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AUDIT REPORT

**ON ANNUAL FINANCIAL STATEMENTS OF THE MINISTRY OF
LOCAL GOVERNMENT ADMINISTRATION FOR THE YEAR ENDED
ON 31 DECEMBER 2010**

Prishtina, June 2011

TABLE OF CONTENT

Executive Summary.....	4
I. Introduction	5
II. Audit Opinion.....	6
III. Status of Prior Years Recommendations.....	7
IV. Financial outcome against the approved budget	8
V. Financial Statements.....	9
V.1 Compliance regarding the external reporting.....	9
V.2 Information Quality.....	10
VI. Budget Execution	10
VI.1 Expenditures.....	10
VI.2 Assets and Debts	13
VII. Management Control.....	14
VII.1 Internal Control Systems.....	14
VII.2 Internal Audit	14
VIII. Overall conclusion on Management of MLGA.....	15
Annex I. MLGA Comments and OAG responses	16
Annex II. Different types of Audit Opinions.....	16

Lista e shkurtesave

AC	Audit Committee
AFS	Annual Financial Statements
AG	Auditor General
AI	Administrative Instruction
CAO	Chief Administrative Officer
CBK	Central Bank of Kosova
EO	Economic Operator
IA	Internal Audit
IAS	International accounting Standards
IAU	Internal Audit Unit
ICO	International Civilian Office
INTOSAI	International Organization of Supreme Audit Institutions
IPSAS	International Public Sector Accounting Standards
KFMIS	Kosovo Financial Management Information System
LIA	Law on Internal Audit
LPFMA	Law no. 03/L-48 on Public Financial Management and Accountability
LPP	Law no.02/L-99 on Public Financial Management as amended and supplemented on 8 th of February 2007, including new law, no. 03/L-241 in place from 01 December 2010.
MEF	Ministry of Economy and Finance
MEST	Ministry of Education, Science and Technology
MLGA	Ministry of Local Government Administration
OAG	Office of the Auditor General
SAI	Supreme Audit Institution

Executive Summary

The Office of the Auditor General (OAG) has carried out an audit of the Annual Financial Statements of the Ministry of Local Government Administration (MLGA) for the year ended 31 December 2010.

Our audit was carried out in accordance with international auditing standards issued by INTOSAI and included such tests and procedures as we deemed necessary to arrive at an opinion on the financial statements.

In forming our opinion we have evaluated the overall adequacy of the presentation of information in the financial statements.

In our opinion the financial statements *in all material aspects* present a true and fair view.

We would like to draw your attention to the fact that the disclosed information on fixed assets is incomplete and inaccurate. The Ministry did not disclose payments from third parties.

The incomplete disclosure of fixed assets does not affect our opinion on the main financial statements compiled in accordance with the IPSAS for Cash Based Accounting.

(ISSAI 400: *Unqualified Opinion with an Emphasis of Matter*)

Our audit has identified weaknesses in several areas of financial management. These weaknesses are described more in depth in the report which should be addressed by the management in order to improve the Organization's performance.

The audit report of 2009 resulted with 12 recommendations. Out of which, six were fully addressed, whilst the other six were in the process of being addressed.

Our main recommendation to the Minister of MLGA is to ensure that clear instructions and procedures are developed, which assist in addressing the weaknesses and shortcomings identified in this report.

We recommend you to particularly ensure that:

- All recommendations given in 2009 are addressed;
- Overall controls over budget planning, monitoring and use are increased;
- Annual Financial Statements are prepared fully in accordance with the AIs and Regulations on Annual Reporting of Budget Organizations;
- Controls over all phases of procurement are strengthened;

- Overall controls over monitoring and use of subsidies are increased;
- All assets are accurately registered and disclosed in financial statements; and
- Internal Audit is further strengthened.

The Management of the Ministry has been given the opportunity to give comments on the draft of this report.

The Management of the Ministry has acknowledged our findings and conclusions presented in the audit report on the AFS for the year 2010 and committed themselves to make every effort to address all recommendations given.

I. Introduction

This audit relates to the annual financial statements of MLGA for the year ended 31 December 2010.

It is the responsibility of MLGA to prepare financial statements in accordance with the Administrative Instruction 16/2010 and International Public Sector Accounting Standards (IPSAS) for “Financial Reporting under the Cash Basis of Accounting”.

The Office of the Auditor General is responsible for carrying out annual regularity audits of MLGA.

A Regularity Audit is defined as an attestation of financial accounting, involving examination and evaluation of Financial Statements and other financial records and expression of opinions 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
- All matters arising from or relating to the audit.

