



INTERNAL AUDIT DIVISION

AUDIT REPORT

Comprehensive Interim Audit of UNMIK Mandate Implementation - Pillar IV

10 March 2008

Assignment No. AP2007/650/15

United Nations  Nations Unies

INTEROFFICE MEMORANDUM

MEMORANDUM INTERIEUR

INTERNAL AUDIT DIVISION · DIVISION DE L'AUDIT INTERNE

OFFICE OF INTERNAL OVERSIGHT SERVICES · BUREAU DES SERVICES DE CONTRÔLE INTERNE

TO: Mr. Joachim Rücker,
A: Special Representative of the Secretary-General, UNMIK

DATE: 10 March 2008

REFERENCE: IAD: 08-01115

FROM: Dagfinn Knutsen, Director
DE: Internal Audit Division, OIOS



SUBJECT: **Assignment No. AP2007/650/15 - Comprehensive Interim Audit of UNMIK Mandate**
OBJET: **Implementation - Pillar IV**

1. I am pleased to present the report on the above-mentioned audit.
2. In your 4 February 2008 memorandum to OIOS, you indicated that UNMIK was not prepared to comment on the draft report, as it did not constitute the correct basis for OIOS recommendations. In OIOS' opinion, however, the findings and recommendations provided in the report identify the main areas for improvement concerning the implementation of the UNMIK mandate. It is also an obligation of the UNMIK Administration to cooperate with OIOS in providing comments on each recommendation outlined in the draft report.
3. OIOS would like to clarify that all findings and tentative recommendations had been discussed with the UNMIK Administration at the exit conference held on 9 August 2007. Therefore, this report has incorporated UNMIK's comments made at the exit conference, as well as the commentaries from your 4 February 2008 response to the draft report. In order for us to close the recommendations, we request that you provide us with information as discussed in the text of the report and also summarized in Annex I.
4. Please note that OIOS will report on the progress made to implement its recommendations, particularly those designated as critical (i.e., recommendations 1, 2, 3, 4, 7, 8, 10, 11, 13, 14, 15, 18, 20, 24 and 25) in its annual report to the General Assembly and semi-annual report to the Secretary-General.

cc: Mr. Jean-Marie Guéhenno, Under-Secretary-General for Peacekeeping Operations
Mr. Philip Cooper, Director, DFS
Mr. Lawrence Rossin, Principal Deputy SRSG, UNMIK
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INTERNAL AUDIT DIVISION

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EXECUTIVE SUMMARY

Comprehensive Interim Audit of UNMIK Mandate Implementation - Pillar IV

At the request of the Special Representative of the Secretary-General (SRSG), the Office of Internal Oversight Services (OIOS) conducted a comprehensive interim audit of the United Nations Interim Administration Mission in Kosovo (UNMIK) mandate implementation. The overall objective of the audit of UNMIK Pillar IV was to assess the governance, risk management and internal control systems and practices that support key economic institutions entrusted to UNMIK Pillar IV in accomplishing its mandate. This report contains the interim results on UNMIK Pillar IV. The audit was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing. OIOS plans to conduct further reviews of UNMIK's mandate implementation in 2008.

Significant deficiencies were identified in governance and internal controls at the Kosovo Trust Agency (Agency or KTA), which has responsibilities in facilitating the implementation of economic reconstruction and development of Kosovo as prescribed in the KTA Regulation. OIOS was of the opinion that UNMIK and the KTA Board of Directors operated the Agency in a way that did not show due regard for adherence to the KTA Regulation, corporate governance principles and policies, financial fiduciary responsibilities, and public accountability requirements. This has resulted in a weak corporate governance framework that represents significant risk to the effective performance and financial sustainability of the Agency and the Enterprises under its administration. OIOS also noted weaknesses in the governance and/or internal oversight frameworks at the Regulatory Bodies, UNMIK Customs Service and the Central Banking Authority of Kosovo.

Kosovo Trust Agency

- The KTA Board of Directors (KTA Board) has not complied with key sections of the KTA Regulation that support public accountability, oversight, and financial fiduciary stewardship of the Agency's resources. And UNMIK failed to take corrective actions in a timely manner.
- The KTA Board contravened the KTA Regulation and the Agency's corporate governance policies, and did not observe corporate governance principles and guidelines set out by the Organization for Economic Co-operation and Development (OECD), by approving two politically active members to the Board of Directors of the Kosovo Energy Corporation J.S.C. (KEK). One of the approved members is in a material conflict of interest. Actions taken by the KTA Board compromise the credibility of the KTA Board as well as the Agency's corporate governance system. UNMIK should provide full disclosure on the conflict of interest and how it will be managed and resolved.
- Independent external audits were not conducted on the Agency's financial accounts for the fiscal years 2002 to 2005. The Agency's operating funds

represent about 10 per cent of the Kosovo Consolidated Budget expenditure appropriations, and totaled €71 million in 2007. In addition, the Agency has not conducted external audits on its trust accounts for the fiscal years 2002 to 2006. The Agency's trust accounts total over €331 million, and are managed through 1,021 bank accounts which require monthly recording and reconciliation. Overall, mechanisms that provide independent assurance that the Agency's accounts were fairly stated and properly managed were not functioning. There is an urgent requirement for UNMIK to conduct the outstanding statutory audits.

- The Agency's financial accounting and information system is inadequate. The spread-sheet based financial management system is inappropriate for the size and complexity of KTA's operations. The financial management system is widely exposed to errors, and potential fraud and mismanagement due to weaknesses in fundamental accounting controls. The system does not provide KTA Management and Board with adequate financial information to monitor and analyze performance of the Agency. Urgent attention is required from UNMIK in this area.
- The Agency's internal audit function does not provide regular independent checks on Management's financial controls and operational processes. In addition, the KTA Board has not established an audit committee. This has weakened both the effectiveness of the internal audit function and oversight of financial management in the Agency and Enterprises. The KTA Board should give priority in establishing an effective audit committee and an independent internal audit function at the Agency.
- Publicly-owned Enterprises (POEs), which are administered by KTA, have yet to develop basic financial systems and controls, and do not produce financial statements that meet international standards. Financial management systems in the POEs are therefore exposed to a high risk of error, poor decision-making, fraud and corruption. The Agency has been slow to take responsibility and action to address these weaknesses. There is a need for an action plan that brings the POEs in line with international financial accounting and reporting standards.
- UNMIK and the Kosovo Energy Corporation J.S.C. (KEK) have not accounted for and disclosed outstanding receivables attributed to enclave areas, estimated at over €90 million (July 1999 to July 2007), and are accumulating at a rate of €15 million per year. There is a need for UNMIK to establish a policy on this issue and develop formal accounting and control mechanisms.

Regulatory Bodies, UNMIK Customs Service and the Central Banking Authority of Kosovo

- OIOS noted that there were concerns about the independence of the regulatory bodies in terms of the appointment of board members and inadequate separation between the executive function of the regulator and the regulator's board. There is a possibility of undue influence over the

regulatory bodies if their budgets are set by the Ministries rather than by the Assembly of Kosovo.

- Recruitment and retention problems have also been noted at certain regulatory bodies caused primarily by the large pay differential between employees of the regulators and the prevailing market rates paid in the sectors being regulated.
- None of the regulatory bodies has an internal audit unit or an audit committee, which breaches the related Law on Internal Audit, and the internal oversight framework needed improvement in the UNMIK Customs Service and the Central Banking Authority of Kosovo.

In commenting on the draft report, the UNMIK Administration stated that it did not provide rationale and context, or the evolution of UNMIK's mandate over the years, and therefore did not constitute the correct basis for recommendations provided by OIOS. UNMIK further commented that although there was merit to a number of points raised by OIOS in the draft report, in their view, the report did not provide a complete and comprehensive description of UNMIK Pillar IV's overall function and performance.

OIOS does not agree with this assessment and points out that the audit was as comprehensive as possible within the timeframe and the resources available. In this regard, OIOS would like to point out that the audit of UNMIK Pillar IV activities focused on the areas presenting the higher risks to the achievement of UNMIK's objectives. OIOS presented its risk-based audit approach to the UNMIK Administration at the commencement of the audit.

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I. INTRODUCTION

1. At the request of the Special Representative of the Secretary-General, the Office of Internal Oversight Services (OIOS) conducted a comprehensive audit of the United Nations Interim Administration Mission in Kosovo (UNMIK) mandate implementation. This report contains interim results on UNMIK Pillar IV. OIOS plans to conduct further reviews of UNMIK's mandate implementation in 2008.

2. UNMIK was established by the Security Council (SC) resolution 1244 (1999) of 10 June 1999. The Mission is mandated to help the SC achieve its overall objective of promoting the establishment of substantial autonomy and self-government in Kosovo, pending a final settlement. The Mission is headed by the Special Representative of the Secretary-General (SRSG), who is the highest international civilian official in Kosovo with the civilian executive powers vested in him by the SC resolution and pursuant to the Constitutional Framework for the Provisional Self-Government in Kosovo (2001). A Principal Deputy Special Representative of the Secretary-General assists the SRSG in directing and managing the Mission, and ensures a coordinated approach by the Mission's pillars which include: (i) police and justice, and civil administration led by the United Nations; (ii) democratization and institution-building financed by the Organization for Security and Cooperation in Europe; and (iii) economic reconstruction and development financed by the European Union.

