

# Accuracy of Annual Accounts 2015 and regularity of transactions of the state



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## Summary of audit results

### What did we audit?

Every year the National Audit Office (NAO) audits the state's annual accounts. Further, the NAO examines whether state agencies have performed their economic transactions in compliance with the essential relevant legislation: the State Budget Acts, the State Assets Act and the Public Procurement Act. In that context, the NAO expresses an opinion as to whether the budget acts have been adhered to in the performance of economic transactions. The most significant observations about omissions detected in transactions with state assets and in public procurements are set out in the audit report.

### Did you know that

As from 2015, instead of drawing up a complete annual report, the Ministries and constitutional institutions (excl. the National Audit Office), and the Government Office prepare only the balance sheet, income statement, state budget implementation report and operational programme implementation report.

To provide an opinion on the accuracy of the annual accounts of the state and the legality of its transactions, the NAO conducts audit operations at the ministries to examine the compliance of economic transactions conducted in 2015 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 the 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.

### What was the scope of our audit?

In addition to the indicators of state accounting entities, the annual accounts of the state contain the financial indicators of public undertakings, foundations controlled by the state and the profit-making state agency. Certified auditors have audited the annual accounts of the aforesaid entities, and the NAO has taken their opinion into account in expressing an opinion on the state's annual accounts.

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. This is the only financial statement provided to the Riigikogu which is 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 2015 State Budget Implementation Report, the revenue collected by the state in 2015 amounted to 7.99 billion euros, which exceeded the revenue of 2014 by 111 million euros. The expenditure and investments incurred by the state amounted to 8.34 billion euros, which exceeded the expenditure of 2014 by 503 million euros. In 2015, the revenue exceeded expenditure by 350 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 the management report within the 2015 Consolidated Annual Report of the State).

According to the consolidated annual accounts of the state, the assets of the state as at 31 December 2015 amounted to 16.3 billion euros whereas the majority were fixed assets. Compared to the preceding period, the monetary value of assets has increased by 51 million euros.

As at 31 December 2015, the state's liabilities totalled 7.1 billion euros - a decrease of 38 million euros compared to the preceding period. Long-term liabilities of 4.85 billion euros comprise the majority of liabilities. The state's loan commitments amount to 2.9 billion euros and have not changed notably compared to the preceding period. The pension commitments of the state amount to approximately 2 billion euros.

### What did we find and conclude based on the audit?

**The 2015 Annual Accounts of the State are correct in all material respects, 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 accounting of state agencies, state-controlled foundations and companies is well managed in most part and the annual accounts are largely free of material errors.

**The NAO is of the opinion that the state's economic transactions were performed in all material respects in accordance with the State Budget Act, the 2015 State Budget Act and its amendment act.** This means that the NAO did not find any significant errors in the implementation of the State Budget Acts.

Although the annual accounts of the state are accurate in the material part and the state has, in most cases, respected the legislation concerning the state budget in effecting economic transactions, it needs to focus more on how to improve budget planning, reporting on state budget implementation, and managing the liquidity risk.

- **The Ministry of Finance has used the funds of the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund for solving the state's liquidity issues.** The audit revealed that, in addition to settling the accounts of the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund, the Ministry of Finance has used the money of those two Funds for effecting payments of the central government because the state lacked liquid financial resources. The NAO finds that such unilateral discretion exercised by the Ministry of Finance, whether on temporary or more permanent basis, has not been expressly set out in the State Budget Act, the Estonian Health Insurance Fund Act or the Unemployment Insurance Act. Such actions require an unambiguous permission/decision from the Riigikogu in the form of legislative provisions to avoid legal disputes and interpretations and ensure legal clarity. Hence,

the Riigikogu needs to decide whether or not it should allow this, and correspondingly revise the wording of relevant legal provisions.

- **The NAO finds that the State Budget Implementation Report does not present information in a way that is sufficiently clear for the users of such information** as the report shows the funds carried forward from the preceding financial year in the column "Final budget" along with the funds for the accounting year which makes them indistinguishable from the expenses for the accounting year. Compared to earlier reports, the notes to the report provide more detailed numerical information on the funds carried forward but there are still no additional explanations as to why the funds needed to be carried over. Therefore, the reader of the report is unable to learn why the money remained unused by the ministries during the preceding and the accounting year, and for what purposes it was allocated.
- **All transactions have not been transparently budgeted.** For instance, funds were allocated to the Ministry of Economic Affairs and Communications for increasing its financial assets without indicating the financial assets to be acquired; the budget did not include funds for the Ministry of Finance to lend to the Environmental Investment Centre (EIC); the Ministry of Social Affairs paid for the acquisition of financial assets on the account of operating expenses (contributions to foundations upon their establishment and acquisition of holdings) although such transactions should have been budgeted as financing transactions. Further, the budget does not include in full the money required for the core activity of the Ministry of the Environment because the core activity is additionally financed each year on project basis from the Environment Programme via the EIC. Furthermore, the revenue from the activities of these two ministries has not been included in their budgets which should be used for any operations related to them. Hence, the budget implementation report is not sufficiently transparent.
- **The state agencies consistently mishandle the budgeting of long-term lease contracts** by failing to recognise the long-term commitments arising from lease contracts as financing transactions in the annual state budget. Thus, for years, the state agencies have violated the State Budget Act that permits the state agencies to assume commitments and effect finance lease transactions only if the state budget allows this and contains the corresponding means. Hence, the concluded lease contracts have been incorrectly recognised in the accounts which leads to errors in the statistics on public finances.
- **The planning of investments and budget implementation in the fields of information and communication could be improved.** As from 2013, an Advisory Committee at the Ministry of Economic Affairs and Communications is involved in the planning of additional financing requests for ICT investments and developments whereas the role and responsibilities of this committee have not been laid down by legislation, and the committee does not effect follow-up checks of the financed activities. The accuracy of planning funds needs to be improved within the government areas of certain ministries because acquisitions have been planned that have been delayed and such delays should have been foreseen, and activities have been planned that were not even started during the budgetary year.
- **The management reporting of ministries should be improved to provide reliable input for management decisions.** The state intends to make the transition to activity-based budgeting that links the budget to specific activities of ministries and their agencies whereby the effectiveness of such activities will be individually measured. The transition to activity-based budgeting is essential to enable measuring the performance of ministries and ensure the reliability and completeness of reports on such performance. To this end, more detailed requirements should be set for the reports on the

implementation of operational programmes of ministries to ensure their reliability and usability as an input for budget decisions.

### 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:**

- initiate the amendment of the State Budget Act and, where necessary, the Estonian Health Insurance Fund Act and the Unemployment Insurance Act to ensure legal clarity as to whether the funds held and invested by the Ministry of Finance may be used for the state's liquidity management;
- 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;
- plan, on uniform basis and in full amount, the funds of all ministries necessary for the performance of statutory functions within their respective budgets;
- guide the ministries during the budgeting process so that they would ask permission for financing transactions in order to eliminate state budget violations arising from contracts already entered into and prevent errors in the planning of new lease contracts;
- draw up more detailed guidelines for preparing the reports on the implementation of operational programmes and include in those guidelines specific requirements to the structure of, and data presentation in, those reports.

**Response of the Minister of Finance and the Minister of Public Administration:** the Ministers agreed with most of the recommendations made by the NAO and undertook to take them into account.

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## Opinion on the accuracy of the Annual Accounts 2015 and the regularity of transactions of the state

### 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 2015 was 97.1 million euros and the balance sheet total as at 31 December 2015 was 16.3 billion euros provide - in all material respects - 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.

### Due to a change in accounting principles, the state's negative balance of cash at bank and in hand turned positive.

#### Changes in the principles of recognising funds and the deposits of clients

2. The NAO points out that in drawing up the annual accounts 2015 the Ministry of Finance has modified the principles of recognising funds and the deposits of clients, and applied these principles retrospectively as from 2013. Hence, the entry for public funds in 2015 (as state assets) recognises, in addition to the money of the central government, the money on the bank accounts of entities administered by the State Treasury (Eesti Väärtpaberikeskus AS, Unemployment Insurance Fund, Health Insurance Fund, state-controlled foundations) amounting to 839 million euros which is held and invested by the Treasury in accordance with the legislation and contracts and recognised under liabilities as deposits of clients. Due to the changes in the accounting principles, as at the end of 2015, the negative balance of cash at bank and in hand amounting to -291 million euros turned positive: 548 million euros.

#### Accounting management in Estonia

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

4. On the NAO's recommendation, the system of financial statements of the state was changed in 2015. According to the changes, the substantive and formal requirements to the annual reports of ministries, constitutional institutions and the Government Office were simplified, i.e. the complete annual report is no longer prepared - instead, the basic financial statements (balance sheet, income statement, state budget implementation report, report on the implementation of operational programmes) are drawn up and approved. This helps save the working hours in ministries that are spent on drawing up hefty reports which have limited use.

5. The Ministry of Finance intends to complete the project of combining support services which began in January 2010 by 1 June 2017 at the latest. Thereby, the financial, personnel and payroll accounting of all ministries and their agencies (excl. the government area of the Ministry of Defence, and the Estonian Internal Security Service governed by the Ministry of the Interior) and of the Government Office will be handled centrally by the Centre of State Support Services.

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

#### Compliance with State Budget Acts

6. According to the State Budget Implementation Report, the revenue collected by the state in 2015 amounted to 7.99 billion euros, and expenditure incurred by the state amounted to 8 billion, investments to 0.34 billion, and financing transactions to 56 million 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 2015 State Budget Act and its amendment act.

## The regularity of economic transactions has not been audited in all state-controlled foundations and companies

### Limitation of audit scope

#### Did you know that

According to the Authorised Public Accountants Act which entered into force in 2010, the audit of regularity of transactions is mandatory for companies where the state holds at least a required interest as defined in the State Assets Act, and for state-established foundations and profit-making state agencies.

7. In order to provide an opinion on the regularity of transactions, the NAO must obtain assurance that the transactions of entities consolidated in the annual report of state have been effected legitimately. In addition to state agencies, the consolidated entities (hereinafter "entities") include government-invested companies, state-established foundations and the profit-making state agency (State Forest Management Centre). The NAO itself conducts audit operations at state agencies whereas foundations, companies and the profit-making agency are audited by certified auditors from audit firms.

8. Not all certified auditors who provided an opinion on the annual accounts of state-controlled companies and foundations and the State Forest Management Centre have audited the regularity of transactions of these entities. Regularity has not been audited because in 2015 some entities had outsourced auditing services on the basis of contracts which did not comprise auditing the regularity of transactions. Certified auditors have audited regularity in a total of 15 companies and foundations. However, regularity was not audited in such a major company like Eesti Energia or foundations like the Environmental Investment Centre and the North Estonia Medical Centre, or in the State Forest Management Centre. (Also, see Annex 1.)

9. The NAO has not conducted additional audit procedures in these entities to assess the legality of transactions meaning that the audit scope is limited in that regard. The NAO has addressed letters to entities whose contracts for auditing services are about to expire highlighting that when concluding new contracts the audit of regularity of transactions should be outsourced too. Further, on its web site, the NAO has published a list of important state-controlled companies and foundations whose transactions should be audited for regularity over the forthcoming years; the relevant information has been communicated to the parties concerned.

## The state's reserves have diminished notably

**Funds held by the state** 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.

#### The Stabilisation Reserve Fund is composed of:

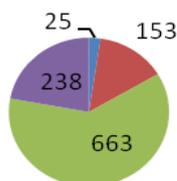
- 1) the funds earmarked as such in the state budget;
- 2) funds transferred to the Stabilisation Reserve Fund according to the decision on distributing the surplus of the unconsolidated cash flows of the state;
- 3) revenue from the privatisation of state assets;
- 4) amounts allocated to the state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

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

### The amount of funds in the Liquidity Reserve has decreased notably

10. The State Budget Act provides for the establishment of the **Stabilisation Reserve Fund** using the financial means of the state. All other financial assets that are not included in the Stabilisation Reserve Fund, i.e. the **funds held by the state** or the central government as well as securities and other financial assets make up the state's liquid financial assets - the Liquidity Reserve. The purpose of the Stabilisation Reserve Fund is to cover extraordinary expenses on managing overall economic risks or preventing or mitigating socio-economic, financial or other crises. The Stabilisation Reserve Fund can be put into use only following a decision by the Riigikogu. 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 Liquidity Reserve is used to effect payments and invest funds on behalf of the said entities.

11. Table 1 shows the changes in the market value of state reserves as from the end of 2014 through to the beginning of 2016. It indicates that the Stabilisation Reserve Fund has grown other the years whereas the Liquidity Reserve has notably shrunk as a result of the activities of the Ministry of Finance. It should be noted that the balance of liquid assets of the central government within the Liquidity Reserve is negative as at the end of 2015. As of 31 December 2015, the liquid assets (incl. reserves), amounting to 816 million euros, of the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund make up the majority of the Liquidity Reserve.



- European Commission
- Health Insurance Fund
- Unemployment Insurance Fund
- Foundations

12. As from the beginning of 2016, the State Treasury modified the form of the monthly statement concerning the reserves so that the statement of reserves no longer features the information on the amount of money in the Liquidity Reserve broken down by entities. Since 2016, the statement shows such information only in the form of a graph, whereas before that the statement featured detailed information for each entity in the form of a table. The graph in the May 2016 statement of reserves shows that, as of March, the balance of central government's liquid assets in the Liquidity Reserve was slightly over 200 million euros on the negative side, whereas the liquid assets of other entities (Estonian Health Insurance Fund, Estonian Unemployment Insurance Fund, state-controlled foundations, European Commission) totalled approximately 1.1 billion euros.

Amount of money of other entities in the Liquidity Reserve as at 31.12.2015, in EUR million

**Table 1. Market value of state reserves as at the end of 2014 and its development in 2015 and up to the beginning of 2016 (in EUR)**

	31.12.2014	31.03.2015	30.06.2015	30.09.2015	31.12.2015	31.03.2016*
<b>Stabilisation Reserve Fund</b>	<b>368,913,286</b>	<b>369,462,678</b>	<b>373,034,445</b>	<b>373,464,755</b>	<b>398,489,324</b>	<b>398,766,918</b>
<b>Liquidity Reserve, incl.</b>	<b>1,125,002,855</b>	<b>1,019,855,802</b>	<b>1,027,672,502</b>	<b>1,095,345,112</b>	<b>747,875,039</b>	<b>795,950,838</b>
Estonian Health Insurance Fund, Estonian Unemployment Insurance Fund, foundations, and the European Commission	927,007,723	949,269,490	973,875,178	1,019,785,713	1,079,498,459	<i>Not distinguished as from 2016*</i>
central government	197,995,132	70,586,312	53,797,324	75,559,399	-331,623,420	<i>Not distinguished as from 2016*</i>
<b>TOTAL RESERVES</b>	<b>1,493,916,140</b>	<b>1,389,318,481</b>	<b>1,400,706,947</b>	<b>1,468,809,867</b>	<b>1,146,364,363</b>	<b>1,194,717,756</b>

\* As from 2016, the State Treasury modified the statement of reserves so that it no longer distinguishes the share of the Health Insurance Fund, the Unemployment Insurance Fund, foundations and AS Eesti Väärtapaberikeskus in the Liquidity Reserve.

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

## Why the liquid assets have shrunk

13. Table 2 shows that, in 2012-2014, the balance of reserves and the central payments office's account was constantly negative but that deficit was compensated for by fixed-term deposits, and the balance of cash at bank and in hand was positive overall.

**Table 2. Distribution of public funds and state reserves by accounts in 2012-2014 (in EUR)**

	31.12.2012	31.12.2013	31.12.2014
<b>Cash at bank and in hand, incl.</b>	<b>33,648,863</b>	<b>144,428,696</b>	<b>8,967,545</b>
cash in hand	5,345	4,949	2,833
pending funds	1,912	1,515	7,920
current accounts at banks	5,290,476	7,241,993	894,181
accounts of reserves and the central payments office	-514,320,805	-593,356,373	-665,817,304
fixed-term deposits	542,671,935	730,536,612	673,879,915
<b>Financial investments, incl.</b>	<b>731,443,409</b>	<b>530,438,342</b>	<b>679,428,626</b>
securities in the trading portfolio:	731,443,409	530,438,342	679,428,626
- short-term bonds	310,657,187	294,230,896	352,538,552
- long-term bonds	420,786,222	236,207,447	326,890,074

Source: SAP

14. Table 3 shows that, as from 2015, the fixed-term deposits no longer make up for the negative balance of reserves and the central payments office's accounts, and that the overall balance of cash at bank and in hand turned negative. The last column of the table indicates that, as at the end of 2015, the negative balance of the central payments office's accounts turned positive. This happened because at year end the accounting principles for cash at bank and in hand were changed, and the money of other entities held by the State Treasury was added to the central payments office's accounts. The accounting principles were changed because the overall balance of cash at bank and in hand was negative.

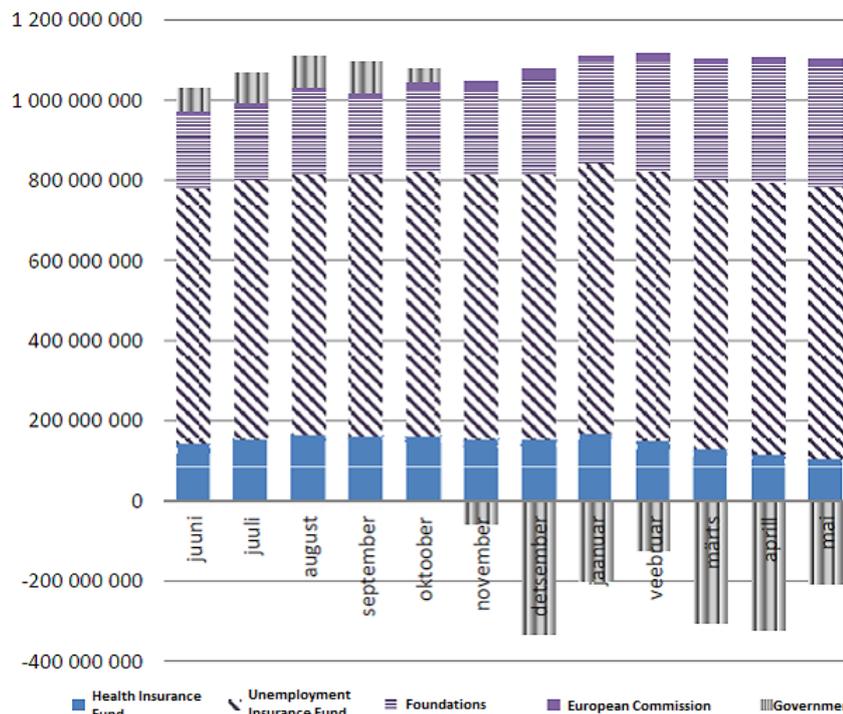
**Table 3. Distribution of public funds and state reserves by accounts in 2015 (in EUR)**

	<b>31.12.2014</b>	<b>31.03.2015</b>	<b>30.06.2015</b>	<b>30.09.2015</b>	<b>31.12.2015</b>
<b>Cash at bank and in hand, incl.</b>	<b>8,967,545</b>	<b>-146,790,636</b>	<b>-123,321,313</b>	<b>-157,770,719</b>	<b>513,855,911</b>
cash in hand	2,833	7,208	4,635	8,006	1,547
pending funds	7,920	2,745	5,520	2,840	4,840
current accounts at banks	894,181	1,329,661	849,629	902,766	828,584
accounts of reserves and the central payments office	-665,817,304	-673,505,199	-640,785,298	-615,534,956	145,444,650
fixed-term deposits	673,879,915	525,374,950	516,604,201	456,850,625	367,576,290
<b>Financial investments, incl.</b>	<b>679,428,626</b>	<b>724,085,150</b>	<b>726,043,837</b>	<b>791,079,430</b>	<b>623,271,428</b>
securities in the trading portfolio:	679,428,626	724,085,150	726,043,837	791,079,430	623,271,428
▪ short-term bonds	352,538,552	301,655,624	293,130,940	248,624,637	153,834,918
▪ long-term bonds	326,890,074	422,429,526	432,912,897	542,454,793	469,436,510

Source: SAP

15. Figure 1 shows the market value of the Liquidity Reserve broken down by clients. The figure indicates that, at the end of 2015, the amount of the central government's liquid assets in the Liquidity Reserve shrunk notably and turned negative after having been positive throughout the years. According to the statements of reserves submitted to the NAO, the central government's liquid assets have not managed to recover in the first half of 2016.

