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Environmental, regulatory and control risks in the financial management of local municipalities

A trap for mice or a trap for cats?

Catch me if you can: but who is going to catch who? Is it possible to operate a subtle, multi-dimensional control system that can detect, identify, and assess the risk factors of a complex municipal environment and set the right direction for the local institutional system? There exist several sensory mechanisms and municipalities have plenty of reaction opportunities. Managing them properly and fine tuning them are indispensable to avoid the cartoon-like set-up of a mousetrap set ever so carefully (or carelessly) ending up trapping the animated character that has set it. Reviewing, analysing and evaluating the control system are classical audit tasks. Its environmental and regulatory risks are particularly important for internal and external audits. Below, I wish to present the characteristics of well-known economic and business environmental analysis models in a municipal context “from the cat’s perspective”, relying on the notions of the international and Hungarian audit terminology. Audit systems have had an increasing role in each segment of the economy in the fields of safe operation and risk management.¹ The situation is not any different concerning local municipalities.

THE EXTERNAL, POLITICAL, ECONOMIC AND SOCIAL COMPONENTS OF THE AUDIT ENVIRONMENT

The special audit environment of the external and internal audits of municipalities is created by the multi-aspect and multi-direction segmentation of the municipal system, characterised by the spatial processes of the economy and the peculiarities deriving from the legislative environment of municipalities. Most democratic governances are vertically segmented, and all of them have developed structures built on coordinated local governance organising territorial coordination mechanisms, which has increased the complexity of communal decisions, and fine-tuned the operation of democratic institutions (local party politics, the management of local public affairs, the institutional representation of regional interests). The federative structure of public finance presupposes a decentralised state finance system and fiscal decentralisation, which is closely linked to the guarantees of democracy, and creates the financial foundation of local governance. In Hungary, the external audits of this complex system are conducted

by the State Audit Office of Hungary, while the internal audits are conducted by town clerks employed by municipalities.

Economy develops within a special *spatial structure*, which can be described partly through deterministic, partly through stochastic models. To outline the audit environment of municipalities, one can rely on works of schools of regional economics, literature on matters of public finance, marketing, and the results of environmental analyses. Spatial structure may be interpreted as the network-like structure of the economic activity (Ms Vas, 2005), within which nodes are created, which then form hierarchies, and finally growth poles evolve. Different resources and factors of production start flowing towards the growth poles, while the innovations characterising the growth poles start spreading or being diffused as special counterflows, sometimes consciously adopted and encouraged by those in control of the poles. The segmentation of the social-economic space is bound to lead to territorial inequalities. The financial management of a municipality always affects and reacts to the processes of a well-defined fragment of a wider spatial structure, thus the distance from the growth pole (i.e. the core-periphery situation) greatly influences the structure of local public expenditures deemed as optimal as well as the revenue leeway of municipalities. The spreading of the notion of the network as a basic concept and its considerable impact are due to the recognition of the (comparative and competitive) advantages of the spatial structure to be exploited, which manifests itself in the formation of dynamically developing core areas of international importance, the strengthening of the network of metropolises and of their special role in the world economy, the strategies of multinational companies selecting locations for their business premises, and the development of suppliers' networks influencing local markets (Lengyel–Rechnitzer, 2004).

Basically, municipalities have an allocation function; they have limited opportunities to reallocate incomes or have an independent conjunctural policy. Local budgets are usually not allowed to apply independent customs policies.² Neither is it possible to conduct local level monetary policies². It is *by taking full advantage of their financial leeway (regarding fiscal³ and income policies⁴)* that municipalities are able to influence local economies, while they have the opportunity to strengthen the competitive position of settlements by harmonising and optimising allocation mechanisms locally. However, the opportunities of different settlements are largely polarised based on their position within the spatial structure, their size, and their administrative status, and competitive conditions are not identical.⁵ Therefore, it is necessary to operate balancing mechanisms.

In Hungary, the state has provided financing for municipalities by sharing the personal income tax with them, by leaving other taxes (currently the motor vehicle tax) with municipalities, by transferring the levying of tax-like funds (such as ranger's contribution, and emission charge) to municipalities, and by running a system of a normative and earmarked supports, and a system of designated and targeted supports providing funding for accumulation expenditures – of very significant local budgetary weights. A part of municipal expenditures relating to health care is covered by social security. The remaining part of local budgetary expenditures is financed by municipalities through the imposition of taxes, which they are legislatively entitled to do.⁶ In Hungary, the *tax policy of municipalities* is aiming at the point of neuralgia of the financing system, as the part of the operative financing deficit hidden in normative supports that can be compensated for using their own incomes can be earned from local tax incomes. The remaining part of local tax incomes may provide funding for the capi-

tal budgeting of municipalities, for the co-financing necessary to be able to avail of grants/supports and to take out development credits, and for the repayment of development credits.