3. A Deputy Special Representative of the Secretary-General (DSRSG), under the direct authority of the SRSG, heads the UNMIK Pillar IV and works in close cooperation with the other UNMIK pillars and components, and in partnership with the Provisional Institutions of Self-Government.

4. According to the Secretary-General's report (S/1999/779) dated 12 July 1999, UNMIK was entrusted to develop a comprehensive approach to the economic development of Kosovo and to create a viable market economy. The overall economic mandate was to develop a legal, institutional and policy framework for Kosovo's economic reconstruction, recovery and development. At the start-up of the Mission, there was an urgent need for the rehabilitation of essential services, particularly water, power and sanitation. Another priority was restarting local economic activities, including developing small and medium enterprises. Basic economic structures needed to be established or restored, including public finance, trade and commerce, currency and monetary policies, a payments system, and a customs service. At the determination of the SRSG, powers and responsibilities for economic development were to be gradually transferred to the provisional institutions and thereafter, UNMIK would provide oversight and support.

5. The Constitutional Framework of Kosovo sets out certain reserve powers vested with the SRSG. Reserved powers relevant to economic development and reconstruction include: monetary policy; final authority to set financial and policy parameters; UNMIK Customs Service; administering public, state and socially owned property; administering railways, frequency management and civil aviation functions; external economic relations; concluding economic

agreements with states and international organizations; establishing arrangements for independent external audit of the Kosovo Consolidated Budget; and appointing members to: (i) the Governing Board of the Central Banking Authority of Kosovo, (ii) the Chief Executive Officer of the UNMIK Customs Service, and (iii) the Auditor General of Kosovo.

6. The legal, regulatory and institutional frameworks for Kosovo's economic reconstruction, recovery and development were established, and include the following UNMIK regulations and administrative directives:

- Regulation 1999/3 Establishment of Customs and Other Related Services
- Regulation 2006/47 (1999/20) Establishment of Central Banking Authority of Kosovo
- Regulation 2005/18 (2002/12) Establishment of Kosovo Trust Agency
- Regulation 2003/17 Public Financial Management and Accountability
- Regulation 2003/18 Establishment of Civil Aviation Regulatory Office Authority
- Administrative Direction 2004/19 Frequency Management Office
- Regulation 2004/20 Law on the Energy Regulator
- Regulation 2005/02 Establishment of Independent Commission For Mines And Minerals
- Railway Regulatory Office - pending draft legislation

7. UNMIK Pillar IV's mandate evolved as economic assessments clarified required institutions, legislation, policies, strategies and mechanisms to reconstruct and develop Kosovo's economy. The 2007 mandate is provided in Annex 2. The ultimate responsibility rests with the SRSG for ensuring that the Mission's mandates are successfully carried out.

8. Comments made by the UNMIK Administration are shown in *italics*.

9. *In its 4 February 2008 response to the OIOS draft report dated 26 December 2007, the UNMIK Administration did not comment on each recommendation stating that the report did not provide rationale and context, or the evolution of UNMIK's mandate over the years, and therefore did not constitute the correct basis for recommendations provided by OIOS. UNMIK further commented that although there was merit to a number of points raised by OIOS in the draft report, in their view, the report did not provide a complete and comprehensive description of UNMIK Pillar IV's overall function and performance.*

10. OIOS does not agree with this assessment and points out that the audit was conducted as comprehensively as possible within the timeframe and the resources available, focusing on the areas presenting the higher risks to the achievement of UNMIK's objectives. OIOS points out that it was not the purpose of the audit to describe the rationale, context or evolution of the audited entity's mandate, although these elements are considered to draw audit conclusions, to the appropriate extent. OIOS would also like to clarify that the findings and tentative recommendations had been discussed with the UNMIK Administration at the exit conference held on 9 August 2007.

II. AUDIT OBJECTIVES

11. The main objective of the audit was to assess the adequacy and effectiveness of governance, risk management and internal controls put in place within the institutions entrusted to UNMIK Pillar IV in accomplishing its mandate of developing the legal, institutional and policy framework for Kosovo's economic reconstruction, recovery and development, with due regard for:

- (a) economy, efficiency and effectiveness of operations;
- (b) adequacy of governance processes;
- (c) compliance with applicable laws and regulations;
- (d) safeguarding resources against loss, misuse and damage; and
- (e) ensuring adequate preparations for the hand-over of systems and processes of UNMIK operations to the future international and local presences.

III. AUDIT SCOPE AND METHODOLOGY

12. A preliminary risk-based diagnostic was conducted on UNMIK Pillar IV's major components, including the Office of the Deputy SRSB and supporting offices, Fiscal Affairs Office, UNMIK Customs Office, Central Banking Authority of Kosovo, Kosovo Trust Agency, and the economic regulators.

13. The preliminary risk assessment utilized an internal control framework¹ as criteria to assess the Pillar's governance, risk management and internal control systems. The assessment included interviews with executive and operational management and other key stakeholders, review of management's strategic and operational documents, and site visits to the Pillar's major components.

14. The audit focussed on key areas of risk which emerged, namely the Kosovo Trust Agency, and governance and oversight controls in the economic regulators, UNMIK Customs, Central Banking Authority of Kosovo, and administrative functions of UNMIK Pillar IV. Further audit work concentrated on the effectiveness of governance and control mechanisms, and on compliance to applicable laws, regulations, policies and procedures. Fieldwork was conducted during the period June to August 2007, and covered the life span of the Mission, with detailed review of operational performance from July 2005 to June 2007.

¹ International Organization of Supreme Audit Institutions (INTOSAI) *Guidelines for Internal Control Standards for the Public Sector* (2004); and the Committee of Sponsoring Organizations of the Treadway Commission (COSO) *Internal Control – Integrated Framework* (1992)

15. The main criteria used in the audit included: (i) Security Council resolution 1244; (ii) applicable laws, regulations, policies and procedures; (iii) Mission strategic and operational plans; (iv) Mission performance reports and external evaluations; (v) International Organization of Supreme Audit Institutions (INTOSAI) Guidelines for Internal Control Standards for the Public Sector; (vi) OECD Principles on Corporate Governance; (vii) OECD Guidelines on Corporate Governance of State-owned Enterprises; and (viii) best practices and other applicable standards.

16. The audit did not evaluate the overall effectiveness of UNMIK Pillar IV and its components in accomplishing its mandate. Rather, the audit assessed management's key governance, risk management and internal controls that supported the Pillar in implementing its objectives to meet its mandate. Also, OIOS was unable to form an opinion on the effectiveness of the Governing Board of the Central Banking Authority of Kosovo (CBAK) due to the denial of access to the Board's Minutes of Meetings.

IV. AUDIT FINDINGS AND RECOMMENDATIONS

A. Kosovo Trust Agency

Structure, responsibilities and accountabilities

17. The Kosovo Trust Agency (KTA) is an independent body pursuant to the Constitutional Framework and is a reserved power to the SRSG.² The Agency was established through UNMIK Regulation No. 2002/12 (the KTA Regulation) on 13 June 2002. This Regulation was amended on 22 April 2005 through the promulgation of UNMIK Regulation No. 2005/18 in what became known as the "Eminent Domain" amendments to the KTA Regulation. The amendments expanded the scope of the original Regulation, facilitating the privatization of Socially-owned Enterprises (SOEs) and addressing issues concerning KTA's mandate over the Publicly-owned Enterprises (POEs).

18. According to the KTA Regulation, the main objectives of the Agency are to: (a) administer the Enterprises as trustee for their Owners in accordance with the KTA Regulation and other regulations, as well as administrative directions and determinations as the SRSG may issue; and (b) carry out ancillary and other activities to preserve or enhance the value, viability and governance of the Enterprises (taking into account any guidance from the SRSG) which encourage the economic reconstruction and development of Kosovo and the welfare of its inhabitants or those of any specific region.

19. Under the direction of the SRSG, the Board of Directors of the Kosovo Trust Agency (KTA Board) is the highest decision making body in the Agency. The KTA Regulation states that all powers of the Agency shall be vested in the

² Section 11.2 of UNMIK Regulation No. 2001/9 Constitutional Framework for Provisional Self-Government in Kosovo, May 2001

Board, and entrusts the Board to take general responsibility for the activities of the Agency and in the fulfillment of this responsibility, to take any action required or permitted by the Regulation. UNMIK, the Provisional Institutions of Self-Government (PISG), and the Assembly of Kosovo are the major stakeholders of the Agency.³

20. As per the KTA Regulation, the KTA Board is composed of eight directors, including four international directors and four residents of Kosovo, which, at the time of the audit was constituted as follows:

- Chairman - Deputy SRSG, UNMIK Pillar IV
- Vice-Chairman - Minister of Trade and Industry, PISG
- Director - Deputy DSRSG, UNMIK Pillar IV
- Director - Deputy SRSG, UNMIK Pillar II Civil Administration
- Director - KTA Managing Director, UNMIK Pillar IV
- Director - Minister of Economy and Finance, PISG
- Director - Minister for Returns and Communities, PISG
- Director - President of the Federation of Independent Trade Unions of Kosovo

21. The Agency's executive management is composed of the Managing Director (MD) and two Deputy Managing Directors. The MD is the chief executive officer of the Agency, and is also a Director on the KTA Board. The MD, under the general control of the KTA Board, conducts the ordinary business of the Agency.