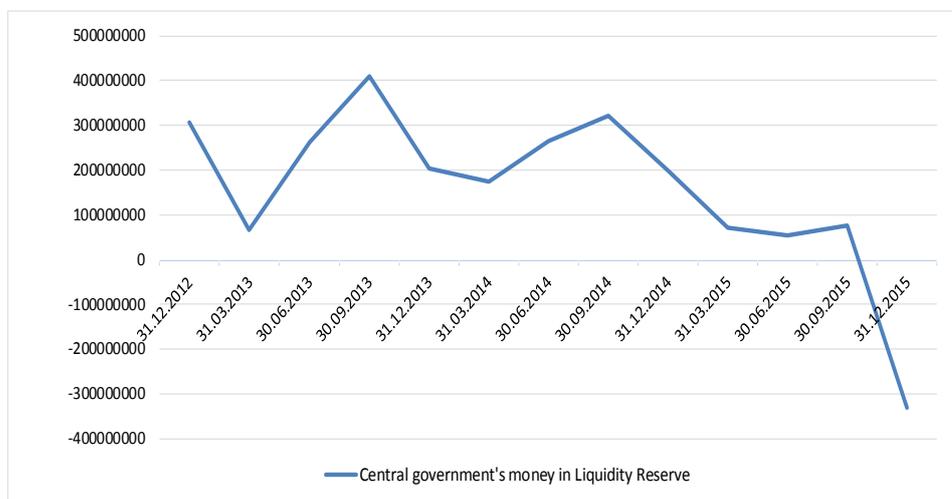
**Figure 1. Market value of the Liquidity Reserve, by clients, June 2015 - May 2016 (in EUR)**



Source: Statements of state reserves by the State Treasury Department of the Ministry of Finance, 31 May 2016

16. Figure 2 shows the amount of central government's liquid assets in a longer perspective: from 2012 to 2015.

**Figure 2. Amount of the central government's liquid assets in the Liquidity Reserve in 2012-2015 (in EUR)**



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

17. There are several reasons why the balance of central government's liquid assets turned negative but, according to the Ministry of Finance, the main factor was the extension of the time limit for transferring foreign aid amounts due to the ending of the EU financial period - although the money had already been disbursed to the recipients in the form of bridge financing it is yet to be collected from the European Commission. The state's own contribution, i.e. the share in co-financing, has already been paid too. According to the Ministry's estimate, the money will be received from the European Commission in 2018.

18. Further, in 2015, the state spent in excess of its collected revenue. In such situations, it is customary that, if expenses and/or payment cannot be avoided or

**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.

postponed, the state finances its commitments by means of a loan or overdraft. Normally, overdraft is used to balance short-term fluctuations as it allows making payments even if there is no money available at the moment; the money will be returned as soon as the incoming amounts exceed the outgoing ones again. However, if the liquidity problem is long-term and the incoming amounts no longer enable to repay the amount of overdraft used, a loan needs to be taken to cover the expenses. Nonetheless, instead of taking a loan or using an overdraft facility, the Ministry of Finance has used the funds of other entities (Health Insurance Fund, Unemployment Insurance Fund, state-controlled foundations, European Commission) held by the state in the Liquidity Reserve.

## Legitimacy of using funds of other entities

**Holding of funds** means ensuring the preservation of funds and managing settlements.

**Investing of funds** 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.

The money in the Liquidity Reserve may be invested only in the following **financial instruments**:

- demand and fixed-term deposits;
- bonds and other emitted and transferable debt instruments (hereinafter "bonds");
- reverse repurchase transactions, repurchase transactions in bonds;
- shares of money market and interest funds designated by the Minister of Finance.

It is not allowed to invest the funds of the Liquidity Reserve in structured bonds.

19. Pursuant to the State Budget Act, **the Ministry of Finance may hold and invest the money of other entities, effect their payments and settlements, and render payment services to them.** Payments and settlements of other entities are effected and payment services are rendered to them in accordance with the rules for execution of state budget payments which set out the conditions and procedures for the services to be rendered. The money of other entities is held and invested in accordance with the Regulation of the Government of the Republic<sup>1</sup> which sets out the principles and conditions for transactions involving such money. The said Regulation lists the **financial instruments** that may be used for investment purposes.

20. According to the State Budget Act, the Ministry of Finance must manage the state's cash flows and the **cash flows generated in connection with holding and investing the money of other entities (incl. Health Insurance Fund, Unemployment Insurance Fund)** on an integrated basis by balancing the positive and negative cash flows of entities. Neither the State Budget Act nor the said Government Regulation provides that a Ministry may, on temporary basis, solve its liquidity problems by using other entities' money that it holds, or balance its own cash flows with such money.

21. There are no specific rules for state-controlled foundations but the Estonian Health Insurance Fund Act/Unemployment Insurance Act provide that the Health Insurance Fund/Unemployment Insurance Fund 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 Health Insurance Fund and Unemployment Insurance Fund shall, according to a holding agreement entered into with the state, hold their money 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.

<sup>1</sup> 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“

### Did you know that

the money of the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund held on the group accounts of the state belongs to those 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.

Similarly to the Stabilisation Reserve Fund, the Health Insurance Fund and the Unemployment Insurance Fund are required to maintain their reserves to manage any risks arising from macroeconomic changes.

22. The audit revealed that, in addition to settling the accounts of the Estonian Health Insurance Fund and the Estonian Unemployment Insurance Fund, the Ministry of Finance has used the money of those two Funds for effecting payments of the central government because the state lacked liquid financial resources.

23. This was possible because, as from 2012, the bank accounts of the Health Insurance Fund and the Unemployment Insurance Fund were joined with the state's group accounts and the Ministry of Finance has the right to effect transactions using their bank accounts.

**24. The NAO points out that, according to public law principles, one may do only something that is clearly permitted by the law; anything not clearly permitted by the law is prohibited.**

25. In view of the above, the NAO finds that such unilateral discretion exercised by the Ministry of Finance, whether on temporary or more permanent basis, has not been expressly set out in the State Budget Act, the Estonian Health Insurance Fund Act or the Unemployment Insurance Act. Such actions require an unambiguous permission/decision from the Riigikogu in the form of legislative provisions to avoid legal disputes and interpretations and ensure legal clarity. Hence, the Riigikogu needs to decide whether or not it should allow this, and correspondingly revise the wording of relevant legal provisions.

26. According to the explanations given during the audit, the Ministry of Finance believes that it has acted correctly and in accordance with the State Budget Act. The Ministry finds that § 67 of the State Budget Act authorises the State Treasury to manage cash flows by balancing the cash flows of different entities meaning that, for example, if the central government's cash flow is negative (i.e. it lacks money to effect all the necessary payments), it can be offset by the positive cash flow of the Unemployment Insurance Fund (i.e. for effecting the necessary payments, and argues that this is the original meaning of the said provision. Pursuant to the State Budget Act, the Ministry of Finance must, at any time, enable other entities to make payments on the account of funds belonging to them and, where necessary, take a loan to meet this obligation. Based on the Estonian Health Insurance Fund Act and the Unemployment Insurance Act, the balance of money held shall earn interest payable according to the rate of yield of liquid financial assets of the state.

27. The NAO disagrees with the Ministry of Finance. § 67 (4) of the State Budget Act provides that, in addition to the state's cash flows, the Ministry of Finance shall manage the cash flows generated in connection with holding and investing the money of other entities on an integrated basis by balancing the positive and negative cash flows of entities. As mentioned above, the rules for holding and investing money have been laid down by a Government Regulation that addresses the investment of money in financial instruments rather than the effecting of payments. Hence, cash flows generated by the use of financial instruments should be used instead of using the money of other entities to solve the central government's liquidity problems. However, it has not been expressly provided whether cash flows are balanced individually within entities or between them. Further, the State Budget Act refers to the state "as is", and not as (another) entity. Therefore, it is not correct to construe the said article as meaning that the state and other entities should be treated equally for the purposes of balancing cash flows. Furthermore, the explanatory memorandum to the Act does not provide unambiguous and clear answers to these issues.

28. The Ministry of Finance argues that the involvement of available financial means of the Health Insurance Fund and the Unemployment Insurance Fund - held by the state according to a holding agreement - for the purpose of offsetting the negative cash flows of the state was the objective of the legal amendment and the intention of the legislator. The NAO finds that given the above the State

Budget Act does not expressly and unambiguously provide for the right of the Ministry of Finance to use the money of the Health Insurance Fund or the Unemployment Insurance Fund to secure its own liquidity, or use the money of other entities for making its own payments - even on temporary basis. The NAO maintains that, in order to ensure legal clarity and avoid disputes, the corresponding right or its non-existence should be clearly set out in the State Budget Act.

29. Despite the lack of legal clarity, the NAO auditors learned that there have not been any cases where the State Treasury has failed to settle the accounts of the Health Insurance Fund or the Unemployment Insurance Fund. The State Treasury and the Ministry of Finance have declared their readiness to disburse to the Health Insurance Fund or the Unemployment Insurance Fund all their money held by the State Treasury whenever necessary.

### Did you know that

**Liquidity risk** is a risk that the state does not have sufficient liquid financial resources for the proper performance of its financial obligations.

**The state's liquid financial resources are considered insufficient for the proper performance of its financial obligations**, 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.

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

- initiate the amendment of the State Budget Act and, where necessary, the Estonian Health Insurance Fund Act and the Unemployment Insurance Act to ensure legal clarity as to whether the funds held and invested by the Ministry of Finance may be used for the state's liquidity management;
- assess the state's **liquidity risk** in its entirety and take measures to mitigate this risk;
- assess whether the current liquidity management model meets the state's needs;
- in the monthly statements of reserves, present information on the amount of other entities' money in the Liquidity Reserve held and invested by the Ministry broken down by entities as was the applicable practice until 2016.

### Response of the Minister of Finance and the Minister of Public Administration:

**The Ministry of Finance is prepared to submit to the Riigikogu proposals for avoiding ambiguous interpretations of the Act.** The Ministry of Finance (MF) has been guided by the spirit and purpose of the Act in accordance with the intentions of the legislator. The legislator decided to hold the cash reserves and the legal reserve of the Health Insurance Fund and the financial means of the Unemployment Insurance Fund in the State Treasury by the 2012 State Budget Act that it adopted on 7 December 2011 in connection with the Act Amending Alcohol, Tobacco, Fuel and Electricity Excise Duty Act, Estonian Health Insurance Fund Act, Local Government Financial Management Act and Unemployment Insurance Act. In that context, § 39 of the Estonian Health Insurance Fund Act was amended and § 341 was added to the Unemployment Insurance Act, and the MF entered into holding agreements with the Health Insurance Fund and the Unemployment Insurance Fund. The involvement of available means of the Health Insurance Fund and the Unemployment Insurance Fund - held by the State Treasury according to a holding agreement - for the purpose of offsetting the negative cash flows of the state was the objective of the legal amendment and the intention of the legislator. 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. Meanwhile, the state pays the Health Insurance Fund and the Unemployment Insurance Fund interest on their balances, i.e. a fee for using their money. Hence, as a result of such operations, their financial resources increase instead of shrinking.

The MF maintains that the liquidity management requirements set out in the applicable legislation ensure the mitigation of the liquidity risk. The principles for the management of state's cash flows are laid down by § 66 of the State Budget Act and the Government Regulation on „Principles for Management of the State's Cash Flows and the Stabilisation Reserve Fund“. A liquidity management framework has been put in place for the State Treasury for keeping the value of the state's liquid resources and instant credit lines on a level that, given a reasonable level of risk, the state can, at any time, properly meet all financial commitments, incl. disbursements on behalf of depositors. According to the Government Regulation, the minimum level of the state's liquid resources must allow offsetting a negative net cash flow over a nine-month period. The calculation of the negative cash flow over the nine-month period takes into account the estimated impact of a potential economic downturn on the state's tax revenue, the servicing of its financial debts, the payments of the Social Insurance Board and social security funds, and the state's potential commitments that are likely to become payable. In addition to the minimum required liquidity provision set out in the Government Regulation, the MF has established an internal requirement that the state must always have liquid financial means (Liquidity Reserve) that cover at least two weeks' payments. The State Treasury has consistently respected the above requirements in managing the liquidity risk. There have been no cases of the amount of the state's liquid financial means or the value of instant credit lines dropping below the set target level.

**The MF finds that the liquidity risk have been mitigated because the liquidity level, incl. compliance with the above requirements, is assessed daily, and we have instant credit lines available, and have the capability to act promptly should such need arise. Further, we find that the applicable liquidity management model ensures the effective use of the funds of the state in its entirety because holding money separately instead of using group accounts would, all in all, increase the state's interest costs.** The compatibility of the liquidity management model with the state's needs and the economic situation is analysed regularly. If circumstances change, adjustments to the model will be proposed. The decisions regarding the structure for ensuring the minimum liquidity provision (Liquidity Reserve and instant credit lines) are made in view of the situation of financial markets and aim to strike the optimal balance between risk and cost. Currently, the loan market conditions are favourable and Estonia's loan capacity is high meaning that there is no need to hold a hefty liquidity provision. In the current situation, the MF can borrow a maximum of 750 million euros from banks on the same day or subject an advance notice of up to 15 days (overdraft, credit lines, and loan from the EIB). This ensures that the payments of all entities included in the state's group accounts are made in due time. The MF will take a loan, if doing so is necessary for managing the cash flows. By postponing the use of borrowed funds, the state saves loan interest costs. Since November 2015, the value of the Liquidity Reserve has dropped below the total value of the deposits concerned but this leads to neither financial risks nor financial loss for the depositors. The state is liable for the liquidity risk, refinancing risk and interest rate risk, and the State Treasury manages these risks. The deposits earn interest according to the rate of yield of investing the assets in the Liquidity Reserve regardless of the value of the reserve, and the depositors are free from the credit risk (the state is liable for negative yield).

**We are willing to modify the statement of reserves and add the information both in table and graph form.**

## Observations on the State Budget Implementation Report, compliance with the State Budget Act, financial management, and management reporting

### Amounts carried over between budgetary years

#### Carry-forward of state budget funds

means extending the time limit for using the state budget funds by a period of one budgetary year. The state budget funds are divided into funds with limits and funds without limits. For funds with limits, investments and subsidies are carried forward in full, and up to three percent of expenditure. Funds without limits are carried forward in full.

### Detailed information on all the funds carried over is still not made public

31. In several audit reports over the earlier years, the NAO has pointed out that the presentation of the State Budget Implementation Report should be improved because its reader does not learn the amount or purpose of money carried forward from the previous accounting year to the next, neither does it identify the ministries to which such funds are assigned. The Annex to the report does not clear up things either as it lists the [funds carried forward from the preceding budget year](#) by their intended purpose showing only the totals for the entire state. Furthermore, there is no information as to why the money remained unused and was carried forward. Although, in his response, the Minister of Finance undertook to disclose that information, the report for 2015 shows no progress in this regard.

32. 502 million euros which remained unused in 2014 were carried forward to the 2015 budget - this accounts for 6.6% of the total expenditure in 2014. For about one quarter of this amount (121 million euros that mostly comprise expenses within the limit of 3%, investments and co-financing of foreign aid) there is detailed information available on the web site of the Ministry of Finance explaining why the money remained unused and for what it is to be used in 2015. However, the report and the Ministry's web site lack information on the remaining amount carried forward to 2015 (381 million euros - mostly awarded foreign aid).

33. The 2015 State Budget Implementation Report indicates that 404 million euros have been carried forward from 2015 to 2016 - this accounts for 4.8% of the total expenditure in 2015. It is positive to see that this year the Annex contains consolidated information on the budget funds carried forward from 2015 to 2016 - broken down by budget components and government areas of ministries. Plus, the principles of carry-over have been outlined for the first time. Despite the improved presentation of numerical information, more detailed information on the reasons for carry-over or the intended purposes is not available. Similarly to the preceding year, the web site of the Ministry of Finance features information on the reasons for and purposes of carrying funds forward from 2015 to 2016 only in the extent of 116 million euros (29% of total, mostly comprising expenses within the limit of 3%, investments and co-financing of foreign aid) with no detailed information on the remaining amount (288 million euros - mostly awarded foreign aid). For instance, the report excludes information on the reasons for the carry-over of foreign aid - whether the reason is the schedule for using foreign aid, or the omissions of ministries and administrations or their low capacity to implement projects. Further, the report does not refer to any external extra materials that could provide such information.

34. The NAO considers this to be a substantial amount the intended purpose of which, broken down by the ministries, has been decided by the Riigikogu in the State Budget Act for the preceding year. However, there is no relevant information on the use of this amount in the state budget implementation report. Further, the analysis and disclosure of amounts carried forward is essential for the Riigikogu in adopting the next year's budget. Therefore, the state budget implementation report should disclose information on the reasons for the carry-forward.

35. The NAO made the relevant recommendation in the previous year's audit report, and to some degree the Ministry of Finance has taken this into account in the preparation of budget documents.

## Planning of financing transactions

According to the explanations provided during the audit, the following contributions were to be paid on account of the **87.7 million euros**: AS Estonian Air 40.7 million, AS Elering 40 million, SA KredEx Balti Innovatsioonifond 6.4 million and OÜ Rail Baltic Estonia 0.65 million euros. In reality, 40.7 million euros were paid as a contribution towards share capital upon founding AS Nordic Aviation Group, and the amount envisaged as a contribution towards the share capital of AS Elering was reduced by 32 million euros to establish OÜ Transpordi Varahaldus and contribute towards its share capital. The planned contribution to AS Elering was made in 2016.

## Budget implementation reports of ministries

### The planning of financing transactions in the annual budget is neither well-considered nor transparent

36. In the previous audits of the consolidated annual report of the state, the NAO has concluded that budget planning in the ministries is improving and the number of errors is growing smaller. However, in the audits conducted in 2015, the NAO has made several observations on the shortcomings in planning funds for the financing transactions within the state budget.

