Importance of External Audit in Improvement of Financial Reporting in Public Institutions: Evidence from Kosovo

by
Mimoza Guda, Hysen Ismajli, Agon Ferati
University of Prishtina, Faculty of Economy, Bank, Finance and Accounting Department
University of Prishtina, Faculty of Economy, Bank, Finance and Accounting Department
Rochester Institute of Technology, Management, Public Policy and Economics Department
mimozaguda@gmail.com, hysen_rismajli@yahoo.com, agonferati@gmail.com

Abstract. The main purpose of this paper is to analyze the progress and readiness of Kosovo municipalities to address the recommendations of the Auditor General to enhance the quality of financial reporting. Management of public funds is one of the main criticisms faced by Kosovo institutions since their formation in 2001. Great importance in this respect plays the Office of the Auditor General (OAG) which serves as supervisor and controller of how public funds are spent by public institutions. Knowing that managing public funds is a very sensitive process dealing with taxpayers' funds, public institutions are required to adhere to principles derived from the Constitution and laws of the Republic of Kosovo, such as the principle of accountability, transparency, and efficiency in the management of public finances for every use of public funds.

In addition, this paper examines the compliance by municipalities of Kosovo with International Accounting Standards applied in the Public Sector (IPSAS) for cash basis financial reporting and local laws and regulations in preparing financial reports. This paper was conducted based on municipal financial reports of 2011-2012 and interviews held with the responsible persons for these reports.

As a result, main challenges of local government remain the deficiencies in almost all elements of financial reports and stagnation in addressing the recommendations of the OAG. Thus, municipalities are not in compliance with the principles of the Constitution and the laws for accountability, transparency and efficiency in the way public funds are spent.

Based on the results, the final section of this paper presents conclusions and recommendations.

Key words: Audit report, Financial reports, IPSAS, Public Institutions.
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1 Introduction

Kosovo, as one of the youngest countries in the world, is facing many problems recently. One of the main criticisms faced by Kosovo's institutions since their formation in 2001 is how they spend public funds. Various scandals for mismanagement of public funds and irregularities in financial reporting of public institutions shown during the transition period have raised questions about the role of general auditor and leaders of public institutions. In addition, the European Commission and the World Bank in Kosovo’s evaluation reports have made observations of misuses of public funds and lack of control over public finances.

Knowing that managing public funds is a very sensitive process dealing with taxpayers' funds public institutions are required to adhere to principles derived from the Constitution and laws of the Republic of Kosovo, such as the principle of accountability, transparency, and efficiency in the management of public finances for every use of public funds. All institutions are obliged to respect these principles in any other relation with citizens that can not necessarily be expressed in financial terms. Kosovo is a democratic country and in democracy every citizen has the right to know whether or not public funds are spent efficiently, honestly, and effectively.

In democracy every citizen has the right to ask for political and administrative accountability in regards to how taxpayers' funds are managed. In today's economic reality, where the globalization of markets prevails and in a complicated transition period the need to have reliable information on the management of public funds is inevitable. Great importance in this respect plays the Office of the Auditor General (OAG) which serves as supervisor and controller of how public funds are spent by
public institutions. OAG, except annual audit reports issued on municipalities also provides recommendations for each of the irregularities identified during the audit so that the same are adjusted or eliminated entirely. Even though six years have passed after the declaration of independence of Kosovo, still the main challenge of local government remains addressing the recommendations of the OAG. Thus, municipalities are not in compliance with the principles of the Constitution and the laws for accountability, transparency, and efficiency in the way public funds are spent.

In addition, this paper aims to analyze the impact and effects that audit of financial statements of public institutions in Kosovo has in detecting and eliminating irregularities identified by the OAG. Further, this analysis examines whether international accounting standards for Public Sector (IPSAS) in financial reporting on cash basis, regulations, guidelines and relevant laws were applied in preparation of the financial statements of municipalities and the progress and readiness of municipalities to address and eliminate findings and problems identified by the OAG in audited financial reports of the previous years.

