



Do Rēzekne City's budget and fiscal management comply with the laws and regulations?

Interim audit report



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Financial audit “On the annual consolidated financial statement for 2023 on the outturn of the state budget and municipal budgets”

Interim report drafted under financial audit “On the annual consolidated financial statement for 2023 of the Republic of Latvia on the outturn of the state budget and municipal budgets” (Audit schedule No 2.4.1-34/2023 of the Audit and Methodology Department of the State Audit Office of Latvia of 3 August 2023) following Sub-paragraph c), Paragraph 3, Section 3 of the State Audit Office Law.

The interim audit report enters into force at the moment of the decision of the Audit and Methodology Department of the State Audit Office on the approval of the interim audit report made.

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Why have we drafted this interim report?

The State Audit Office of Latvia has started a financial audit of the annual consolidated financial statement of the Republic of Latvia for 2023 on the outturn of the state budget and municipal budgets (hereinafter referred to as the ACFSS). The purpose of auditing the ACFSS is to gain sufficient confidence that the ACFSS does not contain significant errors or inconsistencies caused by fraud and to provide an opinion on the accuracy of the ACFSS by 15 August 2024.

The State Audit Office of Latvia uses the work of certified auditors¹ in the audit of the ACFSS in cooperation with the certified auditors invited by the local and regional governments included in the audit sample, as well as by performing additional detailed investigations and analytical investigation procedures.

On 7 August 2023, the Ministry of Finance addressed the State Audit Office of Latvia and the Ministry of Environmental Protection and Regional Development (hereinafter referred to as the MEPRD) with the information that in the process of monitoring the financial activities of local and regional governments, the Ministry identified significant risks to the financial stability of the Rēzekne City Municipality² (hereinafter referred to as Rēzekne City). Already on 14 August 2023, a tripartite meeting of the State Audit Office of Latvia, the Ministry of Finance and the MEPRD took place to discuss the future planned actions of the parties involved and to agree on cooperation mechanisms for the most effective way to gain confidence about the financial situation of Rēzekne City³.

Taking into account the identified risks in Rēzekne City's ability to fulfil its obligations and solve the financial problems that have arisen, the State Audit Office of Latvia included Rēzekne City in the audit scope of the ACFSS for 2023 with the aim of assessing the compliance of the municipal budget management with laws and regulations and the completeness of the assumed obligations. The State Audit Office of Latvia undertook to summarize the results of this assessment in an interim audit report and make it public by the end of 2023.

To achieve the purpose of the planned task, the State Audit Office of Latvia assessed the compliance of the budget and fiscal management of Rēzekne City with the laws and regulations (including the completeness of obligations). When identifying risks during the audit, there were Rēzekne thermal energy tariffs and investment project implementation practices also assessed in addition to the mentioned matter. The issues related to the budget and identified in the audit were assessed by the State Audit Office of Latvia as a matter of compliance by providing an opinion of limited confidence. The limited assurance with which the State Audit Office of Latvia provides its opinion means that, taking into account the variability in accounting data and budget outturn indicators for 2023 during the audit, and the short period of time for conducting the audit procedures (30 August 2023 to 14 November 2023), the audit activities are more limited compared to the activities that would be necessary to provide sufficient confidence.

The auditors draw attention to the fact that the interim audit report basically analyses the period from 1 January 2022 to 14 November 2023, but the work of the participating institutions on identifying and stabilizing the financial situation of Rēzekne City continues. Therefore, the situation will have changed inevitably on the day of the publication of this interim audit report. Considering the above, the State Audit Office of Latvia aims to provide an independent and

impartial assessment regarding the budget management process of Rēzekne City during the mentioned time period in this interim audit report and draw attention to the identified irregularities, whose elimination would have a positive impact on the budget management in the Rēzekne City Municipality.

Summary

The Rēzekne City Municipality is one of the ten city municipalities in Latvia⁴. The figures characterizing Rēzekne City in the period from 2021 to 2023 indicate that the population of Rēzekne City continues to decrease every year (26,839 people in in 2021, wand 26,378 people as of 1 January 2023⁵ or 1.7% less). See Figures 1 and 2 regarding revenues and expenditure of Rēzekne City according to the accrual principle, as well as indicators of balance sheet assets and liabilities for the period from 2020 to 2022.

