INTRODUCTION

In accordance with the auditing plan for the year 2001 of *Riigikontroll* (the State Audit Office) we have completed our examination of the financial statements of the Baltic Defence College (hereinafter "the College") for the year ended 31 December 2000. Our examination was conducted during the period of February, 5th till February 28th, 2001.

We are of the opinion that the legal status of the College was not determined at the time of our examination. As the College has followed the legislation applicable to the public sector, we express the opinion with regard to the financial statements of the College according to the Estonian Accounting Law § 1-16 and the accounting guidelines issued by the Estonian Minister of Finance.

We conducted our audit based on the accounting data as of 31.12.2000. The source documentation of the fixed assets has been reviewed by random tests covering the period since the establishment of the College. We have not audited the financial statements of the College as of 31.12.1999 including figures which influence the results of the financial statements as of 2000. We will not express the opinion about the effectiveness, efficiency and economy.

We submit for your consideration our comments and recommendations (together with your responses) relating to the College's accounting procedures, tax related issues and business and financial position.

The audit manager in charge was Tõnis Saar. The audit specialists involved with the examination were Merike Starovoitov and Õie Soovik. We have interviewed the following employees of the College: Jana Mikaja, Ene Truu, Raival Ilves and Kadi Salu.

ACCOUNTING

Accounting Procedures

1 The accounting entity is required to establish accounting procedures according to the Accounting Law § 16 and the guidelines[1] of the Minister of Finance. According to the Memorandum of Understanding – the basis of the foundation of the College – the Council of the College should approve the Accounting Procedures. At the time of our examination the Council had not formally approved the Accounting Procedures and thus not in accordance with the above-mentioned requirements. We have made the following observations about Accounting Procedures (hereinafter "the Procedures":

1.1 The Procedures do not include the accounting principles of fixed assets. The lack of principles has caused the following shortcomings:

- There are differences between the date of the accounting entry and the date of the statement of fixed assets (special document for approval that the fixed asset has been received and given into use). For example, Monitor Nokia 446X Pro19″ with the purchase value 12 389 kroons, the date of the statement of fixed assets is March 15th, 1999 and the date of accounting entry is March 5th, 1999. This has caused an error in depreciation of 413 kroons. The examination ascertained that the total amount of fixed assets where the dates did not reconcile was 273 538 kroons (purchase value). The depreciation error amounted to 5 160 kroons.

- The statement of fixed assets does not have signatures which approve the receipt, giving into use and correctness of the depreciation calculation of the fixed asset.

- There are no contracts which stipulate the material responsibility.

- There is no source documentation or a summary document for depreciation recording.

- It is not determined when the calculation of the depreciation rate of the fixed assets will start and how often the recordings will be made.

- The principles and depreciation methods of the intangible assets are not determined.

1.2 The inventory procedures of the assets and liabilities are quite general. There are the following shortcomings:

- The physical cash count as of 31.12.2000 has not been made.

- The tax balances have not been reconciled with Tax Authorities as of the year end 2000.

[1] Rahandusministri 17.03.95. a määrus nr 46, p-d 18-19 (17 March 1995 Regulation no. 46 of Minister of Finance, Art.18-19)

- During our examination we found that the physical inventory of fixed assets did not find out the actual shortages (see p 2.9).

1.3 As regards the accounting programme in use the access rights, the rights for making corrections and closing the accounting registers are not determined in the Accounting Procedures.

1.4 The rules of recording transactions and arrangements of document circulation described in the Accounting Procedures should be improved as follows:

- The procedures for the accounting treatment of doubtful receivables are not described.
- The rules for the numeration of sales invoices are not described. During the examination we found that the numeration was changed when the accountant changed. For that reason we cannot be sure that the numeration is continuous.

We recommend to consider the issues mentioned under 1.1 until 1.4 above for improving the Accounting Procedures.

The financial statements of Baltic Defence College as of 31.12.2000

2 We have made the following observations about the financial statements of Baltic Defence College as of 31.12.2000 showing the balance sheet volume of 6 446 455 Estonian kroons and revenue of the year of 1 912 345 Estonian kroons:

2.1 For accounting, the College has followed the legislation applicable to the public sector. The balance sheet and income statement as of 31.12.2000 is in accordance with the Act no.113 (28.12.1999) of Minister of Finance. We want to point out that the above-mentioned act has been cancelled on 30.11.2000[2] .

