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Public accountancy regulations and SAO audits

Why cannot the utilisation of public funds be efficiently audited?

In a democratic state citizens expect that those currently in power should give a detailed account on spending and utilising the public funds trusted to them. The enforcement of accountability has several preconditions, out of which this study focuses on the characteristics arising from the accounting system, since accounting requirements significantly influence the audit system's room for manoeuvring.

THE INFORMATION SYSTEM OF PUBLIC FINANCES

The information system of the public sector plays a significant role in the solution of the above written. Studying the information system in a systemic manner is important because the quality of the audit system is influenced not only by public accountancy, but also by the other two elements of the information system. This article presents the structure of the information system, and locates the accounting system within that. It must be emphasised that the information system must meet differentiated needs. The interested parties require different information on certain fields of the public finances, and look at the information system from different perspectives. Decision-makers typically want to know in which fields public funds have been used, but at the same time cost-efficiency is shifted to the background. In contrast with this, the operative implementers of tasks are driven by the aim to make the effectiveness of utilisation of public funds measurable. The society requires comprehensive information about the utilisation of public funds. In this respect the structure, understandability and information content of the report are of crucial importance.

The quality of the audit system cannot be separated from the system in which the audit activity forms only a portion. *The information system of the public sector consists of three main parts:* the budgetary information and control system, the statistical system and the accounting system. The systemic overview of the information system requires the presentation of the subsystems.

The budgetary information and control system

The budgetary information and control system registers appropriations and the fulfilment thereof by matching them to voting units (Kassó, 2006). The goal of the control system (which appears in the “Final accounts” at the local governments) is to check whether the executive power utilises public funds and public assets in a transparent manner within the framework specified by law. Furthermore, it is responsible to restrict excessive influence by the executive power to ensure that political decision-makers retain their competence in relation to the utilisation of public funds, and to prevent that a few elements of this power be returned to the scope of the government. The basic element of the budgetary information system is the “voting unit”[1], a group of tasks and budgetary frameworks that are approved by the National Assembly, and the fulfilment of which is mandatory upon authorization by the Budget Act. The basic principle is that the tasks must be implemented within the budgets specified by the National Assembly. Apart from this, the National Assembly has an exclusive right to modify the voting units, and the executive power has no say in this. When defining the voting units too broad or too narrow definitions should be avoided.

In order to achieve the goals set in the budget it is necessary to create possible transfers between the voting units and the governmental functions. Practically this means that it is advisable to collect budget data according to supply functions, too, since the fact and extent of the achievement of the set social objectives can be determined on this basis. The main tool for the preparation of these data is the so called COFOG[2], which stands for the Classification of the Functions of Government in Britain. The Ministry of Finance is making efforts to introduce this method, but comprehensive application is still to come.

The statistical system

The goal of statistical methodologies is to measure the financial transactions of public finances, and to process them in a unified structure. According to the statistical concepts, the basic feature of public finances is that the state supplies services to the society, and covers the costs of such tasks from taxes and other revenues, while it also redistributes income and assets.

Due to their significance, the SNA, the GFS and the ESA95 methodologies stand out of all the other statistical methodologies[3]. The methodologies can be distinguished according to the following characteristics:

- temporal relationship between income and consumption – according to which either the cash flow or the accrual based approach is used,
- the conceptual interpretation of public finances,
- assumptions related to the income owners' behaviour – whether they are characterised by short or long-term thinking.

In the period of preparation for the EU budget supervision procedure Hungary was required to prepare its fiscal policy report in accordance with the ESA95 requirements within the Pre-Accession Economic Programme, already from 2001. According to the 2002 amendment of the Public Finance Act, the ESA95 rules need to be taken into account in the annual budget acts. The GFS type data of the budget had to be supplemented, corrected and re-classified so that the public finance deficit and debt data could be determined according to the ESA95 methodology.

The accounting system

The accounting system must reliably and accurately reflect changes (growth and reduction) in public funds and public assets. The accounting system of the public sector must be in line with the fact that the primary goal of the public sector is the provision of a public task, the profit motive is generally not typical, a significant portion of resources for most institutions come from subsidies, and the effectiveness of financial management cannot be assessed simply on the basis of changes in assets in the given period. It is more difficult to establish relationship between the input and output units, and last but not least differences in the principal's and the consumer's entities also reinforce the specific features.

The accounting system of the public sector must not only provide information on the sources and value of public funds, but must also be able to present the costs of the provision of public goods, as well as the costs spent on individual goods and services.

