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The legal and professional regulation of the financial control of local governments in some EU member states

In Europe the concept of local government is interpreted much more widely than it is generally understood among financial auditors. In Hungary this definition is mostly associated with the local and nationality governments and only rarely extends to the idea that non-governmental agencies, chambers and non-profit organisations also operate on the basis of the principle of local government.

This study focuses only on local governments. It does not aim to describe the development of the current situation in Hungary or to analyse or criticise the effective legislation or the existing audit practices. Here we shall describe the legal regulations applicable to the audit of local governments in some European countries.

The selection is not representative. We shall not describe the solutions of Southern European countries (Spain, Portugal, Italy and Greece) and France or Belgium which operate with court-type audit offices. Those Member States have also been left out from the study, the financial audit experiences of which can only be studied indirectly through an intermediary language (Visegrád countries, Baltic States, Scandinavian countries, Balkan States). Experience shows that due to the differences in the professional terminology of the latter countries, misunderstandings occur frequently even if there is no need for an intermediary language for understanding.

Of the 'remaining' European countries, we have focused our attention on Austria and Germany because of our common roots and historic relations as well as the United Kingdom in relation to the SAO-NAO twinning co-operation. The selected countries have different public administration structures and different professional traditions. The culture of their public life has a hundred years of advantage compared to Hungary. The need of the population and taxpayers for accountability, transparency and democratic requirements of publicity differs from the Hungarian needs. This is because we have not managed to eliminate the disadvantages caused by the socialist diversion of forty years since the systemic change. (It is not an exaggeration to talk about further decline.) The author understands that there are no automatic recipes. However, we always must, may and should learn from others.

TIMELINESS AND IMPORTANCE OF THE PROBLEM IN HUNGARY

In Hungary, the external (independent) audit of the efficiency and cash management of local governments were referred under the sphere of competence and tasks of the Audit Office only after the systemic change. The model, which is currently described in the effective legislation

and is applied in the actual practice, did not have any history in Hungary. Until the period of socialism, control fell under the competence of the *Minister of Interior*, while the Minister of Finance and the Minister of Interior were jointly responsible for the accounting regulations. The counties, towns, large and small villages were accountable for their operation to the agencies of executive power. The accounting activities were performed in a regulated, hierarchy-based system: village (town) prefecture, district administrator, county sub-prefect and minister of interior. The *audit offices* formed the central component of the control system. They had a pyramid structure. The chief audit office of the Ministry of Interior was at the top of the pyramid, and the chief audit office of the Ministry of Finance held the highest position in the country. The financial control 'philosophy' based on the audit offices, which could be described as the government internal using the current terminology, reflected the *Hegelian* concept whereby the officer at a higher level of the hierarchy controls the officer subordinated to him and each officer has a high degree of morale.

The current political decision-makers, media workers, scientific and professional public opinion builders know practically nothing of the role of the one-time audit offices in accounting and administration processes or financial control.¹ They did not understand very well either that the activities of the accountancy offices were audited by the audit office as an independent and external agency or that the accountancy offices sent their statements of the use of public funds to the audit office monthly.

The (Supreme) State Audit Office, which operated for 80 years, did not have any tasks concerning the cash management or operation of the local governments. During the 'socialist control' (more specifically, so-called 'council control') period which lasted for four decades

of the party state, Hungary did not have an audit office at all. When the current State Audit Office (SAO) was established, no local governments had existed yet; the system of councils as effective with its own control hierarchy, where each level was tightly controlled by the party. When the Act on the audit office was passed, the last Parliament of the party state was satisfied to declare in this respect that SAO '*controls (...) the use of transfers from the state budget at the local councils ...*'.² Rephrasing the same thing according to the current definitions, this involved only a compliance audit. This means that originally Parliament expected its newly established audit office to control only whether or not the villages and towns used the public funds allocated from the state budget for the same purposes as they were designated by the central administrative agencies.

The legislator did not clarify the *professional contents or frequency* of the audits to be performed by the State Audit Office, or whether or not it 'merely' gave competence to the new institution, originally identified as the '*highest agency of state control*' or it also involved (annually) repetitive tasks with regard to all local municipalities, for the performance of which the SAO would have both professional and political responsibility, either at the start (when the SAO was established), or ever since. A good six months after the approval of the Act on the State Audit Office, when the Act on local governments was passed, the first freely elected Parliament announced the still valid rule according to which '*the operation of local governments is controlled by the State Audit Office*'. This declaration was made without clarifying the meaning of operation or the intentions and targets of the audits. Did Parliament give an opportunity to SAO or did it impose a (regular) obligation on it?

It is a fact that in 1990 the SAO could not get hold of any 'historical handholds', procedures or special methods for coping with the

audit of the finances of local governments, the number of which doubled after the dissolution of the councils. It could not have adopted the former state audit practice (i.e., the government audit methods and procedures) even if it wanted to. However, currently there is a *dual external financial control system* in the local government segment of the budget which is expensive and neither of its components was properly established. The functions of neither the state audit nor the accounting audit are clear. The budget Act imposes an obligation on larger local governments to employ a private auditor, but it does not say anything about the audit of the financial statements of small local governments (more than 2,000 settlements). For formal logical aspects, the legislator expects a solution from SAO in the latter area. According to a provision of the effective Budget Act stating that *'the State Audit Office performs the tasks of the external financial control of the budget'* also suggests that the 'highest financial control agency' should be obliged to enter this no one's land. And there is more! Considering that pursuant to the law the auditor of a larger local government is employed and paid by the local government, we can hardly talk about the independence of the auditor. In Hungary, the number of local governments in a tense (or clearly hopeless) financial situation is increasing. Changes are absolutely necessary and should not be postponed in several areas. With regard to the independent financial control of the Hungarian local governments,

- the (annual) financial statements of (small) local governments should also be audited by an external financial auditor, for which active co-operation with the Hungarian Chamber of Auditors (HCA) is absolutely necessary;³
- procedures need to be developed for the complex assessment of the operation of the local governments and they must be applied in the audits of the State Audit

Office with the purpose of assisting the local governments;

- the independent external audit agency should prepare quantified, transparent, comparable and user-friendly assessments and evaluations which should also be published on the internet.

LEGISLATION AND PRACTICE IN AUSTRIA

Federation (national) legislation

Austria's settlement structure is similar to that of Hungary. Apart from the similarity of the relatively even geographic situation of residential communities (*Gemeinschaften*), villages and towns (*Gemeinden*), another factor supporting a useful comparison with the Hungarian conditions is that, compared to Northern Europe, in our Western neighbour country many settlements have local governments too.