We have carried out an interim audit of the MLGA. During that stage of the audit process we addressed the MLGA’s handling of recommendations given earlier and the quality of financial management. Based on this we have given advices to the management through an audit memo submitted in December 2010.

In order to fulfil our responsibilities for the audit of MLGA, we have undertaken the following activities:

- Reviewed the MLGA Annual Financial Statements against the approved budget for 2010;
- Determined whether the MLGA Annual Financial Statements were prepared in accordance with IPSAS “Financial Reporting under the Cash Basis of Accounting” and Administrative Instruction no. 16/2010;
- Established a materiality level of revenues and expenditures, as a threshold for assisting in determining the type of opinion to render on the financial statements;
- Used a combination of judgment and random sampling to select transactions for testing;
- Undertaken extensive substantive testing of financial transactions;
- Relied on a combination of interviews, analytical reviews, document reviews, and physical verification to assess the validity and propriety of financial transactions; and
- Assessed the quality of work of the Internal Audit within MLGA.

In this report we summarise this year’s audit and give a formal opinion on the Annual Financial Statement 2010.

In regard to our audit opinion for MLGA annual financial statements, the international auditing standards set out specific criteria that govern the type of opinion that can be rendered.

These are set out more fully in Annex 2.

II. Audit Opinion

In our opinion the financial statements *in all material aspects* present a *true and fair view*.

We would like to draw your attention to the fact that the disclosed information on fixed assets is incomplete and inaccurate. The Ministry did not disclose payments from third parties.

The incomplete disclosure of fixed assets does not affect our opinion on the main financial statements compiled in accordance with the IPSAS for Cash Based Accounting.

(ISSAI 400: *Unqualified Opinion with an Emphasis of Matter*).

III. Status of Prior Years Recommendations

Our audit report of the Financial Statements for 2009 resulted in 12 recommendations. Out of which, six have been fully addressed related to: Employees contracts to be signed by the Personnel Manager, Goods should be received by the authorized officer, Procurements to be conducted in accordance with procurement plan, Capital Investment Projects co-financed by MLGA and municipalities have been carried forward as assets to respective municipalities, pay withholding taxes and establishment of an Audit Committee.

The recommendations in the process of implementation are the following:

- Adherence to all requirements stemming out of AI on preparation of financial statements;
- Increase of overall controls related to budget planning, monitoring and use;
- Develop procurement procedures in accordance with applicable laws;
- Management of subsidies;
- Registration of non-financial assets as required under AI no. 21/2009; and
- A more functional Internal Audit Unit.

The failure to fully address our given recommendations has caused similar problems as previous years in the Ministry. Therefore, we express our concern for all unaddressed recommendations.

IV. Financial outcome against the approved budget

The analysis of the outcome in the Financial Statements versus the Approved Budget shows:

Table 1: Overview of budgets and spending **In euro (€)**

Description	Initial Budget	Reviewed Budget	Final Budget	Outcome 2010	Outcome 2009
Government Grant - Budget	10,257,499	9,517,664	9,476,026	8,239,812	10,479,062
Domestic Donations	-	-	-	-	-
External Donations	-	65,846	65,846	65,846	-
I. Total of revenues and transfer of Donations	10,257,499	9,583,510	9,541,872	8,305,658	10,479,062
Wages and Salaries	439,553	680,123	618,301	610,831	526,452
Goods and Services	499,857	699,969	813,805	749,073	538,559
Utilities	30,000	48,435	48,435	33,642	24,539
Subsidies and Transfers	437,249	437,249	437,249	391,406	435,400
Capital Investments	6,583,852	6,566,805	7,620,511	6,520,706	8,954,112
Reserves – from the Contingent Fund	2,266,988	1,150,929	3,571	0	0
II. Total of Expenditures	10,257,499	9,583,510	9,541,872	8,305,658	10,479,062

During 2010, the MLGA spent €8,305,658 or 87% of the final budget. Compared to 2009, MLGA total expenditures decreased for 21% due to the fact of decrease of budget appropriation from the Contingent Fund.

Under the appropriation 2010, the amount of €2,266,988 was allocated in the program of Contingent Expenditures. These funds were allocated to MLGA for the purpose of financial support to the establishment of new municipalities (Gracanica, Klllokot, Partes, Ranilug), and capital investments in these Municipalities. Allocation of funds from this category was made with the consent of the International Civilian Office (ICO). Under the decision no. 02/150 of the Government of Kosovo dated 23.12.2010, €752,674 were taken from the program of Contingent Expenditures for the new municipalities, further on €7,987 was transferred to MEST from the category of Capital Expenditures for the project “Buying Books” (school

materials) from grade 1 to 9. Further on, we noticed a tendency of increasing the expenditures in Capital Investment in the end of the financial year. 58% of the total expenditures from this category incurred in the last three months. The high level of expenditures within Capital investments for the last three months indicates that there are weaknesses in budget planning, management and execution.

