Organisation of the internal control system and accounting and the legality of the economic transactions in the City of Kuressaare in 2004 and 2005

Audit report No. OSV-2-6/06/97 of 29 November 2006

Summary

The purpose of the audit was to assess the compliance of the accounting of the City of Kuressaare with accounting legislation and instructions, the compliance of the economic transactions with relevant legislation and the functionality of the internal control system applied for ensuring the targeted and lawful use of the funds of the City. During the audit annual accounts 2004 and 2005 of the City were not assessed. Instead, the audit points out the main observations regarding the organisation of accounting, the operativeness of the internal control system, and the legality of the transactions performed in the audited areas.

During the audit the City Government of Kuressaare was the most helpful and ready to take essential recommendations into account.

According to the National Audit Office the internal control system of the City of Kuressaare needs considerable improvement in order to ensure the legality and purposefulness of the economic transactions of the City and to prevent the risk of making mistakes in the annual accounts, the risk of entering into harmful transactions, etc. There are deficiencies in the organisation of the accounting of the City of Kuressaare, which have led to serious errors in the annual accounts. The legislation of the state or the City has not been complied with upon performance of economic transactions.

The National Audit Office did not find considerable mistakes in loan accounting or the legality of the transactions in the context of the audited transaction classes.

Main observations

- There are serious deficiencies in the internal control system of the City of Kuressaare. For example:
    - The provisions of the state and City legislation have not been adhered to upon implementation of the budget, records management, asset and liability accounting, organisation of inventory checks and public procurement, disclosure of documents and data, etc. The rules of the internal work organisation of the City of Kuressaare (procedure for records management; the accounting policies and procedures; rules of possession, use and disposal of assets) are not in compliance with the underlying legislation or do not entirely comply with the work organisation and division in the City.
    - The City Government of Kuressaare and some officials have adopted decisions to enter into transactions with the assets of the City, amendment of the approved budget, use of the budget funds and entry into contracts on behalf of the City without having the required competence.
    - The City Government of Kuressaare has used the reserve funds originally allocated for covering incidental expenses for increasing the operating expenses of the City Government and the agencies administered by the City Government and for increasing the sums allocated for remuneration without applying to the City Council for amendment of the budget.
    - The City Government of Kuressaare has paid support and grants without following the procedures established for payment thereof; paid support using the money not allocated for such purpose in the budget; financed the performance of the duties pertaining to the primary activity of the agencies administered by the City Government using the money allocated for support.
    - The supervision exercised by the Audit Committee over the activities of the City Government has been insufficient.
    - As of 31 December 2004 no inventory had been taken of the fixed assets. As of 31 December 2005 inventory was taken of the fixed assets in the course of re-evaluation,

as a result of which the National Audit Office could not assess the objectiveness of carrying out the inventory checks of the fixed assets or the accuracy of accounting the results.

- There are deficiencies in the organisation of the accounting of the City of Kuressaare, which have led to serious errors in the annual accounts. For example:
  - The accounting principles used upon accounting the fixed assets and the manner of presentation of information is not in all cases in compliance with the requirements and underlying principles provided for in the Accounting Act and the accounting principles generally accepted in Estonia.
  - Fixed asset transactions and other economic transactions with third parties and the foundations and companies founded by the City have not always been in compliance with their actual economic substance and following the economic entity principle, as a result of which the information given about the transactions in the annual report is misleading in certain instances.

Main recommendations

To the Council of the City of Kuressaare

- To ensure the adoption of all the required regulations of the Council, updating the effective regulations and bringing them into compliance with the underlying legislation.
- To improve the work of the Audit Committee of the Council in order to ensure systematic supervision over the City Government and the agencies administered by the latter. If necessary, to involve experts in the work of the Audit Committee.

To the City Government of Kuressaare

- To improve the internal control system, incl.:
  - to bring the rules regulating the internal work organisation of the City Government of Kuressaare into compliance with the underlying legislation and the actual work organisation;
  - to make a proposal to the Council to bring the rules of possession, use and disposal of the assets of the City and other rules regulating transactions involving the assets of the City into compliance with the actual needs of the City and to ensure adherence to these rules;
  - to bring the records management into compliance with all the requirements;
  - to improve supervision over implementation of the budget and contracts and to ensure timely arrival of adequate information to the accounting entity.
  - to organise thorough inventory checks of the assets and liabilities;
  - to improve disclosure of relevant information.
- To bring the accounting policies and procedures into compliance with the underlying legislation. In accounting, to follow the legislation of the state and the City and the internal procedures of the City.