- In the audit report concerning the Ministry of Economic Affairs and Communications, the NAO noted that, although the Ministry's budget included **87.7 million euros for boosting financial assets**, neither the Act nor its explanatory memorandum detailed the financial assets to be acquired. Given the impact of such a large amount, the NAO finds that such transactions should be disclosed in the annual State Budget Act and its explanatory memorandum to ensure the transparency of the state budget.
- At the end of 2015, the Ministry of Finance issued a loan of 34.59 million euros to the Environmental Investment Centre without having requested the relevant funds for this financing transaction in the state budget.
- The Ministry of Social Affairs has granted the North Estonia Medical Centre and the Tartu University Hospital 2.66 million euros as contributions to these foundations upon their establishment and for the acquisition of a holding in AS Valga Haigla. These transactions were budgeted as grants (i.e. operating expenses) to the North Estonia Medical Centre and the Tartu University Hospital - however, such acquisition of financial assets should have been budgeted as financing transactions.

### The budget implementation reports of two ministries do not recognise all the revenue from their activities

37. In 2015, the revenue from 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 as its own revenue rather than the revenue of the Ministry of Justice. Likewise, the environmental charges generated by the Ministry of the Environment, amounting to 94.6 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.

38. 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, and the Ministry 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<sup>2</sup> and, 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.

39. In this case, it would be appropriate to plan the environmental charges and recognise their collection as revenue of the Ministry of the Environment, because

<sup>2</sup> Procedure for Drafting of State Budget Strategy and Budgets of Government Areas of Ministries, and for Carry-over of State Budget Funds

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.

40. Consequently, the revenue reflected in the annual accounts and the budget implementation report of the Ministry of the Environment is not comparable. The same applies to the financial statements of the Ministry of Justice. Due to the above errors, the State Budget Implementation Report recognises the environmental charges, the levies of the Ministry of Justice, and the fees for court procedures as revenue of the Ministry of Finance. The NAO has pointed out the inaccurate recognition of environmental charges in the budget over the previous years - however, the error is yet to be corrected.

41. The NAO consistently maintains that, in terms of the annual accounts as well as the budget implementation report, economic transactions should be recognised for the entity handling and responsible for these. According to explanations provided during the audit, the differences between the state budget, the State Budget Implementation Report, and the annual accounts should be eliminated in conjunction with the transition to accrual-based budgeting as from 2017. Nevertheless, it remains unclear for the NAO as to why the budget is planned this way. The Ministry of the Environment and the Ministry of Justice continue to provide the State Budget Department with the revenue forecast for drawing up the annual state budget, whereas the said ministries carry out activities for collecting the revenue. In the future, following the transition to the accrual-based system, such revenue will be attributed to these ministries again.

### **The core activities of the Ministry of the Environment continue to be financed non-transparently**

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

42. Still, the amount that is allocated to all ministries by the annual State Budget Act for financing their core activities is incomplete. So, in 2015, the expenses of the Ministry of the Environment and its agencies were financed from the Environment Programme through the Environmental Investment Centre (EIC). Hence, all of the money necessary for environment-related activities within the Ministry's government area was not planned as expenditure in the Ministry's budget. In 2015, the EIC decided to finance 76 projects of the Ministry of the Environment and its agencies totalling 9.2 million euros. This practice has been implemented for years. According to the 2015 State Budget Implementation Report, the expenditure and investments of the Ministry of the Environment amount to 155.7 million euros meaning that approx. 5% of expenditure and investments were financed through the EIC.

43. In the interests of transparency of the state budget, the National Audit Office disapproves of such financing of the Ministry's core activities, because the money needed for said activities is not recognised in the state budget as the Ministry's operational expenditure, and 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.

44. The NAO finds it unjustified to continue the non-transparent financing of commitments of the Ministry of the Environment and its agencies by means of project-based contracts with the EIC which is a practice that increases the administrative burden.

#### **45. NAO recommendations 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;
- disclose, on the web site of the Ministry of Finance, complete information on the amounts carried forward from the preceding budgetary year to the next;
- disclose, in a separate column of or notes to the state budget implementation report, the funds carried forward from the preceding financial year to the accounting year, broken down by the ministries - similarly to funds carried forward to the following year;
- envisage all financing transactions in the budget and disclose the planned transactions in the explanatory memorandum to the annual state budget.
- plan, on uniform basis and in full amount, the funds of all ministries necessary for the performance of statutory functions within their respective budgets;
- attribute, in the context of drawing up the annual state budget, the revenue to the budget lines of ministries that handle the planning, collection and verification of and accounting for such revenue regardless of the revenue being actually paid to the bank accounts of other entities.

#### **Response of the Minister of Finance and the Minister of Public**

**Administration:** According to the commitment assumed last year by the Ministry of Finance (MF), Note a31 to the Annual Consolidated Report of the State (pp. 183 to 189) includes, as a new item, an overview of the funds carried over from 2014 to 2015 and from 2015 to 2016, broken down by budget components and government areas. The so-called funds with limits, according to a Directive of the Minister of Finance, make up 20 to 30% of amounts carried over whereby relevant detailed explanations are included in the Directive and its Annexes.

A significant share of funds carried over automatically is made up by foreign aid and the related co-financing (35 to 60% of the total carried over). As from the 2014-2020 programming period, the European Commission (EC) makes notably less prepayments compared to the previous period (3% instead of the 10% over the previous period) which means that the amounts recognised as prepayments and carried forward to the following year have shrunk considerably. Since the EC pays only 90% of the amount requested as interim payment, the annual available amount of operating funds is approx. 210 million euros smaller than in the period 2007-2013. As a rule, foreign aid is paid by the EC (in the extent of 90%) to the MF (excl. direct aid) and the MF transfers the money to intermediate bodies so that the latter could make payments to the final beneficiaries towards their certified (analysed and approved) expenses. Therefore, the money received for payments related to foreign aid is held over a longer period on the accounts of the MF, and for shorter periods, on the accounts of intermediate bodies whereby such money is not specifically marked as the rules of distributing foreign aid provide for such holding of funds. The amount of money accumulated on the accounts of intermediate bodies due to this cash flow scheme as at year-end does not provide valuable information on the nature or progress of activities financed from foreign aid. The second-largest group of expenses automatically carried over is made up by balances of tax revenue collected by the state (20 to 30% 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, neither can it be linked to other reasons suggested by the NAO that would necessitate the provision of additional explanations about transfers. In addition to the above two groups, the revenue from economic activities are carried over automatically (4 to 8% of the total carried over). Each state agency may use the revenue from economic activities at its own discretion for carrying out its operations.

**The MF is willing to provide, in the Annex and explanatory memorandum to the Directive of the Minister of Finance and for each budget component and government area, basic explanations about the carry-over of the rest of the funds, i.e. amounts automatically carried over.** To this end, we intend to revise Regulation No. 9 of 4 February 2016 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“.

**However, we would like to point out that due to the transition to accrual-based budgeting the precise figures can be determined later than provided for by the current procedure (in January). We believe the inclusion in the consolidated report of a further overview that provides more detailed information on individual revenue lines or projects than Note a31 would increase the administrative burden and provide no real additional value.** Instead, we recommend that interested parties make use of the detailed view for individual measures, projects, beneficiaries, counties, etc. on the web site of Structural Funds: <http://www.strukturifondid.ee/mis-on-tehtud/>. In 2014, the Monitoring Committee for the 2014-2020 Operational Programme for Cohesion Policy Instruments was set up and the Committee's rules of procedure were adopted. The Monitoring Committee reviews the progress made in attaining the programme's objectives. The MF provides regular monitoring reports on the use of Structural Funds. The first report for 2014-2015 was approved on 25 May 2016 and will be published within two months of its approval at: <http://www.strukturifondid.ee/proov-12/>

**Next time, we will additionally include in the consolidated annual report a reference to the monitoring reports by the European Commission that contain budget-based as well as activity-based information.**

**The Cabinet of Ministers meeting on 7 July 2016 adopted the White Paper on Participatory Policy-making which, *inter alia*, provides that, in order to enhance transparency, the explanatory memoranda to future state budgets will outline the companies that will enjoy an increase in share capital according to the state budget, and the objectives of such increase.** Financing transactions cannot be budgeted with great precision because these depend on the needs of counterparties that might not be formalised as binding commitments at the time of entry into force of the annual budget act.

**The MF agrees with the NAO's recommendation to plan, on uniform basis and in full amount, the funds of all ministries necessary for the performance of statutory functions within their respective budgets.** The search for solutions to this situation is still ongoing. On the one hand, this requires amendment of the Environmental Charges Act in order to redirect in full the revenue assigned to the EIC's budget to the state budget. On the other hand, the applicable solution must ensure flexibility for unforeseen events that could affect the sector, e.g. sharp drop in income or sudden surge of costs.

**In connection with the developments in the financial management system (accrual-based state budget from 2017, and activity-based from 2020), we**

**intend to harmonise the principles of recognising transactions to eliminate the current differences between the accounting principles used in budgeting and accounting.** Harmonisation requires the restructuring of guidelines and the counselling of contributors to the management of public finances during the transition period. For cash-based budgeting we rely on (until the implementation of accrual-based budgeting) the general rule that revenue is recognised in the budget of the government area which receives the money. The responsibility for the collection of environmental charges is divided on the basis of a cooperation agreement between the government area of the Ministry of the Environment (imposition of charges) and the government area of the MF (collection of charges). Likewise, the responsibilities for collecting fees for court procedures are divided between the government area of the Ministry of Justice (MJ) and that of the MF. Hence, the MF is responsible for managing the collection of fees.

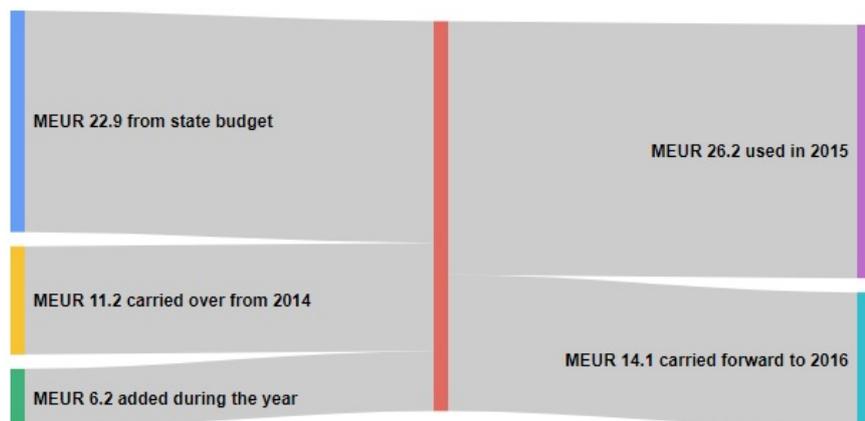
### Budgeting of ICT investments requires further consideration

46. In its annual audits, the NAO has consistently analysed the process of drawing up the state budget. This year, the NAO focused on information and communication technology (ICT) investments within the ministries. To this end, the auditors analysed the planning and management of ICT investments in 2015, and the use of money earmarked for such investments. The objective was to examine the nature of the process of planning ICT investments (how the ministries set priorities, select the activities/projects for investment, and manage this process), find out whether the ministries rely on certain development plans and strategies, and if so, which ones (for important and more large-scale activities), how they develop and finalise the budget for ICT investments and which sources they use, how they monitor budget use, and how they react to the changes in requirements.

### Planning of ICT investments in the state budget

47. Figure 3 shows the funds available for ICT investments in 2015, and its sources and uses. The figure indicates that the 2015 state budget recognised about 57% of the 40.3 million euros available for ICT investments. Nearly 28% was made up by funds carried forward from the preceding year, and more than 15% were added during the year pursuant the Government's decision to reallocate funds between investment projects and/or the amendments to the annual State Budget Act.

**Figure 3. Formation and use of the total amount of 40.3 million euros available for ICT investments in 2015**



Source: Rate of implementation of ICT investments, according to the accounts of ministries; calculations by the NAO (investments on the account of foreign aid are excluded)

48. In 2015, 26.2 million or about two-thirds of the available total were spent and the remainder was carried forward to 2016. The carry-over occurred primarily because of the postponement of activities, whereas in some ministries it was due to additional funds being allocated by way of budget amendments in

December - leaving too little time to use the money. The NAO believes that the possibility of carrying investment appropriations forward to the next year without any limitations does not urge the state agencies to assess their annual financing needs more accurately. The earmarked funds are basically reserved in the budget, i.e. they cannot be used for any other purpose without amending the annual State Budget Act which means that the Government needs to draft an Act Amending the State Budget Act, and the Riigikogu needs to process and adopt it.

49. The NAO finds the budgeting of investments should include a certain extra so that the funds in the investment budget could be redistributed between investment projects more easily and without excessive bureaucracy, and the budget funds could be used more efficiently. To this end, in addition to the distribution of funds between investment projects, an additional list of investments should be approved for cases where the implementation of planned investments is delayed or postponed - without, however, increasing the budget total. Such an arrangement would allow reacting flexibly to the changed circumstances and reduce bureaucracy as additional decisions to be adopted by the Government and the Riigikogu would no longer be needed. A similar model has been used in the past for planning certain foreign aid measures. This would eliminate the need to adjust the breakdown of investment projects of the Government, or the annual State Budget Act, and funds could be distributed by a decision of the minister in charge of the relevant government area as the Government has already approved the investment projects.

**The role of the ICT Committee of the Ministry of Economic Affairs and Communications has not been clearly defined, and the Committee lacks rules of procedure**

50. In 2013, the planning of ICT investments changed: the additional requests for financing ICT development projects from the state budget are filed with the Ministry of Finance (MF) who submits these for expert opinion to the ICT Committee at the Ministry of Economic Affairs and Communications (MEAC) which is composed of the officials from the MEAC, the Information System Authority and, as from 2016, the Data Protection Inspectorate. During the audit, the NAO analysed the basis of the Committee's work arrangements. Interviews revealed that the ICT Committee enjoys an advisory capacity - the Committee's powers or rules of procedure are not laid down by legislation. Hence, the Committee is informal without specific functions or responsibilities. The operating principles are determined by the MEAC and the Committee but these are not laid down in writing, and assessment criteria are based on 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".

51. The said Regulation sets out the main requirements to additional requests for ICT projects: the project must be in line with the national ICT policy, it must be feasible, the expected outcomes must be measurable, and it must be possible to use the project deliverables sustainably (incl. there must be funds available for maintenance). In 2016, the following requirements were added: for using funds with limits, priority is given to projects aimed at furthering the objectives of action plans of the Government of the Republic or transposing EU legislation; the development projects required for performing the core functions of the state are preferably developed using the state's own money instead of aid amounts; aid amounts should be used mainly for leapfrogging.

52. The MEAC ICT Committee reviews up to three additional requests per ministry starting from a value of 200,000 euros per year. The ministries defend their investment requests at the Committee once a year, during the budgeting process. In the light of the requests and the outcome of defending these requests, the ICT Committee forms its opinion and communicates it to the MF who accepts these proposals.

53. It should be noted that the Committee's activities are limited to the review of additional requests and forming an opinion. The Committee does not have an overview of the implementation of projects it has approved, neither does it

request feedback from the ministries. The NAO argues that under these circumstances it is not possible to identify and analyse any errors made so as to improve this process or the management of ICT investments. There is no feedback as to whether or when the financed activities were implemented (funds could have been reallocated for other activities), how effective they were, or whether they achieved the objectives set at the time of making the financing decision. The interviewed coordinators within the Committee assured that the Committee intends to start systematic collection of information on the use of money.

**54.** Interviews with those staff members of ministries who did not participate in the defending of investment requests or in the preparations for this process revealed that the lack of rules of procedure or the legal basis for the Committee's work creates confusion within the ministries because there is no clarity as to the evaluation criteria or considerations applied by the Committee. The meetings of the Committee are not recorded in the minutes and the entire process is informal which means that the applicants do not get feedback as to why the activities were not financed. Further, the Committee and the ministries communicate by e-mail instead of using the budget information system, for example.

**55.** The interviewees raised yet another issue: only three requests, each with a value above 200,000 euros, may be filed with the Committee. They noted that important development projects might cost less and hence be set aside, or, alternatively, the authors might start manipulating the project value, i.e. present its value to be higher than it actually is or include activities beyond what is necessary or justified. Financing for cheaper yet essential development projects cannot be requested from the ICT Committee - the ministries need to find the required amounts within the limits of their own budget. If the ministry's government area is large, finding money for smaller developments is usually not a problem, whereas in ministries with smaller budgets this could prove to be a major obstacle.

**56.** According to the MEAC ICT Committee, the described rules (up to three financing requests with a value above 200,000 euros) are put in place to keep the Committee's workload within reasonable limits - a greater number of requests would not allow analysing the projects in depth. This has led to a situation where the Cabinet of Ministers reviews the ministries' investment requests which remain below the ICT Committee's value threshold but are still considered essential by the ministries, and for which the ministries have no available funds within their budgets. The NAO finds that a reasonable arrangement should be set up for reviewing small-scale requests so that the Cabinet of Ministers would not need to discuss these in detail at its meetings.

**57.** The ICT Committee found it positive that the MEAC has developed a very good nationwide overview of the necessary ICT investments, and that, owing to the strict criteria applicable to requests, the investments are contemplated much more thoroughly and increased attention is paid to the future operating and development costs entailed by the investments. Further, the Committee maintained that their work has urged the ministries to draft ICT strategies for a four-year period outlining the links between the overall objectives and activities of the agencies, on the one hand, and IT objectives and IT development projects, on the other hand, envisaging IT development projects, accompanied by timetables and financing schemes (incl. foreign aid), with reference to the objectives of their core activities, and priorities. For major or expensive projects, it is mandatory to draw up a more thorough action plan and an analysis - of the profitability and effectiveness of the project - that describes the necessity, impact, expected outcomes, preconditions, and ancillary activities of the project. The Committee believes that, owing to ICT strategies and the action plans of large-scale projects, agencies have started to analyse their needs much more accurately and focused on the most important activities.

**Overall, the management of ICT investments is solid but the accuracy of planning needs improvement**

**Central contracting authority** means a contracting entity authorised by the Government of the Republic to carry out procurement on behalf of other state agencies. Other state agencies are required to use the services of the central contracting authority.

58. Mostly, the planning and management of ICT investments in ministries is centralised, except for certain agencies. For example, the Agricultural Registers and Information Board acts independently within the Ministry of Rural Affairs, the Land Board within the Ministry of the Environment, the Tax and Customs Board and Statistics Estonia within the Ministry of Finance, and the National Institute for Health Development and the State Agency of Medicines within the Ministry of Social Affairs.

59. As of the end of 2015, the centralised planning and management of investments is primarily carried out in the IT departments of ministries whereas some ministries have set up specific responsible for their entire government area, for example, specific councils at the executive level. Four ministries have a specific agency for managing ICT investments and operating costs: the Centre of Registers and Information Systems under the Ministry of Justice, the Information Technology Centre of the Ministry of the Environment under the Ministry of the Environment, Information Technology and Development Centre under the Ministry of the Interior, and Information Technology Centre of the Ministry of Finance under the Ministry of Finance.

