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AUDIT REPORT

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Opinion of the State Audit Office on the financial statements for 2003 of the Baltic Defence College

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Tallinn
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Introduction

The State Audit Office has performed the audit of the financial statements of the Baltic Defence College (hereinafter "the College") for the year 2003 in accordance with the audit plan. The audit was conducted in the period from 7 April to 4 May 2004.

The audit is based on the financial information as at 31 December 2003. The principles of financing, accounting and auditing of the College are stipulated in the Memorandum of Understanding[1] (hereinafter: "the Memorandum") concluded between the Baltic countries and supporting parties. Proceeding from the latter, the College conducts its accounting in accordance with the legislation of the Republic of Estonia (the hosting participant), which is specified and supplemented by the regulations concerning financial and accounting matters approved by the Board of the College.

In organising its accounting and preparation of the financial statements, the College has proceeded from legislation, which regulates the accounting and reporting in the public sector of the Republic of Estonia[2].

Audit Manager Jüri Kurss and Junior Auditor Jaana Tõnisson carried out the audit.

[1] The Memorandum of Understanding on cooperation regarding the founding, activity, management, initial financing and travel of staff of the Baltic Defence College located in the Republic of Estonia, concluded between the Minister of Defence of the Republic of Estonia, the Minister of Defence of the Republic of Latvia, the Minister of Defence of the Republic of Lithuania, the Minister of Defence of the Kingdom of Denmark, the Minister of Defence of the Republic of Finland, the Minister of Defence of the Federal Republic of Germany, the Minister of Defence of the Kingdom of the Netherlands, the Minister of Defence of the Kingdom of Norway, the Minister of Defence of the Republic of Poland, the Minister of Defence of the Kingdom of Sweden, the Minister of Defence of the Confederation of Switzerland and the Minister of Defence of the United Kingdom of Great Britain and Northern Ireland.

[2] Regulation no. 106 of the Minister of Finance of 16 December 2003.

1. Bases for the formulation of the opinion

1.1. Mandate of the State Audit Office

As a result of gradual changing of the financing scheme of the College, the financing currently covered by the supporting participants will be transferred to the three Baltic States in the near future; therefore the supporting participants see the auditing of the College as an obligation of Estonia. The Minister of Defence of the Republic of Estonia has made a respective proposal[3] to the State Audit Office on which we have based this audit. The State Audit Office has annually audited the financial statements of the College since 2001.

1.2. The purpose of the audit

The purpose of the audit is to give an opinion on the financial statements of the College for 2003. The opinion is formulated on the basis of the following criteria:

- Whether financial transactions have been recorded in substance and arithmetically correctly;
- Whether the assets are actually owned by the College and whether the debts are actually its liabilities;
- Whether the assets and liabilities exist in reality;
- Whether the assets and liabilities have been appropriately assessed;
- Whether the revenues and expenses are recorded on an accrual basis, in the correct period and to the full extent;
- Whether the accounting system of the College corresponds to the requirements set by the Accounting Act and the regulations of the Minister of Finance and generally accepted accounting principles in the extent applicable to the institutions of the public sector of the Republic of Estonia.

As a result of the audit we do not give an overall opinion on the financial management and the internal control systems, but we present main observations and shortcomings detected during the audit.

1.3. Compliance with standards

The State Audit Office conducted the audit in accordance with the auditing standards of INTOSAI[4]. 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 included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also included assessing the accounting principles used and significant accounting estimates made by the management. We believe that our audit provides a reasonable basis for our opinion on the financial statements of the College.

1.4. Responsibility for the correctness of the financial statements

The Commandant of the College Michael Hesselholt Clemmesen and Jana Lundblad, the person responsible for accounting, are responsible for the preparation of the financial statements and correctness of the information contained therein.

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[3] Letter of the Minister of Defence no. 1-430/5629 of 11 January .2000.
[4] INTOSAI - International Organisation of Supreme Audit Institutions acting under the auspices of the UN.