In local budgets, the necessity to harmonise local taxation and local public expenditure plans appears as a financial constraint, which is the *principle of fiscal equivalence*. The strict application of the principle may be substantially softened by the funds transferred back from the central budget for operational purposes on a non-normative basis, and the loans taken out by municipalities for operational purposes. At the same time, it is necessary to provide equalisation among regions with different opportunities, which typically happens at an “above the nations” level in the European Union. A similar federal mechanism operates in the United States of America.

Decentralisation may result in the cost-effective production of certain goods, and decrease the administrative and audit expenditures relating to service development. The notion of *goods threshold*, which contains the requirements relating to the economies of scale in connection with the production of given goods, is introduced by the specialist literature in this respect. Within that, it is possible to define minimum provision standards, which are set not on a market basis, but on the basis of legislatively laid down requirements of social commitment. Above the provision minimum, we find an interval where the appearance of an extra consumer does not cause any increase in fixed costs (management/personal expenditures, extension of business premises). The higher endpoint of the interval is where fixed costs start increasing.⁷ The scope of the principle of fiscal equivalence is limited by the problem of “overflow”. It is because certain public services may not only be available for local residents, but anyone (e.g. residents of neighbouring settlements, people travelling through).

That might have positive effects, too. Still, this kind of service provision “for outsiders” (e.g. public transport that is free for anyone) presupposes a strong local economy and a prudently compiled local economic program. Negative overflow also appears, for instance in phenomena relating to the irresponsible financial management of municipalities, and in taking out unjustified operational credits, which, ultimately, are financed by the whole of society through additional central budget supports.

Fiscal decentralisation may strengthen the role and importance of the *local level organisation of economic activities*. Municipalities may start competing to attract a middle class of a strong income position, offer business premises to industries and service providers, and lobby for central investment projects. Observing the American federal system, *Tiebout* concluded that the operation of local municipalities showed some analogies with the operation of the competitive sector. Consumers of local public services seek the most advantageous service-price combinations, and the price to pay for public services is the local tax rate. His model presumes the free movement of consumers of local public services, who are also fully informed, the existence of a large number of municipalities, the separation of home and workplace, no overflows, and the existence of some simplifications relating to local taxation and public expenditures. The most interesting thing about the model is exactly its limited applicability. The more of the elements presumed within the system appear in practice, the more clearly the applicability of the rules of the model can be observed. European municipal traditions differ significantly from the assumptions of the model; however, the EU-induced development may foster the appearance of processes that can be described with the model. Inter-settlement competition enhances the innovative activities of the public sector and the efficiency of its

operation. That competitive situation requires a prudent outlining of the *competitive position of the settlement* in Hungary, too, presupposing the careful consideration and harmonisation of local economic programmes, local budgetary policies, local accumulation and investment policies, local taxation, housing management, settlement management, local education and social programmes.

THE DIRECT, SECTOR-RELATED ENVIRONMENT OF MUNICIPALITIES

The different areas of the financial management of municipalities may be best seized *in the public policy sectors producing goods*. Sectors can be formed of groups relating to the most diverse municipal tasks, where the criteria of group formation may be common management and regulatory subsystems, jointly managed institutions, identical legislative environments, identical clientele or targeted social groups, or any other practical aspect. The processes of how goods are produced may be the basis of separating the areas necessary for risk analysis. Interpreting risks may be based on sector characteristics that can be generalised. The process of how goods are produced is an operation-centred approach, within which the – relatively narrowly defined – objective of different municipal tasks is to produce goods and deliver them to the whole of society or to certain target groups within it. This approach needs to be fine-tuned by analysing the environment. The given mechanism, regulation, institutional system – the process of producing municipal goods – can be interpreted as *a communal response* to the challenges of the social, economic, as well as natural environment, and being operation-centred can only be authentic and socially expedient within this context.

Municipal sectors can be grouped in diverse manners, relying on the latest theories con-

cerning the minimal, intermediate and activating functions of the state, as well as on the practical experience and solution methods of the audits conducted by the State Audit Office at municipalities. Below, I attempt to present the intricate system of carrying out municipal tasks through four activity areas, taking into consideration the experience of the State Audit Office based on the knowledge and interpretation of theoretical aspects and the legislative environment (Báger, 2006).

