Kyrgyz Republic
Country Financial Accountability Assessment

March 1, 2004

Operations Policy and Services Unit
Europe and Central Asia Region
ABBREVIATIONS AND ACRONYMS

CA: Chamber of Accounts
CAA: Chamber of Accountants and Auditors
CAE: Country Assistance Evaluation
CAS: Country Assistance Strategy
CDF: Comprehensive Development Framework
CFAA: Country Financial Accountability Assessment
CIS: Commonwealth of Independent States
COGO: Committee of Sponsoring Organizations
CPAR: Country Procurement Assessment Report
EU-TACIS: European Union – Technical Assistance for Commonwealth of Independent States
FMS: Financial Management Specialist
FSAP: Financial Sector Assessment Program
FY: Fiscal Year
GDP: Gross Domestic Product
GFMS: Government Financial Management Information System
GFS: Government Financial Statistics
GSAC: Governance Structural Adjustment Credit
GTAC: Governance Technical Assistance Credit
IMF: International Monetary Fund
IAS: International Accounting Standards
IASB: International Accounting Standards Board
IASC: International Accounting Standards Committee
IDA: International Development Association
IEG: International Education Guideline
IFAC: International Federation of Accountants
IIA: Institute of Internal Auditors
INTOSAI: International Organization of Supreme Audit Institutions
IPAS: International Public Sector Accounting Standards
ISA: International Standards on Auditing
JSC: Joint Stock Companies
KSE: Kyrgyz Stock Exchange
MoF: Ministry of Finance
NBRK: National Bank of the Kyrgyz Republic
NPRS: National Poverty Reduction Strategy
OECD: Organization for Economic Cooperation and Development
OED: Operations Evaluation Department (of the World Bank)
PER: Public Expenditure Review
PIP: Public Investment Program
PMR: Project Monitoring Reports
FRGF: Poverty Reduction and Growth Facility
PSRMAC: Public Sector Resource Management Assistance Center
ROSC: Report on the Observance of Standards and Codes
SAI: Supreme Audit Institution
SCSM: State Commission on Securities
SCFPMB: State Commission on Public Procurement and Materials Reserve
SCSFSA: State Commission on Standards of Financial Accounting and Audit
SOE: State-Owned Enterprise
SSC: Settlement Savings Company
TSA: Treasury Single Account
UAA: Union of Auditors
UNDP: United Nations Development Program
USAID: United States Agency for International Development
WTO: World Trade Organization

Regional Vice-President: Shigro Kami, ECAVP
Country Director: Dennis de Tray, ECCUB
Sector Director: Alain Colliou, ECPS
Sector Manager: John Hegarty, ECPS
Task Team Leader: Sanjay Vani, ECPS
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PREFACE

This report was prepared on the basis of the findings of a series of World Bank missions to the Kyrgyz Republic from January 2002 to June 2002 by a Task Team comprised of Sanjay Vani, Task Team Leader and Talaibek Kosmatov (ECCKY). The Government and private sector counterparts were actively involved in the entire process.

The report is based on the results of interviews and discussions with public and private institutions and on detailed analysis of the laws and other relevant information. Government and private sector counterparts lent their full support to the CFAA mission and engaged with the Bank’s team in a comprehensive dialogue. The Bank is grateful to the Government of the Kyrgyz Republic for this cooperation.

Purpose of the Report

A CFAA considers the strength of the financial accountability framework in both the public and private sectors. The aim of this report is to assess whether the existing framework in both the public and private sectors, as designed and practiced, can ensure proper use of the Kyrgyz Republic’s own resources and those provided by the Bank and other institutions.

One of the CFAA’s main purposes is to assess the risks posed by the financial accountability framework for the implementation of Bank programs and the use of Bank funds, and to propose suitable measures to manage these risks. The CFAA also supports a dialogue with the borrower country and development partners on financial accountability matters, and assists in the design of programs to build financial management capacity.

The CFAA is a diagnostic exercise covering the financial management systems of the public and private sectors of a country. It is not an audit, and it does not provide assurance that all funds are being used for intended purposes. However, it strives for a well-informed and objective assessment of the strengths and weaknesses of financial management systems, a diagnosis of problems and advice on their resolution, and an indication of the level of financial accountability risk in the country concerned.

Each CFAA is expected to cover specific core content. Although financial accountability encompasses a wide range of activities in the private and public sectors of an economy, this CFAA concentrates on the following:

- Transparent and Accountable Budgeting
- Public Sector Accounting and Financial Reporting
- Public Sector Internal Control System
- Public Sector Auditing
- Legislative Scrutiny of Public Sector Financial Management
- Private Sector Financial Accounting and Auditing Practices
The executive arm of the Government has an obligation of safekeeping and proper use of public resources, and provision of a credible legal/regulatory framework to promote good financial governance in both the private and public sectors. The institutional and legal/regulatory regime constitutes the public financial accountability framework in a country.

The Bank’s interest in the CFAA lies mainly in providing inputs for managing fiduciary risks. The Bank’s fiduciary responsibilities to its shareholders and the borrowing Government’s fiduciary responsibilities to its citizens are closely related. The borrowing Government meeting its fiduciary responsibilities to the citizens is a necessary condition for the Bank to meet its fiduciary responsibilities to its shareholders. It is therefore necessary for a country to develop a proper financial accountability framework, in design as well as in practice. The CFAA, therefore, must not only focus on the existing systemic weaknesses giving rise to fiduciary risks, but also advise on developmental needs.

Acknowledgements

The mission members acknowledge the extensive cooperation and assistance received from officials of the Government, state agencies, and private sector institutions interviewed. Dennis de Tray, Country Director, and Mohinder Mudahar, Country Manager offered invaluable assistance and information in carrying out the CFAA. Pedro Rodriguez, Alma Kanani, Natalia Pisareva (ECSPE), Dinara Djoldosheva (ECSHD), Naushad Khan, Karina Mostipan (ECSPS) provided useful comments and valuable information. Zamira Moldobekova, Svetlana Matveeva, and Natalia Turchina, Team Assistants in the Bank’s Bishkek Office, provided excellent support with logistic arrangements for the mission. John Hegarty, ECA Regional Financial Management Manager, Helga Muller, Sector Manager (ECSPE), Owaise Saadat, Sr. Operations Adviser, Natalya Beisenova (ECCU8) and peer reviewers David Shand (OPCFM) and Amitabha Mukherjee (EASPR) offered valuable comments and provided other important inputs to the task. Richard Carroll, Consultant, contributed to the editing of the report.
EXECUTIVE SUMMARY

Country Context

1. The Kyrgyz Republic is a small, mountainous country with a predominantly agricultural economy with a population of about 5 million. It is one of the poorest countries of the former Soviet Union. In 2001, the per capita income was barely US$300, and 52 percent of the inhabitants were considered poor. In an effort to improve its condition, the Kyrgyz Republic has been quite progressive in initiating market reforms and making fiscal adjustments. Although foreign assistance played a substantial role in the country's economic turnaround in the mid-1990s, it is now saddled with a heavy burden of external debt. The Government, with participation from several stakeholders, has prepared a Comprehensive Development Framework and a National Strategy for Poverty Reduction (for the years 2003 to 2005).

2. Immediately following independence, with weak political parties and a lack of democratic traditions, the new President assumed greater responsibilities, including those dealing with the economy. The President continues to retain extensive decision-making powers. The President is responsible for forming the government. A bicameral Parliament provides legislative oversight over the executive.

Overall Fiduciary Assessment

3. At present, there is clearly a moderate to high degree of fiduciary risk in the use of public resources, given the absence of effective cash planning that results in providing no predictability to the line ministries in implementing the approved budget, weak institutional arrangements for assessing the effectiveness of budget implementation, weak internal controls further compounded by the absence of an internal audit function, insufficient accountability arrangements for the State Owned Enterprises, weak external audit, and weak capacity in the legislative body to provide effective parliamentary oversight over the executive. However, on the positive side, it must be noted that basic institutions and a legislative framework have been created in the Kyrgyz Republic and the challenge now is to build the necessary capacity to implement and enforce existing laws and regulations. This requires significant capacity building efforts over a sustained period of time - much also depends upon the commitment from the political leadership. An effective system of public financial accountability requires not only the executive branch to play its role but also the legislature, external auditors, civil society and public to play a meaningful role. Focusing on one aspect of public financial accountability at the expense of the others will not achieve the development objective.

4. NBKR has adopted International Accounting Standards (IAS) for preparing its financial statements. Since 1995, NBKR is audited by one of the Big 4 international audit firms from their offices in London, Moscow, Almaty, or Bishkek. The auditors have issued unqualified audit opinions for the years 2001 and 2000. NBKR also has a professionally staffed Internal Audit Department that reports directly to the Chairman. Considering the above, the Bank could rely upon NBKR’s special deposit accounting, reporting and audit arrangements for meeting the Bank’s current fiduciary requirements in respect of the Special Deposit account for adjustment credits.
5. Given the existing weaknesses in the financial accountability framework, the CFAA recommends that ring-fenced control be maintained for Bank-funded investment projects until the systemic weaknesses described in this report have been adequately addressed. Overall, fiduciary risk is manageable provided the Government takes the steps outlined in this report as well as those mentioned the Public Expenditure Report (PER) and Country Procurement Assessment Report (CPAR). The Government has undertaken several reforms in the past few years, but significant challenges remain.

*Recent Reforms in the Public Sector Financial Management*

6. In the short time span of little over a decade since independence, the Kyrgyz Republic has made significant progress in establishing a legal and an institutional base. The Constitution and supporting laws spell out the roles and responsibilities of the Government, the Parliament, and the Chamber of Accounts (CA). The Kyrgyz Republic has made significant progress in the area of budget preparation and implementation – it has implemented a three-year rolling projection of revenues and expenditures that provides the framework for the annual budget. It has also adopted a 1986 IMF-GFS compliant budget classification system. It has established a functioning treasury system that handles government payments. The Chamber of Accounts, with a staff of 170, conducts external audit, which in actual practice is more in the nature of inspection than audit, of the budget execution without much scope limitation except that it has no authority to conduct interim audits. Both the houses of Parliament are relatively active in the legislative area.

7. In private sector accounting and auditing, the Kyrgyz Republic has taken the lead by requiring all business enterprises to adopt International Accounting Standards (IAS) for financial reporting although this requirement has placed substantial burden on small and medium enterprises not listed on the stock exchange and by enacting a new law on auditing, and by establishing a regulatory body for the audit profession.

8. Although the Kyrgyz Republic has made significant progress in some areas, there are areas that deserve priority attention. For example, the Government has established a treasury system, but must now focus on achieving an efficient cash management system and effective treasury controls. Similarly, noticeable progress has been made in the budget preparation and the next steps of evaluating budget outputs and outcomes and improving commitment controls are key.

*Summary of main Findings and Recommendations*

**Budget Formulation, Implementation, and Evaluation**

9. Weak cash planning and cash management practices provides less predictability in the implementation of approved budgets. There is no certainty as regards availability of funds for the implementation of the approved budget due to over-
estimation of revenues and the absence of effective cash planning. This has several ramifications. To certain extent the responsibility for expenditure prioritization and accountability for budget execution has shifted from the line ministries to MoF. Budget institutions tend to focus more on receiving day-to-day cash allocations from the treasury rather than focusing on broader financial management aspects, such as management of commitments and outstanding liabilities or analyzing the cost of providing services.

10. **Weak Capital Expenditure Budgeting.** There are no clear-cut criteria for evaluating capital expenditure proposals. In a situation where several projects are competing for a limited funds, a clear definition of technical, economic, financial, environment, and social requirements would not only ensure that resource allocation is done efficiently but would also enhance transparency in the decision making process. Moreover, by not clearly estimating the associated recurrent expenditures with the capital projects, there is a risk of improper selection of capital expenditure project.

11. **Absence of mechanisms to evaluate budget programs.** There are no clearly defined mechanisms to measure and evaluate outputs of budget-financed programs. Part of the problem is that outputs are not clearly defined while budget programs are formulated. In the absence of such a mechanism, it is difficult to evaluate the effectiveness and efficiency in implementation of budget programs.

12. Establish realistic expenditure allocations supported by effective cash planning. Develop clear-cut criteria for selection of capital projects, including technical, economic, financial, environment, and social criteria. Establish a budget evaluation function for proper evaluation of budget outputs and accountability of program managers. After the annual budget is approved by the Parliament and the President, the MoF should develop realistic allocation strategy based on sound cash planning methods. This would provide predictability to the line ministries and free up substantial staff time that could be used to focus on broader financial management issues. The Kyrgyz Republic needs to build on the reforms already initiated in the budget preparation area by establishing a budget evaluation function to assess the effectiveness of budget implementation. This would also require clear definition of program outputs, developing output measurement systems, and specifying performance evaluation criteria. It will also require strengthening capacity of the line ministries to undertake program budgeting.

**Internal Controls and Internal Audit**

13. **Weak internal controls and absence of internal audit.** Internal controls is one area that has not received as much attention in the Kyrgyz Republic as it deserves. There are no clear legal requirements that necessitate line ministries to maintain a sound internal control framework and be held accountable for it. The two most recent audit reports of the Chamber of Accounts indicate several instances if non-compliance with laws and widespread fraud/corruption across a number of ministries. The treasury system carries a high risk of over-reporting of payments by the paying banks so as to utilize the float during the month. This CFKA report provides details regarding major risks present in the current treasury operations, particularly regarding reimbursement to the paying banks and transfer of collections from the collecting Banks. The internal control framework is further weakened by the absence of an internal audit function. Internal audit is an essential
element of the internal control framework as it provides an assurance to the management about the efficacy of the internal controls and makes recommendations to strengthen the controls in a timely manner and on a continuous basis.

14. **Strengthen internal controls including internal controls in the treasury.** The treasury needs to establish daily reconciliation of consolidated regional treasury payment requests with the reimbursement by the National Bank of the Kyrgyz Republic (NBKR) to the agent banks, and a daily reconciliation between revenue collections transferred by the agent banks with the taxpayer filled payment forms. This report provides detailed recommendations to strengthen the treasury controls.

15. **Establish a modern internal audit function that is focused on continuously evaluating the internal control framework and assisting line ministries in evaluating program implementation.** External auditors cannot be the main detectors of problems; there is a need for an internal capacity to detect problems on a timely basis. By establishing an effective internal audit function, the internal control framework would be strengthened as the management would be able to take necessary action to address any control weaknesses on a timely basis without waiting for the external auditor to report such weaknesses, which takes place after a significant lapse of time. This report provides a conceptual outline of a modern internal audit function that could be considered while establishing an internal audit function in the Kyrgyz Republic.

**Accounting and financial reporting**

16. Although line ministries prepare modified accrual-based financial statements, consolidated financial statements for the government as a whole are not prepared. Moreover, there is no analysis of the individual accrual-based financial statements of line ministries for determining the extent of unpaid liabilities. The cash-based statements prepared by the treasury are used for cash management purposes and for presentation to the Parliament. There is a distinct lack of understanding on the part of managers in the line ministries and the treasury as to how the accrual-based financials statements could be used for better financial management. Moreover, absence of any meaningful management accounting systems makes analysis and interpretation of costs and performance difficult.

17. Build capacity in the Accounting Methodology Department (MoF) to prepare consolidated financial statements for the Government. Preparation of consolidated financial statements would provide important information on accumulated liabilities that would be useful in cash planning. There is also a need to update and revise the accounting regulations issued in February 2001 by including formats of reports, modifying the Chart of Accounts, and specifying guidelines for consolidation of accounts at various levels. Once the MoF gains sufficient experience in the preparation and analysis of accrual-based financial statements, consideration should be given for the audit of these financial statements by the CA and presentation of such audited statements to the Parliament for information to complement the discussion on cash-based budget execution statements. The extent of accumulated liabilities would provide useful information to the Parliament and provide an indication of how much of the future cash-flows are already committed.
18. Introduce a system of management accounting\(^2\) that could provide useful information on costing and performance accounting to managers, and simultaneously create capacity within departmental management to understand and interpret management accounting reports. Accounting staff spends a large amount of time on reconciling figures instead of producing useful information for management decision-making and control. One solution would be to implement an integrated software that keeps track of budget provisions, commitments, liabilities, and actual expenses, which would not only speed up the preparation of financial reports but also free up the time of the officials for analytical and control work. In addition, efforts should be made to create capacity within departmental management to understand and interpret management accounting data thus ensuring demand for high quality management accounting services.

**External Audit**

19. **Weak Capacity in External audit.** Currently, work performed by the CA corresponds more to the inspection work than audit. The Chamber of Accounts (CA) has very limited capacity to carry out effective financial audits as it has had very little exposure to modern audit techniques and standards. The CA is prohibited from carrying out interim audits during the financial year. Interim audit ensures timely completion of annual audits and also facilitates quick resolution of issues thus preventing its recurrence during the year. The process of appointing the Chairman of the CA is not transparent enough to ensure that the CA remains an independent external audit body although the recent amendments to the Constitution now require the appointment of the Chairman to be done by the President with the consent of the Parliament. The position of the Chairman is an important position in the accountability framework as he provides leadership and direction to the Supreme Audit Institution.