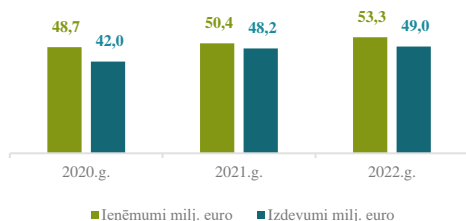


Figure 1. Revenues and expenditure of Rēzekne City according to the accrual principle in 2020, 2021, and 2022⁶ (income in million euros, expenditure in million euros).

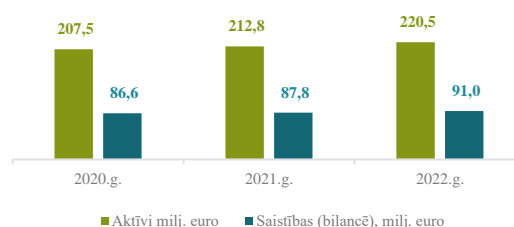


Figure 2. Balance sheet assets and liabilities of Rēzekne City at the end of the 2020, 2021, and 2022 reporting periods⁷ (assets in million euros, liabilities (balance sheet) in million euros).

When assessing the evidence obtained during the audit, Rēzekne City has not complied with laws and regulations⁸ in terms of budget and financial management.

By insufficiently evaluating the commitments already undertaken and the funding necessary for the completion of the projects started, and relying on the availability of financial resources (as evidenced by the observance of the basic principle “*Priority - completion of the started projects*” established in the development of the budget of Rēzekne City for 2023), several violations were committed in the development of the budget of Rēzekne City for 2023, including:

- Initial budget requests of the institutions (*which exceeded the expenses approved in the 2022 estimate*) were reduced not only to the level of 2022, but by 8% more, while not assessing whether such a reduction did not threaten the ability of the municipality to ensure the fulfilment of legally defined functions, tasks and voluntary initiatives in 2023;
- Heating expenditure was calculated according to an unapproved heat supply tariff;
- Expenditure from the targeted grant received from the Ministry of Education and Science (hereinafter referred to as MES) were planned for eight months, without including either revenues or expenditure of at least 3.2 million euros in the general budget, although the municipal budget for each financial year must include all revenues

and loans collected or received by municipalities (municipal institutions), which are appropriated by municipalities for municipal purposes⁹;

- Not taking into account the information about the budget deficit, about which both the Head of the Financial Administration and the institutions informed the management group of the Capital Investment Program and Budgeting Process, the budget of Rēzekne City for 2023 was forwarded for approval. According to the auditors' estimates, the budget did not include the expenditure and the necessary resources to cover that expenditure for at least three months of 2023 at the time of approval.

Irregularities were also found in the process of budget execution, control, and drafting and approving amendments to the budget. The most important thing is that although the Ministry of Finance stated repeatedly that it was impossible to receive new loans, the Central Finance and Contracting Agency (hereinafter referred to as the CFCA) has suspended the disbursement of at least 3 million euros for several projects financed from the EU Structural Funds, however, the budget of Rēzekne City for 2023 was not adjusted accordingly for previously planned, but not received loans, and the true situation of the lack of financial resources was not indicated. It is also important to point out that the liabilities of Rēzekne City to suppliers and contractors amounted to 9.9 million euros¹⁰ as of 31 October 2023, which have increased by 4.8 million euros or 48% compared to 1 January 2023.

When conducting an in-depth assessment of the reasons for the actions of Rēzekne City in the budget requests by correcting heat supply costs according to an unapproved draft tariff, thus reducing the calculated expenditure of the institutions by at least 0.62 million euros, we found that:

- When submitting a thermal energy supply draft tariff for consideration to the Public Utilities Commission (hereinafter referred to as the Regulator) on 11 November 2022, “Rēzeknes siltumtīkli” Ltd (Rēzekne Heat Network) did not provide sufficient information on the economic justification of the submitted draft tariff and compliance with the actual costs in a timely manner;
- As a result of the review of the thermal energy supply tariff, the state budget funds were spent not only for the intended purpose, that is, to allow the most financially vulnerable population groups to receive support for mitigating the impact of the increase in energy prices and general inflation, but also for increasing profits and funds in current accounts of “Rēzeknes siltumtīkli” Ltd (company number 40003215480);
- When reviewing and approving the thermal energy supply tariff only after the end of the state support measures, according to the auditors' estimates, the government paid out at least 4.55 million euros more to “Rēzeknes siltumtīkli” Ltd than it would be after revision of the thermal energy supply tariff.