Multi-tier regulations cover the independent (*external*) financial control of public funds (*Gebarungskontrolle*). The top (federal) level contains the Austrian Audit Office (*Österreichischer Rechnungshof- ÖRH*), which will celebrate its 250th anniversary in a few years. According to the Constitution, its competence has covered the second level of public administration, the provinces (*Länder*) and also partially the third level: communities of at least 20,000 residents and local associations (*Gemeindeverbände*), and their foundations, funds and institutions since 1929.⁴ This category includes 23 towns and the capital city, *i.e.*, *1 per cent of the total local governments* (see *Table 1*). The competent mayors present the final accounts of their towns to the audit office for audit by the end of March each year and, simultaneously, the statements are also presented to the provincial government for information. ÖRH notifies the mayor of the audit

findings, who takes his position and then reports the actions taken to the audit office within three months. ÖRH also notifies the competent provincial government and the federal government on the declarations of the mayors and informs the council of the audited town (*Gemeinderat*), and simultaneously the provincial and federal governments in an official communication (*Bericht*) on the financial year by the end of the subsequent year. Then it also discloses its communication (report). ÖRH also audits those enterprises in which the participation of local governments in charge of more than 20,000 residents is higher than 50 per cent of the registered capital and companies that are operated by the local governments themselves or take part in their operation. The audit office may also audit the finances of local governments in villages with less than 20,000 residents, but such audits can only be conducted upon a specific request of the provincial governments. This is why within the federal audit office organisation, operating with approximately 300 employees and divided into five sections and 35 units, only one unit (*Abteilung Gemeindeverwaltung, Gemeindeverbände*) is dedicated to the financial control of local governments. (Consequently, despite our common historical roots, there are fundamental differences between ÖRH and SAO in terms of rights, interpretation of tasks and organisational structure.)⁵

The types of control of public funds, declared also in constitution, have developed in a historic process for hundreds of years. At the beginning, the inspections only focused on the issue whether or not the accounts and statements reconciled. These days, apart from the mathematical accuracy (*ziffernmäßige Richtigkeit*) the professional contents of audit (*Ordnungsmäßigkeit*) also include compliance with the effective legislation and the review of economy, (*Sparsamkeit*), efficiency (*Wirtschaftlichkeit*) and practicality (*Zweckmäßigkeit*). As the

Austrian Constitution contains rather detailed provisions on issues concerning the State Audit Office, the Act on ÖRH practically only repeats or supplements the declarations of the Constitution with regard to local governments.⁶ The Austrian *Government does not have any financial control tasks at federal level* concerning the local governments. Only the provincial governments and ÖRH are competent in this field.

Table 1

BREAKDOWN OF THE NUMBER OF SETTLEMENTS BY SIZE CATEGORIES
(as of 1 January 2005)

number of residents	number of settlements
– 500	173
501 – 1000	426
1001 – 2500	1 131
2501 – 5000	412
5001 – 10 000	144
10 001 – 20 000	49
20 001 – 50 000	15
50 001 – 500 000	8
capital city	1
Austria	2 359

Source: Schmid, J.: Die Stellung der österreichischer Gemeinden in einer reformierten Bundesverfassung

Doctoral thesis on the constitutional law. Rechtswissenschaftliche Universität Vienna, January 2006, p. 12

Legislation at provincial level

Austria is a federal state; it consists of nine independent provinces (*Bundesland*). With the exception of one, each province (and also the capital city) has its constitution. The majority of the provinces revised their constitutions in the 1980s and 1990s in order to comply with the requirements of our current age and declare the basic human rights at the highest possible level. The constitutions mention the financial control of local governments which is *not the responsibility of the audit offices* in terms of the financial statements.

The federal constitution authorises the provinces to control the finances of their local governments in terms of economy, efficiency and practicality (*überprüft*). The provinces have various financial control institutions (*Landeskontrollenrichtungen*), the organisational structure and independence from the public administration system of the province of which are regulated differently by the various provincial parliaments.

A descriptive document prepared for EURO-RAI⁷ classifies the provincial control agencies into two large groups.

- *The first category contains central or provincial public administrative agencies. E.g., in the province of Vorarlberg, which contains 96 settlements, the number of residents is below 20,000 in 93 villages. The regular financial control in this category (regelmäßige Überprüfung) is exercised by the office of the provincial government, and three towns are controlled by ÖRH. The competent unit of the office (Abteilung Gebarungskontrolle) reviews the financial statements of all villages and local government associations (Rechnungsabschlüsse) annually, and is entitled to issue resolutions of approval with regard to them, as a supervisory authority. Such activities of the office are audited by the Provincial Audit Office (Landesrechnungshof – LRH) as an external independent auditor. [In the spring of 2006, e.g., LRH prepared a detailed report for the provincial parliament and government evaluating its audits conducted between 2001 and 2005. In this period, the audited government office inspected 89 villages. With regard to its activities, the audit office concluded, in terms of quantity, among others, that each village was audited every five years. In terms of the contents of the audits, the conclusion was that they were dominated by the classic types of financial control, i.e., compliance and regulatory aspects (Rechtmäßigkeit und Ordnungsmäßigkeit.)]⁸*

The federal capital (which is not only a local government but also a province) has a control office (Kontrollamt) established in 1920 instead of an audit office. This office is controlled by a director and controls the management of the capital city as well as all the economic organisations in which the local government is the majority owner in a structure of four departments at present. In addition, it also audits the management of public funds by the local public administrative agencies and foundations and funds with legal entity, owned by the local government of the capital city. Such audits are also distinguished according to mathematical accuracy, regularity, economy, efficiency and practicality.⁹ Consequently, there is no difference between the types of audits conducted by the audit offices and other types of controlling institutions. The control office integrated into public administration operates within the magistrate subordinated to the mayor. It reports to the control committee of the capital city (Kontrollausschuß). The procedure, by which its executive officer is appointed (for five years) and recalled by the council of the capital city (Gemeinderat) based on the mayor's proposal, provides a quasi parliamentary feature to this office.

- *The second category contains the institutions directly reporting to the provincial parliament (Landtag). There are two types of such institutions, the individual organisational units parliament (audit offices) and the control committees of parliament (Kontrollausschüsse) which operate with the control offices.*

With the exception of Vienna, there are audit offices in each province. They report only to their own respective parliament, and cannot be instructed by the head of the province (*Landeshauptmann*). The annual regular audit of the financial statements of villages and towns is not included among their responsibilities. This task is performed by the offices, departments

and rapporteurs of the government apparatus. The audit offices occasionally audit the activities of the latter parties. In Burgenland, e.g., the external audit of public funds falls under the competence of a nine-member parliamentary control committee (*Landeskontrollausschuß*), which has its sessions quarterly. The tasks of the audit office established in 2002 are regulated in detail in the Constitution of Burgenland. The financial control of local governments is limited to an *expert opinion* on the management of public funds of the local governments (and local government associations) by the audit office based on an order of the provincial government (*Auftrag*)¹⁰. (In Burgenland province, there are only two auditors in the audit office assigned to this field and only one of them deals with the audit of local governments in part of his time; more specifically, it is not even an audit activity, only the preparation of an expert opinion.)

The legislation of the specific provinces allows for different interpretation, which has an impact on the degree of independence of the controlling organisations from the executive power agencies. One of the issues in the constitutional reform disputes for several years¹¹ is how to draw a clear borderline of the accountability of local governments between an audit by an audit office (*Gebarungskontrolle nach Art des Rechnungshofes*) and the supervisory control (*Gebarungskontrolle im Rahmen der Gemeindeaufsicht*).¹²

The financial control agencies prepare an annual report (*Tätigkeitsbericht*) on their activities, which is submitted to the provincial parliament and government. The ex officio audits are described in individual reports (*Einzelberichte*), addressed to the same authorities. The special reports are submitted to parliament as well as other agencies that sent inquiries concerning those reports or requested them. The reports on the audits of local governments in villages and towns, performed

upon orders, are sent only to the provincial government and the mayor concerned for the purpose of presenting them to the local council (village or town). The mayor must notify the supervisory agencies of all the actions taken.