2.2 . The same act determines the new rules for the financial statements which varies from the previous act. The College has implemented the old version.

2.3 The disclosures of the financial statement of the College are not in accordance with the legislation applicable to the public sector[3].

2.4 The bank accounts in the balance sheet have been stated bigger than actual statement by 17 911 kroons. The difference arises from the mistake of recalculating the bank accounts with the exchange rates of Bank of Estonia

2.5 The balance sheet row 1.3 "Postgiro accounts" includes also amounts which are bank accounts by 2673 388 kroons. These amounts should be recorded in the balance sheet row 1.2 "Bank".

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[2] Rahandusministri määrus 30.11.00. a nr 100 "2000. a. aastaaruande koostamine, esitamine ja kinnitamine" (30 Nov. 2000 Regulation no. 100 of Ministry of Finance with regard to compilation, submitting and appproving of the financial statements of 2000)

[3] Rahandusministri määrus 30.11.00. a nr 100 "2000. a. aastaaruande koostamine, esitamine ja kinnitamine" (30 Nov. 2000 Regulation no. 100 of Ministry of Finance with regard to compilation, submitting and appproving of the financial statements of 2000)

2.6 The balance sheet row 3.1 "Trade receivables" includes receivables of 17 084 kroons from the Ministry of Defence which has arisen in 1999. The Ministry of Defence has not confirmed the liability to the College. According to the accountant of the College the amount is under the clarification in the Ministry of Defence. We are in the opinion that doubtful receivables should be provisioned and recorded as doubtful receivables in the balance sheet.

2.7 "The miscellaneous receivables" include the interest receivable of 6 604 kroons which should be recorded as "The accrued income" (balance sheet row 5.2)

2.8 The fixed assets do not include 3 computers purchased in December 1999 in the total amount of 41 507 kroons and 1 computer of 12 779 kroons purchased in April 2000. Due to that the fixed assets as of 31.12.2000 have been stated less than actual value by 54 286 kroons.

2.9 The fixed assets include the missing computer (lost in 1999) with the residual value of 13 150 kroons. This computer was not indicated as missing during the physical inventory of fixed assets. Due to that the fixed assets are overstated in the balance sheet. In addition to that, the incorrect physical inventory of fixed assets indicates to the weakness of internal control procedures.

2.10 The fixed assets in the total amount of 2 million kroons have been purchased by the General Staff of the Estonian Defence Forces before the registration of the College. The documentation of the transfer of the fixed assets after the registration is missing. Due to that the ownership of the fixed assets is not proven.

2.11 The trade payables do not include the accrued expenses of December 2000 in the total amount of 5 249 kroons. The following expenses and liabilities are understated:

- *Radiolinja Eesti AS* 04.01.2001. invoice no. 0021791404, 2 546 kroons;
- *Radiolinja Eesti AS* 04.01.2001. invoice no.0021791410, 200 kroons;
- *Kaitseväe Ühendatud Õppeasutused* (United Training Units of the Defence Forces") 06.01.2001. invoice no. 17, 2 907 kroons
- *Vatex OÜ* 08.01.2001. invoice no. 1/24, 1 888 kroons.

2.12 The liabilities include the payable of 10 000 kroons to Arvo Kangus. According to the explanation this is for the rent of the apartment for the Head of Administration Department of the College Mr Juris Eihmanis. The amount will be invoiced later to the Latvian Defence College. There is neither contract between lessor and lessee nor invoices for the rent. There is no source document which should be the basis of the accounting entry[4]. For that reason it was not possible to determine the correctness of the period and nature of the liability.

2.13 The tax liabilities related to the personnel (personal income tax and social tax) in the amount of 58 326 kroons is stated on the balance sheet row 13 "Tax liabilities". This amount should be stated on the balance sheet row 14 "Personnel related tax liabilities"[5].

