



SIGMA

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KOSOVO

PUBLIC INTERNAL FINANCIAL CONTROL (PIFC)

ASSESSMENT MAY 2008

1. Legal Framework

This report updates Sigma's 2007 assessment of Public Internal Financial Control (PIFC) in Kosovo.

Public internal financial control (PIFC) in Kosovo is regulated by the following *primary legislation*:

- UNMIK¹ Regulation no. 2001/19 of 13 September 2001 on the Executive Branch of the Provisional Institutions of Self-Government in Kosovo (PISG) sets out the structure of the administration and the role and responsibilities of the government, ministers and ministries. It stipulates, inter alia, that ministers are to ensure that their respective ministries implement appropriate internal controls, and it designates key elements for the establishment of sound internal control systems (allocation of resources; ensuring an appropriate cost-effective and transparent allocation of funds; establishment of anti-fraud and anti-corruption measures, together with the promotion of general fraud awareness as well as the development and maintenance of appropriate systems, procedures and processes to support ministerial functions; human resources and capacity-building in the respective areas of responsibility; and design and implementation of a management information system so that all decisions, policies and processes rest upon a sound and up-to-date basis of accurate data) (art. 1.7).
- PISG Law 2003/2 on Public Financial Management and Accountability (PFMA), adopted by the Assembly of Kosovo and approved by the Special Representative of the UN Secretary General (SRSG), further defines the components of the internal control system and establishes an internal audit unit in the Ministry of Finance (sec. 8). The Assembly passed a new Law on Public Financial Management and Accountability in March 2008, the status of which is uncertain and which is not assessed in this report.
- Internal Audit Law (IAL), adopted by the Assembly of Kosovo on 6 November 2006 (No. 2/L-74), was promulgated on 6 June 2007 (Regulation No. 2007/19) by the SRSG. This law foresees a decentralised internal audit system and the establishment of audit committees in budget organisations, and establishes a Central Harmonisation Unit for Internal Audit (CHU/IA), which is to develop rules, policies, manuals, guidelines and standards, train internal auditors, monitor internal audit developments, and provide a quality assurance oversight of audit work. The CHU is to have the status of a special unit within the MFE. With the promulgation of the IAL, the MFE no longer holds a mandate for conducting internal audit in other public sector organisations, although it may do so upon request.

¹ In accordance with UN Security Council Resolution 1244 of June 1999, the province of Kosovo has been governed by the UN Interim Administration Mission in Kosovo (UNMIK).

Secondary legislation consists of:

- Treasury Financial Rule – Number 01 – PIFC – February 2006: This rule has been developed to further define the accountability chain and the minimum requirements for internal control. It applies to all public administration, which includes ministries, municipalities and reserved power organisations. Its coverage includes regulatory bodies but does not extend to designated entities.
- Treasury Guidelines and Financial Rule – Number 02 – Expenditure of Public Money – June 2006 and as amended November 2006: In the past, the Treasury had developed administrative instructions, which addressed many aspects of the expenditure and internal control issues regarding public monies. This Treasury document updates and consolidates these instructions in a single document. The previous administrative instructions continue to apply unless they differ with the instructions in this guideline document, in which case the instructions set out in this 2006 document are to apply.

Tertiary legislation consists of:

- Internal Audit Manual for Ministries, Municipalities, Authorities and Agencies under the Kosovo Government, November 2004, which includes the Professional Practices Framework and Internal Audit Charter (August 2003).

In addition to the documents listed above, the government approved in January 2005 (Decision 4/130) the Policy Paper on Public Internal Financial Control. However, the legal bearing of the amendments dated 2 May 2007 is unsure.

The strategic direction to enhance internal audit is also included in the Kosovo Action Plan for the Implementation of the European Partnership 2006. Priority Number 75.3 specifically relates to internal audit and requires the Assembly of Kosovo to approve the Law on Internal Audit in the Public Sector and requires the MEF to establish a CHU for Internal Audit.