2 Accounting and auditing in Kosovo

Accounting and auditing in Kosovo is regulated by the “Regulation No. 2001/30 for the establishment of the board of Kosovo’s financial reporting and financial reporting regime of Business Organizations”.

Board for Financial Reporting Standards in Kosovo is responsible for avulsion of accounting standards in accordance with International Accounting Standards (IAS) and decide which IAS standards will be applied taking into account the business environment in Kosovo. This Board is also responsible for avulsion of Auditing standards in accordance with ISAs.

1.2 The scope and mission of the Office of the Auditor General

The Auditor General is an independent constitutional institution and reports directly to the Assembly. The Auditor General is supported by an office, the Office of the Auditor General (OAG). The Auditor Generals mandate and duties are defined by the Constitution and the Law no. 03/L-075 on the Establishment of the Office of the Auditor General and Audit Office in Kosovo. The Auditor General is appointed by the International Civil Representative (ICR).

Ensuring our objectivity and independence is crucial. This should be assured by a proper execution of a broad, sustainable, and lawful mandate; compliance with professional audit standards; and a strong internal Code of Professional Conduct.

We carry out statutory annual regularity audits of the Kosovo Budget and Budget Organizations. We also have the right to carry out other forms of audit and follow budget funds to the final beneficiary. This is within our scope, but it is not annually statutory. Performance Audit is one of these types of audits carried out in order to assess whether the governmental programs are being managed properly, cost-effectively and efficiently, and whether systems for measuring and reporting their efficiency are in place.

OAG reports on their audits to the audited entities and to the Assembly (COPF). All reports are made public and published on their web site. Their reports contain recommendations addressing the most serious identified weaknesses. In doing this, they want to provide to the Assembly, Government and taxpayers a professional and integrated audit service.

OAG wants to assure the taxpayers and international donors that public funds are used economically, effectively and efficiently. OAG will do this by ensuring that public funds are reported, administrated, and used wisely and properly.

OAG currently performs only two roles: monitoring and making recommendations, which often are not enforced by Kosovo institutions. Lack of financial independence limits OAG in conducting legal obligations. The guaranty to stop corruption and to do efficient work is the financial stability of the OAG employees. The government could still
affect the budget and expenditures of the institution. However, ZAP has undertaken some very progressive steps since 2009, i.e. entry into force of certain additional documents to establish a professional audit system based on international standards and best audit practices:

- Code of Ethics and Auditing Standards - INTOSAI
- Regularity Audit Manual
- Resolution A / 66/209 adopted by the General Assembly of the United Nations for the independence of Supreme Audit Institutions
- Corporate Development Strategy
- Performance Audit Guide
- A guide to audit quality management

Despite meeting the expectations of a Supreme Audit Institution, the OAG cannot join INTOSAI due to the fact that Kosovo is not recognized by the United Nations. However OAG participates in various working groups of INTOSAI, as well as in external audit forums as observer.

1.3 Budget of Kosovo Municipalities

Public revenues and public expenditures should be equal in order for the process of public financing to be successful. It is not enough to ensure a certain amount of public revenue, but they should be sufficient to cover public expenditure. Every September, Kosovo municipalities are required to adopt the annual budget for the next fiscal year. The municipal governance structures have legislative responsibility for drafting and approving the annual budget of the municipality. Municipalities should develop and present two main documents to the Ministry of Finance - Medium Term Budget Framework and budget proposal and both documents must be approved by the Municipal Assembly. Most municipalities have failed to respect the deadline for submission of the budget proposal to the municipal assembly. Municipal budgets determine the allocation of scarce financial resources of municipalities. As such, public participation in the development of the municipal budget can contribute to create a budget that reflects the needs and priorities of the residents of the municipality and the municipality demonstrates commitment to the principles of good governance, such as transparency and accountability. In recent years, Kosovo has transferred a number of political, fiscal and administrative powers from the central government to the local level, as part of the overall process of decentralization. This process is in line with the European Charter of the Council of Europe for Local Self-Government and its protocols. Charter, which requires that the principle of self-government be enshrined in domestic law or the constitution, was the first international treaty that created the principle of the transfer of powers to the local level. It underlines that "public responsibilities generally performed as much as possible by the authorities who are closest to the citizen."

