Accuracy of Annual Accounts 2017 and regularity of transactions of the state

Report of the National Audit Office to the Riigikogu, Tallinn, 22 August 2018

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Summary of audit results

What did we audit?

The State Budget Act requires the NAO to audit the accuracy of the annual accounts and the regularity of transactions of the state on an annual basis. The annual accounts of the state consolidate the financial statements of all state accounting entities, state-controlled companies, state-established foundations, and the profit-making state agencies.

To provide an opinion on the accuracy of the annual accounts of the state and the legality of its transactions, the NAO examined the compliance of economic transactions conducted by state authorities in 2017 with the State Budget Acts, and determined whether such transactions have been correctly recognised in their accounts.

The NAO examined whether the state's annual accounts provide true information about the state's financial position and performance for the year ended and whether state agencies have adhered to budget acts while performing their economic transactions.

What was the scope of our audit?

The annual accounts of the state contain the financial indicators of public undertakings, foundations controlled by the state and profit-making state agencies. The annual accounts of companies, foundations and the profit-making state agencies were audited by audit firms. The NAO considered the reports of certified auditors when expressing its opinion of the annual accounts of the state.

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. The consolidated annual report of the state is the only financial statement provided to the Riigikogu - 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 2017 State Budget Implementation Report, the state's revenue in 2017 amounted to 9.16 billion euros.[1] The expenditure and investments incurred by the state amounted to 8.84 billion euros[2] and 414.8 million euros, respectively. In 2017, expenditure and investments exceeded revenue by 100.3 million euros (NB! It is not a surplus or deficit of the government sector because agencies financed from the state budget make up only a part of the government sector - for more information see sub-chapter "Government Sector Surplus/Deficit" of chapter "Financial Indicators for Public and Finance Sector" of the management report within the 2017 Consolidated Annual Report of the State).

According to the consolidated annual accounts of the state, the assets of the state as at 31/12/2017 amounted to 17.3 billion euros whereas the majority were fixed assets (forests, roads, buildings and machinery). Compared to the preceding period, the monetary value of assets has increased by 788.7 million euros.

As at 31/12/2017, the state's liabilities totalled 7.9 billion euros - an increase of 484.8 million euros compared to the preceding period. Long-term liabilities of 4.84 billion euros comprise the majority of liabilities. The state's loan commitments amount to 2.9 billion euros and have remained on the same level compared to the preceding period. The pension commitments of the state amount to approximately 2.4 billion euros.

What did we find and conclude as a result of the audit?

The 2017 Annual Accounts of the State provide in all material respects fair presentation of the state's financial position, financial performance and cash flows during the ended accounting period.

The NAO finds that the 2017 Budget Implementation Report of the state which shows budgetary revenue of 9.16 billion euros, expenses of 8.84 billion euros, investments of 414.8 million euros and financing operations of 159.7 million euros provides reliable information on the state's revenue, expenditure, investments and financing operations.

The NAO is of the opinion that the economic transactions of the state have in all material respects been carried out in compliance with the State Budget Act, the 2017 State Budget Act and the 2017 State Budget Act Amendment Act. This means that the NAO did not find any significant errors in the implementation of the State Budget Acts.

[1] As per line „Revenue included in budget position" in the 2017 State Budget Implementation Report.

[2] As per line „Revenue included in budget position" in the 2017 State Budget Implementation Report.

The main observations of the NAO are as follows:

- **As the optimal size of the Stabilisation Reserve Fund is not laid down by law and the Ministry of Finance has not provided its assessment, there is no idea as to the amount to be held in the fund for it to cover the estimated needs.** For instance, such reserve funds have been set up and their required size determined by the Estonian Unemployment Insurance Fund (EUIF), the Estonian Health Insurance Fund (EHIF) and the Bank of Estonia as well as commercial banks. Over the last two years, the Stabilisation Reserve Fund has not been boosted on account of state budget surplus and no alternative solution has been provided to compensate for this.

- **The transition to accrual-based budgeting was quite smooth. However, all non-monetary expenses are not included in the state budget.** Currently, only depreciation costs are included in the budget whereas other expenses like costs related to calculating public sector pension provisions are not. Nevertheless, they are shown in the State Budget Implementation Report which makes actual expenditure to appear considerably higher than planned expenditure.

- **As from 2016, the budget of the Ministry of Finance contains a targeted reserve fund even though the State Budget Act does not provide for one.** The State Budget Act sets out the framework for budgeting that cannot be modified with annual budgets. In the opinion of the NAO, the purpose of creating such reserve fund remains unclear. The amendment to the State Budget Act that will be enforced from 2020 onwards allows making earmarked allocations within the Government of the Republic's reserve fund to finance measures approved by the government but does not authorise the setting up of a specific reserve fund in the budget of the Ministry of Finance.

- **Functioning of information systems essential for financial accounting was found to be free of any shortcomings that could notably affect the quality of financial data based on these systems.**

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:

- devise principles for determining the optimal size of the Stabilisation Reserve Fund by assessing the nature and amount of any emergency expenditure to ensure the availability of sufficient reserves;

- envisage non-monetary expenses of notable amount in the state budget;

- assess the justification of setting up the reserve fund created within the budget of the Ministry of Finance, and if necessary, align the setting up of that reserve with the State Budget Act and ensure its transparent use.

Response of the Minister of Finance and the Minister of Public Administration: the Ministers agreed with most of the recommendations made by the NAO - save for those concerning the management and use of national reserve funds - and undertook to take them into account.

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Opinion on the accuracy of the Annual Accounts 2017 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 2017 was 452,111,215 euros and the consolidated balance sheet total as at 31/12/2017 was 17,252,225,157 euros provide - in all material respects - fair presentation of the state's financial position, financial performance and cash flows during the ended accounting period, in accordance with Estonian financial reporting standards.**

Conclusions of the NAO regarding the audited areas

2. Table 1 provides an overview of policy areas audited by the NAO and the main conclusions regarding the conformity of economic transactions with the State Budget Acts and their recognition in accounts within the audited areas. The monetary value of operations is as shown in the 2017 unconsolidated income statement of the state.