On 26 September 2007 the MFE and UNMIK published a *Strategy for the Internal Audit Function in the PISG* in Kosovo. This strategy only focuses on internal audit and is a comprehensive and detailed roadmap for the decentralisation of the development of the internal audit function. This strategy is intended to implement the new provisions of the Internal Audit Law (IAL).

2. Institutional Framework

Each budget organisation is required to have a Chief Administrative Officer (CAO), which is the highest executive civil servant in each organisation (permanent secretary). The CAO is in charge of the budget preparation and execution processes by delegation of the minister. The CAO is also responsible for the implementation of financial control in the budget organisation.

The CAO is assisted by relevant officers to ensure proper segregation of duties in authorising the processing, recording and reviewing of activities, as defined in the Treasury Financial Rule No. 1 of February 2006.

The Treasury is located in the Ministry of Finance and Economy (MFE) and is responsible for managing the Kosovo Consolidated Budget. It is in charge of financial control in the completion of the payment process by all budget organisations. The Treasury is also responsible for managing bank accounts in relation to the Central Bank of Kosovo, managing the expenditure of funds, establishing processes for the collection of records, and establishing and maintaining accounting records.

With regard to the processing of payments, the Treasury performs ex ante control. As soon as budget organisations demonstrate strong internal control systems, the Treasury will reduce this point of control. At the time of writing this is still not the case.

The Treasury is also responsible for preparing the financial accounts and maintaining the Financial Rules.

To carry out its functions, each budget organisation uses the Kosovo Financial Management Information System (FMIS) for recording all transactions and the FreeBalance Government Accountability Software system (Treasury general ledger) that is installed in the Ministry of Finance and Economy (MFE). This software supports the major needs of [financial management](#). There are also modules for [budgeting](#), [purchasing](#) and expenditure processes, [revenue](#) and [asset](#) management and reporting.

In compliance with the Treasury Financial Rule No. 1 of February 2006 (section 10), as well as with the Internal Audit Law, the Central Harmonisation Unit for Financial Management and Control (CHU/FMC)

was established in 2007. Responsibility for the harmonisation of financial management and control rules, including assurance of their successful implementation, lies with the Treasury Director. Terms of reference for the CHU/FMC have been prepared by a working group, which is supporting the Director of the Treasury in the further development of financial management and control. The group consists of the Budget Director, a representative of local government, the Chairman of the Public Procurement Commission, the Chairman of the Board of Accounting Standards, a representative of the Legal Department of the MFE, an international advisor and others, depending on the matters under discussion and of interest. The Deputy Director of the Treasury acts as the secretary for this working group. The head of internal audit in the MFE and the Office of the Auditor General act as observers. The tasks of this group are to co-ordinate the development of PIFC, in particular financial management and control rules. They have not met since last year's assessment.

The Internal Audit Unit in the MFE has carried out internal audit in budget organisations in accordance with the above-mentioned Financial Rule no. 1 of the Treasury and following a work plan determined by the Permanent Secretary of the MFE. However, since the promulgation of the Internal Audit Law (6 June 2007), the centralised internal audit system has been in the process of decentralisation. Every budget organisation and autonomous public undertaking is to establish and maintain an internal audit unit. Internal audit units are to be established in approximately 30 municipalities and 15 ministries, which would in total amount to approximately 50 internal audit units. This would mean that some internal audit units would be very small, for example with a single internal auditor, who would act as the head of internal audit in that budget organisation. It is not advisable to have such small internal audit units, as assigning the responsibility for both audit planning and audit implementation to the same person could hamper the quality and effectiveness of the audit.

In 2007 there were about 100 internal auditors in the public administration: 21 in the MFE, 32 in other PISG ministries, 13 in reserved power institutions, and 32 in 26 municipalities. In April 2008 these numbers have not changed much. At present, internal audit capacity has been established in all budget organisations. A total of 37 audits were carried out in 2007, led by the MFE's Internal Audit Unit.

In many administrations, the existence and application of internal control systems are questionable, threatening effective management and good governance. In addition, ministries, municipalities and other audited entities are generally reported to regard the internal audit function as an inspection or policing function that limits management's discretion in utilising public resources, rather than a tool that is meant to enhance the effectiveness of institutions and protect ministers and CAOs from poor execution of the responsibilities delegated to subordinates.