20. **Strengthen capacity of the CA by pursuing twinning arrangements with a well-established Supreme Audit Institution.** The CA would considerably benefit by entering into twinning arrangements with another well-established SAI. This would enable the CA staff to learn latest audit techniques - such as risk-based audit techniques - as well as recent advances in government auditing. There is also a need to authorize the CA to carry out interim audits so as to complete the annual audits on a timely basis.

**Legislative Scrutiny**

21. **Parliamentary Oversight.** The Parliament plays an important role in the accountability framework by providing oversight over the executive. As with the executive branch, the parliamentary Budget and Economic Policy committee lacks capacity to provide meaningful inputs and suggestions over the budget execution reports and audit reports due to several reasons. One of the reasons is lack of exposure to practices and

\(^2\) The term Management Accounting represents a process of providing information to internal managers who are charged with directing, planning, and controlling operations and making decisions. Managerial accounting provides technical and operational data to help management evaluate a department’s and agency’s financial performance. One of the tools of management accounting is costing system – providing information to the manager regarding the cost of providing a service, such as treating a patient in a hospital, helps the manager in planning and controlling the operations. Provision of just the financial information such as expenditures by budget classification, though important and useful, is not enough if the manager has to optimize the use of resources.
procedures adopted in a well functioning parliamentary committees. In addition, the committee has inadequate technical resources that could provide research and analytical inputs during the discussion on budget proposals, budget execution reports, and audit reports.

22. **Strengthen the parliamentary Committee on Budget and Economic Policy to provide effective oversight over the executive by building research and analytical capacity and by providing exposure to international best practices in legislative scrutiny.** The Parliament has a committee to perform a detailed review of budget proposals, budget execution reports prepared by the Government, and audit reports submitted by the CA. There is a need to strengthen its capacity by providing exposure to international best practices and technical resources to carry out analysis and research. The possibility of establishing a fiscal analysis office within the Parliament to be staffed by economists and financial experts should be explored.

23. **State Owned Enterprises' (SOE) audited financial statements and audit reports should be subject to the parliamentary review, just like the financial statements of the government.** Although SOEs control significant amount of public funds and property, there is no automatic reporting on SOEs' financial results and annual audits to the Parliament. The law contains no specific provisions making SOEs annual financial statements and audit reports available to the Parliament. To begin with, annual financial statements and audit reports of SOEs could be submitted to the Parliamentary Budget and Economic Policy Committee for information.

**Social Fund**

24. **Weak internal audit in Social Fund.** As the Social Fund controls enormous resources and has a relatively autonomous structure, SF should have strong internal control framework and an effective internal audit department. The internal audit department within SF is weak and lacks exposure to modern internal audit techniques and procedures particularly risk-based methodology, which is an useful tool considering the large number of beneficiaries serviced by SF. The manual pensioner database is prone to manipulations and errors.

25. **Strengthen internal audit capacity within the Social Fund (SF) and introduce a computerized central pension database.** There is an urgent need to strengthen the internal audit function in the SF. Considering the large number of pension payments, establishing a secured central pension database should receive the highest priority. Moreover, SF would benefit by requiring a periodic financial audit of its operations and finances by an experienced international audit firm.

**Private Sector Accounting and Auditing**

26. **Private sector accounting and auditing.** The timetable for the implementation of IAS is very ambitious given that the country does not have a critical mass of accountants who could implement IAS across the wide spectrum of business enterprises. The State Commission on Standards of Financial Accounting and Audit under the Government of the Kyrgyz Republic (SCSFAA), the regulatory authority over the audit profession, has very weak capacity to provide effective oversight over the audit profession.
27. The State Commission on Standards of Financial Accounting and Audit under the Government of the Kyrgyz Republic (SCSFAA) should conduct a comprehensive review of the experience in implementation of IAS in the country. Based on the SCSFAA review, the Government should determine the applicability of IAS, particularly to the closely held (private) Joint Stock Companies, partnerships, and sole-proprietorships firms, which may not have a direct public interest in their financial reporting.

28. SCSFAA should adopt International Standards on Auditing (ISA) and a Code of Ethics. The capacity of the SCSFAA to provide effective oversight over the audit profession should be strengthened. A separate disciplinary committee within SCSFAA should be established and rules governing working of this committee should be prepared to ensure a transparent and objective disciplinary process. SCSFAA should also ensure that the examination process to determine the eligibility of candidates is transparent and objective. Considering the inadequate capacity within local firms to carry out audits of IAS-based financial statements and follow ISA, the NBKR should establish procedures for ascertaining acceptability of auditors for conducting audit of commercial banks. This is important considering the failure of several banks in the last few years. NBKR should also explore the possibility of requiring mandatory joint audits of commercial banks to be conducted jointly by an international audit firm and a local audit firm so as to improve the skills of and provide exposure to local audit firms in international audit practices.

Next Steps

29. To build on its current reform efforts, the Government should constitute a high-level working group. Experience in many other countries shows that the required changes will entail reaching political consensus and reforming existing institutions or creating new ones. This suggests that a realistic timetable for improvement in public financial accountability will have to stretch over several years and will depend on strong leadership from the top. Experience has also shown that any change of fundamental nature that is driven from outside and that lacks political consensus will fail to achieve its objective. To avoid this danger, the Government should set up a working group to decide on the longer-term conceptual issues identified in this report and launch preparatory work on a detailed action plan. Several systemic improvements would also require technical assistance for formulation and implementation. The attached timetable of Next Steps sets out the possible timeframe of the main recommendations of this CFAA.

Timetable of Recommended Actions

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<tr>
<th>Objectives</th>
<th>Measures</th>
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<tr>
<td>To provide predictability for budget implementation and provide reliable, timely, and useful financial and management reports for better financial management and</td>
<td>a. Develop effective cash planning system</td>
<td>Short-term</td>
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<td>b. Prepare consolidated financial statements for the government as a whole</td>
<td>Short-term</td>
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<td>c. Introduce a system of management accounting to provide useful information on costing and performance accounting</td>
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<td>d. Provide training to departmental managers in the use and interpretation of accrual-based financial statements</td>
<td>Short-term to Long-term</td>
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<td>e. Provide training to departmental managers</td>
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<td>Objectives</td>
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<td>decision making</td>
<td>in the use of management accounting reports</td>
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<td>f. Develop clear-cut criteria for selection of capital projects</td>
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<td>To establish a sound and effective internal control framework</td>
<td>a. Strengthen internal controls including treasury controls on the lines suggested in this report</td>
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<td>b. Establish modern internal audit function</td>
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<td>c. Create a centralized and secure database of employees to strengthen internal controls in payroll processing</td>
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<td>d. Implement the treasury automation project</td>
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<td>e. Discontinue the special means financing of budget institutions</td>
<td>Short-term</td>
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<td>To improve public financial accountability and transparency</td>
<td>a. Publish consolidated financial statements including posting them on the website</td>
<td>Short-term</td>
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<td>b. Improve transparency in the appointment process of the Chairman of the CA</td>
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<td>c. Strengthen capacity of the CA by pursuing twinning arrangements with other well-established SAIs</td>
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<td>d. require certification by the CA for year-end financial statements of the government</td>
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<td>e. Authorize CA to conduct interim audits</td>
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<td>f. Discontinue the practice of retaining 10% of the fines/penalties</td>
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<td>g. Adopt and implement INTOSAI audit standards for audits by the CA</td>
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<td>h. Strengthen the capacity of the parliamentary committee by providing exposure to international best practices and building research and analytical capacity</td>
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<td>i. Provide mechanisms for the parliament to review the annual financial statements and audit reports of State Owned Enterprises</td>
<td>Short-term</td>
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<td>To improve the institutional and regulatory framework for the private sector accounting and auditing</td>
<td>a. Conduct a comprehensive review of the experience in the implementation of IAS and consider applicability of IAS to sole-proprietory firms, partnership firms, SMEs</td>
<td>Short-term</td>
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<td>b. Adopt ISA and Code of Ethics</td>
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<td>c. Strengthen the capacity of the SCSFAA to provide effective oversight over the audit profession and establish disciplinary committee within SCSFAA</td>
<td>Medium-term</td>
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(Short-term measures refer to the time frame of 1 to 2 years, medium-term 3 to 5 years, and long-term in excess of 5 years)
1. COUNTRY AND ECONOMIC BACKGROUND

1.1 The Kyrgyz Republic has weathered economic shocks since independence. The Kyrgyz Republic is a small, mountainous country with a predominantly agricultural economy where 65% of country's population lives in rural, mostly mountainous areas. The country became an independent state when decades of Soviet rule ended in 1991. Despite some progress, the Kyrgyz Republic remains one of the poorest countries of the former Soviet Union. The economy contracted sharply in the early 1990s, and, while foreign assistance played a substantial role in the country's economic turnaround in the mid-1990s, the country suffered severe economic aftershocks from the August 1998 financial crisis in Russia.

1.2 The Kyrgyz Republic has been progressive in initiating market reforms. The Kyrgyz government has taken a number of measures to combat the country's economic problems, including efforts to stabilize rampant inflation, boost industrial production, and stimulate growth. As a result, in 2000 and 2001, the inflation rate was reduced to less than 10% and its GDP grew by more than 5% as industrial production expanded, particularly due to growth in production at the Kumtor gold mines. However, the per capita income was barely able to touch US$300, and 52% of the total population of little less than 5 million were considered poor. Despite the fiscal adjustment, the country is saddled with a heavy burden of external debt. The country's level of external debt of more than 200% of the exports and 116% of the GDP in 2001 is difficult to sustain. In the energy sector, the Kyrgyz Republic's lack of oil and gas reserves has left the country dependent on imports for its energy supplies. Yet, with an abundance of mountain rivers, the Kyrgyz Republic has significant hydroelectric potential.

1.3 The Kyrgyz Republic is divided into 7 oblasts (regions), including the city of Bishkek, which are subdivided into 43 rayons (districts). The President, in consultation with elected local councils, appoints the oblast governors (head of local state administration). The local self-governments to a significant extent are dependent upon the resource transfers from the central government. Moreover, the local governments use the treasury system for financial transactions and the financial administration of the local government is manned and supervised by the Ministry of Finance (MoF). Considering the dependence of local bodies on the central government, and the adoption of central government control systems in the operations of local government, it was agreed that this CFAA will focus on the assessment of financial accountability only at the central government level.

1.4 The November 2001 Country Assistance Strategy (CAS) Progress Report3 emphasized governance and institution building as two of the main elements of Bank's strategy in the Kyrgyz Republic. The report also highlights the need for strong and sustained action on governance as a key element of the poverty reduction strategy. Under the Comprehensive Development Framework (CDF) umbrella, the Kyrgyz authorities have announced their intention to make improved governance a national priority. The National

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3 Kyrgyz Republic: Country Assistance Strategy (CAS) Progress Report No. 23185-KG dated November 9, 2001. A new CAS is currently being prepared and the CFAA diagnostic will be considered in the Bank's assistance strategy.
Strategy for Poverty Reduction (NSPR 2003-05), currently being prepared by the Government, aims at implementing several reforms in the financial management area.

1.5 The Bank has been actively involved in the public sector and financial sector reforms in the Kyrgyz Republic. In the public sector, the Bank financed Public Sector Resource Management Adjustment Credit (PSRMAC), as part of the overall program of stabilization and structural reform, initiated important changes to the budget process and the intergovernmental system. A Public Expenditure Review (PER) and a Country Procurement Assessment Report (CPAR) are currently being carried out and the CFAA team has been working closely with the respective teams to ensure the consistency of recommendations. The Bank is also preparing a Governance Structural Adjustment Credit (GSAC) and Governance Technical Assistance Credit (GTAC) and the CFAA recommendations support the GSAC policy matrix, specifically in the area of public financial management.
2. LEGAL AND INSTITUTIONAL ACCOUNTABILITY FRAMEWORK

2.1 The President is the highest State official and is responsible for forming the government, subject to parliamentary approval for the appointment of the Prime Minister. Immediately following independence, with weak political parties and a lack of democratic traditions, the President assumed greater responsibility for the adoption of important decisions, including those dealing with the economy. The President still has extensive decision-making powers including the authority to appoint directors of administrative departments in consultation with the Prime Minister. The Presidential Administration provides advice to the President and works with the Government. The Constitution, adopted in May 1993 and amended in a February 1996 referendum, mandated a bicameral Parliament, Assembly of People's Representatives (70 seats; members are elected representing territorial interests to serve a five-year term) and the Legislative Assembly (35 seats; members are elected by popular vote to a serve five-year term). However, recent amendments to the Constitution, in February 2003, mandates unicameral Parliament with 75 deputies elected by popular vote for a term of five years.

2.2 The Constitution has provided for legislative oversight over the executive in several ways, for example, by requiring the Parliament to approve the annual budget, and to receive the annual audit report submitted by the CA. The Parliament has separate Budget and Economic Policy Committees for each house of Parliament to review budget proposals and budget implementation reports. The Constitutional provisions facilitate proper legislative scrutiny of executive actions. A schematic diagram depicting institutions of financial accountability is given in Figure 1.

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4 The Constitution of the Kyrgyz Republic, Article 46, section 3
Figure 1: Schematic Diagram of Accountability Institutions

2.3 The Kyrgyz Republic has made remarkable progress in the decade since the end of Soviet rule in establishing a legal and institutional framework for accountability arrangements. The Government abolished the State Financial Inspectorate, which carried out compliance tests, in June 2000 because the inspectorate, to a large extent, duplicated the function performed by the external audit body, the Chamber of Accounts (CA). However, as discussed in the following sections, this has created a vacuum in the internal audit area leaving the line managers with no means of obtaining an assurance on the robustness of the internal control framework in their departments. The Constitution and supporting laws spell out the roles and responsibilities of the Government, the Parliament, and the CA, and a comprehensive Civil Code governs the legal framework in the Kyrgyz Republic. Having set up various institutions, what is now needed is building necessary capacity in these institutions, which lack experience and exposure to international best practices.
3. BUDGETARY CONTROLS

3.1 The November 2001 report on fiscal transparency under the Report on the Observance of Standards and Codes (ROSC) program by the International Monetary Fund (IMF) complimented the Kyrgyz authorities for taking a number of steps in recent years particularly in the area of budget preparation. Kyrgyz authorities have made substantial progress in budget preparation by implementing a three-year rolling projection of revenues and expenditures that drives the preparation of the current year's budget, and by adopting a program budgeting approach. By creating an exclusive Public Investment Program (PIP) Department within the Ministry of Finance (MoF) to prepare a foreign-financed capital expenditure budget, it has enabled a single department to process and prepare information related to such projects. It is important to note that the PIP department is not involved in implementing the projects or monitoring their implementation or in the preparation of domestically financed projects (which are not, in any case, significant in terms of investments).

3.2 The November 2001 report of the IMF concludes that the legal framework for fiscal management is fairly complete. The legal framework for budget management is provided in the Law on the Basic Principles of the Budget (1998) and the Law on Treasury (1994). Broad roles and responsibilities of the government and the Parliament in respect of the budget process are defined in the Constitution of the Kyrgyz Republic. The annual Law on Budget provides the road map for the fiscal operations of the government for the ensuing year.

3.3 The Annual budget separately shows appropriations for republican and local budgets. The consolidation of republican and local budgets forms the State budget and thus presents an overall economic and budgetary program for the country.

Budget Preparation and Approval

3.4 Since the budget is a key policy tool for setting the country’s economic and social development priorities, the President must continue to take the lead role in providing overall direction of the budget. The budget process should ideally commence with a pre-budget statement to the Parliament by the President setting out the economic and social priorities for the budget period. The current practice is for the government to prepare a three-year forecast and submit it to the Budget Commission (not to be confused with the Budget Committee of the Parliament) for approval. The document sets the expenditure priorities considering the programs outlined in the CDF. The CDF secretariat and MoF interact closely during the preparation of the three-year forecast. The document contains three-year forecast of revenue and expenditure by the republican and local budgets and by functions, and also by agencies for the republican level. Revenue forecast

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3Simply stated program budgeting consists of classifying government transactions into functions and programmes in relation to the government’s policy goals and objectives; establishing performance indicators for each program activity; measuring the costs of these activities and the outputs delivered.
4In the recent reorganization of the MoF, the responsibility for the PIP now rests with the Investment Policy Department, which, in addition, is also responsible for state debt and coordination of foreign aid.
7For additional discussion on budgeting, please refer to the PER that was simultaneously prepared by the Bank.
is usually based on IMF prepared indicators. The approved document is then submitted to the President for approval. However, it is important to note that, at present, the Kyrgyz budget consists mainly of: (i) wages; (ii) transfers; and (iii) (foreign-financed) investments. Together, these items account for over 70 percent of total spending, thus limiting the maneuverability for policy-based initiatives.