Table 1. Audited policy areas and opinions by the NAO

Audited area	Monetary value in 2017 (in EUR)	Are the transactions correctly recognised in the accounts?	Have transactions been effected in accordance with State Budget Acts?
Collection of revenue, incl. taxes and social security contributions, sale of goods and services, other revenue, financial revenue	8.4 billion	Yes	Yes
Receipt of support, incl. mediation of support	723 million	Yes	Yes
Granting of support, incl. mediation of support	4.4 billion	Yes	Yes
Effecting of **operating expenses** and assumption of commitments, incl. transferable taxes, labour and management costs, other operating expenses, financial expenses	4.6 billion	Yes	Yes
Transactions in state assets, incl. investments	414.8 million*	Yes	Yes
Depositing of public funds (interest revenue from bonds, deposits and loans, other financial revenue)	6.2 million**	Yes	Yes
Exercise of founder's rights in foundations, non-profit associations and the profit-making state agencies; state participation in legal persons governed by private law (purchase and sale of shareholdings and collection of dividends)	164 million**	Yes	Yes

* As featured in the 2017 State Budget Implementation Report. ** As featured in the state's unconsolidated cash flow statement for 2017.

The financial statements of state-controlled foundations and companies and the profit-making state agencies are generally accurate

Opinions of audit firms on the annual reports of state-controlled companies and foundations and the profit-making state agencies

3. The annual accounts of the state contain the financial indicators of state-controlled companies and foundations and the profit-making state agencies Audit firms 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.

4. In most cases, certified auditors have issued unqualified opinions on the annual accounts for 2017 of state-controlled companies and foundations and the profit-making state agencies with qualified opinions issued on the annual accounts of just one company and one foundation.[3] In terms of their substance and scope the qualifications did not carry sufficient weight to affect the NAO's opinion on the 2017 Annual Accounts of the State.

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

Compliance with State Budget Acts

5. According to the State Budget Implementation Report, the state's revenue in 2017 amounted to 9,158,608,228 euros,[4] expenditure to 8,844,043,423 euros,[5] investments to 414,821,482 euros, and financing transactions to 159,704,038 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 2017 State Budget Act and its amendment act.

Management and use of national reserve funds

Criteria for determining the optimal size of the Stabilisation Reserve Fund (SRF) have not been laid down

Stabilisation Reserve Fund

Stabilisation Reserve Fund - a financial buffer of the government for managing potential crisis situations

6. The state has two reserve funds: the Stabilisation Reserve Fund and the Liquidity Reserve managed by the State Treasury Department of the Ministry of Finance.

7. The market value of the SRF was 412.2 million euros as of the end of 2017 (see Table 2) having grown by 1.5% (6.25 million euros) during the year. The growth came from contributions to the SRF whereas its investments had a negative yield due to the situation on the international financial market. Contributions in 2017 were made solely on the account of profit of the Bank of Estonia in the amount of 7.86 million euros whereas no money was allocated to the SRF from the state budget.

Table 2. Market value of reserve funds, incl. of the Liquidity Reserve, from 31/12/2012 to 31/12/2017, broken down by entities (in EUR million)

	31.12.2012	31.12.2013	31.12.2014	31.12.2015	31.12.2016	31.12.2017

[3] Qualified opinions were issued on the annual accounts of AS Nordic Aviation Group (qualification concerning the justification of discounting a loan) and Hiiumaa Museums Foundation (qualification concerning the failure to recognise financial lease payables).
[4] As per line „Revenue included in budget position" in the 2017 State Budget Implementation Report.
[5] As per line „Revenue included in budget position" in the 2017 State Budget Implementation Report.

Stabilisation Reserve Fund	**347.0**	**360.9**	**368.9**	**398.5**	**406.0**	**412.2**
Liquidity Reserve, incl.	**1,106.2**	**1,055.3**	**1,125.0**	**747.9**	**784.9**	**743.2**
▪ state (central government)	306.4	204.6	198.0	-331.6	-355.2	-464.6
▪ total for other entities:	799.7	850.8	927.0	1,079.5	1,140.1	1,206.8
• Estonian Health Insurance Fund	204.3	199.6	176.4	152.9	119.6	121.0
• Estonian Unemployment Insurance Fund	471.7	535.5	613.0	663.2	702.4	777.1
• foundations	112.3	108.9	119.7	238.2	274.9	272.6
• European Commission	11.4	6.6	17.9	25.3	43.2	36.1
Total reserves	**1,453.2**	**1,416.2**	**1,493.9**	**1,146.4**	**1,190.9**	**1,155.4**

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

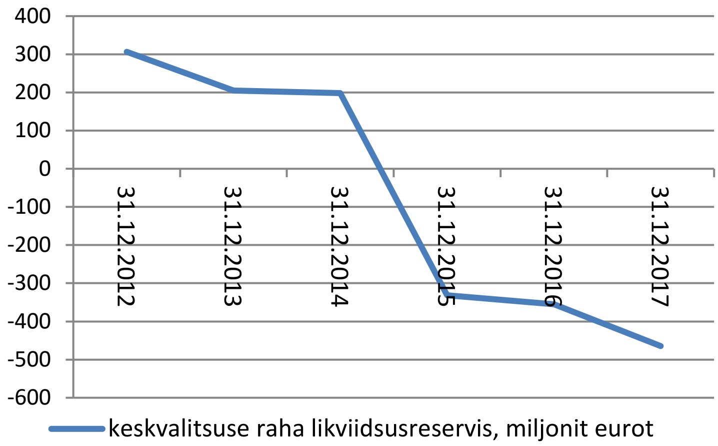
8. The market value of the Liquidity Reserve was 743.2 million (see Table 2) shrinking by 5.3% compared to the preceding year. However, it should be noted that the Liquidity Reserve's market value has fluctuated a lot on monthly basis: ranging from 743 million euros in December to 993 million euros in February. The central government's share in the Liquidity Reserve amounted to -464.6 million euros (see Figure 1); this situation was possible only because the money of other entities included in the reserve (mostly the money of Estonian Unemployment Insurance Fund and Estonian Health Insurance Fund) was sufficient to cover the negative balance generated by the state and maintain the reserve on the required level.