The various control agencies meet annually for the purpose of exchanging their experiences. They co-ordinate their activities with the audits of ÖRH. There are opinions according to which the audits requested by the provincial governments may create a disadvantageous situation for the audited local government, because it depicts a worse picture about it that it should deserve. (E.g., in Upper Austria, where there are 445 local governments, the audit office conducts on average 60 audits each year upon request.) The local and provincial interests are stressed contrary to the federal interests which, obviously, the ÖRH is trying to enforce. (The vehemence is striking, with which the chairman of the Austrian Audit Office proposes referring the competence of independent financial audit of small towns, villages and small communities into the competence of the Federal Audit Office in the new Constitution which is currently being drafted. This solution would generate significant additional tasks for ÖRH.)

The tasks of the audit offices contain the classic types of the control of public fund management in the province (*Landesgebarung*), i.e., they focus on mathematical accuracy (*rechnerische Richtigkeit*) and compliance. However, the so-called 'modern' audit types are also present (efficiency, economy and practicality criteria). The principle of economy means that the lowest amount of public funds should be used for achieving a specific result, but it is only desirable if the lower expense does not undermine the quality (*Minimalprinzip*). The principle of efficiency (*Wirtschaftlichkeitsprinzip*) reflects the relationship between the resources used and the result achieved (*Erfolg*): have the public

funds been used successfully? Consequently, we should aim at the highest possible result at a specific cost (*Maximalprinzip*). The principle of efficiency also involves economy. It is measured with external and internal comparative calculations, cost benefit analyses (*Kosten-Nutzen-Analysen*), especially with regard to capital investments. The principle of practicality expresses whether or not the set target has been achieved and whether or not due consideration was applied to choose the most favourable option to spend the required resources (money and time) as well as whether or not all tasks were performed that could have or had to be performed or were allowed to be performed. The effective legislation does not provide for the frequency of the external financial control.

The audit offices are entitled to audit foundations, funds and institutions that are part of provincial administration as well as enterprises and institutions (*Überprüfung*), in which the province is financially interested and which are operated by the provincial government either alone or together with other parties. In addition, any private individual and legal entity managing the assets of the province and for whom/which the provincial government assumed a guarantee, may also be audited. The scope of the audit also covers public law bodies managing provincial claims and provincial receivables and subsidies (*Gebarung öffentlich-rechtlicher Körperschaften*), and finally, upon the order of the provincial government or the head of government, the finances of local governments and local government associations (*Gemeinden und Gemeindeverbänden*). The legal regulations applicable to the preparation of final accounts and financial control of local governments are contained in the so-called 'municipality law'.¹³

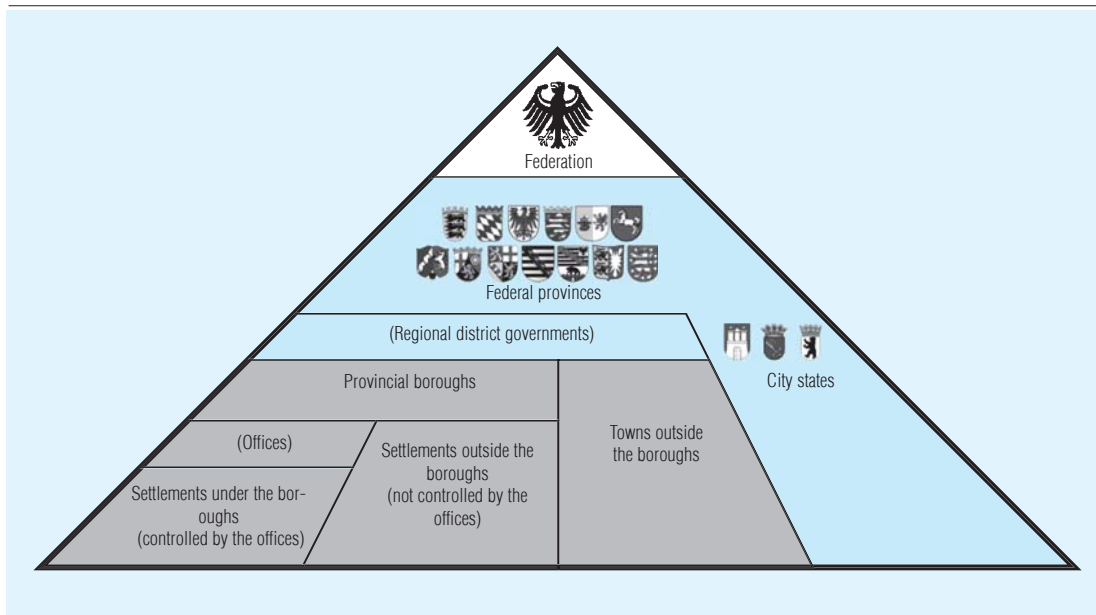
The purpose of the audits is to conclude whether or not the public funds were managed in accordance with the applicable regulations (*zahlenmäßig korrekt*), accurately, economical-

ly, efficiently and practically. The audit offices can make proposals not only for the elimination of insufficiencies, but they can also suggest opportunities for decreasing or eliminating tasks, generating new revenues or increasing the existing revenues. An audit in progress may cover the full range of public fund management or any part thereof; it may give a reliable picture of the management of funds, or may also be performed based on random selection (*stichprobenweise*). Special audits (*Sonderprüfungen*) are performed according to the criteria of the order or request.

The so-called permanent (regular), ex officio audits (*laufende Prüfungen*) are distinguished from the special audits. All decisions about the first category audits are made by the head of the audit office (*control office*), or the head of the financial control committee (*Obmann*) defining whether or not an audit should be a complex audit or should only focus on a specific area or should be performed based on random selection. Some provinces prepare an annual audit plan, which is also presented to the provincial parliament. The nature of any special audit is defined in the order or request.

According to the Act on the audit office of Salzburg province, special audits may be 'ordered' (Kontrollaufträge) based on a parliament resolution, upon the request of at least one third of the MPs or upon the request of the financial control committee of the parliament. Requests (Kontrollersuchen) may also be received from the governor or the government of the province. According to the Styrian Act on the audit office, those capital investment projects where the total cost of implementation is 2‰ higher than the effective appropriation, an audit must be conducted upon the request of the provincial government. The audit office prepares an expert opinion for the provincial government on each audited project. The audit criteria include compliance

LEVELS OF PUBLIC ADMINISTRATION IN GERMANY



Source: Wikipedia

with the cost appropriations and deadlines, implementation of the project according to the plans and compliance with the regulations (standards) for the equipment.

LEGISLATION AND PRACTICE IN GERMANY

The audit of local governments of the European country with the highest population (generating the highest GDP) depends on the historical structure of its public administration. The federal audit office *at the top* (*Bund*) of Chart 1 (*Bundesrechnungshof – BRH*) does not exercise any financial control over the local governments at all.¹⁴ *The second level* consists of thirteen provinces (*Flächenland*), which are also regional (district) local governments (*Regierungsbezirk*), as well as three city states (*Stadtstaat*). The provinces and the former Hansa cities (Hamburg, Bremen and Berlin) are the federal states forming the country

(*Bundesländer*). The settlements (*Gemeinden*) constitute the *third level* of public administration. The towns have different positions, because part of them (in total 116) are 'county boroughs' (*Kreisfreie Städte*), but the majority of them are 'integrated into' a provincial district. Statutory supervision over the minor settlements is exercised by the provincial offices, while the larger ones are 'exempt' from any superior official supervision (*Amtsfreie Gemeinden*).