60. According to a Government Regulation, as from 2014, the powers of the **central contracting authority** have been vested in the Centre of Registers and Information Systems (CRIS) for the acquisition of computers and monitors which means that all state agencies are required to buy laptops, desktop PCs and monitors through the CRIS who awards the corresponding centralised framework contracts by announcing a public tender. According to the interview with the CRIS, computers and monitors purchased through them are, on the average, 25-30% cheaper than the retail price and this benefits particularly smaller contracting entities who would be unable to solicit such discounts due to the small value of contracts.

61. The NAO believes that, overall, the centralisation of planning and management has benefited the government areas because in most part the ministries have an overview of the long-term development needs of ICT within their government areas and the amount of money required. However, the accuracy of planning should be improved in certain government areas because the postponement of certain acquisitions should have been foreseen, and activities have been planned that were not even started during the budgetary year (also, see Figure 3).

62. The investments analysed during the audits are usually reflected in the ministerial or sectoral development plans but, due to the structure of the State Budget Strategy, these investments cannot be clearly associated with the strategy as the latter describes fields of investment in a very general sense. Most investments could be associated with the Estonian Information Society Development Plan 2020 but there were spheres where the associations could not be detected. This is because all ICT investments do not contribute directly to information society development; for example, information systems related to internal security rather serve the very needs of state agencies and are based on the Development Plan for Internal Security. Hence, it could be argued that issues related to ICT development are scattered across various development plans, and there is no comprehensive and nationwide ICT development plan or policy document. The State Budget Strategy does not serve this function either.

**63. NAO recommendations to the Minister of Finance:**

- consider whether it would be necessary to draw up a list of alternative investments that could be financed pursuant to a simplified procedure without an additional decision by the Government or the Parliament in cases where the implementation of the planned investments fails for some reason;

- lay down the functions and rules of procedure of the ICT Committee at the MEAC, and the criteria for assessing investment requests;
- lay down the criteria for evaluating the effectiveness of projects approved for financing by the ICT Committee, and analyse the functioning and performance of the applicable decision-making model;
- find a solution that allows requesting ICT investments for smaller projects and/or current developments;
- for planning ICT investments, use - instead of e-mails - an information system that ensures a simplified application, review and recording process.

**Response from the Minister of Finance:** Regulation No. 9 of 4 February 2016 of the Minister of Finance and the State Budget Act set out the principles the adjustment and breakdown of state budget funds. It would not be practicable to establish a separate procedure for ICT expenditure and the adjustment of investments. According to the current procedures for amending the state budget and adjusting the budget breakdown, funds can be reallocated for other ICT investments and expenses, should such need arise. For analysing the ICT financing needs we have an overview of expenses not financed, but the financing of such expenses requires the setting of priorities within government areas, and making a justified motion to amend the budget legislation or the budget breakdown.

We intend to detail the principles of operation of the ICT Committee in the aforesaid Regulation of the Minister of Finance. § 13 of the said Regulation already lists the criteria applicable to ICT projects. The requests for additional funding are reviewed and evaluated against those criteria.

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.

Neither the MEAC nor the MF have set the value threshold of two hundred thousand euros per project for government areas as mentioned in the audit report. The MEAC pointed out this misunderstanding already in connection with the draft audit report but it was probably overlooked. For filing additional requests related to ICT, it is essential that priorities are set within the government area, whereas the financial value of the project or expenses is irrelevant.

The requests for additional financing of ICT are already being collected through the state budget information system that allows uploading Annex 4 to the said Regulation of the Minister of Finance. E-mails have been used to provide instant initial feedback on the project to the party requesting additional funds. Once the project and expenses have been reviewed and assessed, the Government of the Republic processes the additional requests similarly to any other requests for additional financing and makes the financing decisions. All expenses and additional requests (incl. for ICT) are processed in the state budget information system.

## Interpretation of lease contracts leads to errors

**Terms and conditions of finance lease** are assessed on the basis of the Accounting Standards Board's guideline No. 9 on "Lease accounting" that sets out the criteria for accounting for and recognising lease contracts in the annual accounts.

**Unavoidable expenses** mean, for the purposes of lease contracts, the lease payments for future periods that cannot be avoided upon termination. According to contractual terms and conditions, one must notify of premature termination for a certain number of months in advance.

### The State Budget Act is violated due to the misinterpretation of lease contracts and this leads to errors in the statistics on public finances

64. The audits of the NAO have shown that state agencies lease vehicles, office furniture and computers for carrying out their core activities. The audits have revealed that the lease contracts entered into by state agencies contain several conditions which are in conflict with the State Budget Act and lead to errors in the statistics on public finances.

65. From summer 2015 to spring 2016, the NAO audited the practicability of managing the vehicle fleet of ministries and, in that context, analysed conformity with the **terms and conditions of finance lease** for lease contracts of 73 vehicles used over the period from 1 January 2013 to 30 June 2015. The analysis showed that nearly two-tenths of audited contracts meet the terms and conditions of finance lease. Terms and conditions characteristic of finance lease:

- obligation to settle all lease payments upon premature termination; contract period is 4 or 5 years; current value of minimum lease payments makes up at least 70% of the vehicle's fair value. More than one-tenth of finance lease contracts featured such terms and conditions concurrently;
- other terms and conditions of finance lease that occurred randomly but were present in one-tenth of audited contracts: right to buy the property upon end of contract at its residual value (that right was exercised); current value of minimum lease payments at the time of entry into force of the lease contract is close to the fair value of leased property (over 90%); obligation to compensate for any loss due to a reduction in the value of leased property; obligation to compensate for damage due to premature termination.

66. Thus, for years, the state agencies have violated the State Budget Act that permits them to assume commitments and effect finance lease transactions only if the state budget allows this and contains the corresponding means. In most cases, the state agencies have not asked for such permission, and the payments made under these contracts are not planned or recognised as financing transactions in the annual state budget. Hence, transactions/expenses in the annual state budget are ill-planned and non-transparent. Further, the signed lease contracts are incorrectly recognised in the accounts, i.e. not recognised as property or finance lease commitments.

67. The NAO learned that, in addition to contracts that meet the terms and conditions of finance lease, the state agencies have entered into operating lease contracts that entail **unavoidable expenses**. The NAO auditors discovered that about one-third of audited lease contracts entailed unavoidable expenses. Unavoidable expenses are actual commitments that, in terms of finance statistics and the underlying system of national accounts, must be recognised as commitments on the financial account and, consequently, be accounted for.

68. The state has introduced off-balance sheet accounts to keep account of contracts and the entailing commitments that are not recognised on the balance sheet. The NAO auditors discovered that the said accounts recognise, among other things, contracts that meet the terms and conditions of finance lease, although accounting rules provide that such commitments should be recognised on the balance sheet.

69. Further, the NAO learned that the entries in off-balance sheet accounts are not all related to contracts in question. In addition to lease payments for future periods that cannot be avoided upon termination, such accounts incorrectly recognise payments arising from contracts that can be terminated.

**Incorrect recognition of lease contracts in the accounts leads to errors in the statistics of public finances**

70. Statistics Estonia prepares its statistics on public finances on the basis of the European system of national and regional accounts which contains rules on recognising lease contracts - and such rules are in line with the principles for the classification of lease contracts as set out in the General Rules of State Accountancy. Statistics Estonia calculates debt on the basis of amounts recognised on the corresponding balance sheet accounts in the Balance Records Information System of the Ministry of Finance. Therefore, the correct classification of lease contracts as operating or finance lease and their corresponding recognition in the accounts is necessary to ensure the accuracy of the statistics on public finances.

71. The audited contracts allow concluding that two-thirds of lease contracts entered into by state agencies affect the statistics on public finances. One-third of these should be taken into account as finance lease in calculating the debt burden, and one-third should be recognised on the financial account as commitments arising from unavoidable expenses.

72. The NAO believes that providing for uniform contractual conditions in tender documents would allow avoiding the entry into contracts that meet the terms and conditions of finance lease. Using a standard form allows enables to avoid the standard and special conditions of lessors that encumber the lessee with risks and benefits related to the leased property. A standard form helps avoid conditions that are disadvantageous for the state.

**73. NAO recommendations to the Minister of Finance:**

- develop transparent and unambiguous guidelines for state agencies for the classification of lease contracts;
- guide the ministries during the budgeting process so that they would ask permission for financing transactions in order to eliminate state budget violations arising from contracts already entered into and prevent errors in the planning of new lease contracts;
- draw up standard forms of lease contracts that the agencies could include in tender documents to avoid contracts containing terms and conditions which are disadvantageous and/or characteristic of finance lease;
- require the Centre of State Support Services in coordination with the accountants of state agencies to review all existing lease contracts and recognise them in the accounts in line with the contractual conditions and accounting rules so as to ensure correct source data for government sector statistics;
- require the Centre of State Support Services in coordination with Statistics Estonia to find a solution that would enable Statistics Estonia to gain information on the unavoidable expenses of government areas so as to ensure the accuracy of the financial account in the statistics on public finances.

**Response from the Minister of Finance: The MF does not completely agree with the NAO's criteria for recognising lease contracts as finance or operating lease.** For instance, we find that the obligation to settle all lease payments upon premature termination, whereby the contract period is 4 or 5 years and the current value of minimum lease payments makes up at least 70% of the vehicle's fair value, does not necessarily mean that all risks and benefits related to ownership have been transferred to the lessee. Neither is such transfer of risks and benefits implied by contractual conditions that include obligations to compensate for any loss due to a reduction in the value of leased property or for damage due to premature termination. Lease contracts are classified at the start

of the lease period rather than at the time of learning of the transactions effected upon end of contract or the reduction in the value of property. Generally, lessees enter into lease contracts with the intent to use the property until the end of lease period. The need to enter into insurance policies is assessed in order to safeguard against any negative scenarios that might occur during the lease period. The agencies are not willing to assume commitments that are not prescribed in the state budget. Therefore, they let the lessors know whether they would prefer a finance or operating lease. The NAO sent us a list of specific contracts for leasing vehicles that should have been recognised as finance lease instead of operating lease. Following the inquiries addressed to agencies, we cannot agree with the NAO.

**We are planning to have all real estate lease contracts concluded through Riigi Kinnisvara AS ("Government Real Estate Ltd." or "GRE"). Further, we have agreed on an amendment to the General Rules of State Accountancy to the effect that contracts entered into with GRE would be recognised as operating lease. For vehicles, we intend to make the transition to centralised procurement (a representative from the NAO has participated in the respective working group), whereas computers are already acquired centrally. In view of the aforesaid, we see no need for developing separate guidelines.** We find that the Accounting Standards Board's guideline No. 9 covers the classification of lease contracts. Classification of lease contracts does imply the application of specific rules - instead, it means assessing the risks and benefits related to ownership of property. Hence, we cannot draw up unambiguous classification guidelines. **The Centre of State Support Services (CSSS) constantly reviews, in coordination with the agencies, the new contracts entered into and provides advice on recognising these in the accounts. We argue that additional reviewing of earlier contracts would amount to an excessive effort because the audits have not yielded a list of specific contracts which, according to the opinions provided by the agencies, would be currently incorrectly recognised.**

**We are aware that in some cases assets are intentionally acquired by way of operating lease although it would be economically more efficient to use finance lease. This could be due to the simpler state budget rules applicable to operating lease. We will analyse this bottleneck, provide advice to agencies at briefings and on current basis - during the budgeting process.** Further, we point out that, in summer 2016, the MF prepared a streamlining strategy report on "Acquisition and management of the passenger vehicle fleet of government agencies, and organisation of business travel" that aimed to analyse the ordinary use (incl. acquisition) of passenger vehicles by government agencies and the related costs. Some of the recommendations contained in the report:

- for normal intensity of use (annual mileage up to 25,000 km), prefer payment of full sale price or finance lease that allows extending the vehicle's period of use;
- organise centralised procurement of passenger vehicles through the CSSS. The recommendations will be delivered to the Government of the Republic for decision-making and determining further course of action.

The NAO has considered avoidable expenses to be unavoidable ones. In particular, the lease contracts set out the lessee's obligation to notify a certain number of months in advance of the ordinary or extraordinary termination. If the lessee needs to continue using the property and intends to notify in advance of the termination in accordance with contractual conditions, such expenses are deemed avoidable. Therefore, such commitments are recognised as (conditional) commitments off rather than on the balance sheet. Only actual commitments (that have become due) rather than conditional commitments need to be recognised as commitments for statistical purposes. Statistics Estonia assured us that conditional commitments are not recognised as commitments for statistical

purposes. We have identified cases where the value of conditional commitments was shown to be higher than it was supposed to be. This means that in some cases the agencies have recognised all future operating lease payments on an off-balance sheet account although such accounts should recognise only unavoidable payments that cannot be evaded upon termination of lease contracts (provided that these are smaller than future lease payments). **In coordination with agencies, we will review the conditional commitments recognised on off-balance sheet accounts and endeavour to recognise conditional commitments correctly in the future.** However, this is not related to shortcomings in statistical reports because conditional commitments may not be recognised as financial commitments for the purposes of national accounts.

**Comment from the NAO:** The NAO disagrees with the approach that the described expenses are avoidable as outlined in the response from the Minister of Finance.

The opinion of the NAO is based on information obtained from Statistics Estonia. Following a request from the NAO, Statistics Estonia analysed the articles of lease contracts underlying the aforesaid expenses and sent an e-mail to the NAO on 3 March 2016 where it claimed that the expenses in question amount to actual commitments. Further, whilst inspecting the audit report on "Practicability of managing the vehicle fleet of ministries" for factual errors, Statistics Estonia confirmed on 31 March 2016 that unavoidable expenses (lease payments that cannot be evaded regardless of the contract period or the intended length of use of leased property) amount to actual commitments which, for the purposes of the system of national accounts, should be recognised as commitments on the financial account. The NAO is aware that conditional commitments are not recognised as commitments for statistical purposes but actual commitments should be recognised. The NAO is not aware of any changes by Statistics Estonia in its approach to unavoidable expenses.

In view of the above, the NAO remains true to its opinion and maintains that the Centre of State Support Services should, in coordination with Statistics Estonia, analyse comprehensively the terms and conditions of lease contracts entered into by state agencies so as to determine the type of commitments and expenses in question and ensure the accuracy and comprehensiveness of the data underlying the statistics on public finances, and provide clarity as to where Statistics Estonia could obtain the relevant information.

### **The guidelines for drawing up operational programme implementation reports do not ensure the clarity of reports**

#### **Management reporting of the state**

74. After the obligation of the ministries to file annual reports was abolished in 2015, the report on the implementation of the operational programme remains the only document where the ministries provide an overview of their activities over the year. For preparing the operational programme implementation report, the Ministry of Finance (MF) provided the other ministries with a pre-processed Excel table which the ministry needed to fill in and return to the MF together with a summary opinion. Further, the MF published a short guideline but this addresses only the format of the report, and the reports prepared in such format do not always provide complete information required for describing the outcomes of government's work. For example, the guideline does not require the provision of specific indicators or address the reporting of negative outcomes, or prescribe where or how the operational programme implementation report should be published, etc.

75. For instance, the operational programme implementation report contains a number of indicators that, in order to assess government's work, should have a reference value (normally, preceding year's value), the target value for 2015, and actual value for 2015 but those values are missing in some cases. Some

indicators lack a target value or the intended situation to be achieved by 2015, and some lack the actual value for 2015 - in either case, there is not enough information to determine whether the objective was met. The actual value for 2015 is missing mostly because the data had not yet been obtained at the time of drafting the report - and this leads to another problem: the value for such indicators remains unreported as there will be a new target value for the following year. The NAO finds that in cases where actual attainment of the target cannot be reported the indicator should be accompanied by its closest known value, e.g. the value for the preceding year.

**76.** The NAO maintains that, for each indicator provided, the Ministry of Finance should analyse whether the government uses them for making management decisions or reporting on its activities to the public. If not, the presentation of such indicator should be discontinued because monitoring its value amounts to an unnecessary administrative burden. However, if the indicator is deemed necessary, it should be accompanied by its reference, target and actual value for the accounting year; if actual attainment cannot be reported in a timely fashion due to the procedures for collecting statistical information, the indicator should be accompanied by its closest known value, e.g. the value for the preceding year.

**77.** The government is moving towards activity-based budgeting where state budget funds will be linked to specific programmes so as to provide an overview of the activities on which money is spent and allow assessing the outcomes of such activities and the effectiveness of using the money. The NAO believes that the success of activity-based budgeting requires a solid overview of the field covered by programmes and the outcomes of the related activities; such an overview, however, requires reliable reporting that could be used as input for management decisions. To this end, detailed requirements should be established for reports as otherwise it would only increase bureaucracy.

**78. NAO recommendations to the Minister of Finance:**

- draw up more detailed guidelines for preparing the reports on the implementation of operational programmes and include in those guidelines specific requirements to the structure of, and data presentation in, such programmes;
- analyse whether the government needs indicators included in the operational programme implementation report for making management decisions or reporting on its activities to the public, and if not, discontinue their presentation in the report;
- provide, for all indicators presented, their reference value, target value for the current year, and actual attained value in the current year, or failing that, the closest historical value of the indicator.

**Response from the Minister of Finance:** The procedure for drafting the state budget strategy and the state budget as well as the manual developed by the MF contain specific requirements to the structure of, and data presentation in, operational programmes. Further, the guidelines for operational programmes provide that the form used for operational programmes shall be the 2015 operational programme for government area as adopted by Government Regulation No. 581 of 29 December 2014. The planned activities are reported on. Furthermore, the guidelines include a clear requirement that both positive and negative outcomes must be described for each objective, indicator, measure or activity. We update the guidelines annually. For the sake of clarity, we will include in future guidelines the disclosure requirement set out in the General Rules of State Accountancy. Plus, we will revise the guidelines to reduce the number of shortcomings in the reporting phase. The MF will continue to provide

advice accompanied by examples and be more stringent about the materials received.

The chapter on operational programme implementation as contained in the consolidated annual report presents indicators that, in the opinion of the ministries, best characterise their respective spheres whereby such indicators must completely comply with the operational programme, incl. indicators, adopted by the Government for the corresponding year. The ministries select the essential indicators in view of the Government's policy priorities (that sometimes already contain numerical targets) and the Government's operational programme that elaborates on these. The indicators in the operational programme originate from sectoral development plans that include indicators which have been reviewed by the Government as well as the Riigikogu. The said indicators and the most important activities during the completed period are reflected, *inter alia*, in the State Budget Strategy (SBS) that was developed on the basis of data from the ministries by the Government Office and the MF, and approved by the Government. This provides assurance that the Government considers the indicators in question, some of which are set out in the Government's operational programme and some in the forward-looking SBS, necessary for making management decisions. To provide a detailed overview, the consolidated annual report includes references and links to the ministries' detailed reports on the implementation of the operational programme and other reviews that sum up the past year's results.

We agree that the convenience of using the indicators should be improved for the readers of the report. We will try to find a solution that allows readily using the last known value in cases where the values for the specific year are missing. To this end, we will continue to counsel the ministries and improve the guidelines. However, there are cases where no reference value can be given because certain indicators were not measured in the past, or were measured using a different approach.