9. Central government's payments have constantly exceeded its receipts over the recent years (see Figure 1). According to explanations provided by the Ministry of Finance during previous audits, the sudden drop in the central government's liquid assets in 2015 was mostly due to the ending of the EU financial period and the resulting extension of time limits for disbursements. Even though the money had already been paid to beneficiaries under bridge financing, it was yet to be collected from the European Commission.

For your information

On **Figure 1**, central government means all the ministries, including their government areas, and the Government Office and constitutional institutions.

Figure 1. Amount of the central government's liquid assets in the Liquidity Reserve between 31.12.2012 and 31.12.2017 (in EUR million)



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

10. In the 2016 audit report, the NAO suggested that the Minister of Finance should devise principles for determining the optimal size of the Stabilisation Reserve Fund and regulate the calculation methods, assess the nature and amount of any emergency expenditure, and ensure the availability of sufficient reserves. At the moment, there is no agreement or legislation defining the payments or the period to be covered by the SRF in a crisis situation. The requirement to maintain a balanced state budget was abolished in 2017 which has increased the risk that the government has limited possibilities of boosting the SRF on the account state budget surplus. No alternative solution for augmenting the SRF has not been provided for.

11. Further, the NAO suggested that the reserves of the Health Insurance Fund (EHIF) and the Unemployment Insurance Fund (EUIF) should be managed according to the same principles as the SRF because they all serve a similar purpose: to ensure availability of funds for mitigating or avoiding emergency situations or crises.

12. The Ministry of Finance replied that there is no need to develop regulations requested by the NAO. Deposit agreements and the legislation ensure that the EHIF and EUIF have access to money necessary for their payments, and there is no need to determine the optimal size of the SRF because the SRF is never the only facility available in a crisis situation.

13. Having analysed the views expressed by the Ministry of Finance, the NAO continues to uphold its recommendations: the criteria for determining the optimal size of the SRF should be laid down as without them the SRF's optimal size cannot be calculated or the availability of sufficient reserves ensured.

Neither the Estonian Health Insurance Fund Act nor the Unemployment Insurance Act provide for a basis for using the money of EHIF/EUIF

14. In two previous years, the NAO has pointed out that using the reserves of the EHIF/EUIF for managing liquidity problems is not in conformity with the Estonian Health Insurance Fund Act or the Unemployment Insurance Act. The said Acts provide that the EHIF/EUIF are public law entities which 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 EHIF and the EUIF shall, according to a deposit agreement entered into with the state, hold their money (funds for daily operations plus funds placed in the reserves) on a current account within the group accounts of the state, and make payments using that account.

15. In its 2016 audit report, the NAO maintained that the right of the Ministry of Finance to use the money of EHIF/EUIF for purposes other than their own payments, whether on temporary or more permanent basis, has not been expressly set out in the Estonian Health Insurance Fund Act or the Unemployment Insurance Act. Such actions require an unambiguous decision from the Riigikogu in the form of legislative provisions to avoid legal disputes and interpretations and ensure legal clarity. It is response, the Ministry of Finance argued that the existing legal framework is sufficient and does not need to be modified.

16. In 2017, the NAO asked the Chancellor of Justice to provide an opinion on using the money of EHIF/EUIF towards routine expenses of the state. In an opinion delivered on 18 August 2017, the Chancellor of Justice claimed that even though doing so might be reasonable in economic terms (savings from loan and interest costs) and in line with the State Budget Act, the latter is, nevertheless in conflict with the Estonian Health Insurance Fund Act and the Unemployment Insurance Act. The said Acts allow the Ministry of Finance only to hold the money of EHIF/EUIF but not use it towards routine expenses.

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

- devise principles for determining the optimal size of the Stabilisation Reserve Fund and regulate the calculation methods, assess the nature and amount of any emergency expenditure, and ensure the availability of sufficient reserves;
- manage the legal reserves of the Health Insurance Fund and the Unemployment Insurance Fund in line with the same principles as the Stabilisation Reserve Fund.

Response from the Ministers: The Ministry of Finance (MF) finds that the applicable practice for increasing the Stabilisation Reserve Fund (SRF) is adequate and there is no need to set an additional ceiling for the size of the SRF. The SRF grows mostly on the account of cash flow surplus, profit allocations from the Bank of Estonia, and other irregular revenue. Boosting the reserve on the account of current revenue would mean using the cash flow surplus to withdraw additional funds from the economy which would excessively compromise economic growth. The SRF is an important tool for managing crises and emergencies and its symbolic value is to show that the state is ready for crises. However, in crisis situations, the MF cannot rely solely on the SRF because, firstly, it is extremely difficult to estimate the likelihood of various crises (natural disaster, economic crisis, financial crisis, war) and the level of ensuing expenditure. Secondly, in addition to deploying the SRF, the state can take a loan, cut costs or postpone investments in order to manage the crisis. Nevertheless, prevention of crises and more effective risk management are paramount. The SRF will be deployed only in emergencies. The MF aims to ensure that the state's risks are managed in a way that allows the state to finance its commitments in crisis situations without having to resort to the SRF or so that its deployment is postponed for as long as possible. For example, in a crisis, the state can address international crisis management funds (ESM, IMF) or other countries to borrow money. The SRF was last deployed in 2009 when 224 million euros were withdrawn to mitigate macroeconomic risks resulting from the global economic crisis. Also, two negative supplementary budgets were drawn up in 2009 to cut state budget expenditure by 584 million euros. Back then, IMF's assistance was not needed and the ESM did not exist yet. This demonstrates that deployment of reserves is not the only or primary tool for crisis management.