3.5 The Budget Department within MoF is the nodal agency for the preparation of the annual budget. Based on the three-year projections (to be submitted not later than May 1 of the current year), the Budget Commission, which is appointed by the Government, approves the aggregate resources that the government is expected to mobilize during the next fiscal year, including the expenditure ceilings for line ministries. The next step is for the line ministries to prepare their budget proposals within the ceilings indicated by the MoF. MoF frequently consults the IMF in the budget preparation process.

3.6 The capacity in line ministries to prepare program budgets is very limited and it would take sustained training efforts for the line ministry staff to truly absorb the concept of program budgeting. The program documents provided by ministries vary in quality, and the information is not yet used in a systematic and integrated way in the budget process. Estimates of ongoing costs of government policies are not distinguished from new policies in the budget documents. Although the annual budget is prepared within the framework of three-year rolling projections of revenues and expenditures, program budgeting is still to be mainstreamed while preparing annual budgets. The line ministry staff, who are familiar with the incremental budgeting approach, needs to be trained further in the preparation of program budgets. It is important that the program budgeting approach does not remain just the initiative of the budget department, but that it percolates down to the spending units in the line ministries that must prepare the estimates. In order to achieve this objective, amongst several other actions including improvements in macro-economic forecasting capacity, it will be necessary to conduct training programs at the budget institution levels on a periodic basis until the staff fully absorb these concepts. Additionally, the role of sectoral departments within MoF will have to be reviewed as these departments currently play a dominant role that sometimes acts as a disincentive for the line ministries in accepting full responsibility in the budget preparation process. USAID is currently working on building the capacity in line ministries. At the same time efforts must be made to strengthen research and analytical capacity within the budget and revenue departments of the MoF.

3.7 There is a need for reorganizing the budget calendar so as to allow more time for the budget commission to deliberate on the issues before determining the expenditure ceilings and to provide more time to the line ministries to prepare the

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8 Program budgeting consists of classifying government transactions into programs in relation to the government's policy goals and objectives; establishing performance indicators for each program or activity; and measuring the costs of these activities and the outputs delivered. The terms "program budgeting" and "performance budgeting" are often used interchangeably.

9 The November 2001 report on fiscal transparency under the Report on the Observance of Standards and Codes (ROSC) program by the International Monetary Fund (IMF)

10 The Budget Commission comprises the Minister of Finance, representatives from the Prime Minister's office, line ministries, Parliament, the National Bank of the Kyrgyz Republic, and oblast administration. This is an executive level committee whereas the Parliament's Budget and Economic Policy Committee is a legislative level committee.
draft budget. The Budget Commission gets just two weeks to review the medium term forecast and establish expenditure ceilings for line ministries. Considering the importance of this process that needs reviewing medium term forecasts and determines the expenditure ceilings for line ministries, the amount of time available to the Budget Commission to deliberate on these issues is relatively short.

3.8 The structure and contents of the Budget document presented to the Parliament need to be reviewed with a view to providing comprehensive information in the budget document. The budget document discussed in the Parliament comprises budget estimates at the line ministry level and at the major head level that provides information by sub-agency as well as by economic classification. An explanatory memorandum and analytical tables provide additional information. The budget document, however, lacks information regarding contingent liabilities, forecasting assumptions, and fiscal targets. Although the MoF has most of this data and the Parliamentary committees have a right to ask for this information, it is not routinely provided in the budget document.

3.9 The Constitution effectively restricts the ability of the Parliament to suggest major changes in the draft annual budget as Article 65 (Article 68 in the amended Constitution) requires that an amendment increasing the expenditure level or reducing revenues is required to be introduced with the consent of the government. In addition, the Budget Law states that any proposals by Parliament to increase expenditure levels or reduce revenues shall be accompanied by measures to fund the budget deficit (Article 41). This provision helps in ensuring fiscal discipline while legislative deliberations are ongoing to consider the government’s budget proposals. The Parliament’s Budget Committee reviews the reports of the government, examines the proposals and estimates, and draws conclusions and recommendations for presenting it to the Parliament. The parliamentary Budget Committee gets only 20 days to review the draft budget, which is insufficient for conducting a meaningful review of the budget proposals.

3.10 If the draft annual budget is not approved by December 31st preceding the budget year, the government is entitled to incur expenditures not exceeding 1/12th of the annual estimates proposed in the draft annual budget on a month-by-month basis.

3.11 The Law on Basic Principles of Budget provides for two reserve funds to meet unforeseen expenditures. However, the Law contains no specific provisions regarding procedures for their usage. The maximum limit for appropriation to the President and Government reserve funds, which are separate line items in the annual budget, is one percent each of the total appropriations. For better transparency, it is important that the Law contains specific provisions for the use of reserve funds including guidelines for reporting requirements.

3.12 The Law on Budget provides no guidance on the ceiling for guarantees that can be issued by the government, though the recently enacted Law on External Debt does address some of the issues. Loan guarantees often entail public expenditure priorities that are established by the recipient rather than the Government. For the budgetary process to become a transparent and integrated exercise it is essential that Government loan guarantees which represent contingent burdens on the budgetary
resources be integrated within the budget document itself. Loan guarantees should receive the same executive and legislative scrutiny as other budgetary outlays.

3.13 Although, the Law on Budget authorizes the Chamber of Accounts (CA), the Supreme Audit Institution (SAI) of the country, to “verify” the drafting of the annual budget, the Law on the Chamber of Accounts has no such provision requiring CA to verify the drafting of the budget. There is no clarity on what the word “verify” entails. The Budget Law requires the departments involved in the budget preparation to make available all the documents in respect of budget preparation to CA. CA is required to submit a report on such verification to the Parliament. There seem to be differing views on this authority of the CA and, in the recent past, CA has desisted from carrying out such reviews. The CA is candid in admitting the lack of necessary resources and skills for carrying out effective reviews of budget assumptions and estimates. (See also section 6.7)

Capital Budgeting

3.14 By incorporating foreign-financed capital expenditures into the annual budget, Kyrgyz authorities have taken an important step in improving fiscal discipline and budget coverage. The annual budget document separately lists the foreign financed expenditures in a table provided as an annex to the budget tables.

3.15 The Budget Law requires carrying out of investment benefit evaluation before approval of development programs. Preparation of a sound capital investment program is essential for rationalizing and increasing long-term efficiency of public expenditures. However, clear-cut evaluation criteria specifying technical, economic, financial, environment, and social requirements are yet to be developed. Although substantial portion of the capital expenditure budget is financed from external funds, considering the availability of scarce internally available funds for capital expenditure, absence of a clear-cut and transparent criteria could lead to misallocation, as not all unfinished projects, particularly projects where initial cost-benefit analysis was not undertaken, are worth finishing. Most externally-funded projects undergo some kind of cost-benefit analysis to meet donor requirements.

3.16 The capital investment proposals, particularly those financed domestically, do not clearly indicate estimates of associated recurrent expenditures. As a result, the implied future liability of such recurrent expenditures on the three-year budget estimates is not considered. Moreover, selection of capital projects is influenced by the amount of recurrent expenditures associated with the project, failure to consider this aspect could lead to sub-optimal decisions.

3.17 The Public Investment Program (PIP) department within MoF is responsible for preparing budget estimates for foreign-financed capital expenditures, whereas domestic capital expenditures are primarily compiled by the sectoral departments within MoF in consultation with the line ministries.
Budget Classification

3.18 The Kyrgyz budget classification is GFS-based (1986) and provides information by economic classification, functional classification, and administrative agency. However, in the absence of specific guidelines, the distinction between capital repairs and capital expenditure is often distorted which results in misrepresenting expenditures actually incurred on development projects to be shown as recurrent expenditure and vice-versa. Employee cost of staff working on capital projects is treated as revenue expenditure instead of capital expenditure.

Budget Implementation

3.19 In the absence of sound cash planning and management, there is less predictability for the budget institutions in implementing the approved budget. Although budget institutions do not have to seek approval of the MoF before entering into commitments, they have to seek permission, on a day-to-day basis, from the treasury for requesting payments, which is primarily due to inadequate cash management procedures. The “Monthly Financing Plan” is intended to provide certainty to the spending units, however, in actual practice, the spending units operate on a day-to-day basis for requesting payments from the treasury. The treasury thus exercises discretion in deciding the priorities for payments. This situation severely affects the ability of the budget institutions to plan and implement the approved budget. Moreover, it also forces the line managers to focus on receiving cash allocations instead of concentrating on wider financial management issues. However, the special means finds (see paragraph number 36 below) do provide some flexibility to the spending units in deciding the payment schedules. In order to avoid cash rationing on a day-to-day basis, to reduce discretion in determining payment priorities, and to provide certainty to budget institutions there is an urgent need to develop sound cash planning and cash management systems. The government made a beginning in this area by introducing a new regulation (#121) for preparing and approving financial plans. However, it is too early to judge the impact of this measure.

3.20 Internal controls on commitments are weak. Budget institutions are not required to obtain prior approval of the MoF or the treasury before entering into

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11 A revised GFS Manual issued by the IMF in December 2001 has introduced accrual-based financial reports and balance sheets. Currently, only a few countries are capable of meeting the standards promulgated in the revised manual. Moreover, the Russian version of the manual is yet to be produced. For more information, please see http://www.imf.org/external/pubs/f/efs/manual/index.htm
12 Economic Classification identifies the types of expense incurred by Government for discharging economic responsibilities of the Government. For example, compensation to employees, subsidies, grants etc. The Functional Classification provides information on the purpose for which an expense was incurred. For example, expenses incurred on education or environment protection. Functional Classification should not be confused with the administrative organizational structure of the Government. In situations where functional classification is not aligned properly with the ministries in the Government, it could lead to dispersed accountabilities as more than one line ministry may be responsible for implementing the same program or function.
13 The terms “commitments”, “expenditures”, and “payments” are often confused. Simply stated commitments are the value of the purchase order or contract that binds the agency to buy certain goods or services to the extent specified in the contract or the purchase order, expenditures are the actual amount of goods or services supplied for which full payment may or may not have taken place, payment is the amount transferred from the agency’s bank account to the credit of the supplier’s bank account.
commitments. Despite the availability of accrual-based financial reports prepared by budget institutions and consolidated by line ministries, which could provide useful information for management of liabilities, MoF has yet to develop a robust financial management system that could ensure excessive commitments do not lead to accumulation of huge outstanding liabilities and creating a first charge on future cash flows.

3.21 As the treasury is responsible for making payments on behalf of budget institutions, direct control is exercised by the MoF in ensuring payment requests sent by budget institutions are for approved budget expenditures and within the approved budget allocations. From an internal control perspective, it ensures segregation of responsibilities and exercise of proper ex-ante controls. Although this system assists in avoiding payments in excess of appropriations, it is unable to control commitments made by the budget institutions in excess of approved appropriations, which results in creating unpaid liabilities and creating a demand on next year’s budget proceeds.

3.22 The Budget Law requires Parliament’s approval for any increase in the figures of an already approved budget and provided there are identified sources of funds to cover the additional expenditures, thus ensuring Parliament’s oversight authority. The annual budget is informally corrected almost every month, generally at the end of the financial year, however, the Parliament formally adopts a supplementary budget, which legalizes the changes in the revenues, expenditures and financing targets in line with the executed levels. Amendments are routinely proposed during the year by the line ministries for MoF approval, even for transfer of allocation within the same line item – the line ministries have no flexibility to affect any transfers on their own. This provision, though restrictive for the functioning of a line ministry, ensures budget discipline. MoF is entitled to reallocate within expenditure items without decreasing the protected items (wages, medicines, pension). Typically, at the end of the financial year, the government submits and parliament adopts a supplementary budget, amending both budgeted revenues, expenditures, and financing, and adjusting them to the executed levels. The Law also requires Parliament’s approval for sequestration of expenditures in case of revenue shortfall.

**Budget Monitoring and Evaluation**

3.23 Budget monitoring is limited to monitoring of fiscal targets and little attention is paid to the assessment of effectiveness in the implementation of budget programs. Budget evaluation in the Kyrgyz Republic is primarily focused on collecting regular accounting reports on budget execution and ensuring compliance with spending limitations. The controls are mainly input-oriented rather than outcome-oriented, partly due to the fact that no measurable monitoring indicators are established during the budget process. Moreover, there are neither incentives nor sanctions for the line ministries to evaluate their budget outcomes – better performance does not hold a prospect of additional budget allocation. Periodic evaluation of budget outcomes and integrating the findings into the next year’s budget formulation are key ingredients for improving the overall efficiency of public expenditures and increasing the accountability of program managers. Given the scarcity of funds for making capital expenditures, as evidenced by the significant
dependence upon foreign borrowing, it is important that available resources are deployed in investment projects that yield high returns. Budget evaluation is also an essential element of the program budgeting. It should, however, be noted that several countries are grappling with this issue, as implementation of an effective system of budget evaluation is not a simple process, but requires sustained efforts and perhaps some selective approach to begin with. Currently, skills in this area are lacking and there is insufficient management orientation, and unless this is addressed, any attempt to introduce budget or performance evaluation is unlikely to succeed.

3.24 For budget evaluation to be effective, the budget process should incorporate measurable monitoring indicators in the budgetary process\(^\text{14}\). There are large number of possible indicators (output/process/outcome – reduction in disease, increase in literacy rate, increase in crop yields etc.) of possible relevance to measuring and assessing performance. Budget evaluation should normally be carried out at two stages. First, all budget institutions should carry a self-evaluation of their programs and monitor progress on the performance indicators on an ongoing basis. Second, selective budget evaluation should be carried out by an independent entity (internal auditor or external auditor) upon completion of a program. With increased decentralization it is equally important to institutionalize proper budget evaluation arrangements at the regional and commune/municipality levels. Misallocation is likely without a sound budget evaluation mechanism; projects with low returns (economic, social, financial) will often absorb funds that would otherwise have been allocated to projects with high returns. Improved budget evaluation also yields benefits in terms of identifying troubled projects that need to be either de-funded or restructured.

3.25 It is interesting to note the “Budget Program Passport” system introduced in Kazakhstan for monitoring and evaluating budget programs. The objective of the system is to assess the performance of the budget institution and to ensure control over targeted spending. Budget Program Passports are approved by the Government and local executive bodies. They contain details of budget program cost, funding source, goals, tasks, expected outcomes, executors of tasks, and implementation period. These documents are updated and reviewed regularly to reflect progress in implementation of programs.

3.26 The Budget Law provides for only annual reporting on the budget to the President and the Parliament by June 15 of the following year. There is no requirement to prepare and submit a mid-year brief report on the budget performance that could draw the attention of the President and the Parliament to any emerging fiscal problems, although the government analyzes the budget execution reports more frequently. A brief mid-year progress report would enhance transparency in the functioning of the government and improve legislative oversight over the executive.

Special means

3.27 A large number of budget-financed agencies (e.g., State Tax Department, State Customs Department, Ministry of Health, Ministry of Education, Accounts

\(^{14}\) According to a recent survey by the OECD, three quarters of all OECD countries have performance data in their budgets. Reference: *A brief comparison of the budgeting systems in the G7 countries by OECD*, PUMA, April 2002.
Chamber) collect and spend own revenue. Special means have recently become a considerable source of financing in these agencies. The revenues and expenditures out of these revenues are channeled through the treasury, accounted and reported in the budget\textsuperscript{15}, and are audited by the CA. There is an inherent risk of underreporting of collections and/or use of a float by the budget institutions. A bigger risk is underreporting of financial operations of the government, as special means collections that are not deposited (or reported) with the treasury will not be reflected in the annual financial statements compiled by the treasury. From a public expenditure management perspective, the Public Expenditure Review (PER) concludes that the special means policy creates perverse incentives and rent seeking opportunities for many government agencies undermining the public services provision. The special means do provide some certainty for making essential payments by the line ministries as the funds held under special means account are outside the treasury’s cash controls – though the payments are routed through the treasury, the line ministry does not require prior cash approval for making payments out of the special means. Considering the perennial cash crunch, a large portion of the special means funds are used for paying salaries. As the special means distorts efficient cash management, the Government while banning the system of special means, will need to simultaneously focus on improving its cash and treasury management and provide some predictability for payments. Another option to consider would be to allow only receipts in excess of certain agreed base collected by the budget institutions to accrue to the special account. Internal controls, accounting, auditing of special means are covered in the relevant sections below.

\textsuperscript{15} An attachment to the annual budget law includes breakdown for both budget means and special means by economic classification. The line ministries have to go through the same procedure as with budget means in case of any transfers required amongst the economic classification. (e.g. to agree the adjustments with MoF and so on).
4. INTERNAL CONTROLS

4.1 **Overall internal control framework in the Kyrgyz Republic is weak as evidenced by several instances of illegal use of funds and waste reported year after year by the external auditor.** Treasury controls at the central level are weak – there are instances of over-reporting of payments and underreporting of collections by the agent banks. The internal control framework is further weakened by absence of an internal audit function.

