

AUDIT REPORT

Riga

30 November 2009

No.5.1-2-4/2009

Efficiency of the Resources Utilisation of the Funds Financed from the State Budget under the Ministry of Agriculture and the Environment and Efficiency of the State Credit Guarantees Issued to Enterprises, as well as Compliance Thereof with the Requirements of Regulatory Enactments

Legal Justification of the Audit

1. Legality audit "Efficiency of the Resources Utilisation of the Funds Financed from the State Budget under the Ministry of Agriculture and the Environment and Efficiency of the State Credit Guarantees Issued to Enterprises, as well as Compliance Thereof with the Requirements of Regulatory Enactments" was conducted according to the Section 2 of the Law on the State Audit Office and the audit assignment of the Fourth Audit Department No. 5.1-2-4/2009 of 28 April 2009 and amendments to the audit assignment of 31 July 2009
2. The audit was conducted by Senior State Auditor A.Jakovļevs, State Auditor I.Rancāne, State Auditor J.Salienieks, and Assistant to State Auditor L.Beldava.

Audit Objective

3. The objective of the audit is to obtain assurance on:
 - 3.1. Efficiency of resources utilisation of Latvian Environmental Protection Fund, the Forest Development Fund, the Fish Fund, the Hunting Management Development Fund and compliance thereof with requirements of the regulatory enactments;
 - 3.2. Efficiency and compliance with requirements of the regulatory enactments of the State credit guarantees issued by the State Joint Stock Company "Rural Development Fund" (Unified registration No. 40003227583) and LLC "Latvian Guarantee Agency" (Unified registration No. 40003375584);
 - 3.3. Influence of activity of Latvian Environmental Protection Fund, the Forest Development Fund, the Fish Fund, the Hunting Management Development Fund on traceability and transparency of the State budget planning and utilisation supervision, as well as efficiency of parallel activity of several funds.

Accountability of the State Audit Office Auditors

4. Auditors of the State Audit Office are responsible for the audit report, which is based on the audit evidence obtained during the audit.

Accountability of the State Chancellery

5. Taking into consideration functions of the State Chancellery specified in the regulatory enactment¹:
 - 5.1. To coordinate planning and implementation of the national policy development, and in cooperation with the ministries to present proposals to the Cabinet on priorities for national development;
 - 5.2. In cooperation with the ministries and other State administration institutions to ensure political analysis and strategic planning of sectors, and to present proposals to the Cabinet for national medium term and long term development;
 - 5.3. Upon assignment of the Cabinet to perform functional audits, to inspect and assess effectiveness and efficiency of activity of direct administration institutions,

¹ Sub-paragraphs 3.1, 4.1 and 4.17 of the Cabinet Regulation No.263 of 20 May 2003 "By-law of the State Chancellery".

the State Chancellery is responsible for assessment of recommendations rendered by the State Audit Office in the audit report and for performing activities harmonised with the State Audit Office in accordance with recommendations implementation timetable, considering decisions of the Cabinet.