The MF points out that the Riigikogu assembled all the funds of the EHIF and the EUIF to be centrally managed by the Ministry of Finance in view of the following policies: 1. Improve the management of cash flows and debt commitments in the public sector because:
a) harmonised cash flow management and higher liquidity ensures more efficient use of the state's available financial resources;
b) harmonised conservative investment policies yield cost savings for EHIF/EUIF, and the entire state budget. 2. The MF ensures liquidity of the funds of EHIF/EUIF and any investment losses will not be attributed to them. Further, the EHIF/EUIF need no longer pay for costs related to bank transfers and investment operations. At the time of deciding this, the Riigikogu argued that the positive effect of harmonised cash flow management on the state budget and the EHIF/EUIF outweighs the assumption of increased financial risk ensuing from the presumably longer period of using the reserves of EHIF/EUIF. Investing part of the legal reserves of EHIF/EUIF according to the same principles as the SRF money has been under consideration for several times but it has not been found that it would be reasonable given the objectives set out in legislative amendments made in 2011.

Comment from the NAO: The NAO agrees that there is no immediate need to set a ceiling for the size of reserves but reiterates that it is necessary to develop calculation methods for assessing the whether the reserves are optimal in view of the following periods.

Likewise, the NAO continues to maintain that the legal reserves of the Health Insurance Fund and the Unemployment Insurance Fund should be managed in line with the same principles as the Stabilisation Reserve Fund. Similarly to the Stabilisation Reserve Fund, the Health Insurance Fund and the Unemployment Insurance Fund have a statutory obligation to maintain their legal reserves to manage any risks arising from macroeconomic changes.

Observations on transition to accrual-based budgeting and on drafting and using the state budget

The transition to accrual-based budgeting was relatively smooth

Transition to accrual-based budgeting

18. The state budget used to be cash-based but the 2017 budget was the first accrual-based one. This aligned budgeting with the fundamentals used for accounting. The objective was to make data on the state budget and its implementation comparable with accounting data to provide a better overview of the use of money. Another goal was to enhance the reliability of using state budget funds because the Ministry of Finance believes that accrual-based budgets reflect the economic aspects of decisions more accurately and take into account the overall impact, incl. non-monetary impact, of transactions.

19. The transition to accrual-based budgeting was relatively smooth. Carrying expenses over from 2016 to 2017 created most of the difficulties as it required converting cash-based budget balances into accrual-based ones. The original deadlines were not met and many changes had to be made - the Minister of Finance issued a total of four directives for the purposes of this carry-over.

20. The NAO finds that it is too early to evaluate the attainment of goals set. However, there are some differences between accounting and the state budget, for instance, all operating expenses and investments planned in the budget include value-added tax (VAT) whereas in accounting the VAT is recognised separately, i.e. some expense items in accounting and budget implementation are not comparable. Also, all non-monetary expenses are not included in the state budget with only depreciation costs currently included therein whereas other expenses like costs related to calculating public sector pension provisions are not. This means that on ministerial level certain expenses appear to be notably higher in the implementation phase as compared to the planning phase even though the real reason is that the corresponding expenses were originally not planned in the budget.

21. The NAO finds that in the interests of comparability the budget should include all expenses, incl. non-monetary expenses, to ensure that reports are transparent and comparable.

Differences between the state budget and accounting in terms of recognising environmental charges and government levies have disappeared

22. The NAO has noted over the previous years that environmental charges collected by the Ministry of the Environment and government levies for court procedures and registry services collected by the Ministry of Justice were recognised in the accounts but the state budget implementation reports recognised them as revenue of the Ministry of Finance instead. In conjunction with the transition to accrual-based budgeting, such revenue is recognised in the accounts and in state budget implementation reports from 2017 onwards under the relevant ministries. Hence, the 2017 report no longer features this irregularity.

23. **NAO recommendation to the Minister of Finance and the Minister of Public Administration:** envisage non-monetary expenses of notable amount in the state budget.

Response from the Ministers: The MF will review the current approach to planning non-monetary expenses and revenue in the budget. We will propose a solution specifying the basis, criteria and list for including in the budget such non-monetary revenue and expenses that do not affect the financial position of the government sector. In devising this solution, we will consult the NAO. The solution will be applicable to State Budget Strategy 2020-2023.

The State Budget Act lacks a basis for establishing a targeted reserve fund in the budget of the Ministry of Finance

24. As from the end of 2016 when the 2016 State Budget Act was amended, the budget of the Ministry of Finance features a targeted reserve fund not provided for by the general State Budget Act. This reserve amounted to 73.6 million euros in 2017 whereof 30.1 million euros were deployed. Funds were allocated from the reserve on the basis of a paragraph in the 2017 State Budget Act: the Minister of Finance allocated funds for activities which were proposed by the relevant Ministry and previously approved by the Government of the Republic.

25. According to the State Budget Act, the use of state budget funds must be economical, efficient and effective as well as legitimate and transparent, and the budget breakdown must show expenses necessary for the operations of specific government areas.

26. The NAO finds that the setting up of the targeted reserve fund is not in conformity with the State Budget Act because:

- The targeted reserve fund has been set up within the budget of the Ministry of Finance without legal basis provided for by the State Budget Act that governs the principles of drafting the state budget. According to the State Budget Act, the draft annual state budget act must be in line with existing legislation or legislative drafts previously submitted to the Riigikogu by the Government of the Republic. The State Budget Act sets out the framework for budgeting that cannot be modified with annual budgets.

  However, the 2017 State Budget Act establishes a targeted reserve fund. The general State Budget Act does not refer to any reserve funds other than the reserves of the Government of the Republic (with the exception of SRF) that may be used for unforeseen expenses, investments and financing transactions which cannot be planned during the processing phase of the draft state budget.

  The amendment to the State Budget Act that will be enforced from 2020 onwards allows making earmarked allocations within the reserves of the Government of the Republic to finance measures it has approved but does not authorise the setting up of a specific reserve fund within the budget of the Ministry of Finance.