4.2 **INTOSAI**\(^16\) has defined internal control as a management tool used to provide reasonable assurance that management’s objectives are being achieved. Thus responsibility for adequate and effective internal controls rests with the management, and the head of each Government organization must ensure that a proper and effective internal control regime is in place. Research in the past decade, notably by the Committee of Sponsoring Organizations (COSO), changed the way we look at internal control. Traditional theories, which primarily addressed financial controls, were broadened substantially (for further information on COSO, please refer to Annex 1). The COSO Framework considers not only the evaluation of hard controls, like segregation of duties, but also soft controls, such as the competence and professionalism of employees, and management’s philosophy and operating style. According to COSO, "Internal control is broadly defined as a process, effected by management, designed to provide reasonable assurance regarding the achievement of objectives in the following three categories: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations."

4.3 **The internal control framework in the Kyrgyz Republic includes budgetary controls, treasury controls, accounting and reporting controls, procurement controls, and human resource controls.** Although not part of the internal control system of government, the external audit performed by the Chamber of Accounts has the potential to play a strong reinforcing role for the internal auditor and internal controls. **Budgetary Controls** are established by the Law on Basic Principles of the Budget and related regulations. They include entities subject to the law, the mandatory use of a single consolidated fund, and establish the rules regarding expenditures, revenues, budget preparation, presentation, approval, amendment and reporting. Each budget institution is required to ensure completeness of documentation, availability of budget allocation, and compliance with departmental rules. **Treasury controls** include the following ex-ante controls: verification of documents submitted by the budget institution to ascertain correctness and completeness, availability of budget appropriation, cross-verification with the receipts (taxes deducted at the source and its subsequent deposit). **Accounting and Reporting control** requirements are met through a combination of law and regulation. The budget law requires all transactions to be accounted for and recorded. **Procurement Controls** are established by the Law on Public Procurement and includes mandatory procurement procedures and practices. **Human Resource controls** include recruitment and compensation procedures. Because of the importance of the civil servants in the ministries, human resources will remain a critical component of the management control framework for all ministries and agencies well into the future. While evaluating the system of internal

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\(^16\) http://www.intosai.org/3_INTCOe.html
controls, it is important to remember that even a well-designed system of internal controls can be circumvented by employee collusion and management fraud.

4.4 The Kyrgyz government has created a separate body of Financial Police to strengthen the internal control framework for tax and customs collections in response to perceived inefficiencies and duplications and to strengthen efforts to identify tax violations and control corruption. This separate body was created by combining internal vigilance departments within the tax and customs administrations. However, the departments continue to have inspectorates for carrying out audit of taxpayers. In theory, the independence of the Financial Police was to ensure objectivity and reduce duplication, but by becoming an agency external to those they are charged with monitoring, the Financial Police lost linkages to internal data within the agencies due to confidentiality requirements, and technical and procedural obstacles. Without access to internal records such as returns and audit results, the agency is able to do little more than monitor the functioning of the agencies from a distance, with no noticeable impact on collections or perceived corruption. In view of this, it is essential that the structure and role of the Financial Police be reviewed.

4.5 An additional control mechanism on the revenue side is the tax inspectorate within the Tax Administration, which is in addition to the Financial Police, to conduct inspections of the tax department and taxpayers. The nature of work carried out by the tax inspectorate is more of a routine tax audits, whereas the work of the Financial Police is investigative in nature. The Tax Code allows audit of taxpayers once a year. In addition, an internal inspection Division (part of the central head office) carries out inspection of the work of the tax officers. The inspection department endeavors to cover all the offices once every two years. The board of the Tax Administration considers the report presented by the inspection department before taking action against department staff. However, in the absence of data and reports, the efficacy of the functioning of the tax inspectorate could not be determined.

4.6 An important factor in the efficacy of the internal control framework in the Kyrgyz Republic is the absence of any clear legal requirements that necessitate that line ministries maintain a sound internal control framework within their ministries and be held accountable for it. The Law on Budget has a vague reference to the responsibility of managers and public officers for the "maintenance of the budget funds" (Article 22). Effective internal controls are key management tools that help managers discharge their responsibilities for the efficient and legal use of public resources. A clear legal requirement would influence the line managers to pay more attention to the internal control issues.

4.7 Normal procedures in the Kyrgyz Republic have failed to detect the instances of abuse and waste, which means that not only is the current regime of internal control less than fully effective, but also that management has no means of detecting and resolving these issues as a regular part of their management responsibilities. The two most recent audit reports of CA indicate several instances of non-compliance with laws and fraud/corruption across a wide number of ministries. This indicates that there is an urgent

17 Decree of the President of the Kyrgyz Republic dated 21 January 2001.
need to strengthen the internal control framework by carefully carrying out a detailed risk assessment to evaluate the relevance and effectiveness of various controls and then implementing an action plan, including the broader recommendations contained in this report, for strengthening the internal control framework. As mentioned earlier soft controls play an important role in the internal control framework and it is essential that while carrying out detailed risk assessment, soft controls, such as the competence and professionalism of employees, also be considered. Internal auditors normally carry out such risk assessments to provide an assurance to the management that the internal control framework as designed is adequate to safeguard the public resources and that the controls operate as intended in preventing the waste and abuse of public resources.

**Treasury Controls**

4.8 Frequently, excessive effort is spent on insignificant and small payments, leaving insufficient resources for controlling large and vulnerable payments. The treasury staff, despite lack of automation, has been doing a good job in managing the day-to-day treasury operations. However, as the treasury staff spends most of their time in clerical activities, not much time is left for cash management or on control activities. Internal controls at the Treasury and the budget institution levels are documented in various rules, regulations, and decrees. Internal controls typically focus on identifying and reporting non-compliance in the payment process. Written rules are excessive in some areas and incomplete in others, which leads to an incomprehensive system of internal controls. For example, the treasury has detailed rules as to how to verify the payment requests received from the budget institutions. However, rules are incomplete regarding reconciliation at the central treasury level (see below). Financial risk assessment to determine the focus of attention is practically non-existent as illustrated in the following paragraphs.

4.9 There is no reconciliation done at the consolidated level between the treasury records and amounts reimbursed to the agent banks, which has several risks, including the possibility of over-reporting of payments by the paying bank so as to utilize the float during the month. The government owned Settlement Savings Company (SSC), one of the agent (commercial) banks, handles a significant amount of payments on behalf of the treasury. The Rayon Treasury Office (RTO) receives invoices and bills from the rayon budget institutions for authorization and payment. After processing the bills, RTO sends payment vouchers to the agent bank. The rayon branch of the SSC makes the payment, and prepares and forwards a list of all payments made to the SSC head office in Bishkek. The agent banks make the payment on an “overdraft” basis (i.e. it does not receive any advance funds from the NBKR for effecting payments on behalf of the treasury). The SSC head office, after consolidating the payment lists received from the branches, forwards the consolidated reimbursement request to the NBKR on a daily basis. On the basis of the reimbursement request received from the SSC head office, NBKR reimburses the SSC (See Figure 2). An independent mechanism to reconcile the consolidated list of payments provided by the SSC and the payments approved by the treasury on a daily basis is lacking, and NBKR makes the reimbursement to the SSC directly. Although, reconciliation is done at the rayon level on a daily basis, no reconciliation is carried out at the consolidated level. As a result there are differences between the amount requested by the SSC head office and the total of payment requests by all the treasury offices. The CFAA mission specifically
Kyrgyz Republic CFAA: Internal Controls

requested the treasury to prepare a reconciliation statement for the month of December 2001 (See Table 1), which revealed significant differences between amount requested by the SSC head office and the amount that should have been requested as per the treasury records. Such reconciliation for the other three agent banks also revealed differences. As a result, the central treasury office was able to levy a fine of more than 235,000 soms on the Dos-Credo Bank, one of the agent banks.

Figure 2: Payment System

Table 1: Reconciliation Between Treasury Records and SSC Records

| Table 2: State Budget Revenues and Expenditures (in millions of soms) |
|---------------------------|---------------------------|
|                           | 1999         | 2000         |
| Revenues:                 |              |              |
| Tax Revenues              | 7,732        | 9,849        |
| Non-tax revenue           | 1,777        | 1,603        |
| Other receipts and grants | 427          | 632          |
| Total Revenue             | 9,936        | 12,084       |
| Expenditures:             |              |              |
| Current Expenditures      |              |              |
| Personnel                 | 2,225        | 2,872        |
| Operations and Maintenance| 3,876        | 4,354        |
| Social Fund transfers     | 2,752        | 3,281        |
| Other expenditures        | 1,035        | 1,629        |
| Interest                  | 1,471        | 1,423        |
| Total Current Expenditures| 11,169       | 13,559       |
| Surplus / (Deficit)       | (1,233)      | (1,475)      |
| Capital Expenditures/adj  | 4,153        | 4,209        |
| Total Surplus / (Deficit) | (5,386)      | (5,684)      |
| Financed by:              |              |              |
| Privatization receipts    | 119          | 157          |
| Domestic borrowings       | (1,322)      | (67)         |
| Foreign borrowings        | 6,589        | 5,594        |

4.10 A similar risk exists in the revenue collection mechanism. The tax revenues are collected by specified commercial banks. The commercial banks are required to transfer the collections on a daily basis to the agent banks. There are no checks and balances to
verify whether the banks in actual practice transfer the collections on a timely basis. As with expenditures, there is a risk that the banks could use the float by under-reporting or late reporting the collections. (See Figure 3).

**Figure 3: Revenue Collection**

4.11 Establish urgently an independent mechanism to verify the payments and revenues on a daily basis to ensure receipt of full tax revenues on timely basis and to avoid the float in the payment system. The treasury needs to develop a long-term strategy for treasury management including strong control mechanisms for the payment system. The computerization of the treasury will not automatically solve this problem. It is important that the treasury receives expert guidance on these issues on a continuous basis from a resident treasury adviser (as part of an international technical assistance) rather than on an ad-hoc basis. In the short-term, it is recommended that the treasury implements the following measures to strengthen internal controls in the treasury:

- the central treasury office should obtain daily payment data from rayon treasury offices (which is also forwarded to the agent banks) and reconcile the reimbursement made by NBKR to the agent banks. Another option is, NBKR should not release the reimbursement to the agent banks unless and until advised by the central treasury office, which should collate the daily payment data received from rayon treasury offices and issue the reimbursement instruction to NBKR.
- Each local tax office should reconcile on a daily basis the tax collections as reported by the receiving banks with the copies of individual tax payment forms received from the receiving banks to reconcile the date of tax payment by the taxpayer and the date of receipt in the treasury account.

*Procurement Controls*

4.12 The concurrently prepared CPAR\(^\text{18}\) concludes that the Public Procurement Law has not yet translated into sound practices. Despite a comprehensive law on procurement, weak procurement oversight, a lack of well trained procurement officers, and excessive authority and discretionary powers enjoyed by the “tender committees”, procuring entities have, over time, established undesirable practices which seriously affect bidders’ trust in the procurement system. The report further observes that the State

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\(^{18}\) For detailed discussion on procurement assessment, please refer to the Country Procurement Assessment Report (CPAR) that was prepared concurrently.
Commission on Public Procurement and Materials Reserve (SCPPMR), which is supposed to provide oversight over the decentralized procurement function, is itself getting involved in the procurement process and has thus lost objectivity and independence that are essential prerequisites for an oversight body.

4.13 The CPAR makes several recommendations to strengthen the public procurement system in the Kyrgyz Republic. The key recommendations are: separating the State Material Reserve Function from the SCPPMR to avoid any conflict of interest, reorganizing SCPPMR, and reorganizing the procurement entities by establishing ad hoc tender committees instead of permanent tender committees and by making the administrative or financial department responsible for procurement.

**Human Resource Controls**

4.14 The Kyrgyz Republic is yet to carry out civil service reforms to ensure transparency in the appointment at senior positions and for strengthening the control framework in the public administration. The heads of departments are not appointed on the basis of set criteria such as competitive examinations. Understanding of modern management practices and ability to understand, interpret, and use management accounting reports such as analysis of cost of providing services or analysis of outstanding liabilities or commitments should receive equal emphasis in the selection of departmental managers.

4.15 Considering the significant budget resources spent on employee costs and, more importantly, as wages are paid in cash and not by bank transfer, it would be beneficial to create a computerized secured employee database and payroll system to eliminate the risks of excessive payments and ghost employee payments. Employee salaries and social insurance contributions account for more than 20% of the total recurrent expenditures (see Table 2). The rayon treasury office receives a position list or an employee list for each budget institution at the beginning of each year. The rayon treasury office checks the accuracy of the employee payroll prepared by the budget institution by comparing it with the previous month’s statements and with the list received at the beginning of each year. Although, the SAI audit reports have not observed any serious issues of weaknesses in this area, considering the significant amount of budgetary resources spent on employee costs, computerization of employee payroll would strengthen the internal control. The possibility of making salary payments by direct transfer to the employee bank account should also be explored.
Table 2: State Budget Revenues and Expenditures

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**Internal audit**

4.16 There is much confusion surrounding the concepts of internal controls and their component parts. In transition countries and several other jurisdictions, internal control is considered as synonymous with internal audit. In fact, several languages employ the same word for control and audit. Internal audit is an important element in the internal control framework. It is a management tool, designed to provide information to the management on the proper functioning of the internal control regime. Internal audit can be broadly defined as an objective, independent assurance activity for management, designed to improve an entity’s (or department’s) operations by applying a systematic approach to evaluate and improve the effectiveness of the internal control systems that cover both financial and other management controls.

4.17 The external auditor’s reports are tabled directly in Parliament, and there is no opportunity for the Government to remedy problems before such instances become public knowledge. There is a growing interest by the Parliament and others in the
reports of the CA, which will be increasingly problematic for the government. The opposition and the media may tend to amplify the errors reported by the CA, and may create a climate of public suspicion of the government’s ability to manage public resources. However, the government has to demonstrate that it is making credible progress in this area to avoid any public criticism following the release of the CA audit report. Although there is considerable commonality between the objectives of external audit and those of internal audit, there are important differences. The external auditor is an independent entity, reporting to Parliament and the President. Parliament and the President receive the external auditor’s audit reports and holds the government to account for its maintenance of effective internal controls and for the performance of its programs. Ideally one of the main objectives of external audit is to provide an assurance to the Parliament, and to the general public, on the reasonableness of the budget execution statements prepared by the government whereas the main objective of internal audit is to improve an entity’s operations by applying a systematic approach to evaluate and improve the effectiveness of the internal controls. The external auditor may rely on the results of internal audits during the course of his audit.

4.18 There is no internal audit in the Kyrgyz Republic, except for a small unit in the MoF, which carries out compliance tests for the treasury transactions and in the Ministry of Labor and Social Protection. In June 2000, the government abolished the State Financial Inspectorate (SFI) and the majority of the staff were transferred to the Chamber of Accounts. The main reason for this decision was the overlap between the internal audit and external audit, as the SFI was unable to transform itself and begin rendering professional internal audit service and instead continued to act more like an external auditor rather than as an internal auditor. Currently, there are no internal audit units within the line ministries except for the Ministry of Labor and Social Protection. The line managers, who are under constant pressure to maintain budget discipline, have developed other mechanisms to obtain assurance of financial integrity within their departments. In the absence of internal audit staff, the line managers ask the technical or accounting staff to perform some rudimentary internal audit functions.

4.19 To provide continuous assurance to the management regarding the adequacy and effectiveness of internal controls, the government should consider setting up a modern internal audit function. Internal audit strengthens the internal control framework by not only pointing out weak internal controls on a continuous basis, but also monitoring the actions taken to address the weak internal controls. As mentioned earlier, the internal control framework in the Kyrgyz Republic is weak as evidenced by several instances of non-compliance, waste, and abuse reported by the external auditor. In this situation, absence of internal audit further compounds already weak internal control framework. It is, however, interesting to note the keen interest shown by line ministries in having internal audit arrangements in order to obtain regular assurance on the functioning of the internal controls systems within their department.

4.20 There are essentially two models for organizing the internal audit function — centralized and decentralized. Each has its advantages and shortcomings. In the centralized model, a central internal audit agency carries out internal audit across the government departments. This central internal audit agency, though internal to the government, remains external to the line ministry. Since the centralized model operates
more or less on the lines of external audit, this report describes the characteristics of a decentralized model in greater detail. There are many variations of this two basic structures. Several factors, such as accountability of line managers for internal controls, effectiveness of external audit, and the degree of commitment of line managers, would need to be considered while deciding the structure of internal audit function. Another factor to consider is how strong is the external audit function. Generally, weaker the external audit, the stronger will be the temptation to consider a centralized model. However, in the long run, a weak external audit would seriously impair the accountability structure and should not continue to be the reason for this decision - in other words, efforts must be made to strengthen the external audit function.