22. The Agency has a complement of approximately 270 staff which, *inter alia*, support the administrative oversight of the Enterprises. The Agency's consolidated budget totaled €106.7 million in 2006. Funding for the Agency's operations ("non-capital" and capital) comes from three main sources: the Kosovo Consolidated Budget (€67.7 million, 2006); donor contributions (€29.1 million, 2006); and the European Community Contribution Agreement (€9.9 million, 2006).

23. The Agency has significant responsibilities in developing Kosovo's economy as prescribed in the KTA Regulation. However, OIOS was of the opinion that UNMIK and the KTA Board operated the Agency in a way that did not show due regard for adherence to the KTA Regulation, corporate governance principles and policies, financial fiduciary responsibilities, and public accountability requirements. This has resulted in a weak corporate governance framework that represents significant risk to the economic and effective performance and financial sustainability of the Agency and the Enterprises under its administration. Details of OIOS' findings are discussed in the sections below.

KTA Board's non-compliance with the KTA Regulation on its responsibilities

24. The KTA Board has not complied with several key sections of the KTA Regulation that support public accountability, disclosure and transparency,

³ Code of Corporate Governance for POEs, Kosovo Trust Agency, May 2006

oversight, and fiduciary stewardship of the Agency's resources; and UNMIK failed to take corrective action in a timely manner. OIOS found non-compliance with the following sections of the KTA Regulation:

- Section 15.2 (p) and (q) on the Board's approving the business plan of the Agency and Management performance based on the annual audit report;
- Section 20.1 on the Board submitting quarterly reports to the SRSG summarizing the activities of the Agency and reflecting the financial results;
- Section 20.2 on the Board's publishing annual reports of the Agency;
- Section 20.3 on the Board's approving the annual budget of estimated revenues and expenditures of the Agency; and
- Sections 25.1 and 25.2 on an annual audit of the Agency, including an external financial audit; and an annual audit of trust accounts administered by the Agency directly.

25. In addition, the KTA Board has not fully implemented the following sections of the KTA Regulation:

- Section 6.1 (d) and (j) on issuing sound financial management instructions to the Enterprises and approving business plans and investment plans of Enterprises;
- Section 10.4 on establishing standards of good corporate governance of Enterprises to promote compliance with financial reporting requirements; and
- Section 19.0 on issuing financial policies with a view to ensuring that the Agency carries out its activities in accordance with sound and prudent management practices.

26. OIOS understands that the KTA Board did not conduct formal Board meetings for a 14 month period from February 2004 to April 2005, and that this disruption may be a contributing factor in the performance of the KTA Board. However, the KTA Board has met on a regular basis since May 2005, and therefore, it should be fully aware of its responsibilities. The KTA Board collectively, and the Directors severally, are accountable to the SRSG for compliance to the KTA Regulation.

27. OIOS is of the opinion that an external evaluation of the KTA Board would be helpful in order to explore ways of improving Board practices and the performance of its members. OECD principles and guidelines on corporate governance recommend that boards carry out an annual evaluation to appraise performance and provide advice. The KTA Board has not conducted such an evaluation. An evaluation, whether conducted externally or by the Board itself,

should cover all aspects of the Board's operation including the role of the Board, its design and structure, formal and informal relationships that govern the Board's activities and decision-making, compliance with regulations and by-laws, and competency and skills of its members, including their understanding of corporate governance policies, principles and guidelines.

Recommendations 1 and 2

The UNMIK Administration should:

- (1) Require the Board of Directors of the Kosovo Trust Agency to provide a formal accounting on its non-compliance with the KTA Regulation, which should include its action plan for taking corrective measures; and**
- (2) Strengthen the oversight mechanisms in place for the Kosovo Trust Agency and its Board of Directors by implementing a reform programme based on a comprehensive external evaluation of the KTA governance mechanism.**

The Agency's corporate governance policies were contravened

28. OIOS is deeply concerned with decisions taken by the KTA Board, and supported by the SRSG, on the composition of the Board of Directors of the Kosovo Energy Corporation J.S.C. (KEK).⁴ The decisions showed a lack of regard for the KTA Regulation and the OECD principles and guidelines on corporate governance⁵. It also contravened the Agency's corporate governance policies and set a precedent for potential future deviations.⁶

29. The SRSG and KTA Board had a fiduciary duty to avoid, and to disclose actual and potential conflicts of interest. However, the KTA Board approved politically active members to the Board of Directors of KEK; one of the approved members is in a material conflict of interest. On 14 May 2007, the KTA Board approved the members of the KEK Board. Two of the members were PISG ministers - the Minister of Energy and Mining, and the Minister of Economy and Finance. The KTA Board stated that the appointments of the PISG ministers were made on an "exceptional basis" from the Code of Corporate Governance for POEs due to the "unique and critical state of affairs facing the company"⁷, and the large amount of money needed from the Kosovo Consolidated Budget to support KEK.

30. The by-laws of the incorporated POEs specifically prevent those with active political involvement from participation on POE Boards, as does the Code

⁴ KTA Board meeting minutes, 01 February 2007

⁵ OECD *Principles of Corporate Governance* (2004) and OECD *Guidelines on Corporate Governance of State-owned Enterprises* (2005)

⁶ KTA/POE Code of Corporate Governance, May 2006; Reforms of the Internal Governance of POEs, 23 May 2007

⁷ KTA Board meeting minutes, Board resolution, 14 May 2007

of Corporate Governance. In addition, the Minister of Energy and Mining is the Chairman of the KEK Board. The dual positions create an inherent and material conflict of interest, as the Ministry of Energy and Mining sets Kosovo's energy strategy and policies, and KEK is subject to the Ministry's energy policies.

31. The KTA Board is required to take due care to ensure that decisions are adequately documented to allow effective accountability through audits or scrutiny by the SRSG, PISG or the Assembly of Kosovo. However, the KTA Board failed to fully disclose information that supports a "unique and critical state of affairs" in KEK. There was insufficient disclosure to conclude that a critical state of affairs actually existed. Rather, the evidence suggested progressive improvements at KEK. The SRSG reported that there were improvements at KEK,⁸ and Management's key indicators also showed favorable progress in KEK's financial and operational performance.

32. The OECD principles recommend that boards establish specific committees to consider questions where there is a potential for conflict of interest. Best practice in working to resolve a crisis situation is to establish an Emergency Executive Committee that would report to the Board.

33. During the exit conference held on 9 August 2007, UNMIK Pillar IV Management stated, in this regard, that from a strict corporate governance point of view, UNMIK did not disagree to the establishment of an Emergency Executive Committee. However, they stated that the reasons for overriding corporate governance policies, principles and guidelines were due to KEK's complex set of challenges that could not be addressed by adhering to corporate governance principles only. UNMIK Pillar IV Management further stated that KEK was not only about running a business, but also involved a substantial political context as well, which could not be ignored and required representation of senior political levels.

Recommendations 3 and 4

The UNMIK Administration should ensure that the Board of Directors of the Kosovo Trust Agency:

(3) Provides full disclosure on the recent appointments to the Board of Directors of the Kosovo Energy Corporation J.S.C (KEK), including the basis for the "unique and critical state of affairs" at KEK and the reasons for deviating from corporate governance standards in appointing politically active members and a member having an apparent material conflict of interest; and

(4) Strengthens the Kosovo Trust Agency's oversight and monitoring of the "unique and critical state of affairs" at

⁸ S/2007/395 Report of the Secretary-General on the United Nations Interim Administration Mission in Kosovo, 29 June 2007, Annex 1, pg 15

KEK in order to avoid any actual or perceived conflict of interest in the decisions of the Board.

Improved collaboration is needed with regard to the Agency's strategic planning

34. OIOS found that roles and responsibilities for developing and monitoring the Agency's strategic planning were not clearly defined. UNMIK Pillar IV created the Agency's strategic plans and provided quarterly progress reports. However, the Agency's business objectives and performance indicators (as reported by UNMIK Pillar IV) were not monitored by the KTA Board or Agency Management, which resulted in an accountability reporting gap. The KTA Board has the responsibility to approve the Agency's business plan, as well as to monitor Management's performance; responsibilities which, according to the KTA Regulation, cannot be delegated to the Managing Director.⁹ Collaboration between UNMIK Pillar IV and the KTA Board should be strengthened, and roles and responsibilities for strategic planning and monitoring need to be clearly defined.

35. UNMIK's transitional planning includes preparations for the hand-over of the Agency to successor institutions. The SRSG has established a transitional planning sub-group for the Agency.¹⁰ In March 2007, a KTA Board member expressed dissatisfaction with the progress of the transitional planning sub-group, and stated that the Board was not informed of the progress made towards the Agency's transitional planning¹¹. UNMIK had not provided regular transitional planning information, such as an exit strategy, or progress updates to the KTA Board. Since the KTA Board has general oversight responsibility for the Agency, it should receive regular progress reports in order to effectively prepare for and facilitate the transition process. Regular progress reporting would also enhance the transparency of UNMIK's transitional planning process.

Recommendations 5 and 6

The UNMIK Administration should:

(5) Clarify the respective roles and responsibilities among UNMIK, the Board of Directors of the Kosovo Trust Agency and the Management of KTA with regard to developing, implementing and monitoring the KTA's strategic initiatives; and

(6) Ensure that the exit strategy for the Kosovo Trust Agency is provided to the Board of Directors of the KTA, and that the Board receives regular progress reports on UNMIK's transitional planning.