In Kosovo there are two levels of government: central and local level. In 2008, the Assembly has issued local government law, which states that the municipality is the basic unit of local self-government in Kosovo. The law provides fiscal autonomy for municipalities - municipalities have their own budgets and finances, which are regulated by the Law on Local Government Finance, for exercise of their powers.

Figure 1. Chain of accountability for the central budget organizations. Source: Ministry of European Integration
3 Deficiencies in financial reports of municipalities

3.1 Audit importance

The role of the audit is to ensure users of financial reports that these reports are fair, accurate and reliable, so that users can support their decisions based on these reports data. An audit involves research and verification of accounting data and examination of evidence (facts) which support information presented in the financial statements.

Furthermore, statement IX of INTOSAI in Lima, Peru in 1977 provides additional guidance on the scope of public sector audit:
- To reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to enable corrective measures in individual cases;
- To make those responsible to accept responsibility;
- To provide compensation or take measures to prevent such deviations or at least to make them more difficult.

3.2 Scope and methodology of audit in Kosovo municipalities

It is the responsibility of the Municipality to prepare financial statements in accordance with Financial Rule no.07/2011 and International Public Sector Accounting Standards (IPSAS) for “Financial Reporting under the Cash Basis of Accounting”. OAG or its subcontractors are responsible for conducting regularity audit including examination and evaluation of financial statements and other financial records and provide assurance on:
- Whether the financial statements give a true and fair view of the accounts and financial affairs for the audit period;
- Whether the financial records, systems and transactions comply with applicable laws and regulations;
- The appropriateness of internal controls and internal audit functions; and
- Any other significant matters arising from or relating to the audit.

Audit work reflects audit risk assessment for each municipality. The auditor considers the understanding of the organization to what extent can rely on managerial controls and detailed level of testing required in determining the overall tests which are required to ensure the appropriate level of evidence to support the opinion of the Auditor General.

The following sections provide a more detailed summary of the audit findings relevant to all Kosovo municipalities for financial year ended 31 December 2012 with special emphasis on the observations and recommendations in each area of review.

Audit procedures include a review of internal controls, accounting systems, and procedures only to the extent considered necessary for the effective conduct of audit.

The audit findings should not be considered as representing a comprehensive declaration of all the weaknesses that exist or all improvements that can be made in systems and procedures that have worked.

3.2.1 Audit of annual financial statements

Review of Annual Financial Statements (AFS) considers both compliance with the reporting framework and the quality and accuracy of the information recorded in the financial statements.

The audit approach focuses on understanding and evaluation of actions taken by management to ensure effective financial management and control.
For individual financial systems, the auditor seeks to identify the extent to which actual controls operate. Control systems must be supported (characterized) with clear procedures and guidelines approved by management, respectively by the Municipal Assembly. Effective controls help in better management of public finances, the preparation of reliable financial reports, maintenance of assets and ensure compliance with applicable laws and regulations.

Audit Company "KPMG" on behalf of the OAG has audited the annual financial statements ("AFS") of 11 municipalities out of the total 38 municipalities for the year ended December 31, 2012, while OAG has audited AFS of the rest municipalities, respectively 27 municipalities. Their audit was conducted in accordance with international auditing standards, developed by the International Organization of Supreme Audit Guidelines (INTOSAI) and included tests and procedures that are thought were necessary to give an opinion on the financial statements. Financial statements were supposed to be prepared and presented sincerely in accordance with International Public Sector Accounting Based on Cash (IPSAS) - Accounting Financial Reporting under the Cash Basis and Financial Regulation no. 07/2011 Annual Reporting of Budget Organizations. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation of financial statements that are free from material misstatement whether due to fraud or error.

3.2.2 Review of Compliance
In addition to the audit of financial statement, a compliance review was planned and performed to express a conclusion with limited assurance as to whether, in all material respects, activities, financial transactions and information reflected in the financial statements are in compliance with the authorities that govern them.