Tasks of the accounting system of the public sector (Kassó, 2006):

- recording data derived from the monitoring, measurement and evaluation of the events occurring in relation to the economic systems, and of the resulting situations,
- processing and comparison of the information in a closed system,
- mediation of the reproduction process in organisations that economically separate the sub-processes of production, distribution, replacement and
- satisfying the need for information of the interested parties,
- enforcement of the interests of the affected parties.

From among the elements of the public accountancy system two areas deserve utmost attention, the book-keeping and the reporting systems. The characteristic features of these two subsystems determine to which extent the public accountancy system is able to fulfil the tasks specified above.

Public finance institutions keep modified performance approach records about events affecting their assets and financial situation of their activities in the system of double book-keeping, and in fact they apply the principle of the cash flow based approach. On this basis those economic events are recorded that imply actual money movements, and actually realised transactions. Hence, the expense and cost categories cannot be differentiated in the accounting system, and the revenues and revenue appropriations are not differentiated either. (Szabó – Szamkó, 2001)

The two main advantages of the cash-flow approach are simplicity and inexpensiveness.[4]

CHARACTERISTIC FEATURES OF THE PUBLIC ACCOUNTANCY SYSTEM

The biggest problem of the budgetary information and control system is the lack of definition of the voting units. In the budget approved by the National Assembly titles and appropriations play a crucial role. Under the term voting unit the budget typically means budget titles, which appear in different forms. In certain places the budget title means an institution, while in other places a task or a type of transaction. Yet, the system of titles changes from year to year, and the accounting system is unable to follow. For the time being there is no methodology that could ensure the comprehensiveness and accuracy of the performance data. (Kassó, 2006) On a "small scale" this holds for the budget of the local governments, too. Here it would also be necessary to define voting units and build the budget accordingly. The individual local governmental tasks could be interpreted as voting units, or in the case of larger local governments the breakdown of the individual tasks would also be possible. The situation that has emerged is further complicated by the fact that the chapters and titles change year after year, and that the National Assembly renounces a significant portion of its budgetary right and transfers it to the executive power branch. Therefore the National Assembly makes only apparent decisions about the distribution and utilisation of public funds, the real decision-making power is vested to the Government.

In the financial and statistical system of the government serious methodological, and information system development tasks must be completed so that EUROSTAT conform data could be supplied by the Ministry of Finance during the preparation of the notification report, by the National Bank of Hungary during the preparation of the financial accounts, and by the Hungarian Central Statistical Office during the preparation of the government accounts. (Novák – Vámos, 2008) As far as budgetary accounting is concerned, the Hungarian practice continues to follow the principles formulated in the GFS model. ESA95 accounting is used only in the case of data supplied to the European Commission.

All this causes problems in relation to the fact that running the two systems in parallel is costly and absorbs extra resources. At the same time, due to cash flow based accounting, the statistical system encounters major difficulties during the generation of ESA95 conform data. During the development of the statistical system it cannot be ignored that more and more countries tend to apply the ESA95 methodology, and in relation with that, a version of the accrual based approach.

It can be asked to which extent the current accounting technique complies with the needs of modern financial management. It can be stated that the cash-flow approach does not meet the requirements set against efficient financial management.

Arising from the basic principle of the cash-flow approach, liabilities and claims do not appear explicitly in book-keeping, since they do not imply actual money movements. (Kassó, 2000) Consequently, one of the most important accounting principles, the principle of entirety is not enforced. Although the institutions may decide to keep separate analytical records about their liabilities and claims, but this cannot be regarded as a good practice for two reasons. On the one hand, the utilisation of information from this source is not ensured, since as long as no actual money movement is made, claims and liabilities are factors outside the system, and on the other hand keeping any additional records imply costs. What is more, these costs accumulate as time goes by. However, in reality, claims and liabilities carry important information, since the actual financial situation can be determined only with the joint consideration thereof. Seemingly, liabilities can be increased without consequences, at least in the short run, as long as the aggregate financial burden thereof appears.

Book-keeping fails to show the economic content of depreciation, too. Although it is specified for the institutions what depreciation rate they can use for the different assets, however the real value of depreciation is a factor outside the accounting system. On the other hand, if depreciation is not shown at the real value in accounting, in reality there is a big discrepancy between the market and book values of the assets. Consequently, asset management also gets into a hopeless situation. As a result, it is impossible to accurately determine the time of asset replacement, and at the time of selling the asset the sales price falls short of the market value, which may cause a significant loss for the local government. Due to the restricted nature of asset management the quality of task performance by the given institute cannot be guaranteed either.

