The activities of the authorities of the City of Pärnu in the context of deteriorating financial position and in receivables and payables proceedings through 2008 to 2010

What was done once the financial position started worsening and can the internal control system hedge the risks arising from changes?
Have overdue receivables and payables been attended to and have liabilities been assumed in accordance with rules?

Report by the National Audit Office to the *Riigikogu*
Tallinn, 31 October 2011

Summary of audit results

The National Audit Office (NAO) analysed the activities of the authorities of the City of Pärnu from 2008 to 2010 in connection with the deterioration of the city's financial position and assessed the functionality of the internal control system of the Pärnu City Government for the purpose of hedging risks arising from changes in the financial position.

The NAO also assessed the activities of the Pärnu City Government and its agencies in handling receivables and payables, because the worsened financial position increased receivables and payables. The audit has not focused on the efficiency, effectiveness or economy of the activities of the city authorities.

With its 42,000 inhabitants, the City of Pärnu is the fourth largest municipality in Estonia and an important provider of public services in the region in social, economic and cultural terms. Since the annual budget total of the city is approx. 42 million euros, Pärnu is also an important economic partner for many economic operators and an employer of local residents. The budget revenue of the City of Pärnu is largely based on tax revenue and state budget support. Pärnu's well-being is thus a concern for many and the functioning of the city as a local authority concerns a significant portion of the population and taxpayers of Estonia. In recent years the City of Pärnu has receive a lot of attention in connection with its rapidly deteriorating financial position. In comparison with other larger local authorities, Pärnu's financial indicators have referred to major problems in organising the city's finances and the city's liabilities have skyrocketed. In the event of emergence of financial difficulties, a local authority must quickly identify their reasons and start looking for solutions and must not let problems rise to a level that jeopardises the functioning of the city as a local authority.

At the end of 2010, Pärnu's financial position was characterised by such keywords as a **high debt burden** and **poor solvency**. In the future the city administration must work hard in order to find the right balance between paying off old debts and funding further operations and investing in the development of the city. The contents of the city's budget strategy show the way and we can only hope that the plans will be implemented.

The reasons of the difficult financial position partially date back to 2007 when the forecast of the sale of the city's assets and property proved to be highly optimistic and, believing that revenues will accrue, the expenditure was allowed to increase. The excessive optimism in planning property sales characterises the City of Pärnu also through 2008-2010. In the three

years observed in the audit, the City of Pärnu constantly spent more than it earned. This led to difficulties in paying off the obligations assumed and was, all in all, the main reason for the city's financial difficulties. The economic crisis reached local authorities in 2009, making the city's financial position even tenser and clearly pointing to the excessive risks taken in previous years.

In 2009 the debt burden of the City of Pärnu clearly exceeded the threshold permitted by law. The City of Pärnu was aware of the problems relating to the implementation of the budget through 2008 to 2009 and reacted to them by clarifying its forecasts, but was late in implementing changes and failed to control the deficit.

The NAO finds that risky decisions have been made in managing the City of Parnu, but this finding is largely based on hindsight. Taken separately, none of the decisions (making investments before obtaining money for it from the sale of property, debt obligations assumed with a relatively high interest rate for renovation of the building of the City Government and for construction of a sports centre, etc.) alone is responsible for the city's difficult financial position. It is the result of different choices and external factors. At present we can claim that some choices have proved more risky and negatively affected the city's financial position.

However, the NAO finds that there is also room for improved in the internal control system of the Pärnu City Government regarding faster identification of the characteristics of financial difficulties and notification thereof. Observance of the financial position has been one-sided and focused on implementing the budget. As a task, it should be identified in greater detail. In the future the difficulties faced by the City of Pärnu should be prevented by the restrictions to be established to the budget deficit of local authorities as of 2012.
The NAO found repeated mistakes and disturbances in the payables and receivables proceedings of the Pärnu City Government. These had been caused by a delay in payment of invoices submitted to the city or impeded the operative collection of invoices issued by the city. The deficiencies were largely related to the following:

■ Payables are not registered in the accounts at the right time and it has resulted in a delay of payments. A third of overdue payables examined in the course of the audit based on the random sample principle had been registered in the accounts of the due date or thereafter. It was explained that the invoices reached the Accounting Department too late.

■ There are deficiencies in collecting overdue receivables. In the event of the audited receivables whose accrual had been delayed for a long time (over 120 days), the NAO did not find that any additional measures such as cooperation with debt collection agencies, bringing action against the debtor, etc., had been taken for the purpose of collecting the debt. It also became evident that the possibility of claiming default interest had not been used in the event of regular debtors, although the city had such right under the contract. Single violations of the rules arising from the internal work procedure of the city were also noticed upon informing debtors of their debt. Upon assuming debt obligations, the City of Pärnu has violated the law in the audited period. The liabilities registered in the accounts in 2009 in connection with the construction of the Pärnu sports centre and the liabilities before the Pärnu Schools Foundation took the level of debt of the City of Pärnu to a level that is not permitted under the Rural Municipality and City Budgets Act. At the end of 2010 the debt burden indicator of the City of Pärnu was 82% instead of the permitted 60%. In the current budget strategy of the City of Pärnu the goal is to reduce the debt burden and thus fit within the limits permitted by law by the end of 2013.

Following the audit, the NAO made four recommendations to the Pärnu City Government to improve the internal control system and to eliminate the deficiencies detected in receivables and payables proceedings. In the reply sent to the audit report the Pärnu City Government agreed to follow the recommendations.

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