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2. Opinion on the financial statements for 2003 of the Baltic Defence College

2.1. Qualifications

2.1.1. Material errors exist in the accounting of targeted financing. The targeted financing in the relevant revenue accounts (3718 and 3724) have been first twice (20 June and 25 August 2003) inaccurately recorded as the receivable and revenue and in the course of spending of targeted financing have been again recorded as revenue and expenses (as stipulated in the guidelines), as a result the both amounts in total of 312,932 kroons (20,000 EUR) have been twice recorded in revenue.

2.1.2. Similarly to the previous years the financial statements of the College did not record all assets, liabilities, revenues and expenses, as the statements did not record the resources allocated by the founding states (Denmark, Switzerland, Sweden, Norway, Iceland, Finland, the Netherlands) and by the Baltic States for expenditures connected with staff and cadet travelling, incl. accommodation expenditures, salaries, per diems and travel expenses to the College and back. According to the Memorandum these expenses should be covered by each state.

In the opinion of the State Audit Office the recording of the College's economic activity in separate statements does not provide an integral overview of the activity and assets of this educational institution and the costs required for its operation. The same problem was already pointed out during our audits of the previous years[5].

2.2. Opinion of the State Audit Office

In our opinion, considering the audit scope and excluding the possible impact of the circumstances described in clauses 2.1.1. and 2.1.2., the abovementioned financial statements, indicating the revenue of the year 2003 in amount of 1,405, 197 kroons and the balance sheet volume of 10,004,101 kroons as at 31 December 2003, are drawn up in all material respects in accordance with the Regulation No. 106 "Preparation, submission and approval of the financial statements of the year 2003" of the Minister of Finance of the Republic of Estonia of 16 December 2003.

2.3. Other observations

The observations regarding the accounting which due to the immateriality of amounts have no impact on the correctness of the report and the recommendations related to internal control systems, legality of transactions and financial management have been provided as follows.

2.3.1. The accounting of targeted financing is in places unclear and includes errors.

- The Finnish contribution of 312,932 kroons has been transferred to the account where the Latvian support to the Ukrainian student is recorded, as no new account was opened in the accounting;
- In several cases the payments have been made from the account of targeted financing to the wrong students, e.g. on 31 December 2003 the payments from the account of Latvian support were made to the Ukrainian student instead of the Georgian student, on 9 January 2003 the resources of the Bosnian students have been recorded as the expenses of the Georgian student in amount of 4,694 kroons, also on 31 January 2003 in the same amount.

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[5] Auditor's Report of the State Audit Office No. 2-5/02/3, 24 May 2002 "Auditor's Report of the State Audit Office on the financial statements for 2001 of the Baltic Defence College" and Auditor's Report No. 2-5/03/22, 28 April 2003, "Auditor's Report of the State Audit Office on the financial statements for 2002 of the Baltic Defence College"

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2.3.2. Several transactions are in content handled as the salary and therefore the tax risk could be involved in case of the audit of the Tax Board.

- On 13 June 2003 3,740 kroons were paid to Liina Laaser for the graphic sheet "Baltic Defence College". This work had been drawn up as the sales contract. On 20 June 2003 3,000 kroons were paid as the compensation for expenses for the Norwegian translation to Triinu Rižijs, the employee of the College. The only document designating the transaction – the invoice provided by Triinu Rižijs – could be regarded as the contract.

  We find that the works should have been drawn up as the contract for services, as these are compliant with the terms provided in § 635 of the Law of Obligations Act. The College should have paid social tax[6], income tax[7], unemployment insurance payment[8] and if necessary also funded pension payments[9], as here no self-employed persons are involved. In case of the abovementioned samples the total payment is 5,586 kroons – provided the income tax free minimum is calculated from their basic salary.

2.3.3. The payments uncovered with source documents exist and fuel expenses have been compensated for the foreign lecturers.