4.21 A decentralized model in which the internal audit function works within each line ministry with built-in independence mechanism and appropriate oversight by a central unit provides several advantages. The greatest advantage of this model is the sense of ownership by a line ministry and resulting commitment by the line manager to implement the recommendations made by the internal auditor. As internal auditors work to assist the management in strengthening the internal control framework, a sense of ownership and commitment to implement the recommendations are essential to ensure usefulness of internal audit. A risk in this model is loss of independence by the internal audit unit resulting in its inability to objectively provide advise to the management. However, this risk can be contained by establishing a strong oversight mechanism as described in the following sections.

4.22 Characteristics of a decentralized model. The internal audit department, headed by the Director of Internal Audit (DIA) and reporting to the Finance Minister, should have the following responsibilities:

- **Standard setter**: Develop internal audit standards and enforce their implementation
- **Recruitment**: Develop recruitment policy including entry and promotion criteria and recruit internal audit staff for all internal audit positions across the Government.
- **Training**: Develop and deliver structured training programs including continuous education programs.
- **Quality assurance**: Develop quality assurance mechanisms to ensure high quality of internal audit work.
- **Internal audit work**: carry out internal audit within MoF and agencies controlled by MoF, carry out internal audit work in line ministries when the line ministry internal audit units lack capacity or when issues of significant importance are noticed that require specialized skills

4.23 Each line ministry should establish internal audit units, headed by a director and reporting directly to the line minister. The line ministry internal auditors should provide their audit plans to DIA for information, after the line minister approves them. The line ministry internal audit department should be responsible for conducting internal audits within the line ministry and submitting internal audit reports to the line minister with a
copy to the DIA. The DIA should be responsible for making available a pool of qualified and trained internal auditors to the line minister who should have the authority to choose a particular candidate from the pool. The internal audit staff, though recruited and trained by DIA, should functionally as well as administratively report to the line minister. The DIA should ensure quality of internal audit by proper recruitment, training, setting audit standards, and by review of internal audit reports prepared by line ministry internal audit units.

4.24 Each line minister should prepare an annual assurance letter addressed to the Finance Minister indicating maintenance of effective internal control framework within his or her ministries. This would ensure the accountability of the line minister to maintain an effective internal control framework in his/her ministry and strengthen the decentralized internal audit structure. Similarly, the Finance Minister should submit an annual assurance letter to the Cabinet of Ministers indicating maintenance of effective internal control framework.

4.25 The Minister of Finance should prepare annually and table with the Council of Ministers a government-wide summary and analysis of key internal audit findings and recommendations. This analysis would enhance the ministers’ understanding of the state of management and provide positive incentives for ministries to correct any reported deficiencies.

4.26 The Finance Minister should also establish an Internal Audit Committee to advise on matters of internal audit including a review of annual internal audit reports to ensure high quality internal audit work. The committee should comprise respected members of the audit profession, professors in economics or audit or public finance, and legal experts. The advantage of establishing an Internal Audit Committee comprising professionals from outside the civil service is that the committee would be able to provide unbiased advice to the Finance Minister on the quality of the internal audit reports.

4.27 DIA should adopt internationally acceptable internal audit standards – the Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors (IIA) and, to the extent applicable, Audit Standards issued by the International Organization of Supreme Audit Institutions (INTOSAI). In addition, DIA should develop internal audit manuals, and Code of Conduct for internal auditors.

4.28 While establishing an internal audit function, the Kyrgyz government should ensure that the above described characteristics are given due consideration. Some of the features described above, such as an annual assurance letter, preparation and submission of an annual summary of internal audit report, establishment of an internal audit committee, could be easily incorporated even in the centralized internal audit model.
5. ACCOUNTING AND REPORTING

5.1 Overall the financial reporting system needs a major overhaul. Although line ministries prepare accrual-based financial statements, consolidated financial statements for the government as a whole are not prepared. The cash-based statements prepared by the treasury are used for cash management purposes and for presentation to the Parliament. No reconciliation is carried out between the accrual-based financial reports and cash-based treasury reports at the consolidated level. Financial reports are rarely used for financial planning and management.

5.2 Government accounting in the Kyrgyz Republic is performed by two different organizations. A dual system of accounting is adopted – hybrid accrual-based approach for financial accounting by the line ministries and a cash-based approach for budget accounting by the treasury. The line ministries (spending units) follow a hybrid accrual basis of accounting (liabilities are recorded as and when incurred but revenues are recorded only when received) and maintain their own accounting records in the prescribed formats using a double entry system of accounting. The main purpose of accounting at the line ministries is to keep track of expenses vis-à-vis budget provisions although to a certain extent it does duplicate the accounting done at the Treasury. The recording and reporting of assets and liabilities, albeit in a crude form, has been the legacy of the Soviet system. However, to enjoy the benefits of accrual-based financial reports require some fundamental changes to public sector managerial and personnel arrangements to strengthen accountability relationships. The treasury was set up in mid-90s and it follows a cash basis of accounting and maintains records of all revenues and payments purely from budget accounting perspective. The cash-based budget execution statements prepared by the treasury are submitted to the Parliament since logically the ex-post reporting format should be consistent with the cash-based budgetary process. The Government fiscal year begins on January 1 and ends on December 31.

5.3 Financial management skills in budget institutions are lacking. Budget institutions spend an enormous amount of time on producing various financial reports and statements, but there is a lack of evidence of the reports being used by the departmental management. The Accounting regulation mandates a hybrid accrual basis of accounting by the budget institutions. The purpose of issuing an accrual-based Accounting Plan is to facilitate financial management particularly management of liabilities. This requirement imposes an additional burden on budget institutions, as they are also required to maintain cash-based budget classification accounts, which are reconciled with the treasury records. It is unclear as to how much use is made by the line managers of these accrual-based financial statements. Furthermore, the central treasury, which receives the consolidated statements from each ministry, conducts no analysis of these statements though the statements contain useful information regarding liabilities that could be useful in cash planning. This is partly due to general lack of skills in financial management at the departmental management level. The departmental managers, including treasury managers, would need substantial training in understanding and interpreting the data contained in various financial reports, if these reports are to be useful. Another important reason for this situation is that the entire budget execution process is predominantly focused on the availability of cash from the treasury that the managers are
constantly preoccupied with resolving the availability of funds rather than focusing on broader financial management issues.

5.4 Although line ministries compile annual financial statements on a modified accrual-basis and submit them to the MoF, a consolidated financial statement for the government as whole is not prepared. Reports based on cash accounting have several limitations as it provides an opportunity to misreport the government's true financial actions. Payments or receipts can be pushed back to the previous year or forward to the next. Accrual accounting facilitates assessment of program performance by showing the full cost of programs, enhances the accountability of management for their performance, and in general, provides a wider range of information needed for decision making. At the minimum, it provides useful information, such as accumulated liabilities, that could prove very useful in cash planning. There is no reconciliation carried out between the accounting reports and the treasury reports at the consolidated level. Such reconciliation would ensure accuracy of the consolidated treasury reports that are presented to the Parliament. Both cash-based and accrual-based financial reports serve different purposes and it is not suggested here that either one should be discontinued. Implementation of a full-fledged accrual-based system for government accounting should be an integral part of a wider budget system reform and overall transformation of public sector management. Meanwhile, the MoF should develop the skills required to interpret and use accrual-based financial statements and make efforts to utilize the information already available in the line-ministry prepared accrual-based accounting reports.

5.5 The Law on Budget places the responsibility for preparation of a report on budget execution on the MoF. The report on budget execution together with an explanatory note is required to be submitted to the President and the Parliament no later than 15th May of the year following the budget year. There are delays in meeting this deadline and the report is generally submitted after a delay of about a month. The report provides detailed information on budget (amended) vs. actual for both republican and local budgets as well as for special means. The explanatory note, however, does not include information on arrears accumulated during the year. The report also does not include information on guarantees issued and or invoked during the year. Provision of such information would improve the transparency of the budgetary process.

Accounting rules and procedures

5.6 An Accounting Methodology Department within the MoF is responsible for developing and issuing accounting and reporting guidelines and formats for budget institutions. The department has prepared a comprehensive “Regulation on Accounting by Budget Institutions”, February 2001 containing formats of registers and supporting documents, and instructions for performing accounting in a budget institution. The regulation also contains a Chart of Accounts. The Chart of Accounts has certain deficiencies such as combining debtors and creditors in one account code (Account Code 17) or merging payments and liabilities under the same group. Moreover, the regulations are incomplete in some respects, as they do not include formats of various reports required to be submitted by budget institutions, which continues to be guided by somewhat outdated instructions issued in 1994. The regulations provide no guidance on how to account for settlements and offsets. The Accounting Methodology Department is in the process of
issuing an addendum containing formats of various reports. While revising the regulations, it would be useful if the regulations also specify procedures for consolidation at the next higher level including instructions for netting out transfers and inter-office balances. Rather than create new standards, the department should consider adopting International Public Sector Accounting Standards (IPSAS)\textsuperscript{19} issued by the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC), of particular interest would be IPSAS 6 on Consolidated Financial Statements and Accounting for Controlled Entities. There is a need to hold several training workshops for accountants in the line ministries to ensure better understanding of the requirements and consistent application of principles.

\textit{Accounting and reporting by line ministries}

5.7 \textbf{There are about 3000 budget institutions. Not all the budget institutions have trained accountants to manage the accounting function.} There is no specific provision in the Law on Budget to require budget institutions to establish a finance and accounting unit to be headed by a finance officer or an accountant. However, the recently issued Regulation on Accounting in Budget Institutions dated February 2001 contains a provision that specifies the responsibility of the head of the department to maintain an adequate accounting function. In some budget institutions, such as in the central office of the Ministry of Agriculture and Water Resources, accounting is handled by non-accountants. Some budget institutions have experienced bookkeepers but lack skills in management accounting and reporting. For example, information regarding cost of providing services, say cost per patient, or comparison between cost of construction between two different periods or different rayons. However, it is also important to note that there is a general lack of understanding of financial management on the part of managers and, thus, there is hardly any demand for management accounting reports. So any efforts to strengthen the financial management function should also emphasize training of departmental management in understanding and interpreting financial management reports to ensure that there is a demand for such reports.

5.8 \textbf{The line ministry and budget institution officials find the financial reporting process too cumbersome and complex, much of which is due to a lack of understanding of the reasons and the need for preparing several reports.} Each spending unit of a line ministry verifies bills before forwarding them to the treasury for payment, keeps records, and prepares reports related to budget execution. They prepare a monthly budget execution report, which is cash-based for reconciliation with the treasury. In addition, they prepare a quarterly financial information report (Form 2) and submit it to the line ministry head office. Similarly, a Report on Special Means (Form 4) is prepared which is also checked and approved by the treasury. A Balance Sheet (Form 1) is prepared on semi-annual and annual basis that provides useful information about liabilities incurred and assets created. As the treasury maintains accounts on a cash-basis, the Balance Sheet of a budget institution is not required to be verified by the treasury.

\textsuperscript{19} \url{http://www.ifac.org/PublicSector/} The PSC of IFAC has issued 18 IPSASs as of September 2002 and is planning to issue 2 more IPSAS before the close of the year 2002.
5.9 The accounting at budget institutions is laborious and done manually. Budget Institutions are required to maintain several registers and produce numerous reports. However, there is no provision for management accounting data that could provide useful information on costing and performance accounting to the managers. A large amount of time is spent by the budget institution staff on reconciling figures rather than on producing useful information for management control and decision-making. One solution is to consider implementation of an integrated software that keeps track of budget provisions, commitments, liabilities, and actual expenses. An integrated system would not only speed up the preparation of financial reports but also free up the staff time for analytical and control work. An automated system would facilitate better controls over commitments and budget allocations. A computerized integrated Government Financial Management Information System (GFMIS) would ensure availability of consistent, reliable, and timely information to policy makers, program managers, and auditors. In the recent past, EU TACIS had prepared a comprehensive proposal for developing a GFMIS under the Public Sector Resource Management Adjustment Conference (PSRMAC) Project and this proposal deserves serious consideration.

Treasury Accounting

5.10 The treasury maintains separate records for the republican and local budgets. The regional treasury offices cater to about 3000 budgetary institutions. The treasury is comprised of a central department located in Bishkek, 7 oblast treasury offices and 54 rayon/city treasury offices. The central treasury has a Treasury Single Account (TSA) with the National Bank of the Kyrgyz Republic (NBKR). Regional treasury offices maintain four transit accounts (zero balance accounts) with agent (commercial) banks, which are selected on the basis of a tender, for effecting transactions on republican and local budgets and separately for general budget and special means.

5.11 A pilot program to automate treasury operations using Russian software (1-C) is under implementation in two city treasury offices. Although computerization of the treasury operations is urgently needed, it will not eliminate certain duplication in accounting. An Integrated Financial Management Information System, that integrates accounting at the budget institution and the treasury, would eliminate duplication in accounting, ensure integrity of the accounting data, and provide quicker information to the decision makers. It is interesting to note the lead taken by two CIS countries in the region, viz. Kazakhstan and Ukraine, in computerizing the treasury operations, which are financed by the Bank. The Kazakhstan treasury modernization project has implemented a state-of-the-art distributed system, which is linked by a high-speed network. The automated treasury system also captures commitment information and helps in tracking liabilities.

5.12 There is no recording of commitments in the treasury ledgers. The Treasury maintains accounts on a cash-basis and records transactions as and when treasury receives money or makes payment on behalf of a budget institution. The regional treasury offices maintain Treasury General Ledgers containing individual accounts for each budget institution. The allocations received from the central treasury office are recorded against each account to keep track of actual payments vis-à-vis allocation. The treasury ledgers are maintained manually on a columnar basis, which, although facilitates analysis and tabulation but are unwieldy to maintain and prone to errors.
5.13 All budgetary institutions collecting revenues are required to deposit the collections with the regional treasury office in a separate special means account and receive immediate allocation at a predetermined rate for incurring expenses. It is difficult to ascertain whether this rule is complied with in practice and to what extent. As mentioned earlier, special means funds are increasingly used to finance current expenditures such as salaries. There is an inherent risk of underreporting of collections and/or use of a float by the budget institutions. A bigger risk is underreporting of financial operations of the government, as special means collections that are not deposited (or reported) with the treasury will not be reflected in the annual financial statements compiled by the treasury.

5.14 The treasury offices prepare periodic reports on the performance of revenues, and expenditures. MoF has a Computer Center (named Internal Control and State Budget Department) to collate and compile the treasury reports received from the regional treasury offices. The report on budget execution together with an explanatory note is required to be submitted to the President and the Parliament no later than 15\textsuperscript{th} May of the year following the budget year. There are delays in submitting the budget execution report to the Parliament. It is important to note that these reports are unaudited when presented to the Parliament and the CA then gets two months to provide an audit report to the Parliament.

Revenue Accounting

5.15 The Kyrgyz Republic levies a total of 24 taxes, excluding Social Fund payments. All of the taxes and contributions are collected by the central government. The tax and custom revenues are collected in separate transit accounts in approved commercial banks. The revenues collected at the end of the day are required to be transferred by the collecting banks to the treasury account with one of the four agent banks. In some villages, that lack banking facilities, taxes are collected by the Tax Administration officials in cash, which are then deposited in the transit accounts of the treasury. Part of the Custom duties is also collected in cash by the Customs Department. All revenue receipts are classified and accounted for according to the information available in the payment orders submitted by the receiving bank. The treasury then forwards a copy of the payment order, which is filled in by the taxpayer and received from the receiving bank, to the Tax Administration. Recently, some receiving banks have started sending only one copy of the payment order to the treasury, which is then passed on to the Tax Administration. As a result, at times, in absence of a documentary record with the treasury, the reconciliation between the treasury office and the tax administration is rendered difficult. The Tax Administration maintains an individual card for each taxpayer. The individual cards are updated on the basis of a monthly tax declaration received from the taxpayer, and the payment order received from the treasury. The monthly tax declaration indicates the self-assessed liability of the taxpayer, which is then compared with the actual payment received as evidenced by the payment order. The tax collections are reconciled on a daily basis between the rayon tax office and the rayon treasury office. The Tax Administration head office submits daily tax collection figures and a monthly report by the type of taxes to the MoF. The above procedures are considered adequate from accounting controls perspective.

5.16 The practice of collecting taxes in kind has now been banned. Until 2001, taxes collected in kind, such as wheat, contributed about 27\%, 15\%, and 3\% in the years 1999,
2000, 2001 respectively\textsuperscript{20}. Grain, collected as taxes, is stored in owned or rented warehouses. This practice posed several difficulties, not only in terms of safekeeping, but also for accounting, storage losses, and deterioration in grain quality etc.