3.3 Analysis and findings
In order to arrive to a conclusion we have used reports of the OAG for all municipalities as at and for the year ended December 31, 2012. From 38 municipalities, 3 of them had not submitted financial reports at all and therefore the auditor was unable to perform his job. Auditor's main findings in almost all municipalities are:

The quality and accuracy of the information presented in the annual financial statements
Findings: The primary reliable source of information for the preparation of financial statements is Free Balance, the accounting software used by all municipalities. However, since Free Balance is not being used to record payments from third parties, property plant and equipment or outstanding invoices, it cannot solely be used to produce comprehensive financial statements as at and for the year ended December 31, 2012.
Recommendation: It is recommended that the preparation of the municipality’s financial statements should include procedures and tools that are designed to ensure that information required is recorded, processed, summarized, and appropriately reported in the financial statements.

Revenues
Findings:
- Billing systems. Municipalities do not maintain billing records for revenue except for tax on property. Instead only cash collections from such revenue streams are recorded.
- Collection of revenues. Except for taxes on property and business licenses, municipalities’ management does not maintain separate sub ledgers or lists of all its debtors from various taxes.
- Reconciliation of Revenues. No formal reconciliations of revenues collected were performed by the respective departments with the accounting department during the year 2012.
Recommendation: It is recommended that municipalities should consider to:
- Implement a billing system that includes updated details about the payers, their current address, history and collection rating. Such information should be accessible only to a limited number of
persons and with the authorization of management.

- Enter and centrally control the approved tariffs and tax rates in the system in order to calculate and generate bills automatically.
- Automatically link the operational and billing units and perform regular reconciliations between them, in cases where the billing is directly related to services supplied by the operational units.

**Procurement**

Finding: during the inspection of the procurement files the auditor has noted some non compliance with procedures as required by Public Procurement Law PL 04/L-042.

Recommendation: It is recommended that municipalities take further steps to improve controls over expenses and payments and strictly comply with laws and local regulatory requirements.

**Assets**

**Handling of receivables**

Findings: The Municipality does not have in place a robust process for identifying, evidencing and following up on issued invoices for its taxes. The Municipality has not taken necessary actions to collect these amounts and no aging analysis is maintained.

Recommendation: It is recommended that the Mayor ensures a process is designed and established, which ensures that receivables are recorded upon issuing of each invoice and that overdue amounts are followed up regularly.

**Capital and non capital assets**

Finding: Although the municipalities have prepared and disclosed a list of real estate property in Note 30, for certain assets, there are uncertainties regarding ownership rights of the municipality or various other Kosovo Government Agencies and lack of supporting ownership documentation.

Due to a lack of supporting documentation for the measurement of a significant part of its property, plant, and equipment, municipalities sought to measure such items at fair value based on a valuation performed by an internally established committee.

Recommendation: It is recommended that management should involve additional resources in the registration, control, and valuation of the assets of the municipality.

**Internal Audit System**

Findings: Municipalities have not established an audit committee.

Recommendation: It is recommended that management should ensure that municipalities consider the establishment of an audit committee with members having relevant expertise of financial reporting and internal controls. The audit committee should establish appropriate policies and procedures to ensure a high standard of corporate governance.

All these findings and recommendations have existed almost entirely in the auditor's reports for the previous year and only in some municipalities a very small part of the recommendations were implemented.

The following are the key findings for all municipalities highlighted in the auditor's reports as at and for the year ended December 31, 2011.

![Figure 3. Key findings in the auditor report for the year 2011 Source: Municipalities annually reports for 2011](image)

Not all of these audit recommendations were implemented by municipalities in 2012. The figure below shows the implementation of recommendations from municipalities in 2012, for the above findings.
Figure 4. Implementation of 2011 findings in 2012.
Source: Municipalities annually reports for 2011 and 2012