- The purpose of this targeted reserve remains unclear - why should there be a reserve fund that duplicates the reserves of the Government of the Republic. If the use of money can be foreseen during the budgetary year, even if the exact amount needed is not known, such money should be planned in the budget of the respective government area. Extra amounts can be added by way of state budget amendments

For your information

The amendment to the State Budget Act adopted in June 2017 (effective from 1 January 2020) provides that funds in the reserves of the Government of the Republic may be earmarked for implementing activities it has approved, and that it may authorise the relevant minister (Minister of Finance) to determine the allocation of such earmarked funds. This legislative amendment only stipulates that funds will be earmarked within the reserves of the Government of the Republic and it does not authorise the setting up of a separate reserve fund within the budget of the Ministry of Finance.

or allocated from the reserves of the Government of the Republic in emergency situations as necessary.

The explanatory memorandum to the state budget indicates that the purpose of the reserve fund was known at least in part at the time of drafting the state budget. For instance, money for the following was planned in the targeted reserve: construction of the Eastern border and of the building of the IT agency by the Ministry of the Interior, repayment of aid amounts to the European Commission by the Ministry of Finance, and transition to accrual-based budgeting in various ministries. According to notes to the State Budget Implementation Report, these projects were indeed funded from the targeted reserve. This has led to a situation where some operating expenses of other government areas are planned in the budget of the Ministry of Finance which conflicts the principles of the State Budget Act in that the budget breakdown must show expenses necessary for the activities of specific government areas.

- Allocating money from the targeted reserve fund increases bureaucracy - it requires prior approval by the Government of the Republic, a request from the relevant Ministry to the Minister of Finance, and a decision by the latter. If expenses have been planned in the state budget, then effecting such expenses only requires a relevant decision by the Riigikogu.

27. **NAO recommendation to the Minister of Finance and the Minister of Public Administration:** assess the justification of setting up the reserve fund created within the budget of the Ministry of Finance, and if necessary, align the setting up of that reserve with the State Budget Act and ensure its transparent use.

Response from the Ministers: the idea behind setting up the targeted reserve fund was to avoid additional decision-making procedures within the government for substantive decisions where the precise timetable, budget distribution across the years, and other similar details are not known at the time of making the decision. We find that planning such funds in the government area’s budget is not reasonable because the targeted reserve allows redirecting the funds as necessary by means of a decision by the government (when the detailed timetable, amounts, etc. become clear). Otherwise, the funds would remain in the government area’s budget where, in extreme cases, they can be redirected only at year-end by means of a legislative amendment. We are of the opinion that this solution ensures optimal and flexible use of state budget funds. The MF will assess the conformity of setting up the targeted reserve fund with the State Budget Act and make adjustments as necessary. The MF will assess the possibilities of describing the funds included in the targeted reserve more clearly in the explanatory memorandum to the state budget. Directives of the Minister of Finance on allocating funds from the targeted reserve are available to the public. Directives that were marked for internal use by error have been made public.

The explanatory memorandum to the state budget is more informative now

Errors attributable to carelessness in drafting the state budget

28. Compared to the preceding year (2016), there were less errors attributable to carelessness in drafting the state budget in 2017. Only a few insignificant errors were identified.

Quality of the explanatory memorandum to the state budget

29. In the course of its 2016 audit, the NAO examined the content of the explanatory memorandum to the 2016 State Budget Act. It looked into the clarity and comprehensibility of explanations (whether the components parts and intended purposes of sums are clear), their completeness and transparency (all relevant lines are explained, there are no significant differences between the budget and the explanatory memorandum, and material changes compared to the preceding year are outlined), and rationality (there are no thorough explanations on irrelevant amounts).

30. The NAO learned that the 2016 explanatory memorandum was of uneven quality, failed to explain some significant amounts and certain major changes in the budget, provided some information that conflicted the budget or other parts of the memorandum itself, and contained thorough explanations for some very small expense items. During its follow-up audit the NAO assessed the explanatory memorandum to the 2018 State Budget Act.

31. When reviewing the memorandum, the NAO found that its quality has notably improved: there were only a few unexplained budget items, and in most cases, major changes compared to the preceding budget were explained and justified. Some calculation errors and differences between the memorandum and the budget attributable to carelessness were identified. The most notable one was the financing transaction of 215 million euros by the Ministry of Finance as outlined in the memorandum - a contribution to increase the share capital of AS Eesti Energia - that should have been 10 times smaller, i.e. 20 million euros. The error was corrected in the explanatory memorandum's version published in January 2018 on the web site of the Ministry of Finance but the version submitted to the Riigikogu in autumn 2017 contained this error.

32. The NAO welcomes the notably improved quality of explanations in the memorandum. However, avoidance of errors of calculation and those due to carelessness should be further addressed because the explanatory memorandum outlines the substance of activities financed from the state budget and it is the main tool used by the Riigikogu to make budget decisions. Hence, it is essential that any information in the memorandum should be clear, reliable, complete and unambiguous.

Funding of core functions of the Ministry of the Environment's government area is about to get a legal solution

Funding of core functions of the Ministry of the Environment's government area

33. Over the course of several years, the NAO has pointed out that core functions of the Ministry of the Environment and its agencies have not been fully financed from the state budget - some of the funding has come from 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. The NAO argued that this reduced budgetary transparency as well as the potential success rate of other applicants participating in calls for proposals, and increased the EIC's administrative burden.

34. In spring 2018, a legislative draft for amending the Environmental Charges Act was filed with the Riigikogu to establish a legal basis for changes in the funding of the Ministry of the Environment's core functions. According to the Ministry of Finance, the process of drafting the 2019 State Budget Act already takes into account that all core functions of the Ministry of the Environment and its agencies should be funded from the state budget.

Usability – data can be accessed and used in a timely and convenient manner.

Confidentiality – data are protected from unauthorised processing.