[4] Raamatupidamise seadus § 7 lg 2 (Accounting Act § 7 (2))
[5] Rahandusministri 30.11.00. a määrus nr 100 § 26 (11 Nov 2000 Regulation no.100 of Minister of Finance § 26)

2.14 The General Staff of the Estonian Defence Forces has concluded employment contracts with the employees of the College who have been hired before registration of the College. These contracts have not been delivered to the College after the registration. After the registration no contracts have been concluded either with the employees hired before or hired after. Due to that fact we are not able to express the opinion of the following:

- About the correctness and completeness of the payroll expenses in the total amount of 936 683 kroons (including social tax) because of the missing source documentation for salary calculations;

- About vacation pay accrual in the total amount of 12 825 kroons, which is based on the inventory of vacation as of 31.12.2000. The inventory is not reliable due to the reason that no vacation has been approved by source documentation. According to the explanations all employees have been on vacation though. We also want to point out that the vacation pay accrual is stated in the balance sheet row 14 "Personnel related tax liabilities" instead of the row 15.1 "Liabilities to personnel". The vacation pay accrual does not include social tax of 4 131 kroons, by that amount the liabilities and expenses are understated.

2.15 The phone and communication expenses include prepayment to *AS Hotronic* 06.12.2000. invoice no. 600-2000 for the installation of communication systems. Due to that the expenses are understated by 66 000 kroons. The prepayment should be stated on the balance sheet row 9.6 "Prepayments for fixed assets".

2.16 The accrual basis principle has not been followed when the communication expenses for November – December, invoice no. 4 to *" Kaitseväe Ühendatud Õppeasutused* "(United Training Units of the Defence Forces")14.01.2000. was recorded as expenses in 2000, due to that the expenses are overstated by 75 871 kroons.

2.17 Other income includes the amounts which are not related to the main activities of the College. We are in the opinion that this income should not be recorded in the financial statements of the College.

- Income account of Juris Eihmanis – invoices in the amount of 71 689 kroons for the accommodation to be reimbursed by the Latvian Defence College.
- Income account of Elita Marga – the reclamation in the amount of 14 132 kroons for incorrectly overpaid lecturing fee.
- Income account of Heikko Teino – repayment for personal telephone calls in the amount of 365 kroons.
- Income account of Michael Clemmesen – expenses in the amount of 87 154 kroons to be reimbursed by Michael H. Clemmesen (or Denmark) that have been paid by Baltic Defence College
- The financial income of 2000 includes the interest for 1999 in the total amount of 5 325 kroons, due to that the financial income is overstated.

2.18 The instalments for the expenses and investments (endowments) made by supporting countries during 2000 are stated in the income statement row 1.6 " Income

from legal and physical persons" in the total amount of 7 337 940 kroons. The amount not used is stated in the balance sheet row 11.6 "Other short-term liabilities" in the amount of 1 243 856 kroons. According to the Act of Minister of Finance[6] the endowments, including instalments and endowments should be stated on the balance sheet row 18.4 "Endowments". We want to point out that all receivables from other states should be recorded as endowments. According to that the residual value of the fixed assets should be recorded as endowments. We recommend to correct also the opening balances to make the balances comparable.

We recommend to make corrections to the financial statements according to the observations mentioned under 2.1 until 2.18 above.

TAX RELATED RISKS

3.1 According to the agreement the College is using guest lecturers who receive 150 EUR per lecture. In the year 2000 the total amount was 31 577 kroons. There is no written contract made. We want to point out that as there is no written contract and the receiver is not the resident by the Estonian tax law there is a potential tax risk that the payments made by the College will be taxed by withholding tax[7] and social tax[8].

3.2 A considerable amount (approximately 395 000 kroons) of other personnel expenses are related to travelling and catering. During the audit we did not get the list of employees of the College. Due to that the expenses for visitors and for own employees could not been separated. We want to point out that for the own employees these expenses are treated as fringe benefits and should be taxed by withholding tax[9]and social tax[10].

3.3 The College has paid travelling expenses approximately in the amount of 839 000 kroons, including the persons who are neither the employees of the College nor members of the board according to Estonian tax law. In addition, the College has paid daily allowance for the participants of seminars arranged by the College in the total amount of 31 900 kroons. Such payments should be taxed with withholding tax [11] and income tax[12].

