

Accuracy of Annual Accounts 2016 and regularity of transactions of the state

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Summary of audit results

What did we audit?

The State Budget Act requires the NAO to audit the accuracy of the annual accounts and the regularity of transactions of the state on an annual basis. The annual accounts of the state consolidate the financial statements of all state accounting entities, state-controlled companies, state-established foundations, and the profit-making state agency.

To provide an opinion on the accuracy of the annual accounts of the state and the legality of its transactions, the NAO conducted audit operations at the ministries to examine the compliance of economic transactions conducted in 2016 with the State Budget Acts, the State Assets Act and the Public Procurement Act, and determine whether items which are relevant in terms of the state's report have been correctly recognised in the financial statements of the ministries. The results of conducted audit operations are set out in the audit reports which the NAO has prepared for each Ministry. The financial audit reports are available on the website of the NAO.

The NAO examined whether the state's annual accounts provide true information about the state's financial position and performance for the year ended and whether state agencies have adhered to budget acts while performing their economic transactions.

Further, the report contains an overview of the implementation of government reform but the NAO abstains from expressing its opinion on that matter.

What was the scope of our audit?

The annual accounts of the state contain the financial indicators of public undertakings, foundations controlled by the state and profit-making state agency. The annual accounts of companies, foundations and profit-making state agency were audited by certified auditors. The NAO considered the opinions of certified auditors when expressing its opinion of the annual accounts of the state. The certified auditors who provided their opinions on the annual accounts of foundations, companies and the profit-making state agency did not assess the regularity of their transactions (except for the companies and foundations listed in Annex 1 hereto) and the NAO has not performed any additional activities in this respect.

The NAO did not carry out audit procedures to check the additional information about local authorities, the public sector and the government

sector disclosed in the Consolidated Annual Report of the State because, according to the State Budget Act, this is not the NAO's duty.

Why is this important for the taxpayers?

The Consolidated Annual Report of the State endorsed by the Government of the Republic, accompanied by the NAO's audit report concerning it, is submitted to the Riigikogu for approval. The consolidated annual report of the state is the only financial statement provided to the Riigikogu - the user of the report.

According to the Accounting Act, the purpose of submitting the annual accounts of the state is to allow the Riigikogu to exercise control over the government, give the government the opportunity to explain its activities during the accounting year and provide the Riigikogu with necessary information for adopting new budgeting decisions.

By auditing the state's annual accounts the NAO provides assurance that the accounting indicators presented to the Riigikogu and the public provide true information about the state's financial position and performance for the year ended and that the State Budget Implementation Report includes relevant information about the state's revenue as well as expenditure, investments and financing operations made on the account of such revenue.

According to the 2016 State Budget Implementation Report, the revenue collected by the state in 2016 amounted to 8.58 billion euros, which exceeded the revenue of 2015 by 594 million euros. The expenditure and investments incurred by the state amounted to 8.55 billion euros, which exceeded the corresponding indicator for 2015 by 210 million euros. In 2016, the revenue exceeded expenditure and investments by 34 million euros (NB! It is not a surplus or deficit of the government sector which is calculated using other calculation methods - for more information see sub-chapter "Government Sector Surplus/Deficit" of chapter "Financial Indicators for Public and Finance Sector" of the management report within the 2016 Consolidated Annual Report of the State).

According to the consolidated annual accounts of the state, the assets of the state as at 31 December 2016 amounted to 16.5 billion euros whereas the majority were fixed assets (forests, roads, buildings and machinery). Compared to the preceding period, the monetary value of assets has increased by 171 million euros.

As at 31 December 2016, the state's liabilities totalled 7.4 billion euros - an increase of 338 million euros compared to the preceding period. Long-term liabilities of 4.88 billion euros comprise the majority of liabilities. The state's loan commitments amount to 2.9 billion euros, having decreased by 16 million euros compared to the preceding period. The pension commitments of the state amount to approximately 2 billion euros.

What did we conclude as a result of the audit?

The 2016 Annual Accounts of the State are correct in all material respects - save for the qualification on the value of fixed assets - which means that they give a true and fair view of the state's financial position as well as its financial performance and cash flow for the year ended.

The NAO issues a comment on the fixed assets of AS Eesti Raudtee amounting to 184.7 million euros as recognised under item “Tangible fixed assets” on the consolidated balance sheet of the state because there were indications that the value of said assets might have fallen.

The accounting of state agencies, state-controlled foundations and companies, and the profit-making state agency is well managed in most part and most annual accounts are free of material errors.

The NAO finds that the 2016 Budget Implementation Report of the state which shows budgetary revenue of 8.58 billion euros, expenses of 8.25 billion euros, investments of 299.34 million euros and financing operations of 26.49 million euros provides reliable information on the state’s revenue (incl. grants received), expenditure, investments and financing operations.

The NAO is of the opinion that the economic transactions of the state have in all material respects been carried out in compliance with the State Budget Act, the 2016 State Budget Act and the 2016 State Budget Act Amendment Act. This means that the NAO did not find any significant errors in the implementation of the State Budget Acts.

The main observations of the NAO are as follows:

- **As the optimal size of the Stabilisation Reserve Fund is not laid down by law and the Ministry of Finance has not provided its assessment, there is no idea as to the amount to be held in the fund for it to be sufficient in a crisis.** For instance, such reserve funds have been set up and their required size determined by the Estonian Unemployment Insurance Fund (EUIF), the Estonian Health Insurance Fund (EHIF) and the Bank of Estonia as well as commercial banks.
- **According to the Estonian Health Insurance Fund Act and the Unemployment Insurance Act, EUIF and EHIF may not use their money for any purpose other than that laid down by their respective Acts. The Ministry of Finance has used their money for making payments on behalf of the state which is in conflict with the aforesaid Acts.** The NAO points out that the money of the EHIF and the EUIF held on the group accounts of the state belongs to those public law entities, i.e. that money is the property of the Health Insurance Fund and the Unemployment Insurance Fund. According to the law, the Ministry of Finance may hold and invest the money on those accounts, effect their payments and settlements, and render payment services to them.
- **The EHIF and EUIF legal reserves amounting to 129.3 million euros as at 31 December 2016 should, due to their nature, be placed in the Stabilisation Reserve Fund (SRF) instead of the Liquidity Reserve** where different rules apply to holding, investment and deployment of funds. Similarly to the SRF, the EHIF and EUIF are required to maintain a legal reserve to mitigate the risks stemming from macroeconomic changes, and this reserve may be deployed only in emergency situations following a specific decision to that end.

- **The state budget should be more accurate and its explanatory memorandum should better clarify the substantive aspects and be more uniform.** During the audit of the state budget implementation report, the NAO learned that the totals in the 2016 State Budget Act had not been adjusted following the amendments made during the processing of the draft act, and that the calculations for deriving the sectoral totals contained errors. Having analysed the explanatory memorandum to the 2016 state budget, the NAO concluded it was of uneven quality, and it lacked explanations for some expenditure, featured notable changes in revenue and expenditure, and contained excessive information that was not helpful for reading the budget. At the time of drawing up the explanatory memorandum, there were no specific requirements in place for such memoranda.
- **Activity-based state budgets might not be the most effective method for ensuring more efficient use of money.** The Riigikogu has adopted the State Budget Act Amendment Act whereby it has decided to make the transition to activity-based budgeting by 2020. However, no objectives, methods or action plans for this transition have been laid down although the actual transition has already begun.

What did we recommend as a result of the audit?

Important recommendations of the NAO to the Minister of Finance and the Minister of Public Administration:

- devise principles for determining the optimal size of the Stabilisation Reserve Fund by assessing the nature and amount of any emergency expenditure to ensure the availability of sufficient reserves;
- initiate the mutual alignment of the State Budget Act, the Estonian Health Insurance Fund Act and the Unemployment Insurance Act provided that using the money of the EHIF and EUIF for making payments on behalf of the state is in line with the nature and functions of these two public law entities;
- place the legal reserves of the EHIF and EUIF in the Stabilisation Reserve Fund, reassess the target level for the amount of money in the Liquidity Reserve and ensure the availability of sufficient reserves;
- set out specific requirements for the composition of information provided in the explanatory memorandum to the annual state budget, and coordinate the drafting of that memorandum so as to ensure uniform quality of information therein;
- analyse the necessity of making the transition to activity-based budgeting, and - provided that it is decided to continue with the process - lay down the principles for activity-based budgeting and the action plan for transition.

Response of the Minister of Finance and the Minister of Public Administration: the Ministers agreed with most of the recommendations made by the NAO - save for those concerning the management and use of national reserve funds - and undertook to take them into account.

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Opinion on the accuracy of the Annual Accounts 2016 and the regularity of transactions of the state

Provided that the qualification is disregarded, the state's annual accounts are accurate in all material respects

Accuracy of annual accounts

1. The annual accounts of the state which indicate that the consolidated net result of the state in 2016 was -139,074,451 euros and the consolidated balance sheet total as at 31 December 2016 was 16,463,514,853 euros provide - in all material respects, save for the comment on the value of fixed assets - a true and fair view of the state's financial position, financial performance and cash flows during the ended accounting period, in accordance with the generally accepted accounting principles of Estonia.

2. In the opinion of the NAO, the accounting management in state agencies is sound in general.

The balance recognised for the item "Tangible fixed assets" might be inaccurate

Qualification on the value of fixed assets

3. The consolidated balance sheet item "Tangible fixed assets" amounting to 8.35 billion euros as set out in the state's annual accounts reflects, among other things, the fixed assets of AS Eesti Raudtee amount to 280.8 million euros.

4. The certified auditor of AS Eesti Raudtee has issued a qualified opinion on the company's annual accounts. The auditor's comment relates to the book value of the company's tangible fixed assets totalling 187.4 million euros as at 31 December 2016. On the balance sheet date, there were indications (situation on the freight market, i.e. continuous shrinking of freight capacities since 2012, and the management's forecasts for future developments on the market) that the value of said assets may have decreased. Therefore, corporate management conducted an **asset value test** to identify the potential need to write down the assets.

5. The certified auditor was unable to obtain reasonable assurance that the inputs and premises used by the management for conducting the test were justified. Hence, the auditor was not able to determine whether and to what extent the **recoverable amount** of tangible fixed assets as at 31 December 2016 and 31 December 2015 remained below its residual book value, and whether, to what extent and for which period the loss from write-down should have been recognised.

6. The public sector financial accounting and reporting guidelines¹ contain a principle that consolidated reports must consolidate subsidiaries under **dominant influence (i.e. controlled)**, incl. AS Eesti Raudtee, using the line-by-line method which means that any write-downs of the company's assets will affect the value of tangible fixed assets on the consolidated balance sheet of the state.

Asset value test – test carried out to determine the potential need for write-down of assets. During value test, the estimated sale price or instrumental value of the asset (so-called **recoverable amount**) is determined, and if both are smaller than the balance sheet value of the asset, the asset must be written down.

A subsidiary is considered to be under **dominant influence**, if the reporting entity owns more than 50% of the subsidiary's voting shares, or has control over the subsidiary's operational or financial policies, or has the right to appoint or remove most of the Supervisory Board Members.

¹ Regulation No. 105 of the Minister of Finance that was titled General Rules of State Accountancy until 31 December 2016, and renamed as Public Sector Financial Accounting and Reporting Guidelines as from 1 January 2017.

7. In view of the aforesaid, the NAO auditors were unable to obtain sufficient evidence supporting the need to write down the consolidated balance for item “Tangible fixed assets” on the state’s balance sheet, or to increase the expensed amount under income statement item “Depreciation and value adjustment of fixed assets”. Further, the situation described above affects the balance for balance sheet item “Shareholdings in public sector and associated undertakings” in the unconsolidated accounts, and for income statement item “Financial income and expenses”.

The accounting in foundations and companies controlled by the state and in the profit-making state agency is generally sound

Opinions of auditors on the annual reports of companies and foundations controlled by the state and of the profit-making state agency

8. The annual accounts of the state contain the financial indicators of companies and foundations controlled by the state and of the profit-making state agency. Certified auditors have audited the annual accounts of these entities, and the NAO has taken their opinion into account in expressing an opinion on the state’s annual accounts.

9. In most cases, certified auditors have issued unqualified opinions on the annual accounts for 2016 of state-controlled companies and foundations and the profit-making state agency (also, see Annexes 2 and 3), except for opinions on the annual accounts of AS Eesti Raudtee, AS Nordic Aviation Group, Hiiumaa Museums Foundation and Rail Baltic Estonia OÜ . The opinion of the NAO on accuracy of the annual accounts of the state was affected by the certified auditor’s qualified opinion on the annual accounts of AS Eesti Raudtee (see paragraphs 3 to 7).

Observations on the annual accounts of AS Eesti Energia

10. The certified auditor who audited the annual accounts of AS Eesti Energia issued an unqualified opinion. Given the level of relevance as determined by the NAO, the certified auditor informed the NAO about circumstances implying that the company’s assets might be overvalued by up to 3.3 million euros and its equity capital and profit for the reporting year by up to 4.3 million, and that its liabilities might be undervalued by 1 million euros.

11. Such observations originated from the following:

- the auditor was unable to obtain reasonable assurance that the inputs and premises used by the management for conducting a value test for the tangible fixed assets of its subsidiary Enefit Solutios AS were justified;
- the company had not recognised in its equity capital and income statement the results of the efficiency test conducted for the derivatives classified as hedging instruments;
- in the 2016 financial year, the company has applied an inaccurate calculation formula for determining the amount of CO₂ allowances used for its operations meaning that the provision made for CO₂ allowances is incorrect too.

Predominantly, the budget funds were used in accordance with the State Budget Acts

Compliance with State Budget Acts

12. According to the State Budget Implementation Report, the state’s revenue in 2016 amounted to 8,584,553,739 euros, expenditure to

8,251,062,222 euros, investments to 299,341,000 euros, and financing transactions to 26,486,927 euros. The National Audit Office is of the opinion that the state's economic transactions were performed in all material respects in accordance with the State Budget Act, the 2016 State Budget Act and its amendment act.

Management and use of national reserve funds

In five years, the Stabilisation Reserve Fund has grown by one-fifth but the government has yet to develop criteria for determining the optimal size of the Fund

Stabilisation Reserve Fund

Stabilisation Reserve Fund - a vital financial buffer used by the government to provide financing in potential crisis situations.

13. The state has two reserve funds: the Stabilisation Reserve Fund and the Liquidity Reserve. The purpose of the **Stabilisation Reserve Fund** (SRF) is to cover extraordinary expenses on managing overall economic risks or preventing or mitigating socio-economic, financial or other crises. The SRF can be put into use only following a decision by the Riigikogu. It is managed by the State Treasury Department of the Ministry of Finance.

14. The SRF is a pool of assets made up by state budget funds and other proceeds. Established in 1997, it originally amounted to 45.2 million euros (701.6 million Estonian kroons). In 1998-1999, it was used to satisfy claims assigned by the customers of Eesti Maapank amounting to 17 million euros. In 2009, 224 million euros were withdrawn from the SRF to mitigate macroeconomic risks resulting from the global economic crisis.

15. According to the State Budget Act, the SRF is increased on account of:

- funds earmarked as such in the state budget;
- funds transferred to the Stabilisation Reserve Fund according to the decision on distributing the surplus of the unconsolidated cash flows of the state;
- revenue from the privatisation of state assets;
- amounts allocated to the state budget from the profits of the Bank of Estonia;
- revenue from the administration of the Stabilisation Reserve Fund;
- other financial means prescribed by law.

16. As at 31 December 2016, the SRF amounted to 406 million euros (see Table 1), having grown by nearly 73 million over the last five years (see Table 1). The reserve fund has grown mainly on the account of annual profit allocations from the Bank of Estonia (31.9 million euros) and the surplus of the unconsolidated cash flows of the state (24.7 million euros in 2015).

17. In this context, it should be noted that on 19 July 2017 the Riigikogu adopted the State Budget Act Amendment Act. The said Act provides that

in 2018 the government may use the budget surplus from preceding years towards the planned deficit for the current year which means abandoning the applicable budget balance rule which stated that the expenditure for the budget year may not exceed revenue for that year.

18. Using this option gives rise to an increased risk that the surplus of the unconsolidated cash flows of the state is no longer placed in the SRF as such surplus might not be generated. Revenues from privatisation (total of 10.6 million euros in the last five years) as well as revenues from the administration of the reserve fund (total of 6.2 million euros in the last five years) are relatively small and do not boost the reserve fund considerably. The allocation from the profits of the Bank of Estonia has been higher, varying from 5 to 8.5 million euros across the years.

19. Hence, there is an increased risk that abolishing the annual budget balance requirement notably downsizes the contributions to the SRF, plus the Ministry of Finance has not devised an alternative solution to compensate for this.

20. The Government of the Republic has laid down rules for determining the liquidity provision target level (also, see paragraphs 22 to 26 and 38 to 43) in its regulation but there are none for calculating the optimal size of the SRF. It should be noted that the SRF is an important reserve fund for mitigating the effects of potential crises.

21. Therefore, the NAO believes that the Ministry of Finance should assess the nature and level of potential emergency expenses, devise criteria for determining the optimal size of the SRF, and ensure the availability of sufficient reserves as the money currently held in the SRF might not be sufficient in a crisis situation. For instance, such reserve funds have been set up and their required size determined by the Estonian Unemployment Insurance Fund (EUIF), the Estonian Health Insurance Fund (EHIF) and the Bank of Estonia as well as commercial banks.

Table 1. Market value of reserves 31.12.2011–31.05.2017, incl. the market value of the Liquidity Reserve, by entity, in EUR

	31.12.2011	31.12.2012	31.12.2013	31.12.2014	31.12.2015	31.12.2016	31.05.2017
Stabilisation Reserve Fund	332,978,128	347,032,206	360,903,427	368,913,286	398,489,324	405,945,665	413,110,880
Liquidity Reserve, incl.	604,891,317	1,106,153,630	1,055,320,607	1,125,002,855	747,875,039- fold	784,905,140- fold	709,027,618- fold
<i>state (central government)</i>	<i>278,686,723</i>	<i>306,415,275</i>	<i>204,571,764</i>	<i>197,995,132</i>	<i>-331,623,420</i>	<i>-355,158,484</i>	<i>-501,907,662</i>
<i>total for other entities:</i>	<i>326,204,594</i>	<i>799,738,355</i>	<i>850,748,843</i>	<i>927,007,723</i>	<i>1,079,498,459</i>	<i>1,140,063,625</i>	<i>1,210,935,280</i>
▪ EHIF	164,403,584	204,299,859	199,640,561	176,345,702	152,881,144	119,620,328	109,127,085
▪ EUIF	0	471,681,157	535,539,346	613,020,065	663,193,276	702,373,457	752,929,231
▪ foundations	146,504,510	112,336,421	108,941,724	119,690,222	238,154,600	274,857,902	322,089,252
▪ European Commission	15,296,500	11,420,919	6,627,213	17,951,734	25,269,440	43,211,937	26,789,712
Total reserves	937,878,445	1,453,185,837	1,416,224,034	1,493,916,140	1,146,364,363	1,190,850,805	1,122,138,498

Source: Statements of state reserves by the State Treasury Department of the Ministry of Finance, data for the Treasury

Liquidity Reserve

Funds held by the central government means funds, held and invested on statutory or contractual basis, of legal entities in

public law, government-established or government-invested private law legal entities, or private law legal entities that perform administrative functions of the state.

Central government as defined by the NAO means all the ministries, including their government areas, and the Government Office and constitutional institutions.

Compared to previous years, the Liquidity Reserve has notably shrunk due to the central government's negative cash flows

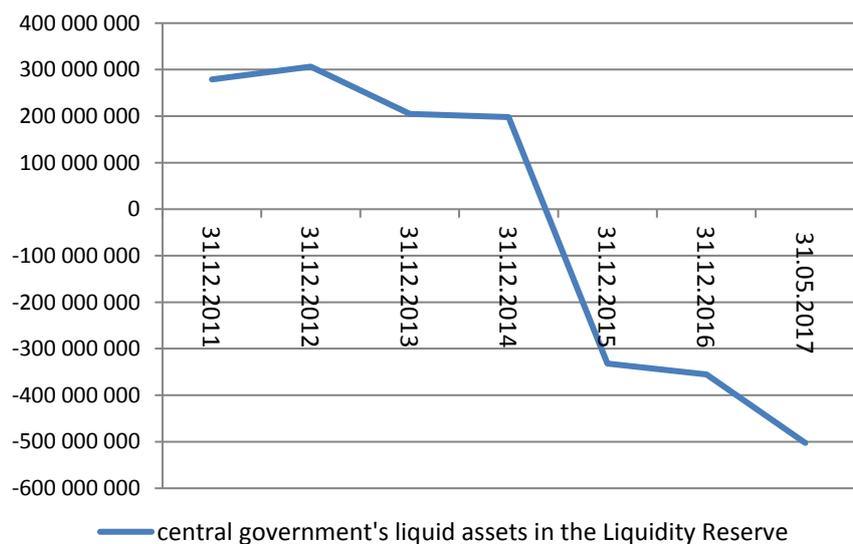
22. Financial assets that are not included in the Stabilisation Reserve Fund, i.e. the **funds held by the central government** as well as securities and other financial assets, make up the state's liquid financial assets - the Liquidity Reserve.