Currently there is no monitoring or co-ordination of internal auditors' work or movements across the PISG, and the allocation of auditors is such that smaller, low-risk entities, such as municipalities, have one auditor for every budget of 2 to 3 million EUR, while larger and more complex ministries often have only one auditor for every budget of 5 to 10 million EUR. This allocation of audit resources does not maximise the effectiveness of the function.

The Internal Audit Department in the MFE (IAD/MFE) had been fulfilling the role of a Central Harmonisation Unit for Internal Audit (CHU/IA). However, in accordance with the Internal Audit Law (IAL), a separate unit for the CHU/IA has now been established, i.e. split off from the Internal Audit Department of the MFE. The Internal Audit Unit also undertakes tasks specified by the Permanent Secretary, the Minister of Finance and other budget-users. These tasks arise as a result of complaints and queries.

The IAL prescribes that within the MFE the CHU/IA is to have the status of a special department and that the total number of staff in the CHU/IA is not to exceed five. In April 2008 the special department of CHU/IA is staffed with part-time auditors from the MFE's Internal Audit Unit.

No audit committees have yet been established. This is not a surprise, taking into account the early stage of PIFC in Kosovar entities and institutions and the limited understanding of the role and task of internal audit at management level.

3. Reform Agenda and Capacities

The *Strategy for the Internal Audit Function in the PISG* of 26 September 2007 is a detailed roadmap for the next stage in the development of the internal audit function in the Government of Kosovo. This Strategic plan presents the way forward to achieve the objectives framed by the IAL and also specific aspects that need to be addressed in institution building as well as enhancing the administrative capacity, in particular regarding knowledge and skills.

According to the Strategy, in the period between the beginning of internal audit reform and the achievement of reform objectives, a number of transitional issues should be addressed, such as:

- rebalancing the allocation of internal audit resources across the government;
- avoiding the loss of existing trained internal audit capacity and using opportunities to redeploy auditors;
- ensuring that internal auditors meet professional certification and licensing requirements.

The current EU-funded technical assistance project to support the Internal Audit Department aims to assist in the implementation of the internal audit legislative framework. The project also includes development of related secondary legislation to the IAL; strengthening of the capacity of the internal audit function across the PISG; and assistance to the MFE and other budget organisations in carrying out the internal audit plan. More than 25 pilot audits (in accordance with EU standards) are part of this project.

In addition, according to the Strategy, a number of weaknesses remain in the IAL, which could be addressed in a future amendment so as to align the law with international good practice and the *acquis communautaire*². The secondary and tertiary legislation guiding the implementation of the IAL also have to be enhanced and harmonised.

4. Assessment

In the broad sense of the term, the internal control structure has been established in Kosovo. The basic legal framework is sound, with clear structures of accountability. However, the chain of control is no stronger than the weakest link of the internal control chain. Internal audit operates within an audit environment that is weak in Kosovo. Efforts to prevent errors or mismanagement need to be enhanced, and basic knowledge, skills and competences need to be addressed more intensively before internal audit can function effectively.

It remains urgent for the CHU/FMC to concentrate on the training of staff working on financial management and control systems in budget organisations. The financial management system and related systems need to be strengthened to improve the quality of financial management and its related controls. This improved quality also implies increased understanding of the meaning of the given responsibilities as well as of the recently introduced functions of managerial accountability and the linked supervision and monitoring that this system implies. These functions are still new to the Kosovar environment, which is accustomed to a strong centralised system and which until recently has been run by international organisations. These organisations have drafted the legal framework in a principles-based style that does not fit the Kosovar administrative tradition; as a result, adherence to this framework is weak.

International institutions have pushed for the establishment of internal audit. This emphasis on internal audit seems to be a premature focus, as the issue of assistance to the initial control structures has hardly been addressed. The development of internal audit is basically under the responsibility of the Ministry of Finance and Economy (MFE). Efforts to establish operational internal audit in the other budget organisations are underway. Every budget organisation now has an internal audit capacity, either a unit or an auditor. The new Strategy proposes to transfer capacity from the MFE to the other budget organisations. This intention should be considered with due care. Such a transfer should be viewed from the point of the effectiveness and independence of the audit function. It is undesirable to set up very small internal audit units; for reasons of efficiency it is better to form a pool of auditors for the small budget organisations.