The settlement structure of Germany (*see Table 2*) is similar to the Hungarian structure with the very significant difference that the average number of residents in the settlements is much higher than in Hungary: on average there are 7,000 residents in each settlement. In the German financial control terminology, there is a distinction between a 'local audit' (*örtliche Prüfung*) and 'external audit' (*überörtliche Prüfung*). The audits in the first category are performed by the audit offices of the towns.

Table 2

NUMBER AND POPULATION OF THE SETTLEMENTS IN THE PROVINCES

Province	Settlement	of which towns	average number of residents
Rheinland-Pfalz	2,306	123	1,758
Bayern	2,056	315	6,076
Schleswig-Holstein	1,119	64	2,533
Baden-Württemberg	1,108	311	9,692
Niedersachsen	1,022	164	7,811
Sachsen-Anhalt	1,016	121	2,403
Thüringen	968	127	2,388
Mecklenburg-Vorpommern	849	84	1,995
Sachsen	497	178	8,551
Hessen	426	189	14,261
Brandenburg	420	112	6,066
Nordrhein-Westfalen	396	268	45,527
Saarland	52	17	20,061
Bremen	2	2	331,990
Hamburg	1	1	11,754,182
Berlin	1	1	3,404,037
Deutschland	12,239	2,077	6,726

Source: Wikipedia

Regulation at provincial level

The legal regulations of each province define the concept (villages and towns are the basis and members of the state as a regional government of citizens, it promotes the welfare of its residents, it performs the tasks imposed on it by the province and the federal state; it defines the rights and obligations of the citizens to take part in local administration), its legal status, and scope of operation of a settlement. Apart from a lot of other issues, the legal regulations provide for the method of qualification into a town district (*Stadtkreise*) or large town (*Große Kreisstädte*) and lay down the rules of asset and fund management (*Sondervermögen, Treuhandvermögen*) accounting and the annual report. They also contain requirements for the internal audit and disclosure.¹⁵

The law on local governments of almost each province of Germany declares the need for a spe-

cial audit of the finances of the local governments (*Kassenprüfung*) by an independent external audit agency. This primarily assumes accounting (bookkeeping) and taxation issues. This external control-type audit is not directly defined by law. It may be considered as one subtype of the compliance audit (*Ordnungsmäßigkeit*). As it is well known, a compliance audit does not only focus on the accuracy of bookkeeping (*buchhalterische Korrektheit*), but also on general compliance with the law (*ganz allgemeine Rechtmäßigkeit*). It also checks whether or not public administration performs its tasks in accordance with the regulations and in an up-to-date fashion, whether or not it respects the basic principles and essential and formal requirements. The principle whereby the important matters must be managed properly has a priority (*materieller Richtigkeit*).¹⁶ Any matter is important if it had or may have a financial impact. The so-called *Kassenprüfung* also checks the accuracy of bookkeeping based on random selection. The report on these issues is the

basis for the exemption of the managers of the audited organisation from their economic liability. During the audit of bookkeeping, the following questions need to be answered: Are the revenue and expense documents available? Are the documents classified in a timely order? Are inventories kept in accordance with the regulations? Do the contracts and resolutions exist for the lawful wage and remuneration payments? Were there any unnecessary expenses (e.g., default interest)? Was the most favourable bid chosen in public procurements? etc.

All provinces (including also the three city states) have an audit office, but only some of them are directly responsible for controlling the financial reports of the local governments. The audit offices are autonomous both with regard to the federation and BRH. According to scientific research, the variable instruments used in the external independent financial control forming part of their activities, can be classified into five categories.¹⁷

■ The first group contains provinces (Saar Region, Brandenburg, Lower Saxony until 2005) applying the so-called integrated *authority* solution (*integrierte Behördenlösung*). In these provinces a separate office is responsible for the external audit (*Gemeindeprüfungsamt, Kommunales Prüfungsamt*). This office belongs to the Ministry of Interior or the district government or the provincial council office). The independent audits performed by this office constitute a public task, one of the components of the legal supervisory system of the state. In this context, its primary objective is to support the state supervision (*staatliche Kommunalaufsicht*) over the local governments. German experts also describe this type of external audit as (traditional) compliance audit, concentrating on compliance with the public regulations (*Rechtmäßigkeitsprüfung*) for the management of local governments. However, the activities of the offices also

reflect attempts for economic audits, such as for example with regard to the counties (*Landkreise*) and large towns (*kreisfreie Städte*) based on comparative indicators.¹⁸

■ The second group contains provinces applying the *institutional* solution (*Anstaltslösung*). In these provinces a separate public law institution assumes the tasks of the state and performs independent financial audits in local governments. They are supervised by the Ministry of Interior as the highest supervisory authority. The institution (*Gemeinde- oder Kommunalprüfungsanstalt*) is financed with the contributions of the audited local governments and the collected audit fees. The institutions may also provide consultation services in relation to the regular audits for a special fee. This solution also focuses on supporting state supervision. It also supports comparisons within the province and specialisation of the auditors. The institute is managed by a Board of Directors, which is chaired by a chairman. The chairman is appointed by the Minister of Interior for eight years. The members are elected for five years from the representatives of the association of local governments. The audits are limited to compliance audits (*Ordnungsmäßigkeitsprüfung*). This is explained by the rights of the settlements¹⁹ to have a local government, expressed in the constitution, and that the financial control of the local government is a partial function of state supervision. (At the same time, we must also note that the German Budget Act declares the principles of economy and efficiency.) The legislation of Baden-Württemberg, Lower Saxony and Northern Rhine Westphalia belongs to this category.

For example in Baden-Württemberg towns must establish an audit office (Rechnungsprüfungsamt), reporting directly to the mayor. In smaller settlements the supervisory authority (Rechtsaufsichtsbehörde), while in settlements

with more than 4,000 settlements a legally independent state control institution (Gemeindeprüfungsanstalt) performs the external audit (externe Revision der Kommunen. (This institute for example had a staff of 160 employees in 2006 and audited 1,503 financial statements. In addition, it also audited the accounts of 198 towns and villages, 717 associations of local governments and 133 foundation reports. It also audited the accounts of 226 construction projects and 14 hospitals and prepared 92 so-called Kassenprüfung. It provided consultancy services on organisation, efficiency and special professional issues in 250 cases.)²⁰ Both audit agencies report to the Ministry of Interior. Neither of them has a right to impose any sanction. During the quarterly audits the external audit agencies rely on the results of the 'local' audits related to the annual accounts and the final accounts.

■ The third group applies a *board-type* solution. There is only one province, Bavaria, in this group, where this model has existed since 1919. In this model the independent financial control and state supervision are strongly separated from each other. The first function is performed by an association (*Bayerischer Kommunalen Prüfungsverband*), subordinated only to the law and reporting to the Bavarian Minister of Interior. The association is led by a director and has a provincial committee and presidium. It is financed with contributions and expert fees. (The hourly audit fees are published on the website of the association.) The provincial law on local governments covers the external financial audit (*überörtliche Rechnungs- und Kassenprüfungen*)²¹. The association performs such audits as an authority only in the member local governments. Upon the members' request efficiency audits may also be performed in such local governments and expert opinions may be prepared or consultancy services may also be provided. The books and financial reports of those local govern-