Scope of the Audit

6. The audit is conducted in accordance with international auditing standards recognised in the Republic of Latvia.
7. The audit was planned and performed to obtain reasonable assurance on:
 - 7.1. Efficiency of utilisation of resources allocated within budget programme of the Ministry of the Environment 21.00.00 “Environmental Protection Fund”, and compliance thereof with requirements of the regulatory enactments;
 - 7.2. Efficiency of utilisation of resources allocated within budget sub-programme of the Ministry of Agriculture 24.02.00 “State Aid Measures in Forest Sector”, which is formed by the resources of the Forest Development Fund and the Hunting Management Development Fund, and compliance thereof with requirements of the regulatory enactments;
 - 7.3. Efficiency of utilisation of resources allocated within budget sub-programme of the Ministry of Agriculture 25.02.00 “Fish Fund”, and compliance thereof with requirements of the regulatory enactments;
 - 7.4. Efficiency of granting the State credit guarantees issued by the State Joint Stock Company “Rural Development Fund” and LLC “Latvian Guarantee Agency”, and compliance thereof to requirements of the regulatory enactments.
8. Taking into consideration that the audit was conducted on the field, within which several responsible institutions are involved, four audit reports were drawn up as the result of the audit:
 - 8.1. To the Ministry of the Environment regarding efficiency of resources utilisation of Latvian Environmental Protection Fund and compliance thereof with requirements of the regulatory enactments;
 - 8.2. To the Ministry of the Agriculture regarding efficiency of resources utilisation of the Forest Development Fund, the Fish Fund, the Hunting Management Development Fund and compliance thereof with requirements of the regulatory enactments, and efficiency of granting the State credit guarantees issued by the State Joint Stock Company “Rural Development Fund” and compliance thereof to requirements of the regulatory enactments;
 - 8.3. To the Ministry of Economics regarding efficiency of granting the State credit guarantees issued by LLC “Latvian Guarantee Agency” and compliance thereof with requirements of the regulatory enactments;
 - 8.4. To the State Chancellery regarding efficiency of the parallel activity of Latvian Environmental Protection Fund, the Forest Development Fund, the Fish Fund, the Hunting Management Development Fund and credit guarantee institutions.
9. To obtain audit evidence inspection, assessment and analysis of the documents was conducted at the Administration of Latvian Environmental Protection Fund, the Ministry of Agriculture, the State Joint Stock Company “Rural Development Fund”, LLC “Latvian Guarantee Agency”, the State Agency “Latvian Fish Resources Agency” and the Rural Support Service.
10. Projects in the period from 1 January 2008 to 30 April 2009 were included into audit sampling. Statistical analysis of the projects was conducted on 2008 and the first half of 2009.
11. Scope of the audit:
 - 11.1. At Latvian Environmental Protection Fund, the Forest Development Fund, the Fish Fund and the Hunting Management Development Fund the auditors examined the following:

- 11.1.1. Legislative regulation of activity of the Funds;
 - 11.1.2. Type of financing granted by the Funds;
 - 11.1.3. Compliance of utilisation of the resources of the Funds with the objectives of respective Fund;
 - 11.1.4. Compliance of utilisation of the Funds resources with requirements of the regulatory enactments
 - 11.1.5. Evaluation of project applications;
 - 11.1.6. Supervision over utilisation of financing granted by the Funds;
 - 11.1.7. Measures for eliminating conflict of interest.
- 11.2. At the State Joint Stock Company “Rural Development Fund” and LLC “Latvian Guarantee Agency” the auditors examined the following:
- 11.2.1. Compliance of granting the guarantees with requirements of the regulatory enactments;
 - 11.2.2. Control measures for decreasing risks related to guarantee supervision;
 - 11.2.3. Administration expenditure.
12. The following was not included in the scope of the audit:
- 12.1. Damage compensations to users of land, which are connected with significant damage caused by the specially protected non-huntable species and migratory species of animals², disbursed from the resources of Latvian Environmental Protection Fund in accordance with the regulatory enactment³, thereby the data of the audit report does not include the disbursed compensation amount LVL 356 273;
 - 12.2. Utilised financing of the Fish Fund in the amount of LVL 23 108, which in 2008 in accordance with the regulatory enactment⁴ was transferred to the Ministry of the Environment for material incentives to the persons, who have contributed to protection of fish resources, and which was utilised for producing fishing cards;
 - 12.3. Financing allocated by the Forest Development Fund in 2008 for scholarships of the students of Forest Faculty of Latvia University of Agriculture in the amount of LVL 20 160.

Summary

Impact of the Activity of the Funds on the Process of Supervision over Planning and Utilisation of the State Budget

13. Due to the provisions of the regulatory enactments⁵ allowing the possibility of utilising the financing of the Funds for such State administration objectives, the financing for implementation of which shall be included into budgets of institutions, the situation has been created that in 2008 and in the first half of 2009 from the resources of the Funds in the amount of LVL 16 886 793 financed from the budget programmes of the Ministry of Agriculture and the Environment only 19.8% or LVL 3 341 838 are allocated to non-governmental organisations and enterprises for

² In 2008 compensations were disbursed in the amount of LVL 298 000, in 2009 – in the amount of LVL 58 273 for the damages caused in 2008.

³ Cabinet Regulation No.778 of 20 November 2007 “Procedures by which the Amount of Such Damages for Users of Land, which are Connected with Significant Damage Caused by the Specially Protected Non-huntable Species and Migratory Species of Animals, Shall Be Determined”.

⁴ Sub-paragraph 8.6 of the Cabinet Regulation No.388 of 19 December 1995 „By-law of the Fish Fund”.