- The compensation claim of 497 kroons for the light alcoholic drinks presented to the accounting department of Soren Frausig on 6 May 2003 is handled as the fringe benefit, as the source document[10] certifying the financial transaction should be the basis for each accounting entry. As no source documents exist, it could not be assessed for which the expenses are compensated. We point out that the fringe benefits need to be correspondingly taxed.
- The fuel expenses in total amount of 1,447 kroons related to coming to lecture from Tallinn to Tartu have been many times compensated for Jüri Luik. The compensation of these expenses could be regarded as fringe benefit[11], as the service has been actually rendered here (without contract) [12]. Thus these expenses should have been taxed with fringe benefit tax in amount of 1,550 kroons.

2.3.4. The College mediates the computer equipment and accessories from AS Ordi – as AS Ordi sells products with very favourable price to the College, the College also purchases the latter to its employees who pay to the College based on the invoice presented by the College. This business activity carried out by the College is condemnable, as this is neither its main activity nor related to its objectives.

2.3.5. The internal accounting regulations of the College do not regulate the reporting for the use of bank cards. As a result, the transactions conducted with debit cards are recorded in the accounts on the basis of bank statements to which expense documents are appended. The expenditure made with credit card is certified with the bank statement (the original document is usually missing in internet purchases). In order to enhance internal control, the internal accounting regulations must be amended, stipulating the reports to be submitted, their deadlines, the persons authorized to approve them and persons responsible.

2.3.6. The internal accounting regulations should specify how the so-called free balance of listeners is accounted for. The latter name is misleading, as the financing balance of a single student could be regarded as a liability.

The calculated balance of financing incurring right after the deduction of direct expenses (travelling expenses, scholarship etc.) from the amount allocated to the student is here dealt with. The general

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[6] Social Tax Act § 2 1 (1) (6)
[7] Social Tax Act § 2 (1) (6)
[8] Unemployment Insurance Act § 40 (1) (3)
[9] Funded Pension Act § 7 (1)
[10] Income Tax Act § 48 (4)
[11] Income Tax Act § 48 (4)
[12] Income Tax Act § 48 (3)

expenses of the College have been covered in account of free balance and in the interests of clarity of accounting this so-called free balance is separately transferred to the bank account.

2.3.7. The bank interests are not always transferred through the account of financial income (e.g. on 30 September 2003 the latter are directly transferred to the account of targeted financing in amount of 467 kroons). Interest income from bank accounts should be transferred through the account of financial income, ensuring the understandability and comparability of accounting. The latter is stipulated by the accounting regulations of budgetary agencies[13] and regulation of the minister of finance[14]. This requirement has also been stipulated in the internal accounting regulations of the Baltic Defence College.

2.3.8. The outdated VAT requirement in amount of 52,325 kroons was recorded in expenses on 1 December 2003 to the wrong account 5991 "Foreign exchange losses from the suppliers". The account 5990 "Other operating expenses" should have been used.

2.3.9. The suppliers have repeatedly returned the invoices paid twice for and erroneously paid for the other company. For example 59.7 kroons was returned to Eesti Posti Tartu PK AS on 28 January 2003 and 454.01 kroons was returned to AS Air Cargo Estonia on 6 August 2003. The latter refers to the weakness of internal control system. For example the relevant note could be always made on the source document by paying the invoices and pay to the suppliers only based on the original source documents.

2.3.10. The liability of the College to OÜ Hotelligrupp (681 kroons) had been recorded in the liabilities report, although no service was actually rendered to the College by OÜ Hotelligrupp, also no invoice nor credit invoice had been received. In case the institution has recorded its transaction in the accounting registry, the basis should be the source document[15]. The invoice and its credit invoice were faxed from OÜ Hotelligrupp in the course of the audit and the mistake was corrected. In order to ensure the correctness of the report the accounting department should establish and correct such errors during the stock count of liabilities at the latest.