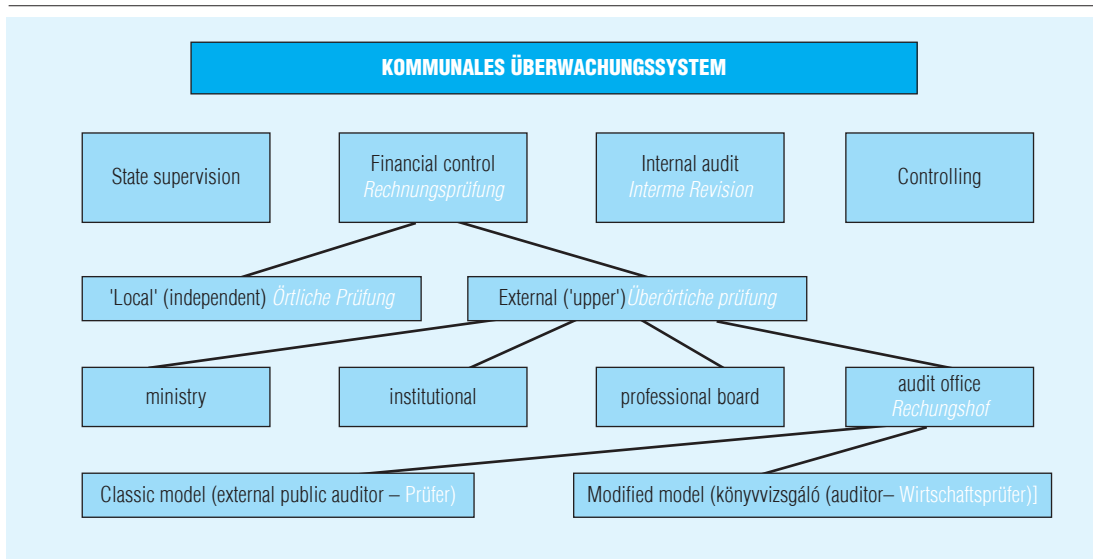
ments that are not members of the association are audited by the public offices of the provincial council (*staatliche Rechnungsprüfungsstellen der Landratsämter*).

The Bavarian local governments prepare consolidated financial statements, while their own companies and hospitals apply the same accounting principles as the businesses (kaufmännisches Rechnungswesen). Technical contents of the external audits, conducted every four years:

- *Review of the fundamental rules of the fund management of local governments and compliance with the budget;*
- *Review of incoming and outgoing payments, incomes and expenditures, revenues and costs, the consolidated annual report and variation of assets*
- *Compliance, efficiency and economy principles;*
- *Did the expenditures (including the insignificant staff and pocket expenses) lead to any result?*

■ The fourth group contains only those provinces which chose the so-called *classic audit office* solution (*klassische Rechnungshöflösung*). Part of their activities is the audit of the overall economic operation and budget of the local governments and their associations. The member of the audit office, responsible for this task, is also a member of the board of auditors, therefore he also has an influence on the audit findings related to the provincial budget. (It is well-known that the German Federal Audit Office operates as a board adopting its audit findings in the form of decisions made by auditor colleagues.) The provincial audit offices operating with the classic model are part of the supervisory system operated by both the state and local governments (*Überwachungssystem – see Chart 2*). They are primarily responsible for regulatory (compliance) and efficiency-type audits. This group contains Saxony, Mecklenburg-Forepomerany, Rhine-

SUPERVISORY SYSTEM OF THE GERMAN VILLAGES AND TOWNS



Pfalz, Schleswig-Holstein and Sachsen-Anhalt provinces.

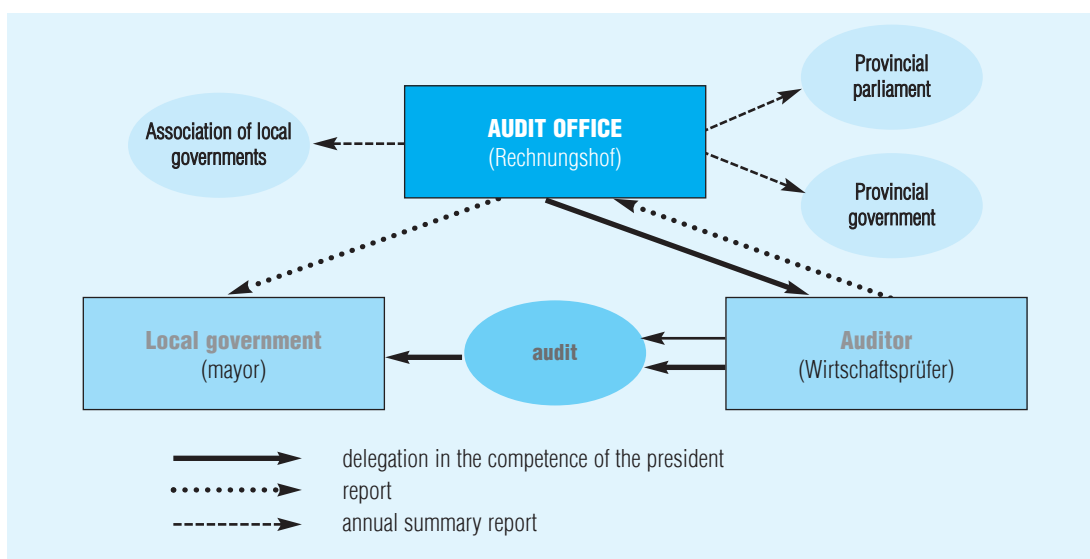
■ In the provinces (Hessen, Thüringen) forming the fifth group the competent external auditor is the audit office, but, compared to the previous group, these provinces chose a *modified audit office* solution. The most important feature of this solution is that the law gives the right to the president of the audit office to audit the local governments. In this model therefore the audit findings are not established in the form of decisions of audit colleagues. The decisions are made by the president of the audit office. He can designate the members of his own staff to perform audits or may also employ auditors, audit companies or any other suitable third parties for audits. Consequently, the audits are not performed by public servants (*Prüfungsbeamte*) therefore, this solution is also described as de-regulation, de-nationalisation or outsourcing, because the audit office does not directly audit the annual reports of the local governments.²² The law does not prescribe annual frequency for this task. LRH performs comparative audits in unspecific topics.

In Germany the federal audit office is not

authorised to audit local government, only part of the provincial audit offices audit the financial statements of the local governments. However, there is no audit vacuum in legislation. There is independent financial control over each local government at every 4–5 years instead of a yearly audit. Wherever it is not the responsibility of the audit office, it falls under the competence of the Ministry of Interior with the exception of Bavaria. In six provinces the audit offices directly audit bookkeeping and reporting, and in two provinces this responsibility is assigned to an external auditor or audit company. All this makes it possible that the law authorises the president of the audit office and not the office itself to conduct the audits. One example for this is province Hessen, the audit office of which 'outsourced' the audit type investigations, and it conducts comparative analyses. (See Chart 3) The audit offices also perform performance audits, in fact they prefer it to the 'classic' compliance audits. Some laws state that the audit office may leave certain accounts un-audited. Consequently, the Hessen audit office performs multi-lateral structural audits of the cer-

Chart 3

MODIFIED AUDIT MODEL (THE HESSEN MODEL)



tain local government layers, target professional associations and with regard to the overall provincial local administration primarily for the purpose of comparing the budget stability of the local governments. The audits are generally financed from the public funds of the province, and are supplemented with fees and contributions collected from the audited organisations. Regardless of who performs the independent external audit, the party is not authorised to impose sanctions. The reports are also sent to the competent public (provincial) authorities.