EDUCATION, CULTURE AND SPORT

The Act on Local Authorities stipulates that providing kindergarten education and primary education are compulsory tasks of all municipalities. Having kindergartens and primary schools plays a key role in the social and economic life of settlements. The status, way of life, and employment opportunities of families are fundamentally affected by the presence and availability of educational institutions. The longer a child feels attached to the *local educational system*, the longer they stay in a given settlement, as a consequence of which they are socialised locally. The more levels of the educational system a given settlement is capable of maintaining, the more attractive it appears to its environment. That explains why settlements, primarily towns, strive to fulfil the voluntarily undertaken task of running institutions of secondary education and vocational institutions (the law stipulates that providing secondary education is a task of counties and the capital city). It is not accidental that growth poles have all started off as university seats and their agglomerations world-wide, and that the R&D premises of international companies are located in core areas. The educational system sensitively reacts to processes of social and economic growth, and may also generate and sustain changes in a positive direction. From

within the task group of *supporting activities relating to public education, science, art, as well as sport*, providing space to host activities of public education, providing public library services, and supporting local sport activities are compulsory for all municipalities⁸. In larger settlements, organising and supporting culture and sport appear linked to the sector of organisation of education, but as an independent area. Similarly to the educational system, culture is a conjuncture sensitive sector, a potential catalyst of growth. Local residents' level of professional training and level of education in the broader sense cannot be sharply separated from each other, thus supporting education, culture and sport is a real opportunity to shape the competitive position of a settlement. Theoretically, the task groups listed above are among the intermediate functions of the state.

SOCIAL CARE, CHILD PROTECTION, HEALTH CARE

The activities listed encompass a wide range of task provision. What they all have in common is that they can be classified as minimum functions of the state. Providing basic social care is one of the compulsory tasks of municipalities. It means delivering transfers provided relying on central budgetary funds to those in need, and social care-related obligations within the framework of care work, whose forms of basic social care are: meal service, home help, family support service, as well as special forms of basic social care.⁹ Within the framework provided by the sector-related legislation relating to the *social agenda*, more complex formats of providing care, institutions offering temporary accommodation, and other formats of providing accommodation may be established to help those in need. The activity of the *child and youth protection* sector is very close to the social agenda. The social sector and the child protec-

tion sector deal with problems of vulnerable social groups, and are rather recession sensitive. The social sector also plays an important role in developing regions as growth does not affect everyone in a given region, and the frequency of occurrence and the number of cases relating to certain problems may be independent of socio-economic dynamics (disabled people, the elderly, mentally injured people, families at risk, children, the homeless). The number of those living near the poverty threshold may decrease in a developing region, but it is also possible that there is only a decrease in proportions (due to better-off people flowing to a prosperous area), while the number of cases may stay unchanged or might even increase slightly. The significance of the social sector may grow in declining regions and in ones falling behind. It is necessary to deal with the problems of families and individuals with decreasing incomes, belonging to the less competitive layers who may potentially become impoverished. *The participation of municipalities in finding a solution to employment problems* also belongs to the activity relating to the social agenda, which aim may be achieved through public purpose employment and public utility employment. Municipalities often take the opportunity to link the provision of social support with participation in public purpose employment programmes. Within the framework of *basic health care*, municipalities are obliged to provide GP services to adults and children, dental services, emergency medical services linked to basic health care, health visitor's services, and school welfare officer's services.

LOCAL INFRASTRUCTURE

Municipalities have the compulsory tasks to provide healthy drinking water, public lighting, and maintain local public roads and public

cemeteries. Pursuant to sector-related legislation, spatial planning, the creation of an aesthetic built environment, and the protection of the local architectural heritage are also compulsory. Providing local infrastructure includes activities connected to settlement development, the protection of the natural environment, water management and rainwater runoff management, canalisation, and the participation in local energy provision. Pursuant to sector-related legislation, municipalities are obliged to provide sewage disposal and sewage cleaning, and to outline a programme of environmental protection for the settlement, within the framework of which, besides several other compulsory tasks aiming to protect the environment, they are obliged to provide rainwater runoff management in compliance with all regulations. The compulsory task of municipalities stipulated by sector-related legislation concerning providing protection against inland water and floods also belongs here, and, interpreting settlement infrastructure in a wider sense, so do the municipal tasks relating to housing management, local public transport, and ensuring public cleanliness and settlement cleanliness. Pursuant to sector-related legislation, waste transport and management, and the temporary storage, transport and management of liquid waste are compulsory tasks. The provision of local fire protection and the local tasks relating to public security are very close to providing infrastructure. Pursuant to sector-related legislation, ensuring the opportunity to obtain fire extinguishing water is another compulsory task of municipalities. From the point of view of infrastructure theory, settlements are a rather complex area, a system of elements where the roles assumed by the state range from its minimum to its activating functions. Due to all these factors, the infrastructure of a settlement may be regarded as highly vulnerable. If it is lacking, regressing, or becomes overloaded, it may become an obstacle to (or the