5.17 The Tax Administration has started a computerization process with financial assistance from the USAID under which an integrated tax information system is being developed (by Barents group). A pilot program to computerize rayon tax administration records is currently underway. This initiative is likely to assist the Tax Administration in processing the tax data more efficiently and enable it to analyze the information more effectively. However, none of the local offices of customs department has computers to process the import and export data. Efforts to automate the customs department would further strengthen internal controls and expedite accounting and reporting.

Public access to financial statements

5.18 The annual budget law is in the public domain and is required to be published in the press (article 12 of the Law on Budget). However, there are no specific provisions requiring publication of actual data (financial statements). The approved budget together with annexes and explanatory notes is not published as a printed document and is difficult to obtain for public use, though the fiscal data put on the National Statistical Committee’s website (http://nsc.bishkek.su/Eng/Home/Index.html#Financial) provides some information on a consolidated basis. Recently, MoF also has begun posting monthly information on budget implementation on it’s website. It is, however, not certain as to what extent the civil society is able to access and use this information to hold the Government accountable.

\textsuperscript{20} Source - the State Tax Administration
6. EXTERNAL AUDIT

6.1 Overall the external audit body, the Chamber of Accounts, is in need of significant capacity building inputs so to absorb and implement acceptable international audit standards and practices and to transform from an “inspection” or “control” body to an external audit body. Coupled with this capacity building needs, certain other measures to amend the legal framework governing the Chamber of Accounts (CA) are also required. The process of appointment of the Chairman of the CA needs to be made transparent, the CA should be able to determine its own staff structure, the practice of retaining 10% of the fines needs to be discontinued, and the Parliamentary committee should have a role in determining the budget requirements of the CA. There is a need for clearly defining the role of the CA by replacing the word “control” with “audit”, by requiring the CA to provide an opinion on the annual financial statements of the government, and by authorizing the CA to carry out interim ex-post audits.

6.2 The Chamber of Accounts (CA), established in 1996 by the Law on Chamber of Accounts, performs the external public audit in the Kyrgyz Republic. The CA evolved from the State Financial Inspectorate, established in 1992, which in 1995 became the Chamber of Control until it was formed as Chamber of Accounts in 1996.

6.3 The Constitution does not contain core principles of CA except specifying the responsibilities of the Parliament and the President to appoint members of the CA. However, the roles and responsibilities of the CA are defined in the Law on Chamber of Accounts, 1996. Its status is described as “… supreme body of the state financial and economic control….”. It is clearly intended therefore to be the Supreme Audit Institution (SAI) of the Kyrgyz Republic.

6.4 The Law states that the CA is accountable to the President and the Parliament. By specifying the President and the Parliament as the primary recipient of audit reports, the Law has clearly established the reporting relationships for the CA.

6.5 There is no definition of the term “audit” in the law. The word “control” is often used in the law to indicate the responsibilities of the CA. The word “control” connotes check or restraint or ex-ante activity rather than examination or ex-post audit, which was the main function of the “Control and Revision Agency” in the Soviet times. The law casts the responsibility on the CA to formulate proposals for elimination of deviations in particular, and improvement of the budget process in general. But more importantly, the CA currently has no certification role in respect of year-end financial statements of the government as a whole or accounts of ministries and other State organizations. In order to properly reflect the role of the CA, the term “control” in the law should be replaced with the word “audit” and the CA should be required to provide an

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21 The Lima Declaration adopted by INTOSAI states the purpose of audit as follows: “The concept and establishment of audit is inherent in public financial administration as the management of public funds represents a trust. Audit is not an end in itself but an indispensable part of a regulatory system whose aim is to reveal deviations from accepted standards and violations of the principles of legality, efficiency, effectiveness and economy of financial management early enough to make it possible to take corrective action in individual cases, to make those accountable accept responsibility, to obtain compensation, or to take steps to prevent--or at least render more difficult--such breaches.” http://www.intosai.org/2_LIMADe.html
opinion on the annual financial statements. However, replacing the words in the law would not make much difference in the work performed by the CA unless the concept of audit, distinct from control, is understood clearly by the staff and other stakeholders.

6.6 The CA should be granted authority to conduct interim audits during the year so as to avoid the year-end rush and to provide an opportunity to the budget institutions to correct any deviations at an early stage. The law grants the authority to the CA for "...identification of effectiveness and expediency of public spending...". The CA is also authorized to "control" the process of privatization. The SAI has a broad scope of audit that includes use of state funds transferred to local governments, and entities in which the state has a financial stake. There is no scope limitation in the laws restricting the authority of the CA to plan and conduct an audit except the CA is not allowed to audit the transactions for the current year; it can audit the transactions only after the year-end. Moreover, the CA is not allowed to audit the entire financial statements of the NBKR\[22\] except expenditures out of budgetary resources provided during the year. Auditors should have the independence and authority to plan their audits, having an authority to carry out ex-post audits during the year is very important. The law should be amended to provide this authority to the CA.

6.7 Although the Law on the CA has no reference to the CA's role in "verifying" the draft annual budget, the Law on Budget authorizes the CA to "verify" the draft annual budget. The Budget Law requires the departments involved in the budget preparation to make available all the documents of budget preparation to the CA. The CA is required to submit a report on such verification to the Parliament. There seems to be differing views on this authority of the CA and, in the recent past, the CA has desisted from carrying out such reviews. The CA is candid in admitting lack of necessary resources and skills for carrying out effective reviews of budget assumptions and estimates. Considering the current skill base in the CA and the need to prioritize the focus of the CA, it is not advisable for the CA to start such reviews of draft budgets.

Structure and working of the Chamber of Accounts

6.8 The CA has 12 members, six of whom are appointed by the two houses of Parliament, and four by the President. The President also appoints the Chairman of the CA. The recent amendments (February 2003) to the Constitution now require the appointment of the Chairman to be done by the President with the consent of the Parliament. However, the Parliament now has the right to appoint only one-half of the members (instead of 2/3rd earlier) and the President will now appoint the balance half of the members (earlier only 1/3rd). The current Chairman and all members nominated under the provisions of the old Constitution will serve till the end of their terms. The term of the Chairman is five years and that of members is concurrent with the term of the Parliament. The appointment process, though largely political, requires the nominees to have experience in "control", economics, and finance. For example, there were 116 applications for the four positions in the CA (for appointment by the Legislative Assembly of the Parliament). The ultimate selection was based on compromises reached with various factions within the Legislative Assembly. There is a need for a clear-cut criterion for

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\[22\] NBKR's annual financial statements are audited by an international audit firm.
selection and appointment of members of the CA. The Chairman of the CA is not involved in the appointment process. The President has the full right to dismiss the Chairman before the expiry of his term if the President concludes that the Chairman has an unsatisfactory performance in fulfilling his duties or when he has abused the powers of the Chairman. The members of the CA can be dismissed by the appointing authority under specified circumstances.

6.9 The alternative models chosen by the Russian Federation and Ukraine, also formerly parts of the Soviet Union, provide an interesting development in the CIS region though not necessarily representing an international best practice. The Russian Federation has established an Accounts Chamber accountable to the Federal Assembly. The Russian Federation Constitution, at least in principle, clearly lays the foundation for the independence and neutrality of Accounts Chamber. Similarly, Ukraine has also established an Accounting Chamber that is accountable to the Parliament. It would be useful to study these models, because independence (from the executive) and neutrality are an essential features of an objective and effective external auditing body.

6.10 The Chairman and other members are barred from conducting business, accepting any duties with remuneration, and continue membership of the Parliament. However, the law is silent on their continuation of membership of political parties.

6.11 The President has the authority to approve the structure, staffing, and employee compensation policies of the CA on the recommendation of the Chairman of the CA. Except for the above, the Law has adequate provisions to ensure the functional and organizational independence of the CA, so as to enable it to accomplish its task objectively and effectively. In order to enhance independence of this important organ of public accountability, providing autonomy to the CA to determine its staffing and structure should be considered. As mentioned earlier, most of the CA staff was transferred from the State Financial Inspectorate, which was closed down in June 2000. After the transfer the staff strength of the CA went up to 310, but later it was reduced to 170. Due to the lack of adequate number of staff, the CA performs audit at the rayon level only once in 2-3 years. However, there is ample scope for rationalizing the staff allocations for inspection work as very often the team of inspectors spends considerably long time carrying out inspections. For example, a team of 8-10 inspectors from the CA were inspecting the Health project for over five months in a row. The CA has an independent cadre of staff and the staff is not on loan from the line ministries. The CA is authorized to retain departmental staff or outside experts in assisting in its work. The CA operates from the central office in Bishkek and three regional offices.

6.12 In order to strengthen independence of the CA, the Budget committee of the Parliament, rather than the MoF, should discuss and approve the budget request of the CA. The budget of the CA is a separate line item in the Republican budget. However, there are no clear provisions regarding how the budget allocations would be determined. In the absence of clear guidance, the allocations are subject to the normal bargaining between various sectors. This situation, where the CA is at the mercy of MoF to receive adequate budget for its activities, may compromise the independence of the CA.
6.13 The CA retains, as do other budget institutions including law enforcement authorities, 10% of the fines/penalties as an additional resource for its expenses. This practice provides a perverse incentive to the CA to maximize the receipts rather than focus on the primary objective of audit and causes conflict of interest. The fact that the funds in the special means provide certainty to the institutions for making payments, does not mean that this practice should continue for bodies such as the CA. While it is important that this practice is discontinued forthwith, for successful discontinuation, the MoF simultaneously will need to improve the cash and treasury management practices so as to provide predictable payments to the budget institutions.

6.14 The internal working of the CA is governed by the “Rules of Procedure of the Kyrgyz Republic Chamber of Accounts” and the Law on Chamber of Accounts. The rules provide for collective decision making at the meeting of the 12 members presided over by the Chairman. Decisions at the CA meetings are made by the majority of votes cast by the members. In case of a tie, the Chairman has the deciding vote.

6.15 The CA prepares a quarterly and annual plan of work that is approved at the meeting of the Chamber. However, a detailed audit program for each agency is approved by the Chairman himself. The Chairman also has the right to authorize unscheduled inspections, which is, however, required to be approved at the subsequent meeting of the Chamber.

6.16 The inspection/audit team is required to prepare an inspection report, which is presented to the budget institution or the enterprise being audited. The inspection report typically highlights issues of compliance with rules and regulations. The manager and the accountant of the institution are required to put their signatures on the inspection report. The management response is attached to the report. The audit report is discussed at the meeting of the Chamber at which the manager or accountant may be invited. The meeting decides on the recommendations for eliminating the violations, on penalties to be imposed, and actions to be taken against individuals. Although the law contains a provision that in case of non-fulfillment of orders issued by the CA, the Chairman has the right to suspend transactions with the agency concerned, it has rarely been invoked. An order of the CA can be appealed in the court of law.

6.17 Providing directions to the executive could be counter-productive, as it interferes in the executive’s authority over the decision making process. The enforcement of financially sound procedures and adequate follow-up on audit reports from the CA is essentially the responsibility of the management. The CA should provide objective analysis of the problem and alternative solutions and leave the decision making to the executive. Otherwise, there is an inherent risk in the CA’s ability to comment on its own recommendations later.

6.18 The Law on Chamber of Accounts does not specify any requirement on adoption of audit standards. The CA claims to follow the Kyrgyz Audit Standards. Not only are these standards in variance with internationally accepted standards, but even the actual implementation of these standards is far from satisfactory. The CA is planning to issue its own audit standards in the future. It is strongly recommended that the CA should consider adopting the INTOSAI audit standards instead of creating another set
of standards. The present audit approach adopted by the CA is based on the examination of financial transactions, identification of financial discrepancies, and fraud investigation. The focus of the audit is compliance testing and not much attention is given to the financial audit or internal control risk assessments. There is little evidence of the application of modern audit procedures and techniques, such as risk-based audit approach, to the planning and prioritization of audit work. There is a considerable gap in the knowledge and understanding of modern international audit practice.

6.19 The auditors in the CA need substantial training and on-the-job experience in implementing modern international audit practices and procedures particularly risk-based audit approach and financial audits. Considering background of most of the audit staff who have strong experience in the control and revision work but very little exposure to the modern auditing practice, the CA would benefit by entering into twinning arrangements with another well-established SAI that would enable the CA staff to learn latest techniques in risk-based auditing and recent advances in government auditing. The CA has not received any substantive technical assistance in the past. The CA needs to formulate a training program on audit covering aspects such as, Audit Standards, Risk Assessment and Control, Audit Reports, Quality Control in Audit work, and professional ethics. CA will need technical assistance in implementing these programs.

CA Annual Reports

6.20 There are no clear and specific provisions on preparation and submission of audit reports on the annual budget execution statements by the Chamber of Accounts either in the Law on Chamber of Accounts or the Law on Basic Principles of Budget. The Law on Basic Principles of Budget has an indirect provision that requires the Parliament to review the report of the Chamber of Accounts before approving the government’s report on execution of the budget. However, it should be noted that the CA does not provide any report on the budget execution statements but instead produces an annual report on its activities as mentioned in the law on CA. There is a need to amend the laws to specifically require the CA to provide an annual audit report on the financial statements in addition to the report on its activities.

6.21 The reports submitted by the CA for the year 2000 and 2001, reveal several irregularities presented in Table 3:

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Table 3: Findings of the Chamber of Accounts

<table>
<thead>
<tr>
<th>Findings</th>
<th>FY2001</th>
<th>FY 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illegal expenditures (million soms)</td>
<td>20.4</td>
<td>478.8</td>
</tr>
<tr>
<td>Unintended expenditures (million soms)</td>
<td>25.8</td>
<td></td>
</tr>
<tr>
<td>Embezzlements, deficits (million soms)</td>
<td>14.7</td>
<td>10.5</td>
</tr>
<tr>
<td>Other financial offences (million soms)</td>
<td>101.9</td>
<td></td>
</tr>
<tr>
<td>No. of officials dismissed / ordered to retire</td>
<td>86</td>
<td>14</td>
</tr>
<tr>
<td>No. of officials charged with admin. penalties</td>
<td>692</td>
<td>138</td>
</tr>
<tr>
<td>No. of officials ordered to pay fine</td>
<td>118</td>
<td>7</td>
</tr>
<tr>
<td>No. of cases transferred to law enforcement bodies</td>
<td>288</td>
<td>42</td>
</tr>
</tbody>
</table>

(Source: Chamber of Accounts Reports)

6.22 Although the audit report contains several instances of illegal and unintended expenditures, embezzlements and other financial offenses, the budget institutions, however, contend that it includes several minor and inconsequential lapses. The audit report does not provide an executive summary and it is difficult to discern major issues amidst the vast amount of detailed factual information. The format and presentation of the report could be greatly improved by clearly highlighting the exact nature of control weaknesses, issues and conclusions, and by providing an executive summary. It will also be important that the CA identifies the root cause of the reported violations or provides description of control weaknesses or failures. In addition, the report should also state the purpose, scope of the audit, and auditing standards followed in the conduct of the audit. It is recommended that the CA follow the INTOSAI audit report standards for the preparation of the annual audit report.

6.23 The CA should consider developing its website to provide useful information to civil society and the mass media. The law on CA authorizes the CA to provide information regarding its activity to the mass media. However, there is no requirement to provide copies of the annual report on the performance of the CA to the mass media. The CA provides information to the mass media on a selective basis. For example in 2001 the CA made available 69 press bulletins. In order to improve transparency in the working of the government, it is advisable to make available annual reports of the CA to the mass media. The CA has no website that could be accessed by civil society or the mass media.

6.24 Although the CA has staff with expertise in inspections and investigations, as stressed earlier, the CA needs to train and develop professional skills of its auditors in modern audit practices including audit of financial statements and risk-based approach to auditing. In view of the inadequate skills base in conducting financial statements audit, the audit of Bank-financed projects should continue to be carried out by acceptable private sector audit firms until CA develops the necessary capacity and skills base.
7. LEGISLATIVE OVERSIGHT OVER THE EXECUTIVE

7.1 Overall the Parliament is relatively quite active in the legislative area (compared with other Parliaments in the Central Asia region), but needs to build significant capacity to provide effective oversight over the executive.

7.2 The Constitution has provided for legislative oversight over the executive in several ways. For example, by requiring the Parliament to approve the annual budget and to receive the annual report of the government on budget implementation. Parliament also has the authority to appoint eight members (out of 12) at the CA (the recent amendments to the Constitution reduces the number of members to be appointed by the Parliament from 2/3rd to 1/2 ). The CA presents an annual report on its activities to the President and the Parliament.

7.3 The Parliament has separate Budget and Economic Policy Committees for each house of Parliament to review budget proposals and budget implementation reports. The committees rely on analytical reports prepared by the MoF and are required to review budget proposals within 20 days. Each committee presents its report on the budget proposal at the plenary session of the Parliament. The capacity of both the committees to conduct proper review of the budget proposal and budget execution reports is limited, as it does not have specialized staff to provide research inputs and technical expertise. Without independent supporting research data, the discussions in the committees could easily degenerate into political rhetoric rather than substantive policy discussions.