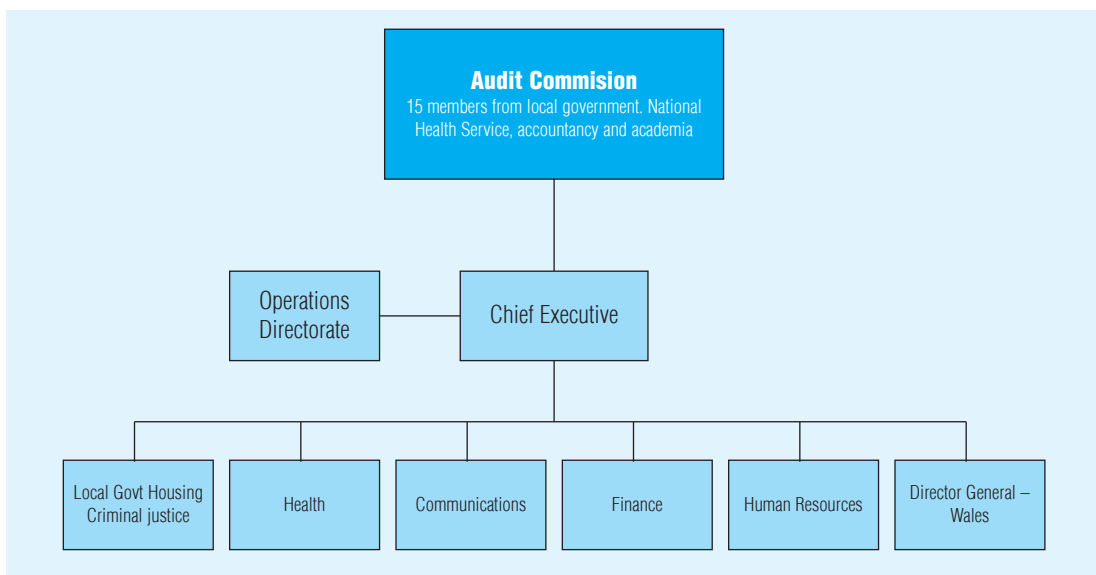
The audit reports of the audit of office usually summarise the findings of one year (Jahresbericht), but there are also some reports, which are prepared every two years²³. These are detailed reports on 200–300 pages. All audits are based on randomly selected samples (stichprobenweise Prüfung). The German law interpretation (similarly to Austria) is based on the assumption that local governments operate without violating the laws and regulations and fulfilling all their tasks specified by law. The expression of audit is not used in Germany.

LEGISLATION AND PROFESSIONAL REGULATIONS IN ENGLAND

Institutional framework of audit

In Britain the external financial audit of local governments and local authorities is the responsibility of a government commission (*Audit Commission for Local Authorities in England and Wales – AC*), which has been active since 1983. In 1990 the competence of the AC was extended to the *National Health Service*. In 2000, it was extended with the so-called 'best value inspections', applicable to certain services and functions of local governments. In 2003 the inspection of housing associations was also added to the tasks and competencies of AC. The AC appoints the auditor of the local governments (and any other regional agency) following consultation with the organisation to be audited. (The health authorities are exceptions from this rule.) The auditors could be employees of the *Operations Directorate*, i.e., extended arm of the AC or employees of a private audit company. The audited organisations do not have the option to select their own auditors individually.

TASK STRUCTURE AND ORGANISATION OF THE AUDIT COMMISSION



Source: Public Sector Audit Institutions in Europe (EURORAI, 2004) p. 112 Regional

AC receives a relatively low amount from the central government in the form of transfers. The majority of its revenues are audit fees and consideration for inspection work conducted at local governments and health services. The fees are established by the committee. The operations directorate and the employed private audit companies charge identical fees, because they fulfil the same role in the audit (audit of the reports). The members of the 15-member board are appointed by the deputy minister. The members are selected from a large group. (See Chart 4). Their tasks include the audit of the financial reports of local governments, health and other services (hotel service, fire brigade, civil defence, etc.), i.e., 11,000 public institutions (audited and inspected bodies). With its staff of 2,300 employees, the AC audits the financial reports of more than 250 local governments²⁴ and also conducts performance audits primarily with regard to health services. (The report of each local government is available on the Internet.) As an external independent agency (independent watchdog) it audits on behalf of the government and not the Parliament.

Comprehensive Performance Assessment – CPA

The effective British laws set a requirement to take measures for providing the best services not only for the local governments, but also for all local authorities (for example supervision of national parks, fire and disaster prevention agencies). At the same time, the audit commission was generally authorised to inspect such. In the initial period (2000–2001) there was a strong distinction between the audit of the financial reports and the other supervisory type audits, but later the two audit types were combined (*combined audit and inspection work*). The purpose of this measure was to provide the widest possible overview for the population on how its own local government performs its tasks compared to the other local governments in England (and Wales). The reports integrate audit- and supervisory-type findings. They are completed with the assessment of the capabilities of the local management in terms of community management.

In December 2002 the AC published the comparative reports of 150 local governments, and in 2003 and 2004 they published a comparative report of 238 district governments. In 2005 it developed and introduced a complex audit of 46 fire fighting and disaster prevention authorities, falling also under its competence. The group of local government bodies is significantly larger than that of local governments. The AC glossary classifies all the organisations here to which auditors are delegated on the basis of the effective legislation. Apart from the village and town councils, various authorities also belong to this group (police headquarters, fire fighting headquarters, national park supervisions, etc.).

The CPA also includes three types of customised audit procedures, developed for *three audit areas*:

- First the methods applicable to the *single tier and county councils (single tier and county councils)* (since 2002) and then
- To the *district councils (district councils)* and finally
- The *fire fighting and life saving authorities*.

The main purpose is to assist local authorities improve the quality of *residential services*. The professional contents of the audit system are the *measurement and assessment of the performance of local governments*, extending to the organisation and full range of their activities. The system framework is defined by a *four directional approach and evaluation*:

- ① Corporate assessment (*Corporate assessment*);
- ② Assessment of the use of resources (*Use of resources*);
- ③ Service assessment (*Service assessment*);
- ④ Direction of travel (*Direction of travel*).

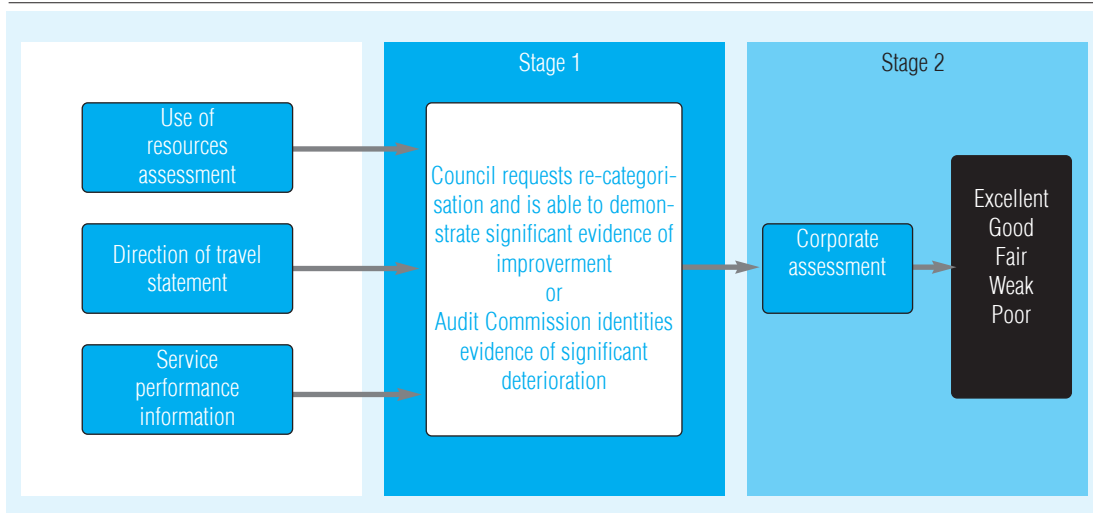
The CPA covers the review and evaluation of the entire of system of operation. It is a multi-dimensional *audit, "system control" model*, which evaluates the real financial and management processes simultaneously and collectively.