⁵ Law “On Latvian Environmental Protection Fund”; Section 43, Paragraph three of the Law “On Forests”; Section 31 of the Hunting Law; Sections 27 to 29 of the Fishery Law.

achievement of socially beneficial objectives, in turn 81,2% or LVL 13 544 955 are allocated to projects for implementation of the objectives of the State administration institutions⁶.

14. Allocating financing from the Funds under the of the Ministry of Agriculture and the Environment (hereinafter – the Funds) to various types of projects, the process of supervision over planning and utilisation of the State budget has been made non-transparent, as:
 - 14.1. The State administration institutions receive additional financing from the Funds for performance of their functions, which forms approximately 10% of total budget expenditure of institutions;
 - 14.2. During the audit assessing approved projects, the auditors recognised that LVL 13 544 955 or 81.2% from resources of the Funds have been allocated:
 - 14.2.1. To direct administration institutions for implementation of the State administration tasks in the amount of LVL 7 730 415;
 - 14.2.2. For delegating State administration tasks to private individuals and other public persons in the amount of LVL 1 258 555;
 - 14.2.3. For procurements for State needs in the amount of LVL 2 152 122;
 - 14.2.4. For grants to local governments and local government institutions for various measures and development of infrastructure in the amount of LVL 2 183 878;
 - 14.2.5. For funds for unforeseen events in the amount of LVL 219 985.
15. In 2008 and in the first half of 2009 allocating LVL 7 730 415 or 45.8% from the total financing of the Funds *to direct administration institutions for implementation of the State administration tasks*:
 - 15.1. Budget planning principles⁷ are not observed. These principles specify that State administration institutions shall request financing for performance of their administration tasks from the State budget within the framework of preparation of draft annual State Budget Law, not by submitting project applications (requests for financing) to the Funds financed from the State budget, thus inefficiently utilising their resources;
 - 15.2. Councils of the Funds, taking decisions regarding projects submitted by institutions of direct administration, participate in the approval of the budget of the State administration institutions and perform tasks⁸ in the competence of the Ministry of Agriculture and the Environment related to distribution of resources to State administration institutions subordinated thereto.
16. In 2008 and in the first half of 2009 allocating LVL 1 258 555 or 7.5% from the total financing of the Funds *for delegating State administration tasks to private individuals and other public persons*, regulatory enactments, specifying basic requirements of activity of the State administration, are not observed. The regulatory enactments stipulate that an institution of direct administration shall directly authorise a private individual to perform the State administration tasks under the

⁶ Assessing approved projects of Latvian Environmental Protection Fund, the auditors categorised six types of projects financed from the Fund: financing to direct administration institutions for implementation of the State administration tasks; financing for delegating State administration tasks to private individuals and other public persons; procurements for State needs; grants to local governments and local government institutions for various measures and development of infrastructure; funds for unforeseen events; aid to non-governmental organisations and enterprises for achievement of socially beneficial objectives; “aid to non-governmental organisations and enterprises for achievement of socially beneficial objectives” for the purposes of this audit shall be referred to as financing for activities that bring benefits to the society or a part thereof within respective sector, not including the financing to the State administration institutions for performance of their functions.

⁷ Section 1, Clause 3 and Section 17, Paragraph two, Clause 5 of the State Administration Structure Law; Section 1, Paragraph two; Chapter 1 “Terms Used in this Law” of the Law “On Budget and Financial Management”.

⁸ Sub-paragraph 11.5 of the Cabinet Regulation No.244 of 29 April 2003 “By-law of the Ministry of the Environment”; Sub-paragraph 11.5 of the Cabinet Regulation No.245 of 29 April 2003 “By-law of the Ministry of Agriculture”.

competence thereof in accordance with the procedures specified by the regulatory enactments⁹ and the financing for implementation of the authorisation shall be allocated from the budget of respective institution, not from the Funds financed from the State budget.