23. In addition to the money of the **central government**, the Liquidity Reserve includes the money of the Estonian Health Insurance Fund, the Estonian Unemployment Insurance Fund, state-controlled foundations, and the money prepaid by the European Commission towards EU aid. The SRF is maintained especially for crisis situations, whereas the Liquidity Reserve is used for everyday payments and investments of the central government and the aforesaid entities.

24. Table 1 shows that in 2012 **the size of the Liquidity Reserve nearly doubled as compared to 2011** (grew by 501 million euros). This is because as from December 2011 the money and reserves of the EHIF and as from 2012 the money and reserves of the EUIF were merged with central government's money and are held on a current account within the group accounts of the state.

25. Further, Table 1 demonstrates that as from 2015 the size of the Liquidity Reserve has shrunk by one-third in comparison to the preceding years because the amount of central government's liquid assets within the Liquidity Reserve has plummeted. Figure 1 shows that, compared to 2015, the central government's negative share in the reserve fund (see Table 1, line "state (central government)") has further increased as of 31 May 2017, exceeding 500 million euros and accounting for over 41% of the total amount for other entities.

Figure 1. Amount of the central government's liquid assets in the Liquidity Reserve from 31.12.2011 to 31.12.2017 (in EUR)



Source: NAO's calculations based on the statements of state reserves by the State Treasury Department of the Ministry of Finance

Bridge financing – disbursement of funds with the support of the state before actually receiving foreign aid funding. Once the foreign funding is received, the money obtained as bridge financing must be returned to the state budget.

Use of money of the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund

Holding of money means ensuring the preservation of money of other entities and managing settlements of their behalf.

Investing of money means the effecting of transactions involving securities and deposits to earn profits from the money that is not needed for making expenses at the material time.

26. According to the Ministry of Finance, the plummeting of central government's liquid assets is due to the negative cash flows for the state budget. This means that the central government's payments exceed proceeds. The Ministry finds that this is due to the disbursement of EU structural aid towards which the EU hasn't transferred the funds yet. Hence, **bridge financing** has been used to disburse funds to the beneficiaries.

Using the reserves of the Health Insurance Fund and the Unemployment Insurance Fund for solving the central government's liquidity problems is inappropriate

27. As the central government itself holds no liquid assets (i.e. daily expenditure notably exceeds any proceeds), the Ministry of Finance has used the money (incl. reserves) of the EHIF and the EUIF which are part of the Liquidity Reserve and have been entrusted with the Ministry. However, the NAO finds that such use is not compatible with the legislation.

28. The NAO points out that the money of the EHIF and the EUIF held on the group accounts of the state constitutes the property of those two entities. According to the law, the Ministry of Finance may **hold and invest** that money, use it to effect payments and settlements of the EHIF and the EUIF, and render payment services to them.

29. The Estonian Health Insurance Fund Act/Unemployment Insurance Act provide that the EHIF/EUIF are public law entities which may not grant loans or secure the (loan) commitments of other entities and set out the intended purpose of using their money. The said Acts provide that the EHIF and the EUIF shall, according to a holding agreement entered into with the state, hold their money (money plus funds placed in the reserves) on a current account within the group accounts of the state, and make payments using that account. Hence, the said two Funds may not use their money for any purpose other than that laid down by their respective Acts.

30. The NAO wrote already last year that the State Budget Act, the Estonian Health Insurance Fund Act or the Unemployment Insurance Act do not authorise the Ministry of Finance to use the money of the EHIF/EUIF beyond those Funds' own payments, i.e. for effecting payments on behalf of the state either on temporary or more permanent basis. Such actions require an unambiguous permission/decision from the Riigikogu in the form of legislative provisions to avoid legal disputes and different interpretations and ensure legal clarity.

31. The Ministry of Finance has supplemented the section on holding and investing the money of other entities within the State Budget Act Amendment Act adopted on 19 June 2017 with the Ministry's right to use the money so held. However, there has been no motion to amend the Estonian Health Insurance Fund Act or the Unemployment Insurance Act accordingly. The NAO finds that supplementing the State Budget Act does not award the Ministry of Finance the right to use the money of EHIF/EUIF - two public law entities - because according to the Estonian Health Insurance Fund Act and the Unemployment Insurance Act, the Ministry may only hold and invest their money, and agreements with

those entities have been entered into for that purpose only. Hence, the current activities of the Ministry of Finance contradict the law.

Some of the EHIF/EUIF money held and invested by the Ministry of Finance should be placed in the Stabilisation Reserve Fund

Legal reserves of the Health Insurance Fund and the Unemployment Insurance Fund

32. As mentioned above, pursuant to the Estonian Health Insurance Fund Act and the Unemployment Insurance Act, the EHIF and the EUIF hold their legal reserves on a current account within the group accounts of the state, and make payments using that account. To this end, both entities have signed a holding agreement with the Ministry of Finance.

33. According to the 2016 Annual Accounts of the EHIF, as at 31 December 2016, the Ministry is holding a total of 119.6 million euros whereof 60.8 million as EHIF's legal reserves.

34. According to the 2016 Annual Accounts of the EUIF, as at 31 December 2016, the Ministry is holding a total of 702.4 million euros whereof 68.5 million as EUIF's legal reserves.

35. The Estonian Health Insurance Fund Act reads that the legal reserve of the Fund is a reserve fund made up of its budgetary means to mitigate risks to the health insurance system that arise from macroeconomic changes. The legal reserve may be deployed only in an emergency and on the basis of a Government Order following a proposal from the minister responsible for this policy sphere. Before making such a proposal to the cabinet of ministers, the responsible minister will hear the opinion of the EHIF Supervisory Board.

36. The Unemployment Insurance Act reads that the legal reserve of the Fund is a reserve fund made up of its budgetary means to mitigate risks to the unemployment insurance system that arise from macroeconomic changes. The legal reserve may be deployed only on the basis of a decision of the EUIF Supervisory Board in an emergency situation where the money in the EUIF's earmarked fund proves to be insufficient. Before making the corresponding decision, the Supervisory Board shall, through the responsible minister, submit a proposal to the cabinet of ministers for increasing the rate of the unemployment insurance premium to a level that ensures the collection of sufficient funds to meet the objectives of the EUIF.

37. The NAO finds that the EHIF and EUIF legal reserves totalling 129.3 million euros as at 31 December 2016 should, due to their nature, be placed in the Stabilisation Reserve Fund (SRF) instead of the Liquidity Reserve where different rules apply to holding, investment and deployment of funds. Similarly to the Stabilisation Reserve Fund, the Health Insurance Fund and the Unemployment Insurance Fund are required to maintain their legal reserves to manage any risks arising from macroeconomic changes. This money may be deployed only in emergency situations following a specific decision to that end.

Management of liquidity risk

Liquidity risk is a risk that the state does not have sufficient liquid funds for the proper performance of its financial commitments.

The state's liquid funds are considered insufficient for the proper performance of its financial commitments, if all of the following conditions are met:

- over a three-month period, the total unused balance of the Liquidity Reserve and the loan taken by the state is smaller than the estimated negative net cash flow of the state over a nine-month period;
- according to the cash flow forecast, over the following three months, the total unused balance of the Liquidity Reserve and the loan taken by the state remains below what is required to offset the estimated negative net cash flow of the state over a nine-month period.

Source: Government of the Republic Regulation No 44 of 21 March 2014

The liquidity risk management policy is solid but the liquidity provision contains the reserves of the EHIF and the EUIF which is inappropriate

38. To meet its commitments, the central government has deployed a significant amount of other entities' money held by it (30.7% of the total reserve as of the end of 2015 and 31.2% as of the end of 2016). Meanwhile, the central government must be able to fully return the reserves of EHIF and EUIF to them when required. In its audit report concerning the accounts for 2015, the NAO pointed out to the Ministry of Finance that the Ministry should assess the state's **liquidity risk** in its entirety and estimate whether the current liquidity management model meets the state's needs.

39. The Ministry responded to the NAO that the applicable liquidity management policy ensures the mitigation of the liquidity risk and thus needs to adjustments. The Ministry is convinced that it can at any given time promptly meet all financial commitments, incl. disburse the funds of depositors, as the State Treasury has been subjected to liquidity management criteria for keeping the amount of liquid resources and instant credit at the required level.

40. The NAO analysed the Ministry's liquidity risk management efforts. As a result, the NAO can argue that the applicable liquidity management policy is appropriate and the liquidity provision target level determined by the State Treasury is sufficient but it includes the legal reserves of the EHIF and the EUIF that are essentially stabilisation reserves rather than liquidity reserves. **Therefore, the current reserves might not be sufficient, if maintaining the legal reserves of the EHIF and EUIF is properly reorganised in view of their intended purpose.**

41. At the same time, the Ministry of Finance is envisaging changes in the criteria for determining the liquidity provision target level by shortening the accounting period for decrease in tax revenue (six months instead of nine) as well as the accounting period for the repayment of interest and principal for debt commitments and the acquisition of shareholdings (one month instead of nine). According to the Ministry's calculations (as of March 2017), the said changes would lower the liquidity provision target level by 25% to allow reducing the capacity of overdraft and short-term credit facilities for which the state needs to pay to transaction and commitment fees to the creditors amount to 120,000 euros in 2017 and 320,000 euros in 2018.

42. The NAO is of the opinion that the planned changes do not allow sufficient response time because in the event of an extensive or rapid economic downturn or financial crisis the state needs an adequate buffer period to assume long-term debt commitments and draw up a negative supplementary budget where necessary. The NAO believes that the state should have a sufficient liquidity provision to cover short-term deficit and such deficit should not be financed by means of loans as borrowing is time-consuming and significantly more expensive.

43. Further, the NAO points out that the balance of central government's liquid assets within the Liquidity Reserve has constantly remained negative since Q4 2015. The Liquidity Reserve has maintained its minimum level mostly thanks to the money of the Estonian Health Insurance Fund, the Estonian Unemployment Insurance Fund and state-

controlled foundations which is held and invested by the Ministry of Finance, as well as overdraft and short-term credit facilities provided by credit institutions. Hence, maintaining a bigger liquidity buffer is relevant because smooth disbursements on behalf of EHIF, EUIF and foundations need to be ensured besides the central government's own payments.

Management of the Stabilisation Reserve Fund

44. The NAO argues that the Ministry of Finance's intent to save costs related to credit agreements is most welcome but alternative reasonable options should be considered. For instance, the Ministry could consider saving costs by assigning the management of the Stabilisation Reserve Fund to the Bank of Estonia which, in addition to its own reserves, manages the investment portfolio of the Guarantee Fund on the basis of a cooperation agreement and is willing to invest other long-term reserves of the public sector.

45. NAO recommendations to the Minister of Finance and the Minister of Public Administration:

- devise principles for determining the optimal size of the Stabilisation Reserve Fund by assessing the nature and amount of any emergency expenditure to ensure the availability of sufficient reserves;
- place the legal reserves of the EHIF and EUIF in the Stabilisation Reserve Fund, reassess the target level for the amount of money in the Liquidity Reserve and ensure the availability of sufficient reserves;
- analyse in coordination with the Bank of Estonia whether assigning the management of the Stabilisation Reserve Fund to the Bank of Estonia would allow cost savings;
- initiate the mutual alignment of the State Budget Act, the Estonian Health Insurance Fund Act and the Unemployment Insurance Act provided that using the money of the EHIF and EUIF for making payments on behalf of the state is in line with the nature and functions of these two public law entities.

Response of the Minister of Finance and the Minister of Public Administration: The Ministry of Finance (MF) finds that the applicable practice for increasing the Stabilisation Reserve Fund (SRF) is adequate and there is no need to set an additional ceiling for the size of the SRF. The SRF grows mostly on the account of cash flow surplus, profit allocations from the Bank of Estonia, and other irregular revenue. Boosting the reserve on the account of current revenue would mean using the cash flow surplus to withdraw additional funds from the economy which would excessively compromise economic growth. The MF disagrees with the argument that amendments to the State Budget Act imply waiver of the balance requirement which in turn notably reduces the amount of money placed in the SRF. The balance rule adjustment certainly does not have a direct impact on the SRF. However, it might have indirect effects but merely in terms of the annual breakdown rather than across longer periods. Firstly, the balance rule governs the structural position. And cash flows depend on the nominal position which - depending on the economic cycle - may differ from the structural position and have a different direction. Further, cash flows are affected by

financing operations that are not recognised in budget position calculations. Hence, if there is a structural surplus, cash flows could still be negative, and the other way round. Secondly, the balance rule is applied to budget planning whereas the transfer of funds to the SRF depends on the actual situation, i.e. budget implementation.

The SRF is an important tool for managing crises and emergencies and its symbolic value is to show that the state is ready for crises. However, in crisis situations, the MF cannot rely solely on the SRF because, firstly, it is extremely difficult to estimate the likelihood of various crises (natural disaster, economic crisis, financial crisis, war) and the level of ensuing expenditure. Secondly, in addition to deploying the SRF, the state can take a loan, cut costs or postpone investments in order to manage the crisis. Nevertheless, prevention of crises and more effective risk management are paramount.

The SRF will be deployed only in emergencies. The MF aims to ensure that the state's risks are managed in a way that allows the state to finance its commitments in crisis situations without having to resort to the SRF or so that its deployment is postponed for as long as possible. For example, in a crisis, the state can address international crisis management funds (ESM, IMF) or other countries to borrow money. The SRF was last deployed in 2009 when 224 million euros were withdrawn to mitigate macroeconomic risks resulting from the global economic crisis. Also, two negative supplementary budgets were drawn up in 2009 to cut state budget expenditure by 584 million euros. Back then, IMF's assistance was not needed and the ESM did not exist yet. This demonstrates that deployment of reserves is not the only or primary tool for crisis management.

The MF points out that the Riigikogu assembled all the funds of the EHIF and the EUIF to be centrally managed by the Ministry of Finance in view of the following policies:

1. Improve the management of cash flows and debt commitments in the sector because:

- a) harmonised cash flow management and higher liquidity ensures more efficient use of the state's available financial resources;
- b) harmonised conservative investment policies yield cost savings for EHIF/EUIF, and the entire state budget.

2. The MF ensures liquidity of the funds of EHIF/EUIF and any investment losses will not be attributed to them. Further, the EHIF/EUIF need no longer pay for costs related to bank transfers and investment operations.

At the time of deciding this, the Riigikogu argued that the positive effect of harmonised cash flow management on the state budget and the EHIF/EUIF outweighs the assumption of increased financial risk ensuing from the presumably longer period of using the reserves of EHIF/EUIF. Hence, placing the legal reserves of EHIF/EUIF in the SRF would not be essentially compatible with the objectives set out in the legislative amendments adopted by the Riigikogu in 2011.

In 2013, the MF weighed all aspects of collaborating with the Bank of Estonia in managing the SRF. At the time, the interest rates had dropped

and it was not financially reasonable for the state to assign the management of the SRF to the Bank of Estonia. The related management and performance fees would have significantly reduced the profitability of the SRF. We doubt that in 2017, when interest rates are even lower or negative, it would be feasible for the state to outsource the SRF management services. However, the MF does not preclude the possibility that, in the future, if interest rates are notably higher, it will reconsider relevant collaboration with the Bank of Estonia.

The EHIF and EUIF have not appeared as if by themselves, they have been set up by means of legislation. The state establishes public law legal entities as independent bodies in order to entrust them with the performance of certain public functions. It follows that public law legal entities also perform public administration functions which the state considers appropriate to implement through independent bodies rather than state agencies. Further, public law legal entities cannot, by their nature, be entrusted with functions that would not be part of the state's functions. Furthermore, public law legal entities cannot have functions beyond those of the state. Likewise, public law legal entities cannot have rights or obligations for which the state could not set limits.

Laws are the main instrument used by the state to determine the limits of the rights and obligations of such entities. Laws set out the functions of said entities. Also, laws determine the extent to which public law legal entities enter into private law relationships (e.g. various restrictions on assuming commitments or pursuing business). The state regulates the rights and obligations of public law legal entities in view of its own interests related to the specific area of public administration. However, by delegating functions to such entities the state does not entrust them with responsibility for managing the area of public administration in question. Further, despite setting up public law legal entities, the state retains responsibility for the functioning of the state as a whole meaning that the state may - in order to improve such functioning - rearrange the limits and principles of operation of said entities.

According to § 9 (2) of the Constitution of the Republic of Estonia, the fundamental rights laid down therein do not extend to public law legal entities. Essentially, fundamental rights are a person's subjective rights vis-a-vis public authorities. However, a public law legal entity constitutes a public authority - it is established by the state in public interests and essentially for the performance of some of the state's functions. Hence, as a rule, public law legal entities do not need constitutional protection against the state. The public law legal entities that require constitutional protection against the state are exhaustively listed in the Constitution (§ 38 (2) universities and research institutions, § 111 Bank of Estonia, and § 154 (1) local authorities) whereas the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund are not among them.²

Consequently, the legal capacity and autonomy of the EHIF and the EUIF are not absolute - these are determined by the legislator and can therefore be limited by law. The rights and obligations of public law legal entities

² Also, see Truuväli, E-J and others. Constitution of the Republic of Estonia. Commented edition. Tallinn 2008, page 109, § 9, comment 5.2.3.

are more limited than those of private law entities just as the ownership rights of public entities are usually more limited.³

The purpose of the Act Amending State Budget Act, Alcohol, Tobacco, Fuel and Electricity Excise Duty Act, Estonian Health Insurance Fund Act, Local Government Financial Management Act and Unemployment Insurance Act in connection with 2012 State Budget Act, 7 December 2011, was to preserve the autonomy of the EHIF and the EUIF in performing their core functions. Changes made in the ownership rights of EHIF/EUIF related to very specific aspects - the holding and investing of funds. The holding and investing of funds is not a core function of EHIF/EUIF meaning that they retained full autonomy in performing their statutory functions.

The amendments adopted with the Act of 7 December 2011 did not interfere with the performance of core functions of EHIF/EUIF. This is supported by § 39 (2) of the Estonian Health Insurance Fund Act and § 341 (2) of the Unemployment Insurance Act which clearly provide that the deposit agreement with the state must, at any time, allow EHIF/EUIF to make payments using money held on a current account within the group accounts of the state to perform their statutory functions. In view of the need to maintain constant and unlimited access of EHIF/EUIF to their money, the Estonian Health Insurance Fund Act and the Unemployment Insurance Act provide for entering into deposit agreements rather than loan agreements.

We would like to explain that the deposit agreement is essentially an agreement where the depositary (in this case the state) undertakes to safekeep the movable property entrusted to it by the depositor (in this case EHIF/EUIF) and return it to the depositor at the end of the deposit period. The Law of Obligations Act allows the interpretation that the property to be deposited includes money which means that each agreement where a person entrusts its money with another person is not necessarily a loan agreement.

According to the regulatory framework set up under the Act of 7 December 2011, the funds of EHIF/EUIF are held on their own current accounts and they have unlimited rights to use their funds at any given time. Such a legal relationship amounts to a deposit relationship rather than a loan relationship. An essential feature of a loan agreement is the lender's obligation to disburse the loan amount to the borrower, i.e. in this case, transfer the money to the current account of the state. Another essential feature of a loan agreement is the lender's obligation to enable the borrower to use the loan throughout the agreed period and refrain from reclaiming the loan amount before the agreed repayment date. The latter feature is not characteristic of the regulatory framework established by the said Act.

A deposit agreement is, for instance, a current account agreement made with a bank - undoubtedly, the bank uses the money on the current account to finance its other products but such an agreement is made for an indefinite period (demand deposit), hence not constituting a loan agreement. The reason here is that the money is held on the account of

³ See Merusk, K. Avalik-õiguslik juriidiline isik avaliku halduse organisatsioon. *Juridica*, 1996, No. 4, pages 174 to 178.

the current account holder and the holder may use his money any time. The current situation is similar - the money of EHIF/EUIF is held on their current accounts within the group accounts of the state and they can use their money any time.

The argument in the report that the MF has used the money of EHIF/EUIF towards the commitments of the state is misleading and not based on the legal concept of money as a fungible item. Likewise, this argument is not compatible with the Law of Obligation Act's provisions on agreements for depositing money. § 39 (1) of the Estonian Health Insurance Fund Act and § 341 (1) of the Unemployment Insurance Act clearly provide that a deposit agreement shall be entered into between the state and EHIF/EUIF. The provisions on deposit agreements are set out in the Law of Obligations Act that extends to deposit agreements between the state and EHIF/EUIF. According to § 896 (1), if fungible items, especially money, are deposited, the parties agree that the depositary undertakes to return items of the same kind, quality and quantity rather than the same item itself. Ownership and risk of accidental loss of items will be transferred to the depositary at the time of transfer of possession. Hence, the law provides that depositing money as a fungible item essentially means that the ownership of the item is transferred to the depositary and the depositary may use the depositor's money until the end of the deposit period.