Its purpose is to assist improve the quality of operation of the local governments and make their activities *comparable*. The four directional approach applied to the various organisations requires various procedures. In this framework the AC (as indicated in *Chart 5*), in each local government *every three years*,

- Assesses *the quality of services*: the child and youth policy, care for old people, real estate (home) management (including energy and water supply, care for homeless people, etc.), environment and nature protection (waste and rubbish removal, etc.), cultural services (libraries, museums, sports opportunities, tourists services), fire protection and disaster prevention;
- Evaluates the *use of the resources* available for such activities (the financial position and finances, the financial report, the operation of the internal management system and the correlation between the expenditures and quality of services);
- Judges the *activities of the management board* (attempts, plans, ranking and decision-making capacities, willingness to learn, achievement of the set targets, etc.);
- 'Classifies' *the directions and intensity of development of the local government*.

The objectivity of CPA is based on the use of specific *performance indicators*, and quantification of *performance* between excellent and unacceptable. It uses sufficiently detailed criteria for providing the various grades. The results and outputs are summarised in tables by local government and are *published* also in aggregate tables. The 'marked' performance of any local government within a particular category (in line with the four-directional approach indicated above and also as an aggregate result) is *comparable to the mark of any other local government*. The detailed evaluations of the audited local governments are also accessible on the Internet.

CPA PROCEDURE FOR THE ASSESSMENT OF THE DISTRICT LOCAL GOVERNMENTS



The reports also vary. Apart from the audited local governments, they are used and read by the most interested external parties (public agencies, interest representation organisations, creditors, media, etc.). The reports are available on the AC website, which naturally does not only publish the reports, but presents also other important technical information (guidelines, indicators, legislative background, etc.).

The AC developed procedural guidelines for the independent financial audit of local governments, which are periodically revised and published.²⁵ These guidelines define the mission, nature, level and scope of the local audit work, covering all the activities of the organisation. As AC defined its own mission, it intends to be the driving force of development of local public services. In its interpretation external financial control is an important part in the process of accounting for public funds, but it is not the accounting function itself. This latter one is the competence and task of the government and not the financial audit agency. The AC practice significantly contributes to the good management of community funds and effective governance of public services (*corporate governance*).

The external auditors in the public sector primarily provide an independent opinion of the financial report of the audited agency, but their work is more than that: it also covers the review of the various measures of the local governments and the integration of the findings into a report. The three criteria, based on which AC distinguishes the independent financial audit of the public sector from that of the private sector are as follows:

- In the public sector the external auditors (external auditors of the public sectors) are appointed *independently* from the audited agency;
- The activities of the external auditors of the public sector do not only include the audit of the financial report, but also involve the *economy, efficiency and profitability* aspects of the management of the organisation and the managerial actions;
- The external auditors of the public sector may make their report summarising the results of their work *available for the public*.²⁶

It should also be mentioned that, in co-operation with other competent supervisory agencies (*other local services inspectorates*), AC has

also developed another evaluation system described as the Comprehensive Area Assessment (CAA). As the CPA system, it also has four main components:

- ① *Joint risk assessment*, performed with the agency supervising the local governments;
- ② Quantified evaluation of the *direction of travel (development)* for each local authority;
- ③ *Assessment of the use of resources* in each public institution;
- ④ *Publication* of the results and repeated evaluation of the national performance indicators.

Contrary to CPA, the CAA to be introduced in 2009 focuses on the operation, conditions and performance (outcomes) of a larger area instead of the individual local governments. The CAA is an innovative approach trying to find ways for *joint information collection and co-operation of the official agencies*. It tries to present the quality of the services provided by the various local government agencies and local authorities to the population. It gives a clear and objective evaluation of the success of operation of the local agencies in a particular zone for the purpose of improving the quality of life. As the generally presented information of this assessment is directly accessible for anyone, it may help citizens to call their representatives to account and join the decision-making processes.

The valid local government model in England and Wales has three ultimate goals:

- ① *Financial assessment* of the measures of the audited organisation in relation to
 - the legality of transactions (legality),
 - the financial position
 - internal financial control systems (internal financial control)
 - and the standards of financial conduct, prevention of corruption;
- ② *Audit* of the financial report of the agency;
- ③ *Assessment of the measures* of the organisation in relation to

- the economic, effective and profitable use of resources
- elaboration and publication of the special performance information (especially in the case of local government bodies)
- and compliance with statutory requirements.

This model implements the so-called integrated audit concept of the Audit Commission, according to which any work focusing on the assessment of a problem provides information for another assessment. In this context the activities of the auditors focus on a risk-based approach to audit planning (*risk-based approach to audit planning*). This reflects an overall assessment (overall assessment) of the relevant risk that is applied to the audited agency. According to this approach the auditors focus not only on savings, but also how local governments can use the savings for their own benefits. They give advice for the improvement of the quality of management in order to provide more effective services, but they do not participate in political decisions. One of the main objectives of AC is to learn the best practice of the local agencies and recommend it to other local governments.

Each healthy organisation would like to understand its own performance, therefore it measures it regularly to know whether or not it works well (and if it does, how well), and to get to know the opportunities to improve the situation. The AC relied on this concept when it renewed the *National Indicator Set (National Indicator Set)* of local governments. The competent ministry published a *set of 199 indicators* in May 2008. These indicators (*see Table 3*) try to supply professional information for the central government for managing the matters of local governments. In this context the vfm audit activities of AC mean *comparisons between local governments and publishing* the results thereof. The performance indicators collected from local governments indicating their performance (*performance indicators*) are

available also for the general public (Internet). The Government defines the 'best value' general indicators (*Best Value General Indicators*) and the list of service specific indicators. The local governments use them both for planning and the preparation of their reports (*reviews*) to assess their own performance. The AC complements the government indicators with its own performance indicators (*Audit Commission Performance Indicators*).

The independent financial audit reports on local governments are primarily addressed to the audited organisations. In England and Wales the reporting obligation and responsibility of the Audit Commission and the auditors are clearly distinguished. The AC must prepare annual reports. These reports are sent to the Secretary of State (*Secretary of State*) from where they are sent to both houses of Parliament. The law sets a requirement for AC to prepare studies (*the Commission must undertake studies*), in which it makes proposals to improve the efficiency of operation of local

governments (*recommendations for improving value for money in local government*). Each local government receives these studies, which are also available for the general public, and then they are also sent to the competent members of Parliament. If the reports contain proposals of any nature that fall within the scope of interest of the Central Government then the studies are also sent to the chief auditor of NAO.

Pursuant to the law, auditors have various reporting obligations:

- a certificate (*certificate*) stating that the financial report has been audited in compliance with the legislative requirements;
- opinion (*opinion*) on the financial report;
- statutory report (*statutory report*) for specific local governments on the audit of performance of their plans (*audit of the best value performance plan*);
- a letter addressed to the members of all elected bodies of the local government on the annual audit (*annual audit letter*), summarising the major audit findings.