Arising from the cash-flow approach the institutions are not able to determine the actual costs of the tasks they supply, since only those economic events are recorded that imply immediate money movements. However, this technique causes problems during budgeting, too, because several events of the accounted transactions burden a year other than the budget year, and vica versa, several items are not included in the budget for the subject year despite the fact that they should form integral parts thereof. However, without knowing the entire costs no decision can be made about the optimum organisational framework of the completion of the given task, about its implementation in an entrepreneurial or another organisational form. *Effective financial management is impossible without knowing the entire costs.* Neither the owner's, nor the investor's approach can be enforced, since public funds cannot be cost-effectively and efficiently utilised with this registration method.

The cash-flow approach makes it possible to cover financial management problems experienced in the public sector, the bad economic situation can be presented as favourable. *The objective assessment of the financial management of the public sector is further hindered by the deficiencies of the reporting system.* Due to the inaccuracy and incompleteness of the basic data on financial management the reports prepared on the financial management of the institutions do not give a real picture about financial management. The balance sheet is unsuitable for laying the foundation for any asset related decision. The asset balance sheet contains a lot of misleading information. The principle of evaluation is not only intransparent and incomprehensible, but it is explicitly suitable for misleading the decision-makers. The supplied information can be evaluated according to the objectives, and can be taken both as favourable and unfavourable values. For example, in 2009, in a final accounts summary of a town with county rank it was formulated rather praisingly and positively that the budget of the local government was positive for the first time in many years, while the budget of the town fell into a debt spiral. Furthermore, it happened at this local government that due to the above the final accounts presented an increase in the assets of the local government, as if they did not know that own assets can be defined as a difference between assets and liabilities. Ratings related to misunderstandings could be further listed. Such misunderstandings can result from the fact that the valid legal regulation does not include the mandatory separation of the operational and the development budgets. As a result it often happens that development funds are channelled to the other budget to cover operational expenses. This makes the evaluation of the financial management of the processes more confusing, less transparent and inaccurate.

Measuring the effectiveness of financial management is almost impossible. The calculation of the economic indicators used in the business sector is hindered, and the yielded results must also be taken with reservations. This problem is encountered by, for instance, the economic partners of the local governments, who must assess the financial situation of the local government in order to reduce their risks, but this is not possible in the absence of relevant information. The financial evaluation of the public sector is an especially important and topical issue for Hungarian financial service suppliers, since the local governments are becoming increasingly indebted. The strategy formerly used by credit institutions, according to which it is worth lending to local governments, since in case of non-payment the state will support local governments in need of help, is beginning to change. *Credit institutions are more prudent about lending to local governments,* since it has become clear for them, too, that most of the Hungarian local governments have insufficient resources, and two thirds of the nearly 3,200 local governments are unable to fulfil even their mandatory tasks, i.e. the overwhelming majority of the local governments lack adequate financial capacities to secure or repay loans.[5]

For political decision-makers application of the cash-flow approach may seem advantageous, since it can be easily seen from the budget which institutions and in what amounts receive public funds, and after the closure of the subject year the reports reflect spending the given resources. In other words, the desired objectives may seem to have been achieved for the decision-makers.

The institution-centred cash flow financing technique does not allow for tracking the spending of public funds, and only shows the amounts spent by the individual institutions during the given year. Therefore, the actual performance of the institution performing the task cannot be measured, and on top of that, the adequate quality of task performance cannot be guaranteed either. However, political arguments for the cash-flow approach represent only half of the truth. In the short run, within a year, the above political interests can prevail, however, in the long run, over more than a year, not only the path of financial resources, but the cost-efficient utilisation thereof would matter equally for politicians committed to public affairs. In the case of limited resources efficient utilisation is a key question.

Information on revenues yielded and costs spent in a given budget year is provided by the final accounts in order to make the executive power and the assembly of the local governmental give account of the utilisation of public funds trusted to them, as well as of changes in the value of public assets. (Mariska, 1900) However, *for the time being the content of final accounts is not defined exactly,* requirements exist only for the structure thereof. Presentation of the statements and balance sheets required to be attached to the final accounts represents a rather sizeable problem at the level of public finance institutions and local governments alike. The major elements of the established table system are defined, however the concrete content thereof is not clear. It is in part due to the confusion of requirements that the individual organisations or units mandated to prepare reports are either unable to create this table system, or enter erroneous data, or make mistakes when filling in the form. These deficiencies are highlighted by the audits conducted by the State Audit Office (SAO) every year[6]. It would be extremely necessary to provide clear regulations for the table system, and tables showing non-relevant information should be deleted from this set of tables.

The accuracy of data contained in the final accounts can be questioned. This comes from the fact that on one hand almost all revenue items are presented without compliance with centrally regulated financial reporting rules, while on the other hand the basic financial reports contain only hardly over 50 percent of the expenditures. It poses a further problem that hardly more than 30 percent of the basic reports are subjected to financial audits.