### **The regulation on strategic planning is still to be adopted**

## **Strategic planning**

79. In its 2012 audit report on "Activities of the Government of the Republic in assessing the impact of its work and in reporting of the results of its work", the NAO pointed out that the state's management report does not provide a reliable overview of the impact of the Government's activities on attaining development goals essential for the society, and that a costly system of development plans burdening the ministries has been put in place for managing the country's development although that system finds little use in decision-making. The NAO found that the Riigikogu and the Government need to provide clear guidelines as to what kind of (performance) information they need for managing the national development goals. If the objective is to use impact assessment and reporting more extensively in making management decisions, the system of development plans should be reorganised, the principles of impact assessment (scope, priorities, tier, financing, mechanisms for verifying the reliability of data) should be put in place, impact assessment capacity should be enhanced, the best practices should be identified, and the specific uses of strategic plans as regards drawing up the state budget and making management decisions concerning the government areas should be determined. In his response, the Minister of Finance noted that the ministry is already devising development plans for strategic management and budgeting.

80. The State Budget Act adopted on 19 February 2014 provides for the development of strategic documents that include policy fundamentals, sectoral development plan, government area development plan and programme in order to ensure that any expenses are well-reasoned. The Government of the Republic was supposed to adopt a specific regulation on the procedure for the development, implementation, reporting, assessment and amendment of strategic documents. However, two years after the enactment of the State Budget Act, the

said procedure is yet to be introduced. According to the renewed plans, this regulation is to be adopted by the end of 2016.

**81.** Because the strategic planning framework is not in place, the Government does not systematically monitor the reporting on the development plans of government areas or assess any progress made. Instead, the Government is actively engaged in monitoring the implementation of its short-term operational programme, and the overview of the implementation of the operational programme in 2015 is available on the Government's web site. The NAO finds that long-term development should be ensured in spheres that are excluded from the Government's specific priorities for some reason - therefore, it is important that the monitoring of strategic planning and implementation would cover all the state's activities rather than only the Government's operational programme.

**82. NAO recommendation to the Minister of Finance:** adopt a procedure for the development, implementation, reporting, assessment and amendment of strategic documents to create a system for monitoring the implementation of strategic documents.

**Response from the Minister of Finance:** It would be an exaggeration to claim that the strategic framework has not been put in place. An important part of the rules originate from the State Budget Act and its implementing provisions. Further, strategic planning is governed by Regulation No. 47 of 16 December 2015 of the Minister of Finance. Additionally, a manual available directly at <https://sites.google.com/site/eelarvejuhend/> has been developed to help link strategic planning with financial management. We agree that, in the interests of clarity, the said Regulation needs to be updated. This requires a Government Decision. In the course of drafting this document, the views of different government areas have given rise to the need to further analyse the preparation of the budget. The Government of the Republic has commissioned the Ministry of Finance to prepare a letter of intent for renewing the State Budget Act. The time limits for performing this task are set out in the Government's operational programme.

**Comment from the NAO:** The NAO reiterates that the procedure for strategic planning as provided for by the State Budget Act has not been developed, and there is still no systematic approach to strategic planning. By now, a complicated and cumbersome system of development plans and reporting has been put in place but that system is used little in making budget decisions and monitoring their effectiveness. The NAO finds that individual provisions across legislation do not replace an integral framework required for making well-reasoned budget decisions. To this end, the Riigikogu and the Government of the Republic need to provide clear guidelines as to what kind of (performance) information they need for managing the national development goals, and in this light, reorganise the entire strategic planning system.

## Other observations on the regularity of transactions

### The number of violations of the Public Procurement Act by state agencies has not dropped

**83.** According to the Public Procurement Register, the state agencies had a total of 1,849 completed or pending procurements in 2015 amounting to 490 million euros (also, see Table 4). The register shows that, compared to the preceding year, the number of procurements was smaller by 225 and their total value had dropped by 144 million euros.

### Auditing of public procurement in state agencies

**Table 4. The number and monetary value of completed and pending procurements by state agencies in 2015**

Ministry	Number of completed and pending procurements in 2015	Total value (EUR million) of completed and pending procurements in 2015
Ministry of Education and Research	320	35
Ministry of Justice	73	13
Ministry of Defence*	199	133
Ministry of the Environment	175	17
Ministry of Culture	37	13
Ministry of Rural Affairs	115	14
Ministry of Economic Affairs and Communications	450	139
Ministry of Finance	93	31
Ministry of the Interior	200	66
Ministry of Social Affairs	122	19
Ministry of Foreign Affairs	42	10
Government Office	23	1

Source: Public Procurement Register

**84.** Every year, the NAO has audited the procurement activities of state agencies, incl. compliance with the principles of the Public Procurement Act. In its earlier audits, the NAO has identified a number of cases where the procurement procedures and simplified procedures required by the law were not carried out, and detected irregularities in the documentation of procurement procedures, identified cases of failure to submit procurement reports, and found shortcomings in procurement rules and the preparation or updating of procurement plans.

There is an obligation to apply a standard procurement procedure, if the goods and services to be acquired cost 40,000 euros or more, or the construction work to be commissioned costs 250,000 euros or more.

According to the Public Procurement Act, a simplified procedure must be applied, if the outsourced goods or services cost more than 10,000 euros (excl. VAT), or if the commissioned construction work costs more than 30,000 euros (excl. VAT).

A simplified procedure begins with publishing a notice of simplified procurement in the register. The contracting authority may, but does not have to, apply all the rules set out in the Public Procurement Act. After awarding the contract, the contracting authority shall file with the register a public procurement report, and after contract end, an annex to the report.

**85.** In this year's audits, similarly to previous years, the NAO examined the internal controls in place for procurement procedures and audited the conformity of selected procurements with the Public Procurement Act and the internal rules of agencies. Among other things, the NAO inspected whether procurement procedures had been conducted for procurements exceeding the threshold and whether the correct type of procedure had been selected.

**86.** The audit results indicated that - although the internal controls for procurement activities are in place and generally solid, i.e. in most cases, sufficiently detailed procurement rules have been developed and procurement plans are up to date - the number of omitted simplified procedures and standard procedures has increased as compared to the preceding year. Further, there are still cases where the submission of reports to the register is omitted or delayed; however, it is to be noted that such delays have become less frequent.

**87.** The government areas of the Ministry of Education and Research (total of 33 cases) and the Ministry of the Interior (total of 20 cases) featured the largest number of omitted simplified and standard procedures. The Ministry of Justice, the Ministry of Culture and the Ministry of Economic Affairs and Communications had omitted at least 11 simplified and standard procedures.

88. Further, there were violations in the Ministry of Defence, the Ministry of Rural Affairs, the Ministry of Social Affairs, the Ministry of Foreign Affairs, the Ministry of the Environment, the Ministry of Finance, the Government Office, the Chancellery of the Riigikogu, and the Supreme Court. Some procurement procedures, incl. simplified procedures had been omitted.

89. The number of violations of the Public Procurement Act has not grown smaller which implies that these violations refer to weaknesses in the procurement planning, implementation and supervision system. The main 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.

90. The conducted audits revealed that the state agencies still struggle with the procurement of travel services and airline tickets. In 2015, travel services and airline tickets have been purchased without applying a public procurement procedure by the Ministry of Culture, the Ministry of Foreign Affairs whose procurement procedure failed, and some of the agencies governed by the Ministry of Education and Research. The Ministry of the Interior, the Ministry of Economic Affairs and Communications, the Ministry of Social Affairs and the Ministry of Justice purchased airline tickets as [tour operator services under simplified procedure](#). However, according to the Public Procurement Act, the airline tickets must be purchased (i.e. air transport services outsourced) by applying the standard procurement procedure instead of a simplified procedure.

91. The NAO finds that the acquisition of tour operator and air transport services requires better analysis, central coordinated and counselling, and thorough planning of the terms and conditions of procurement.

### **The procurement activities of state-controlled companies and foundations need improvement**

92. 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. The certified auditors who audited the annual accounts of those foundations and companies 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 2015 did not include auditing the regularity of transactions. The NAO has not conducted additional audit operations in these entities either. Therefore, general conclusions for state-controlled companies and foundations, and the State Forest Management Centre cannot be drawn.

93. On its web site, the NAO has published a list of important state-controlled companies and foundations whose transactions should be audited for regularity. Further, the NAO web site features guidelines for auditing the regularity of transactions and the NAO guidelines communicated to certified auditors<sup>3</sup>. The NAO has assisted the certified auditors in auditing the regularity of transactions in state-controlled foundations and companies - organised an information day, arranged meetings with certified auditors, and replied to their questions on daily basis.

For [services acquired under simplified procedure](#), the contracting entity must publish and invitation to tender on its web site or in the Public Procurement Register, and file with the latter a public procurement report, if the expected contract value, excl. VAT, exceeds 40,000 euros. If the expected total value of the contract exceeds the international threshold, the contracting authority must, in addition, draw up a technical description according to the Public Procurement Act.

### **Auditing of public procurements in state-controlled companies, foundations, and the State Forest Management Centre**

<sup>3</sup> NAO guidelines to auditors of entities controlled by the state for providing an opinion on the regularity of economic transactions in 2015.

**In 2015, the procurement activities were audited in 15 out of the 37 foundations and companies designated as essential by the NAO**

94. According to the Public Procurement Register, the state-controlled companies, foundations and the profit-making state agency had a total of 1,502 completed or pending procurements in 2015 amounting to 527 million euros. Compared to the preceding year, the number and monetary value of procurements has grown: 431 procurements more, and total value 258 million euros higher. The NAO believes that one of the reasons for the increase in the total value of procurements is the monitoring of compliance with the Public Procurement Act exercised by the Ministry of Finance in the context of national and administrative supervision, and by the certified auditors mentored by the NAO.

95. Compared to the previous year, the number of state-established foundations and companies whose procurement activities were audited by certified auditors has grown. In 2014, the procurement activities of seven foundations and one company were audited. In 2015, the certified auditors audited procurement activities in nine state-controlled foundations and six companies. (Also, see Annex 1 to the report.)

**The procurement activities of nearly one half of auditees were free from irregularities**

96. In 2015, no shortcomings were identified in the procurement activities of four (Estonian Drama Theatre, Information Technology Foundation for Education, Enterprise Estonia, and KredEx) of the audited foundations and three (Riigi Kinnisvara AS, AS Eesti Liinirongid and Eesti Raudtee AS) of the audited companies. These entities had put in place internal controls for procurement activities in accordance with the Public Procurement Act, and respected its fundamental principles in purchasing goods and services, organising design contests, contracting for construction work, and awarding concessions for construction work and services.

**Shortcomings in the procurement activities of AS Tallinna Sadam group**

97. The audit revealed that AS Tallinna Sadam and its subsidiary AS TS Energia had failed to put in place such internal controls for managing procurement activities that would adequately comply with the requirements of the Public Procurement Act. Further, in 2015, the said public limited companies failed to adequately respect the general principles of managing public procurement with respect to purchasing goods, contracting for services, organising design contests, contracting for construction work, and awarding concessions for construction work and services. The auditors identified cases where procurement procedures, incl. simplified procedures were omitted, the type of procedure was incorrectly selected, and other instances of non-compliance with the general principles of public procurement.

**Shortcomings in the procurement activities of AS Eesti Loto**

98. Likewise, AS Eesti Loto has failed to put in place internal controls for managing procurement activities in accordance with the legal requirements, and ignored the fundamental principles of the Public Procurement Act in purchasing goods and services and contracting for construction work - a number of public procurement procedures, incl. simplified procedures, were omitted.

99. In the audit report on "Management of public procurement in state-controlled companies and state-established foundations" published in February 2013, the NAO pointed out that AS Eesti Loto had not defined itself as a contracting entity for the purposes of the Public Procurement Act. Back then, the NAO maintained that AS Eesti Loto is a contracting entity for the purposes of the Public Procurement Act because it provides - as its core or ancillary activity - services which are in public interest and have no industrial and/or commercial characteristics. Until 9 September 2015 when the Minister of Finance sent a letter to AS Eesti Loto where he adopted a definitive view that AS Eesti Loto must start acting as a contracting entity for the purposes of the Public Procurement Act, the company refused to define itself as such contracting entity. The company started to align its procurement practices with the law only after being required to do so by the Minister of Finance.

## Omitted procurement procedures in the Foundation Tartu University Hospital

100. Similarly to the preceding year, the certified auditor of Tartu University Hospital issued a qualification concerning the omission of procurement procedures. For other entities, the observations mostly concerned shortcomings in the internal control system, and in some cases, the omission of simplified procurement procedures.

101. The NAO finds that companies and foundations should improve their internal controls for procurement management and align procurement arrangements with the Public Procurement Act.

### 102. NAO recommendations to the Minister of Finance and 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;
- in the context of planning the monitoring of compliance with the Public Procurement Act, consider whether monitoring should be intensified in state-controlled companies and foundations where compliance with the said Act has not been or is not planned to be audited;
- analyse the procurement of air transport and tour operator services, and implement, in coordination with the ministries, measures to align their outsourcing with the Public Procurement Act, incl. consider using centralised procurement.

### Response of the Minister of Finance and the Minister of Public Administration:

over the recent years, the MF has prioritised centralised and joint procurement, and we intend to continue our current practice to foster it. Last year's developments in this field were remarkable, especially in terms of the activities of the Centre of Registers and Information Systems (CRIS) and Government Real Estate Ltd (GRE). Midway through 2016, a procurement unit was launched in the Centre of State Support Services (CSSS) that provides procurement management services to the MF and the MJ, their government areas, and the Government Office. In June, the Government of the Republic adopted two Orders to expand the scope for centralised procurement:

- Order No. 224 of the Government of the Republic of 30 June 2016 designated the CSSS as the optional centralised contracting entity for public tenders of government agencies and the state agencies administered by them.
- Order No. 225 of the Government of the Republic of 30 June 2016 designated the CSSS as the mandatory centralised contracting entity for public IT tenders of government agencies and the state agencies administered by them.

In the future, the CSSS intends to conduct joint procurements in addition to centralised ones. More attention should be paid to consolidating the information on procurement needs. In connection with the increased role of the CSSS in conducting centralised procurement, one of its functions is to consolidate the procurement needs of agencies so as to plan centralised procurement more effectively. In coordination with the CSSS, we intend to introduce the CSSS procurement portal for managing optional and mandatory centralised procurement to allow informing the agencies about the centralised public tenders planned by the CSSS, consolidate the procurement needs of interested agencies in cases of optional centralised tenders, prepare the tender documents, etc. Further, we plan to publish the relevant information through the public procurement portal managed by the MF. In parallel, optional centralised tenders will be published on the CSSS web site. The task of the CSSS is to draw up a

procurement plan that covers the procurement needs of all agencies served by the CSSS. Therefore, one of the objectives of the CSSS is to consolidate similar procurement needs of agencies and organise joint invitations to tender whenever possible. The procurement plan will be published on the CSSS web site as well to allow agencies not served by the CSSS on contractual basis joining the public tenders featured in the procurement plan. In 2016, the MF began to develop the new e-environment for public procurement with more attention paid to possibilities of centralised and joint procurement. In parallel, we work together with the CSSS to develop an e-catalogue which should make the management of public tenders and the formalisation of contracts much more convenient, especially in terms of joint and centralised procurement. The e-catalogue allows simplified placement of orders under contracts awarded following procurement procedures, monitoring of current contracts, and drafting of necessary documentation. This electronic solution simplifies and harmonises the ordering process in the framework of conducted public tenders so as to reduce labour costs.

Where possible, we will take the NAO's recommendations into account in planning the monitoring activities and drawing up the risk analysis. The purpose of regular monitoring is to obtain a complete overview of the procurement activities of contracting entities, and where necessary, draw their attention to shortcomings, and map the structural problems arising in connection with the application of public procurement rules. Regular monitoring is based on annual risk analysis. In 2014, the monitoring based on risk analysis focused on local government authorities above all. In 2015-2016, we used the general risk level as the benchmark without limiting the sample by the types of contracting entities. To achieve comparable results and draw conclusion, it is necessary be consistent in terms of risk assessment methods as well as sampling criteria.

The MF has met with the representatives of the Estonian Travel and Tourism Association to develop the most effective tender criteria for air transport and tour operator services. In the second half of 2016 and in 2017, we intend to analyse, in coordination with the CSSS, the possibilities for centralised procurement of air transport and tour operator services across the government sector. Further, over the recent years, we have consulted the European Commission in this regard and examined the relevant practices of other countries (e.g. Finland). Furthermore, authorities from other Member States (e.g. Lithuania) have contacted us to learn about our practices. Overall, this topic is quite complex and gives rise to issues in other countries as well. In addition, we would like to note that clarity in the selection of procedural rules is enhanced by the fact that due to the new directives on public procurement the travel agency and tour operator services can no longer be procured by applying the simplified procedure. To alleviate the problems related to contracting for such services we have consistently provided advise to contracting authorities and, after analysing the possibilities of centralised procurement in cooperation with the CSSS, we will determine the need for developing the relevant guidelines.

## Observations on accounting

### Drawing attention to the recognition of state forests

Formula for calculating the book value of state forests:

$$\text{metsa väärtus} = \frac{MT - MK}{I - P},$$

where MT – revenue from forest management, i.e. the average sale price of timber multiplied by the average estimated annual prescribed cut over a ten-year period;

MK – expenses on forest management, i.e. the average estimated expenses over a ten-year period that allow achieving the prescribed cut values and create the required preconditions for the regeneration of forests;

I – discount rate of 4%,

P – inflation rate, i.e. the estimated average value over a ten-year period.

Source: Annex 8 to the General Rules of State Accountancy

### Inflation rate that affects the value of forests

– value-added deflator for forestry included in the GDP estimate that characterises in greater detail the price changes in the forestry sector. The forestry sector deflator depends on the growth of the deflators for production and intermediate consumption (fuel and other purchased goods and services) - to determine its value, the deflator changes over the years are analysed, the dynamics of timber prices, the changes in the export and import price indexes and the producer price index for wood processing are reviewed, and trends and correlations are analysed. The forestry sector deflator is forecast for a five-year period.

### Forests not included in the prescribed cut

means that part of managed forests which is left growing as a result of forest management, incl. the timber volume of forest stands, both conifer and hardwood. Forest management includes silviculture, and forest use, planning and protection. Non-managed forests are strictly protected forests designed mainly for the conservation of natural features.

### The accounting methods for state forests ignores the characteristics of state forests

103. As at 31 December 2015, the **book value of state forests** was 3.19 billion euros. Compared to 2014, this figure has dropped by 4.3 million euros, primarily due to revaluation. Up to 2015, the book value of state forests was recalculated only if the average sale price of timber had changed by more than 10%, but since 2015, the state forests are revalued as at the end of each year.

104. According to the valuation methods for state forests applicable since 2010, the valuation of forests includes only forests included in the cutting plan, and the prescribed cut values in solid cubic metres are determined by the Supervisory Board of the State Forest Management Centre (SFMC) in the SFMC Development Plan. In 2015, the value of forests is calculated on the basis of the average estimated annual prescribed cut over a ten-year period as set out in the SFMC Development Plan 2015-2020. As the valuation methods are based on the average estimated revenue, expenses and inflation rate over a ten-year period, the prescribed cut values approved by the SFMC Supervisory Board for the sixth year are expected to prevail until the tenth year. Although the state forests are expected to be used sustainably for an indefinite period, the SFMC Development Plan provides, over a six-year period, for an annual increase of 3% in the prescribed cut. Hence, the NAO lacks assurance whether the constant growth of the prescribed cut ensures sustainable use of forests and whether the planned cut values are proportionate to volume increment.