When assessing the accounting and control of liabilities, several non-compliances with the statutory requirements¹¹ were detected, for instance:

- The sub-balance sheet does not show potential liabilities for the concluded contracts for future long-term investments, which, according to the information provided by the municipality, amount to 13.7 million euros, as well as securities;
- When drafting quarterly reports, accounting of expenditure is not ensured according to the accrual principle, for example, in the first quarter report on the liabilities of the

municipality, the liabilities of at least 0.62 million euros are not indicated, which were included in the second quarter report;

- The 2022 inventory has not been carried out in substance and in accordance with the statutory requirements¹² because an inventory has not been carried out for all balance and sub-balance sheet assets and liabilities, and the results of the inventory have not been collected and approved. Since the 2023 inventory order is drafted identically to the 2022 approach, there is a risk that inconsistencies will also be allowed in the 2023 closing inventory.

At the same time, while assessing the matters related to budget management of Rēzekne City, the audit also found deficiencies in the planning, implementation and financing of RĒZEKNE infrastructure development projects, for example:

- Adequate inclusion of investment projects in development planning documents is not always ensured to plan the necessary funding for their implementation within a given budget year in a timely manner;
- Economy and effectiveness aspects of investment projects are not evaluated sufficiently, which would allow identifying the amounts of future expenses for the maintenance of these infrastructure facilities;
- While attracting funding from European Union (hereinafter - EU) Structural Funds, Rēzekne City developed projects supported by EU funding for the restoration of degraded areas, although no document or evaluation has been developed on the possibilities of using undeveloped land and degraded areas.

In the interim report of the audit, Rēzekne City Municipality is given three recommendations to improve the management of the budget and fiscal management system and to ensure the transparency of financial processes, as well as accounting control.

References

- ¹ International Standard on Auditing (ISA) 600 “Special Considerations - Audits of Group Financial Statements (including the work of component auditors)” and International Standard of Supreme Audit Institutions ISSAI 1600 on the application of ISA 600 in public sector audits requirements.
- ² Letter No 3.2-19/13-1/2397 of the Ministry of Finance “On an extraordinary audit in Rēzekne City Municipality” of 7 August 2023.
- ³ Letter No 6-3.5.4.1e/104 of the State Audit Office of Latvia “On the invitation to a joint meeting” of 9 August 2023.
- ⁴ Section 8, Part Three of the Law on Administrative Territories and Settlements.
- ⁵ <https://stat.gov.lv/lv/dinamiskais-grafiks/galv-iedzivotaju-skaitis-novados> (viewed on 14 November 2023).
- ⁶ Source of information: “Financial report on the financial results of the economic activity” of the Rēzekne City Municipality for the years 2021 and 2022.
- ⁷ Source of information: “Financial report on the financial position (balance sheet)” of the Rēzekne City Municipality for the years 2021 and 2022.
- ⁸ Law on Budget and Fiscal Management; Section 4, Part Three, Section 77, Parts One and Two of the Law on Local and Regional Governments; Section 2 of the Law on Municipal Budgets; Section 7 of the Law on Local and Regional Governments” (valid until 31 December 2022); Section 5, Part Two, Section 15, Part One, Section 33, Part One of the Accounting Law; Articles 313 and 425 of Cabinet Regulation No 87 “Accounting Procedure in Budget Institutions” of 13 February 2018; Article 2.3 of Cabinet Regulation No 776 “Procedure for drafting and submitting monthly reports” of 17 August 2010; Article 2 of Rēzekne City Municipality Regulations (in force until 1 July 2024); Article 849 of Rēzekne Accounting Procedures in Rēzekne Municipal Institutions (with amendments based on Rēzekne City Council Decision No 748 of 10 February 2023); Order No 69/vp of the Chairperson of the Rēzekne City Council “On the preparation of the budget project of the Rēzekne City Municipality for 2023”.
- ⁹ Section 6 of the Law on Budget and Fiscal Management.
- ¹⁰ Accounting registers of Rēzekne City. Ledger for the period from 1 January 2023 to 31 October 2023, summary of account “5311 Liabilities to suppliers and contractors”.
- ¹¹ Section 5, Part Two and Section 33, Part One of the Accounting Law; Articles 313 and 425 of Cabinet Regulation No 87 “Accounting Procedure in Budget Institutions” of 13 February 2018; Article 2.3 of Cabinet Regulation No 776 “Procedure for drafting and submitting monthly reports” of 17 August 2010.
- ¹² Sections 15 and 17 of the Accounting Law; Chapter 9 of Cabinet Regulation No 877 “Regulations for Accounting” “Methods of inventory, procedure for conducting inventory, procedure for documenting results and recording differences discovered in inventory” of 21 December 2021.