§ 67 (2) of the State Budget Act grants additional authorisation to use the money as it stipulates that the state use the deposited money provided that the owners of the money can make payments on account of their money any time. We disagree with the NAO's opinion and argue that this matter need not be regulated by the Estonian Health Insurance Fund Act or the Unemployment Insurance Act. The Estonian Health Insurance Fund Act and the Unemployment Insurance Act require the EHIF/EUIF to deposit their funds pursuant to a deposit agreement on a current account within the group accounts of the state. Neither the Estonian Health Insurance Fund Act nor the Unemployment Insurance Act do not regulate how the state should hold the funds under the deposit agreement. Similarly, the said Acts do not regulate how a credit institution should hold the EHIF/EUIF funds under the deposit agreement. The Estonian Health Insurance Fund Act governs the activities of the EHIF - public law legal entity - and, by analogy, the Unemployment Insurance Act governs the activities of the EUIF, whereas the state's activities related to managing its cash flows and holding the money of other entities are governed by the State Budget Act, and the nature of the deposit agreement is defined in the Law of Obligations Act. In this context, the State Budget Act is a constitutional legal instrument which means that issues governed by the State Budget Act cannot be regulated by so-called ordinary instruments (e.g. Estonian Health Insurance Fund Act, Unemployment Insurance Act). Neither is it legally proper or necessary to regulate the contents of the deposit agreement between the state and the EHIF/EUIF in specific legal instruments beyond the Law of Obligations Act.

Undoubtedly, the depositary must comply with the deposit agreement's terms and conditions - in this case - ensuring that the owners of the money can use the money on their accounts to make payments any time. Another similarity to holding money in the bank is that banknotes are not kept in the bank's safe deposit box with "tags attached". Surely, the bank

uses the deposited money and the depositor will not be able to reclaim the very same banknote. We underline that the money of EHIF/EUIF is still there and, according to § 67 (1) and (2), the MF must enable entities that hold money in the State Treasury to make payments on the account of their funds at any time for the purpose of performing their statutory functions. There is no evidence that the MF has obstructed the EHIF/EUIF in making payments on account of their funds and thereby violated the law or the applicable deposit agreements. The MF can borrow sufficient amounts from the banks on the same day or subject to a notice of up to 15 days to ensure that the payments of all users of the group accounts of the state will be made as and when necessary. The MF will resort to borrowing, if doing so is necessary for managing the cash flows. By postponing the use of borrowed funds, the state saves loan interest costs.

The need to amend the Estonian Health Insurance Fund Act and the Unemployment Insurance Act was addressed by the Finance Committee of the Riigikogu during the legislative proceeding of the draft 456 SE following a motion for amendment by the faction of the Estonian Free Party. The Finance Committee did not consider it necessary to amend the said Acts and decided that making the relevant adjustment in the State Budget Act is sufficient. In § 67 (2) of the State Budget Act, the Riigikogu has expressly authorised the state to use third parties' funds that it holds until such time as the owners of the money express their intent to deploy those funds.

We reiterate that, even if the money of EHIF/EUIF was held by a credit institution rather than the state, the money of those public law legal entities would be most certainly be put to use. In such case, the credit institution would use the held funds to finance its other expenses and return the funds to EHIF/EUIF only on demand. It remains unclear whether in that case the NAO would argue that such actions by credit institutions are not permitted and should be prohibited by specific legal instruments?

The rules and principles for the management of state's cash flows as set out in Regulation No. 44 of 21 March 2014 of the Government of the Republic on „Principles for Management of the State's Cash Flows and the Stabilisation Reserve Fund“ are designed to ensure that the state has, at any time, access to funds required for conducting transactions specified in the state budget as well as funds for making payments on behalf of entities depositing their money with the state. The MF must ensure that at any given moment the Liquidity Reserve holds enough money to ensure smooth routine payments of entities keeping their money in the State Treasury (§ 66 (1) of the State Budget Act). To this end, the MF draws up cash flow forecasts on a daily basis and, based on such forecasts, either invests available money or borrows funds. According to § 67 (4) of the State Budget Act, cash flows are managed integrally pursuant to the said Regulation which means that the approach outlined in the report - for cash flow management purposes, the state should be distinguished from EHIF/EUIF or the EHIF from the EUIF - is not based on the provisions of the State Budget Act.

Further, we would like to explain that, according to § 9 (2) through (6) of Regulation No. 44 of 21 March 2014 of the Government of the Republic

on „Principles for Management of the State's Cash Flows and the Stabilisation Reserve Fund“, the minimum level of the Liquidity Reserve for the group is determined on the basis of forecasts for negative net cash flows of the state and entities keeping their money in the State Treasury rather than on the basis of the total of funds of group members with positive balance (balance of funds of EHIF + EUIF \leq balance of Liquidity Reserve). The minimum level of the Liquidity Reserve for the group is determined on the basis of the nine-month forecast for the level of negative net cash flows of the state which, among other factors, takes in account the total payments from social security funds. The outlined regulatory framework is based on the consolidated cash flow management principle which provides that the Liquidity Reserve must hold sufficient funds to make payments of all entities keeping money there, whereas cash flows are managed integrally meaning that at a specific time the cash flows of various entities might be balanced out. Pursuant to § 67 (2) of the State Budget Act, the balancing of intra-group cash flows may not limit the ability of EHIF/EUIF to make payments, but the explanatory memorandum to the said Act clearly provides for the possibility that the balances of the state's accounts might be negative at some point. Meanwhile, the state pays the Health Insurance Fund and the Unemployment Insurance Fund interest on the balances of their accounts (not based on the balance of the Liquidity Reserve), i.e. a fee for using their money. Hence, as a result of such operations, their financial resources increase instead of shrinking.

To sum up the foregoing, the MF finds that the use of money of the EHIF/EUIF as provided for by the legislation and at times when the said public law legal entities do not need this money to perform their functions, does not affect the nature of EHIF/EUIF or their ability to perform duties entrusted with them. The holding and investing of funds is not a core function of EHIF/EUIF meaning that they retained full autonomy in performing their statutory functions and using their money. The Estonian Health Insurance Fund Act and the Unemployment Insurance Act are in line with the State Budget Act - each Act has its specific scope and it would not be legally proper to use the Acts governing the activities of the EHIF/EUIF to regulate or duplicate areas within the scope of the State Budget Act which is a constitutional legal instrument.

Comment from the NAO: To ensure legal clarity, the NAO has requested the Chancellor of Justice to form an opinion on this matter.

Drafting and use of state budgets, and changes in the near future

The structure of state budgets has changed year after year which has improved comparability with the State Budget Implementation Report

Presentation of state budgets

46. The state budget is a financial plan of the state which sets out funds that the state plans to collect, mediate or use during the budgetary year. The state budget is broken down into administrative categories (government areas of ministries, constitutional institutions, Government Office) and according to financial nature (revenue, expenditure, investment and financial operation).

47. The contents (structure, breakdown, level of detail, etc.) of the state's annual financial plan drafted and adopted by the Riigikogu on annual basis (annual State Budget Acts) has changed year after year. Over the last ten years, the appearance of the budget act has changed considerably whereas some changes have improved the comparability of the annual budget act with the budget implementation report. Examples:

- annual State Budget Acts recognise all planned revenue and expenditure in all material respects;
- annual State Budget Acts mostly envisage budgetary revenue according to their statutory collectors (except for the observation outlined in paragraphs 59 to 62).
- a note (a31) to the State Budget Implementation Report explains the reasons for differences between planned and actual proceeds (incl. grants, revenue from economic activities);
- transactions between state agencies are distinguishable in all material respects (except for purchase & sale of goods and services) and have been recognised once in the report for most cases;
- annual State Budget Acts predominantly assign budgetary expenditure to agencies actually disbursing the funds.

48. Likewise, the information disclosed on budgetary expenses and investments to be carried over has improved. The report indicates the amounts carried over from 2015 to 2016 and forward from 2016 to 2017 and designates the relevant ministerial government areas. The reasons for not using the money have been disclosed in all material respects.

49. Regardless of the foregoing, there are still some material and fundamental errors in the drafting and use of the state budget.

50. NAO recommendation to the Minister of Finance and the Minister of Public Administration: outline, in the consolidated annual report of the state, justifications for carrying forward significant amounts from the accounting year to the following year, and include a reference to the location of more detailed information.

Response of the Minister of Finance and the Minister of Public Administration: Note a31 to the Annual Consolidated Report of the State (pp. 180 to 186) includes an overview of the funds carried over from 2015 to 2016 and forward from 2016 to 2017, broken down by budget components and government areas. In conjunction with the transition to accrual-based budgeting as from 2017, there are several adjustments in relation to the provisions of the Regulation of the Ministry of Finance on "Procedure for Drafting of State Budget Strategy and Budgets of Government Areas of Ministries, and for Carry-over of State Budget Funds" as regards the process of carry-over of unused funds:

- funds are carried over in two parts - the advances in January and the main part in August;

- balances carried over by agencies are adjusted with prepayments and commitments, and the use of investments in 2015 has been extended by a further year.

The so-called funds with limits, according to a Directive of the Minister of Finance, make up about 35% of amounts carried over whereby relevant detailed explanations are included in the Directive and its Annexes. An overview of funds carried over as advances is available on the web site of the MF at <http://www.fin.ee/riigieelarve-2017>.

A significant share of the remaining funds that are “carried over automatically” is made up by foreign aid and the related co-financing (about 40% of the total carried over). As the final balances that include adjustments for prepayments and commitments are determined in the course of auditing, the relevant overview will be available by the end of August.

The second-largest group of expenses automatically carried over is made up by balances of tax revenue collected by the state (about 20% of the total carry-over) that are to be transferred to other entities (Health Insurance Fund, Unemployment Insurance Fund, local authorities, etc.) according to tax laws. The obligation to transfer the money and the relevant procedures are set out in tax laws. We believe that Note a31 shows - with sufficient clarity - how much remained untransferred as at year-end. Money does not remain untransferred because of omitted work or low capacity.

In addition to the above two groups, the revenue from economic activities are carried over automatically (about 5% of the total carried over). Each state agency may use the revenue from economic activities at its own discretion for carrying out its operations.

A finalised overview of carry-over of funds with limits as well as automatic carry-overs will be made available on the web site of the FM no later than in September 2017. As adjustments will no longer affect the carry-overs in future years, the overview will be comprehensive and it will be included in the annual consolidated report of the state and accompanied by references to more detailed information.

The drafters of the 2016 State Budget Act have made more careless errors than in earlier years

51. The NAO detected that the 2016 State Budget Act adopted by the Riigikogu contains errors. Most of these are attributable to carelessness.

52. The aggregate amounts in the 2016 State Budget Act have not been recalculated or adjusted following the amendments made in the course of the legislative proceeding in the Riigikogu. The added or adjusted amounts were shown under the budgets for respective government areas but the aggregates for revenue, expenditure, investments and financing operations as provided in the heading of the state budget were not corrected. Further, the budgeted amounts classified according to functions of government (COFOG) have been miscalculated.

53. The audit revealed that the financing operations of the government area of the Ministry of Rural Affairs were not accurately recognised in

Errors in the totals in the 2016 State Budget Act

Financing operations of the Ministry of Rural Affairs

the 2016 State Budget Act. Specifically, the totals for lines concerning the increase and decrease of financial assets feature signs opposite to what they should be.

54. The explanatory memorandum to the 2016 State Budget Act indicates that 2.56 million euros were planned for intervention purchases - this expense should have been recognised in the Act and its explanatory memorandum as increase of financial assets and be preceded by a minus sign. The plan was to gain 2.06 million euros from the sale of products in intervention stockpiles - as it constitutes revenue, the decrease in financial assets should have been preceded by a plus sign.

55. As a result of these errors, the budget and its explanatory memorandum indicate that the financing operations result in budgetary revenue of 0.5 million euros. However, they should have recognised a decrease of 0.5 million euros in funds.

The financing of the core function of the government area of the Ministry of the Environment is not transparent

Financing of the Ministry of the Environment through the Environmental Investment Centre

56. The core functions of ministries are still not completely financed from the total allocated to them under the annual State Budget Act. So, in 2016, the core function of the Ministry of the Environment and its agencies were financed through the Environmental Investment Centre (EIC). Hence, all of the money necessary for environment-related activities within the Ministry's government area were not planned as expenditure in the Ministry's budget. In 2016, the activities of the Ministry of the Environment and its agencies were financed in the amount of 8.7 million euros through the EIC. This practice has been implemented for years.

57. In the interests of transparency of the state budget, the National Audit Office disapproves of such financing of the Ministry's core function, because there is no comprehensive overview of the amount the Ministry needs from the state budget for its activities. Further, this practice increases the administrative burden, because in order to receive funds through the EIC, the Ministry and its agencies must prepare project applications, which the EIC then reviews and the Ministry's committee evaluates. Thereafter, the EIC's Supervisory Board will approve the applications. Later, the beneficiaries must report on the use of support and the EIC will then inspect these reports.

58. Previously, the Ministry of Finance has agreed with the NAO's observation and promised to seek remedies.

Budget revenue of two ministries is recognised in the budget of the wrong ministry

Budget revenue of ministries

59. Revenue of 15 million euros generated by the activities of the Ministry of Justice (incl. government fees for court procedures, various fees charged for services provided by registers) has been recognised in the budget implementation report of the Ministry of Finance rather than in the relevant report of the Ministry of Justice. Likewise, the environmental charges generated by the Ministry of the Environment, amounting to 70.95 million euros, are recognised in the budget implementation report of the Ministry of Finance rather than that of the

Ministry of the Environment. The Ministry of the Environment and the Ministry of Justice keep account of environmental charges and government levies, respectively.

60. These errors have occurred because, in drawing up the annual state budget, the Ministry of Finance has envisaged the aforesaid revenue on its own budget lines because the money is paid to the bank accounts of the Tax and Customs Board. The Ministry of Finance finds that in this case the revenue must be planned in the budget of the Ministry that receives it. However, this principle has not been outlined in the Budgeting Guidelines.⁴ According to the General Rules of State Accountancy, revenue (incl. government fees and charges) should be recognised in the income statement of the state accounting entity that provided services in return of the corresponding revenue.

61. In such cases, it would be appropriate to plan the environmental charges and recognise their collection as revenue of the Ministry of the Environment, because it is responsible for the planning, imposition, verification and accounting of revenue from environmental charges. Likewise, it would be appropriate to plan and recognise the collection of levies and fees for court procedures as revenue in the budget of the Ministry of Justice because levies and procedural fees are imposed by courts governed by the Ministry of Justice.

62. The 2017 State Budget Act and its explanatory memorandum provides that as from 2017 the government levies collected through courts and the Centre of Registers and Information Systems are recognised in the budget of the Ministry of Justice, and environmental charges in the budget of the Ministry of the Environment. This is due the transition to accrual-based budgeting that harmonises the accounting principles for budgeting and book-keeping, and recognises revenue in the budgets of entities responsible for generating it.

The level of detail of the state budget's expense lines has been reduced which complicates the verification of the expediency of expenses

Level of detail and verifiability of the budget

63. The comparability of the state budget with its implementation report has slowly improved over the years, whereas information on the intended use of budgeted amounts has become more limited. The level of detail of expenses in the State Budget Act has been reduced: preceding annual state budgets distinguished between expenses according to their purpose (e.g. budget indicated the nature and beneficiary of grants) but this practice has been abandoned over the years and such information is available for some expenses only.

64. Although this presentation method provides flexibility for the Government of the Republic should the intended purpose of budget funds change, it undermines the Riigikogu's control over budget drafting and implementation.

65. According to the State Budget Act Amendment Act adopted on 19 June 2017, the level of detail of expenses determined in the annual budget

⁴ Regulation No. 9 of the Ministry of Finance, 4 February 2016, on "Procedure for Drafting of State Budget Strategy and Budgets of Government Areas of Ministries, and for Carry-over of State Budget Funds".

act will be reduced even further because the Riigikogu will no longer endorse the economic purpose of expenses - this will be done by respective ministers responsible for each sphere.

66. The NAO finds that the roles of the executive and the legislature should be balanced. This means that the Riigikogu must have sufficient powers and information to monitor the activities of the Government of the Republic.

67. The said legislative amendment replaces development plans of ministerial government areas with sectoral development plans. Drafting of such development plans is not mandatory (save where provided for by the law), if the required performance goals are set out in the explanatory memorandum to the state budget.

68. According to the State Budget Act, the budget is to be planned across performance areas and programmes which will be listed by the cabinet of ministers who have the power to change the contents of performance areas and programmes even as often as annually when drafting the state budget (or when the cabinet is reshuffled, for instance). This undermines the Riigikogu's ability to have a say in issues of national importance.

69. It remains unclear, however, in which form and how specifically will the contents of performance areas and programmes be described, i.e. what kind of information will the Riigikogu have for deciding how much money it should allocate to certain performance areas or programmes. Also, it remains unclear as to how will the government ensure comparability with the implementation of preceding annual budgets that should serve as input for budget decisions.

70. If distribution of funds between programmes is modified often and the sufficiently detailed information about their contents is not provided, the Riigikogu will be unable to have a say about the substantive aspects of the budget because essential and substantive budget adjustments remain overshadowed by the technical changes in budget presentation.

The explanatory memorandum to the state budget should be more accurate and uniform and clarify substantive aspects better

Importance of the explanatory memorandum to the State Budget Act

71. The changes introduced by the State Budget Act Amendment Act of 19 June 2017 significantly increase the role of the explanatory memorandum to the state budget in budget proceedings because detailed information on financed activities will now be provided only in the memorandum. Therefore, the explanatory memorandum should provide adequate information on the essence of financed activities and do so in a manner that would allow making reasoned decisions on determining the amount of money required. The information should be clearly structured, reliable, complete and free from any ambiguities.

72. The increasing importance of the explanatory memorandum is further evidenced by the new requirement in the State Budget Act to the effect that the explanatory memorandum to the annual state budget must contain information on planned investments, cash flow forecast and budget balance over the following three years.

Quality of the explanatory memorandum to the State Budget Act

Comprehensible and **clear** – the reader of the explanatory memorandum does not require expert knowledge about the sphere in question to understand what the budgeted amount consists of and which activities are to be financed using that amount.

Complete and **transparent** – all the important lines are explained, there are no major amounts for which lack substantive explanation or are accompanied by a shallow explanation, there are not significant differences between the memorandum and the adopted budget, and major budget adjustments compared to the preceding year have been explained.

Rational – there are no detailed explanations about insignificant amounts.

73. To provide an opinion on the current drafting quality of the explanatory memorandum, the NAO assessed the contents of the explanatory memorandum to the 2016 State Budget Act. To this end, auditors analysed the information in the memorandum and the use of funds earmarked for specific activities. The aim was to ascertain whether the information on ministerial government areas in the explanatory memorandum to the 2016 State Budget Act is **comprehensible** and **clear**, **complete** and **transparent**, and **rational**.

74. The NAO thinks that the state budget's explanatory memorandum prepared under the leadership of the Ministry of Finance is an essential document describing the ends to which the taxpayers' money is used and outlining the priorities. Hence, the memorandum needs to be sound, i.e. all budget lines in the State Budget Act and its explanatory memorandum need to be in conformity with each other and for important budget lines the memorandum must explain the purpose of using the money. Such explanations need to be comprehensible, clear, complete, transparent and rational.

75. The general public and the Riigikogu can use the memorandum to assess the expediency and necessity of expenses. The inadequacy or incompleteness of explanations in the memorandum increases the risk that the State Budget Act is used to channel money into activities that cannot be assessed for necessity and/or this money is not used expediently.

76. As at the time of drafting the 2016 budget, there were no adequate requirements in place for the explanatory memorandum drawn up for the budget of the ministry's government area, or for the information included in such memorandum. The reference material to be used was the Regulation of the Minister of Finance on "Procedure for Drafting of State Budget Strategy and Budgets of Government Areas of Ministries, and for Carry-over of State Budget Funds". The Regulation required the ministries to provide detailed explanations about certain budget lines without containing any requirements for the explanatory memorandum to the draft annual state budget. Requirements to the memorandum's contents are specified in the State Budget Act but these are not enough to ensure its high quality.

77. The requirements in the Rules for Good Legislative Practice and Legislative Drafting concerning explanatory memoranda to legislative drafts do not take into account the substantive characteristics of the explanatory memorandum to the annual draft state budget.

78. Officers of the State Budget Department of Ministry of Finance coordinated the preparation of the explanatory memorandum. In 2016, the Ministry of Finance (MF) furnished the government areas with pre-completed forms of the explanatory memorandum that contained tables with lines for which explanations were requested.

79. In the course of interviews conducted by the NAO, the officials of ministries told that the memorandum is essentially drafted on the basis of available materials and the officers of the MF have requested shortening the texts as well as providing further clarifications. On the aggregate, the interviewed individuals find that too few guidelines are provided for drafting the memorandum.

Examples of shortcomings in the explanatory memorandum to the 2016 State Budget Act

80. As a result of its audits, the NAO concludes that the explanatory memorandum to the 2016 state budget is of uneven quality, does not explain the essential purpose of expenses or the significant adjustments in revenue and expenditure. On the other hand, it provided excessive information that did not help in reading the budget. For example, there were long explanations about activities not directly linked to expenses, small budget items, and legislative amendments envisaged for the coming year. In one instance, the registered properties of a government area were listed.

81. The explanatory memorandum to the state budget featured several errors of calculation as well as careless errors:

- The expenditure on investment support of the Ministry of Social Affairs as shown in the table in the explanatory memorandum to the Act were 5.6 million euros smaller than provided for by the budget and detailed in the text of the memorandum. The memorandum contains a table on the provision of social services showing a total of 39.5 million euros available for 2016 but adding up the figures in the detailed breakdown yields a total of 38.5 million euros which is one million euros less.
- In the budget of the Ministry of Culture, the totals for lines “Granted earmarked support” and “Additional allocation” differed by 1.3 million euros from the total for detailed lines. The totals for labour and management costs added up to 20 million euros although the table showed only 15 million.