Integrity – data are authentic, rely on the original source, and have not been subject to unauthorised modification.

Operation and reliability of information systems that support financial reporting

Information systems essential for financial reporting

35. State authorities use several information systems which handle data that are essential for the agency's core functions as well as for financial reporting. The NAO selected 20 of these information systems for auditing (see Table 3) to assess their reliability in terms of financial reporting. Typically, systems are deemed reliable if usability, confidentiality and integrity of data handled in the systems are ensured according to standards. Sufficient security measures need to be put in place to achieve this. According to the Regulation on System of Security Measures for Information Systems of Government of the Republic, implementing the security measures system includes the following: determining security classes in line with data security objectives and selecting appropriate security measures based on implementing guidelines of the three-level reference security system for information systems (ISKE), and implementing and auditing measures.

Table 3. Information system covered by the audit

Ministry*	Name of information system	Accounting data that rely on the system
MJ	Land register	Revenues
MJ	Court information system	Revenues
ME	Environmental permits information system (KLIS)	Revenues
MRA	PRIAX, ARMA (accounting system for decisions and payments), aid, MARSA 2	Aid
MEAC	Traffic register	Revenues
MEAC	Electronic maritime information system	Revenues
MF	Register of Taxable Persons (MKR)	Revenues
MF	SAP (accounting software)	Central reporting system (for financial, personnel and salary accounting)
MF	RTIP (self-service portal for government employees)	Assets, management costs, labour costs
MF	SFOS (Register of Structural Aid)	Aid
MF	e-Treasury	Cash at bank and in hand

MF	Balance Records Information System	Central reporting system
MF	Fitek information system for processing purchase invoices	Assets, management costs
MI	MIS - Information System on Proceedings	Revenues
MI	UUSIS - program for processing document applications	Revenues
MI	OZZ - cash register program for offices handling applications for identity documents	Revenues
MSA	Social Protection Information System	Benefits and allowances

* MJ - Ministry of Justice; ME - Ministry of the Environment; MRA - Ministry of Rural Affairs; MEAC - Ministry of Economic Affairs and Communications; MF - Ministry of Finance; MI - Ministry of the Interior; MC - Ministry of Culture; MSA - Ministry of Social Affairs

For your information

The NAO describes the situation observed during the audit in a more general manner than usual because Public Information Act sets out restrictions on disclosing information on security measures, security systems, technological solutions and their weaknesses, even on title/heading level. Making such information public could significantly compromise the interests of

36. The NAO analysed the reliability of information systems in terms of financial accounting across eight areas: ISKE audit of information system, availability and relevance of data security policy, management of access rights, system logging and monitoring, backups, agency's physical security, management of information system modifications, auditing of applications.

37. Details of shortcomings identified whilst auditing IT systems and the NAO recommendations for eliminating such shortcomings have been communicated - by means of a memorandum - to the relevant minister whose government area was the target of audit observations.

ISKE audits were omitted in multiple instances

ISKE audits and data security policy

38. The mandatory ISKE Regulation[6] adopted by the government which provides for regular ISKE audits helps ensure data security. For six audited information systems, no ISKE audits had not been commissioned at all or audits were conducted less frequently than required. Omitting ISKE audits poses a supplementary risk for the information system as well as for the security and preservation of data assets.

39. As regards data security policy, the auditors examined whether and how database operators guide and support data security efforts and whether legislation, rules and other requirements governing the domain are observed. Further, the auditors determined whether a framework structure was put in place for managing data security to initiate and manage the introduction and implementation of data security measures within the organisation. Auditors learned that policies and procedures governing data security were operational and appropriate in most cases. Shortcomings were identified in three ministry's government areas with one lacking a backup policy, another lacking rules for introducing their data security policy to their staff and suppliers, and yet another relying on a generally obsolete data security policy.

[6] Government of the Republic Regulation No 252 of 20 December 2007 on System of Security Measures for Information Systems.

There are multiple problems related to managing access to information systems

Management of access rights

40. One of the essential features of database security is that only authorised users can access systems and applications. The NAO analysed access rights policies put in place to ensure the security of information systems, incl. setting up, modification, suspension and deletion of user accounts, regular review of access needs, and compliance with the relevant rules.

41. A rather frequent problem is that access rights are not inventoried regularly or with due care, or that internal rules of procedure do not provide for such activities at all. For eight information systems, the corresponding procedure was not in place, and for two systems the applicable procedure was neglected. Also, there were cases where individuals whose duties had changed or who had left employment but still remained users of the information system even though they no longer needed access to the system. The NAO underlines that regular inventories of user rights are strictly necessary to ensure security.

42. As regards access rights, two information systems featured shortcomings in the structure of user roles meaning that some users enjoyed overly extensive access rights which were neither proportionate with their duties nor justified. This poses an extra risk of system abuse which could lead to a data leak or (un)intentional tampering, for example. In these information systems, the scope of rights assigned to user roles should be reviewed and where possible new appropriate roles should be created to better meet the needs arising from occupational duties.

Not all agencies have assessed the need for analysing activity logs

Logging and monitoring

43. The availability and appropriateness of activity logs is necessary to records events in the system (incl. security incidents) and collect sufficient evidence. The NAO examined whether the logs exist and whether they record user activity, extraordinary situations, errors and security events. It also examined whether the logs are preserved, protected from unauthorised access, and analysed.

44. The majority of state authorities do have an operational logging system. However, logs are usually analysed retrospectively on a case-by-case basis. Failure to conduct proactive and need-based analysis of logs increases the risk that any anomalies or potential attacks will not be detected in good time. The NAO deems it essential to determine whether databases contain sensitive information, and if they do, logs should be subjected to regular analysis.

System recovery tests are usually not documented

Backups

45. As for making backups, the auditors firstly examined whether database operators make regular backup copies of their data and systems, and regularly test the recovery of systems and services by means of such backup copies.

