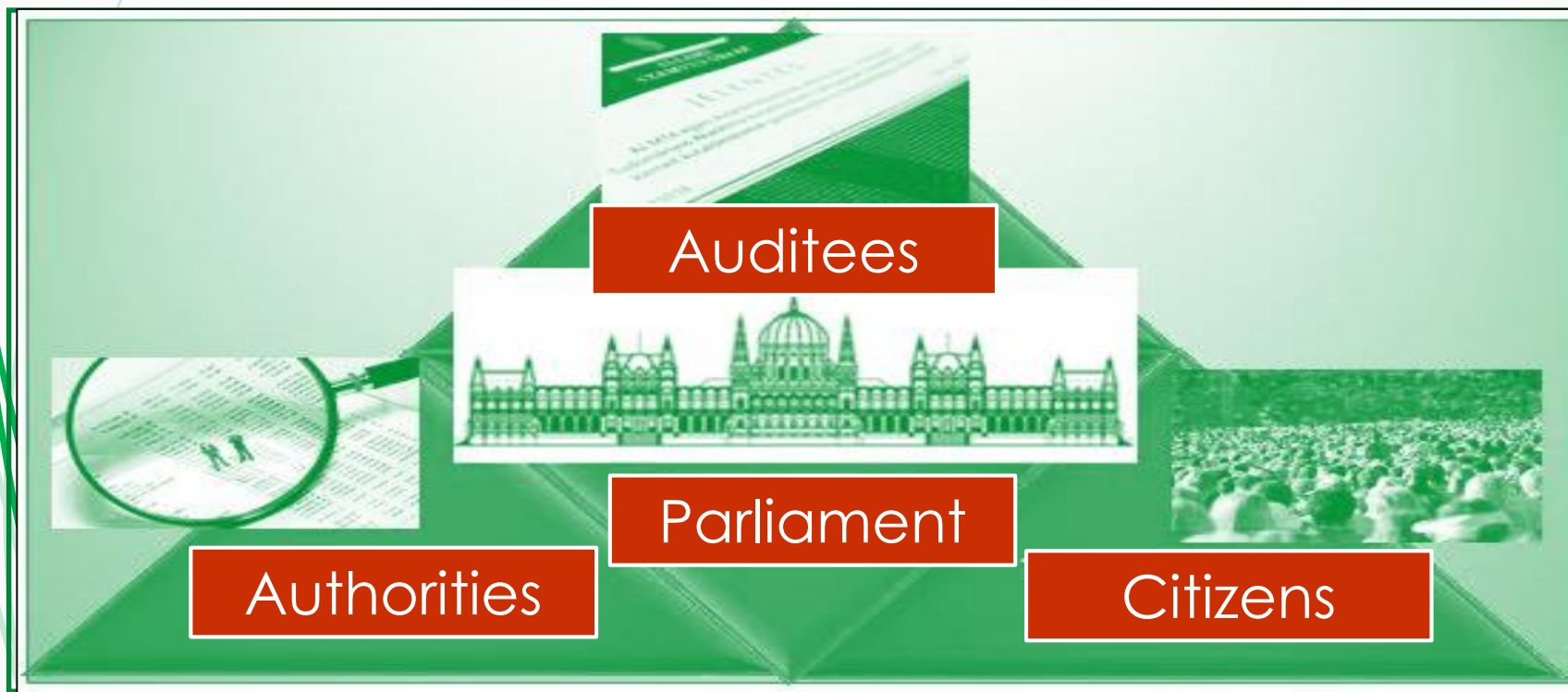
Voluntary self assessment

Local
Governments
Internal Controls
Ethnic minority
local government
bodies

Utilisation of audit results – self assessments

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The utilisation of the audits is realised on multiple levels: on the level of the National Assembly, the audited entities and the citizens. Thus, this is all achieved by a reflected audit planning, recognizing the international standards, implementing an approach that focusses on utilisation and with innovation.



*„Audit creates order, order
creates value”*