105. Further, the **value of state forests intended to be cut is affected by the inflation rate P** that the Ministry of Finance forecasts for five years only. The accounting methods for state forests are based on ten-year forecasts meaning that using the five-year inflation rate in the model does not ensure comparability.

106. In addition, the NAO points out that, because **forests not included in the prescribed cut** is not recognised on the balance sheet, it is not possible to use the information on the line "Biological assets" on the balance sheet of the SFMC or the state for drawing conclusions as to the changes that have occurred over the years in the value of state-managed forests. The valuation of state forests should take into account that the SFMC's functions include more than just the sale of felled timber, and therefore, the impact of forest management on the value of assets should be recognised.

107. In order to obtain an overview of the developments which occurred in state forests during the accounting year, one must read the State Forest Management Centre's annual report and its notes.

108. In the opinion of the NAO, several circumstances imply that the forest valuation methods should be revised: partial recognition of managed state forests, using forecasts of varying length in the methods, proportionality of the planned cut values to volume increment, etc.

109. **NAO recommendation to the Ministry of Finance:** review, in coordination with the State Forest Management Centre, the accounting methods for state forests and, wherever possible, adjust it to accommodate the characteristics of state forests.

**Response from the Minister of Finance:** It is difficult to develop reasonable and reliable accounting principles that accommodate the characteristics of forests without giving rise to excessive expenses and efforts. We have dealt with this issue for years and renewed the accounting principles in coordination with the

NAO. This year, we would also like to address this matter to possibly come up with new ideas for improving the recognition of forest value.

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

**Unqualified opinion with highlighted circumstances** – the annual accounts are accurate in all material respects but the auditors draw attention to a certain fact that is essential for understanding the information presented in the financial statement.

**The inter-transmission system operator compensation mechanism (ITC)** is a mechanism of compensating for cross-border electricity flows provided for by EU Regulation No. 838/2010 that involves transmission system operators of more than 30 European countries. The mechanism's principle of operation is that the country's transmission system operator shall, through the ITC Fund, compensate the other transmission system operators for extra costs arising from cross-border flows of electricity, if the corresponding country has exported or imported electricity during the accounting period, and shall receive compensation, if the transit flows generated by the market participants of other countries have passed through the country in question.

## Recognition of pension provisions

### The accounting in foundations and companies controlled by the state is generally sound

110. The annual accounts of the state contain the financial indicators of state-controlled companies and foundations, and 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.

111. Auditors who audited the annual accounts 2014 of state-controlled companies and foundations have issued unqualified opinions (also, see Annexes 2 and 3 hereto), excl. opinions on the annual accounts of Hiiumaa Museums Foundation and Foundation Tallinn Science Park Tehnopol. For the annual accounts 2015 of AS Eesti Raudtee, the certified auditor issued an **unqualified opinion with highlighted circumstances**. These circumstances did not affect the opinion of the NAO on the accuracy of the annual accounts of the state.

112. In his report, the certified auditor of AS Eesti Raudtee highlighted the circumstance that, as of 31 December 2015, the company does not meet the contractual conditions for the loan commitment. Because of that, the creditor may require the immediate repayment of the loan balance amounting to 38.2 million euros. As of the date of drawing up the annual accounts, the company's Management Board was not aware of the creditor using such right.

113. The certified auditor who audited AS Elering informed the NAO that the revenue, net profit and equity capital of the company were undervalued by nearly 0.9 million euros because, in its income statement, the company has recognised the revenue from transactions related to **ITC** as being 0.9 million euros smaller.

### Accounting and recognition of pension provisions requires further consideration

114. According to the applicable accounting rules, the pension increases and occupational pensions earned by the balance sheet date but not paid out to former and working public servants are recognised as provisions on the balance sheet of the state accounting entity where they earned the respective benefit. Pursuant to the Public Service Act, the Social Insurance Board keeps account of the pension provisions of retired employees. The State Accounting Department of the Centre of State Support Services keeps account of the pension provisions, accumulated according to the Public Service Act and set up for employees who retired from the agencies, if these provisions were received from the agency as a transfer, and forwards these in the form of a transfer to the Social Insurance Board as at the end of the year when the employee attains retirement age. Pensions are disbursed by the Social Insurance Board.

115. The NAO believes that it is possible to make improve the efficiency of accounting and recognising pension provision. To this end, it should be done centrally at the Centre of State Support Services on the basis of data received from the state accounting entities and the Social Insurance Board, and provisions should be recognised on the balance sheet of the Ministry of Finance.

**116. NAO recommendation to the Minister of Finance and the Minister of Public Administration:** change the arrangements for accounting and recognising pension provisions so that the accounting and recognition would be carried out within a single state accounting entity - the Ministry of Finance.

**Response of the Minister of Finance and the Minister of Public**

**Administration:** Mostly, the CSSS keeps account of pension provisions as accounting has been increasingly centralised. However, we do not find it correct to recognise the expenses arising from the adjustment of pension provisions only in the financial statements of the MF because in that case, the statements of other government areas would not feature the major expenses arising from occupational pension and pension increase schemes applicable to the staff of their government areas. Most adjustments in pension provisions are due to the occupational pensions of police officers, members of the Defence Forces, and judges. We believe that the financial statements of the relevant government areas are the right place for recognising such items.

**Information on transactions with related parties is not disclosed****Transactions with related parties**

**Control** means the power to control the financial or business policy of another company.

**Significant influence** means the power to participate in the making of decisions concerning the financial or business activities of the subject of investment without having control over such decisions.

117. The General Rules of State Accountancy provide that the 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. 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**.

118. The NAO finds that the above principle does not ensure the transparency and verifiability of transactions with related parties because all transactions need not be disclosed. The actions of the public sector should provide an example to the private sector but as regards disclosing transactions with related parties the state has opted for a principle that is notably less stringent than those applicable to the private sector. The NAO finds it essential to disclose all transactions between related parties; such practice is in line with the International Public Sector Accounting Standards (ISPAS) and the internationally recognised best practices of public sector. In this context, it is irrelevant whether the transaction between related parties was compatible with the general requirements, market situation or legal requirements. Introducing the outlined principle in the country helps to further the objective - set out in the Government's anti-corruption strategy - to enhance the transparency of decisions and activities. Where necessary (many transactions), different types of transactions should be grouped and their nature and substance explained.

**119. NAO recommendation to the Minister of Finance and the Minister of Public Administration:** adjust the General Rules of State Accountancy so that all transactions with related parties are disclosed in the form of a separate statement along with the financial statements of the state accounting entity.

**Response of the Minister of Finance and the Minister of Public**

**Administration:** We find that the disclosure of values of transactions with related parties is disproportionately expensive and essentially impracticable in real life - therefore, we consider it unreasonable to adjust the general rules.

According to Accounting Standards Board's guideline No. 2, the purpose of disclosing transactions with related parties is to understand how transactions not compatible with the market situation affect the financial statements. It should be noted that transactions in the public sector are effected in accordance with the legislation and the principle that transactions not provided for by the law are not permitted. Likewise, according to the Anti-corruption Act, there restrictions apply to related parties who are natural persons (ministers, secretaries general, general directors, members of management board, etc.). They are required to provide declarations of economic interest which, among other things, list their close ones and their participation in companies. Such declarations are subject to verification according to the said Act. Further, it should be noted for the public

sector that many databases would need to be modified to collect transaction information on related parties. How else would it be possible to disclose in financial statements how much the executives and their close ones paid taxes, received social benefits or paid for consumed electricity, etc. Collection of data, incl. identification of related parties and monitoring and describing any changes regarding them in the databases, would create an unreasonable administrative burden and, at the same time, give rise to issues related to data protection, privacy, and freedom of enterprise. You have inaccurately stated that international accounting standards require the disclosure of transaction information in the public sector under standard conditions. We would like to draw your attention to IPSAS 20 „Related Party Disclosures“, incl. paragraph 27 which provides that the disclosure of information on transactions effected under market conditions is not required.

**Comment from the NAO:** The NAO does not agree with the view that the disclosure of information on transactions with related parties causes an unreasonable administrative burden. For example, private sector initiatives have led to the development of databases that, on the basis of data available in national registers, allow determining the connections between various persons, their payment discipline, arrears, etc. The government can develop an IT solution with little cost to identify transactions with related parties. The NAO reiterates that transactions with related parties should be disclosed in a separate statement along with the financial statements of state accounting entities. This will help to reduce the risk of corruption notably.

## Conclusions of the NAO regarding the audited areas

120. Table 5 provides an overview of areas audited by the NAO and the main conclusions regarding the audited areas. The monetary value of policy areas as in the 2015 state budget implementation report.

**Table 5. Overview of audit areas and the corresponding opinions of the NAO**

Audited area	Monetary value in 2015, 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?
<b>Collection of revenue</b> , incl. taxes and social security contributions, sale of goods and services, other revenue	7.321 billion	Yes	Yes
<b>Receipt of support</b> , incl. mediation of support	393 million	Yes	Yes
<b>Granting of support</b> , incl. mediation of support	4.023 billion	Yes	Yes
Effecting of <b>operating expenses</b> and assumption of commitments, incl. labour and management costs, other operating expense, financial expenses, effecting of public procurement	4.122 billion	Yes	Yes
<b>Transactions in state assets</b> , incl. investments, financing transactions, effecting of public procurement	378 million	Yes	Yes
<b>Depositing of public funds</b> (interest revenue from bonds, deposits and loans, other financial revenue)	10 million*	Yes	Yes
<b>Exercise of founder's rights</b> in foundations, non-profit associations and profit-making agencies; state participation in legal persons governed by private law	213 million*	Yes	Yes

\* As featured in the state's unconsolidated cash flow statement for 2015.

**121.** A summary of audited 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

On the basis of the audit, the NAO made several recommendations to the Ministry of Finance. On 16.08.2016, the ministers sent their response to the recommendations made by the NAO.

NAO recommendations	Replies from the ministers
<p><b>Use of funds of Estonian Health Insurance Fund and Eesti Töötukassa for state's liquidity management</b></p> <p><b>30. NAO recommendations to the Minister of Finance and the Minister of Public Administration:</b></p> <ul style="list-style-type: none"> <li>▪ initiate the amendment of the State Budget Act and, where necessary, the Estonian Health Insurance Fund Act and the Unemployment Insurance Act to ensure legal clarity as to whether the funds held and invested by the Ministry of Finance may be used for the state's liquidity management;</li> <li>▪ assess the state's liquidity risk in its entirety and take measures to mitigate this risk;</li> <li>▪ assess whether the current liquidity management model meets the state's needs;</li> <li>▪ in the monthly statements of reserves, present information on the amount of other entities' money in the Liquidity Reserve held and invested by the Ministry broken down by entities as was the applicable practice until 2016.</li> </ul> <p>(Paragraphs 10-29)</p>	<p><b>Response of the Minister of Finance and the Minister of Public Administration:</b></p> <p><b>The Ministry of Finance is prepared to submit to the Riigikogu proposals for avoiding ambiguous interpretations of the Act.</b> The Ministry of Finance (MF) has been guided by the spirit and purpose of the Act in accordance with the intentions of the legislator. The legislator decided to hold the cash reserves and the legal reserve of the Health Insurance Fund and the financial means of the Unemployment Insurance Fund in the State Treasury by the 2012 State Budget Act that it adopted on 7 December 2011 in connection with the Act Amending Alcohol, Tobacco, Fuel and Electricity Excise Duty Act, Estonian Health Insurance Fund Act, Local Government Financial Management Act and Unemployment Insurance Act. In that context, § 39 of the Estonian Health Insurance Fund Act was amended and § 341 was added to the Unemployment Insurance Act, and the MF entered into holding agreements with the Health Insurance Fund and the Unemployment Insurance Fund. The involvement of available means of the Health Insurance Fund and the Unemployment Insurance Fund - held by the State Treasury according to a holding agreement - for the purpose of offsetting the negative cash flows of the state was the objective of the legal amendment and the intention of the legislator. 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. Meanwhile, the state pays the Health Insurance Fund and the Unemployment Insurance Fund interest on their balances, i.e. a fee for using their money. Hence, as a result of such operations, their financial resources increase instead of shrinking.</p> <p>The MF maintains that the liquidity management requirements set out in the applicable legislation ensure the mitigation of the liquidity risk. The principles for the management of state's cash flows are laid down by § 66 of the State Budget Act and the Government Regulation on „Principles for Management of the State's Cash Flows and the Stabilisation Reserve Fund“. A liquidity management framework has been put in place for the State Treasury for keeping the value of the state's liquid resources and instant credit lines on a level that, given a reasonable level of risk, the state can, at any time, properly meet all financial commitments, incl. disbursements on behalf of depositors. According to the Government Regulation, the minimum level of the state's liquid resources must allow offsetting a negative net cash flow over a nine-month period. The calculation of the negative cash flow over the nine-month period takes into account the estimated impact of a potential economic downturn on the state's tax revenue, the servicing of its financial debts, the payments of the Social Insurance Board and social security funds, and the state's potential commitments that are likely to become payable. In addition to the minimum required liquidity provision set out in the Government Regulation, the MF has established an internal requirement that the state must always have liquid financial means (Liquidity Reserve) that cover at least two weeks' payments. The State Treasury has consistently respected the above requirements in managing the liquidity risk. There have been no cases of the amount of the state's liquid financial means or the value of instant credit lines dropping below the set target level.</p> <p><b>The MF finds that the liquidity risk have been mitigated because the liquidity level, incl. compliance with the above requirements, is assessed daily, and we have instant credit lines available, and have the</b></p>

NAO recommendations	Replies from the ministers
	<p><b>capability to act promptly should such need arise. Further, we find that the applicable liquidity management model ensures the effective use of the funds of the state in its entirety because holding money separately instead of using group accounts would, all in all, increase the state's interest costs.</b> The compatibility of the liquidity management model with the state's needs and the economic situation is analysed regularly. If circumstances change, adjustments to the model will be proposed. The decisions regarding the structure for ensuring the minimum liquidity provision (Liquidity Reserve and instant credit lines) are made in view of the situation of financial markets and aim to strike the optimal balance between risk and cost. Currently, the loan market conditions are favourable and Estonia's loan capacity is high meaning that there is no need to hold a hefty liquidity provision. In the current situation, the MF can borrow a maximum of 750 million euros from banks on the same day or subject an advance notice of up to 15 days (overdraft, credit lines, and loan from the EIB). This ensures that the payments of all entities included in the state's group accounts are made in due time. The MF will take a loan, if doing so is necessary for managing the cash flows. By postponing the use of borrowed funds, the state saves loan interest costs. Since November 2015, the value of the Liquidity Reserve has dropped below the total value of the deposits concerned but this leads to neither financial risks nor financial loss for the depositors. The state is liable for the liquidity risk, refinancing risk and interest rate risk, and the State Treasury manages these risks. The deposits earn interest according to the rate of yield of investing the assets in the Liquidity Reserve regardless of the value of the reserve, and the depositors are free from the credit risk (the state is liable for negative yield).</p> <p><b>We are willing to modify the statement of reserves and add the information both in table and graph form.</b></p>
<p><b>Planning of the budget</b></p> <p><b>45. NAO recommendations to the Minister of Finance and the Minister of Public Administration:</b></p> <ul style="list-style-type: none"> <li>▪ 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;</li> <li>▪ disclose, on the web site of the Ministry of Finance, complete information on the amounts carried forward from the preceding budgetary year to the next;</li> <li>▪ disclose, in a separate column of or notes to the state budget implementation report, the funds carried forward from the preceding financial year to the accounting year, broken down by the ministries - similarly to funds carried forward to the following year;</li> <li>▪ envisage all financing transactions in the budget and disclose the planned transactions in the explanatory memorandum to the annual state budget.</li> <li>▪ plan, on uniform basis and in full amount, the funds of all ministries necessary for the performance of statutory functions within their respective budgets;</li> <li>▪ attribute, in the context of drawing up the annual state budget, the revenue to the budget lines of ministries that handle the planning, collection and verification of and accounting for such revenue regardless of the revenue being actually paid to the bank accounts of other entities.</li> </ul> <p>(Paragraphs 31-44)</p>	<p><b>Response of the Minister of Finance and the Minister of Public Administration:</b> According to the commitment assumed last year by the Ministry of Finance (MF), Note a31 to the Annual Consolidated Report of the State (pp. 183 to 189) includes, as a new item, an overview of the funds carried over from 2014 to 2015 and from 2015 to 2016, broken down by budget components and government areas. The so-called funds with limits, according to a Directive of the Minister of Finance, make up 20 to 30% of amounts carried over whereby relevant detailed explanations are included in the Directive and its Annexes.</p> <p>A significant share of funds carried over automatically is made up by foreign aid and the related co-financing (35 to 60% of the total carried over). As from the 2014-2020 programming period, the European Commission (EC) makes notably less prepayments compared to the previous period (3% instead of the 10% over the previous period) which means that the amounts recognised as prepayments and carried forward to the following year have shrunk considerably. Since the EC pays only 90% of the amount requested as interim payment, the annual available amount of operating funds is approx. 210 million euros smaller than in the period 2007-2013. As a rule, foreign aid is paid by the EC (in the extent of 90%) to the MF (excl. direct aid) and the MF transfers the money to intermediate bodies so that the latter could make payments to the final beneficiaries towards their certified (analysed and approved) expenses. Therefore, the money received for payments related to foreign aid is held over a longer period on the accounts of the MF, and for shorter periods, on the accounts of intermediate bodies whereby such money is not specifically marked as the rules of distributing foreign aid provide for such holding of funds. The amount of money accumulated on the accounts of intermediate bodies due to this cash flow scheme as at year-end does not provide valuable information on the nature or progress of activities financed from foreign aid. The second-largest group of expenses automatically carried over is made up by balances of tax revenue collected by the state (20 to 30% 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>