⁹ UNMIK Regulation No. 2005/18, Section 15 Responsibilities of the Board

¹⁰ Sub-work group of the Property and Economy Multilateral Working Group on Transition.

¹¹ KTA Board meeting minutes, 7 March 2007

Failure to ensure public accountability and oversight of the Agency's financial resources

36. OIOS was deeply concerned to note that UNMIK and the KTA Board have not shown due regard for public accountability, disclosure and transparency, and oversight of the Agency's financial resources. OIOS determined that they have failed to ensure the integrity of the Agency's accounting and financial reporting systems, including independent internal and external audit; and that appropriate systems of financial and operational controls were in place. In summary, OIOS observed the following:

- External audits have not been conducted for the KTA-Kosovo Consolidated Budget financial accounts for the fiscal years 2002 to 2005; and the trust funds for the fiscal years 2002 to 2006;
- The Agency does not have proper financial accounting and management information systems; and
- Independent oversight functions in the Agency are not effective.

(a) External audit

37. Appropriations from the Kosovo Consolidated Budget (KCB) to the Agency are significant, representing about 10 per cent of total KCB expenditures and totaled €71 million in 2007. External audits have not been conducted on the KTA-KCB financial accounts for fiscal years 2002 to 2005. Therefore UNMIK, the KTA Board, and the PISG have no independent external assurance that the financial accounts are fairly stated, and free from material errors and fraud.

38. Furthermore, OIOS is concerned that an annual financial audit of KTA trust funds for the fiscal years 2002 to 2006 has not been conducted. Trust funds total €331 million and are held in about 1,021 bank accounts. There are numerous transactions recorded to the bank accounts, which requires an understanding of the legal and financial processes involved in privatization and liquidation of Socially-owned Enterprises. In 2006, the Office of the Auditor General of Kosovo (OAG) conducted an audit of the privatization process and found deficiencies in the design and operation of the internal control system.¹²

39. The absence of an external audit of the KTA-KCB financial accounts and the trust accounts represents an unacceptable risk to UNMIK, the PISG, and the Agency. The SRSG is responsible to ensure that the appropriate independent audit arrangements are established for the KCB, which includes the Agency.¹³ The KTA Regulation also directs the SRSG to conduct additional audits as may

¹² OAG, External Review of the Privatization Process Undertaken by the Kosovo Trust Agency, December 2006

¹³ UNMIK Regulation No. 2000/7 (1999/16) Establishment Of The Central Fiscal Authority Of Kosovo And Other Related Matters, Section 5 Independent Audit, 18 February 2000

be determined necessary; and sets out the KTA Board's responsibly for ensuring annual financial audits are completed.¹⁴

40. The OAG is legally required to audit the financial statements of the Agency,¹⁵ and has conducted its first audit of the KTA financial statements for the fiscal year 2006. According to the Auditor General, external financial audits of the Agency from 2002 to 2005 were not completed for two main reasons: (i) a lack of capacity in the OAG's office; and (ii) attempts to outsource the audit were unsuccessful, because at least 3 responsive bidders were not obtained.¹⁶

41. OIOS is concerned with the lack of action taken by the SRSG and the KTA Board to ensure that external audits have been conducted for KTA's public funds. There was no evidence in the KTA Board meeting minutes of alternate arrangements made for conducting external audits; indicating that the SRSG and Board were either not aware of their responsibilities, or did not show due regard.

42. During the exit conference, UNMIK Pillar IV Management stated that the obligation for conducting external audits of the Agency lies with the Office of the Auditor General and that the OAG did not commission an external audit of the Agency's financial accounts from 2002 to 2005, due to its lack of capacity.

Recommendation 7

The UNMIK Administration should give urgent priority to commissioning an independent external audit of: (i) the Kosovo Trust Agency – Kosovo Consolidated Budget financial accounts for the fiscal years 2002 to 2005; and (ii) the Agency's trust fund accounts for the fiscal years 2002 to 2006.

(b) Financial accounting and information system

43. The Agency utilizes a spreadsheet-based financial accounting information system. The system consists of a series of excel spreadsheets. For example, there are 100 worksheets for liquidation accounts and 552 worksheets for privatization accounts. Each worksheet contains numerous cross-referenced formulas. The spread-sheet based financial management system is inappropriate for the size and complexity of KTA operations, and is unacceptable for an organization that has been operating for five years, for the below reasons:

- The system does not provide double-entry accounting control which is fundamental in ensuring the integrity of accounting;
- The spreadsheet formulas require regular updates and are therefore susceptible to errors;

¹⁴ KTA Regulation 2005/18, Section 25, External Audits

¹⁵ UNMIK Regulation No. 2002/18 Establishment of the OAG, Section 3.2

¹⁶ Law 2003/17 Law on Public Procurement in Kosovo

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- The KTA Finance Department is both the designer and user of the system, which does not provide for adequate segregation of duties that is critical in the internal control system. Such weaknesses in the internal control system compromise the integrity of financial information produced, and increase the risk of errors, poor decision-making, fraud, and mismanagement; and
 - The current system does not provide standard integrated accounting features such as a general ledger, subsidiary ledgers, and a trial balance commonly available in accounting software packages, nor does it provide a proper audit trail. OIOS determined that the financial information provided to KTA Management and the KTA Board was not comprehensive enough for adequate monitoring and informed decision-making.

44. Concerning its current financial management system, UNMIK Pillar IV Management stated that it met the control standards and reporting needs. However, they would consider implementing an automated accounting system to improve the efficiency of the existing accounting system.

Recommendation 8

The UNMIK Administration should ensure that the Kosovo Trust Agency implements an adequate automated financial accounting information system as a matter of priority.

(c) Independent oversight functions in the Agency are not effective

45. The Agency's Internal Audit Unit (IAU) does not provide regular independent checks on Management's financial controls and operational processes. The IAU also does not operate in compliance with professional standards promulgated by the Institute of Internal Auditors.¹⁷ The KTA Board has not established an audit committee that would monitor and support the independence of the internal audit function, and provide financial oversight of the Agency.

46. The IAU spends considerable time responding to management requests, most of which are investigative in nature. As a result, the auditors are too heavily involved in overseeing operational effectiveness (for which management is responsible), and their independence and objectivity are compromised. The reporting structure of the IAU does not provide operational independence without its direct access to the Board or an audit committee thereof.

47. The KTA Board has not adequately performed functions normally done by an audit committee. For example, the KTA Board showed little interest in reviewing the OAG's audit of the privatization process.¹⁸ Given that the

¹⁷ International Standards for the Professional Practice of Internal Auditing

¹⁸ OAG, External Review of the Privatization Process Undertaken by the Kosovo Trust Agency, December 2006

privatization process is a major function of the Agency, OIOS would have expected the KTA Board to scrutinize and provide comments on the report.

48. An audit committee of the KTA Board is needed to monitor and support the internal audit function. It is increasingly common for institutions comparable to the KTA to establish audit committees, often at the request of their stakeholders. It is also recommended as good practice by the OECD corporate governance principles. The KTA by-laws state that the Board may establish a committee to assist it in performing its functions, and OIOS believes that it has identified several areas where an audit committee of the KTA Board could significantly improve the Board's performance in discharging its oversight responsibilities.

49. During the exit conference, UNMIK Pillar IV Management accepted the need to strengthen the Agency's internal audit function. However, it also stated that the reporting line of the Internal Audit Unit was not a new issue and needed to be carefully considered.

50. UNMIK Pillar IV also stated that rationale for an audit committee of the KTA Board was debatable, since the Agency is a trustee and an asset manager, and has no real business operations. A KTA audit committee would only be concerned with the Agency's financial matters and not financial matters concerning the POE's, as this was the responsibility of the POE audit committees.

Recommendations 9 and 10

The UNMIK Administration should ensure that the Board of Directors of the Kosovo Trust Agency:

(9) Strengthens the independent internal audit function by requiring it to adopt professional internal auditing standards and having it report directly to the Board or an audit committee thereof; and

(10) Considers establishing an audit committee to assist the Board to more effectively carry out its oversight responsibilities.

B. Administration of Publicly-owned Enterprises (POEs) and Socially-owned Enterprises (SOEs)

51. The Agency administers 26 Publicly-owned Enterprises which employ about 14,000 people. The POEs include: Kosovo Energy Corporation J.S.C. (KEK); Post and Telecommunication of Kosovo Holding J.S.C. (PTK); Pristina International Airport Holding J.S.C. (PIA); District Heating Enterprise Termokos J.S.C.; District Heating Enterprise Gjakova J.S.C.; District Heating Company in Mitrovica Termomit; Kosovo Landfill Management Company J.S.C.; Kosovo Railways Holding J.S.C.; Kosovo Transmission, System Market Operator J.S.C.

(KOSTT); 3 regional irrigation enterprises; 7 regional waste enterprises; and 7 regional water enterprises.

52. The Agency's major operational goals for POEs in 2007 were to:
- Preserve and enhance the value of POEs by finalizing the incorporation process for all POEs;
 - Introduce proper corporate governance through the establishment of boards of directors;
 - Build capacity within the POEs by on the job "shadowing" as part of the transfer of management, vocational training, support from accountants for training under the European Agency for Reconstruction (EAR) incorporation project; and
 - Propose legislation to enable POEs to structure themselves in a more effective and efficient manner (e.g., Corporate Group Tax).