Even though numerous efforts have been made in the training of internal auditors (approximately 10% of the effective working days of internal auditors are dedicated to training), the implementation of professional internal audit standards in budget organisations is still in its early stages. The CHU/IA has expressed a great need to train auditors in basic knowledge, skills and competences, such as the analysis of audit findings and the drafting of good recommendations.

The practice so far seems to be that the MFE's Internal Audit Unit has performed a centralised audit function across the budget organisations. This practice is changing with the implementation of the decentralised audit system. The Internal Audit Department in the MFE has functioned as a central inspectorate on individual financial transactions rather than focusing on the development of an effective management and internal control system. The annual audit report of the IAD/MFE provides essentially transaction-related findings. However, the major findings can be grouped into four categories: lack of general knowledge of the Treasury

² Appendix B of the Strategy list 16 weaknesses in the new Internal Audit Law.

Financial Rules and their implications; procurement; management of public property; and budget management.

Although the new Internal Audit Law addresses the new, entirely decentralised system, it will take time before the internal auditor is seen as a professional assessor of the internal control system and not as a sort of financial policeman.

To date many staff have been trained and a number of workshops have been held, both for staff dealing with financial management and control and for those dealing with internal audit. However, staff in budget organisations seem to be taking some time to recognise the responsibilities implied in financial management and control and the linked obligations. The notion of internal audit does not seem to be understood. As there is still a general confusion about the distinction between internal control and internal audit, and line managers' knowledge of accountability and its aims is lacking, it is difficult to implement a sound PIFC system.

There have been different approaches to PIFC and IA, reflecting the various donor and executing agency perspectives and the lack of an integrating policy framework, and this has resulted in weak harmonisation, which in turn could lead to confusion. The weaknesses in the Internal Audit Law (IAL), recorded in the new Strategy document (Appendix B) are without a doubt surmountable. The new IAL is basically in line with the internal control standards defined in the Public Financial Management and Accountability Law (PFMA Law) and related secondary legislation. However, some refinements to align this legislation with international and EU good practice of internal audit would seem to be necessary over time. Some shortcomings could create a number of administrative difficulties; for example, the head of internal audit will have a salary equivalent to that of a permanent secretary.

The functional independence of internal audit is not ensured. The permanent secretary / Chief Administrative Officer (CAO) is to ensure the independence of internal auditors in the planning, implementation and reporting of the results of an internal audit, but it would seem to be very difficult to ensure this independence, since all staff, according to the current Civil Service Law, are employed on contractual arrangements, permanent secretaries included. Staff contracts can be up to three years, and then can be renewed. Staff can also be dismissed before their term of appointment ends. Staff contracts are signed by the head of the budget organisation and therefore there are strong vested interests, in particular for the position of the head of internal audit. It will take time before the essence of professional ethics in internal audit is understood and adhered to.

One of the tasks of audit committees is to support the independence of internal audit. It is worthwhile to have an audit committee that has the power and authorisation to oversee and review the implementation of both FMC and IA. As long as mature, efficient FMC systems are not in place and IA is not working in a more professional manner, it will be difficult to set up audit committees. Furthermore, it will be difficult to recruit qualified and dedicated members for the audit committees, especially in small budget organisations.