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	<p>neither can it be linked to other reasons suggested by the NAO that would necessitate the provision of additional explanations about transfers. In addition to the above two groups, the revenue from economic activities are carried over automatically (4 to 8% 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><b>The MF is willing to provide, in the Annex and explanatory memorandum to the Directive of the Minister of Finance and for each budget component and government area, basic explanations about the carry-over of the rest of the funds, i.e. amounts automatically carried over.</b> To this end, we intend to revise Regulation No. 9 of 4 February 2016 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“.</p> <p><b>However, we would like to point out that due to the transition to accrual-based budgeting the precise figures can be determined later than provided for by the current procedure (in January).</b> We believe the inclusion in the consolidated report of a further overview that provides more detailed information on individual revenue lines or projects than Note a31 would increase the administrative burden and provide no real additional value. Instead, we recommend that interested parties make use of the detailed view for individual measures, projects, beneficiaries, counties, etc. on the web site of Structural Funds: <a href="http://www.strukturifondid.ee/mis-on-tehtud/">http://www.strukturifondid.ee/mis-on-tehtud/</a>. In 2014, the Monitoring Committee for the 2014-2020 Operational Programme for Cohesion Policy Instruments was set up and the Committee's rules of procedure were adopted. The Monitoring Committee reviews the progress made in attaining the programme's objectives. The MF provides regular monitoring reports on the use of Structural Funds. The first report for 2014-2015 was approved on 25 May 2016 and will be published within two months of its approval at: <a href="http://www.strukturifondid.ee/proov-12/">http://www.strukturifondid.ee/proov-12/</a></p> <p><b>Next time, we will additionally include in the consolidated annual report a reference to the monitoring reports by the European Commission that contain budget-based as well as activity-based information.</b></p> <p><b>The Cabinet of Ministers meeting on 7 July 2016 adopted the White Paper on Participatory Policy-making which, inter alia, provides that, in order to enhance transparency, the explanatory memoranda to future state budgets will outline the companies that will enjoy an increase in share capital according to the state budget, and the objectives of such increase.</b> Financing transactions cannot be budgeted with great precision because these depend on the needs of counterparties that might not be formalised as binding commitments at the time of entry into force of the annual budget act.</p> <p><b>The MF agrees with the NAO's recommendation to plan, on uniform basis and in full amount, the funds of all ministries necessary for the performance of statutory functions within their respective budgets.</b> The search for solutions to this situation is still ongoing. On the one hand, this requires amendment of the Environmental Charges Act in order to redirect in full the revenue assigned to the EIC's budget to the state budget. On the other hand, the applicable solution must ensure flexibility for unforeseen events that could affect the sector, e.g. sharp drop in income or sudden surge of costs.</p> <p><b>In connection with the developments in the financial management system (accrual-based state budget from 2017, and activity-based from 2020), we intend to harmonise the principles of recognising transactions to eliminate the current differences between the accounting principles used in budgeting and accounting.</b> Harmonisation requires the restructuring of guidelines and the counselling of contributors to the management of public finances during the transition period. For cash-based budgeting we rely on (until the implementation of accrual-based budgeting) the general rule that revenue is recognised in the budget of the government area which receives the money. The responsibility for the collection of environmental charges is divided on the basis of a cooperation agreement between the government area of the Ministry of the Environment (imposition of charges) and the government area of the MF (collection of charges). Likewise, the responsibilities for collecting fees for court procedures are</p>

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	divided between the government area of the Ministry of Justice (MJ) and that of the MF. Hence, the MF is responsible for managing the collection of fees.
<p><b>Planning of ICT investments</b></p> <p><b>63. NAO recommendations to the Minister of Finance:</b></p> <ul style="list-style-type: none"> <li>▪ consider whether it would be necessary to draw up a list of alternative investments that could be financed pursuant to a simplified procedure without an additional decision by the Government or the Parliament in cases where the implementation of the planned investments fails for some reason;</li> <li>▪ lay down the functions and rules of procedure of the ICT Committee at the MEAC, and the criteria for assessing investment requests;</li> <li>▪ lay down the criteria for evaluating the effectiveness of projects approved for financing by the ICT Committee, and analyse the functioning and performance of the applicable decision-making model;</li> <li>▪ find a solution that allows requesting ICT investments for smaller projects and/or current developments;</li> <li>▪ for planning ICT investments, use - instead of e-mails - an information system that ensures a simplified application, review and recording process.</li> </ul> <p>(Paragraphs 46-62)</p>	<p><b>Response from the Minister of Finance:</b> Regulation No. 9 of 4 February 2016 of the Minister of Finance and the State Budget Act set out the principles the adjustment and breakdown of state budget funds. It would not be practicable to establish a separate procedure for ICT expenditure and the adjustment of investments. According to the current procedures for amending the state budget and adjusting the budget breakdown, funds can be reallocated for other ICT investments and expenses, should such need arise. For analysing the ICT financing needs we have an overview of expenses not financed, but the financing of such expenses requires the setting of priorities within government areas, and making a justified motion to amend the budget legislation or the budget breakdown.</p> <p>We intend to detail the principles of operation of the ICT Committee in the aforesaid Regulation of the Minister of Finance. § 13 of the said Regulation already lists the criteria applicable to ICT projects. The requests for additional funding are reviewed and evaluated against those criteria.</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 substantively (maintenance, personnel, development costs, etc.) making it impossible to apply uniform performance assessment criteria.</p> <p>Neither the MEAC nor the MF have set the value threshold of two hundred thousand euros per project for government areas as mentioned in the audit report. The MEAC pointed out this misunderstanding already in connection with the draft audit report but it was probably overlooked. For filing additional requests related to ICT, it is essential that priorities are set within the government area, whereas the financial value of the project or expenses is irrelevant.</p> <p>The requests for additional financing of ICT are already being collected through the state budget information system that allows uploading Annex 4 to the said Regulation of the Minister of Finance. E-mails have been used to provide instant initial feedback on the project to the party requesting additional funds. Once the project and expenses have been reviewed and assessed, the Government of the Republic processes the additional requests similarly to any other requests for additional financing and makes the financing decisions. All expenses and additional requests (incl. for ICT) are processed in the state budget information system.</p>
<p><b>Planning of lease contracts</b></p> <p><b>73. NAO recommendations to the Minister of Finance:</b></p> <ul style="list-style-type: none"> <li>▪ develop transparent and unambiguous guidelines for state agencies for the classification of lease contracts;</li> <li>▪ guide the ministries during the budgeting process so that they would ask permission for financing transactions in order to eliminate state budget violations arising from contracts already entered into and prevent errors in the planning of new lease contracts;</li> <li>▪ draw up standard forms of lease contracts that the agencies could include in tender documents to avoid contracts containing terms and conditions which are</li> </ul>	<p><b>Response from the Minister of Finance: The MF does not completely agree with the NAO's criteria for recognising lease contracts as finance or operating lease.</b> For instance, we find that the obligation to settle all lease payments upon premature termination, whereby the contract period is 4 or 5 years and the current value of minimum lease payments makes up at least 70% of the vehicle's fair value, does not necessarily mean that all risks and benefits related to ownership have been transferred to the lessee. Neither is such transfer of risks and benefits implied by contractual conditions that include obligations to compensate for any loss due to a reduction in the value of leased property or for damage due to premature termination. Lease contracts are classified at the start of the lease period rather than at the time of learning of the transactions effected upon end of contract or the reduction in the value of property. Generally, lessees enter into lease contracts with the intent to use the property until the end of lease period. The need to enter into insurance policies is assessed in order to safeguard against any negative scenarios that might occur during the lease period. The agencies are not willing to assume commitments that are not prescribed in the state budget.</p>

NAO recommendations	Replies from the ministers
<p>disadvantageous and/or characteristic of finance lease;</p> <ul style="list-style-type: none"> <li>▪ require the Centre of State Support Services in coordination with the accountants of state agencies to review all existing lease contracts and recognise them in the accounts in line with the contractual conditions and accounting rules so as to ensure correct source data for government sector statistics;</li> <li>▪ require the Centre of State Support Services in coordination with Statistics Estonia to find a solution that would enable Statistics Estonia to gain information on the unavoidable expenses of government areas so as to ensure the accuracy of the financial account in the statistics on public finances.</li> </ul> <p>(Paragraphs 64-72)</p>	<p>Therefore, they let the lessors know whether they would prefer a finance or operating lease. The NAO sent us a list of specific contracts for leasing vehicles that should have been recognised as finance lease instead of operating lease. Following the inquiries addressed to agencies, we cannot agree with the NAO.</p> <p><b>We are planning to have all real estate lease contracts concluded through Riigi Kinnisvara AS ("Government Real Estate Ltd." or "GRE"). Further, we have agreed on an amendment to the General Rules of State Accountancy to the effect that contracts entered into with GRE would be recognised as operating lease. For vehicles, we intend to make the transition to centralised procurement (a representative from the NAO has participated in the respective working group), whereas computers are already acquired centrally. In view of the aforesaid, we see no need for developing separate guidelines.</b> We find that the Accounting Standards Board's guideline No. 9 covers the classification of lease contracts. Classification of lease contracts does imply the application of specific rules - instead, it means assessing the risks and benefits related to ownership of property. Hence, we cannot draw up unambiguous classification guidelines. <b>The Centre of State Support Services (CSSS) constantly reviews, in coordination with the agencies, the new contracts entered into and provides advice on recognising these in the accounts. We argue that additional reviewing of earlier contracts would amount to an excessive effort because the audits have not yielded a list of specific contracts which, according to the opinions provided by the agencies, would be currently incorrectly recognised.</b></p> <p><b>We are aware that in some cases assets are intentionally acquired by way of operating lease although it would be economically more efficient to use finance lease. This could be due to the simpler state budget rules applicable to operating lease. We will analyse this bottleneck, provide advice to agencies at briefings and on current basis - during the budgeting process.</b> Further, we point out that, in summer 2016, the MF prepared a streamlining strategy report on "Acquisition and management of the passenger vehicle fleet of government agencies, and organisation of business travel" that aimed to analyse the ordinary use (incl. acquisition) of passenger vehicles by government agencies and the related costs. Some of the recommendations contained in the report:</p> <ul style="list-style-type: none"> <li>▪ for normal intensity of use (annual mileage up to 25,000 km), prefer payment of full sale price or finance lease that allows extending the vehicle's period of use;</li> <li>▪ organise centralised procurement of passenger vehicles through the CSSS. The recommendations will be delivered to the Government of the Republic for decision-making and determining further course of action.</li> </ul> <p>The NAO has considered avoidable expenses to be unavoidable ones. In particular, the lease contracts set out the lessee's obligation to notify a certain number of months in advance of the ordinary or extraordinary termination. If the lessee needs to continue using the property and intends to notify in advance of the termination in accordance with contractual conditions, such expenses are deemed avoidable. Therefore, such commitments are recognised as (conditional) commitments off rather than on the balance sheet. Only actual commitments (that have become due) rather than conditional commitments need to be recognised as commitments for statistical purposes. Statistics Estonia assured us that conditional commitments are not recognised as commitments for statistical purposes. We have identified cases where the value of conditional commitments was shown to be higher than it was supposed to be. This means that in some cases the agencies have recognised all future operating lease payments on an off-balance sheet account although such accounts should recognise only unavoidable payments that cannot be evaded upon termination of lease contracts (provided that these are smaller than future lease payments). <b>In coordination with agencies, we will review the conditional commitments recognised on off-balance sheet accounts and endeavour to recognise conditional commitments correctly in the future.</b> However, this is not related to shortcomings in statistical reports because conditional commitments may not be recognised as financial commitments for the purposes of national accounts.</p>

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	<p><b>Comment from the NAO:</b> The NAO disagrees with the approach that the described expenses are avoidable as outlined in the response from the Minister of Finance.</p> <p>The opinion of the NAO is based on information obtained from Statistics Estonia. Following a request from the NAO, Statistics Estonia analysed the articles of lease contracts underlying the aforesaid expenses and sent an e-mail to the NAO on 3 March 2016 where it claimed that the expenses in question amount to actual commitments. Further, whilst inspecting the audit report on "Practicability of managing the vehicle fleet of ministries" for factual errors, Statistics Estonia confirmed on 31 March 2016 that unavoidable expenses (lease payments that cannot be evaded regardless of the contract period or the intended length of use of leased property) amount to actual commitments which, for the purposes of the system of national accounts, should be recognised as commitments on the financial account. The NAO is aware that conditional commitments are not recognised as commitments for statistical purposes but actual commitments should be recognised. The NAO is not aware of any changes by Statistics Estonia in its approach to unavoidable expenses.</p> <p>In view of the above, the NAO remains true to its opinion and maintains that the Centre of State Support Services should, in coordination with Statistics Estonia, analyse comprehensively the terms and conditions of lease contracts entered into by state agencies so as to determine the type of commitments and expenses in question and ensure the accuracy and comprehensiveness of the data underlying the statistics on public finances, and provide clarity as to where Statistics Estonia could obtain the relevant information.</p>
<p><b>Activity reporting of the state</b></p> <p><b>78. NAO recommendations to the Minister of Finance:</b></p> <ul style="list-style-type: none"> <li>▪ draw up more detailed guidelines for preparing the reports on the implementation of operational programmes and include in those guidelines specific requirements to the structure of, and data presentation in, such programmes;</li> <li>▪ analyse whether the government needs indicators included in the operational programme implementation report for making management decisions or reporting on its activities to the public, and if not, discontinue their presentation in the report;</li> <li>▪ provide, for all indicators presented, their reference value, target value for the current year, and actual attained value in the current year, or failing that, the closest historical value of the indicator.</li> </ul> <p>(Paragraphs 74-77)</p>	<p><b>Response from the Minister of Finance:</b> The procedure for drafting the state budget strategy and the state budget as well as the manual developed by the MF contain specific requirements to the structure of, and data presentation in, operational programmes. Further, the guidelines for operational programmes provide that the form used for operational programmes shall be the 2015 operational programme for government area as adopted by Government Regulation No. 581 of 29 December 2014. The planned activities are reported on. Furthermore, the guidelines include a clear requirement that both positive and negative outcomes must be described for each objective, indicator, measure or activity. We update the guidelines annually. For the sake of clarity, we will include in future guidelines the disclosure requirement set out in the General Rules of State Accountancy. Plus, we will revise the guidelines to reduce the number of shortcomings in the reporting phase. The MF will continue to provide advice accompanied by examples and be more stringent about the materials received.</p> <p>The chapter on operational programme implementation as contained in the consolidated annual report presents indicators that, in the opinion of the ministries, best characterise their respective spheres whereby such indicators must completely comply with the operational programme, incl. indicators, adopted by the Government for the corresponding year. The ministries select the essential indicators in view of the Government's policy priorities (that sometimes already contain numerical targets) and the Government's operational programme that elaborates on these. The indicators in the operational programme originate from sectoral development plans that include indicators which have been reviewed by the Government as well as the Riigikogu. The said indicators and the most important activities during the completed period are reflected, inter alia, in the State Budget Strategy (SBS) that was developed on the basis of data from the ministries by the Government Office and the MF, and approved by the Government. This provides assurance that the Government considers the indicators in question, some of which are set out in the Government's operational programme and some in the forward-looking SBS, necessary for making management decisions. To provide a detailed overview, the consolidated annual report includes references and links to the ministries' detailed reports on the implementation of the operational programme and other reviews that sum up the past year's results.</p> <p>We agree that the convenience of using the indicators should be improved for the readers of the report. We will try to find a solution that allows readily using</p>

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	<p>the last known value in cases where the values for the specific year are missing. To this end, we will continue to counsel the ministries and improve the guidelines. However, there are cases where no reference value can be given because certain indicators were not measured in the past, or were measured using a different approach.</p>
<p><b>Strategic planning</b></p> <p><b>82. NAO recommendation to the Minister of Finance:</b> adopt a procedure for the development, implementation, reporting, assessment and amendment of strategic documents to create a system for monitoring the implementation of strategic documents.</p> <p>(Paragraphs 79-81)</p>	<p><b>Response from the Minister of Finance:</b> It would be an exaggeration to claim that the strategic framework has not been put in place. An important part of the rules originate from the State Budget Act and its implementing provisions. Further, strategic planning is governed by Regulation No. 47 of 16 December 2015 of the Minister of Finance. Additionally, a manual available directly at <a href="https://sites.google.com/site/eelarvejuhend/">https://sites.google.com/site/eelarvejuhend/</a> has been developed to help link strategic planning with financial management. We agree that, in the interests of clarity, the said Regulation needs to be updated. This requires a Government Decision. In the course of drafting this document, the views of different government areas have given rise to the need to further analyse the preparation of the budget. The Government of the Republic has commissioned the Ministry of Finance to prepare a letter of intent for renewing the State Budget Act. The time limits for performing this task are set out in the Government's operational programme.</p> <p><b>Comment from the NAO:</b> The NAO reiterates that the procedure for strategic planning as provided for by the State Budget Act has not been developed, and there is still no systematic approach to strategic planning. By now, a complicated and cumbersome system of development plans and reporting has been put in place but that system is used little in making budget decisions and monitoring their effectiveness. The NAO finds that individual provisions across legislation do not replace an integral framework required for making well-reasoned budget decisions. To this end, the Riigikogu and the Government of the Republic need to provide clear guidelines as to what kind of (performance) information they need for managing the national development goals, and in this light, reorganise the entire strategic planning system.</p>
<p><b>Public procurement</b></p> <p><b>102. NAO recommendations to the Minister of Finance and the Minister of Public Administration:</b></p> <ul style="list-style-type: none"> <li>▪ continue and expand centralised procurement and foster joint procurement, implement publicity measures to this end, and consolidate and analyse the agencies' procurement needs;</li> <li>▪ in the context of planning the monitoring of compliance with the Public Procurement Act, consider whether monitoring should be intensified in state-controlled companies and foundations where compliance with the said Act has not been or is not planned to be audited;</li> <li>▪ analyse the procurement of air transport and tour operator services, and implement, in coordination with the ministries, measures to align their outsourcing with the Public Procurement Act, incl. consider using centralised procurement.</li> </ul> <p>(Paragraphs 83-101)</p>	<p><b>Response of the Minister of Finance and the Minister of Public Administration:</b> over the recent years, the MF has prioritised centralised and joint procurement, and we intend to continue our current practice to foster it. Last year's developments in this field were remarkable, especially in terms of the activities of the Centre of Registers and Information Systems (CRIS) and Government Real Estate Ltd (GRE). Midway through 2016, a procurement unit was launched in the Centre of State Support Services (CSSS) that provides procurement management services to the MF and the MJ, their government areas, and the Government Office. In June, the Government of the Republic adopted two Orders to expand the scope for centralised procurement:</p> <ul style="list-style-type: none"> <li>▪ Order No. 224 of the Government of the Republic of 30 June 2016 designated the CSSS as the optional centralised contracting entity for public tenders of government agencies and the state agencies administered by them.</li> <li>▪ Order No. 225 of the Government of the Republic of 30 June 2016 designated the CSSS as the mandatory centralised contracting entity for public IT tenders of government agencies and the state agencies administered by them.</li> </ul> <p>In the future, the CSSS intends to conduct joint procurements in addition to centralised ones. More attention should be paid to consolidating the information on procurement needs. In connection with the increased role of the CSSS in conducting centralised procurement, one of its functions is to consolidate the procurement needs of agencies so as to plan centralised procurement more effectively. In coordination with the CSSS, we intend to introduce the CSSS procurement portal for managing optional and mandatory centralised procurement to allow informing the agencies about the centralised public tenders planned by the CSSS, consolidate the procurement needs of interested agencies in cases of optional centralised tenders, prepare the tender documents, etc. Further, we plan to publish the relevant information</p>