17. As the regulatory enactment^{s10} allow the possibility of allocating the financing from the Funds to projects, which in essence shall be regarded as *procurement for State needs*, in 2008 and in the first half of 2009 LVL 2 152 122 or 12.7% were allocated from the total financing of the Funds, not observing basic requirements of activity of the State administration and regulatory enactments¹¹, that regulate public procurement and specify that:
 - 17.1. State Secretaries of Ministries shall plan financial resources for the State administration institutions subordinated to the Ministry for provision of their activity, therefore service procurements shall be financed from the budget of that State administration institution, which needs respective services;
 - 17.2. Research commissioned by a State administrative body is a procurement for State needs, and the State administrative body shall commission such research within the scope of the budget thereof and in accordance with competition procedures;
 - 17.3. Procedures specified in the regulatory enactment shall be applied to procurements for State needs.
18. In 2008 and in the first half of 2009 allocating LVL 2 183 878 or 12.9% from the total financing of the Funds *for grants to local governments and local government institutions for various measures and development of infrastructure*, regulatory enactments¹², regulating the State budget planning were not observed. The regulatory enactments stipulate that the structure of State budget grants and earmarked grants to be allocated to local government budgets shall be determined by special laws.
19. In 2008 and in the first half of 2009 allocating LVL Ls 219 985 or 1.3% from the total financing of the Funds *for funds for unforeseen events*, regulatory enactment¹³ was not observed. The regulatory enactment stipulates that funds for unforeseen events and for particularly significant measures at a national level shall be determined in the sub-programme “Funds for Unforeseen Events” of the Ministry of Finance basic budget of the annual State Budget Law.

Influence of Concurrent Operation of Several Funds on Economical and Efficient Utilisation of the State Budget Resources

20. By not establishing unified procedures, a situation has been created, when activity of the State institutions promoting one objective – administration of projects – is regulated by regulatory enactments of different hierarchical level, institutions have different authorisations and they apply essentially different principles of Funds operation, as:
 - 20.1. Activity of Latvian Environmental Protection Fund is specified by the law¹⁴, in turn procedures by which the Forest Development Fund, the Fish Fund and the Hunting Management Development Fund are operated are specified by the Cabinet Regulations;
 - 20.2. For administration of activity of Latvian Environmental Protection Fund a special institution has been established – the Administration of Latvian Environmental Protection Fund, in turn

⁹ Sections 49 and 50 of the State Administration Structure Law; Cabinet Regulation No.419 of 27 July 2003 “Procedures by which Institutions of Direct Administration Enter into Participation Contracts and Procedures by which Participation Contracts Shall Become Publicly Available”.

¹⁰ Law “On Latvian Environmental Protection Fund”; Law “On Forests”; Hunting Law; Fishery Law.

¹¹ Sub-paragraph 11.5 of the Cabinet Regulation No.244 of 29 April 2003 “By-law of the Ministry of the Environment”; Sub-paragraph 11.5 of the Cabinet Regulation No.245 of 29 April 2003 “By-law of the Ministry of Agriculture”; Section 37 of the Law “On Scientific Activity”; Section 8 of the Public Procurement Law.

¹² Section 44, Paragraph one of the Law “On Budget and Financial Management”; Paragraph 19 of the Cabinet Regulation No.359 of 26 May 2008 “Regulations regarding Basic Principles for the Development and Submission of Budgetary Requests” (in force until 9 October 2009).

¹³ Section 12, Paragraph one of the Law “On Budget and Financial Management”.

¹⁴ Law “On Latvian Environmental Protection Fund”.

administration of activity of the Forest Development Fund and the Hunting Management Development Fund is ensured by the Ministry of Agriculture, but for the Fish Fund – by the State Agency “Latvian Fish Resources Agency”;

20.3. At three Funds out of four included in the scope of the audit – Latvian Environmental Protection Fund, the Forest Development Fund, the Hunting Management Development Fund:

20.3.1. Project application submission is carried out by announcement of project tenders;

20.3.2. Project evaluation is performed by advisory boards of the funds, applying different evaluation principles;

20.3.3. Sector experts are attracted for evaluation of project applications, at the Forest Development Fund evaluation experts are attracted also for assessment of project reports;

in turn at the Fish Fund projects are evaluated in the submission sequence, not applying evaluation criteria;

20.4. Remuneration of project evaluation experts at the Funds is established differently, for example, LVL 15 are established for evaluation of one project at Latvian Environmental Protection Fund, in turn LVL 60 are established for evaluation of one project at the Forest Development Fund and LVL 100 for evaluation of a project report;

20.5. Mechanisms for supervision of projects that have received financing and financing utilisation control mechanisms are different, providing for inspections of source documents and inspections on project implementation locations in case of Latvian Environmental Protection Fund and the Forest Development Fund, as well as not providing in the regulatory enactments for performance of supervision in case of the Fish Fund and the Hunting Management Development Fund,

thus creating different approach to project implementers, developing different approach to supervision of utilisation of the State budget funds and influencing effectiveness of expenditure related to activity of institutions, when administering projects.