82. The purpose of some important budget lines was not detailed. For example, for the Ministry of Economic Affairs and Communications, there was no explanation as to what kind of financial assets were planned to be acquired for the 32.65 million euros earmarked in the budget act. The explanatory memorandum to the 2017 State Budget Act provides that information.

83. However, the memorandum does not detail all significant changes in budgeted amounts as compared to the preceding year:

- In the government area of the Ministry of Defence, the expenditure on international membership fees grew by 0.77 million euros (10.3%) and management costs went up by 2.7 million (45%) as compared to the preceding year but the reasons behind this increase were not included in the memorandum.
- The 2016 budget of the Ministry of the Environment contained revenue from the sale of greenhouse gas emission allowances that exceeded the preceding year’s figure by 26.0 million euros. However, there was no explanation as to why such revenue growth is expected. The expenditure of the Environmental Agency dropped by 1.8 million euros but the reasons behind this were not provided.

84. Throughout the memorandum, there were no explanations provided for budget adjustments made during legislative proceedings in the Riigikogu - funds were added to some budget lines and a further 6.5 million euros were allocated following proposals from Members of the

Riigikogu. For those items, a table showing the allocated amounts was added to the memorandum but there was no explanation as to which organisations would be supported using such funds. The NAO finds that additional explanations help achieve greater transparency, clarity and comprehensibility.

85. The explanatory memorandum contained conflicting information:

- As for the budget of the Ministry of Culture, there were conflicts between tables and body text of the memorandum - the text implied an increase in expenses whereas the table showed a decrease.
- As for the Ministry of the Interior, the explanation about the change in the management costs of the Police and Border Guard Board was controversial. The same explanation justified both a decrease as well as an increase in costs.

86. For several ministerial government areas, explanations were given about clearly insignificant expenses. For instance, in the budget of the Ministry of Social Affairs, revenues amounting to 140 and 1,600 and 2,128 euros were detailed. For Ministry of Justice, revenues from the sale of stocks and fixed assets amounting to 300 euros were explained in detail.

87. The NAO argues that it is not reasonable to burden the reader with unnecessary information and the explanatory memorandum to the budget should focus only on information that is essential for better understanding the budgeted revenue, expenses, investments and financial operations.

88. NAO recommendations to the Minister of Finance and the Minister of Public Administration:

- exercise greater care in drafting the budget act, take into account all adjustments made during legislative proceedings, and ensure conformity between amounts shown on the various budget lines;
- set out specific requirements for the composition of information provided in the explanatory memorandum to the annual state budget both on ministerial and national level, and coordinate the drafting of that memorandum so as to ensure uniform quality of information therein.

Response of the Minister of Finance and the Minister of Public Administration: We agree that the quality of State Budget Acts and their explanatory memoranda can be further improved. The Ministry of Finance (MF) and the ministerial government areas have made consistent efforts to this end. In coordination with the ministerial government areas, the process of drafting the 2017 state budget has been developed to automatically create the state budget and its explanatory memorandum within the information system. This development has notably reduced the administrative burden and the number of errors in introducing last minute decisions in the budget act.

In the future, we will try to work more closely with the Riigikogu whilst the Riigikogu makes changes in the state budget.

The general guidelines for drafting explanatory memoranda are being developed. These will be included in the manual on state budget drafting. Further, we'll reserve more time for harmonising the information disclosed in explanatory memoranda.

Financing of foundations

The state budget fails to provide an overview of the financing of foundations

89. Although the state establishes more and more new foundations and the funding granted to foundations keeps growing, the annual State Budget Act or its explanatory memorandum lack an overview of funding awarded.

90. For years, the NAO has been reiterating that the financing of foundations from the state budget should be more transparent. The annual State Budget Act and its explanatory memorandum hardly provide clarity as to the amount and purpose of funding to be allocated to foundations. As the aggregate allocated to foundations is made up of various sources and budgets of different government areas, there is no summary overview, and it is impossible to learn how much money the foundations actually get from the state budget.

91. The Ministry of Finance has undertaken to provide consolidated information at least in the explanatory memorandum to the state budget but has failed to do so over the last five years. Consequently, readers still need to scroll through the 2016 State Budget Act and its explanatory memorandum to find bits and pieces of information about the funding of foundations. And to make matters even worse - information in the memorandum is incomplete as there are no data for some foundations.

92. **NAO recommendation to the Minister of Finance and the Minister of Public Administration:** during the process of drafting the state budget, consolidate and disclose in the budget's explanatory memorandum complete information on funding provided to foundations and indicate the intended purpose of such funds.

Response of the Minister of Finance and the Minister of Public Administration: Funding to be granted to foundations is not completely finalised at the time of processing the budget in the Riigikogu because the grant of funding is the responsibility of ministers who adopt final decisions only at the beginning of the year after the Riigikogu has already approved the budget. However, we will try to negotiate with the ministerial government areas so that such information would be available and included in the adjusted explanatory memorandum prepared at the start of the year.

Planning of ICT investments

Planning of ICT investments in the state budget can be further improved

93. It is audit report for the 2015 financial year, the NAO made several recommendations on the planning of investments in information and communication technology (ICT). The main reason behind the said recommendations was that the role, functions, criteria for evaluating financing requests and rules of procedure of the committee that works at the Ministry of Economic Affairs and Communications (MEAC) and is involved in the planning of ICT investments were not formally laid down, and this lead to non-transparency as to the weight and justification of the committee's decisions.

94. The Ministry of Finance (MF) has complied with two of the recommendations. As from February 2017, the role and functions of the ICT Committee at the MEAC are set out in a Regulation of the Minister of Finance⁵ on the procedure for drafting the state budget. In the course of drafting the 2017 state budget, the MF has informed all government areas and constitutional institutions that, from now on, ICT financing requests below 200,000 euros will be also be reviewed by the Committee.

95. However, the rules of procedure of the ICT Committee have not been established and there is no requirement to assess the effectiveness of ICT projects. The NAO finds maintains that the Committee's rules of procedure should be laid down to ensure transparency of the evaluation process, and the effectiveness of approved ICT projects should be assessed. This would allow establishing clearer links between the Committee's decisions and the outcomes of projects, and putting greater responsibility on implementing entities for achieving success.

96. NAO recommendation to the Minister of Finance and the Minister of Public Administration: establish rules of procedure of the ICT Committee and lay down the criteria for assessing the effectiveness of projects that have been awarded financing by the Committee.

Response of the Minister of Finance and the Minister of Public Administration: We will review the so-called ICT Committee's rules of procedure and the criteria for reviewing supplementary financing requests before the new State Budget Act 2019-2022 process, and we intend to combine the processes of review of ICT projects and justification of ICT strategies of government areas and write down specific guidelines for those processes. § 13 of the Regulation of the Minister of Finance already lists the general criteria applicable to ICT projects.

The financed ICT projects and expenses are monitored on the same basis as any other state budget funds. First and foremost, ICT projects should help attain the objectives and outcomes set for the government area, and various indicators are used to measure this. It would not be practicable to develop a standalone set of rules for performance assessment as this would increase the administrative burden and create confusion with regard to the existing performance assessment principles. Further, ICT expenses differ substantively (maintenance, personnel, development costs, etc.) making it impossible to apply uniform performance assessment criteria.

Activity-based budgeting

Activity-based budgeting is a budgeting method where - in view of the organisation's strategic goals - firstly, the amount of outputs (programs) required during the budget period is determined and budgeted, and secondly, the amount of activities and resources necessary for achieving such outputs and the corresponding expenditure is determined. In parallel, the concept of performance budgeting is used to convey the same meaning.

Activity-based state budgets might not be the most effective method to achieve the desired outcomes

97. The state intends to make the transition to **activity-based state budgets** by 2020, and the MF believes that this approach should provide an overview of how much the state contributes towards the attainment of goals set across various sectors. Such goals derive from sectoral development plans.

⁵ Regulation No. 9 of the Ministry of Finance, 4 February 2016, on "Procedure for Drafting of State Budget Strategy and Budgets of Government Areas of Ministries, and for Carry-over of State Budget Funds".

98. The MF believes that the transition to activity-based state budgets should facilitate more effective cooperation between government areas to improve coherence between goals, activities and resources.

99. At the time of drawing up the audit report, the MF and the other ministries had not yet come to an agreement on the principles and substantive aspects of activity-based budgeting or the relevant transition programme. The MF has briefly addressed the goals of activity-based budgeting in the manual on strategic planning and financial management. The primary purpose of activity-based budgeting is to achieve more effective use of budget funds.

100. The NAO finds that without an agreement within the cabinet of ministers on the principles and substantive aspects of activity-based budgeting it would be difficult to reach a consensus between the ministries as to what should be done and what the final outcome should look like, because each government area has its own interpretation of the goals and the measures for achieving them.

101. Likewise, the ministers should think it through and determine how the budget should be managed and how the information on activities should be used for decision-making. This determines what kind of framework will be established for activity-based budgeting, what kind of data is needed to implement it, and how will information be consolidated, presented and used. The NAO claims that these aspects have not been adequately addressed albeit the transition to activity-based budgeting has already started.

102. The NAO is sceptical about the need to convert the state budget into an activity-based budget. The NAO believes that the use of activity-based cost accounting in ministries within certain limits could lead to more efficient use of budget funds but the activity-based approach to state budget drafting might not be the optimal solution for attaining this goal.

103. There has been no analysis as to whether, in which areas and how the use of activity-based budgeting would be reasonable. Neither has anyone considered whether the desired benefits could be achieved by employing simpler and less labour-intensive alternatives.

104. As long as there are no clear agreements, specific goals or designated users of information so obtained, and no substantive analysis has been conducted, there is a risk that a lot of effort will be put into creating something that nobody will use or need. Of course, drafting activity-based state budgets is possible but the question is whether it is necessary and feasible.

105. The NAO finds that - regardless of what will be the next steps after the analysis - the following criteria need to be met: the principles, activities, and action plan for transition to activity-based budgeting have been laid down; uniform cost accounting methods and the supporting software are available; and all parties have a common understanding of activity-based budgeting, its necessity, and the benefits to be gained.

106. According to the manual on strategic planning and financial management developed by the MF, activity-based cost management will allow much more accurate assessment of the cost of various services and

Activity-based cost accounting

programmes. As the price of each service is derived from the cost of activities necessary for providing the service, it is easier to understand how changes in the price of various cost components affect the final cost of the service. Information on the actual cost of services and programmes allows making well-considered management decisions

Cost analysis software

Cost model – a set of principles for collecting data on direct and indirect costs, breaking down costs between activities or services, and calculating the cost of services or products.

107. Activity-based cost accounting requires appropriate software. Functions supporting activity-based accounting that are included in the state's financial accounting software SAP have not been put into use yet. If the government decides to start using the functions offered by SAP, a uniform **cost model** should be employed.

108. The NAO maintains that the MF should develop criteria defining the cost model and its mandatory elements. This ensures that the cost calculation methods are homogeneous, hence allowing comparability across ministries.

109. To develop a common understanding, the MF has invited public tenders and subsequently signed framework agreements with two audit companies in November 2016 to advise state agencies in matters concerning the transition to activity-based budgeting. The aim of these advisory activities is to prepare ministerial government areas for the transition to activity-based budgeting and revise the methods for such transition in coordination with the contracting authority.

110. The tasks of the project team include gaining an overview of the current situation of government areas and the work processes of agencies, developing accounting items for activity-based accounting, and advising on the development of the cost model.

Pilot project of the Ministry of Education and Research

111. The transition to activity-based budgeting will take place in line with the readiness, willingness and capabilities of the ministries. The Ministry of Education and Research (MER) was the first government area to use the activity-based approach for drawing up its part of the 2016 state budget.

112. The Ministry of Social Affairs, the Ministry of the Interior, the Ministry of Defence and the Ministry of Finance have commenced with preparations, and the Ministry of Culture has been involved in relevant discussions. The Ministry of Social Affairs decided to use the activity-based approach for drawing up its part of the 2018 state budget and the Ministry of the Interior opted to do so as from the 2019 budget. The remaining ministries will draft their budgets accordingly starting with the budget for 2020.

113. The MER pioneered the adoption of activity-based budgeting in 2016. One of the MER's objectives was to better understand what is done and why, or what should be done to respond faster to changes and use resources more purposefully and flexibly. In addition, the MER sought to ensure the availability of solid management information for policy design and decision-making.

114. The NAO is of the opinion that the MER has not yet attained those objectives. The transition to activity-based budgeting was formal - without properly planning the operational aspects and without adequate guidance and methodological support from the Ministry of Finance.

115. The transition process and implementation of activity-based budgeting was labour-intensive and burdensome for the involved staff members of the MER and the agencies it governs. As informed by the governed agencies, the instructions they received from the MER for using activity-based budgeting were insufficient.

116. The Budget Department of the Ministry of Finance has failed to ensure that the MER would adopt activity-based budgeting in line with the corresponding objectives. A lot of work has been done following the rushed and ill-advised actions of the MER but there is no assurance that the resulting financial information has a target group and such information can be used for making management decisions.

117. The MER deemed it positive that the transition to activity-based budgeting yielded greater flexibility in drafting and implementing the budget because ministers were granted the authority to adjust the breakdown of operational costs and investments within programmes. The NAO believes that this outcome could have been achieved without adopting activity-based budgeting.

Need to analyse the efforts so far

118. The NAO finds that clear decisions have been omitted in the process of transition to activity-based state budgets and the preparations for the process have been inadequate. As the transition to activity-based budgeting significantly changes the financial management policy of the state, the Ministry of Finance should review the current process, set clear targets and goals, assess whether such transition is still justified, and determine whether the efforts so far have led or may lead to the desired goals.

119. NAO recommendations to the Minister of Finance and the Minister of Public Administration:

- analyse the need to make the transition to activity-based budgeting, and if the process is to continue:
 - agree on the principles of activity-based budgeting and the relevant transition programme, and ensure that all parties have a common understanding of activity-based budgeting and its implementation;
 - ensure the availability of uniform methods for activity-based budgeting and of software that enables its implementation;
 - determine how the budget should be managed and how the information on activities should be used; and
- thereafter, provide the government with an overview of progress achieved and further actions.

Response of the Minister of Finance and the Minister of Public Administration: The transition to activity-based budgeting is based on the applicable State Budget Act that was drafted in the light of the following analyses: report by a parliamentary committee on “Potential paradigm shift in fiscal policy within the parliamentary system of Estonia”, OECD reports on “Towards a Single Government Approach” and “Fostering Strategic Capacity across Governments and Digital

Services across Borders”, NAO audit on “Activities of the Government of the Republic in assessing the impact of its work and in reporting of the results of its work”, study by professor Giuseppe Gross on “Performance-based budgeting: A cross-country comparison”, the project by Policy Research Centre Praxis on “Determination of performance areas of the state”, and the joint report by the University of Tartu and Geomeedia OÜ on “Analysis of strategic planning and management of the state”. The list is not exhaustive.

The essential principles of activity-based budgeting are set out in the State Budget Act and its explanatory memorandum that introduced activity-based budgeting in 2014. The most important principle is the balancing of needs and possibilities within the budget in view of the state’s strategic objectives. The state budget is drawn up on the basis of available funds according to the financial forecast of the state and the needs outlined in strategic development plans. Needs are outlined on the basis of the desired effects to be achieved in the community and the services provided to people that are financed from the state budget. For example, the state arranges the provision of emergency medical care to boost the number of healthy life years. Activity-based budgeting means that the state budget determines how much money the state allocates to each sector whereby the planned and actual cost of each activity designed for the population is known. The budget consists of performance areas and programmes. Sectoral totals consist of the prices of relevant government-financed services calculated using the cost models.

Activity-based information enables public sector leaders and the general public to better evaluate the economy, efficiency and effectiveness of expenses made using taxpayers’ money. The management information obtained through activity-based budgeting will be used by the MF for drafting the state budget and conducting budget negotiations and by the ministers for managing the activities and budgets of their government areas.

The MF supplies the action plan for transition to activity-based budgeting as part of the “Overview of developments in strategic planning and financial management”. The main stages set out therein include structuring of strategic planning, introduction of cost models in state agencies, and mapping on public services. In 2017, the state introduced the accrual-based budget as a preparatory measure. To support the transition the MF will arrange the revision of legislation and instructional materials, the development of IT solutions, and the provision of training. The transition of each ministry will be supported by an individual project that comes with its own action plan.

The methodology required for the transition to activity-based budgeting is set out in documents listed below. The basic rules and work arrangements are governed by the legislation. The State Budget Act adopted by the Riigikogu puts in place the legal framework for activity-based budgeting. Detailed rules are contained in implementing provisions: “Budget Classification”, “Procedure for Drafting of State Budget Strategy and Budgets of Government Areas of Ministries, and for Carry-over of State Budget Funds”, “Types of Strategic Development Plans, and Procedures for Drafting, Revising, Implementing and Evaluating Them, and for Reporting Thereon” and “Public Sector Financial Accounting and

Reporting Guidelines”. Detailed instructions supporting the transition are all on the web site “Manual on Strategic Planning and Financial Management”.

The software necessary for introducing activity-based budgeting that allows collecting and processing the relevant information includes the State Budget Information System (SBIS2), the Strategic Management Information System (SMIS), and the accounting and reporting modules of the SAP accounting software. These systems have been redeveloped to accommodate the transition. To cut the workload related to the management of cost models and enable the use of more complex models, we are currently acquiring the Cost Accounting Information System (CAIS).

The cabinet of ministers is informed as and when necessary. The last time the cabinet discussed the transition to activity-based budgeting was in connection with the amendment of the State Budget Act in spring 2017.

Management of public procurement, disclosure of procurement agreements and transactions with related parties

The number of public invitations to tender announced by state agencies and state-controlled companies and foundations and the profit-making state agency has grown

120. According to the Public Procurement Register, the state agencies had a total of 2,036 completed or pending procurements in 2016 amounting to 592 million euros (also, see Table 2). The register shows that, compared to the preceding year, the number of procurements was higher by 187 and their total value had grown by 101 million euros. In its financial audits for 2016, the NAO has audited the compatibility of economic transactions of ministries (excl. the Ministry of Foreign Affairs) with the Public Procurement Act.

Table 2. The number and monetary value of completed and pending procurements by state agencies and entities governed by them in 2016

State agency	Completed and pending procurement projects in 2016	
	Number	Total value (EUR million)
Ministry of Education and Research	228	21
Ministry of Justice*	51	6
Ministry of Defence	172	102
Ministry of the Environment	322	132
Ministry of Culture	44	4
Ministry of Rural Affairs	130	21
Ministry of Economic Affairs and Communications	523	162

Value and audit of public procurement

Ministry of Finance**	119	36
Ministry of the Interior	195	52
Ministry of Social Affairs	142	40
Ministry of Foreign Affairs	47	10
Government Office	32	3
Constitutional institutions	31	3
Total	2,036	592

* As from 1 July 2016, any procurement projects for the Ministry of Justice and the agencies it governs are managed by the Centre of State Support Services, save for ICT procurements which are still managed by the Centre of Registers and Information Systems.

** Procurement projects managed by the Centre of State Support Services on behalf of the Ministry of Justice and the agencies it governs are recognised on the line for the Ministry of Finance.

Source: NAO calculations based on the Public Procurement Register as at 2 February 2017

121. The obligation to comply with the principles set out in the Public Procurement Act and conduct procurement procedures where necessary extends to all foundations controlled by the state, the profit-making state agency, and most of the state-controlled companies (hereinafter “entities”). On its web site, the NAO has published a list of important entities whose transactions should be audited for regularity. The certified auditors who audited the annual accounts of those entities have not audited compliance with the Public Procurement Act in all state-controlled companies, foundations, or the profit-making state agency, because the contracts for outsourcing auditing services in 2016 did not include auditing the regularity of transactions.

122. Similarly to state agencies, the number of procurements by entities has grown. In 2016, entities announced 1,578 public tenders (see Table 3) which is 76 more than over the preceding year. However, the total value of their public procurement has dropped by 26 million euros. Certified auditors have audited compliance with the Public Procurement Act in companies and foundations listed in Annex 1.

Table 3. The number and monetary value of completed and pending procurement projects by state-controlled companies and foundations and the profit-making state agency in 2016

	Completed and pending procurement projects in 2016	
	Number	Total value (EUR million)
Government-invested companies	705	224
State-established foundations	715	159
State Forest Management Centre	158	118
Total	1,578	501

Source: NAO calculations based on the Public Procurement Register as at 2 February 2017

The number of similar irregularities has grown over the years

123. The purpose of the Public Procurement Act is to ensure the transparent, expedient and economical use of the money of contracting authorities, equal treatment of entities, and effective exploitation of the prevailing competition environment for public procurement purposes. The Act sets out general principles to serve those purposes.

Purpose of the Public Procurement Act

124. The audits concerning the 2016 financial year conducted in ministries and entities revealed that internal controls required for procurement management were in place in most cases, save for AS Tallinna Sadam, and that such controls are usually solid. This means that, overall, sufficiently thorough procurement procedures are in place and procurement plans are mostly up to date.

125. However, the omission of procurement procedures, incl. simplified procedures, still continues to be a problem. In 2016, state agencies and entities have made purchases totalling at least 4.2 million euros and at least 11.1 million euros, respectively, without inviting public tenders.

126. Further, contracting authorities and entities violate procedural rules, fail to submit public procurement reports and their annexes to the Public Procurement Register or submit after a delay, etc. As for state agencies, the NAO made observations in all ministerial audits, whereas in 11 out of 27 audited entities the auditors did not detect such irregularities. A detailed overview of violations of the Public Procurement Act is set out in Table 4.