Table 3

SOME NATIONAL INDICATORS APPLICABLE TO LOCAL GOVERNMENTS

Number	Indicator
5	general satisfaction with a local zone
8	sports and recreation of adults
9	use of public libraries
10	visits to museums and galleries
13	English language skills of immigrants
15	severely violent crimes
24	satisfaction with the actions of the police and local authorities against anti-social behaviour
28	crimes committed with arms
39	hospitalisation of alcohol addicts
47	number of people who died or were severely injured in road accidents
52	school meals (lunch)
54	services to handicapped children
57	participation of children in quality and spectator sport
117	people aged 16-18, who do not work or participate in education or further training
123	ban on smoking
129	final care for people who wish to die at home
151	ratio of employees among the people of active working age, etc.

CONCLUSIONS

Without aiming for completeness, we can draw some conclusions that are especially relevant for the financial audit of Hungarian local governments.

▶ In the analysed European countries the external financial audit of local governments is performed by significantly different *types of institutions*.

▶ The organisational and institutional solutions are not consistent even within *the individual states* (Germany, United Kingdom).

▶ The external financial audit of local governments is typically a task of *the government and not the audit office*. (The exceptions include some German provinces and the Austrian audit office in terms of its audits performed in towns with more than 20,000 residents.)

▶ The audit objectives (procedures) are declared in *high level regulations*. The audit tasks, competencies and responsibilities are clearly separated.

▶ The annual financial report of *each* local government is audited in one form or another every year (audit).

▶ In this field the independent *internal control* institutions have a very important role.

▶ The *professional contents* of the audits include the compliance (Ordnungsmässigkeit, financial audit) and performance audit aspects.

▶ While the external audit of the annual reports is *mandatory*, performance audits are rather optional.

▶ The audit methods are continuously developed, as a result of which the integrated audit has been established in the United Kingdom (CPA).

▶ The frequency of audits is one year for annual reports and *3–5 years* for other audits.

▶ *Private auditors* also perform audits in the public sector, based on assignments issued by the state control agencies and not by local governments.

▶ The audit procedures are identical in the *public and private sectors*, the financial auditors of the two sectors (private auditors, public auditors) co-operate with each other.

▶ Local governments generally *pay a fee* for the audits.

▶ The *auditors* have a high degree of *independence*, and assume responsibility in proportion to their independence.

NOTES

¹ This conclusion is clearly proved by a study written with a scientific approach and published a few years ago, the author of which deliberately did not distinguish between the concepts of the audit office, the court of accounts and the accountancy office. (Kinga Pétervári: Közpénzek – magánpénzek avagy a számvéveszéki ellenörzés alkotmányjogi problémái (Public funds – private funds or the problems of a State Audit Office audit under the constitutional law. Gondolat. Budapest, 2004, pp. 61–86.) The consultants and opponents of this PhD thesis, referred to as a 'masterpiece' of PhD theses, were well-known university teachers and constitutional judges.

² See the provisions of the original Article 2 (5) of the Act on the State Audit Office. Parliament passed the Act on 30 October 1989. Date of promulgation: 10

November 1989. The quoted provisions remained effective for years following the approval of the Act on local governments in 1990.

³ AO published a press release on its website about a co-operation agreement signed by its president and the chairman of the Hungarian Chamber of Auditors when the manuscript of this study was closed.

⁴ Bundes-Verfassungsgesetz, Chapter V (Rechnungs- und Gebarungskontrolle) Stand 10. April 1995

⁵ The Austrian Constitution contains unique provisions regulating the audit of local governments (Bundesrechnungsabschluss), which is similar to the solution whereby the final accounts of the state are prepared and submitted to Parliament by ÖRH. Another unique rule is that each document

- on a national debt or public commitment must be countersigned by the president of ÖRH or his deputy. (However, such a countersignature applies only to the legitimacy of the debt ensuring that the debt is regularly entered into the public general ledger.)
- ⁶ Rechnungshofgesetz, Bundesgesetz vom 16. Juni 1948 über den Rechnungshof
- ⁷ Regionale externe Finanzkontrolle (2. überarbeitete und erweiterte Auflage) EURORAI, 2001
- ⁸ Prüfbericht über die finanzielle Kontrolle der Gemeinden durch die Abteilung Gebarungskontrolle (IIIc). Bregenz, im Juni 2006
- ⁹ Verfassung der Bundeshauptstadt Wien (Wiener Stadtverfassung – WStV)
- ¹⁰ Landes-Verfassungsgesetz über die Verfassung des Burgenlandes. Artikel 74. Aufgaben des Landes-Rechnungshofes, Paragraph (2), Point 6
- ¹¹ The chairman of the 80-member Österreich-Konvent (active between June 2003 and end of January 2005), dedicated to the preparation of the state and constitution reform, was Dr. Franz Fiedler, former President of the Austrian Audit Office.
- ¹² This is one of the dilemmas described by Tanja Koller for the authors of the Constitution: Die Neuerungen für den Rechnungshof – insbesondere die Überprüfung der Gebarung von Gemeinden und Gemeindeverbänden durch Landeskontrollenrichtungen, *Journal für Rechtspolitik* 15, 322 – 330 (2007)
- ¹³ Neuhofer, H.: *Gemeinderecht*. Zweite, völlig neuarbeitete Ausgabe, pp. 505–507, Springer, Vienna – New York
- ¹⁴ For more details see: Zavelberg, H. G.: *Die Kontrolle der Staatsfinanzen*, Duncker & Humblot, Berlin, 1989
- ¹⁵ See, e.g., *Gemeindeordnung für Baden-Württemberg in der Fassung vom 24. Juli 2000*
- ¹⁶ For details see *Regionale externe Finanzkontrolle (Eine vergleichende Studie) 2. überarbeitete und erweiterte Auflage*, EURORAI, 2001
- ¹⁷ Binus, K.H.: *Überörtliche Kommunalprüfung*. Dissertation Martin-Luther-Universität, Halle-Wittenberg, 2005
- ¹⁸ See for example *Zusammenfassender Bericht zur überörtlichen Prüfung (Energiemanagement in den Landkreisen und kreisfreien Städten des Landes Brandenburg)* Ministerium des Innern, Kommunales Prüfungsamt. Potsdam, 14. 11. 2006
- ¹⁹ See the German Constitution (Grundgesetz, Art. 28)
- ²⁰ See the 2007 annual report of the provincial institute http://www.gpabw.de/gbericht/taetigkeiten_der_gpa.htm#Statistik
- ²¹ *Gemeindeordnung für den Freistaat Bayern in der Fassung der Bekanntmachung vom 22. August 1998*
- ²² Vetzberger, K.: *Die überörtliche Rechnungsprüfung in Thüringen*. Landes- und Kommunalverwaltung (*Zeitschrift*) 2001, pp. 546–548
- ²³ See for example: *Thüringer Rechnungshof Bemerkungen 1995 zur Haushalts- und Wirtschaftsführung mit Bemerkungen zu den Haushaltsrechnungen 1992 und 1993*
- ²⁴ The structure of settlements in England is fundamentally different from the residential structure of Central or Southern Europe; there are significantly fewer settlements than for example in Hungary. However, it has twice as many local governments as settlements, which is explained with the segmentation of towns into districts.
- ²⁵ *Code of Audit Practice for local government bodies*. First published in March 2005 by the Audit Commission for local authorities and the National Health Service in England
- ²⁶ These characteristic features of the audit of public funds are in line with the position of the Public Audit Forum, which includes all the national audit agencies of the United Kingdom.