bottleneck of) local social and economic development.

LOCAL ADMINISTRATION

The financial management of municipalities is affected by local administration. A flexible, citizen-friendly mayor's office may hold some appeal for the settlement. The activity of the mayor's office controlling the different sectors may become more effective. Mayor's office officials supervising the different sectors are found in each settlement type, while the size, the segmentation, and the level of specialisation of the office organisation all differ depending on the size of the settlement and the complexity of its different activities. The coordination and the controlling and supervising functions of mayor's offices may create a seamless whole out of the intricate, complex activities of the different sectors, thus the direction of the different sectors is also important from the point of view of the financial management of municipalities. It is a complex aspect enhancing the competitiveness of the settlement. Theoretically, it represents the minimal and activating functions of the state.

THE INTERNAL ENVIRONMENT, AND THE ORGANISATIONAL AND REGULATORY SYSTEMS OF MUNICIPALITIES

By reviewing and coordinating the management of the different sectors, the mayor's office can ensure that the financial management of municipalities form a seamless whole, the effects of settlement policy be coordinated, and its system of objectives set the right direction for regional harmony. In that respect, the most important document is the *economic programme* of the municipality is. The economic programme is at the top of the hierarchy of

planning documents. However, it is not a mechanical “sum total” of sector-related professional policies. The economic programme is to be *adequate for the social-economic* environment of the settlement, giving an appropriate response to the problems deriving from the spatial structure of the environment of the settlement, the regional processes, their size and complexity. The economic programme is a document determining the *competitive position* of the settlement, from which sector-specific policies can be deduced.

The economic programme is a result of negotiations and trade-offs; however, it constitutes a quality type control risk if the economic programme is superficial and does not represent the genuine economic objectives of the settlement, while sector-related negotiations are carried out independently of the programme, through informal channels. In such cases substantial discrepancies between the economic programme and the sector-specific policies, as well as among the different sector-specific policies themselves are likely to be found. Such problems might arise during the planning process and the negotiations relating to the budget, and indicate conflicts that cannot be resolved within the operative processes. A document containing the *financing strategy* and medium-term financing plan of the municipality may be part of the economic programme. Decisions on the desirable position of the budget, the extent of the acceptable deficit, the extent of necessary development credits to be taken out, and the method of obtaining such credits are made within the framework of the financing strategy. The local tax policy and investment policy, fitting to the medium-term financing plan, can also be represented in the economic programme. Failing to *periodically supervise* the economic programme constitutes a further control risk. Optimistically speaking, the environment is bound to show positive changes as a result of the programme, while,

quite pessimistically, one can say that the environment changes adversely independently of the programme. Observing the changes in the environment occurring due to complex reasons may be regarded as a realistic approach.

Reviewing the economic programme and making sure it fits to the regional programmes can be regarded as the highest level of local municipal *monitoring systems*. The fact that the Act on Local Governments refers adopting the economic programme to the competence of the bodies of representatives is a guarantee element deriving from democratic governance.¹⁰ Pursuant to the amended stipulations of the Act, reviewing, complementing and amending the economic programme has been made possible within the decision making competence of the bodies of representatives, too. Over the past years, the audits of the State Audit Office have paid special attention to the activities of municipalities relating to drawing up economic programmes. The reports of the State Audit Office evaluating a representative sample of municipalities show a gradual increase in the proportion of prominent municipalities and town municipalities creating economic programmes (76%, 81%, and 82% of them did in 2004, 2005, and 2006, respectively).