Table 4. Type and number of violations of the Public Procurement Act detected in the course of audits at state agencies and entities

Type of violation	State agencies	Entities
Statutory procurement procedures were omitted, incl.	99	103
simplified procedures were omitted	73	31
Incorrect type of procedure	5	1
Public procurement report filed with delay or omitted	70	3
Procurement documents, incl. procurement reports, are incomplete or contain inaccurate information	5	4
Written contract omitted	3	1
Shortcomings in the verification of tax arrears	10	17
Procurement procedures need revision	6	16
Other violations of the Act	6	4
Invitation to tender potentially tailored to certain bidders	0	2
Violation of procedural rules, incl. failure to respect time limits or verify compliance with criteria	6	7
Contracting entity failed to define itself as such	0	1
Total violations	210	159

Source: NAO audit reports and memoranda, and reports by certified auditors to the NAO

Violations of the Public Procurement Act have become more frequent whereas the nature of violations remains unchanged

State agencies and entities violate the general principles of the Public Procurement Act in a similar manner

127. In 2016, similarly to previous years, both state agencies and entities have mostly violated the **principles of transparency and verifiability**. This means that information provided to persons interested in tendering was neither equally available to everyone nor was it sufficient, relevant and up to date, or that the entire procurement procedure was neither public nor documented.

128. The NAO argues that respecting the said principles is essential to allow retrospective verification of events, decisions and their justifications.

129. The implementation of these principles must be supported by the procurement procedures of agencies. In this context, it is important that these regulate the agency's work arrangements insofar as necessary and are compatible with the Public Procurement Act. The Estonian Chamber of Trade and Commerce points out the same in its opinion⁶ on the draft of the Public Procurement Act adopted on 14 June 2017 adding that the procedures should be made public and the Public Procurement Register, for example, should allow monitoring whether the procurement is implemented in compliance with the applicable procedure.

130. Agencies governed by the Ministry of Defence and the Ministry of Education and Research were the most frequent violators of the principles of transparency and verifiability among state agencies. The most common violation attributable to the Ministry of Defence was the delayed filing of public procurement reports and their annexes with the Public Procurement Register. As for the government area of the Ministry of Education and Research, procurement procedures required by the Act were omitted.

131. Also, the **principles of equal treatment and proportionality** are frequently violated. This means that all persons interested in tendering, applicants and tenderers are not subjected to uniform criteria and/or everyone is not granted an equal opportunity to be awarded with the contract.

132. For example, contracting entities have often failed to verify whether the tenderer has **tax arrears**. Due to this omission, tenderers who should have been eliminated from the procurement procedure because they had tax arrears or failed to meet the established qualification criteria were qualified or even declared successful.

133. The NAO finds that awarding contracts to tenderers who fail to meet the qualification criteria set out in the Public Procurement Act but are declared successful due to inadequate controls makes it questionable whether the contracting entity will actually receive the goods or services because the tenderer might not be able to meet the commitments it has assumed in its tender.

Tax arrears means, for the purposes of the Public Procurement Act, arrears of national taxes or local taxes levied in the municipality of the place of residence or seat of the tenderer, or social security contributions, or interest calculated on tax not paid by the due date.

⁶ See Note 2 to the explanatory memorandum, <https://www.riigikogu.ee/tegevus/eelnoud/eelnou/ecbd5b61-734c-41b1-bff5-a54f285bce53/Riigihangete%20seadus>.

134. The Estonian Association of SMEs, the Estonian Chamber of Trade and Commerce and the Estonian Employers' Confederation have highlighted the same risk in their opinions on the draft of the Public Procurement Act adopted on 14 June 2017. Further, they have pointed out that in such cases there is a risk that the procurement must be cancelled and a new invitation to tender announced. This, however, amounts to a waste of resources of tenderers and contracting entities and causes notable delays.

135. The number of violations of the **principle of economy and feasibility** by contracting entities is a somewhat smaller. The purpose of this principle is to ensure that the public procurement of the state and public sector is managed optimally so that the right item is acquired at the right time, in the correct amount and in the right place, and the price/quality ratio is optimal.

136. A similar number of audit observations concern shortcomings related to the **effective use of competition**. Applying this principle helps determine which of the tenderers is capable of submitting the most attractive tender. Competition between tenderers increases economy and is essential in ensuring transparency.

137. The highest number of violations of the principles of equal treatment and proportionality, economy and expediency, and effective use of competition was detected by the auditors in the government area of the Ministry of Education and Research - approximately twice as much as in agencies governed by the Ministry of Culture and the Ministry of Economic Affairs and Communications.

138. In terms of entities, the foundations and companies governed by the Ministry of Social Affairs and the Ministry of Economic Affairs and Communications featured the highest number of irregularities for all fundamental principles. Among the said entities, foundations North Estonia Medical Centre (NEMC) and Tartu University Hospital, and the public limited company Tallinna Sadam accommodated three top spots in the violators' ranking. All said entities omitted procurement procedures, incl. simplified procedures. Plus, NEMC was often guilty of not verifying potential tax arrears before contract award, thus neglecting the principles of equal treatment and proportionality.

Reasons behind irregularities

139. The irregularities described above are caused by a number of factors from human errors to not being familiar with or misinterpreting the Public Procurement Act. Like over the previous years, errors are usually caused by poor or inaccurate planning: entities are unable to estimate the amount or cost of goods or services that are needed. The shortcomings in the organisation of procurements are problems related to the varying interpretation and implementation of the Act and insufficient experience or capability, especially in small agencies.

Avoiding conflicts of interest

140. One of principles of the Public Procurement Act is **avoiding conflicts of interest**. This means that in the fulfilment of their duties, individuals must refrain from making decisions that directly affect his own financial interests or those of his close relatives or legal entities connected to him.

141. In the course of audit procedures, the NAO examined whether and how the members of procurement committees at state agencies declare

their independence from tenderers. Usually, members of procurement committees do not provide written declarations of independence from tenderers. Although the procurement procedures established in many agencies do not require the committee members to declare their independence, the Public Procurement Act requires the contracting entities to avoid conflicts of interest that could damage competition when conducting public procurement.

142. According to the Anti-corruption Act, officials may not carry out acts or make decisions or be involved therein, if the decision is made or act is carried out with regard to the official himself or a person related to him, or the official is aware of conflicting interests, risk of corruption or other circumstances that arise doubt as to his impartiality or objectivity.

143. The NAO believes that the measures applied by state agencies might not be sufficient to avoid conflicts of interest because there is no assurance that committee members are independent every time they are involved in the committee's work.

144. The NAO finds that requiring the relevant officials to declare in writing that they have no conflict of interests raises awareness of the applicable procedural restrictions and helps to ensure that the use of public funds, incl. the management of public procurement, is fair and unbiased. To avoid increasing the administrative burden, this declaration could be inserted in documents which the committee members need to sign according to the Public Procurement Act, for example, the report on the qualification of tenderers.

145. NAO recommendations to the Minister of Public Administration:

- continue and expand centralised procurement and foster joint procurement, implement publicity measures to this end, and consolidate and analyse the agencies' procurement needs;
- make the declaration of independence mandatory and, to that end, instruct contracting entities to employ solutions which do not increase the administrative burden; and
- intensify monitoring in state-controlled companies and foundations where compliance with the Public Procurement Act has not been or is not planned to be audited.

Response of the Minister of Public Administration: The expansion of centralised and joint procurement has always been one of the objectives pursued by the government as attested by two orders adopted by the Government of the Republic in 2016 on extending centralised procurement.

The centralised procurement powers of the Centre of Registers and Information Systems (CRIS) were extended as from 1 July 2017 to include the acquisition of printers. Hence, the CRIS is the mandatory central contracting entity for acquiring office computers, monitors and printers for ministries, the agencies they govern, and the Government Office. In addition to centralised procurement, the CRIS arranges joint procurement in the field of ICT.

The Centre of State Support Services (CSSS) was appointed as a voluntary central contracting entity for government agencies and the state agencies administered by them as from 1 July 2016. As a result, agencies are relieved of the duty to acquire goods and services individually and can focus on their core functions.

As from 1 January 2016, the CSSS provides services to the Government Office and as from 1 July 2016 to the Ministry of Finance (MF) and the Ministry of Justice and the agencies governed by them. As the CSSS was established for the purpose of providing centralised support services to state agencies, the analysis of further expanding centralised and joint procurement will continue, and presumably the CSSS will take over the management of procurement for the government area of the Ministry of Social Affairs in 2017.

The functions of the CSSS include, among other things, consolidating the procurement needs of agencies it serves into a single procurement schedule to determine public tenders aimed at acquiring similar items and arrange joint procurement. The joint procurement plan of CSSS and CRIS is available at <https://kesksedhanked.rik.ee/> providing an overview of past and planned joint and centralised procurement projects.

In this context, it is worth highlighting the establishment of the Centre for Defence Investment that manages defence procurement as from 1 January 2017.

The MF in coordination with other ministries will continue to analyse the possibilities of expanding joint and centralised procurement. Notices of joint procurement and information on tendering is published, among other channels, in the public e-procurement portal: <https://riigihanked.riik.ee/lr1/web/guest/index>.

To improve the transparency and verifiability of public tenders, the MF has - following the procurement procedure analysis conducted in 2014 - recommended supplementing the procurement procedures with the requirement that procurement committee members and other officials guiding the procurement process must sign a written declaration certifying that they have no conflicts of interest. Further, to mitigate the risk of violation of procedural restrictions, we recommended that agencies put in place procedures for scrutinising the declarations of lack of conflicts of interest.

§ 9 of the new Public Procurement Act requires all contracting entities to put in place measures for preventing, identifying and eliminating conflicts of interest.

Furthermore, for providing guidance to contracting entities, we have published in the public e-procurement portal a reference to the Manual on Avoiding Conflicts of Interest developed jointly by the Ministry of Justice and the MF to help contracting entities introduce proper preventive measures for avoiding conflicts of interest. The manual is available at <https://riigihanked.riik.ee/lr1/web/guest/huvide-konflikti-kasiraamat>.

As another step to prevent and avoid conflicts of interest, we intend to further develop the Public Procurement Register in 2018 and allow

persons associated with the procurement to use the register for declaring that they have no such relation with the tenderer that would compromise their impartiality.

Since 2013, the annual risk analysis has served as the main input for preparing the MF's scheduled inspection plan for public procurement. The risk analysis aims to define priority areas for inspection (e.g. types of contracting entities or procurement procedures entailing a higher risk). Risk indicators (objective numerical values, estimations) are defined and the types of contracting entities are selected on the basis of information collected in the course of conducting public tenders and by the Public Procurement and State Aid Department whilst supervising public tenders. Another source is NAO audits and recommendations. We agree that the procurement activities of state-controlled companies and foundations require continued attention, and in preparing the inspection plans for following years we will take into account, insofar as possible, the NAO recommendation to inspect companies and foundations whose procurement activities have not been audited in recent years.

Also, we would like to point out that every year the scheduled inspection sample developed on the basis of the MF's risk analysis has included some companies controlled by the state or local government and state-controlled foundations - a detailed overview is available at <https://riigihanked.riik.ee/lr1/web/guest/2016-jarelevalve>.

The scheduled inspection sample for 2017 includes several companies and foundations controlled by the state or local government. As the inspection procedures for 2017 are pending, information on contracting entities in the sample is not public yet.

All aforesaid recommendations by the NAO would certainly be supported by improving the general know-how of contracting entities which is a potential EU initiative in the field of public procurement in the framework of the professionalisation measure.

Some agencies do not disclose procurement contracts or such contracts are not quickly and readily accessible

Disclosure of contracts

146. In its audits, the NAO assessed the practices of state agencies related to the disclosure of procurement contracts and identified several shortcomings. The government areas of the Ministry of Culture, the Ministry of the Environment, and the Ministry of Education and Research featured the highest number of failures to disclose contracts and their metadata.

147. The NAO auditors learned that agencies in the said government areas were little aware of the Public Information Act's requirements to disclose information on contracts - they had no idea what should be made public or where or when. Procurement contracts were neither available on the agencies' web sites nor entered in their public document registers. Plus, there were cases where agencies completely lacked a public document register in 2016.

A **restriction on access** is applied to information listed in § 35 of the Public Information Act that the holder of information may not disclose and that should be classified as internal.

Procurement contracts must be completely exempt from the restriction on access because procurement procedures are conducted using public money and § 36 (1) 9) and 10) prohibit the classification of use of budget funds, fees and benefits paid from the budget, or financial commitments of agencies.

Subjecting contracts to a restriction on access

Business secret means - according to § 63 (1) of the Competition Act - information concerning the business activities of an undertaking the communication of which to other persons is likely to harm the interests of such undertaking, above all, technical and financial information relating to know-how, information concerning the methodology of validation of expenditure, production secrets and processes, sources of supply, volumes of purchase and sales, market shares, clients and distributors, marketing plans, expenditure and price structures and sales strategy are deemed to be business secrets. Information subject to disclosure or disclosed to the public does not constitute a business secret.

148. To ensure the transparency and verifiability of using public funds, the Public Information Act requires the state agencies to allow anyone to access public information as quickly and readily as possible. As procurement contracts contain public information, these must be registered and made available in the agencies' public document registers. If a procurement contract is subject to a **restriction on access**, the contract must be entered in the agency's public document register by indicating its metadata and the basis for imposing the restriction. Any public information in the contract must be disclosed whenever a request for information is filed.

149. In other government areas, the failure to disclose contracts and their metadata was mostly due to negligence of officials and weak internal controls. For example, agencies governed by the Ministry of the Interior held several contracts that were not entered in the document registers although the agencies were convinced that it was necessary to do so: officials were unaware that upon entering the contract in the document management system, a note on disclosure should have been made in the system.

150. Agencies had subjected nearly one-half of contracts inspected during audits to a restriction on access. The NAO examined whether imposing such restrictions was justified. Two-thirds of contracts subjected to a restriction on access were classified on the basis of Public Information Act § 35 (1) 17) which provides that an agency may not disclose information that might compromise a **business secret**.

151. The NAO argues that the initiative for classifying information as a business secret can originate from a business - the state agency can only do so in cases where the presence of a commercial secret in the contract is evident. According to the agencies, they imposed the restrictions at their own discretion without businesses showing any initiative.

152. Invoking business secrecy was very popular among agencies governed by the Ministry of Economic Affairs and Communications who justified the restriction as follows: if a tender which is confidential pursuant to the Public Procurement Act is annexed to the procurement contract, the contract is automatically subjected to a restriction on access. For years, the Road Administration has employed the practice that every procurement contract is accompanied with the relevant tender which means that all contracts are automatically subjected to a restriction on access.

153. However, for the purposes of the Public Procurement Act, tenders may be treated as such only until the completion of the procurement procedure. Once the contract has been awarded, the Act no longer applies and restrictions on access may not be imposed on this ground. The imposition of restrictions should be based on the Public Information Act and the disclosure of tenders on their content.

154. The NAO finds that automatically subjecting contracts to the restriction is not justified. Even though contracting entities must protect confidential data like technical information or business secrets after the completion of the procurement procedure, their decision to disclose or not disclose information should be based on what the business operator sees as confidential information and why.

155. Before imposing automatic restrictions on contracts the agencies should analyse the contents of tenders and obtain assurance that such restrictions are justified. Above all, agencies must respect the rule that procurement contracts are public documents just as tenders usually are after the end of the procurement procedure. Further, agencies should analyse whether it is justified to annex the tender to each procurement contract. Tenders could be handled separately from contracts in the agencies' document registers.

156. Even though agencies disclose contracts subjected to a restriction on access when a request for public information is filed, the general public is unable to verify the use of public money as quickly and readily as would be reasonable.

157. NAO recommendation to the Minister of Public Administration: raise the state agencies' awareness of the need to disclose contracts awarded following public tenders to ensure that information is quickly and readily accessible for everyone and restrictions on access are granted only insofar as justified.

Response of the Minister of Public Administration: The Public Procurement Register publishes basic information about contracts awarded following public tenders - parties, date of signature, contract period, cost and any significant contract amendments made during the contract period. Contracting entities can add files containing contracts in the register but these are not public. The further developments of the Public Procurement Register to be undertaken in 2018 will allow contracting entities to publish contract files in the register.

However, it should be noted that the disclosure of contracts is a matter of principle affecting the entire public sector and cannot be decided lightly or without proper reasoning. It is true that normally contracts are either disclosed or access to them is restricted through document registers.

Pursuant to § 36 (1) 9) and 10) of the Public Information Act (PIA), documents on the use of budget funds of municipalities or public law legal entities and fees and benefits paid from their budgets as well as data on the financial commitments of information holders may not be classified as internal. However, § 35 (1) 17) of the PIA prohibits disclosing the business secrets of business operators. In the framework of freedom of enterprise and protection of property rights, business secrets of operators are a sort of constitutional value which in this context means that any disclosure of contracts must strike a reasonable balance between public and private interests and employ a solution that is practical and minimises the burden on parties involved.

As for the confidentiality of tenders, I disagree with the opinion in paragraph 153 to the effect that the Public Procurement Act no longer applies once the contract has been awarded. Concurring with this opinion would, among other things, lead to an interpretation that once the procurement contract has been awarded the parties may amend it at their own discretion and without restrictions - but this is not true. According to § 110 (5) of the new Public Procurement Act, tenders are confidential until the decision announcing the successful tender is made. Information in tenders may be disclosed only insofar as provided for by the Public Procurement Act.

The Ministry of Finance fosters the publication of procurement contracts in the Public Procurement Register and we intend to increase awareness of this opportunity through the public e-procurement portal, training courses, and other media. Besides, the European Commission is currently examining the practice of disclosing contracts in the EU Member States to make relevant recommendations by the end of 2017 that we can use as input for designing any national measures.

Disclosure of transactions with related parties

Related parties include the members of the highest governing bodies, executives, and their family members, including spouses, unmarried partners and children, as defined in the accounting policies and procedures of the government area as well as foundations, non-profit associations and companies where the aforesaid persons either individually or collectively with their family members have control or significant influence.

Identification and disclosure of transactions with related parties

158. The Public Sector Financial Accounting and Reporting Guidelines⁷ (“General Rules”) provide that annual accounts shall disclose information on transactions with **related parties** that are not in line with the legislation or the general requirements of the accounting entity's internal documents, or the market situation. The NAO argues that the principles contained in the General Rules and the accounting policies and procedures of government areas are not sufficient to ensure that all the required transactions are recognised in annual accounts.

159. According to the General Rules, individuals drawing up, coordinating and approving transaction documents are responsible for collecting information on transactions with related parties. The duty of such individuals is to supplement transaction documents subject to disclosure with the corresponding information so that accountants could recognise the transactions in balance records using the proper counterparty code. The NAO finds that assigning the duty to endorse documents to parties related to the transaction fails to ensure impartial assessment of transactions and increases the risk that transactions which are not in line with the legislation or market situation are omitted from the annual accounts.

160. The NAO finds that individuals independent from transactions - like the internal auditors of ministries - should be responsible for the identification and disclosure of transactions with related parties within the government areas. The NAO identified only a few cases where the government areas had followed this principle. For example, the responsible individual in the Ministry of Finance is the Head of its Internal Audit Department.

161. The NAO believes that principles set out in the General Rules and implemented by the government areas need to be adjusted to provide readers of annual accounts with more accurate information on transactions with related parties for evaluating the effectiveness of internal controls and the impact of transactions on financial statements.

162. The NAO maintains that the state should increase the transparency of transactions conducted at state agencies by disclosing even such transactions between related parties that are not recognised in the annual accounts. The NAO pointed this out in the audit report concerning the 2015 financial year.

⁷ Regulation No. 105 of the Minister of Finance that was titled General Rules of State Accountancy until 31 December 2016, and renamed as Public Sector Financial Accounting and Reporting Guidelines as from 1 January 2017.

The **public money application** is a web application for viewing and analysing the data in the Balance Records Information System. The application is available at <http://riigiraha.fin.ee>.

163. The NAO finds that the fastest and easiest solution would be using the **public money application** as provided for by the government's Anti-corruption Strategy for disclosing transactions of local governments. The strategy includes the goal to disclose transactions for each private law legal entity - currently, the Balance Sheet Records System recognises transactions with public sector counterparties only and transactions with private law entities only on aggregate.

164. Another goal is to interconnect the Balance Sheet Records System and the Commercial Register to display the members of management and owners of counterparties in the public money application. As the strategy provides for the further development of the application anyway, it should extend to the entire government sector rather than disclosing only the transactions of local government bodies. This would help the general public and the agencies themselves to identify transactions with related parties, improve the transparency of transactions throughout the government sector and manage the corruption risk.

165. NAO recommendations to the Minister of Public Administration:

- amend the General Rules so that transactions with related parties would be identified and disclosed by an independent individual;
- undertake to further develop the public money application in coordination with the Minister of Justice so that the general public would have access to information on all government sector transactions broken down by private law counterparties, and the members of management and owners of such counterparties.

Response of the Minister of Public Administration: We agree that the state should consider further increasing the transparency of the transactions of government sector bodies and disclosing more information on transactions with related parties.

However, we believe that merely appointing an individual responsible for identifying transactions with related parties does not solve the problem because the collection of data required for such monitoring, incl. the collection of personal data within agencies, should be in line with the provisions of the Personal Data Protection Act. Therefore, the individual responsible should either collect personal data subject to the approval of related parties or delegate the responsibility for disclosing transactions with related parties to such related parties. The Head of Internal Audit Department of the MF has done so by requiring the related parties to furnish an additional declaration.