46. The majority of state authorities did have a backup policy for regularly backing up data and systems. However, in a few cases the conducting of recovery tests and making of backups was not systematic and lacked uniform criteria. Failure to put in place documented rules for backup and recovery increases the risk that data are not backed up and system recovery is not tested as frequently as it should be.

47. Two ministries admitted that the recovery plans of their information systems are not tested as frequently as required by their internal rules. Further, the auditors learned that most ministries do not document the test results meaning that they were unable to provide the NAO with proof about conducting the tests or their results. Irregular testing of recovery procedures or failure to conduct such tests increases the risk that when actual recovery procedures are implemented the system cannot be recovered during the prescribed time limit or it cannot be recovered at all, and that potential shortcomings in current recovery plans cannot be identified. As recovery tests are not recorded, the successfulness of recovery attempts, any shortcomings identified or the potential need to revise recovery plans are not known.

No major problems were identified in physical security or the management of system modifications

Physical security

48. As regards physical security, the NAO examined whether the data and data processing tools are protected from environmental risks and physical access that could compromise them or cause disturbances. The auditors learned that, in general, the server rooms of audited information systems protect the data and data processing tools from environmental risks and unauthorised physical access.

Management of information system modifications and developments

49. To prevent tampering with systems and applications it is essential that the procedure for making modifications is sufficiently regulated and that the rules are respected. All agencies/ministries save for two have a procedure in place for managing modifications. And usually the adopted procedures were respected.

The integrity of financial data is ensured in general

Auditing of applications

50. The purpose of auditing applications was to identify information system processes for creating, recognising, processing and reporting financial data/transactions, and examine whether the automated processes of information systems are operational and ensure the integrity and accuracy of financial data. In general, the automated processes of audited information systems were operational.

51. All in all, the NAO did not identify any shortcomings in the operation of information systems that could significantly affect the quality of financial data based on these systems.

/signed digitally/

Janar Holm
Auditor General

NAO recommendations and replies from the Ministers

On the basis of the audit, the NAO made several recommendations to the Ministry of Finance. The Minister of Finance and the Minister of Public Administration responded to NAO recommendations on 14 August 2018.

Comments from the Ministers on the audit report
We would like to thank the NAO for their work and constructive cooperation. The audit report highlights areas in managing public finances that need improvement and we will take these into account in our future development efforts.

NAO recommendations	Replies from the Ministers
Management of reserves 17. Recommendations to the Minister of Finance and the Minister of Public Administration: ▪ devise principles for determining the optimal size of the Stabilisation Reserve Fund and regulate the calculation methods, assess the nature and amount of any emergency expenditure, and ensure the availability of sufficient reserves; ▪ manage the legal reserves of the Health Insurance Fund and the Unemployment Insurance Fund in line with the same principles as the Stabilisation Reserve Fund. **(paragraphs 6 to 16)**	**Response from the Ministers:** The Ministry of Finance (MF) finds that the applicable practice for increasing the Stabilisation Reserve Fund (SRF) is adequate and there is no need to set an additional ceiling for the size of the SRF. The SRF grows mostly on the account of cash flow surplus, profit allocations from the Bank of Estonia, and other irregular revenue. Boosting the reserve on the account of current revenue would mean using the cash flow surplus to withdraw additional funds from the economy which would excessively compromise economic growth. The SRF is an important tool for managing crises and emergencies and its symbolic value is to show that the state is ready for crises. However, in crisis situations, the MF cannot rely solely on the SRF because, firstly, it is extremely difficult to estimate the likelihood of various crises (natural disaster, economic crisis, financial crisis, war) and the level of ensuing expenditure. Secondly, in addition to deploying the SRF, the state can take a loan, cut costs or postpone investments in order to manage the crisis. Nevertheless, prevention of crises and more effective risk management are paramount. The SRF will be deployed only in emergencies. The MF aims to ensure that the state's risks are managed in a way that allows the state to finance its commitments in crisis situations without having to resort to the SRF or so that its deployment is postponed for as long as possible. For example, in a crisis, the state can address international crisis management funds (ESM, IMF) or other countries to borrow money. The SRF was last deployed in 2009 when 224 million euros were withdrawn to mitigate macroeconomic risks resulting from the global economic crisis. Also, two negative supplementary budgets were drawn up in 2009 to cut state budget expenditure by 584 million euros. Back then, IMF's assistance was not needed and the ESM did not exist yet. This demonstrates that deployment of reserves is not the only or primary tool for crisis management. The MF points out that the Riigikogu assembled all the funds of the EHIF and the EUIF to be centrally managed by the Ministry of Finance in view of the following policies: 1. Improve the management of cash flows and debt commitments in the public sector because: a) harmonised cash flow management and higher liquidity ensures more efficient use of the state's available financial resources; b) harmonised conservative investment policies yield cost savings for EHIF/EUIF, and the entire state budget. 2. The MF ensures liquidity of the funds of EHIF/EUIF and any investment losses will not be attributed to them. Further, the EHIF/EUIF need no longer pay for costs related to bank transfers and investment operations. At the time of deciding this, the Riigikogu argued that the positive effect of harmonised cash flow management on the state budget and the EHIF/EUIF outweighs the assumption of increased financial risk ensuing from the presumably longer period of using the reserves of EHIF/EUIF. Investing part of the legal reserves of EHIF/EUIF according to the same principles as the SRF money has been under consideration for several times but it has not been found that it would be reasonable given the objectives set out in legislative amendments made in 2011. **Comment from the NAO:** The NAO agrees that there is no immediate need to set a ceiling for the size of reserves but reiterates that it is necessary to develop calculation methods for assessing the whether the reserves are optimal in view of the following periods. Likewise, the NAO continues to maintain that the legal reserves of the Health Insurance Fund and the Unemployment Insurance Fund should be managed