Policies¹¹ are documents that are intended for internal use but may be made available for the general public, adequately managing the risks arising from the changes of the environment of the given sector. Policies are found adequate in relation to the inherent risks deriving from the environment and the organisational system of the sector if they provide an analysis of the municipal goods produced as a response to the changes in the environment, and of the extent of the interventions made possible by the sector-related legislation. They determine the necessary regulations, procedures, incentives, and possible financial transfers, which then need to be created and amended in municipal decrees. They contain situation

analyses in view of provision formats rendered necessary due to regional processes, and the profiles, sizes, facilities, head count requirements, capacities and locations of institutions that are either to be established or has already been functioning. Should policies fail to be substantially detailed, risks deriving from the environment of the sector and the organisational system might not be identified, and, consequently, such risks might have a stronger impact. That impact might even be unlimited or more significant for want of a prudent institutional system based on policies. Due to the insufficient frequency of reviewing the policies compared to the pace of changes in the environment, or due to a lack of harmony between in changes of the economic programme and the policies, control quality will be damaged.

A concept relating to annual budgetary incomes and expenditures can be compiled based on the policies, in accordance with the objectives of the economic programme. The obligation to compile an annual budget concept is required by legislation. Ultimately, the annual concept needs to be in harmony with the economic programme. The difference between the original estimates of budgetary incomes and expenditures, i.e. the planned deficit, is to be determined in accordance with the basic principles of the financing strategy, while the method of financing the budgetary deficit is to be determined in accordance with the concept of the financing strategy and the medium-term financing plan. It is expedient to harmonise the planned estimates of local tax incomes with the concept of the local tax policy, and it is expedient for the estimates of operational expenditures to be based on the objectives of the policies. It is necessary for the incomes for accumulation purposes to be in harmony with the asset policy guidelines. The estimates of expenditures for accumulation purposes are to reflect the priorities of the investment policy. The annual level planning system – the formulation

of the concept, the preparation of the draft budget decree, mid-year amendments to the budget decree, and the preparation of the appropriation accounts – may be regarded as the lowest, *elementary level of the planning-monitoring system*. This level's failure to acknowledge the identifiable regulatory and planning risks indicates a quality type defect of the control system, which might query the reliability of the whole planning system, and tends to result in significant control risks. At the same time, formulating the budget concept is a *feedback mechanism* testing the harmonisation of different policies and the execution of the economic programme. It is a control risk if the process of the compilation of the budget fails to indicate significant deviations from the objectives, or the demand that certain necessary changes be made in the economic programme and the policies due to the scarcity of funds. According to State Audit Office audits, 95–96 per cent of municipalities formulated budget concepts in the period between 2004 and 2006. (The proportion based on a representative sample was 100 per cent in 2005.) However, the well-groundedness of the concept and taking locally generated incomes and well-known obligations into consideration were deemed as adequate at 85–87 per cent of municipalities.

THE REGULATORY SYSTEM LINKED TO THE EXECUTION OF MUNICIPAL BUDGETS

The regulatory elements known as *authorisation* and *segregation of duties* in the international audit terminology can be identified in the practice of Hungarian municipalities, too. The *financial control* executing operative financing is linked to the execution of the budget as a particularly important sub-system.

During the operation of *authorisation*, a transaction is most typically diverted to a high-

er authorisation level based on its financial size, but the procedures also distinguish sensitive and complicated events whose occurrence requires the insertion of a higher authorisation level independently of financial sizes. Authorisation is adequate for the risks inherent in the system if it assigns levels of audit procedures to the real distribution of the financial sizes of transactions, and if, statistically speaking, it determines the medium level of authorisation correctly. Authorisation is inadequate if the levels of authorisation have not been outlined based on the real distribution of financial transaction sizes. Authorisation is of inadequate quality if transactions of complex, sensitive types requiring special procedures have been evaluated inconsistently with reality, the procedures fail to filter out genuinely complex or sensitive events, or divert less complex or sensitive events to the special branch. The inadequacy of authorisation might lead to the occurrence of type I and type II audit errors in a higher than acceptable quantity, and there might be some overaudited and underaudited operational areas. For this reason, the quality of authorisation constitutes a high control risk (to be evaluated with a high weighting factor). This control risk area comprises the regulation of the decision making competences of municipalities regarding budget and asset management issues. The regulatory systems of municipalities have been being audited by the State Audit Office continuously. According to their findings, in 2004 and 2005, 80 per cent, and in 2006, 87 per cent of mayor's offices regulated the order of decision making relating to budgetary issues (commitment). They have observed an improving tendency regarding the regulatedness of asset management competences, too. In 2004, 90 percent, in 2005, 98 per cent, and in 2006, all of the municipalities in the representative sample outlined decision making competences relating to asset management, setting them out in regulations.