7.4 As mentioned earlier, the Parliament can reject the entire budget, but cannot amend the budget without an agreement with the government. In particular, the Parliament cannot pass any legislation that has financial implications without prior approval of the government. This provision helps in ensuring fiscal discipline while legislative deliberations are ongoing to consider the government’s budget proposals.

7.5 There are no specific provisions in the Constitution or other laws requiring the Parliament to approve and or adopt the audit report submitted by the CA. As the Parliament has very little leverage in forcing the executive to implement the recommendations made by the CA, an important accountability mechanism that could ensure implementation of recommendations is missing. The Law on Basic Principles of budget requires the Parliament to only consider the report of the CA while approving the government’s report on budget implementation. Similarly, there is no provision in the law that empowers the Parliament or its committees to call the Chairman or members of the
CA to the meetings while discussing the audit report or the budget execution report. Since Parliament is the recipient of the audit reports, it is essential that it have adequate capacity to conduct a detailed review of the audit reports, including the ability to ask for clarifications from the executive and the CA, to provide directions to the government based on this review, and to conduct follow-up required to ensure that adequate actions are taken to address the issues. There is a need to clarify the role and authorities of the Parliament in the review and approval of annual audit report of the CA.

7.6 In order to enhance transparency and strengthen public accountability, the Budget Committee should consider opening the proceedings to the media and/or public when it holds discussions on the audit reports.

7.7 State Owned Enterprises’ (SOE) audited financial statements and audit reports should be subject to the parliamentary review, just like the financial statements of the government\textsuperscript{24}. Although SOEs control significant amount of public funds and property, there is no automatic reporting on SOEs’ financial results and annual audits to the Parliament. The law contains no specific provisions making SOEs annual financial statements and audit reports available to the Parliament. To begin with, annual financial statements and audit reports of SOEs could be submitted to the Parliamentary Budget and Economic Policy Committee for information.

\textsuperscript{24} The SOEs in the Kyrgyz Republic are significant in number and magnitude. It is common for SOEs to draw substantial resources (directly or indirectly) from the government budget, especially given the fact that the government also imposes obligations on them. In fact, over the past decade the bulk of SOE investments have been supported directly or indirectly by the budget. As a result, the SOEs account for a significant portion of the current stock in the Kyrgyz Republic of external public debt (about 37 percent in 2000) and for the bulk of the state’s domestic debt. (Source PER)
8. SOCIAL FUND

8.1 **Overall the Social Fund**\(^{25}\) has developed a good accounting system, but should now pay attention to strengthening internal audit function and building a centralized secured database of pensioners. Although SF is audited annually by the CA, SF would benefit by getting its financial statements audited, at least once in five years, by an international firm that has expertise in pension and insurance audit.

8.2 **The Social Fund (SF) administers pensions and social security in the Kyrgyz Republic.** In addition, it collects contributions for health insurance on behalf of the Health Insurance Fund. However, since the pension payment is the priority for the SF, amounts transferred to the Health Insurance Fund are often delayed and are less than the amount due (see Table 4). The SF, though financially dependent upon the government\(^{26}\), has an autonomous structure. It has a tripartite supervisory board comprising representatives from the government, trade unions, and employers. The Law authorizes the SF to utilize 2.5% of the contributions toward its management expenses (the U.S. Social Security Program spends less than 1 percent on administration). **The budget of the SF is approved by the government and the Parliament.**

### Table 4: Finances of the Social Fund for the Financial Year 2001  
*(figures in millions of Soms)*

<table>
<thead>
<tr>
<th></th>
<th>Pension Fund</th>
<th>Social Insurance Fund</th>
<th>Unemployment Insurance Fund</th>
<th>Medical Insurance Fund</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receipts of contributions and other receipts</td>
<td>2,962.10</td>
<td>159.52</td>
<td>136.23</td>
<td>171.58</td>
<td>3,429.43</td>
</tr>
<tr>
<td>Payments/Transfers</td>
<td>3,350.44</td>
<td>149.46</td>
<td>101.29</td>
<td>109.41</td>
<td>3,710.60</td>
</tr>
<tr>
<td>Surplus/(Deficit)</td>
<td>(388.34)</td>
<td>10.06</td>
<td>34.94</td>
<td>62.17</td>
<td>(281.17)</td>
</tr>
<tr>
<td>Arrears of contributions</td>
<td>1,125.55</td>
<td>26.80</td>
<td>72.40</td>
<td>78.25</td>
<td>1,303.00</td>
</tr>
<tr>
<td>Arrears of pensions due/liabilities</td>
<td>184.30</td>
<td>800.76</td>
<td>120.46</td>
<td>233.62</td>
<td>1,339.14</td>
</tr>
</tbody>
</table>

*(Source: Financial Statements of the SF)*

8.3 **The SF collects contributions directly (not through the Tax Administration) on the basis of accrued salaries/income for the year**\(^{27}\). The SF maintains a shared information system of registration of natural and judicial persons with the Tax Administration. The contributions (including those for medical insurance, employment fund, insurance fund) amounts to 39% of salaries. The collections and payment of pensions takes place at the rayon levels. The contributions are collected by selected commercial banks (not through the treasury) including SSC. The SF maintains two separate accounts

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\(^{25}\) Social Fund is the biggest of the extra-budgetary fund.

\(^{26}\) During years 1999 and 2000 the SF received Soms 344 million and 150 million, respectively, as budgetary support from the government. For the year 2002, a sum of Soms 310 million is provided in the annual budget.

\(^{27}\) Social insurance contributions for persons involved in farming activities are paid to the SF at the rate of 1/4\(^{th}\) of the land tax base rate each quarter. The self-employed pay contributions of 38% of three times the minimum wage adjusted for actual income as reported in tax returns.
with the banks: one account to collect the contributions and another account for meeting the expenditures (funded out of transfers from the collection account). Most of the payments to the pensioners are handled by the post offices (Kyrgyzpochtasy), which charge a fee of 1% of actual pension payment. The total amount of pensions paid during the year 2001 was Soms 3.1 billions to approximately 539,000 pensioners.

8.4 **Some contributions (and some pension payments) are received in kind which is not only riskier than bank transactions but are also expensive.** It obliges the SF to manage the inventories and assume the risk for storage losses. The amount of in-kind contributions has been declining and was less than 10% of total contributions in 2001. The valuation of goods, such as flour and sugar, is at a pre-determined rate (established by the Anti-Monopoly Commission), which is always less than the market price. If the value of a standard pre-packaged good (sack of flour or sugar) exceeds the monthly pension due it is considered a pre-payment for the next month.

8.5 **The SF uses a computerized accounting system and has installed computers in all rayon offices, financed under donor-funded projects including EU-TACIS.** Each rayon office has an accounting unit. The modified Russian 1-C software is used for accounting and reporting. Quarterly financial statements are prepared by the rayon and oblast offices for consolidation at the headquarters level. However, the pensioner data is still manual and SF needs to do much more by establishing a centralized secured pensioners database for ensuring integrity of the data and improving controls. As the SF serves a large number of beneficiaries, maintaining pension records on a manual basis is not only cumbersome and laborious but is prone to errors and abuse.

8.6 **Asset management is not a major activity for the SF.** The SF is still dependent upon budgetary support and does not have a large surplus of funds that could be invested in different securities. However, in the long term, SF will need to develop skills and capacity in efficient asset management.

8.7 **There is a need to upgrade the skills of internal auditors by providing training in risk-based audit methodology particularly in view of the fact that SF is a decentralized organization and serves a large number of pensioners in the country.** The SF has a separate internal audit department consisting of 7 staff. Currently, the Director’s position is vacant. The main objectives of internal audit compliance testing rather than provide an assurance to the management about the robustness of the internal control framework in SF.

8.8 **The SF’s Receipt and Payment Statement is audited by the Chamber of Accounts.** The audit report on the SF finances is included in the consolidated audit report of the CA, which is submitted to the Parliament. The audit report for the year 2001 highlights financial violations including illegal expenses without providing any details of these violations. Considering the peculiar nature of operations of SF, it is advisable that an international firm that has expertise in pension and insurance audit, at least once in five years, conducts an operation and financial audit the SF. Such an audit would help SF in strengthening its accounting and control framework.

8.9 **SF has not created any reserve fund out of which pensions could be paid, and it relies on monthly contributions to pay monthly pensions.**
9. ANTI-CORRUPTION MEASURES

9.1 Strong internal control framework coupled with effective internal and external audit are essential prerequisites for protecting public finances from fraud, waste and abuse. As discussed in the earlier paragraphs, external audit reports have highlighted several instances of illegal, and unintended expenditures in addition to embezzlements. In order to curb misuse of public finances and rent-seeking opportunities, it is imperative that the government strengthens internal controls and establishes a mechanism to evaluate the effectiveness of the internal controls on a continuous basis by setting up an internal audit function. In addition, the Government needs to implement several recommendations made in the CPAR for strengthening the procurement function, which is generally a critical area prone to high degree of corruption. These efforts should be supplemented by strong enforcement mechanisms to ensure that actions are taken to implement recommendations made by the auditors — by strengthening the Parliamentary Budget and Economic Policy Committee.

9.2 As in many transition economies, corruption is perceived to be a major problem. A recent report28 by the Bank on a corruption survey in the Kyrgyz Republic observed a high proportion of enterprises and households that reported encountering bribery – 42% of the households and 48% of enterprises surveyed reported that they made an unofficial payment in the 12 months before the survey. An earlier survey report (2000) by an independent non-governmental organization “Center for Public Opinion Studies and Forecasts” carried out under the auspices of UNDP program on crime prevention also highlighted wide spread corruption in public life.

9.3 The Government has been actively pursuing anti-corruption program. The decree approved by the government On Strengthening of Anti-corruption, Smuggling, and Economic Crimes Struggle in the Kyrgyz Republic for 2001-2003 outlines the government strategy for combating corruption. A separate body of Financial Police was created in January 2001 to prevent and reduce corruption in the tax and customs authorities in the Kyrgyz Republic – although it has yet to make much impact (see section 4.4).

9.4 A proposed Bank-financed Governance Structural Adjustment Credit (GSAC) and Governance Technical Assistance Credit (GTAC) would support reforms aimed at improving the targeting, transparency, and effectiveness of public expenditures. The key components of GTAC include treasury modernization including cash planning module, commitment, expenditure, and accounts payable module; rationalization of the organizational structure in the MoF to establish clear accountability lines in budget management; and establishing a civil service management agency. The Bank has been supporting the Government in implementing an anti-corruption program. In the past, the Bank had financed, jointly with EU-TACIS and UNDP, the Public Sector Resource Management Adjustment Credit29 that aimed at strengthening the debt management, fiscal management, financial management and reporting, and tax administration. The Bank had also financed a couple of grants for establishing and strengthening the procurement function. Such initiatives have facilitated establishment of various institutions and created

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28 The World Bank: Governance in Kyrgyz Republic (March 2002)
29 PSRMA (USD 44 millions) credit was approved in 1997 and closed in 2000.
a legislative framework where none existed earlier. The challenge now is to implement and enforce existing laws and regulations, and strengthen the capacity in various institutions to perform effectively. The Bank has also been providing support through non-lending activities in the Government’s anticorruption efforts.
10. FIDUCIARY ARRANGEMENTS IN BANK FINANCED PROJECTS

10.1 Overall fiduciary risks in Bank-financed projects are managed by establishing ring-fenced Project Implementing Units (PIUs), which install separate project financial management systems distinct from the government accounting and reporting systems and maintain separate audit trail of project transactions. Annual project financial statements are audited by acceptable private audit firms. Given the existing weaknesses in the financial accountability framework, it is recommended that ring-fenced control be maintained for Bank-funded investment projects until the systemic weaknesses described in this report have been adequately addressed.

10.2 Most of the projects are managed by stand-alone PIUs except a few. The core staff in each PIU includes an accountant and a procurement officer. Due to the scarcity of skilled accounting professionals, recruitment of accountants for the projects is difficult, and the PIU often ends up hiring a person with some bookkeeping background who then undergoes extensive training in project financial management.

10.3 Major areas of internal control weaknesses are weak organizational structure, which results in poor allocation of responsibilities for accounting and reporting on project activities; non-compliance with Bank requirements, such as the one requiring that Bank-provided funds not be commingled or used for activities other than those for which they were intended; or inadequate accounting mechanism over counterpart resources. Due to unavailability of adequate on-time counterpart funds, the Bank funds are often used for pre-financing ineligible expenditures that should have been paid out of counterpart funds. PIUs, in consultation with the Bank-FMS, are working to improve the internal control framework. The Bank management has also been regularly discussing the issue of counterpart funding with Kyrgyz authorities. Due to the small size of the project, no PIU has established an internal audit function. With the availability of a full-time FMS based in Bishkek, it will be now possible to closely supervise and monitor the financial management aspects of projects and provide quick guidance to the PIU staff on financial management issues.

10.4 A procurement consultant, appointed by the Bank, is currently carrying out an independent procurement review of selected 100 contracts in Bank-financed projects in the Kyrgyz Republic. The preliminary findings of this review indicate no major instances of misprocurement. Major observations include absence of proper system to levy liquidated damages in respect of delays in contract execution, shorter validity for performance security, and arbitrary amendment of bid security requirements.

10.5 The Bank carried out an on-site assessment of audit firms in the Kyrgyz Republic in June 2001 to determine their eligibility to audit Bank-financed projects. The review revealed that most local firms lack either the technical capacity or the requisite experience to carry out such audits. Other than the Big 4 audit firms, only one local firm was considered eligible to carry out project audits.

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30 Since the Kyrgyz Republic became a member of the World Bank in September 1992, it has received commitments of about US$621 million for 27 projects. All lending to the country has been on IDA terms. There are 15 projects currently under implementation.
10.6 Until FY 2000 all the projects were audited by Big 4 audit firms based in Almaty, Kazakhstan because of the lack of acceptable local audit firms. This situation has changed with the acceptance of a local firm to audit Bank-financed projects. This local audit firm is auditing the financial statements of several projects for FY 2001. However, this has resulted in relying on a single audit firm for the audit of Bank-financed projects and has raised questions about the quality of audit reports. A review of the audit reports for FY 2001 prepared by the local audit firm indicates that, although the reports are generally submitted on time and cover the project financial statements including Statement of Expenditures, there are teething problems in handling audits of Bank financed projects, and lack of strong quality control mechanisms to ensure high quality audit. The Bank will need to continuously monitor the quality of audits performed by the local audit firm particularly in view of the fact that the firm seems to have accepted more work than it could handle.

10.7 NBKR has adopted International Accounting Standards (IAS) for preparing its financial statements. However, NBKR has to fully comply with the IAS particularly as regards reporting of unrealized gains on foreign exchange related transactions (IAS 8 and 21) and preparation of cash flow statements (IAS 7). NBKR has also taken steps for reporting of financial instruments in line with IAS 39. Since 1995, NBKR is audited by one of the Big 4 international audit firms from their offices in the UK, Moscow, Almaty, or Bishkek. The auditors have issued unqualified audit opinions for the years 2001 and 2000. The audits are carried out by the external auditors in accordance with the International Standards of Auditing (ISA). NBKR also has a professionally staffed Internal Audit Department that reports directly to the Chairman. The proceeds of the adjustment credits deposited with NBKR are used by the MoF to repay foreign currency debts or receiving local currency equivalent and credited to the treasury account. Considering the above, the Bank could rely upon NBKR’s special deposit accounting, reporting and audit arrangements for meeting the Bank’s current fiduciary requirements in respect of the Special Deposit account for adjustment credits.

10.8 Considering the failure of several banks in the Kyrgyz Republic in the past few years, the Bank should carry out a fiduciary assessment of commercial banks holding project special accounts in order to assess the risk to the special account funds deposited with these banks. Most Bank-financed projects in the Kyrgyz Republic have their special accounts in private commercial banks such as Kyrgyz PromstroiBank, JSC Bank Kyrgyzstan, and Demir International Bank.

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31 Since the tasks of central banks are quite different from the business enterprises primarily for whom the IAS are applicable, NBKR contends that keeping in mind its responsibility to maintain purchasing power of domestic currency, it has been complying with the IAS to the extent possible for central banks.

32 NBKR selects international auditors on a tender basis annually.
11. SUMMARY OF RECOMMENDATIONS FOR PUBLIC SECTOR ACCOUNTABILITY REFORMS

11.1 The Kyrgyz Republic’s key development initiatives, the National Strategy for Poverty Reduction (NSPR - 2003-05) and the Comprehensive Development Framework (CDF – 2010), both make clear that the enormity of the challenge facing reformers is well understood, and that the governance reforms including financial management and accountability reforms must play a key role in poverty reduction.