Further development of the public money application is neither a simple nor quick task because this requires software developments for identifying information in suitable format in accounting systems and any interconnected information systems and moving this information into the public money application; interfaces linking the latter to the Commercial Register would need further development too. Example of a problem: accounting systems contain many entries, incl. aggregate entries, that are not accompanied by registry codes identifying specific counterparties. Hence, software developments might not yield the desired outcome.

We intend to involve the Heads of Internal Audit of the ministries in discussing the recommendations made by the NAO and seeking better solutions for monitoring transactions with related parties and disclosing transactions with private sector counterparties. Thereafter, we can consider revising the General Rules and further developing the public money application.

Overview of the implementation of government reform

Implementation of government reform

Government reform – restructuring of governance launched in 2015 with one of its goals being more effective and affordable arrangement of work within the government sector which requires reducing the government sector staff in line with the shrinking of working-age population.

166. In 2015, the Government of the Republic launched the implementation of the **government reform** with its main focus on reducing the government sector staff during the period from 1 June 2015 to 31 May 2016. Other (long-term) measures of the government reform included analysis of government functions (central government sector and social security funds) and any related restructuring proposals, mapping and analysis of public services, resource pooling, etc.

167. As the government's decision affects the management of public finances and the use of budget funds allocated to ministries, the NAO analysed the implementation of the staff cut in all ministerial government areas. In that context, the NAO examined the implemented and envisaged budget and staff adjustments and the core and auxiliary functions involved. The NAO auditors analysed whether and how the cuts have affected the provision of services and implementation of activities.

168. Based on this, the NAO finds that the reform has not witnessed many new initiatives and, in most cases, previously developed restructuring plans were put into effect. In ministries that lacked any previous reform programmes, the lay-offs were more painful and led to the deterioration of services provided, staff overload and labour shortage.

169. The government decision set lay-off targets for each ministerial government area taking partly into account the earlier lay-offs and the number of staff. The Ministry of the Interior which had already laid off a notable number of staff was allowed to lay off less and another exception was made for persons in active service in the Defence Forces, plus some nationwide projects were taken into account (e.g. Estonian presidency, work ability reform and Republic of Estonia 100).

170. The papers drafted by the MF and submitted to the cabinet of ministers addressed, among other things, the potential risks related to lay-offs: foundations whose staff number has grown the most will be excluded; services will be outsourced using contracts under the law of obligations rather than employment contracts; core functions will be financed from external sources, etc.

171. In addition, the said papers noted that notably cutting the government sector spending and staff number calls for fundamental changes in the performance of government functions and provision of public services, and that changes in government sector spending and, staff number and work arrangements can take place only if the government sector starts doing something fundamentally differently (structural reforms, reorganisation of functions) or starts doing less (delegation to private or third sector). Focusing only on staff cuts without reorganising the

services and processes could compromise the performance of the core functions of government and the quality and availability of services.

172. Interviews conducted by the NAO revealed that several ministries complied with the lay-off commitment by implementing previously developed reform programmes which reduced the need for labour. So, the Ministry of Defence restructured the manned guard services of the Defence League, the Tax and Customs Board governed by the MF reorganised its functions, and in the government area of the Ministry of Justice the support services of prisons and the work of registers maintained by courts were reorganised. In the said ministries, the lay-off scheme did not entail the pressure to reduce the provision of services or cut some activities because the long-term plans already took into account the need for staff cuts and these ministries had enough time to prepare for reorganisation, for example, by automating some work operations or centralising the support services.

173. However, in other ministries the lay-off process was not so smooth, affecting the provision of services, resulting in some labour shortage and staff overload. Officials of the Ministry of the Environment, the Ministry of Culture, the Ministry of Rural Affairs, the Ministry of the Interior, and the Ministry of Economic Affairs and Communications pointed out the negative effects on: the amount of services provided; the workload of current staff, and; the time limits for service provision.

174. The only one who failed to meet the target was the Ministry of Social Affairs as the hospitals it administers refused to carry out the lay-offs arguing that the planned lay-offs would significantly compromise the capacity to provide health services. The Chancellor of Justice whom the Tartu University Hospital Foundation addressed a petition claimed that the Ministry has no authority to directly intervene in the foundation's management or prescribe the number of its staff.

175. The NAO finds that implementing such superficial staff cuts without evaluating their impact on services and functions is unreasonable because it jeopardises the functioning of some services provided by the state. Also, such cuts do not take into account the current inefficiency: duplication of functions between government areas and excessive bureaucracy, and potential substitute functions that should be discontinued in the first place.

176. Likewise, this approach does not take into account past reforms and thus puts ministries which have already tried to rationalise their operations at a disadvantage compared to ministries that have not paid any attention to this so far.

177. The NAO believes that staff cuts are possible only following an analysis of the functions and duties of the state and determination of the number of staff required to perform them. Before massive lay-offs, the government analyse their impact on service provision and support staff cuts by other restructuring measures, for example, optimising the provision of support services or automating some functions. This systematic approach allows identifying areas to be reformed and ensuring that functions are optimised in the best possible way and without compromising services provided by the state.

178. The MF submitted a similar opinion to the cabinet of ministers before the latter decided to go ahead with universal lay-offs.

Conclusions of the NAO regarding the audited areas

179. Table 5 provides an overview of policy areas audited by the NAO and the main conclusions regarding the regularity of economic transactions in the audited areas. The monetary value of policy areas as in the 2016 state budget implementation report.

Table 5. Audited policy areas and opinions by the NAO

Audited area	Monetary value in 2016, in EUR	Are the transactions correctly recognised in the accounts?	Have the principles of the listed legislation been respected in conducting transactions within the audit scope?
Collection of revenue , incl. taxes and social security contributions, sale of goods and services, other revenue, financial revenue	7.967 billion	Yes	Yes
Receipt of support , incl. mediation of support	618 million	Yes	Yes
Granting of support , incl. mediation of support	4.038 billion	Yes	Yes
Effecting of operating expenses and assumption of commitments, incl. labour and management costs, other operating expenses, financial expenses, public procurement	4.201 billion	Yes	Yes
Transactions in state assets , incl. investments, and public procurement	299 million	Yes	Yes
Depositing of public funds (interest revenue from bonds, deposits and loans, other financial revenue)	14 million*	Yes	Yes
Exercise of founder's rights in foundations, non-profit associations and the profit-making state agency; state participation in legal persons governed by private law (purchase and sale of shareholdings and collection of dividends)	148 million*	Yes	Yes

* As featured in the state's unconsolidated cash flow statement for 2016.

180. A summary of audited policy areas and the NAO's opinions, broken down by ministries, is set out in Annex 4 hereto. The NAO has given detailed explanations of the omissions found and recommendations on how to avoid them in the audit reports and memos sent to state accounting entities. The financial audit reports are available on the website of the NAO.

/signed digitally/

Alar Karis
Auditor General

NAO recommendations to and replies from the Minister of Finance and the Minister of Public Administration

The NAO's audit did not result in any recommendations to the Ministry of Finance in this report. On 27 July 2017, the ministers sent their response to the draft audit report by the NAO.

Overall comments on the audit report

The report by the NAO serves as an input for improving the management of public finances and developing the policy on and strategic planning of state assets as it highlights the various aspects of the said policy areas that need improvement.

We would like to thank the NAO for their efforts and look forward to continued constructive cooperation over the forthcoming accounting periods.

NAO recommendations	Replies from audited entity
<p>National reserve funds</p> <p>45. NAO recommendations to the Minister of Finance and the Minister of Public Administration:</p> <ul style="list-style-type: none"> ▪ devise principles for determining the optimal size of the Stabilisation Reserve Fund by assessing the nature and amount of any emergency expenditure to ensure the availability of sufficient reserves; ▪ place the legal reserves of the EHIF and EUIF in the Stabilisation Reserve Fund, reassess the target level for the amount of money in the Liquidity Reserve and ensure the availability of sufficient reserves; ▪ analyse in coordination with the Bank of Estonia whether assigning the management of the Stabilisation Reserve Fund to the Bank of Estonia would allow cost savings; ▪ initiate the mutual alignment of the State Budget Act, the Estonian Health Insurance Fund Act and the Unemployment Insurance Act provided that using the money of the EHIF and EUIF for making payments on behalf of the state is in line with the nature and functions of these two public law entities. <p>(paragraphs 13 to 44)</p>	<p>Response of the Minister of Finance and the Minister of Public Administration: The Ministry of Finance (MF) finds that the applicable practice for increasing the Stabilisation Reserve Fund (SRF) is adequate and there is no need to set an additional ceiling for the size of the SRF. The SRF grows mostly on the account of cash flow surplus, profit allocations from the Bank of Estonia, and other irregular revenue. Boosting the reserve on the account of current revenue would mean using the cash flow surplus to withdraw additional funds from the economy which would excessively compromise economic growth. The MF disagrees with the argument that amendments to the State Budget Act imply waiver of the balance requirement which in turn notably reduces the amount of money placed in the SRF. The balance rule adjustment certainly does not have a direct impact on the SRF. However, it might have indirect effects but merely in terms of the annual breakdown rather than across longer periods. Firstly, the balance rule governs the structural position. And cash flows depend on the nominal position which - depending on the economic cycle - may differ from the structural position and have a different direction. Further, cash flows are affected by financing operations that are not recognised in budget position calculations. Hence, if there is a structural surplus, cash flows could still be negative, and the other way round. Secondly, the balance rule is applied to budget planning whereas the transfer of funds to the SRF depends on the actual situation, i.e. budget implementation.</p> <p>The SRF is an important tool for managing crises and emergencies and its symbolic value is to show that the state is ready for crises. However, in crisis situations, the MF cannot rely solely on the SRF because, firstly, it is extremely difficult to estimate the likelihood of various crises (natural disaster, economic crisis, financial crisis, war) and the level of ensuing expenditure. Secondly, in addition to deploying the SRF, the state can take a loan, cut costs or postpone investments in order to manage the crisis. Nevertheless, prevention of crises and more effective risk management are paramount.</p> <p>The SRF will be deployed only in emergencies. The MF aims to ensure that the state's risks are managed in a way that allows the state to finance its commitments in crisis situations without having to resort to the SRF or so that its deployment is postponed for as long as possible. For example, in a crisis, the state can address international crisis management funds (ESM, IMF) or other countries to borrow money. The SRF was last deployed in 2009 when 224 million euros were withdrawn to mitigate macroeconomic risks resulting from the global economic crisis. Also, two negative supplementary budgets were drawn up in 2009 to cut state budget expenditure by 584 million euros. Back then, IMF's assistance was not needed and the ESM did not exist yet. This demonstrates that deployment of reserves is not the only or primary tool for crisis management.</p> <p>The MF points out that the Riigikogu assembled all the funds of the EHIF and the EUIF to be centrally managed by the Ministry of Finance in view of the following policies:</p> <ol style="list-style-type: none"> 1. Improve the management of cash flows and debt commitments in the sector because:

NAO recommendations	Replies from audited entity
	<p>a) harmonised cash flow management and higher liquidity ensures more efficient use of the state's available financial resources; b) harmonised conservative investment policies yield cost savings for EHIF/EUIF, and the entire state budget.</p> <p>2. The MF ensures liquidity of the funds of EHIF/EUIF and any investment losses will not be attributed to them. Further, the EHIF/EUIF need no longer pay for costs related to bank transfers and investment operations.</p> <p>At the time of deciding this, the Riigikogu argued that the positive effect of harmonised cash flow management on the state budget and the EHIF/EUIF outweighs the assumption of increased financial risk ensuing from the presumably longer period of using the reserves of EHIF/EUIF. Hence, placing the legal reserves of EHIF/EUIF in the SRF would not be essentially compatible with the objectives set out in the legislative amendments adopted by the Riigikogu in 2011.</p> <p>In 2013, the MF weighed all aspects of collaborating with the Bank of Estonia in managing the SRF. At the time, the interest rates had dropped and it was not financially reasonable for the state to assign the management of the SRF to the Bank of Estonia. The related management and performance fees would have significantly reduced the profitability of the SRF. We doubt that in 2017, when interest rates are even lower or negative, it would be feasible for the state to outsource the SRF management services. However, the MF does not preclude the possibility that, in the future, if interest rates are notably higher, it will reconsider relevant collaboration with the Bank of Estonia.</p> <p>The EHIF and EUIF have not appeared as if by themselves, they have been set up by the government by means of legislation. The state establishes public law legal entities as independent bodies in order to entrust them with the performance of certain public functions. It follows that public law legal entities also perform public administration functions which the state considers appropriate to implement through independent bodies rather than state agencies. Further, public law legal entities cannot, by their nature, be entrusted with functions that would not be part of the state's functions. Furthermore, public law legal entities cannot have functions beyond those of the state. Likewise, public law legal entities cannot have rights or obligations for which the state could not set limits.</p> <p>Laws are the main instrument used by the state to determine the limits of the rights and obligations of such entities. Laws set out the functions of said entities. Also, laws determine the extent to which public law legal entities enter into private law relationships (e.g. various restrictions on assuming commitments or pursuing business). The state regulates the rights and obligations of public law legal entities in view of its own interests related to the specific area of public administration. However, by delegating functions to such entities the state does not entrust them with responsibility for managing the area of public administration in question. Further, despite setting up public law legal entities, the state retains responsibility for the functioning of the state as a whole meaning that the state may - in order to improve such functioning - rearrange the limits and principles of operation of said entities.</p> <p>According to § 9 (2) of the Constitution of the Republic of Estonia, the fundamental rights laid down therein do not extend to public law legal entities. Essentially, fundamental rights are a person's subjective rights vis-a-vis public authorities. However, a public law legal entity constitutes a public authority - it is established by the state in public interests and essentially for the performance of some of the state's functions. Hence, as a rule, public law legal entities do not need constitutional protection against the state. The public law legal entities that require constitutional protection against the state are exhaustively listed in the Constitution (§ 38 (2) universities and research institutions, § 111 Bank of Estonia, and § 154 (1) local authorities) whereas the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund are not among them.⁸</p> <p>Consequently, the legal capacity and autonomy of the EHIF and the EUIF are not absolute - these are determined by the legislator and can therefore be limited by law. The rights and obligations of public law legal entities are more limited than those of private law entities just as the ownership rights of public entities are usually more limited.⁹</p>

⁸ Also, see Truuväli, E-J and others. Constitution of the Republic of Estonia. Commented edition. Tallinn 2008, page 109, § 9, comment 5.2.3.

⁹ See Merusk, K. Avalik-õiguslik juriidiline isik avaliku halduse organisatsioon. Juridica, 1996, No. 4, pages 174 to 178.

NAO recommendations	Replies from audited entity
	<p>The purpose of the Act Amending State Budget Act, Alcohol, Tobacco, Fuel and Electricity Excise Duty Act, Estonian Health Insurance Fund Act, Local Government Financial Management Act and Unemployment Insurance Act in connection with 2012 State Budget Act, 7 December 2011, was to preserve the autonomy of the EHIF and the EUIF in performing their core functions. Changes made in the ownership rights of EHIF/EUIF related to very specific aspects - the holding and investing of funds. The holding and investing of funds is not a core function of EHIF/EUIF meaning that they retained full autonomy in performing their statutory functions.</p> <p>The amendments adopted with the Act of 7 December 2011 did not interfere with the performance of core functions of EHIF/EUIF. This is supported by § 39 (2) of the Estonian Health Insurance Fund Act and § 341 (2) of the Unemployment Insurance Act which clearly provide that the deposit agreement with the state must, at any time, allow EHIF/EUIF to make payments using money held on a current account within the group accounts of the state to perform their statutory functions. In view of the need to maintain constant and unlimited access of EHIF/EUIF to their money, the Estonian Health Insurance Fund Act and the Unemployment Insurance Act provide for entering into deposit agreements rather than loan agreements.</p> <p>We would like to explain that the deposit agreement is essentially an agreement where the depositary (in this case the state) undertakes to safekeep the movable property entrusted to it by the depositor (in this case EHIF/EUIF) and return it to the depositor at the end of the deposit period. The Law of Obligations Act allows the interpretation that the property to be deposited includes money which means that each agreement where a person entrusts its money with another person is not necessarily a loan agreement.</p> <p>According to the regulatory framework set up under the Act of 7 December 2011, the funds of EHIF/EUIF are held on their own current accounts and they have unlimited rights to use their funds at any given time. Such a legal relationship amounts to a deposit relationship rather than a loan relationship. An essential feature of a loan agreement is the lender's obligation to disburse the loan amount to the borrower, i.e. in this case, transfer the money to the current account of the state. Another essential feature of a loan agreement is the lender's obligation to enable the borrower to use the loan throughout the agreed period and refrain from reclaiming the loan amount before the agreed repayment date. The latter feature is not characteristic of the regulatory framework established by the said Act.</p> <p>A deposit agreement is, for instance, a current account agreement made with a bank - undoubtedly, the bank uses the money on the current account to finance its other products but such an agreement is made for an indefinite period (demand deposit), hence not constituting a loan agreement. The reason here is that the money is held on the account of the current account holder and the holder may use his money any time. The current situation is similar - the money of EHIF/EUIF is held on their current accounts within the group accounts of the state and they can use their money any time.</p> <p>The argument in the report that the MF has used the money of EHIF/EUIF towards the commitments of the state is misleading and not based on the legal concept of money as a fungible item. Likewise, this argument is not compatible with the Law of Obligation Act's provisions on agreements for depositing money. § 39 (1) of the Estonian Health Insurance Fund Act and § 341 (1) of the Unemployment Insurance Act clearly provide that a deposit agreement shall be entered into between the state and EHIF/EUIF. The provisions on deposit agreements are set out in the Law of Obligations Act that extends to deposit agreements between the state and EHIF/EUIF. According to § 896 (1), if fungible items, especially money, are deposited, the parties agree that the depositary undertakes to return items of the same kind, quality and quantity rather than the same item itself. Ownership and risk of accidental loss of items will be transferred to the depositary at the time of transfer of possession. Hence, the law provides that depositing money as a fungible item essentially means that the ownership of the item is transferred to the depositary and the depositary may use the depositor's money until the end of the deposit period.</p> <p>§ 67 (2) of the State Budget Act grants additional authorisation to use the money as it stipulates that the state use the deposited money provided that the owners of the money can make payments on account of their money any time. We disagree with the NAO's opinion and argue that this matter need</p>

NAO recommendations	Replies from audited entity
	<p>not be regulated by the Estonian Health Insurance Fund Act or the Unemployment Insurance Act. The Estonian Health Insurance Fund Act and the Unemployment Insurance Act require the EHIF/EUIF to deposit their funds pursuant to a deposit agreement on a current account within the group accounts of the state. Neither the Estonian Health Insurance Fund Act nor the Unemployment Insurance Act do not regulate how the state should hold the funds under the deposit agreement. Similarly, the said Acts do not regulate how a credit institution should hold the EHIF/EUIF funds under the deposit agreement. The Estonian Health Insurance Fund Act governs the activities of the EHIF - public law legal entity - and, by analogy, the Unemployment Insurance Act governs the activities of the EUIF, whereas the state's activities related to managing its cash flows and holding the money of other entities are governed by the State Budget Act, and the nature of the deposit agreement is defined in the Law of Obligations Act. In this context, the State Budget Act is a constitutional legal instrument which means that issues governed by the State Budget Act cannot be regulated by so-called ordinary instruments (e.g. Estonian Health Insurance Fund Act, Unemployment Insurance Act). Neither is it legally proper or necessary to regulate the contents of the deposit agreement between the state and the EHIF/EUIF in specific legal instruments beyond the Law of Obligations Act.</p> <p>Undoubtedly, the depository must comply with the deposit agreement's terms and conditions - in this case - ensuring that the owners of the money can use the money on their accounts to make payments any time. Another similarity to holding money in the bank is that banknotes are not kept in the bank's safe deposit box with "tags attached". Surely, the bank uses the deposited money and the depositor will not be able to reclaim the very same banknote. We underline that the money of EHIF/EUIF is still there and, according to § 67 (1) and (2), the MF must enable entities that hold money in the State Treasury to make payments on the account of their funds at any time for the purpose of performing their statutory functions. There is no evidence that the MF has obstructed the EHIF/EUIF in making payments on account of their funds and thereby violated the law or the applicable deposit agreements. The MF can borrow sufficient amounts from the banks on the same day or subject to a notice of up to 15 days to ensure that the payments of all users of the group accounts of the state will be made as and when necessary. The MF will resort to borrowing, if doing so is necessary for managing the cash flows. By postponing the use of borrowed funds, the state saves loan interest costs.</p> <p>The need to amend the Estonian Health Insurance Fund Act and the Unemployment Insurance Act was addressed by the Finance Committee of the Riigikogu during the legislative proceeding of the draft 456 SE following a motion for amendment by the faction of the Estonian Free Party. The Finance Committee did not consider it necessary to amend the said Acts and decided that making the relevant adjustment in the State Budget Act is sufficient. In § 67 (2) of the State Budget Act, the Riigikogu has expressly authorised the state to use third parties' funds that it holds until such time as the owners of the money express their intent to deploy those funds.</p> <p>We reiterate that, even if the money of EHIF/EUIF was held by a credit institution rather than the state, the money of those public law legal entities would be most certainly be put to use. In such case, the credit institution would use the held funds to finance its other expenses and return the funds to EHIF/EUIF only on demand. It remains unclear whether in that case the NAO would argue that such actions by credit institutions are not permitted and should be prohibited by specific legal instruments?</p> <p>The rules and principles for the management of state's cash flows as set out in Regulation No. 44 of 21 March 2014 of the Government of the Republic on „Principles for Management of the State's Cash Flows and the Stabilisation Reserve Fund“ are designed to ensure that the state has, at any time, access to funds required for conducting transactions specified in the state budget as well as funds for making payments on behalf of entities depositing their money with the state. The MF must ensure that at any given moment the Liquidity Reserve holds enough money to ensure smooth routine payments of entities keeping their money in the State Treasury (§ 66 (1) of the State Budget Act). To this end, the MF draws up cash flow forecasts on a daily basis and, based on such forecasts, either invests available money or borrows funds. According to § 67 (4) of the State Budget Act, cash flows are managed integrally pursuant to the said Regulation which means that the approach outlined in the report - for cash flow management purposes, the state should be distinguished from EHIF/EUIF or the EHIF from the EUIF - is not based on the provisions of the State Budget Act.</p>