Weak financial management systems and controls in POEs

53. The Agency took over administration of the Publicly-owned Enterprises in 2002. After five years, the POEs do not yet have basic financial controls in place, nor do they prepare financial statements in accordance with international financial reporting standards. The financial management systems in the POEs are exposed to a high risk of errors, poor decisions, fraud and corruption. UNMIK Pillar IV and the KTA Board have been slow to take responsibility and action to improve financial management in the POEs. The KTA Board needs to strengthen its oversight mechanisms in this area. A strategic approach should be taken to address the issues and bring the POEs in line with international financial accounting and reporting standards.

(a) Qualified or disclaimer of audit opinion of financial statement

54. From 2002 to 2005, all of the major POEs (PTK, KEK, PIA, Kosovo Railways, and district heating enterprises in Pristina and Gjakova) received either qualified or disclaimer audit opinions on their financial statements. A disclaimer of opinion is of particular concern as, according to the OAG, it "indicates that there are serious weaknesses in the system of internal controls operated by the entity which are so significant as to prevent them [auditor] from forming any audit opinion about the financial statements."¹⁹

(b) Inadequate follow-up of recommendations from audits and evaluations of POEs

55. A comprehensive audit of the POEs was conducted for the period ending 31 December 2002, which included: (i) an audit of the financial statements, (ii)

¹⁹ Report of the OAG on the Financial Statements of the Kosovo Consolidated Budget For the Year Ended 31 December 2005

an operational review, and (iii) a forensic audit. Management indicated that some POEs have made progress in implementing audit recommendations. Other POEs have lagged behind due to a lack of experienced personnel.²⁰ However, UNMIK Pillar IV and KTA Management were unable to provide the report of this audit to OIOS for review and to determine the adequacy of the implementation of the audit's recommendations.

56. In 2006, the OAG together with the accounting firm of KPMG performed comprehensive evaluations on the financial management and internal control systems in KEK, PIA, Kosovo Railways, District Heating Termokos, and the Waste, Water, and Irrigation Enterprises. Systemic weaknesses were identified and comprehensive recommendations were made to strengthen systems and controls. Observations from the OAG-KPMG evaluations included:

- Lack of formalized financial policies and procedures to ensure preparation of financial statements in accordance with International Financial Reporting Standards.
- Lack of formal controls over accounting entries.
- No formal process for the preparation of financial statements.
- Lack of an appropriate accounting and financial reporting system due to the use of a spreadsheet-based system.
- Lack of a proper budgeting and forecasting process.
- Absence of procedures for the valuation of technical parameters of assets.
- Lack of proper reconciliation procedures regarding property, plant and equipment, including physical counts and recording assets.
- No internal monitoring process of the tenders.
- Lack of proper monitoring of the information inputted to the billing system.
- Absence of legally binding contracts (especially at KEK where 40% of the customers were without a contract).
- No formal process over the estimation of allowances for bad debts.
- No formal procedures in place for the reconciliation of balances with suppliers and lenders.
- Lack of defined duties and responsibilities of the board of directors.
- Lack of an overall assessment of performance of the Company and corrective actions taken.
- Lack of formal evaluation of fraud risks, proper antifraud control procedures and an adequate code of conduct.
- Lack of formalized monitoring and control procedures.
- Lack of monitoring and evaluation of training results.
- Insufficient efforts to address the risks at the strategic level.
- Lack of an adequate and competent staff in the internal audit activity; properly designed audit methodology; and an internal audit charter.
- Lack of qualified information technology (IT) personnel, IT security policies, and a business continuity plan. Inadequate physical security and back-up media stored on-site.

²⁰ UNMIK Pillar IV (EU) Preliminary Business Plan 2005

57. Interviews with Management and the auditors, and review of subsequent evaluations indicated there was unsatisfactory progress in implementing audit recommendations at KEK, PIA, and the Waste, Water and Irrigation Enterprises. Management consultants at KEK considered the accounting and management information “extraordinarily weak”. KTA Management also acknowledged that little action had been taken to correct weaknesses identified in the June 2006 OAG-KPMG evaluation of KEK. At PIA, a review conducted by OAG-Deloitte²¹ in June 2007 identified continuing weaknesses in basic accounting controls.

(c) Slow progress in the implementation of recommendations from the OAG-commissioned review of the privatization process of Socially-owned Enterprises

58. The OAG commissioned an external review of the Agency’s privatization process of Socially-owned Enterprises.²² The review was conducted by an external auditor in June and July 2006. The major objectives of the audit were to provide reasonable assurance that: (i) the Agency’s privatization process complied with relevant regulations and provisions; (ii) the internal control system was properly designed and working sufficiently to ensure transparency and correctness of the process; and (iii) the disposal of assets followed value for money principles.

59. The overall findings of the review were as follows:

- The Agency had achieved a large number of privatizations of SOEs in a short period of time; and it has complied with the procedures and organization set out in the Regulations and its own Operational Policies with the exception of required regular reporting;
- The design and operation of the internal control system over the privatization process has fallen short of the spirit of the Regulations and best practices;
- The process does not ensure that assets are sold for the best possible value and best benefit to Kosovo; and
- The Agency’s Internal Audit Unit does not have as significant a role as would be expected in evaluating the privatization process.

60. Furthermore, the review identified non-compliance with reporting requirements and good practice. The audit report stated that the “KTA does not operate with full and open disclosure of material facts to the public.” It also found that there was a lack of transparency in the privatization process, leading to an opinion that the Agency does not comply with section 10.2 of the KTA Regulation. Section 10.2 requires the KTA Board to include in their Operational

²¹ OAG-Deloitte, The review of certain payments to ICAO and ICAA, Pristina International Airport J.S.C., 14 June 2007

²² OAG, External Review of the Privatization Process Undertaken by the Kosovo Trust Agency, December 2006

Policies “...transparent and uniformly applied procedures for the purposes of ensuring fair competition of bidders and obtaining a fair market value for shares in Corporations...”

61. The review made recommendations to: (i) improve the transparency of information and reporting of the privatization process, including providing information in a comprehensive annual report; (ii) conduct pre-sale valuations of Enterprises; (iii) develop accounting standards and disclose financial and non-financial information according to international standards for SOEs; (iv) enhance anti-fraud standards; (v) utilize independent external expertise for evaluations when deemed necessary; (vi) strengthen bid opening controls; and (vii) utilize the Internal Audit Unit for monitoring and evaluating the privatization process.

62. The Agency’s Managing Director provided the OAG’s report to the KTA Board in March 2007, but provided an updated action plan only in July 2007. The SRSG²³ and UNMIK Pillar IV²⁴ have identified the need to better implement audit recommendations, and in OIOS’ view, the KTA Board and Management should give a higher priority to reviewing and monitoring progress made in implementing audit recommendations for the privatization process. OIOS therefore reiterates its view that there is a need for the KTA Board to establish an audit committee to assist the Board in performing its oversight functions in a more effective manner.

(d) Inadequate financial oversight mechanism

63. The KTA Board has not developed adequate oversight mechanisms for the POEs, such as accountability reporting from the POEs to the KTA Board. Management did not report to the KTA Board the findings of the 2006 OAG-KPMG evaluations or the progress in implementing the related recommendations. As previously discussed, the KTA Board has general oversight responsibilities and administrative authority which includes ensuring sound financial management of the Enterprises.

64. The KTA Board should require regular reporting from the POEs on implementation of audit recommendations. The KTA Board should also develop a strategic action plan to address the recommendations identified in the OAG-KPMG financial management and internal control evaluations. The KTA Board (through an audit committee) should monitor progress towards implementing audit recommendations and achievement towards its action plan, and provide regular progress reports to the SRSG.

65. During the exit conference, the UNMIK Pillar IV Management acknowledged the need to strengthen the quality of financial management systems and controls in the POEs, and stated that financial reforms at POE’s have to be implemented through the POE corporate structures and boards of directors. The KTA Board (or an audit committee thereof) would not have oversight

²³ S/2007/395 Report of the Secretary-General on the United Nations Interim Administration Mission in Kosovo, 29 June 2007

²⁴ UNMIK Pillar IV 2007 Business Plan, Pillar IV Mandate

responsibilities of the financial affairs of the POEs. UNMIK Pillar IV also noted that significant progress has been made in some POEs, and that the POE boards and POE management will continue to target all existing weaknesses in a structured manner.

Recommendations 11, 12 and 13

The UNMIK Administration should:

(11) Strengthen the quality of financial management systems and controls in the Publicly-owned Enterprises as a matter of priority by requesting the Board of Directors of the Kosovo Trust Agency to implement a strategic action plan towards that end which should include arrangements for regular progress reporting to the KTA Board on the implementation of the action plan;

(12) Remind the Board of Directors of the Kosovo Trust Agency and KTA Management of their responsibility to provide oversight of the Publicly-owned Enterprises; and

(13) Require the Board of Directors of the Kosovo Trust Agency to compile the recommendations from all previous reviews and audits; assess and prioritize their importance, and ensure the full implementation of those recommendations deemed critical to the Mission's success.