Another problem related to the reports is that they are prepared according to the institutional approach, i.e. data are specified at the level of the institutions. The other problem is that the accounting system includes the appropriations, too. Hence, the accounting records become even more detailed, which considerably hinders the interpretation of voting units. It can be noted that the local governments could calculate other data, too, from the mandatory registration and accounting systems, from which information relevant to them could also be generated.

The reports reflect the exclusion of depreciation from the system. Asset related information show a false picture without the inclusion of this category in the system, wherefore asset related decisions cannot be rational.

The Public Finance Act and the government decree issued for the enforcement thereof list in detail what statements the local governments are required to attach to their final accounts. However, these statements cannot be automatically generated using the accounting system. The compilation of these statements puts a lot of added burden on the local governments, since each local government must determine the structure and method of generation of the required tables, while usability can be very much questioned.

The greatest problem of the current regulation is that cash flow based book-keeping and the related reporting practice do not serve the interests of public finance management, the pieces of information are often inaccurate, and therefore they too generate the possibility of squandering.

EXPECTATIONS OF THE AUDIT SYSTEM TOWARDS PUBLIC ACCOUNTANCY

For the time being public accountancy cannot produce the appropriate information for the affected parties, including the audit system. To prove this statement we must first of all interpret the type of information required by the audit system, and then we must explore the causes due to which the public accountancy system is unable to generate the required information. The inspection of all connection points between the audit and the public accountancy systems would be beyond the scope of this study, wherefore in this article the subjects of analysis are SAO audits within the audit system, and the accounting systems of the local governments of settlements with the public accountancy system.

Pursuant to the law in effect, the SAO is responsible for the audit of the financial management of the local governments, however the concrete content of this task is not specified. The SAO is free to decide on the method of task performance, as well as on the subject and method of such audits.

Due to its limited capacity the SAO is unable to audit the financial management of all local governments each year.[7] Therefore, the SAO focuses its so called comprehensive audits on the local governments of the capital, the counties, towns with county rank, and of the districts of Budapest, which have more significant assets at their disposal. Comprehensive audits affect around 300 local governments a year, and on top of that a few hundred other local governments can be audited within a given year using other audit types. (Lóránt, 2007) Consequently, in a given year the financial management of more than 2,000 of the 3,200 local governments is not subjected to an external audit. Typically small local governments are left out of the audits. This requirement is a typical example of legal underregulation.

The information needed for SAO audits in the local governmental sector can basically be derived from the characteristic features of comprehensive audits. *The main objective of comprehensive audits* is to provide a systemic evaluation for a given period of whether the development and operation of the internal control systems in the public sector provide sufficient security for the adequate, lawful, cost-effective, efficient and/or effective completion of state and/or local governmental financial management tasks, for the protection of resources, and for ensuring reliable financial and non-financial information supply and reporting systems.

During comprehensive audits the internal management system becomes assessable through the evaluation of the control system. The most important areas of the analysis of the control systems are the following (SAO, 2006):

- the budgeting and the final accounts preparation processes,
- the level of regulation of the financial and accounting activities of the mayor's office,
- whether or not the IT system used during financial and accounting tasks is regulated.

SAO audits must collect information on these areas. However, practical experience shows that the accounting system is not suitable for the generation of the required information.

Why does the accounting system used by the local governments fail to meet the audit needs?

The problem is caused by the inadequacy of the public accountancy system. Not only has Hungary got no public accountancy act, consistency among the elements of regulations is not ensured either. Under- and overregulation are present at the same time. The applied book-keeping technique, i.e. the cash-flow approach is not able to meet the needs of the affected parties. The features arising from the cash-flow approach hinder the efficient performance of SAO audits, too.

Certain part of the generated information is unnecessary, these pieces of information can be used neither during the decision-making process, nor during the audits. *The accounting principles are not fully enforced in the accounting and the registration systems,* and consequently the public accountancy system cannot be expected to be efficient. Another feature of the system is that the data can be generated only at significant costs. Due to the cash-flow approach local governmental decision-makers cannot determine the exact actual costs of the individual tasks, without which rational financial management is inconceivable. Transparency is also hampered by the fact that the local governments do not separate their operational and development budgets, although this can be regarded as a golden rule in public finances. In many cases separation is not effected due to the financial problems of the local governments, since in this manner the balance of the budget can be seemingly ensured. However, the risks that will appear in the budget later on may jeopardise task performance by the local governments. Even if separation is carried out formally, it often happens that the operational and the development budgets include "rows" that belong to the other budget type contentwise, and where operational and development expenditures are mixed. The basic principles of budgeting are not enforced during the compilation of the budget or the final accounts, wherefore accountability is almost impossible to maintain.