2.3.11. In inserting the data to the accounting programme the errors due to the programme had occurred which caused the incurrence of the liability to the wrong period in the accounting programme (e.g. in January instead of November) and the incorrect print-outs of accounts. The computer programme should be also tested regarding the other errors and amendments made in case of their incurrence.

2.4. Recommendations

Recommendations of the State Audit Office to the Board and the Commandant of the Baltic Defence College

- To record all business activities of the College in one set of financial statements to ensure an integral view of the activity of this educational institution, its assets and running expenses. If necessary, separate reporting for each supporting state might be considered (to meet the needs of the supporting states).
- To specify and amend the accounting of targeted financing in the internal accounting regulations and guarantee thus the prevention of errors. We recommend applying the periodic balance comparisons between the financing institutions and the College, where the amounts transferred to the College and received were indicated and the balance of targeted financing as to single students or their groups provided.
- To specify the order for making the purchases in the internal accounting regulations which is characteristic of good financial management.
- To ensure that no resale of products would be carried out to the employees of the College;

[13] Regulation No. 46 of the Minisiter of Finance of 17 March 1995
[14] Regulation No. 106 of the Minisiter of Finance of 16 December 1995
[15] Accounting Act §4 (2) and (3).

- **To complete the accounting procedures so that:**
  - **the reporting of debit and credit cards were stipulated;**
  - **accounting entries without source documents would be excluded;**
  - **accrued income would be recorded in the correct period;**
  - **ensure the recording of receivables, liabilities, income and expenses to the correct accounts;**
  - **the contracts with all employees should be concluded and the correct payment of taxes guaranteed;**
  - **the timely and correct payment of invoices would be guaranteed.**

/signature/

Kaie Karniol
Head of Department
Financial Audit Department

The answer of the Baltic Defence College

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BALTIC



AD SECURITATEM
PATRIARUM

BALTIC DEFENCE COLLEGE

Mrs. Kaie Karniol
State Audit Office
Financial Audit Department

13 May 2004/ *6.5.0/1316*

Answer to the draft sent by you regarding the financial statements for 2003 of the Baltic Defence College.

Below we present our opinions by clauses as follows:

2. Opinion on the financial statements for 2003 of the Baltic Defence College

2. 1. *Qualifications*

2.1.1. We are in the opinion that the given qualification is justified. The error has been liquidated by correct recording of accounts.

2.1.2. We have previously already answered to the given qualification during the audit of 2002, that me, as the representative of the College, could not change the accounting procedure agreed in establishing the College. I share the opinion that the resources allocated to the Baltic Defence College by the Estonian state could be recorded in integrated accounting, instead of being currently recorded in the balance sheet of Estonian National Defence College.

2.3. *Other observations*

2.3.1. The necessary specifications on targeted financing have been entered to the internal accounting regulations since 2004.

- The Latvian support has been recorded at the separate account (2238)
- No sums have been paid from the account of Latvian support to the Georgian student. Latvia supports the Ukrainian student who has received payments from this account. The error incurred due to the wrong name of the student on the entries of correct accounts.

The entries of 9 January 2003 and 31 January 2003 have been amended – the account 6311 was recorded instead of 6315.

2.3.2. On 20 June 2003 3,000 kroons have been paid to Triinu Rizijis, the employee of the College, for translations on which she has presented the invoice to the Baltic Defence College. As she is the self-employed person, the College has the right to settle this invoice as the invoice received from the suppliers (based on FIE Certificate No. 5665).

During the conclusion of the contract with Liina Laaser it was agreed that the seller pays the taxes subject to the law on the amount received from the transaction made, which Liina Laaser has also done according to the information of the College.

2.3.3.

- We agree with the statement that the payment uncovered with source document was once made (Soeren Frausig). The latter was due to the organisation of training of the syndicate in the Kingdom of Denmark, where juice and soft drinks were offered during the visit of the museum. The claim was filed to the Baltic Defence College regarding the soft drinks, which are not handled as the light alcoholic drinks by the Baltic Defence College, but as the soft drinks. The source document was missing, as the museum of the relevant county of the Kingdom of Denmark did not issue this. The source document was though missing, but this was just the visit to the museum during the training, so the fact that alcoholic drinks (or light alcoholic drinks) are consumed is excluded.