A chain of audits built on each other may be created (*segregation of duties*) if an operation can only be executed subsequent to the closure of the previous work phase and providing that its performance has been of an acceptable quality. Audit is genuine if the next work phase is truly separated from the previous one by the segregation of duties to be performed by different people, and if identifiable (documented and contractual) interests and responsibilities can be linked to high quality takeovers between work phases. Segregation can be ensured by the detailed regulation of processes taking into consideration the risks inherent in the system, by the closed, watertight outlining of job descriptions in full consistence with the procedures, and by determining incompatibilities between audit functions. The separation of operations is inadequate if procedures have not been fully regulated as required by the risks inherent in the system, or if job descriptions have been outlined defectively, or if the incompatibility of duties has not been regulated. Separation of tasks of an inadequate quality results in a significant control risk, the risks inherent in the system can be felt without genuine harnessing (abatement). An unacceptably high error ratio may endanger the operation of the financial management system, and increases the likelihood of incurring losses (nearing the level of inherent risks). Within the financial management of municipalities, countersigning contracts and proofs of financial transactions, validating economic transactions, and last but not least, indeed, quite importantly, verifying professional performances, serving as an input into the operative audit process of the budget, belong to this control risk area. The State Audit Office has been paying special attention to the verification of professional performances in the course of their audits. Between 2004 and 2006, they found an extremely high proportion of errors indicating grave problems in connection with the execution of municipal

budgets, and the operational reliability of the relating control system. 32 per cent, 44 per cent and 42 per cent of municipalities failed to verify professional performances in the three respective years. From 2007 on, the State Audit Office has further developed its audit methodology regarding the systems auditing the execution of municipal budgets. They have been paying special attention to this major problematic risk area relying on statistical tools, and carrying out compliance audits serving to enhance the efficiency of the audits.

The risk area relating to *financial control* is especially important because of the cash-based approach of the budget management of municipalities. Financial control makes it possible to supervise the financial and financing operations indispensable for the execution of the budget. Adequate financial control can ensure meeting the financing demands deriving from the planned deficit and the different scheduling of budgetary incomes and expenditures, providing cash flow for institutions, tracking and collecting debts, meeting obligations without delay, managing the cash transactions of the whole financial management of the municipal system (corporate connections, supported organisations) and the drawdowns of external funds seamlessly. Financial control is considered to be of adequate quality if it executes an annual, constantly updated operative financial plan, and ensures its liquidity finance demand at an optimal cost, sparing its own funds, taking out operational bridging loans. Financial control is of inadequate quality if permanent disturbances are experienced in its cash flow, and in the course of its meeting obligations, or if a permanent, or gradually increasing operational credit portfolio is created. Municipalities control financial processes by compiling liquidity plans, and allocation fund schedules, by operating mini treasury systems, by buying and selling securities mid-year, and by drawing down and repaying operational credit facilities.

The quality of financial control constitutes a significant control risk, its weakness or the lack of financial control may result in insolvency, which constitutes a danger for the financial management of municipalities, and the cost of excess financing may cause significant losses (Vigvári, 2005b).

The regulatory and logical frameworks of the internal and external audits of municipalities

An independent internal audit may be deemed as one of acceptable quality if its activity focuses on the most important control risks of the financial management of a municipality, and it tests the outlining and operation of control mechanisms adequate for the inherent risks with acceptable frequency. It is possible to identify professional audits within the sectors (the educational sector, technical audits of investment projects, etc.) which audit the control systems of the given sector and the professional standard of the activities. However, it is important to emphasise that audits of that type cannot replace internal audits – as it is stipulated by the relevant legislation, too. *Internal audits* are compulsory to conduct pursuant to the legislation on municipalities. That legislation stipulates the formal elements of audits, the rights and duties relating to audits, the planning and execution systems of audits, the compulsory steps of the realisation process of auditor findings, and the necessary documentations in detail. The lack or poor quality of internal audits constitute serious control risks, no overview or testing are conducted in relation to the control system and there is no regular feedback on necessary adjustments. The audits by the State Audit Office have monitored and made comments on the impacts of the legislation on internal audits introduced in 2003, partly based on international models, and

have promoted its more and more widespread application. 34%, 73% and 87%, i.e. a rapidly growing proportion of the regulatory frameworks of the internal audit systems of municipalities met the amended legislative requirements in 2004, 2005, and 2006, respectively. Strict compliance regarding issues of content, and the introduction of efficient audit planning and modern audit procedures inevitably require a long transition period, and according to the findings of the State Audit Office regarding 2006, for instance only half of the municipalities had made capacity analyses to support their audit plans with, and half of the municipalities had met the requirements regarding necessary qualifications.