21. Taking into consideration the competence of the Cabinet¹⁵ to initiate functional audits, within the framework of which effectiveness and efficiency of activity of direct administration institutions is assessed, applying the abovementioned mechanism efficiency of concurrent operation of several Funds – Latvian Environmental Protection Fund, the Forest Development Fund, the Hunting Management Development Fund and the Fish Fund – shall be assessed, as well as the possibilities of expenditure optimisation, as:

21.1. Objectives of Latvian Environmental Protection Fund, the Forest Development Fund, the Hunting Management Development Fund and the Fish Fund specified in the regulatory enactments¹⁶ are similar, and randomly inspecting financed projects, it was disclosed that, for example, projects that conform also with the objectives of other Funds have been granted financing from Latvian Environmental Protection Fund in the amount of LVL 530 313;

21.2. LVL 1 214 430 were allocated for projects on informing the public, to ensure public information via television, radio and press regarding issues, which in essence complies with objectives of all Funds;

21.3. Councils of the funds take decisions on approval of projects, and in general councils of the Funds consist of representatives of the same institutions – the Ministry of the Environment, the Ministry of Agriculture, the Ministry of Finance, Latvian Association of Local and Regional Governments, which nevertheless has not eliminated overlapping of objectives of the projects supported by various Funds.

¹⁵ Sub-paragraph 4.17 of the Cabinet Regulation No.263 of 20 May 2003 “By-law of the State Chancellery”.

¹⁶ Section 2, Paragraph one and Section 3 of the Law “On Latvian Environmental Protection Fund”; Section 43, Paragraph three of the Law “On Forests”; Section 31, Paragraphs one and three of the Hunting Law; Section 27 of the Fishery Law.

Activity of the State Joint Stock Company “Rural Development Fund” and LLC “Latvian Guarantee Agency”

22. As two State capital companies – LLC “Latvian Guarantee Agency” and the State Joint Stock Company “Rural Development Fund” – issue credit guarantees to enterprises in case of insufficient credit security and:

22.1. Guarantee granting mechanisms in these capital companies are the same;

22.2. Rural enterprises are not ensured the opportunity to receive credit guarantees for agriculture and rural development measures according to “one stop shop” principle, as the State Joint Stock Company “Rural Development Fund” does not issue export credit guarantees, which can be obtained by rural enterprises at LLC “Latvian Guarantee Agency”;

concurrent operation of two separate State capital companies with the same activity objectives would only be justified in case if there would exist certain restrictions of the European Union regulatory enactments for merging such entities or if individual operation of entities would be more efficient in terms of cost, which in the audit did not prove to be the case.

23. Assessing revenue and administrative expenditure, as well as employee workload at the State Joint Stock Company “Rural Development Fund” and LLC “Latvian Guarantee Agency”, it may be concluded that at both capital companies there are expenditure optimisation opportunities, which could be facilitated by merging the capital companies:

23.1. Administration cost of one guarantee at the State Joint Stock Company “Rural Development Fund” is by 22% higher than at LLC “Latvian Guarantee Agency”, even though the same principles of operation exist with regard to guarantee administration.

23.2. Distribution of responsibilities at the State Joint Stock Company “Rural Development Fund”, where two Board members in addition to their work at the Board perform guarantee administration contrary to Board members at LLC “Latvian Guarantee Agency”, who perform only their duties related to work at the Board, indicate that Board members of the size and specifics of such capital companies have the ability also performing everyday guarantee administration.

23.3. The salary of the Director and the Chairman of the Board of LLC “Latvian Guarantee Agency” is established unreasonably high with respect to work performance, in total being four times larger than the salary of respective official at the State Joint Stock Company “Rural Development Fund” as of 30 April 2009.

23.4. The expenditure on keeping accounts at the State Joint Stock Company “Rural Development Fund” and LLC “Latvian Guarantee Agency” is unreasonably high compared to average market price for accounting services, as:

23.4.1. Average monthly work remuneration of an accountant at LLC “Latvian Guarantee Agency” four times exceeds average market price for accounting services and in the four months of 2009 1.1 times exceeds the salary of the Chairman of the Board of LLC “Latvian Guarantee Agency”;

23.4.2. Average monthly work remuneration of an accountant at the State Joint Stock Company “Rural Development Fund” eighteen times exceeds average market price for accounting services.