- The clause 6.6 of the internal regulations of the Baltic Defence College stipulates that when personal transport is used for business travel, the College compensates 1.20 kroons per each kilometre crossed. As Jüri Luik was the visiting lecturer who required no fee for the lectures delivered and as he arrived with the personal car, the College compensated him according to the kilometres covered.

2.3.4. We disagree with your opinion that the College should not mediate computer accessories to its employees, if needed. This is not a business activity, as the College has not gained benefit from it. I see no reason why the employee of the College should not purchase himself computer accessories with special price by taking advantage of the benefits meant for loyal customers. We draw your attention to the fact that this was not the regular sales activity, but these cases were quite exceptional.

2.3.5. The clause 5.1.1.2. of the internal accounting regulations of the College stipulates the procedure for using the debit cards, which is the bank statement and the expense documents attached to it.

2.3.6. Since 2004 the procedure for settling the free balance of listeners has been entered to the internal accounting regulations.

2.3.7. The bank interests were transferred through the account of targeted financing, so the latter would be comparable with the balance of the relevant bank account. The amendment was made with the entry to the account of financial income 8010.

2.3.8. There was an obvious error made regarding the VAT claim where the account 5991 has been mistakenly used instead of account 5990. The error has been corrected.

2.3.9. The invoices presented in January for December by Uninet AS and Radiolinja Eesti AS have been recorded as at 31 December 2003.

2.3.10.

- We disagree with the statement that the suppliers have repeatedly returned the invoices paid twice or for another company. The given situation where the invoice was paid for another company is the first and only case and thanks to immediate response the mistakenly transferred sum in amount of 477.90 EEK (30.54 EUR) was returned at first chance.
- The relevant note will be always made to the source document when paying for the invoice. As to the amount of 59.70 EEK (3.81 EUR) of Eesti Post AS it was the double receipt of original invoice with 1-month interval.
- In case of Air Cargo the invoice of 2002 was sent at the beginning of 2003. Many companies have made a mistake with the number of year on the invoices issued at the beginning of the year, therefore no attention was paid and the invoice was paid, as no liability from 2002 existed regarding the mentioned company, the latter was dealt with as the outstanding invoice.
- In case of Hermann Travel it was an obvious error of Hermann Travel itself, whereby the invoice was presented both to the College and the passenger who had already paid the invoice to Hermann Travel. The case concerned the visiting lecturer of the College.
- It could not be allowed that the College always pays based on the original document, as due to the specific nature of the College the cases occur whereby one or another service is immediately needed (e.g. accommodation invoices from Lithuania, Latvia to be paid before the beginning of the training, whereby the original invoice is usually issued when leaving the hotel). It is not allowed by the College that the training is cancelled as a result of not ordering some service or not paying the invoice for the latter. The only possible solution in such cases has been the immediate payment of invoices based on the invoices received either by fax or mail, which are later replaced with the original invoice. The given situation was already explained in the course of preparing the financial statements for 2002.

2.3.11. During the stock count of liabilities we discovered that the College has the existing liability for the benefit of Hotelligrupp OÜ. Actually this liability did not exist, but as no credit invoice was sent to the College by Hotelligrupp OÜ the basis for cancelling the given sum in accounting was missing. We contacted the accounting of Hotelligrupp OÜ by phone, but no credit invoice was sent. The invoice was sent when the former accountant in Hotelligrupp OÜ was replaced with the new one who immediately responded to our request.

2.3.12. The incurrence of liabilities to the wrong period in accounting programme was not due to the error resulting from the programme, but due to the configuration setup of the computer. The errors incurred have been amended.

/signature/
Michael H. Clemmesen
Commandant of the College

/signature/
Jana Lundblad
Chief Accountant