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The Council and Government of the City of Kuressaare agreed with most of the recommendations set out in the report of the National Audit Office, submitting additional explanations and an action plan in their reply, which has been annexed to the audit report.

The Council and Government of the City of Kuressaare did not agree with some of the positions given in the draft audit report (see the reply), which have been provided with explanations by the National Audit Office and which have been amended by the National Audit Office in the context of the audit report as follows:

- <u>Clause 2.1.1 "Possession of fixed assets and transfer of possession"</u>: The National Audit Office remains true to its position that the fixed assets used for performance of the statutory goals by the agencies administered by the City Government should be transferred to the respective agencies pursuant to the procedure set out in section 7 of the Rules of the City Assets of Kuressaare and accounted under the fixed assets of these agencies. According to the Rules of the City Assets, the former practice of entering into possession contracts with the administered agencies is applicable to the transfer of possession to third persons. The obligations and rights of the agency administered by the City Government as the possessor of the City assets arise from its status, the statutes of the agency and they have been set out in the Rules of the City Assets and laws. According to Guideline No. 1 of the Estonian Accounting Standards Board, an asset object is accounted in the balance sheet of the respective institution, which uses it for achievement of the goals established for it. The wording of clause 2.1.1 of the audit report has been slightly amended.

- Clause 2.1.3 "Transfer of fixed assets": The State Audit still finds that it is not right to account the transactions of the transfer of fixed assets free of charge as a write-off of the fixed assets, because it does not correspond to the economic substance of the transactions. Free transfer of the fixed assets should be accounted as a surrender of the assets, i.e. non-monetary targeted financing. Upon accounting the non-monetary targeted financing, the local government unit must proceed from Guideline No. 12 of the Estonian Accounting Standards Board. In clause 2.1.3 of the audit report the reference to the basis of accounting the non-monetary targeted financing has been amended.
- Clause 2.1.6 "Granting use of fixed assets free of charge": Considering the principles of operation of the public sector the National Audit Office still finds that granting long-term use of assets without charge should be considered as a surrender of the funds, i.e. non-monetary targeted financing. Upon accounting the non-monetary targeted financing, the local government unit must proceed from Guideline No. 12 of the Estonian Accounting Standards Board. In clause 2.1.6 of the audit report the wording and the reference to the basis of accounting the non-monetary targeted financing have been amended.
- Clause 2.1.9 "Transfer of fixed assets to the foundation": The National Audit Office remains true to its position that the will of the City of Kuressaare, the founder, to transfer the registered immovables specified in clause 2.1.9 of the audit report to the Foundation cannot be derived from the foundation resolution of the Kuressaare Sports Facilities Foundation (i.e. Regulation No. 27 of the Council of the City of Kuressaare of 27 November 2003). The respective resolution stipulates that the registered immovables will be transferred to the Foundation after their registration in the register of foundations. Subsection 5 (6) of the Foundations Act does not allow for the acquisition of the legal condition of the founder by the transfer of the assets to the Foundation after its foundation. The respective will of the City of Kuressaare, the founder, could not be derived from the contract by which the assets were transferred to the Foundation free of charge. The National Audit Office has proceeded from the aforementioned documents. Therefore the National Audit Office is still of the opinion that it is not correct to treat the free transfer of the assets to the Foundation as a transfer of the assets to the foundation capital and as an acquisition of a shareholding in the foundation capital of the Foundation as has been done in the annual reports of 2004 and 2005. The reference to the basis for accounting the non-monetary targeted financing has been changed in clause 2.1.9 of the audit report.
- Clause 2.1.2 "Registration of fixed assets": On the basis of the reviewed documents (incl. certificates, the register of the fixed assets, etc.) the National Audit Office came to the conclusion that the roads specified in clause 2.1.2 of the audit report had not been registered as of 31 December 2004. According to an accounting certificate, the roads were registered as of 31 March 2005 and during the re-evaluation of the fixed assets in 2006 it was estimated that their fair value was approx. EEK 8 million. According to the City of Kuressaare, these roads had been registered as of 31 December 2004, but accounted in the register of the fixed assets not under the independent objects of the fixed assets, but under the acquisition cost of other roads. The position of the City of Kuressaare has been given in clause 2.1.2. Nevertheless the National Audit Office finds that the fixed asset balances of the City Government of Kuressaare do not reflect their actual division and value as of 31 December 2004 mainly because the re-evaluation of the fixed assets had not been made. The actual division and value of the fixed assets was identified during the re-evaluation of the fixed assets as of 31 December 2005.

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