3.4 The balance sheet row "Miscellaneous receivables" include VAT receivable from Tax Board in the amount of 202 630 kroons. The College has not registered as VAT responsible organisation. Tax Board though returns the VAT according to VAT Law[13] and the Act of Ministry of Finance[14]. According to the explanation the College makes

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[6] Rahandusministri 18.05.00. a määrus nr 44 § 2 lg 2 (18 May 2000 Regulation no. 44 of Minister of Finance § 2 (2))
[7] Tulumaksu seadus § 41 lg 2 (Income Tax Act § 41 (2))
[8] Sotsiaalmaksu seadus § 2 lg 1 (Social Tax Act § 2 (1))
[9] Tulumaksu seadus § 48 (Income Tax Act § 48)
[10] Sotsiaalmaksu seadus § 2 lg 1 (Social Tax Act § 2 (1))
[11] Tulumaksu seadus § 41 lg 1 ja lg 2 (Income Tax Act § 41 (1)(2))
[12] Sotsiaalmaksu seadus § 2 lg 1 (Social Tax Act § 2 1))
[13] Käibemaksu seadus § 14 lg 3 (Value Added Tax Act §14 (3))
[14] Rahandusministri 24.09.96. a määrus nr 73, p 4 (24 Sept. 1996 Regulation no. 73 of Minister of Finance Art.4)

an application for the Ministry of Defence who imparts it to the Tax Board. We are in the opinion that as the College is not listed as the legal person in the mentioned regulation[15], the VAT requirement to Tax Board is not reasonable.

[15] Rahandusministri 24.09.96. a määrus nr 73, p 2(24 Sept. 1996 Regulation no. 73 of Minister of Finance Art.2)

LEGAL STATUS

The College is registered in The Register of Estonian Enterprises, Institutions and Organisations as of 31.12.2000 as an institution similar to government agencies. We want to point out that the register will be liquidated and the institutions not reregistered in the Business Register or the Register of Government and Municipal Agencies as of 01.05.2001 will be erased.

Tõnis Saar
Audit Manager
Financial Audit Department

A copy of the report received on .....2001.a.

Our viewpoints and comments will be submitted to the *Riigikontroll* (the State Audit Office) at the latest on .....2001.a.

Michael Hesselholt Clemmesen
Brigadier General
Chief of the College

Jana Mikaja
Chief Accountant

Chief Auditor's Report

The Report no. 11-7/014 of Chief Auditor from 05.06.2001

[Nonofficial translation from Estonian original]

The financial statements of Baltic Defence College of the year 2000

We have audited the financial statements of the Baltic Defence College (hereinafter "the College) for the year ended 31 December 2000. These financial statements are the responsibility of the management board of the College. Our responsibility is to express an opinion on these financial statements based on our audit.

The above mentioned report includes only the use of supporting participants' (Denmark, Switzerland, Sweden, Norway, Iceland, Finland) agreed payments and other subsidies, the contributions of three Baltic States allocated to the College are not reflected here.

We conducted the audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management. We believe that our audit provides a reasonable basis for our opinion on the financial statements.

1. We have not audited the financial statements of the College as of 31.12.1999. The practical audit procedures used by us did not enable to get enough assurance about the data on the balance sheet. The amounts shown in the balance sheet as of 31.12.1999 form a part of the revenue of 12 months of the year 2000.

2. We will not express the opinion on the fixed assets in the total amount of 2 million kroons. These fixed assets have been purchased by the General Staff of the Estonian Defence Forces before the registration of the College in The Register of Estonian Enterprises, Institutions and Organisations (the College was registered at 17.11.1999). The source documentation of the transfer of the fixed assets after registration is missing and due to that the ownership of the fixed assets is not proven.

3. The General Staff of the Estonian Defence Forces has concluded employment contracts with the employees of the College who have been hired before registration of the College. These contracts have not been delivered to the College. After the registration (17.11.99) no

contracts have been concluded either with the employees hired before or hired after. Due to that fact we are not able to express the opinion of the following:

- About the correctness and completeness of the payroll expenses in the total amount of 936 683 kroons (including social tax) because of the missing source documentation for salary calculations;

- About vacation pay accrual in the total amount of 12 825 kroons, which is based on the inventory of vacation as of 31.12.2000. The inventory is not reliable due to the reason that no vacation has been approved by source documentation in 2000. According to the explanations all employees have been on vacation though and this has been taken into account during the inventory.

4. The instalments for the expenses and investments (endowments) made by supporting participants during 2000 are not stated in the balance sheet row "Endowments", the revenue of previous periods is not corrected which is in conflict with the Regulation of the Minister of Finance[2]. In our opinion all these instalments should be recorded as endowments.