Further improvements are needed for audit committees and internal audit functions in key POEs

66. OIOS found that the effectiveness of the audit, finance and insurance advisory committees (audit committee), and internal audit functions in the POEs varied widely. The Post and Telecommunications of Kosovo J.S.C., for example, has made substantial progress in developing an effective internal audit function and audit committee. However, the internal audit function at KEK lacked independence and capacity. KEK's audit committee had not been active since the departure of its chairman in late 2006. At the time of OIOS' audit, PIA was still in the process of establishing an effective audit committee and internal audit function.

67. Annual evaluations of the POE boards and audit committees have not been conducted, as required by the Code of Corporate Governance of POEs. Similarly, quality assurance assessments have not been conducted on the internal audit functions, as required in the professional practice of internal auditing. Annual evaluations would assist the Agency in bringing the overall effectiveness of audit committees and internal audit functions in line with international standards.

68. In this regard, UNMIK Pillar IV Management stated that the re-establishment of the KEK Audit, Finance and Insurance Committee was in

progress. The UNMIK Pillar IV Management also stated that the functions and performance of the POE boards were constantly being evaluated through the KTA POE Department, which includes a corporate governance professional.

Recommendations 14 and 15

The UNMIK Administration should:

(14) Ensure that the Kosovo Trust Agency re-establishes the Audit, Finance and Insurance Committee of the Kosovo Energy Company J.S.C.; and

(15) Require the Kosovo Trust Agency to conduct annual evaluations of the boards of directors of the Publicly-owned Enterprises (including audit committees thereof); and conduct quality assurance assessments of their internal audit functions.

KEK's outstanding receivables for enclave areas have not been adequately accounted for and disclosed

69. OIOS is concerned about the status of outstanding receivables related to the provision of utilities in the enclave areas. KEK has not accounted for and disclosed outstanding receivables attributed to enclave areas. Outstanding receivables from July 1999 to July 2007 were estimated at over €90 million, and are accumulating at a rate of €15 million per year. UNMIK has not established a policy or mandate on this issue, and therefore it has not formally accounted for the outstanding receivables in the KCB and in KEK's financial accounts.

70. Outstanding receivables in enclave areas are indirectly funded through KCB transfers and subsidies to KEK; and indirectly reflected in KEK's bottom line net operating losses. This significantly overestimates KEK's operating losses and does not reflect the real cost of electricity production.²⁵ In 2006, KEK's operating losses were €59.5 million (€85.9 million, 2005),²⁶ of which 19 per cent (10 per cent, 2005)²⁷ can be attributed to outstanding receivables in enclave areas. It also does not provide adequate disclosure in the KCB. Good governance and international financial reporting standards require that obligations and responsibilities be disclosed and related costs should be covered in a transparent manner.

71. UNMIK does not have a formal policy on this issue. OECD guidelines on corporate governance recommend that any obligations and responsibilities that a POE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations. Ideally, a policy on the issue would be formalized through specific Laws,

²⁵ KTA Board meeting minutes, 7 June 2007

²⁶ 2006 KEK Financial Overview, presentation to the KTA Board, 7 June 2007

²⁷ Letter from KEK Managing Director to UNMIK SRSG, KEK invoices for the Supply of Electricity to Enclaves, 2 May 2007

Regulations or directives, as UNMIK has done with other programmes.²⁸ OIOS acknowledges the political difficulties in developing such a policy. However, Management should, as a minimum, develop an administrative directive to formalize an accounting treatment of the uncollectible receivables in enclave areas, in order to ensure full disclosure, transparency and accurate reporting by KEK.

72. During the exit conference, UNMIK Pillar IV Management stated that UNMIK has worked towards ending the boycott of Kosovo institutions, including the payment of electrical bills in enclave areas; and that the issue was discussed at the UN Security Council. Furthermore, UNMIK Pillar IV Management stated that full transparency on the issue has been encouraged.

Recommendations 16 and 17

The UNMIK Administration should establish:

(16) A policy and issue an administrative directive on accounting for and controlling outstanding receivables from electricity services provided to enclave areas; and

(17) A strategy to resolve the issue of uncollectible electricity bills from enclave areas.

C. Economic Regulatory Bodies

73. In 1999, the regulatory framework for civil aviation, energy, mining, telecommunications, frequency management, railways, and waste management did not exist. The 2001 Constitutional Framework required the establishment of independent sector regulators and that the bodies and offices shall carry out their functions independently of the Provisional Institutions of Self-Government (PISG). In addition, Annex I (Constitutional Provisions), Article 9 (Economic Provisions) of the Comprehensive Proposal for the Kosovo Status Settlement of February 2007 states that “Kosovo shall establish independent market regulatory bodies”.

74. The following bodies were created while the process has not been completed for the Railway Regulatory Office:

- The Law on Telecommunications was adopted by the Assembly of Kosovo on 10 December 2002 (Law No. 2002/7) and promulgated by UNMIK Regulation No. 2003/16 and established the Telecommunications Regulatory Authority (TRA).
- UNMIK Regulation No. 2005/2 created the Independent Commission for Mines and Minerals (ICMM) in Kosovo. ICMM regulates the mining sector and implements and enforces the Mining Law, handles exploration and exploitation license applications, approves applications for, and

²⁸ For example, Social assistance, War invalids, Trepca Pensions

controls transport and handling of commercial explosives, provide mines inspectorate services, terminates illegal mining activities and collects royalties.

- In 2004, the UNMIK Regulation No. 2004/20 promulgated the Law No. 2004/9 (on Energy Regulator) and established the Energy Regulatory Office (ERO). The ERO is responsible for regulating the activities in Kosovo's energy sector, including electricity, heating and natural gas.
- The Water and Waste Regulatory Office, established as an independent body pursuant to Section 11.2 of the Kosovo Constitutional Framework, by UNMIK Regulation 2004/49.
- The Civil Aviation Regulatory Office was established by UNMIK Regulation No. 2003/18, and is an independent body responsible for regulating civil aviation issues in Kosovo.
- Frequency Management is a reserved power of the SRSG, as per UNMIK Regulation 2001/9. The Frequency Management Office exercises administrative control and authority over frequency management in Kosovo.

Independence and the governance structure of the economic regulatory bodies need to be strengthened

75. OIOS noted with concern the findings from the 2007 assessment of the Regulators in Kosovo by the 'Technical Assistance Information Exchange Instrument under Directorate General Enlargement of the European Commission (TAIEX) assessment mission.' The assessment has highlighted the independence issue of the Regulators and recommended that the respective legislation should be amended to secure the independence of the regulators. Furthermore, the review stated that the Regulators should be fully accountable to the Assembly of Kosovo, and be financially independent and funded through annual fees levied on the regulated utilities (i.e. not to have salaries set at civil servant levels paid through the Kosovo budget).

76. The following are some examples of the TAIEX findings on the TRA, ICMM and ERO:

- There is confusion stemming from the regulatory text in Regulation 2003/16 whereby Section 3 (b) states that 'TRA, established as an independent body...' but there is somewhat contradictory text in Section 4 (1) which states that 'the TRA is established as independent within the Ministry'.
- The Board of TRA comprises of five persons. The members of the Board are recommended by the Minister of Transport and Telecommunications, proposed by the Government and subject to appointment by the Assembly, which may introduce an element of political influence in the appointments.

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- The ICMM should continue to exercise its independent regulatory/executive functions with respect to the issuance of licenses and permits and with increased authority to monitor/enforce compliance by sector participants with such licenses and permits as well as applicable legislation.
 - The new amendments emphasized the fact that “the monthly salary of a Board’s member shouldn’t be higher than the salary of a Minister.” This restriction, as well as the determination of salaries by the Assembly, might influence the financial independence of the energy regulator. Due to the specialized and highly demanding tasks of the energy regulator’s Board and staff, no restrictions should be placed on salary levels.

77. In addition, OIOS noted that a letter was sent on 25 April 2007 by the World Bank to the Minister of Mining and Energy in regard to the Aide-Memoire for the Lignite Power Technical Assistance Project, wherein the Bank stated that it has been made aware of a potential violation of the Letter of Energy Sector Development Policy, and the Energy Community of South East Europe Treaty as well, regarding the alleged interference with the authority of the ERO to set electricity tariffs. UNMIK had responded that the related PISG worked with ERO to set up new tariffs, which did not encroach upon the independence of ERO.

Recommendation 18

(18) UNMIK Administration should amend the respective regulations on the Regulatory Bodies to provide that the Assembly of Kosovo should approve the budgets of the Regulators and the appointment of the Board Members.

The functioning of the Board of Directors of ICMM needs to be improved

78. OIOS noted the following instances that indicated a need for improvement in the functioning of the Board of Directors of ICMM.

- A November 2006 review by the OAG of implementation of procurement procedures at the ICMM addressed the issue of one Board Member who had overridden the Head of Information Technology (IT) on numerous occasions, despite the Board Member not having an IT background. Numerous email discussions and arguments of the Board Member were cited in the OAG report as demonstrating an override of controls.
- In its comments to the above mentioned audit observation, UNMIK stated that: “The Director/Deputy director of ICMM was informed by the IT Manager in May 2006 of his concerns. After some internal investigations within ICMM, the DSRSG, Pillar IV and the Pillar IV Controller were informed in June 2006. The DSRSG instructed the Controller to review this case. This internal review established that the

concerned Board Member had misused his positions and exceeded his competencies in his functions of an ICMM Board Member”...“The audit carried out by OAG in December 2006 broadly confirmed the findings of the Pillar IV Controller, and the Director ICMM finally confirmed the findings of OAG with his letter dated 31 January 2007. The recommendations of the OAG were then implemented by Pillar IV and ICMM.”