The State Audit Office audits municipalities' relations with the central budget in view of supports for operational and accumulation purposes, linked to the audit of the appropriation accounts of the different chapters of the central budget. These audits are closer to the methodology of financial audits, but they contain compliance elements, and the *focus of the audit* and its approach are different from that of a municipal audit, the findings are evaluated at both local and national levels based on the methodology applied internationally by state audit offices, which differs from audit standards regarding several points. The essence of the methodology applied by state audit offices is that special audit procedures are applied using the *ISA framework*, taking into account the considerations of the public sector.¹² The practical guidelines relating to international audit procedures necessary for state audit offices are expected to be fully compiled by 2010.¹³ The professional committees of INTOSAI are adhering to the basic principles of international auditing procedures while developing an international methodology for state audit offices. They accept the ethical principles of international auditing, and the meticulous, critical professional approach of investigating

veracity and authenticity (*professional judgement / professional scepticism*), and expect state audit office evaluation practice based on sufficient and appropriate audit evidence.

International audit methodology based on the COSO report, outlined to assess risks (ISA 315 and ISA 330), whose application in the public sector is to be prepared by the end of 2008, is worth special attention. The international standard outlined for risk assessment determines an integrated and systematic analysis/assessment and audit procedure which tracks the control environment of the audit object, analyses the risk assessment procedure applied by the audit object, the information system based on it, the control mechanism supported by the information system, and the monitoring activity, utilising the *top down approach*. One might picture that system as a model using filters that are able to sense, alleviate and transform the impacts of a risky environment. It is a multi-layer mechanism, and its layers present increasingly clear pictures as a result of risk management. The approach applying the (previously outlined) interpretation of the system, i.e. that auditing, auditing the public sector, and the audits of state audit offices conducted in the public sector keep the knowledge regarding the risks of the audit object gained in the course of the audit activity up-to-date, making early assumptions more precise and modifying them in the course of a systematic process of assessment depending on the reliability of the information tested, is particularly important. Risk assessment is not an optional activity in the course of the audit, but an essential central element of the audit activity demanding planning, checking and continuous assessing (Anerud, 2008).

Audits of the financial management of municipalities, comprising several aspects, are carried out by the State Audit Office. In the framework of such audits – following the definitions of international practice – the control

risk areas of the financial management of municipalities are rated through *compliance audits*, while a general survey and an assessment of the economy, efficiency and success of key financial management activities are created through *performance audits*. According to international auditing practice, outlining the audit methodology of a large number of territorial units requires a special approach. It is necessary to make sure that audit types that easily adjust to changing financial sizes, match audit methods with the characteristics of a territorial unit, provide relevant information concerning the whole population, and are based on representative samples are outlined (Sepsey, 2006).

A well-organised and regularly tested control mechanism may require and indeed outline through its own regular replies the risk model of the financial management of municipalities which is sensitive to its external and internal environments, and operates effectively, efficiently and economically. The model may only be approximated by real processes, and the well-known audit errors (type I and type II errors, underaudited and overaudited areas) may give experts plenty to think about. In practice, naturally, the issue of who the trap is set for – the mouse or the cat? – may be there in the minds of those operating and examining the auditing systems as a standard question.

NOTES

¹ Regarding the growing value of the audit function, see Kovács (ed., 2007) and Vigvári (2008); regarding its bearing on public finance, see Vigvári (2005a).

² We find exceptions in the British Commonwealth and the United Kingdom, e.g. Gibraltar may conduct an independent trade policy, and Scotland has the right to issue banknotes (Forman, 2003).

³ Fiscal leeway may be gained by shaping the operational and accumulation budgets based on careful planning, by developing local public services through proper coordination and optimising their expenditures, by taking out credits for the purpose of accumulation, by obtaining support for the purpose of accumulation, and by rationally shaping local tax policy within the given legislative framework, also relying on an active investment policy, community investment programmes, and the stimulation of private equity.