Conclusion

According to our assessment MLGA did not spend the overall budget for 2010 effectively.

At the same time, spending the 58% of the budget for capital investment in the last quarter bears the risk that payments could be made with no proper control. This is a consequence of failures in carrying out procurements in a timely fashion.

Recommendation 1

We recommend the MLGA Minister to ensure that:

- Overall controls related to planning, monitoring and use of budget are increased; Especially the improvements are focused towards a planning of cash flow and allocation of expenditures is made on quarterly basis; and
- Planning of procurement processes is improved in terms of time.

V. Financial Statements

V.1 Compliance regarding the external reporting

Based on the requirements in LPFMA no. 03/L-048 and Administrative Instruction 16/2010, we identified the following:

- The Ministry has prepared the FS in compliance with AI no. 16/2010 on Annual Reporting of Budget Organizations, with the exception of disclosures of assets and payments from third parties;
- FS have been prepared in accordance with IPSAS “Financial Reporting under Cash Basis of Accounting”;
- FS have been signed on 31.01. 2011 by the Chief Administrative Officer and Chief Financial Officer;
- FS were submitted to the MEF / Treasury on 6th of April 2011, after the foreseen time limit, due to changes in Article 10 of FS;
- FS have been prepared only in Albanian; and

- Quarterly financial reports were not submitted to the Minister of MEF in 2010.

V.2 Information Quality

The MLGA's financial statements prepared on 31.01.2011 for the year ended on 31 December 2010 were not in accordance with Administrative Instruction no.16/2010. They contained material errors and were incorrect. Therefore, during the audit process we have requested from MLGA to correct the original version of financial statements.

MLGA financial statements were corrected after our request and sent to the Treasury for the second time. However, there are still some mistakes left without being corrected.

The following inaccuracies were not corrected by the Management:

- Payments from third parties were not disclosed (€5,846); and
- Note 27, Summary of non-financial assets in financial statements is not met completed under AI 16/2010.

Conclusion

Failure to disclose assets and payments from third parties in the financial statements makes these statements less usable.

Recommendation 2

We recommend the MLGA Minister to ensure that:

- In preparing financial statements all requirements stemming from AI and other legal requirements on external reporting are taken into account.

VI. Budget Execution

VI.1 Expenditures

1.1 Purchases through Procurement

We have tested 69 samples that cover 4,579,969€ of expenditure payments carried out through procurement procedures. We noticed that the Ministry has undertaken procurement procedures not in compliance with the Law on Public Procurement.

Payments for capital investments from the Category of subsidies

Regarding the project “Construction of sewerage in the village Dardhishte”, in amount of €1,448, the payment was made from the category of subsidies. No funds were transferred from subsidies to the capital investments as compensation.

Registration of expenditures in wrong codes

In the contract “Supply with woods for social categories in a multiethnic quarter in the suburban part – Mitrovica” in amount of €30,000, the payment is recorded in the code for Capital Expenditures, and not in the category of Goods and Services.

Conclusion

Registration of expenditures in wrong codes reflects inaccurate positioning of expenditures.

Recommendation 3

We recommend the MLGA Minister to ensure that:

- For each change in designation of funds, firstly all required approvals are secured and then to proceed with changing the economic code,

1.2 Other Purchases

Exceeding the limit set for expenses of the land line phones

We have reviewed the landline phone expenses for three months, and noticed an excess of spending limits set by the AI no. 04/2008 on the use of phones in the Government of the Republic of Kosovo. We have noticed that expenses for land line for 2010 have exceeded the limits set for their use despite the steps taken by the Management.

Conclusion

MLGA does not have adequate controls which would reasonably ensure that telephone expenses incurred according to the defined limits. This increases the risk that public funds are irrationally spent.

Recommendation 4

We recommend the MLGA Minister to ensure that:

- Controls over phone expenses are strengthened in order that those expenditures are in line with defined ceilings; and
- All officers that have exceeded the allowed ceilings are identified and overspent amounts are reimbursed to the Budget of the Ministry.