- In addition, based on its review of the Board meeting minutes, the OAG noted that while all mining licenses and permits were voted upon by the Board, the Board did not vote on procurement projects, whereas the Board Member in question had made all the final decisions on procurement.

79. UNMIK has a responsibility to foster a climate of independence in the Boards of the Regulators through the appointment of qualified, independent Board Members. One possible mechanism for selecting the Board Members is to have a selection system based on merit where candidates are selected by a recruitment committee using objective criteria that is consistent and transparent.

80. In this regard, UNMIK Pillar IV Management stated that as a result of an internal review conducted in 2006, the ICMM Governing Board made a decision, on 26 October 2006, to refrain from performing any executive tasks.

Recommendations 19 and 20

The UNMIK Administration should:

(19) Establish a mechanism for selecting board members of the Regulatory Bodies based on merit using objective criteria and a transparent process; and

(20) Ensure that adequate separation exists between the executive function of the Regulatory Bodies and their Governing Boards; the former discharging the executive functions and the latter being responsible for strategic decisions and policy.

Recruitment and retention problems

81. Recruitment and retention problems have been noted at ERO and ICMM, which were caused primarily by the large pay differential between employees of the Regulators and the prevailing market rates paid in the sectors being regulated. This problem has been exacerbated by higher salaries paid in the international organizations working in Kosovo, which in some cases were 4 to 5 times the salaries offered by the Regulators. The TAIEX assessment mission had reached the same conclusion.

82. OIOS was informed that the ERO and ICMM had lost several knowledgeable staff members to local companies such as KEK, which doubled

their salaries and to international organizations where the salaries were more than doubled.

83. Table 1 below shows the statistical information on the approved and vacant posts, and the number of staff that had left the Regulators from 2004 to 2007.

Table 1: Statistical Information on Staffing of the Regulators

	2004		2005		2006		2007	
	ERO	ICMM	ERO	ICMM	ERO	ICMM	ERO	ICMM
Total Approved Posts	18	57	26	58	26	58	27	64
Vacant Posts	7	13	7	9	0	4	6	2
Staff attrition	0	1	2	9	4	8	5	4

84. During the exit conference, UNMIK Pillar IV Management stated that temporary measures were recently introduced to increase the salaries of key ICMM staff by 100 per cent and to increase the allowances of ERO staff. However, they added that the temporary measures might not be sufficient as the issues are influenced by the forces in the labor market.

Recommendation 21

(21) The UNMIK Administration should develop measures to help Regulatory Bodies to retain key staff members, including ways to offset the pay differentials prevailing in the external labor market.

Internal oversight framework not established by the Regulators

85. UNMIK Regulation No. 2007/19 On the Promulgation of the Law On Internal Audit Adopted By The Assembly Of Kosovo (6 June 2007) requires the establishment and maintenance of an internal audit unit within each budget organization that should report to its audit committee. The audit committee is responsible for promoting internal control systems, approving the audit plan and ensuring the implementation of the internal audit unit's recommendations by management.

86. None of the Regulators had established an internal audit unit or an audit committee at the time of the audit. UNMIK referred to Article 10 (Exemption from the Requirement to Establish an Internal Audit Unit) of the Law on Internal Audit as a reason for not establishing internal audit functions at the Regulators. The article reads:

Article 10.1. Notwithstanding the requirement of Article 9.1 'which stipulates that every budget organization or autonomous public undertaking shall establish and maintain an internal audit unit', the Central Internal Audit Harmonization Unit – with the consent of the Minister – may exempt a budget organization or autonomous public undertaking from the requirement

of Article 9.1 if such an exemption is objectively justifiable for either of the following reasons:

- An insufficient number of Internal Auditors to permit the budget organization to comply with Article 9.1; or
- The size, budget or other specific circumstances of the budget organization or the autonomous public undertaking are such that it would be, from a cost-effectiveness perspective, unreasonable to require the budget organization or autonomous public undertaking to establish an Internal Audit Unit.

87. Article 10.3 of the same Law, however, stipulates that: “Any exemption granted under Article 10.1 shall expire after 24 months...” The intent of the Law is to establish and maintain a permanent internal audit function, and any exemptions from this Law are temporary.

88. In this regard, UNMIK Pillar IV Management stated that the Law on Internal Audit was promulgated by UNMIK in June 2007, and the Law foresees a transitional period to implement legal requirements for the concerned entities.

Recommendation 22

(22) The UNMIK Administration should ensure that the Regulatory Bodies establish and maintain internal audit units and audit committees unless an exemption has been formally granted in accordance with Articles 10.1 and 10.3 of the Law on Internal Audit.

D. UNMIK Customs Service

Internal oversight framework needs improvement

89. The UNMIK Customs Service (UCS) has an Internal Audit Department with five audit staff, including the head of the Department. Two of the audit staff hold degrees in economics, one in sociology, one in engineering, and one has a high school diploma. The audit staff has taken various accounting and auditing training courses. However, none of the audit staff are certified accountants or auditors. The role of the Internal Audit Department is to review the UCS internal procedures and resources. It was noted that the UCS does not have an audit committee, instead the Department reports to the Director General. The Internal Audit Department has neither an audit charter nor an audit manual, which collectively include the audit methodologies, procedures, responsibilities, reporting mechanism, code of ethics and statement on conflicts of interest.

90. At the exit conference, an UNMIK Customs Service representative stated that it disagreed that independence of the internal audit function would be impaired if it did not report to an Audit Committee or a Board. UNMIK Customs Service also stated that it was not common practice for public organizations such as Customs to establish an Audit Committee. However, with the promulgation of

the Law on Internal Audit (4 July 2007) requiring the establishment of an audit committee, UNMIK Customs Service would explore how best to implement such a committee.

Recommendations 23 and 24

The UNMIK Administration should:

(23) Ensure that the Internal Audit Department at the UNMIK Customs Service develops and maintains an audit charter and audit manual; and

(24) Enhance the independence of the Internal Audit Department of UNMIK Customs Service by establishing an audit committee and ensuring that the Department has a direct reporting line to the Committee.

Unreconciled bank transfers needs to be investigated

91. The OAG of Kosovo in its audit of the KCB for the year ended 31 December 2005 reported that two transfers totaling €2.9 million were made from the main UCS bank account on 23 December 2005. Normally such transfers are made to the main KCB receipts account, but in these cases the OAG was unable to identify into which KCB bank account the money was transferred. OIOS noted that the UCS officials were not aware of the status of this issue.

Recommendation 25

(25) The UNMIK Administration should ensure that an investigation of the transfers of €2.9 million from the UNMIK Customs Service bank account to an unidentified KCB bank account is carried out as a matter of priority, and that the results are reported to the Office of the Auditor General.

E. The Central Banking Authority of Kosovo

Internal oversight framework needs improvement

92. On August 24, 2006 the SRSG signed UNMIK Regulation No. 2006/47 that transformed the Banking and Payments Authority of Kosovo into the Central Banking Authority of Kosovo (CBAK). CBAK, as an independent body, has operational and administrative autonomy, and functions outside the framework of the Kosovo governmental structures.

93. The CBAK has an Internal Audit Department headed by the Inspector General (IG) in addition to four audit staff. Three of the audit staff hold degrees in economics and has a high school diploma. All of the audit staff have attended various training courses in Kosovo and abroad. However, none of the audit staff including the IG is a certified accountant or certified auditor.

94. Based on OIOS' review of the Internal Audit Department and considering the CBAK operations, we concluded that the internal audit function is relatively well managed in line with the international standards, in terms of independence, and its relationship and reporting line to senior management and to the Governing Board. For example, in May 2005, a consulting report issued by the International Monetary Fund, made a general comment on the audit reports issued by the CBAK Internal Audit Department, which pointed out the improvement in their quality in comparison to previous reports it reviewed. It stated that the reports have a relatively good structure; work performed is well defined; findings are supported in the document; and recommendations and follow-up are clear.

95. However, there is room for improvement in the area of reporting and audit staff qualifications. It was also noted that the Department has neither an audit charter nor an audit manual, which collectively include the audit methodologies, procedures, responsibilities, reporting mechanism, code of ethics and statement on conflicts of interest.

Recommendation 26

(26) The UNMIK Administration should ensure that the Internal Audit Department at the Central Banking Authority of Kosovo develops and maintains an audit charter and audit manual.

Scope limitation on OIOS' review of the functioning of the CBAK Governing Board

96. The Central Banking Authority of Kosovo has a Governing Board consisting of five members appointed by the SRSG, namely the Managing Director (MD) who shall be the CEO of the CBAK, and four non-executive Directors among the Chairperson of the Board. The Governing Board formulates policies for the operations of the CBAK and supervises their implementation.

97. OIOS was unable to form an opinion on the effectiveness of the Governing Board and whether its work is in compliance with the respective regulations due to the fact that the Managing Director denied access to the Board's Minutes of Meetings on the grounds that the CBAK is dealing with confidential issues. Such denial is considered a scope limitation on OIOS' work.

V. ACKNOWLEDGEMENT

98. We wish to express our appreciation to the Management and staff of UNMIK for the assistance and cooperation extended to the auditors during this assignment.