5. In the income statement row 1.7 "Correction of incomes" the financing from supporting participants is stated in the sum of 668 489 kroons. This sum should be stated in the row 1.6 "Income from legal and physical persons".

6. The balance sheet does not include the potential taxation obligations ensuing from the payment risks. In our opinion the realisation of tax risk is probable. We have brought out the following business transactions from what the College has not calculated nor paid the tax according to the Income Tax Act and the Social Tax Act:

   - A considerable amount (approximately 293 174 kroons i.e. 37%) of the other personnel expenses are related to representation and catering. During the audit we could not separate the expenses that were paid for own employees. We want to point out that for the own employees these expenses are treated as fringe benefits and should be taxed with fringe benefit's withholding tax according to the Income Tax Act [1], and with social tax according to the Social Tax Act [2].

   - The College has paid travelling expenses approximately in the amount of 839 000 kroons, including the persons who are neither the employees of the College nor members of the board according to Estonian tax law. In addition, the College has paid daily allowance for the participants of seminars arranged by the College in the total amount of 31 900 kroons. According to the Tax Law such payments are considered as payments which should be taxed with withholding tax [3].

7. The balance sheet row "Miscellaneous receivables" include VAT receivable from Tax Board in the amount of 202 630 kroons. The College has not been registered as VAT responsible organisation. Tax Board though returns the VAT according to VAT Law[4] and the Act of

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[1] Tulumaksu seadus § 48 (Income Tax Act § 48)
[2] Sotsiaalmaksu seadus § 2 lg 1 (Social Tax Act § 2 (1))
[3] Tulumaksu seadus § 41 lg 1, lg 2 (Income Tax Act § 41 (1), (2))
[4] Käibemaksu seadus § 14 lg 3 (Value Added Tax Act §14 (3))

Ministry of Finance[5]. According to the explanation the College makes an application for the Ministry of Defence who imparts it to the Tax Board. We are in the opinion that as the College is not listed as the legal person in the mentioned regulation[6], the VAT requirement to Tax Board is not reasonable.

In our opinion, except for the effects of the information included in the p. 1-7, the above mentioned financial statements as of 31.12.2000, showing the revenue of the year 2000 in amount of 1 911 327 kroons and the balance sheet volume as of 31.12.2000 of 6 462 332 kroons is drawn up in accordance with the Act no. 100 (30.11.2000) of the Minister of Finance[7].

Without qualifying our opinion, we draw the attention of the management of the College and the Minister of Defence to the following circumstances connected to the activities of the College:

- The above mentioned statements do not cover all the assets, liabilities, incomes and expenses. The use of instalments and endowments made by the supporting participants (Denmark, Switzerland, Sweden, Norway, Island, Finland) are shown in the statements, but the resources given by the three Baltic Countries are not shown. There is a separate accounting and the separate financial statements for the use of the governmental resources of Estonian Republic. According to the unaudited data the resources given to College from governmental budget of Estonia in year 2000 were 4 036 255 kroons. As of 31.12.2000 the amount of assets obtained was 467 266 kroons and the loss was 235 570 kroons. In our opinion the separate statements do not give the overall view of the activities, assets nor the necessary expenses for the maintenance of the College.
- As of 31.12.2000 the College was registered in The Register of Estonian Enterprises, Institutions and Organisations as an institution similar to government agencies. We draw the management's attention to the fact that The Register of Estonian Enterprises, Institutions and Organisations will be liquidated and the institutions not reregistered in the Business Register or the Register of Government and Municipal Agencies as of 01.05.2001 will be erased. Until the moment of the release of current opinion the College has not been reregistered.

/Signature/

Kaie Karniol
Chief Auditor
Department of Financial Audit

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[5] Rahandusministri 24.09.96. a määrus nr 73, p 4 (24 Sept. 1996 Regulation no. 73 of Minister of Finance Art.4)
[6] Rahandusministri 24.09.96. a määrus nr 73, p 2(24 Sept. 1996 Regulation no. 73 of Minister of Finance Art.2)
[7] Rahandusministri määrus 30.11.00. a nr 100 "2000. a. aastaaruande koostamine, esitamine ja kinnitamine" (30 Nov. 2000 Regulation no. 100 of Ministry of Finance "With regard to compilation, submitting and approving of the financial statements of 2000")