1.3 Remunerations (wages and salaries)

The budget for wages and salaries in MLGA was €18,301 while, according to data in FS, €10,831 were spent in this category or 99% of the approved budget. According to the final budget, MLGA has 116 employees. Out of them, 96 are regular employees, while 20 employees are paid from the contingent fund as Preparation teams for new Municipalities.

The Regulation no. 2001/36 on civil service stipulates that management of personnel files requires timely update, by completing them with the required documents.

We noticed that the personnel files in 10 cases were not properly updated and sorted, and MLGA officers do not sign the monthly payroll list.

Conclusion

The failure to properly update the employees' file and payroll not signed by officials, present some of the internal control shortcomings within the Human Resource management.

Recommendation 5

We recommend the MLGA Minister to ensure that:

- Personnel files are continuously maintained and updated with all required changes and information as well as all payroll lists are signed by each officer within the Ministry.

1.4 Subsidies and Transfers

The budget for the category of subsidies was €437,249 while, according to AFS there were spent €391,406 or 90% from this category.

Use of Subsidies in MLGA was not fully transparent. Subsidies paid to a designated entity or a private enterprise should be based on a formal agreement between the budget organization and recipient of the subsidy. During testing of this category, we have noticed:

Payment projects from the category of Subsidies

In one case, under the decision dated 23.10.2010 by Permanent Secretary, €30,000 have been allocated for the project of "professional oversight, design and revision of projects in the MLGA. Such allocation of means cannot be classified as a subsidy.

Conclusion

We conclude that despite our earlier recommendations, MLGA failed to establish better controls related to management of subsidies.

Failure to apply clear procedures and criteria increases suspicion if expenditures are in line with financial rules for the use of the category of subsidies.

Recommendation 6

We recommend the MLGA Minister to ensure that:

- A legal framework is drafted specifying clearly all criteria for giving subsidies.

VI.2 Assets and Debts

2.1 Capital and non- capital assets

MLGA Management was not able to provide any accurate evidence on physical counting of assets as of 31 December 2010. Consequently, we could not verify the data in the accounting with those of physical counting. We have noticed that MLGA has established a committee for asset registration and inventory on 14.02.2011. However, the report on asset inventory is not completed yet.

MLGA registered in KFMIS, all capital investment projects financed in the municipalities as their own property. Nevertheless, after these projects are finalized, they have sent a request to Treasury for transferring these assets in the respective Municipalities.

Conclusion

MLGA does not have adequate controls over the effective management of own assets. Further on, the lack of an accurate register and complete data on assets makes it impossible for the management of the Ministry to have a real statement of assets and apply appropriate controls.

Recommendation 7

We recommend the MLGA Minister to ensure:

- A comprehensive register of assets, premises and equipments and that the same are registered and disclosed in financial statements; and
- Regular physical counting over the existence of assets and reconcile the outcome of counting with the asset and accounting register.

VII. Management Control

VII.1 Internal Control Systems

The chapters described above have identified weaknesses of internal control within MLGA. Shortcomings are noticed starting from reporting/drafting of qualitative financial statements, low level of budget execution, uncontrolled phone expenses, subsidies given, up to poor asset management.

Conclusion

Current internal controls in MLGA do not provide sufficient assurance in order to prevent, detect and correct errors and irregularities in the organization.

Recommendation 8

We recommend the MLGA Minister to ensure that:

- Functional review of administrative procedures and internal control is made by analyzing whether current design and implementation are appropriate. Where failures are identified procedures and controls are strengthened or new measures are proposed in order to be completely effective and in line with set objectives; and
- For officers who have lack of knowledge in certain areas, additional capacity building is provided.

VII.2 Internal Audit

MLGA has an IAU which consist of the Internal Audit Director and one officer. IAU prepared an annual audit plan, which foresaw that eight audits should be carried out. During the year, IAU managed to finalize five reports: two reports according to the annual plan and three reports upon the request of the Minister and Permanent Secretary. As understood the unit did not fulfil the annual audit plan.

Internal audit was more focused in covering 2009. This is not consistent with the concept and nature of internal audit as a service giving suggestions on more qualitative development of operational activities and continuous improvement of internal control.

Further on, findings and recommendations of the IAU are not properly addressed. We have not noticed any action plan for their implementation from the respective departments.

MLGA established an Audit Committee on 31.01.2011, in composition of three members.

Conclusion

In 2010, IAU failed to fulfill the role as an assurer of implementing internal controls. Lack of management action on internal audit recommendations is notable. The lack of an Audit Committee might also be an explanation to the limited actions on external audit recommendation.