NAO recommendations	Replies from the Ministers
	in line with the same principles as the Stabilisation Reserve Fund. Similarly to the Stabilisation Reserve Fund, the Health Insurance Fund and the Unemployment Insurance Fund have a statutory obligation to maintain their legal reserves to manage any risks arising from macroeconomic changes.
Planning of non-monetary expenses in the state budget 23. Recommendation to the Minister of Finance and the Minister of Public Administration: envisage non-monetary expenses of notable amount in the state budget. **(paragraphs 20 to 21)**	**Response from the Ministers:** The MF will review the current approach to planning non-monetary expenses and revenue in the budget. We will propose a solution specifying the basis, criteria and list for including in the budget such non-monetary revenue and expenses that do not affect the financial position of the government sector. In devising this solution, we will consult the NAO. The solution will be applicable to State Budget Strategy 2020-2023.
Justification of setting up an *targeted* reserve fund 27. Recommendation to the Minister of Finance and the Minister of Public Administration: assess the justification of setting up the reserve fund created within the budget of the Ministry of Finance, and where necessary, align the setting up of that reserve with the State Budget Act and ensure its transparent use. **(paragraphs 24 to 26)**	**Response from the Ministers:** the idea behind setting up the targeted reserve fund was to avoid additional decision-making procedures within the government for substantive decisions where the precise timetable, budget distribution across the years, and other similar details are not known at the time of making the decision. We find that planning such funds in the government area's budget is not reasonable because the targeted reserve allows redirecting the funds as necessary by means of a decision by the government (when the detailed timetable, amounts, etc. become clear). Otherwise, the funds would remain in the government area's budget where, in extreme cases, they can be redirected only at year-end by means of a legislative amendment. We are of the opinion that this solution ensures optimal and flexible use of state budget funds. The MF will assess the conformity of setting up the targeted reserve fund with the State Budget Act and make adjustments as necessary. The MF will assess the possibilities of describing the funds included in the targeted reserve more clearly in the explanatory memorandum to the state budget. Directives of the Minister of Finance on allocating funds from the targeted reserve are available to the public. Directives that were marked for internal use by error have been made public.

Overview of the Consolidated Annual Report

The Consolidated Annual Report of the State has been prepared pursuant to the State Budget Act and Estonian financial reporting standards. 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 financial data of 17 state accounting entities, incl. agencies in their areas of government, the State Forest Management Centre, 67 state-controlled foundations and 30 state-controlled 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

Audit objective

The State Budget Act requires the NAO to audit the annual accounts of the state. Likewise, the NAO is required to audit the regularity of transactions conducted by the state.

The objective of the audit is to provide an opinion on the annual accounts 2017 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 2017, the consolidated and unconsolidated income statement, report on changes in net assets and cash flow statement for the financial year ended on 31 December 2017, 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 Estonian financial reporting standards, 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 2017 State Budget Act and the 2017 State Budget Act Amendment Act.

Audit scope

In order to provide an opinion on the accuracy of the state's annual accounts, the NAO assessed the conformity of the annual accounts with Estonian financial reporting standards. The main requirements of these principles are set out in the Estonian Accounting Act, which is supplemented by the guidelines of the Accounting Standards Board and the Public Sector Financial Accounting and Reporting Guidelines.

Estonian financial reporting standards are based on internationally recognised accounting policies (EU directives on accountancy, International Public Sector Accounting Standards).

Auditing of compliance with State Budget Acts is divided into two segments: auditing the regularity of transactions and auditing the budget implementation report). In order to express an opinion on the regularity of transactions, the NAO audited whether or not the transactions were performed in accordance with the State Budget Act, the 2017 State Budget Act and the 2016 State Budget Act Amendment Act in all material respects. To this end, the NAO examined whether: state budget revenues had been collected; expenses, investments and financing operations were effected expediently; and the budget adopted with the annual state budget act and budget amendments have been respected.

Further, the NAO examined whether state agencies assumed commitments only when funds were allocated to them for this end in the state budget and whether all revenues, expenses, investments and financing operations have been broken down in a manner that clearly determines their financial nature or purpose. In the context of auditing the budget implementation report, the NAO examined whether the report was drawn up in accordance with the budget breakdown and whether any adjustments were justified.

Limitation of scope

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 reasonable assurance that the financial statements are free of any material misstatements and that transactions, insofar as audited, comply with the State Budget Act, the 2017 State Budget Act and the 2016 State Budget Act Amendment Act in all material respects.

During the audit, evidence was collected on the numerical values and information disclosed in financial statements and on the regularity of transactions. To facilitate the planning of appropriate audit operations, the NAO took into account the internal control system put in place for drawing up financial statements and ensuring the regularity of transactions. The NAO does not issue an opinion on the effectiveness of internal controls on the whole. Also, the auditors examined whether the applied accounting policies were relevant and any accounting estimates by the management were justified.

The NAO is of the opinion that the audit provides a sufficient basis for expressing an opinion on the accuracy of the annual accounts, the reliability of the state budget implementation report and the regularity of transactions.

Time of completing the audit

The audit was completed in July 2018.

Audit team

The audit involved auditors from the Audit Department, and it was managed by Sale Ajalik, Senior Auditor of the Audit Department in the capacity of Project Manager.

Contact particulars

For further information on the audit, please contact the NAO Communication Unit by phone: +372 640 0704 or +372 640 0777, or e-mail: riigikontroll@riigikontroll.ee.

The electronic version of the audit report (pdf) is available on web site 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 2-1.8/60156/36.

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

28 July 2017 - Accuracy of Annual Accounts 2016 and regularity of transactions of the state

29 August 2016 - Accuracy of Annual Accounts 2015 and regularity of transactions of the state

19 August 2015 – **Accuracy of consolidated annual report 2014 and regularity of transactions of the state**

12 August 2014 – Accuracy of consolidated annual report 2013 and regularity of transactions of the state

15 August 2013 – Accuracy of consolidated annual report 2012 and regularity of transactions of the state

27 August 2012 – Accuracy of consolidated annual report 2011 and regularity of transactions of the state

All reports are available on the NAO web site **www.riigikontroll.ee**