- 35 out of 38 municipalities have submitted financial reports
- Purchasing through procurement - findings in 34 municipalities: 6 have fully addressed the recommendation, 18 partly, and 10 have not addressed at all.
- Wages and salaries - findings in 10 municipalities: 3 have fully addressed the recommendation, 5 partly, and 2 have not addressed at all.
- Compliance with the reporting framework - findings in 28 municipalities: 12 have fully addressed the recommendation, 6 partly, and 10 have not addressed at all.
- Internal audit system - findings in 29 municipalities: 8 have fully addressed the recommendation, 8 partly, and 13 have not addressed at all.
- Internal control system - findings in 27 municipalities: 5 have fully addressed the recommendation, 13 partly, and 9 have not addressed at all.
- Subsidies and transfers - findings in 23 municipalities: 10 have fully addressed the recommendation, 5 partly, and 8 have not addressed at all.
- Revenues - findings in 31 municipalities: 1 has fully addressed the recommendation, 15 partly, and 15 have not addressed at all.
- Handling of capital and non-capital assets - findings in 30 municipalities: 4 have fully addressed the recommendation, 13 partly, and 13 have not addressed at all.
- Handling of debts - findings in 26 municipalities: 7 have fully addressed the recommendation, 9 partly, and 10 have not addressed at all.
- Handling of accounts receivable - findings in 20 municipalities: 5 have fully addressed the recommendation, 5 partly, and 10 have not addressed at all.

4 Conclusion and recommendations

Accountability in public resources is very important in the process of administration and is the key to a healthy democracy. The audit of public institutions is primarily the interest of the citizens since they are the major taxpayers and contributors to the state budget and as a result these institutions are funded by these funds. Audit plays a major role in assessing the financial position of public institutions since it evaluates the financial condition of an institution and as a result the management of public funds.

Auditors should pay more attention to those elements that risk of manipulation and overriding of controls by the responsible officers is greater and assess whether they can rely on internal controls and internal auditor’s work performed.

The overall conclusion reflects the review of the controls associated with the AFS, Financial Management and Control and the Internal Audit System. As a result of the tests performed it was noted that there are significant weaknesses in internal controls in all municipalities. This is reflected in the poor quality of the AFS, weaknesses in management operating controls in the areas highlighted by the auditor and areas of special concern in a number of activities and responsibilities of municipalities.

Audit recommendations are intended to support the municipality in improving financial controls and increase other aspects of operational activity. The external auditor has considered the responses to the recommendations made in the year 2011.
It is recommended that further action is needed by all municipalities to address some important recommendations from the last year. All municipalities have many deficiencies in internal controls in many areas. The importance of internal control of public finances is little understood by management and professional staff of municipalities. Reasons for qualified opinion or opinion with emphasis of matter for previous years are repeated year after year. The financial statements have not been prepared in full compliance with the requirements of financial rule 07/2011 and IPSAS.

Further, it was analyzed the quality of the information presented in the financial statements and it was found that in some areas these are incomplete and inaccurate. Audit recommendations are rarely addressed by management. Therefore, management approach should eventually change and accountability must be strengthened at all levels.

Having analyzed all the findings and weaknesses identified by the external auditor in the AFS of municipalities, management of all municipalities should address the following recommendations:

- Must raise awareness of leaders about the role of the external auditor and the effects of its findings and recommendations;
- Must raise awareness of managers and all municipal staff about the needs for internal controls;
- Extraction of clear policies and procedures for all processes;
- Increasing the responsibility and accountability measures and be applied at all levels of the organization;
- A review of the internal control system is unavoidable in all municipalities to ensure effective functioning and be in compliance with all laws and regulations;
- Management of each municipality should establish a working group to analyze in depth all audit findings and propose appropriate measures to eliminate all deficiencies, weaknesses, and irregularities identified.

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Authors’ description

Mimoza Guda:
Affiliation: University of Prishtina “Hasan Prishtina”, Faculty of Economy, Kosovo
Education: MSc, Banking, Financing and Accounting Department
Fields of interest: Finance, Audit and Accounting.

Hysen Ismajli:
Affiliation: University of Prishtina “Hasan Prishtina”, Faculty of Economy, Kosovo
Education: Prof. Asoc.Dr, Banking, Financing and Accounting Department
Fields of interest: Finance, Audit and Accounting.

Agon Ferati:
Affiliation: Rochester Institute of Technology, NY
Education: BSc, Management, Public Policy and Economics Department
Fields of interest: Finance, Audit and Management.