NAO recommendations	Replies from audited entity
	<p>Further, we would like to explain that, according to § 9 (2) through (6) of Regulation No. 44 of 21 March 2014 of the Government of the Republic on „Principles for Management of the State's Cash Flows and the Stabilisation Reserve Fund“, the minimum level of the Liquidity Reserve for the group is determined on the basis of forecasts for negative net cash flows of the state and entities keeping their money in the State Treasury rather than on the basis of the total of funds of group members with positive balance (balance of funds of EHIF + EUIF ≤ balance of Liquidity Reserve). The minimum level of the Liquidity Reserve for the group is determined on the basis of the nine-month forecast for the level of negative net cash flows of the state which, among other factors, takes in account the total payments from social security funds. The outlined regulatory framework is based on the consolidated cash flow management principle which provides that the Liquidity Reserve must hold sufficient funds to make payments of all entities keeping money there, whereas cash flows are managed integrally meaning that at a specific time the cash flows of various entities might be balanced out. Pursuant to § 67 (2) of the State Budget Act, the balancing of intra-group cash flows may not limit the ability of EHIF/EUIF to make payments, but the explanatory memorandum to the said Act clearly provides for the possibility that the balances of the state's accounts might be negative at some point.</p> <p>Meanwhile, the state pays the Health Insurance Fund and the Unemployment Insurance Fund interest on the balances of their accounts (not based on the balance of the Liquidity Reserve), i.e. a fee for using their money. Hence, as a result of such operations, their financial resources increase instead of shrinking.</p> <p>To sum up the foregoing, the MF finds that the use of money of the EHIF/EUIF as provided for by the legislation and at times when the said public law legal entities do not need this money to perform their functions, does not affect the nature of EHIF/EUIF or their ability to perform duties entrusted with them. The holding and investing of funds is not a core function of EHIF/EUIF meaning that they retained full autonomy in performing their statutory functions and using their money. The Estonian Health Insurance Fund Act and the Unemployment Insurance Act are in line with the State Budget Act - each Act has its specific scope and it would not be legally proper to use the Acts governing the activities of the EHIF/EUIF to regulate or duplicate areas within the scope of the State Budget Act which is a constitutional legal instrument.</p> <p>Comment from the NAO: To ensure legal clarity, the NAO has requested the Chancellor of Justice to form an opinion on this matter.</p>
<p>Presentation of state budget</p> <p>50. NAO recommendation to the Minister of Finance and the Minister of Public Administration: outline, in the consolidated annual report of the state, justifications for carrying forward significant amounts from the accounting year to the following year, and include a reference to the location of more detailed information.</p> <p>(paragraphs 46 to 49)</p>	<p>Response of the Minister of Finance and the Minister of Public Administration: Note a31 to the Annual Consolidated Report of the State (pp. 180 to 186) includes an overview of the funds carried over from 2015 to 2016 and forward from 2016 to 2017, broken down by budget components and government areas. In conjunction with the transition to accrual-based budgeting as from 2017, there are several adjustments in relation to the provisions of the Regulation of the Ministry of Finance on “Procedure for Drafting of State Budget Strategy and Budgets of Government Areas of Ministries, and for Carry-over of State Budget Funds” as regards the process of carry-over of unused funds:</p> <ul style="list-style-type: none"> ▪ funds are carried over in two parts - the advances in January and the main part in August; ▪ balances carried over by agencies are adjusted with prepayments and commitments, and the use of investments in 2015 has been extended by a further year. <p>The so-called funds with limits, according to a Directive of the Minister of Finance, make up about 35% of amounts carried over whereby relevant detailed explanations are included in the Directive and its Annexes. An overview of funds carried over as advances is available on the web site of the MF at http://www.fin.ee/riigieelarve-2017.</p> <p>A significant share of the remaining funds that are “carried over automatically” is made up by foreign aid and the related co-financing (about 40% of the total carried over). As the final balances that include adjustments for prepayments and commitments are determined in the course of auditing, the relevant overview will be available by the end of August.</p>

NAO recommendations	Replies from audited entity
	<p>The second-largest group of expenses automatically carried over is made up by balances of tax revenue collected by the state (about 20% of the total carry-over) that are to be transferred to other entities (Health Insurance Fund, Unemployment Insurance Fund, local authorities, etc.) according to tax laws. The obligation to transfer the money and the relevant procedures are set out in tax laws. We believe that Note a31 shows - with sufficient clarity - how much remained untransferred as at year-end. Money does not remain untransferred because of omitted work or low capacity.</p> <p>In addition to the above two groups, the revenue from economic activities are carried over automatically (about 5% of the total carried over). Each state agency may use the revenue from economic activities at its own discretion for carrying out its operations.</p> <p>A finalised overview of carry-over of funds with limits as well as automatic carry-overs will be made available on the web site of the FM no later than in September 2017. As adjustments will no longer affect the carry-overs in future years, the overview will be comprehensive and it will be included in the annual consolidated report of the state and accompanied by references to more detailed information.</p>
<p>Explanatory memorandum to the State Budget Act</p> <p>88. NAO recommendations to the Minister of Finance and the Minister of Public Administration:</p> <ul style="list-style-type: none"> ▪ exercise greater care in drafting the budget act, take into account all adjustments made during legislative proceedings, and ensure conformity between amounts shown on the various budget lines; ▪ set out specific requirements for the composition of information provided in the explanatory memorandum to the annual state budget both on ministerial and national level, and coordinate the drafting of the memorandum so as to ensure uniform quality of information therein. <p>(paragraphs 71 to 87)</p>	<p>Response of the Minister of Finance and the Minister of Public Administration: We agree that the quality of State Budget Acts and their explanatory memoranda can be further improved. The Ministry of Finance (MF) and the ministerial government areas have made consistent efforts to this end. In coordination with the ministerial government areas, the process of drafting the 2017 state budget has been developed to automatically create the state budget and its explanatory memorandum within the information system. This development has notably reduced the administrative burden and the number of errors in introducing last minute decisions in the budget act.</p> <p>In the future, we will try to work more closely with the Riigikogu whilst the Riigikogu makes changes in the state budget.</p> <p>The general guidelines for drafting explanatory memoranda are being developed. These will be included in the manual on state budget drafting. Further, we'll reserve more time for harmonising the information disclosed in explanatory memoranda.</p>
<p>Financing of foundations</p> <p>92. NAO recommendation to the Minister of Finance and the Minister of Public Administration: during the process of drafting the state budget, consolidate and disclose in the budget's explanatory memorandum complete information on funding provided to foundations and indicate the intended purpose of such funds.</p> <p>(paragraphs 89 to 91)</p>	<p>Response of the Minister of Finance and the Minister of Public Administration: Funding to be granted to foundations is not completely finalised at the time of processing the budget in the Riigikogu because the grant of funding is the responsibility of ministers who adopt final decisions only at the beginning of the year after the Riigikogu has already approved the budget. However, we will try to negotiate with the ministerial government areas so that such information would be available and included in the adjusted explanatory memorandum prepared at the start of the year.</p>
<p>Planning of ICT investments</p> <p>96. NAO recommendation to the Minister of Finance and the Minister of Public Administration: establish rules of procedure of the ICT Committee and lay down the criteria for assessing the effectiveness of projects that have been awarded financing by the Committee.</p> <p>(paragraphs 93 to 95)</p>	<p>Response of the Minister of Finance and the Minister of Public Administration: We will review the so-called ICT Committee's rules of procedure and the criteria for reviewing supplementary financing requests before the new State Budget Act 2019-2022 process, and we intend to combine the processes of review of ICT projects and justification of ICT strategies of government areas and write down specific guidelines for those processes. § 13 of the Regulation of the Minister of Finance already lists the general criteria applicable to ICT projects.</p> <p>The financed ICT projects and expenses are monitored on the same basis as any other state budget funds. First and foremost, ICT projects should help attain the objectives and outcomes set for the government area, and various indicators are used to measure this. It would not be practicable to develop a standalone set of rules for performance assessment as this would increase the administrative burden and create confusion with regard to the existing performance assessment principles. Further, ICT expenses differ</p>

NAO recommendations	Replies from audited entity
	substantively (maintenance, personnel, development costs, etc.) making it impossible to apply uniform performance assessment criteria.
<p>Transition to activity-based budgeting</p> <p>119. NAO recommendations to the Minister of Finance and the Minister of Public Administration:</p> <ul style="list-style-type: none"> ▪ analyse the need to make the transition to activity-based budgeting, and if the process is to continue; ▪ agree on the principles of activity-based budgeting and the relevant transition programme, and ensure that all parties have a common understanding of activity-based budgeting and its implementation; ▪ ensure the availability of uniform methods for activity-based budgeting and of software that enables its implementation; ▪ determine how the budget should be managed and how the information on activities should be used; and ▪ thereafter, provide the government with an overview of progress achieved and further actions. <p>(paragraphs 97 to 118)</p>	<p>Response of the Minister of Finance and the Minister of Public Administration: The transition to activity-based budgeting is based on the applicable State Budget Act that was drafted in the light of the following analyses: report by a parliamentary committee on "Potential paradigm shift in fiscal policy within the parliamentary system of Estonia", OECD reports on "Towards a Single Government Approach" and "Fostering Strategic Capacity across Governments and Digital Services across Borders", NAO audit on "Activities of the Government of the Republic in assessing the impact of its work and in reporting of the results of its work", study by professor Giuseppe Gross on "Performance-based budgeting: A cross-country comparison", the project by Policy Research Centre Praxis on "Determination of performance areas of the state", and the joint report by the University of Tartu and Geomedia OÜ on "Analysis of strategic planning and management of the state". The list is not exhaustive.</p> <p>The essential principles of activity-based budgeting are set out in the State Budget Act and its explanatory memorandum that introduced activity-based budgeting in 2014. The most important principle is the balancing of needs and possibilities within the budget in view of the state's strategic objectives. The state budget is drawn up on the basis of available funds according to the financial forecast of the state and the needs outlined in strategic development plans. Needs are outlined on the basis of the desired effects to be achieved in the community and the services provided to people that are financed from the state budget. For example, the state arranges the provision of emergency medical care to boost the number of healthy life years. Activity-based budgeting means that the state budget determines how much money the state allocates to each sector whereby the planned and actual cost of each activity designed for the population is known. The budget consists of performance areas and programmes. Sectoral totals consist of the prices of relevant government-financed services calculated using the cost models.</p> <p>Activity-based information enables public sector leaders and the general public to better evaluate the economy, efficiency and effectiveness of expenses made using taxpayers' money. The management information obtained through activity-based budgeting will be used by the MF for drafting the state budget and conducting budget negotiations and by the ministers for managing the activities and budgets of their government areas.</p> <p>The MF supplies the action plan for transition to activity-based budgeting as part of the "Overview of developments in strategic planning and financial management". The main stages set out therein include structuring of strategic planning, introduction of cost models in state agencies, and mapping on public services. In 2017, the state introduced the accrual-based budget as a preparatory measure. To support the transition the MF will arrange the revision of legislation and instructional materials, the development of IT solutions, and the provision of training. The transition of each ministry will be supported by an individual project that comes with its own action plan.</p> <p>The methodology required for the transition to activity-based budgeting is set out in documents listed below. The basic rules and work arrangements are governed by the legislation. The State Budget Act adopted by the Riigikogu puts in place the legal framework for activity-based budgeting. Detailed rules are contained in implementing provisions: "Budget Classification", "Procedure for Drafting of State Budget Strategy and Budgets of Government Areas of Ministries, and for Carry-over of State Budget Funds", "Types of Strategic Development Plans, and Procedures for Drafting, Revising, Implementing and Evaluating Them, and for Reporting Thereon" and "Public Sector Financial Accounting and Reporting Guidelines". Detailed instructions supporting the transition are all on the web site "Manual on Strategic Planning and Financial Management".</p> <p>The software necessary for introducing activity-based budgeting that allows collecting and processing the relevant information includes the State Budget Information System (SBIS2), the Strategic Management Information System (SMIS), and the accounting and reporting modules of the SAP accounting software. These systems have been redeveloped to accommodate the transition. To cut the workload related to the management of cost models and</p>

NAO recommendations	Replies from audited entity
	<p>enable the use of more complex models, we are currently acquiring the Cost Accounting Information System (CAIS).</p> <p>The cabinet of ministers is informed as and when necessary. The last time the cabinet discussed the transition to activity-based budgeting was in connection with the amendment of the State Budget Act in spring 2017.</p>
<p>Management of public procurement</p> <p>145. NAO recommendations to the Minister of Public Administration:</p> <ul style="list-style-type: none"> ▪ continue and expand centralised procurement and foster joint procurement, implement publicity measures to this end, and consolidate and analyse the agencies' procurement needs; ▪ make the declaration of independence mandatory and, to that end, instruct contracting entities to employ solutions which do not increase the administrative burden; and ▪ intensify monitoring in state-controlled companies and foundations where compliance with the Public Procurement Act has not been or is not planned to be audited. <p>(paragraphs 120 to 144)</p>	<p>Response of the Minister of Public Administration: The expansion of centralised and joint procurement has always been one of the objectives pursued by the government as attested by two orders adopted by the Government of the Republic in 2016 on extending centralised procurement.</p> <p>The centralised procurement powers of the Centre of Registers and Information Systems (CRIS) were extended as from 1 July 2017 to include the acquisition of printers. Hence, the CRIS is the mandatory central contracting entity for acquiring office computers, monitors and printers for ministries, the agencies they govern, and the Government Office. In addition to centralised procurement, the CRIS arranges joint procurement in the field of ICT.</p> <p>The Centre of State Support Services (CSSS) was appointed as a voluntary central contracting entity for government agencies and the state agencies administered by them as from 1 July 2016. As a result, agencies are relieved of the duty to acquire goods and services individually and can focus on their core functions.</p> <p>As from 1 January 2016, the CSSS provides services to the Government Office and as from 1 July 2016 to the Ministry of Finance (MF) and the Ministry of Justice and the agencies governed by them. As the CSSS was established for the purpose of providing centralised support services to state agencies, the analysis of further expanding centralised and joint procurement will continue, and presumably the CSSS will take over the management of procurement for the government area of the Ministry of Social Affairs in 2017.</p> <p>The functions of the CSSS include, among other things, consolidating the procurement needs of agencies it serves into a single procurement schedule to determine public tenders aimed at acquiring similar items and arrange joint procurement. The joint procurement plan of CSSS and CRIS is available at https://kesksedhanked.riik.ee/ providing and overview of past and planned joint and centralised procurement projects.</p> <p>In this context, it is worth highlighting the establishment of the Centre for Defence Investment that manages defence procurement as from 1 January 2017.</p> <p>The MF in coordination with other ministries will continue to analyse the possibilities of expanding joint and centralised procurement. Notices of joint procurement and information on tendering is published, among other channels, in the public e-procurement portal: https://riigihanked.riik.ee/lr1/web/guest/index.</p> <p>To improve the transparency and verifiability of public tenders, the MF has - following the procurement procedure analysis conducted in 2014 - recommended supplementing the procurement procedures with the requirement that procurement committee members and other officials guiding the procurement process must sign a written declaration certifying that they have no conflicts of interest. Further, to mitigate the risk of violation of procedural restrictions, we recommended that agencies put in place procedures for scrutinising the declarations of lack of conflicts of interest.</p> <p>§ 9 of the new Public Procurement Act requires all contracting entities to put in place measures for preventing, identifying and eliminating conflicts of interest.</p> <p>Furthermore, for providing guidance to contracting entities, we have published in the public e-procurement portal a reference to the Manual on Avoiding Conflicts of Interest developed jointly by the Ministry of Justice and the MF to help contracting entities introduce proper preventive measures for avoiding conflicts of interest. The manual is available at https://riigihanked.riik.ee/lr1/web/guest/huvide-konflikti-kasiraamat.</p> <p>As another step to prevent and avoid conflicts of interest, we intend to further develop the Public Procurement Register in 2018 and allow persons associated with the procurement to use the register for declaring that they have no such relation with the tenderer that would compromise their impartiality.</p>

NAO recommendations	Replies from audited entity
	<p>Since 2013, the annual risk analysis has served as the main input for preparing the MF's scheduled inspection plan for public procurement. The risk analysis aims to define priority areas for inspection (e.g. types of contracting entities or procurement procedures entailing a higher risk). Risk indicators (objective numerical values, estimations) are defined and the types of contracting entities are selected on the basis of information collected in the course of conducting public tenders and by the State Aid Department whilst supervising public tenders. Another source is NAO audits and recommendations. We agree that the procurement activities of state-controlled companies and foundations require continued attention, and in preparing the inspection plans for following years we will take into account, insofar as possible, the NAO recommendation to inspect companies and foundations whose procurement activities have not been audited in recent years.</p> <p>Also, we would like to point out that every year the scheduled inspection sample developed on the basis of the MF's risk analysis has included some companies controlled by the state or local government and state-controlled foundations - a detailed overview is available at https://riigihanked.riik.ee/lr1/web/guest/2016-jarelevalve.</p> <p>The scheduled inspection sample for 2017 includes several companies and foundations controlled by the state or local government. As the inspection procedures for 2017 are pending, information on contracting entities in the sample is not public yet.</p> <p>All aforesaid recommendations by the NAO would certainly be supported by improving the general know-how of contracting entities which is a potential EU initiative in the field of public procurement in the framework of the professionalisation measure.</p>
<p>Disclosure of procurement contracts</p> <p>157. NAO recommendation to the Minister of Public Administration: raise the state agencies' awareness of the need to disclose contracts awarded following public tenders to ensure that information is quickly and readily accessible for everyone and restrictions on access are granted only insofar as justified. (paragraphs 146 to 156)</p>	<p>Response of the Minister of Public Administration: The Public Procurement Register publishes basic information about contracts awarded following public tenders - parties, date of signature, contract period, cost and any significant contract amendments made during the contract period. Contracting entities can add files containing contracts in the register but these are not public. The further developments of the Public Procurement Register to be undertaken in 2018 will allow contracting entities to publish contract files in the register.</p> <p>However, it should be noted that the disclosure of contracts is a matter of principle affecting the entire public sector and cannot be decided lightly or without proper reasoning. It is true that normally contracts are either disclosed or access to them is restricted through document registers.</p> <p>Pursuant to § 36 (1) 9) and 10) of the Public Information Act (PIA), documents on the use of budget funds of municipalities or public law legal entities and fees and benefits paid from their budgets as well as data on the financial commitments of information holders may not be classified as internal. However, § 35 (1) 17) of the PIA prohibits disclosing the business secrets of business operators. In the framework of freedom of enterprise and protection of property rights, business secrets of operators are a sort of constitutional value which in this context means that any disclosure of contracts must strike a reasonable balance between public and private interests and employ a solution that is practical and minimises the burden on parties involved.</p> <p>As for the confidentiality of tenders, I disagree with the opinion in paragraph 153 to the effect that the Public Procurement Act no longer applies once the contract has been awarded. Concurring with this opinion would, among other things, lead to an interpretation that once the procurement contract has been awarded the parties may amend it at their own discretion and without restrictions - but this is not true. According to § 110 (5) of the new Public Procurement Act, tenders are confidential until the decision announcing the successful tender is made. Information in tenders may be disclosed only insofar as provided for by the Public Procurement Act.</p> <p>The Ministry of Finance fosters the publication of procurement contracts in the Public Procurement Register and we intend to increase awareness of this opportunity through the public e-procurement portal, training courses, and other media. Besides, the European Commission is currently examining the practice of disclosing contracts in the EU Member States to make relevant</p>

NAO recommendations	Replies from audited entity
	<p>recommendations by the end of 2017 that we can use as input for designing any national measures.</p>
<p>Transactions with related parties</p> <p>165. NAO recommendations to the Minister of Public Administration:</p> <ul style="list-style-type: none"> ▪ amend the General Rules so that transactions with related parties would be identified and disclosed by an independent individual; ▪ undertake to further develop the public money application in coordination with the Minister of Justice so that the general public would have access to information on all government sector transactions broken down by private law counterparties, and the members of management and owners of such counterparties. <p>(paragraphs 158 to 164)</p>	<p>Response of the Minister of Public Administration: We agree that the state should consider further increasing the transparency of the transactions of government sector bodies and disclosing more information on transactions with related parties.</p> <p>However, we believe that merely appointing an individual responsible for identifying transactions with related parties does not solve the problem because the collection of data required for such monitoring, incl. the collection of personal data within agencies, should be in line with the provisions of the Personal Data Protection Act. Therefore, the individual responsible should either collect personal data subject to the approval of related parties or delegate the responsibility for disclosing transactions with related parties to such related parties. The Head of Internal Audit Department of the MF has done so by requiring the related parties to furnish an additional declaration.</p> <p>Further development of the public money application is neither a simple nor quick task because this requires software developments for identifying information in suitable format in accounting systems and any interconnected information systems and moving this information into the public money application; interfaces linking the latter to the Commercial Register would need further development too. Example of a problem: accounting systems contain many entries, incl. aggregate entries, that are not accompanied by registry codes identifying specific counterparties. Hence, software developments might not yield the desired outcome.</p> <p>We intend to involve the Heads of Internal Audit of the ministries in discussing the recommendations made by the NAO and seeking better solutions for monitoring transactions with related parties and disclosing transactions with private sector counterparties. Thereafter, we can consider revising the General Rules and further developing the public money application.</p>

Overview of the Consolidated Annual Report

The Consolidated Annual Report of the State has been prepared pursuant to the State Budget Act and the Generally Accepted Accounting Principles of Estonia. The Consolidated Annual Report of the State comprises the state's annual accounts with the State Budget Implementation Report (i.e. the state's consolidated and unconsolidated report), additional information about local governments, the public sector and the government sector, and the management report.