STATUS OF AUDIT RECOMMENDATIONS

Recom. no.	C/O ¹	Actions needed to close recommendation	Implementation date ²
1	O	Submission of documents to OIOS that provide a formal accounting of the non-compliance of the KTA Regulation and an action plan for implementing corrective measures.	Not provided
2	O	Submission to OIOS, the comprehensive external evaluation of governance mechanisms supporting the Board of Directors in the KTA, and documentation supporting the implementation of the evaluation's resulting reform programme.	Not provided
3	O	Submission of documents to OIOS that supports UNMIK's decision to override corporate governance policies and standards regarding the appointments to the Board of Directors of the Kosovo Energy Corporation J.S.C (KEK); including the basis for the "unique and critical state of affairs" at KEK, and the reasons for appointing politically active members and a member having an apparent material conflict of interest.	Not provided
4	O	Submission of documents to OIOS providing assurance that oversight and monitoring mechanisms are strengthened in order to avoid any actual or perceived conflict of interest in the decisions of the Board of Directors of the Kosovo Energy Corporation J.S.C.	Not provided
5	O	Submission of documents to OIOS providing clarification of the roles and responsibilities in developing, implementing and monitoring the KTA's strategic initiatives.	Not provided
6	O	Submission to OIOS, the Agency's exit strategy and regular progress reports provided to the Board of Directors of the KTA on UNMIK's transitional planning.	Not provided
7	O	Submission of external audit reports to OIOS, of the: (i) the Kosovo Trust Agency – Kosovo Consolidated Budget financial accounts for the fiscal years 2002 to 2005; and (ii) the Agency's trust fund accounts for the fiscal years 2002 to 2006.	Not provided
8	O	Submission of documents to OIOS, supporting the implementation of an adequate automated financial accounting system in the Kosovo Trust Agency.	Not provided
9	O	Submission of documents to OIOS, supporting the implementation of mechanisms that strengthen the internal audit function in the Agency, and establishment of reporting lines that provides an appropriate level of organizational independence.	Not provided
10	O	Submission of documents to OIOS, supporting the establishment of an effective audit committee that reports to the Board of Directors of the KTA.	Not provided
11	O	Submission to OIOS, the strategic action plan that addresses financial management reforms in the POEs and documents that support the establishment of monitoring controls through the Board of Directors of the KTA.	Not provided
12	O	Submission of documents to OIOS that supports UNMIK's understanding of its responsibilities to provide oversight to the POE's.	Not provided
13	O	Submission of documents to OIOS that supports the completion of the assessment and prioritization of recommendations from all previous reviews and audits of the POEs, and full implementation of those recommendations deemed critical to the Mission's success.	Not provided
14	O	Submission of documents to OIOS that supports the reconstitution of the KEK Audit, Finance and Insurance Committee.	Not provided
15	O	Submission of documents to OIOS that supports the establishment and	Not provided

Recom. no.	C/O ¹	Actions needed to close recommendation	Implementation date ²
		implementation of annual evaluations of the boards of directors in POEs; and quality assurance assessments of the internal audit functions in POEs.	
16	O	Submission of documents to OIOS that supports the establishment of a policy and issuance of an administrative directive on accounting for and controlling outstanding receivables from electricity services provided in enclave areas.	Not provided
17	O	Submission to OIOS, a strategy that addresses the issue of uncollectible electricity bills from enclave areas.	Not provided
18	O	Submission to OIOS, the amendment of the respective regulations that requires the Assembly of Kosovo to approve the budgets of the Regulators and the appointment of the Board Members.	Not provided
19	O	Submission of documents to OIOS that supports the establishment of a mechanism that selects board members for the regulatory bodies based on merit, using objective criteria and a transparent process.	Not provided
20	O	Submission of documents to OIOS that support action taken to ensure adequate separation between the executive function and Governing Boards in the Regulatory Bodies.	Not provided
21	O	Measures taken by UNMIK to retain key staff members in the Regulators, and offset pay differentials in the prevailing external labor market.	Not provided
22	O	Submission of documents to OIOS on actions taken to either establish and maintain audit units and audit committees in the Regulatory Bodies, or otherwise obtain a formal exemption.	Not provided
23	O	Submission to OIOS the audit charter and audit manual for UNMIK Customs Service.	Not provided
24	O	Submission of documents to OIOS that support the establishment of an audit committee in the UNMIK Customs Service and direct reporting of the UNMIK Customs Service audit function to the Committee.	Not provided
25	O	Submission of documents to OIOS that support the completion of an investigation of transfers totaling €2.9 million from the UNMIK Customs Service bank to an unidentified account, and provision of the investigation report to the Office of the Auditor General.	Not provided
26	O	Submission to OIOS the audit charter and audit manual from the Central Banking Authority of Kosovo.	Not provided

1. C = closed, O = open

2. Date provided by UNMIK in response to recommendations.

UNMIK PILLAR IV MANDATE - 2007

1. Assist, advise and support the SRSG in the tasks given to him under UNSCR 1244 (1999) in the area of economic reconstruction and development;
2. Oversee and, where required under applicable law, manages economic and financial competencies in reserved areas, including the institutional structures created to this end. These structures include the UNMIK Customs Service, the Central Banking Authority of Kosovo, the Civil Aviation Regulatory Office and the Kosovo Trust Agency. Ensures the implementation of the recommendations of audit reports regarding in particular, the Publicly Owned Enterprises (POEs);
3. Further strengthens the economic and fiscal legal and institutional framework in order to create a viable market economy; drafts and implements legislation in reserved areas of competence; and makes sure, in coordination with the PISG, that developed legislation and policies in transferred areas are EU compatible, in line with section 5.7 of the Constitutional Framework for Provisional Self-Government of Kosovo (UNMIK Regulation No.200 1/9);
4. In cooperation with the PISG, works on the implementation of those Standards for Kosovo relevant to the economy and reports on the progress made in their implementation;
5. Develops, in close consultation with the PISG without prejudice to the determination of the final status of Kosovo, international economic relations including international economic agreements, in particular with the International Financial Institutions, and promotes integration of Kosovo in relevant regional economic and trade initiatives;
6. In line with the overall UNMIK policy for transfer of competences, assists the PISG in developing a plan for comprehensive capacity-building in the area of economic reconstruction and development; contributes to the design of technical assistance programmes, in coordination with donors and implementing agencies and in particular with the European Agency for Reconstruction;
7. Monitors the implementation of transferred competencies and functions exercised by the PISG in the area of economic reconstruction and development, and intervenes in cases of abuse or failure of the PISG to implement their tasks;
8. Contributes to the promotion of the European perspective of Kosovo and its progress within the Stabilization and Association Process, relying on the UNMIK European Integration Office and cooperating closely with the UNMIK Office of the Strategy Coordinator, under the SRSG and the Office for European Integration Processes in the Office of the Prime Minister (UNMIK Administrative Direction No 2004/18);
9. Maintains close working relations with representatives of all institutions of the European Union and its Member States as well as representatives of the international community;
10. Reports regularly to the European Commission on progress regarding the implementation of the Pillar's mandate; consults with the European Commission on relevant issues and holds regular co-ordination meetings;

UNMIK PILLAR IV MANDATE - 2007

11. Respects the special terms and conditions stipulated in the Contribution Agreement between the European Commission, acting on behalf of the European Community, and UNMIK and takes all necessary measures to ensure sound and effective management and good use of funds provided from the European Community budget for the operating costs of Pillar IV; and
12. Undertakes such extra tasks as may be requested by the Secretary-General of the United Nations or his Special Representative, which are not included in the above mandate and are consistent with the UNSCR 1244, after consultation and agreement with the European Commission.

ACRONYMS AND ABBREVIATIONS

Agency	Kosovo Trust Agency (as per definition in KTA Regulation)
CBAK	Central Banking Authority of Kosovo
DSRSG	Deputy Special Representative to the Secretary General
EAR	European Agency for Reconstruction
EC	European Commission
Enterprises	Entity or assets that the Agency has the authority to administer
EU	European Union
FMO	Frequency Management Office
KCB	Kosovo Consolidated Budget
KEK	Kosovo Energy Corporation J.S.C.
KPMG	Formally known as Klynveld Peat Marwick Goerdeler
KOSTT	Kosovo Transmission, System Market Operator (TSMO) J.S.C.
KTA	Kosovo Trust Agency
KTA Regulation	UNMIK Regulation No. 2002/12 and No. 2005/18
IAU	Internal Audit Unit
ICAA	Icelandic Civil Aviation Administration
ICAO	International Civil Aviation Organization
ICMM	Independent Commission for Mines and Minerals
INTOSAI	International Organization of Supreme Audit Institutions
MEF	Ministry of Economy and Finance (also referred to as MFE)
MEM	Ministry of Energy and Mining
OAG	Office of the Auditor General of Kosovo
OECD	Organization for Economic Co-operation and Development
OIOS	Office of Internal Oversight Services
OSCE	Organization for Security and Co-operation in Europe
PIA	Pristina International Airport J.S.C.
PISG	Provisional Institutions of Self-Government
POE	Publicly-owned enterprise
PTK	Postal and Telecommunications of Kosovo J.S.C.
Railways	Kosovo Railways J.S.C.
SOE	Socially-owned enterprise
SRSG	Special Representative of the Secretary-General
SSO	Special spin-off
TRA	Telecommunications Regulatory Authority
UNMIK	United Nations Interim Administration Mission in Kosovo