⁴ Theoretically, the leeway of municipalities in view of their income policies may range from total autonomy concerning incomes to a total lack of the same. Systems of financing are profoundly influenced by historically developed models. They partly depend on the basic model of governance (unitarian, federal), and partly on the characteristics of the state tax monopoly. At the national/federal level of governance we usually find tasks relating to defence, home affairs and foreign policy. Education, health care and

law enforcement may be vertically segmented, depending on traditions. Unitarian governance disallows local taxation (the French model), whereas federal states leave relatively high amounts of tax at the level of the provinces (however, in the German model, the practice of tax imposition is insignificant at the lowest local level).

⁵ Their distance from the growth pole, the strength of their connection with a given agglomeration, a regional cluster, and the town network, the characteristics of their position within the region, and the presence of the factors relevant for the selection of the locations of business premises may differ significantly. In Hungary, economic spatial structure is characterised by the so-called west-east slope (Forman, 2003), and the differences between the position of the capital city and of the countryside may also be regarded as significant.

⁶ The applicable tax types (property-type and communal-type taxes, tourism tax and local business tax), tax rates and exemptions, and the system of allowances are outlined by municipal decrees within the legislatively created framework.

⁷ Education is typically such a sector. Locally provided primary education is a compulsory municipal task in Hungary, and ensuring minimum provision and setting cost-efficient sizes may cause problems depending on settlement types.

⁸ Considering sector-related legislation, see Takács (2003), p 13

⁹ Pursuant to the Amendment of Act III./1993. on Social Administration and Welfare Benefits, effective as of January 1 2005, basic social care, as regulated earlier, is to be provided by so-called basic social care centres, whose activities are to include daytime care and child welfare service as well as the basic activities regulated earlier (see Sections 57 (4) *a* to *e* of the Act). Amending the Act brought about a significant expansion of the scope of basic services. Sections 57 (1) *a* to *j* of the Act contain the list of tasks relating to village caretaker's service and farm caretaker's service, social information service, meal service, home help, family support service, emergency signal home help service, community care facilities, support service, street social work, and daytime care.

¹⁰ The growing importance of the economic programme is reflected by the fact that the content of the economic programme was regulated in detail in the amendment of Act LXV./1990 on Local Governments, effective as of August 31 2005. The justification of the amendment of the Act on Local Governments clearly signalled that the Act had stipulated that municipalities should prepare economic programmes as early as in 1990; however, most of the municipalities had failed to meet that stipulation as it was unclear for them what the economic programme was to contain. The amendment of the Act provided guidelines for the municipalities by determining the objectives, certain professional aspects and the term of the economic programme. Pursuant to Section 91 (6) of the Act on Local Governments, the content of the economic programme should cover solutions relating to development ideas, the promotion of fulfilling the conditions necessary for the creation of new workplaces, the settlement development policy, the objectives of the tax policy, the provision and the improvement of the standards of different public services. In the case of towns, it is also to cover the investment support policy, and the objectives of the urban areas management policy. Pursuant to Section 91 (7) of the Act on Local Governments, the economic programme should be adopted by the body of representatives within 6

months of their initial meeting if it is for the term of an election mandate. If the existing economic programme has been in effect since before the end of the previous mandate, it is to be reviewed by the freshly elected body of representative within 6 months of their initial meeting and to be complement or amended in view of a term at least as long as that lasting until the end of the mandate. Municipalities had to first apply the stipulations of the amended Act after the 2006 elections.

¹¹ In this respect, Hungarian municipalities do not tend to use the term policy. Different municipal sectors draw up task fulfilment plans, service provision concepts, development concepts, and institute development plans. I have found the introduction of the term policy justified so as to spread international terminology and to unify those different terminologies.

¹² International Standards on Auditing (ISA) determine all the important steps from the acceptance of a task to the compilation of the audit report and the acceptance of the findings through the stages of planning and implementation, also describing best practice. The standards form a tight logical framework from the recommended objectives and terminology of an audit (ISA 200) to the methodology of compiling auditor's reports (ISA 700), through the description of planning procedures (ISA 300). A detailed lecture on the ISA framework and its application in the public sector was presented at the conference on the financial audit methodology of European state audit offices held in Vilnius, in October 2008 (Anerud, 2008).

¹³ The objective of the current standardisation regarding state audit offices is to compile a Practice Note (PN) for each ISA standard. The two together (ISA+PN) are to form the state audit office audit procedure (ISSAI). The professional development project, whose products compiled at the end of 2008 had completed the necessary harmonisation relating to audit risk management and compliance audits (ISSAI 1315, 1330, and ISSAI 4100 and 4200) is to continue. The committees in charge of the project have promised to complete the whole task by 2010.

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