The accounts of 17 state accounting entities with the agencies in their areas of government, the State Forest Management Centre, 68 foundations under the control of the state and 30 companies are consolidated in the consolidated annual accounts of the state. Additional information is given about 213 local authorities, and the indicators of the foundations, non-profit organisations and subsidiaries under their control are also included. On top of the above, additional information about the government sector and public sector also contains legal entities in public law and entities under their direct or indirect control.

The Minister of Finance and the Minister of Public Administration are responsible for the preparation of the Consolidated Annual Report of the State and state accountancy is organised by the Financial Accounting Department of the State Shared Service Centre.

Description of audit

Audit objective

The State Budget Act requires the NAO to audit the annual accounts of the state. Likewise, the NAO is required to audit the regularity of transactions conducted by the state.

The objective of the audit is to provide an opinion on the annual accounts 2016 and the regularity of transactions of the state. The Annual Accounts of the State contain the balance sheet of consolidated and unconsolidated assets and liabilities as at 31/12/2016, the consolidated and unconsolidated income statement, report on changes in net assets and cash flow statement for the financial year ended on 31/12/2016 a summary of the accounting policies and procedures used in preparing the annual accounts and other explanatory notes. The annual accounts contain the State Budget Implementation Report as a supplementary statement.

Principles for expressing an opinion

The NAO's opinion on the accuracy of the annual accounts of the state and the regularity of transactions means that:

- the annual accounts are correct if they are prepared pursuant to the accounting principles generally accepted in Estonia and to the Accounting Act, and all material information which provides a correct and fair view of the financial position of the state has been made public;
- transactions are legitimate if performed in compliance with the State Budget Act, the 2016 State Budget Act and the 2016 State Budget Act Amendment Act.

Observations made in the report are findings which, due to the irrelevance of the amounts and the circumstances related to the appearance thereof, did not affect the opinion of the National Audit Office regarding the accuracy of the annual accounts and the regularity of transactions, but which could result in significant errors in the annual accounts or regularity of transactions under different conditions. Regarded as relevant are observations, which, once learned, will affect the user of the annual accounts. Relevancy depends on the financial value and substance of the observation and it is assessed on the basis of the

applicable circumstances. The financial value of relevance is determined as a percentage of assets calculated on the basis of data in the consolidated annual accounts of the state. The assessment of errors takes account of quantitative aspects of relevance like substance, context (e.g. intent), and potential damage (e.g. corruption, revenue forgone, economic inexpediency).

Audit scope

In order to provide an opinion on the accuracy of the state's annual accounts, the NAO assessed the conformity of the annual accounts with the Generally Accepted Accounting Principles of Estonia. The main requirements of these principles are set out in the Estonian Accounting Act, which is supplemented by the guidelines of the Accounting Standards Board and the Public Sector Financial Accounting and Reporting Guidelines. The Generally Accepted Accounting Principles of Estonia are based on internationally recognised accounting policies (EU directives on accountancy, International Public Sector Accounting Standards).

Auditing of compliance with State Budget Acts is divided into two segments: auditing the regularity of transactions and auditing the budget implementation report). In order to express an opinion on the regularity of transactions, the NAO audited whether or not the transactions were performed in accordance with the State Budget Act, the 2016 State Budget Act and the 2016 State Budget Act Amendment Act in all material respects. To this end, the NAO examined whether: state budget revenues had been collected; expenses, investments and financing operations were effected expediently; the budget adopted with the annual state budget act and budget amendments have been respected, and; prepayments made from the budget were unavoidable.

Further, the NAO examined whether state agencies assumed commitments only when funds were allocated to them for this end in the state budget and whether all revenues, expenses, investments and financing operations have been broken down in a manner that clearly determines their financial nature or purpose. In the context of auditing the budget implementation report, the NAO examined whether the report was drawn up in accordance with the rules and whether any adjustments were justified.

As to acquisition of assets, auditors examined the compliance of transactions with the general principles of the Public Procurement Act, including economy, feasibility, equal treatment and proportionality, transparency and verifiability, effective competition, and avoidance of conflict of interests. To this end, on selective basis and following a risk assessment, acquisitions exceeding the threshold were checked for compliance with the procedures set out in the PPA, whereas simplified procedures were checked for compliance with the general principles of public procurement. The compliance of operations of selected companies and foundations (see the list in Annex 1) with the Public Procurement Act was audited by certified auditors from the private sector.

In the context of auditing the conformity of transactions with the State Assets Act, auditors examined - on selective basis and following a risk assessment - whether transactions were conducted in respect of the principles of governing state assets and essential requirements as set out in the said Act.

Limitation of scope

The annual accounts of the state contain the financial indicators of public undertakings, foundations controlled by the state and profit-making state agency. The annual accounts of companies, foundations and profit-making state agency were audited by certified auditors. The NAO considered the opinions of certified auditors when expressing its opinion of the annual accounts of the state. The certified auditors who provided their opinions on the annual accounts of foundations, companies and the profit-making state agency did not assess the regularity of their transactions (except for the companies and foundations listed in Annex 1 hereto) and the NAO has not performed any additional activities in this respect.

The NAO does not provide an opinion on the management report presented as part of the Consolidated Annual Report of the State. The numerical values in the management report originating directly from the annual accounts were checked.

The NAO did not carry out audit procedures to check additional information (annual accounts) about local authorities, the public sector or the government sector disclosed in the Consolidated Annual Report of the State.

Audit approach

The NAO carried out the audit in accordance with INTOSAI (International Organisation of Supreme Audit Institutions) auditing standards which address the auditing of financial statements and the legality of transactions in the framework of an audit of financial statements. These standards require that an audit be planned and performed in a manner that allows the auditor to decide with reasonable assurance that the financial statements are free of any material misstatements and that transactions, insofar as audited, comply with the State Budget Act, the 2016 State Budget Act and the 2016 State Budget Act Amendment Act in all material respects.

During the audit, evidence was collected on the numerical values and information disclosed in financial statements and on the regularity of transactions. To facilitate the planning of appropriate audit operations, the NAO took into account the internal control system put in place for drawing up financial statements and ensuring the regularity of transactions. The NAO does not issue an opinion on the effectiveness of internal controls on the whole. Also, the auditors examined whether the applied accounting policies were relevant and any accounting estimates by the management were justified.

The NAO is of the opinion that the audit provides a sufficient basis for expressing an opinion on the accuracy of the annual accounts, the reliability of the State Budget Implementation Report and the regularity of transactions.

Time of completing the audit

The audit was completed in July 2017.

Audit team

The audit involved auditors from the Financial Audit Department, and it was managed by Angela Onno, Senior Auditor of the Financial Audit Department in the capacity of Project Manager.

Contact particulars

For further information on the audit, please contact the NAO Communication Service by phone: +372 640 0704 or +372 640 0777, or e-mail: riigikontroll@riigikontroll.ee.

The electronic version of the audit report (pdf) is available on web site www.riigikontroll.ee.

The summary of the audit report is available in English also.

The reference number of the audit report in the NAO records system is 2-1.8/17/60154/142.

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NAO's earlier audits on the consolidated annual report of the state

29 August 2016 - **Accuracy of Annual Accounts 2015 and regularity of transactions of the state**

19 August 2015 – **Accuracy of consolidated annual report 2014 and regularity of transactions of the state**

12 August 2014 – **Accuracy of consolidated annual report 2013 and regularity of transactions of the state**

15 August 2013 – **Accuracy of consolidated annual report 2012 and regularity of transactions of the state**

27 August 2012 – **Accuracy of consolidated annual report 2011 and regularity of transactions of the state**

All reports are available on the NAO web site www.riigikontroll.ee.

Annex 1. State-controlled companies and foundations subject to audit of regularity of transactions, and results of audits of their procurement activities

Foundation/ company	Entity has put in place internal controls for the management procurement activities in accordance with the Public Procurement Act	Entity has respected the fundamental principles of the Public Procurement Act in its procurement activities
AS Hoolekandeteenused	Yes	Yes, except for the observation on non-compliance with procedural rules whilst managing a public procurement procedure
North Estonia Medical Centre	Yes, except for the observation on the need to revise procurement rules	Yes, except for the comment on the omission of procurement procedures, incl. simplified procedures, and the violation of procedural rules
Tartu University Hospital	Yes	Yes, except for the comment on the omission of procurement procedures, incl. simplified procedures, and the violation of procedural rules
Viljandi Hospital	Yes	Yes
Archimedes Foundation	Yes	Yes, except for observations on potential purchases outside the procurement framework, and the failure to enter into a written agreement
Information Technology Foundation for Education	Yes	Yes
Estonian Research Council Foundation	Yes	Yes
Innove Foundation	Yes	Yes
Foundation Science Centre AHHA	Yes	Yes
Enterprise Estonia Foundation	Yes	Yes, except for the comment on purchases that could encompass purchases of goods and services that should have been acquired under applicable framework agreements or for which a procurement procedure should have been conducted
Foundation KredEx	Yes, except for the observation on the harmonisation of internal processes	Yes
Foundation Tallinn Science Park Tehnopol	Yes, except for observations on the shortcomings in procurement rules and the failure to respect said rules	Yes
AS Eesti Liinirongid	Yes	Yes
AS Eesti Vedelkütusevaru Agentuur	Yes	Yes, except for the comment on the omission of simplified procedures
Eesti Loots AS	Yes	Yes, except for the comment on the omission of procurement procedures, incl. simplified procedures
AS Eesti Raudtee	Yes	Yes
EVR Cargo AS	AS EVR Cargo has not defined itself as a contracting entity and consequently the certified auditor has not issued an opinion on the regularity of the company's economic transactions in 2016	
Saarte Liinid AS	Yes	Yes

Tallinna Sadam AS	No, the applicable procurement rules are not compatible with the Public Procurement Act	No, procurement procedures, incl. simplified procedures, were omitted, and the principles of the Public Procurement Act were violated
Rural Development Foundation	Yes	Yes
Riigi Kinnisvara AS	Yes	Yes
Eesti Loto AS	Yes	Yes, except for the comment on the omission of procurement procedures, incl. simplified procedures
Tehvandi Sports Centre Foundation	Yes, except for observations on shortcomings in procurement rules	Yes, except for observations on the omission of procurement procedures, incl. simplified procedures, and the division of procurement into lots
Estonian Drama Theatre Foundation	Yes, except for observations on shortcomings in procurement rules	Yes
Vanemuine Theatre Foundation	Yes	Yes
Narva Museum Foundation	Yes	Yes, except for the observation on the omission of simplified procedures
Estonian Open Air Museum Foundation	Yes	Yes, except for the observation on the omission of simplified procedures

Source: reports for 2016 from certified auditors to the NAO

Annex 2. Results of audits at foundations under dominant influence of the Ministry

Foundation	Total assets as at 31.12.2016 (in EUR million)	Opinion
Environmental Investment Centre	181.3	Unqualified opinion
Holstre-Polli Health Centre	1.1	Unqualified opinion with highlighted circumstances
A.H. Tammsaare Museum at Vargamäe	0.4	Unqualified opinion
Läänemaa Development Centre	0.1	Unqualified opinion
Saaremaa Development Centre	0.1	Unqualified opinion
Viljandimaa Development Centre	0.04	Unqualified opinion
Võrumaa Development Agency	0.1	Unqualified opinion
Tuuru Foundation	0.2	Unqualified opinion
Jõgevamaa Development and Enterprise Centre	0.1	Audit is pending
Koeru Care Centre	2.0	Unqualified opinion
Raplamaa Development and Enterprise Centre	0.1	Unqualified opinion
Estonian e-Health Foundation	2.4	Audit is pending
Estonian Fund for Disabled People	0.1	Unqualified opinion
Image Database for Estonian Healthcare	2.0	Unqualified opinion
Haapsalu Neurological Rehabilitation Centre	4.1	Unqualified opinion
North Estonia Medical Centre	206.2	Unqualified opinion
Sillamäe Rehabilitation Centre for Drug Addicts (undergoing liquidation)	0.2	Audit is pending
Tartu University Hospital	183.8	Unqualified opinion
Viljandi Hospital	13.1	Unqualified opinion
Hiiumaa Hospital	1.9	Unqualified opinion
Jõgeva Hospital	2.1	Unqualified opinion
Enterprise Estonia Foundation	48.4	Unqualified opinion
State Infocommunication Foundation	10.2	Unqualified opinion
Foundation Estonian Accreditation Centre	0.5	Unqualified opinion
Foundation KredEx	192.7	Unqualified opinion
Foundation Tallinn Science Park Tehnopol	19.2	Unqualified opinion
Rural Development Foundation	68.5	Unqualified opinion
Private Forest Centre	1.7	Unqualified opinion
Cultural Publications Foundation	0.7	Unqualified opinion
Tehvandi Sports Centre Foundation	17.9	Unqualified opinion
Estonian Song and Dance Celebration Foundation	1.1	Unqualified opinion
Integration Foundation*	1.4	Unqualified opinion
Estonian Drama Theatre Foundation	8.1	Unqualified opinion

Estonian Film Institute	1.3	Unqualified opinion
Jõulumäe Recreational Sports Centre	2.8	Unqualified opinion
Narva Alexander's Cathedral Foundation	0.3	Audit is pending
Rakvere Theatre Foundation	6.3	Unqualified opinion
Tartu St. John's Church Foundation	0.02	Unqualified opinion
Ugala Theatre Foundation	17.5	Unqualified opinion
Estonian National Commission for UNESCO	0.01	Unqualified opinion
Old Town Theatre Foundation	0.2	Unqualified opinion
Russian Theatre	10.2	Unqualified opinion
Virumaa Museums Foundation	4.1	Unqualified opinion
Endla Theatre Foundation	3.6	Unqualified opinion
Vanemuine Theatre Foundation	16.1	Unqualified opinion
Theatre NO99 Foundation	0.5	Unqualified opinion
Foundation NUKU	1.1	Unqualified opinion
Narva Museum Foundation	10.9	Unqualified opinion
Haapsalu and Läänemaa Museums Foundation	2.3	Unqualified opinion
Estonian Healthcare Museum Foundation	0.8	Unqualified opinion
Estonian Open Air Museum Foundation	10.6	Unqualified opinion
Estonian Concert Foundation	21.0	Unqualified opinion
Estonian National Symphony Orchestra	0.8	Unqualified opinion
Hiiumaa Museums Foundation	0.3	Qualified opinion
Estonian Language Foundation	0.2	Unqualified opinion
Foundation Estonian Philharmonic Chamber Choir	0.3	Unqualified opinion
Pärnu Museum Foundation	0.2	Unqualified opinion
Foundation Art Museum of Estonia (established in 2016)	2.1	Unqualified opinion
National Foundation of Civil Society	1.4	Unqualified opinion
Estonian Foreign Policy Institute	0.1	Unqualified opinion
International Centre for Defence and Security	0.2	Unqualified opinion
Culture Fund of President of the Republic	0.01	Unqualified opinion
Estonian Cooperation Assembly	0.03	Unqualified opinion
Information Technology Foundation for Education	18.7	Unqualified opinion
Innove Foundation	30.3	Unqualified opinion
Estonian Qualifications Authority	0.9	Unqualified opinion
Archimedes Foundation	44.5	Unqualified opinion
Estonian Research Council Foundation	7.0	Unqualified opinion
Foundation Science Centre AHHA	10.6	Unqualified opinion
Sports Education and Information Foundation	1.1	Unqualified opinion

* The business name of the Integration Foundation used to be Integration and Migration Foundation Our People until 15 March 2017.

Source: audited annual reports for 2016

Annex 3. Results of audits at companies governed by the Ministry

Company	Size of holding (%)	Total assets as at 31.12.2016 (in EUR million)	Opinion
Eesti Energia AS (group)	100	3087.2	Unqualified opinion
Riigi Kinnisvara AS (group)	100	508.9	Unqualified opinion
Eesti Loto AS	100	18.0	Unqualified opinion
AS Levira (group)	51	25.5	Unqualified opinion
AS Hoolekandeteenused	100	39.4	Unqualified opinion
Tallinna Sadam AS (group)	100	638.7	Unqualified opinion
Eesti Post AS (group)	100	77.0	Unqualified opinion
Tallinna Lennujaam AS (group)	100	155.5	Unqualified opinion
Lennuliiklusteeninduse AS	100	29.2	Unqualified opinion
Saarte Liinid AS	100	59.5	Unqualified opinion
Eesti Loots AS	100	19.5	Unqualified opinion
AS Eesti Liinirongid	100	170.4	Unqualified opinion
Teede Tehnokeskus AS	100	2.8	Unqualified opinion
Metrosert AS	100	3.5	Unqualified opinion
AS Eesti Vedelkütusevaru Agentuur	100	154.9	Unqualified opinion
A.L.A.R.A. AS	100	1.4	Unqualified opinion
Eesti Raudtee AS	100	301.4	Qualified opinion
Eesti Teed AS	100	28.7	Unqualified opinion
KredEx Krediidikindlustus AS	100	39.5	Unqualified opinion
Elering AS	100	903.7	Unqualified opinion
EVR Cargo AS	100	64.8	Unqualified opinion
Rail Baltic Estonia OÜ	100	2.2	Qualified opinion with highlighted circumstances
Nordic Aviation Group AS	100	29.9	Qualified opinion
Transpordi Varahalduse OÜ	100	51.9	Unqualified opinion
AS Vireen	100	6.4	Unqualified opinion
Eesti Põllumajandusloomade Jõudluskontrolli AS	93.3	1.1	Unqualified opinion
OÜ Eesti Geoloogiakeskus	100	1.4	Unqualified opinion
AS Eesti Kaardikeskus	100	0.6	Unqualified opinion
OÜ Eesti Keskkonnauuringute Keskus	100	10.0	Unqualified opinion
AS Ökosil	35	1.7	Unqualified opinion
AS Eesti Vanglatööstus	100	1.1	Unqualified opinion
AS Andmevara*	100	0.5	Unqualified opinion

* The public limited company belonged to the state until 20 April 2016

Source: audited annual reports for 2016

Annex 4. Overview of audited areas and the corresponding opinions of the NAO

Ministry	Audited area						
	Collection of revenue, incl. taxes and social security contributions, sale of goods and services, other revenue	Receipt of support, incl. mediation of support	Granting of support, incl. mediation of support	Effecting of operating expenses and assumption of commitments, incl. labour and management costs, other operating expense, financial expenses, effecting of public procurement	Transactions in state assets, incl. investments, financing transactions, effecting of public procurement	Depositing of public funds (interest revenue from bonds, deposits and loans, opening balances for banking operations, other financial revenue)	Exercise of founder's rights in foundations, non-profit associations and profit-making agencies; state participation in legal persons governed by private law
Ministry of Education and Research	Not audited	Not audited	Yes	Yes, incl. observations	Yes	Not audited	Not audited
Ministry of Justice	Yes	Not audited	Not audited	Yes, incl. observations	Yes, incl. observations	Not audited	Not audited
Ministry of Defence	Not audited	Not audited	Not audited	Yes, incl. observations	Yes, incl. observations	Not audited	Not audited
Ministry of the Environment	Yes	Not audited	Yes	Yes	Yes	Not audited	Not audited
Ministry of Culture	Yes, observations were made	Not audited	Yes, incl. an observation	Yes, incl. observations	Yes, incl. observations	Not audited	Yes, incl. observations
Ministry of Economic Affairs and Communications	Yes	Yes	Yes	Yes, incl. observations	Yes, incl. observations	Not audited	Yes
Ministry of Rural Affairs	Yes	Yes	Yes	Yes, incl. observations	Yes, incl. observations	Not audited	Not audited
Ministry of Finance	Yes	Yes	Yes	Yes	Yes, incl. observations	No, a comment was made	Yes
Ministry of the Interior	Not audited	Not audited	Not audited	Yes, incl. observations	Yes, incl. observations	Not audited	Not audited
Ministry of Social Affairs	Yes	Yes	Yes	Yes	Yes	Not audited	Not audited

Source: audit reports of ministries for 2016