Another problem is institution-centredness in financial management, which does not serve efficient task performance. *Institution-level financial management itself hinders task-level financial management,* and the definition of expenditures at task level. The cash-flow approach and institution-level financial management do not allow for financial management on the basis of the cost-benefit principle, not even where it would directly be possible. Institution-centred financial management further aggravates the situation arising from the application of the cash-flow approach, since most of the available information can be interpreted at institutional level, and due to the cash-flow approach the reality content must also be taken with some reservations. The books of the institutions, similarly to those of the local governments, do not clearly show the actual expenditures, wherefore breakdown by tasks is not possible either, which would be of utmost importance. It causes further problems in the system that due to the established financial system the players are not interested in maintaining transparency. In most cases the financing local government obviously knows that the resources provided are not sufficient for the quality operation of the institution, but has no adequate funding ability.

The rules of local governmental reporting are not well thought after, the data tables required to be attached to the reports contain little information. Due to the basic principle of the accounting system *the reality content of the basic institutional reports can be questioned,* what is more, the external, independent audit thereof is not ensured either. External audits cannot rely on internal audits either. The asset management of the local governments is not efficient, the *asset balance sheet contains unreliable data,* mostly due to the improper handling of depreciation. The accounting and the registration systems are unable to functionally classify book-keeping data, which would be the starting point for external audits. Changes in and non-compliance with the rules result in the fact that it is impossible to create multiannual data series, and audits are unable to do comparisons.

The situation is further complicated by the fact that *public finance institutions can also establish economic organisations.* These organisations have significant public funds at their disposal. According to some estimates, in the local governmental system such funds account for around 15–20 percent of local governmental expenditures (Hegedűs – Tönkő, 2007), whereby they significantly influence economic processes. In fact, these organisations form a quasi-sector where the public sector (community policy aspects) and the private sector (market economy aspects) are present at the same time, and *separation of the public area is ensured* neither theoretically, nor empirically. The applied accounting logic is of utmost importance from this point of view, too, since the book-keeping and reporting obligations of institutions belonging to the quasi-sector are stipulated by the Accounting Act, while other public finance institutions are governed by Government Decree 249 of 2000. This means that in the system of double-entry book-keeping organisations belonging to the first group apply the rules pertaining to business organisations, while public finance organisations apply the cash flow based approach. Consequently, aggregation of the data is hindered, and not only the methodology is unavailable, but unfortunately, the desire for transparency is also often missing. Audits by the owners must evidently be reinforced.

Apart from the lack of information audits are also hindered by the lack of definition of audit tasks. As an example one can cite the budget proposal, the content of which is not specified in the Act on the SAO. The SAO gets into a difficult situation at the local governments, too, since the law appoints the SAO to audit the financial management of the local governments, however it is not clear whether other organisations may also perform checks, and if yes, with what content. The relationship between SAO audits and book-keeping at the local governments is an especially topical issue.

CONCLUSIONS

In today's Hungary public accountancy does not provide an appropriate registration and accounting basis for audits to follow the movements and utilisation of public funds in a comprehensive and continuous manner. Therefore, audits are primarily able to examine the validity and lawfulness of the utilisation of public funds.

The accounting system used in the public sector needs to be transformed. The most important step is that a shift must be made from cash flow to accrual based accounting. This improves the conditions for financial and SAO audits to have an adequate manoeuvring room, and to be able to assess the legality, economic rationality and efficiency of the utilisation of public funds.

Notes

1 The voting unit contains the tasks associated with the appropriations, about which political decision-makers form opinion. The term was coined by Zsuzsanna Kassó.

2 Based on the classification system not only budgetary, but accounting type information can also be produced. The only precondition is the availability of the IT background.

3 A similar process can be observed in the case of the statistical systems as in the public accountancy system, i.e. accrual based methods are given preference. The production of deficit figures has become more complicated, however, the underlying accounting figures reflect reality much better by the partial or comprehensive application of the accrual based method, and consequently the information content of the data has also improved significantly.

4 At the same time, these two main advantages of the cash-flow approach erode due to the disadvantages of its application, as a result of which information on the financial management of the system of public finances cannot be generated.

5 The irresponsible lending practice of credit institutions has significantly contributed to the indebtedness of the local governmental system.

6 However, the realisation of the findings and recommendations of the State Audit Office is ad hoc, and only little progress is made in this area.

7 Studying the practice of SAI audits in other European countries it can be determined that in most European states the local governmental systems are audited not by the SAIs, but somehow by the central government.

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