Recommendation 9

We recommend the MLGA Minister to ensure that:

- IAU when preparing the annual audit plan is focused more on the processes and activities if the current year;
- IAU recommendations are addressed by the Management under concrete action plans deriving from respective Departments; and
- The Audit Committee is strengthened for ensuring appropriate oversight of Audit plans and outcomes.

VIII. Overall conclusion on Management of MLGA

Overall Conclusions

Our conclusion is that financial management and general controls within MLGA in general functions well. Still there are some weaknesses that need to be improved. Budget execution rate of 87% is a clear indication that MLGA needs to improve budgetary policies. Even this year, MLGA did not manage to prepare AFS fully in line with legal framework. The problem of registration and disclosure of all assets is also followed from year to year. MLGA has not yet provided the deserved space to internal audit, which we think would help to a large extent in improving and setting appropriate controls.

However, compared to last year we have noticed a good progress. MLGA should make further efforts to eliminate weaknesses and deficiencies identified in this report.

Overall Recommendation

We recommend the Minister to carefully review and analyse the areas with shortcomings emphasized in this report and take proper actions as recommended in the report.

Annex I. MLGA Comments and OAG responses

The Management of the Ministry has acknowledged our findings and conclusions presented in the audit report on the AFS for the year 2010 and committed themselves to make every effort to address all recommendations given.

Annex II. Different types of Audit Opinions

(extract from ISSAI 400)

9. An audit opinion is normally in a standard format, relating to the financial statements as a whole, thus avoiding the need to state at length what lies behind it but conveying by its nature a general understanding among readers as to its meaning. The nature of these words will be influenced by the legal framework for the audit, but the content of the opinion will need to indicate unambiguously whether it is unqualified or qualified and, if the latter, whether it is qualified in certain respects or is adverse (paragraph 14) or a disclaimer (paragraph 15) of opinion.

10. An unqualified opinion is given when the auditor is satisfied in all material respects that:

- (a) the financial statements have been prepared using acceptable accounting bases and policies which have been consistently applied;
- (b) the statements comply with statutory requirements and relevant regulations;
- (c) the view presented by the financial statements is consistent with the auditor's knowledge of the audited entity; and
- (d) there is adequate disclosure of all material matters relevant to the financial statements.

11. Emphasis of Matter. In certain circumstances the auditor may consider that the reader will not obtain a proper understanding of the financial statements unless attention is drawn to unusual or important matters. As a general principle the auditor issuing an unqualified opinion does not make reference to specific aspects of the financial statements in the opinion in case this should be misconstrued as being a qualification. In order to avoid giving that impression, references which are meant as "emphasis of matter" are contained in a separate paragraph from the opinion. However, the auditor should not make use of an emphasis of matter to rectify a lack of appropriate disclosure in the financial statements, nor as an alternative to, or a substitute for, qualifying the opinion.

12. An auditor may **not be able to express an unqualified opinion when** any of the following circumstances exist and, in the auditor's judgement, their effect is or may be material to the financial statements:

- (a) there has been limitation on the scope of the audit;
- (b) the auditor considers that the statements are incomplete or misleading or there is an unjustified departure from acceptable accounting standards; or
- (c) there is uncertainty affecting the financial statements.

13. Qualified Opinion. Where the auditor disagrees with or is uncertain about one or more particular items in the financial statements which are material but not fundamental to an understanding of the statements, a qualified opinion should be given. The wording of the opinion normally indicates a satisfactory outcome to the audit subject to a clear and concise statement of the matters of disagreement or uncertainty giving rise to the qualified opinion. It helps the users of the statements if the financial effect of the uncertainty or disagreement is quantified by the auditor although this is not always practicable or relevant.

14. Adverse Opinion. Where the auditor is unable to form an opinion on the financial statements taken as a whole due to disagreement which is so fundamental that it undermines the position presented to the extent that an opinion which is qualified in certain respects would not be adequate, an adverse opinion is given. The wording of such an opinion makes clear that the financial statements are not fairly stated, specifying clearly and concisely all the matters of disagreement. Again, it is helpful if the financial effect on the financial statements is quantified where relevant and practicable.

15. Disclaimer of Opinion. Where the auditor is unable to arrive at an opinion regarding the financial statements taken as a whole due to an uncertainty or scope restriction which is so fundamental that an opinion which is qualified in certain respects would not be adequate, a disclaimer is given. The wording of such a disclaimer makes clear that an opinion cannot be given, specifying clearly and concisely all matters of uncertainty.

16. It is customary for SAIs to provide a detailed report amplifying the opinion in circumstances in which it has been unable to give an unqualified opinion.