5. Recommendations

- Priority should be given to enhanced and increased understanding of the meaning of given responsibilities in the accountability chain, through training of senior and middle management and of staff performing various controls in the chain of transactions, so as to ensure that funds are spent as intended and that correct decisions are taken by all relevant actors.
- To further advance internal audit, it is essential for the audit environment to develop as well. No attention is currently being paid to the financial management and control system. It is therefore necessary to devote efforts to enhancing the quality of financial management and control systems. This will be useful as well for the training of staff in the internal audit system, as it will contribute to improved recommendations and added-value for management. It is therefore crucial to strengthen the professional capacity in financial management and control in the Ministry of Finance and Economy, line ministries and municipalities so as to ensure the enhanced implementation of the new legal instruments on financial management and control. In particular:
 - Assign to the CHU/FMC the task of assisting line ministries in developing an annual strategic plan, with a linked training programme to enhance the quality of financial management and control;
 - Develop, by the CHU/FMC, a capacity-building programme in financial management and control for key financial actors in line ministries to reinforce the core of the financial management and control system. Assistance from the EU in this regard should be considered.

- In addition, it is important to develop and establish organisational values and culture (*esprit de corps*). This is particularly challenging, as the length of staff contracts is only three years, in accordance with the Civil Service Law. As this law is being overhauled, a review should be carried out to analyse current posts in comparison with job classifications and to determine conditions for attracting and retaining the best staff. Consideration should also be given to ensuring a freer hand in recruitment and to developing a long-term human resources strategy. Experience has shown that it takes an average of four to seven years to properly train a professional auditor.
- Consideration could be given to reviewing the new Internal Audit Law so as to ensure that in the long run it is fully compatible with internationally recognised internal audit standards.
- Further development of linked legislation is needed, such as updating of the internal audit manual and the Internal Audit Charter to align them with the Internal Audit Law. It is of paramount importance, however, to maintain a pragmatic approach and concentrate on basic cornerstones, ensuring their understanding in order to get them right, rather than engaging in a theoretical approach.
- Careful consideration is needed when deciding to establish an internal audit unit (IAU) in a ministry, budget organisation, independent institution or municipality. The size of the budget entities and their risk profiles should play an important role in the allocation of scarce IA capacity. Internal audit units comprised of fewer than three auditors are not desirable. For small budget entities, the use of auditors from a pool of auditors is the obvious solution. This pool could be set up in the Ministry of Finance and Economy (MFE). It is not advisable to outsource internal audit capacity to the private sector, where governance and internal control differ considerably from the public sector. When reviewing the IAL, this aspect could be reconsidered.
- Training of the current and future auditors in basic knowledge, skills and competences remains of utmost importance, and training in basic IT-auditing is part of this. This training is to be organised by the CHU/IA, preferably with practical technical assistance from the EC.
- Practical training and certification programmes are to be set up, under the auspices of the CHU/IA and with the support of the EC, for starting internal auditors, which meet internationally accepted qualifications.
- Further long-term efforts are needed to advance the setting up of audit committees that have the power and authorisation to oversee and review the implementation of both FMC and IA and that support the independence of internal audit.

6. External Assistance

The European Agency for Reconstruction (EAR) has been the key agency supporting the development of the internal audit function in Kosovo.

From 2003 to the beginning of 2006 the Internal Audit Unit in the MFE received twinning assistance. Among other elements, this assistance consisted of training – a theoretical part (three months or 80 hours) and a practical part (pilot audits organised by the MFE and the twinner).

Currently there is an EU-funded technical assistance project to support the Internal Audit Department in the MFE. In total 1550 working days of assistance will be provided over a period of 18 months. The project, which started on 1 March 2007. The project will end in August 2008. It should be noted that this project only relates to internal audit and that no actions are foreseen to address those responsible for the implementation and execution of the budget and budget programmes.

The World Bank supported the creation of the Society of Certified Accountants and Auditors in Kosovo (SCAAK) in 2003. SCAAK is the professional body responsible for licensing auditors and accountants in the private sector. The same body has also been engaged in the training of internal and external auditors in the public sector as well as of the financial police.

A two-year training and certification programme for public sector accountants was introduced in 2003 by the Centre of Excellence in Finance (CEF), Slovenia, in three pilot countries (Albania, Croatia and Slovenia) within the framework of a project on capacity-building in public accounting. Following the positive experience of the pilot implementation, a second group of countries and territories (Kosovo, former Yugoslav Republic of Macedonia, Moldova and Romania) decided to join the project in 2007. CEF has a relationship with CIPFA (Chartered Institute of Public Finance and Accountancy in the U.K.).