NAO recommendations	Replies from the ministers
	<p>through the public procurement portal managed by the MF. In parallel, optional centralised tenders will be published on the CSSS web site. The task of the CSSS is to draw up a procurement plan that covers the procurement needs of all agencies served by the CSSS. Therefore, one of the objectives of the CSSS is to consolidate similar procurement needs of agencies and organise joint invitations to tender whenever possible. The procurement plan will be published on the CSSS web site as well to allow agencies not served by the CSSS on contractual basis joining the public tenders featured in the procurement plan. In 2016, the MF began to develop the new e-environment for public procurement with more attention paid to possibilities of centralised and joint procurement. In parallel, we work together with the CSSS to develop an e-catalogue which should make the management of public tenders and the formalisation of contracts much more convenient, especially in terms of joint and centralised procurement. The e-catalogue allows simplified placement of orders under contracts awarded following procurement procedures, monitoring of current contracts, and drafting of necessary documentation. This electronic solution simplifies and harmonises the ordering process in the framework of conducted public tenders so as to reduce labour costs.</p> <p>Where possible, we will take the NAO's recommendations into account in planning the monitoring activities and drawing up the risk analysis. The purpose of regular monitoring is to obtain a complete overview of the procurement activities of contracting entities, and where necessary, draw their attention to shortcomings, and map the structural problems arising in connection with the application of public procurement rules. Regular monitoring is based on annual risk analysis. In 2014, the monitoring based on risk analysis focused on local government authorities above all. In 2015-2016, we used the general risk level as the benchmark without limiting the sample by the types of contracting entities. To achieve comparable results and draw conclusion, it is necessary be consistent in terms of risk assessment methods as well as sampling criteria.</p> <p>The MF has met with the representatives of the Estonian Travel and Tourism Association to develop the most effective tender criteria for air transport and tour operator services. In the second half of 2016 and in 2017, we intend to analyse, in coordination with the CSSS, the possibilities for centralised procurement of air transport and tour operator services across the government sector. Further, over the recent years, we have consulted the European Commission in this regard and examined the relevant practices of other countries (e.g. Finland). Furthermore, authorities from other Member States (e.g. Lithuania) have contacted us to learn about our practices. Overall, this topic is quite complex and gives rise to issues in other countries as well. In addition, we would like to note that clarity in the selection of procedural rules is enhanced by the fact that due to the new directives on public procurement the travel agency and tour operator services can no longer be procured by applying the simplified procedure. To alleviate the problems related to contracting for such services we have consistently provided advise to contracting authorities and, after analysing the possibilities of centralised procurement in cooperation with the CSSS, we will determine the need for developing the relevant guidelines.</p>
<p><b>Accounting of the state forest</b></p> <p><b>109. NAO recommendation to the Ministry of Finance:</b> review, in coordination with the State Forest Management Centre, the accounting methods for state forests and, wherever possible, adjust it to accommodate the characteristics of state forests.</p> <p>(Paragraphs 103-108)</p>	<p><b>Response from the Minister of Finance:</b> It is difficult to develop reasonable and reliable accounting principles that accommodate the characteristics of forests without giving rise to excessive expenses and efforts. We have dealt with this issue for years and renewed the accounting principles in coordination with the NAO. This year, we would also like to address this matter to possibly come up with new ideas for improving the recognition of forest value.</p>
<p><b>Accounting of pension provision</b></p> <p><b>116. NAO recommendation to the Minister of Finance and the Minister of Public Administration:</b> change the arrangements for accounting and recognising pension provisions so that the accounting and recognition would be carried out within a single state accounting</p>	<p><b>Response of the Minister of Finance and the Minister of Public Administration:</b> Mostly, the CSSS keeps account of pension provisions as accounting has been increasingly centralised. However, we do not find it correct to recognise the expenses arising from the adjustment of pension provisions only in the financial statements of the MF because in that case, the statements of other government areas would not feature the major expenses</p>

NAO recommendations	Replies from the ministers
<p>entity - the Ministry of Finance. (Paragraphs 114-115)</p>	<p>arising from occupational pension and pension increase schemes applicable to the staff of their government areas. Most adjustments in pension provisions are due to the occupational pensions of police officers, members of the Defence Forces, and judges. We believe that the financial statements of the relevant government areas are the right place for recognising such items.</p>
<p><b>Disclosure of transactions with related parties</b></p> <p><b>119. NAO recommendation to the Minister of Finance and the Minister of Public Administration:</b> adjust the General Rules of State Accountancy so that all transactions with related parties are disclosed in the form of a separate statement along with the financial statements of the state accounting entity. (Paragraphs 117-118)</p>	<p><b>Response of the Minister of Finance and the Minister of Public Administration:</b> We find that the disclosure of values of transactions with related parties is disproportionately expensive and essentially impracticable in real life - therefore, we consider it unreasonable to adjust the general rules.</p> <p>According to Accounting Standards Board's guideline No. 2, the purpose of disclosing transactions with related parties is to understand how transactions not compatible with the market situation affect the financial statements. It should be noted that transactions in the public sector are effected in accordance with the legislation and the principle that transactions not provided for by the law are not permitted. Likewise, according to the Anti-corruption Act, these restrictions apply to related parties who are natural persons (ministers, secretaries general, general directors, members of management board, etc.). They are required to provide declarations of economic interest which, among other things, list their close ones and their participation in companies. Such declarations are subject to verification according to the said Act. Further, it should be noted for the public sector that many databases would need to be modified to collect transaction information on related parties. How else would it be possible to disclose in financial statements how much the executives and their close ones paid taxes, received social benefits or paid for consumed electricity, etc. Collection of data, incl. identification of related parties and monitoring and describing any changes regarding them in the databases, would create an unreasonable administrative burden and, at the same time, give rise to issues related to data protection, privacy, and freedom of enterprise. You have inaccurately stated that international accounting standards require the disclosure of transaction information in the public sector under standard conditions. We would like to draw your attention to IPSAS 20 „Related Party Disclosures“, incl. paragraph 27 which provides that the disclosure of information on transactions effected under market conditions is not required.</p> <p><b>Comment from the NAO:</b> The NAO does not agree with the view that the disclosure of information on transactions with related parties causes an unreasonable administrative burden. For example, private sector initiatives have led to the development of databases that, on the basis of data available in national registers, allow determining the connections between various persons, their payment discipline, arrears, etc. The government can develop an IT solution with little cost to identify transactions with related parties. The NAO reiterates that transactions with related parties should be disclosed in a separate statement along with the financial statements of state accounting entities. This will help to reduce the risk of corruption notably.</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, 69 foundations under the control of the state and 35 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

### Justification and objective of audit

Pursuant to the State Budget Act, the NAO shall provide an opinion on the accuracy of the annual accounts and the regularity of transactions of the state.

The objective of the audit is to provide an opinion on the annual accounts 2015 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 December 2015, the consolidated and unconsolidated income statement, report on changes in net assets and cash flow statement for the financial year ended on 31 December 2015 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 2015 State Budget Act and the 2015 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 the course of giving an opinion on the accuracy of the state's 2015 annual accounts, the National Audit Office evaluated the compliance of the annual accounts with the Generally Accepted Accounting Principles of Estonia. The

Generally Accepted Accounting Principles are based on internationally recognised accounting policies and procedures (EU directives on accountancy, international standards of financial accounting and international standards of state accountancy) and their main requirements are established in the Accounting Act of the Republic of Estonia, which are supplemented by the guidelines issued by the Accounting Standards Board as well as the General Rules of State Accountancy.

In order to express an opinion on the regularity of transactions, the NAO audited whether or not the transactions of state agencies were performed in accordance with the State Budget Act, the 2015 State Budget Act and the 2015 State Budget Act Amendment Act in all material respects. For this purpose the NAO focused on the expediency and transparency of state budget implementation by checking the expedient use of the investments and expenses of state agencies, their adherence to the budget and the justification of prepayments and expenses.

In addition to expressing an opinion on adherence to the State Budget Act, the NAO paid attention to adherence to the main principles of the Public Procurement Act and the State Assets Act when auditing regularity. For this purpose it checked, on a random basis, whether the procedure stipulated in the Public Procurement Act was followed in the case of acquisitions that exceeded the limit and whether the main principles of public procurements had been adhered to in respect of smaller acquisitions and evaluated whether assets had been used, preserved and transferred prudently.

### **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 sufficient assurance that the financial statements are free of any material misstatements and that transactions comply with the State Budget Act and the 2015 State Budget Act in all material respects.

During the audit, evidence was collected on the numerical values and disclosed information included in the annual accounts and on the regularity of transactions. To facilitate the planning of appropriate audit operations, the NAO considered the internal control system introduced for drawing up true and fair annual accounts and ensuring the legality of transactions without providing an opinion on the effectiveness of internal controls. Also, the audit looked into the relevance of accounting policies, the reasoning behind accounting estimates, and the overall presentation of the annual accounts.

The NAO is of the opinion that the audit provides a sufficient basis for expressing an opinion on the accuracy of the annual accounts and the regularity of transactions.

### **Time of completing the audit**

The audit was completed in July 2016.

## **Audit team**

Auditors of the Financial Audit Department took part in the audit, and it was managed by Gert Schultz, Senior Auditor of the Financial Audit Department in the capacity of Audit 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](mailto:riigikontroll@riigikontroll.ee)

The electronic version of the audit report (pdf) is available on web site <http://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 2-1.8/16/60139/11.

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

19 August 2015 – **Report of the National Audit Office on the 2014 Consolidated Annual Report of the State**

12 August 2014 – **Report of the National Audit Office on the 2013 Consolidated Annual Report of the State**

15 August 2013 – **Report of the National Audit Office on the 2012 Consolidated Annual Report of the State**

27 August 2012 – **Report of the National Audit Office on the 2011 Consolidated Annual Report of the State**

15 August 2011 – **Report of the National Audit Office on the 2010 Consolidated Annual Report of the State**

31 August 2010 – **Report of the National Audit Office on the 2009 Consolidated Annual Report of the State**

All reports are available on the NAO web site [www.riigikontroll.ee](http://www.riigikontroll.ee)

## Annex 1. Opinions of certified auditors on the regularity of economic transactions of companies and foundations controlled by the state

Entity's name	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
Archimedes Foundation	Yes, except for observations on the shortcomings in the applicable procurement rules	Yes
Enterprise Estonia Foundation	Yes	Yes
Estonian Drama Theatre Foundation	Yes	Yes
Estonian Research Council Foundation	Yes, except for observations on the shortcomings in the applicable procurement rules	Yes, except for observations on internal controls and non-compliance with the principles of the Public Procurement Act
Information Technology Foundation for Education	Yes	Yes
KredEx Foundation	Yes	Yes
Tartu University Hospital Foundation	Yes	Yes, except for an observation on the omission of procurement procedures, incl. simplified procedures
Tehvandi Sports Centre Foundation	Yes, except for observations on the shortcomings in the applicable procurement rules	Yes, except for observations on the omission of a simplified procedure and non-compliance with the principles of the Public Procurement Act
Foundation Tallinn Science Park Tehnopol	Yes, except for observations on the shortcomings in the applicable procurement rules	Yes, except for an observation on non-compliance with the principles of the Public Procurement Act
AS Eesti Loto	No, the applicable procurement rules are not compatible with the Public Procurement Act	No, observations on the omission of procurement procedures, incl. simplified procedures, and non-compliance with the principles of the Public Procurement Act
AS Eesti Liinirongid	Yes	Yes
AS Eesti Vedelkütusevaru Agentuur	Yes	Yes, except for observations on the omission of simplified procedures
Eesti Raudtee AS	Yes	Yes
Riigi Kinnisvara AS	Yes	Yes
Tallinna Sadam AS (incl. subsidiary AS TS Energia)	No, the applicable procurement rules are not compatible with the Public Procurement Act	No, observations on the omission of procurement procedures, incl. simplified procedures, and on internal controls and non-compliance with the principles of the Public Procurement Act

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

Foundation	Total assets as at 31.12.2015 (in EUR million)	Opinion
Environmental Investment Centre	203.12	Unqualified opinion
Holstre-Polli Health Centre	1.25	Unqualified opinion
A.H. Tammsaare Museum at Vargamäe	0.34	Unqualified opinion
Läänemaa Development Centre	0.07	Unqualified opinion
Saaremaa Development Centre	0.05	Unqualified opinion
Viljandimaa Development Centre	0.06	Unqualified opinion
Võrumaa Development Agency	0.12	Unqualified opinion
Tuuru Foundation	0.16	Unqualified opinion
Jõgevamaa Development and Enterprise Centre	0.07	Unqualified opinion
Koeru Care Centre	1.99	Unqualified opinion
Raplamaa Development and Enterprise Centre	0.07	Unqualified opinion
Estonian e-Health Foundation	2.86	Unqualified opinion
Estonian Fund for Disabled People	0.08	Unqualified opinion
Image Database for Estonian Healthcare	1.88	Unqualified opinion
Haapsalu Neurological Rehabilitation Centre	4.0	Unqualified opinion
North Estonia Medical Centre	207.26	Unqualified opinion
Sillamäe Rehabilitation Centre for Drug Addicts	0.27	Unqualified opinion
Tartu University Hospital	183.84	Unqualified opinion
Viljandi Hospital	13.16	Unqualified opinion
Hiiumaa Hospital	2.11	Unqualified opinion
Jõgeva Hospital	2.15	Unqualified opinion
Enterprise Estonia Foundation	56.67	Unqualified opinion
State Infocommunication Foundation	8.8	Unqualified opinion
Foundation Estonian Accreditation Centre	0.44	Unqualified opinion
Foundation KredEx	173.64	Unqualified opinion
Foundation Tallinn Science Park Tehnopol	17.14	Qualified opinion
Rural Development Foundation	51.8	Unqualified opinion
Private Forest Centre	1.46	Unqualified opinion
Cultural Publications Foundation	0.68	Unqualified opinion
Tehvandi Sports Centre Foundation	17.49	Unqualified opinion
Estonian Song and Dance Celebration Foundation	1.20	Unqualified opinion
Integration and Migration Foundation "Our People"	1.29	Unqualified opinion
Estonian Drama Theatre Foundation	8.91	Unqualified opinion

Estonian Film Institute	1.56	Unqualified opinion
Jõulumäe Recreational Sports Centre	2.90	Unqualified opinion
Narva Alexander's Cathedral Foundation	0.45	Being audited
Rakvere Theatre Foundation	5.36	Unqualified opinion
Tartu St. John's Church Foundation	0.03	Unqualified opinion
Ugala Theatre Foundation	14.15	Unqualified opinion
Estonian National Commission for UNESCO	0.01	Unqualified opinion
Old Town Theatre Foundation	0.31	Unqualified opinion
Russian Theatre	10.72	Unqualified opinion
Virumaa Museums Foundation	4.01	Unqualified opinion
Endla Theatre Foundation	3.55	Unqualified opinion
Vanemuine Theatre Foundation	20.87	Unqualified opinion
Theatre NO99 Foundation	0.47	Unqualified opinion
Foundation NUKU	0.34	Unqualified opinion
Narva Museum Foundation	10.57	Unqualified opinion
Haapsalu and Läänemaa Museums Foundation	1.27	Unqualified opinion
Estonian Healthcare Museum Foundation	0.79	Unqualified opinion
Estonian Open Air Museum Foundation	10.11	Unqualified opinion
Estonian Concert Foundation	21.05	Unqualified opinion
Estonian National Symphony Orchestra	0.72	Unqualified opinion
Hiiumaa Museums Foundation	0.27	Qualified opinion
Estonian Language Foundation	0.48	Inspection, unqualified
Foundation Estonian Philharmonic Chamber Choir	0.19	Unqualified opinion
Pärnu Museum Foundation (established in 2015)		Not audited
National Foundation of Civil Society	1.82	Unqualified opinion
Estonian Foreign Policy Institute	0.12	Unqualified opinion
International Centre for Defence and Security	0.12	Unqualified opinion
Culture Fund of President of the Republic	0.03	Unqualified opinion
Estonian Cooperation Assembly	0.01	Unqualified opinion
Information Technology Foundation for Education	18.75	Unqualified opinion
Innove Foundation	34.80	Unqualified opinion
Estonian Qualifications Authority	0.73	Unqualified opinion
Archimedes Foundation	44.42	Unqualified opinion
Estonian Research Council Foundation	10.70	Unqualified opinion
Science Centre AHHA	11.29	Unqualified opinion
Sports Education and Information Foundation	1.02	Unqualified opinion

Source: audited annual reports for 2015

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

Company	Size of holding (%)	Total assets as at 31.12.2015 (in EUR million)	Opinion
Eesti Energia AS (group)	100	2957.8	Unqualified opinion
Riigi Kinnisvara AS (group)	100	413.92	Unqualified opinion
Eesti Loto AS	100	16.68	Unqualified opinion
AS Levira (group)	51	25.43	Unqualified opinion
AS Hoolekandeteenused	100	41.52	Unqualified opinion
Tallinna Sadam AS (group)	100	581.08	Unqualified opinion
Eesti Post AS (group)	100	56.79	Unqualified opinion
Tallinna Lennujaam AS (group)	100	142.63	Unqualified opinion
Lennuliiklusteeninduse AS	100	31.08	Unqualified opinion
Saarte Liinid AS	100	57.24	Unqualified opinion
Eesti Loots AS	100	19.77	Unqualified opinion
AS Eesti Liinirongid	100	175.21	Unqualified opinion
Teede Tehnokeskus AS	100	2.9	Unqualified opinion
Metrosert AS	100	3.59	Unqualified opinion
AS Eesti Vedelkütusevaru Agentuur	100	156.11	Unqualified opinion
A.L.A.R.A. AS	100	1.49	Unqualified opinion
Eesti Raudtee AS	100	302.67	Unqualified opinion with highlighted circumstances
Eesti Teed AS	100	30.85	Unqualified opinion
KredEx Krediidikindlustus AS	100	37	Unqualified opinion
Elering AS	100	861.93	Unqualified opinion
EVR Cargo AS	100	71.32	Unqualified opinion
Rail Baltic Estonia OÜ	100	1.41	Unqualified opinion
Nordic Aviation Group AS	100	38.63	Not audited
Transpordi Varahalduse OÜ	100	48.17	Not audited

## Annex 4. Overview of audited areas broken down by the ministries, and the corresponding opinions of the NAO

<b>Audited area</b>	<b>Collection of revenue, incl. taxes and social security contributions, sale of goods and services, other revenue</b>	<b>Receipt of support, incl. mediation of support</b>	<b>Granting of support, incl. mediation of support</b>	<b>Effecting of operating expenses and assumption of commitments, incl. labour and management costs, other operating expense, financial expenses, effecting of public procurement</b>	<b>Transactions in state assets, incl. investments, financing transactions, effecting of public procurement</b>	<b>Depositing of public funds (interest revenue from bonds, deposits and loans, opening balances for banking operations, other financial revenue)</b>	<b>Exercise of founder's rights in foundations, non-profit associations and profit-making agencies; state participation in legal persons governed by private law</b>
<b>Ministry of Education and - Research</b>	Yes	Yes	Yes	Yes, incl. observations	Yes, incl. observations	Not audited	Yes, incl. observations
<b>Ministry of Justice</b>	Yes	Yes	Yes	Yes, incl. observations	Yes, incl. observations	Not audited	Not audited
<b>Ministry of Defence</b>	Yes	Not audited	Yes	Yes, incl. observations	Yes, incl. observations	Not audited	Not audited
<b>Ministry of the Environment</b>	Yes	Yes, incl. an observation	Yes	Yes, incl. observations	Yes	Not audited	Not audited
<b>Ministry of Culture</b>	Yes	Yes	Yes, incl. an observation	Yes, incl. observations	Yes, incl. observations	Not audited	Yes, incl. observations
<b>Ministry of Economic Affairs and Communications</b>	Yes	Yes	Yes	Yes, incl. observations	Yes, incl. observations	Not audited	Yes, incl. observations
<b>Ministry of Rural Affairs</b>	Yes	Yes, incl. observations	Yes, incl. observations	Yes, incl. observations	Yes	Not audited	Yes

<b>Audited area</b>	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
<b>Ministry of Finance</b>	Yes	Yes	Yes	Yes, incl. observations	Yes, incl. observations	No, a qualification was issued	Yes