11.2 In a short span of a decade since independence, the Kyrgyz Republic has succeeded in establishing various institutions and enacting laws and regulations in the area of public financial accountability. However, as several accountability institutions are of recent origin and lack experience and exposure to international best practices in their area of operations, they have not been fully effective. There is clearly a moderate degree of fiduciary risk in the use of public resources, given the weak institutional arrangements for assessment of effectiveness of budget programs, weak internal controls compounded by absence of internal audit mechanisms, and weak capacity in the legislative body to provide effective parliamentary oversight over the executive. The biggest challenge facing Kyrgyz Republic is to build necessary capacity in these institutions to implement and enforce existing laws and regulations.

11.3 This CFAA has identified the following major issues in the public sector financial accountability:

- weak internal controls in several areas such as treasury, budget implementation, procurement, human resources, accounting and reporting as evidenced by large amounts of illegal unintended expenditures, embezzlements and other financial offences reported by the external auditor;
- weak cash management as the treasury cash rations on a day-to-day basis, which creates uncertainty for budget institutions in implementing their plans;
- absence of a legal basis for internal audit in the public sector;
- weak capacity in the CA for carrying out effective financial audits and focusing attention on the basis of risk assessment;
- weak capacity in line ministries to undertake systematic budgeting exercise;
- budget monitoring is limited to monitoring of fiscal targets as little attention is paid to assessment of program effectiveness;
- lack of systematic management accounting and weak capacity in departmental management to absorb and use management accounting data in decision making and management processes;
- weak capacity in the parliamentary committees to provide effective legislative oversight over the executive; and
- inadequate accountability arrangements for SOEs
Experience in many other countries shows that the required changes will entail reaching political consensus and reforming existing institutions or creating new ones. This suggests that a realistic timetable for improvement in public financial accountability will have to stretch over several years and will depend on strong leadership from the top. Experience has also shown that any change of fundamental nature that is driven from outside and that lacks political consensus will fail to achieve its objective. Ideally, the Kyrgyz Republic should set up a high-level policy group to decide on the longer-term conceptual issues identified in this CFMA report and to launch the preparatory work on a detailed action plan. Several systemic recommendations would require technical assistance for formulation and implementation. For example, strengthening the CA and establishing a modern internal audit function will require advice from experts and extensive training for the staff.

Given the existing weaknesses in the financial accountability framework, the CFMA recommends that ring-fenced control be maintained of Bank-funded investment projects until the systemic weaknesses described in this report have been adequately addressed. Overall, fiduciary risk is manageable provided the Government takes the steps outlined in this report as well as those mentioned in the PEIR and CPAR. Considering, satisfactory accounting, internal control, and audit systems in NBKR, the Bank can continue to rely upon it for managing the proceeds of the adjustment credits in the Special Deposit account.

The recommendations for strengthening public sector accountability are grouped into two: one that involves policy decisions and second in the nature of systemic/technical improvements further divided into short term, medium term and long term measures. While all these recommendations are important in strengthening the financial accountability in the Kyrgyz Republic, the timing and sequencing of the implementation will be critical in ensuring their success.

**Key Recommendations**

**Short term**

- strengthen internal controls and strengthen the treasury cash management function;
- establish daily reconciliation of consolidated district treasury payment requests with the reimbursement made by NBKR to the agent banks;
- reconcile on daily basis between revenue collections transferred by the agent banks with the taxpayer filled payment forms; and
- grant authority to the CA to perform interim post audits

**Medium term**

- enact the Law on Public Sector Internal Audit and build internal audit capacity;
- establish effective internal audit structures in the line ministries;
- prepare rules and methodology for conducting internal audits in the public sector;
- provide extensive training to the internal audit staff;
require internal auditors to carry out detailed COSO-based assessments of internal controls to analyze their effectiveness;

require a certification role for the CA in respect of the year-end financial statements of the government both cash-based and modified accrual-based;

make the process of appointment of the Chairman of the CA transparent;

discontinue the special means provisions; and

clearly define the accountability of the SOEs. Annual audited financial statements and the audit reports of SOEs should be made part of annual government fiscal accounts and placed before Parliament.

**Systemic Improvements**

**Short term**

- hold several training programs for the line ministry accounting staff for developing better understanding of the recently issued accounting regulations and for introducing the concepts of financial management;
- provide training to departmental managers in understanding and interpreting financial management reports;
- strengthen the skills of the line ministry staff to undertake program budgeting by conducting extensive training programs;
- develop clear-cut criteria for selection of capital projects, including technical, economic, financial, environment, and social criteria;
- publish annual financial statements, both cash-based and accrual-based, including posting them on the website; and
- strengthen the internal audit capacity within SF by adopting internationally acceptable internal audit standards and by providing training to the internal audit staff;

**Medium term**

- implement the treasury modernization project by computerizing the transaction processing, and linking the treasury system to the central server;
- computerize the employee payroll, which constitutes a significant portion of budget expenditures, by creating a centralized and secure employee database that would strengthen the internal controls in payroll processing;
- build capacity in the Accounting Department (MoF) to prepare consolidated modified accrual-based financial statements for the Government;
- consider adopting International Public Sector Accounting Standards (IPSAS);
• introduce a budget evaluation function for proper evaluation of budget outcomes, thus enabling the results to be factored into the capital budgeting process and increasing the accountability of project managers;
• adopt INTOSAI audit standards in the conduct of external audit by the CA;
• strengthen the capacity of the CA – enter into twinning arrangements with a well-established SAI;
• create a secured central pension database;
• conduct an operational and financial audit of SF by an international audit firm at least once in five years; and
• strengthen the parliamentary committees on Budget and Economic Policy to provide effective oversight over the executive by building research and analytical capacity and by providing exposure to international best practices in the legislative scrutiny.

Long Term

• introduce uniform and integrated accounting and reporting software in budget institutions that use the same database as the treasury and adhering to the one transaction – one data entry – one record principle;
12. PRIVATE SECTOR ACCOUNTING AND REPORTING

Institutional and Market Structure Overview

12.1 The Kyrgyz Republic has made significant revisions to the existing laws or introduced new laws on accounting, auditing, and securities market to attract domestic and foreign investors.

12.2 The capital market is at an early stage of development and not a significant source of funds. The Kyrgyz Stock Exchange (KSE) was established in 1995 and the State Commission on Securities Market under the Government of the Kyrgyz Republic (SCSM), established in 1991, was last reorganized in December 2000. As of January 1, 2002 the number of registered Joint Stock Companies (JSC) is 1,471, of which only 24 are listed on the KSE (9 are traded). There are 24 insurance companies, 20 banks, 2 depositories, 23 brokerage dealer companies (active 13), 15 registrar companies, 16 investment funds (not all are active), 9 asset management companies, and 7 trust management companies (managing state-held shares in JSCs).

12.3 The amount of funds lent by the commercial banking sector is still very limited and the economy is largely cash-based. The Kyrgyz Republic has a conventional two-tier banking system. The central bank, National Bank of the Kyrgyz Republic (NBKR), is legally independent, charged with the conduct of monetary policy and the supervision of banks, including the power to license and delicense banks. Banks lend funds in both national and foreign currency primarily to a few enterprises in the industrial and services sectors.

12.4 The insurance sector is still in the early stages of development, although the legal structure for the industry and industry oversight appears to be largely in place. The State Insurance Supervision (SIS) is the regulatory authority for the sector. Three large firms dominate the market, the remaining firms are quite small and specialized.

12.5 The State Commission on Standards of Financial Accounting and Audit under the Government of the Kyrgyz Republic (SCSFAA) is the authorized body to introduce IAS and ensure its application. SCSFAA is also the regulatory authority for the audit profession. SCSFAA functions as a commission and is headed by a Chairman who is appointed by the Government.

12.6 There are two accounting and auditing associations in the country. One is the Union of Accountants and Auditors (UAA) and the other is the Chamber of Accountants and Auditors (CAA), which have memberships of about 550 and 140 respectively. The main training initiatives in accounting and auditing have been carried out through several USAID projects.

The Current Statutory Framework – Financial Reporting

12.7 A new Law on Accounting enacted in April 2002 has introduced steep financial reporting requirements for all business entities irrespective of their size or public interest in their financial reporting. The timetable, in the Government resolution
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(# 593) dated September 28, 2001, envisages a switchover to IAS by all joint stock companies, banking, and financial institutions in fiscal year 2002. All other enterprises are required to implement IAS for financial reporting in fiscal year 2004. Even small partnership firms or closely held (private) companies would be required to prepare their financial statements based on IAS. The proposed timetable is very ambitious given the fact that the country does not have a mass of accountants who could implement IAS across the spectrum of business enterprises. It is interesting to note that the European Union requires only the listed companies in the European Union to prepare their consolidated financial statements following IAS from 2005. The European Regulation on the application of International Accounting Standards was enacted on July 12, 2002, hence allowing more than three years to these companies to prepare for the switchover.

12.8 Capacity to monitor compliance with IAS is lacking. Although, the Law requires SCSFAA to ensure compliance with IAS, it has no capacity to monitor compliance. Moreover, entities are not required to file their annual financial statements with SCSFAA, rendering this requirement rather impossible to meet.

12.9 The National Bank of the Kyrgyz Republic requires all banks to prepare financial statements in accordance with its accounting policy guidelines. Although these guidelines to a very large extent are based on IAS, there are some important variations, for example, valuation of fixed assets. As a result, the financial statements cannot be said to be based on the IAS. However, recently the NBKR has issued new regulations that require the banks to comply with IAS.

12.10 A decree issued by MoF governs the system of accounting and financial reporting in the insurance sector. The objective of the decree is to bring the financial reporting by the insurance companies in line with IAS. SIS is made responsible for ensuring compliance with this decree. Although, the decree purports to adopt IAS for financial reporting, it describes several aspects that are dealt with by IAS. For example, fixed assets, valuation of assets, and foreign exchange transactions. There is an inherent risk that such explanations and definitions may contradict IAS provisions and may not be updated as and when IAS are revised.

12.11 The Government resolution requires the tax authorities to accept the IAS-based financial statements as the starting point for tax computation – the tax computation would still be based on the Tax Laws that may provide different treatment for certain expenses or revenues. However, tax inspectors currently lack understanding and interpreting IAS-based financial statements.

12.12 The Law on Business Partnerships and Companies requires management of JSCs to submit an annual report, a balance sheet, and income statements to the general meeting of shareholders and make these available to shareholders. These documents are required to be signed by all members of management and the board of directors. The financial statements may not necessarily be audited by an independent external auditor. The Civil Code requires all open JSCs to publish their financial statements in accordance with International Accounting Standards.

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33 Member states may permit or require that listed companies also prepare their legal entity financial statements in accordance with International Accounting Standards.
statements\footnote{Civil Code of the Kyrgyz Republic: Article 140} without specifying how long after the end of the financial year or the mode of such publication.

12.13 **All Joint Stock Companies (JSCs) have to file their annual financial statements with the SCSM.** In 2001, out of 1,457 JSCs registered with SCSM, only 900 submitted their annual reports. Currently, the SCSM lacks the capacity to monitor and enforce compliance.

12.14 **All JSCs that have made public issues and/or registered the prospectuses have to submit quarterly reports to SCSM.** Out of 95 JSCs that have registered their prospectus with SCSM, only 62 JSCs have been submitting their quarterly reports. Quarterly reports include information on major events during the quarter that have an impact on the financial and economic activities of a JSC.

12.15 **SCSM has the authority to conduct inspections of JSCs with prior approval from the State Commission on Development of Business under the Government of the Kyrgyz Republic.** In 2001, SCSM carried out 184 examinations of JSCs on the basis of complaints and applications (number of complaints received in 2000 were 150). The examination revealed 703 violations of legal requirements. The majority of these violations were in the nature of improper maintenance of shareholder registers, non-payment of dividends (Soms 557,000—approx. USD 11,800) were paid as a result of SCSM intervention), and improper handling of the shareholder meetings (16 company executives were subjected to administrative sanctions, 6 CEOs were fined for providing incomplete information, 36 executives were fined for not submitting information to the SCSM).

12.16 **The SCSM has approved rules “On Disclosure of information in the Securities Market” to strengthen the disclosure requirements for issuers.** These rules require JSCs to provide additional information regarding share capital, and shareholders so as to facilitate monitoring by the SCSM of insider trading transactions.

*The Current Statutory Framework – Audit of Financial Statements*

12.17 **A new Law on Auditing Activity enacted in July 2002 has replaced the 1998 law governing audit requirements and the audit profession.** The new law has deleted several provisions that were either inconsistent with or duplicated the provisions of the Civil Code, for example, liabilities of the parties to the agreement. The new law provides for the mandatory audit of banks and financial institutions licensed by NBKR, insurance companies, and joint stock companies that have publicly issued shares. In addition, the Civil Code requires all open JSCs to appoint an external independent auditor to audit the annual financial statements.\footnote{Civil Code of the Kyrgyz Republic: Article 148}

12.18 **The Law on Joint Stock Companies, 2003 requires all JSCs to elect Inspection Commission comprising shareholders for the purpose of “control over the financial and economic activity of the JSC”.** An independent audit of the financial statements can be initiated by the inspection commission, board of directors, general meeting of shareholders, or by shareholders holding more than 10% of the voting shares.
12.19 **The new Law on Auditing requires that audits should be carried out in accordance with the law and standards.** The SCSFAA is authorized to develop national audit standards, which are then required to be approved by the government (Article 8). The 35 Kyrgyz Audit Standards issued so far are all based on International Standards on Audit (ISA). However, recently the SCSFAA has issued regulation (#235) adopting ISA as the auditing standards.

12.20 **The earlier Law provided for the mandatory issuance of a management letter, whereas the new law requires only issue of an audit report containing an audit opinion.** Issuing a management letter is a standard practice and should rightly be covered by the audit standards.

12.21 **An audit firm can assume the legal form of either a sole proprietorship, partnership, or society, but not as an open joint stock company, and has to be licensed by SCSFAA.** All audit firms are required to have at least two certified auditors as staff. The manager (CEO) of the firm can only be a licensed auditor. The firm should have at least 50 percent of the staff that are citizens of the Kyrgyz Republic and when the manager is a foreigner the requirement increases to 75 percent.

12.22 **The licensing procedures are governed by the “Regulations on Licensing of Auditing Activity in the Kyrgyz Republic”.** The previous law mandated three types of licenses to be issued by SCSFAA for audit of general nature, audit of banks and financial institutions, and audit of securities market (such as brokers, trust funds, registrars, investment funds etc). The SCSFAA had (until June 2002) issued 38 general audit licenses, 10 licenses for audit of banks and securities market each. The license was issued for three years at a time and was extendable. The new law has removed different types of audit licenses partly to be consistent with international practices.

12.23 **The old law authorized NBKR to specify the minimum qualification/eligibility criteria for audit of banks although NBKR never invoked these powers.** The new law empowers NBKR to establish minimum requirements and accordingly the NBKR has issued tentative guidelines in February 2003.

12.24 **The new law spells out grounds that prohibit an auditor from carrying out audits in certain circumstances.** When the auditor has shares, is related to the promoter or shareholder, is a promoter (founder), or holds employment in the entity, or has property interest, he is prohibited from accepting an audit assignment for such an entity. If the audited company has shares in the audit firm, then that audit firm cannot carry out audit of the shareholder company. The Law also states that if an audit firm provides accounting services or prepares the financial statements of an entity in the previous two financial years, then it cannot render audit services to the same entity. A firm of auditors is barred from engaging any business activity excepting those that are specifically mentioned in the law. Acceptable activities include auditing; accounting services; preparing financial statements; financial analysis; consultancy for accounting, tax, management, or finance; training in accounting, auditing, finance or economics.

12.25 **The Law requires all audit firms to have mandatory civil liability insurance according to the rules and conditions prescribed in the civil legislation.** However, in the absence of efficient civil liability insurance mechanism, such a requirement, in actual
practice, is not feasible. There is a need to further elaborate, in the respective laws, the mechanism for legal and regulatory framework for such business.

**The Audit Profession**

12.26 The skills base in the country is very limited particularly for carrying out audits of IAS-based financial statements following International Standards on Auditing (ISA). There are approximately 180 certified auditors and about 40 audit firms having general audit license. The audit profession is in infancy and the audit firms are struggling to grow professionally. Three international network firms have offices in Bishkek (Deloitte & Touche, PricewaterhouseCoopers, and KPMG).

12.27 An Attestation Committee established by the SCSFAA examines eligible students in four subjects for awarding general audit certificate. The law requires the qualified auditors to undergo annual continuous education program.

12.28 The SCSFAA is the regulatory authority for the audit profession. The new Law specifies grounds for revoking licenses issued to auditors. In the past the SCSFAA had not revoked any audit license. Neither the SCSFAA nor the SCSM has the capacity to carry out audit quality assurance activities, although the new law clearly requires the SCSFAA to ensure compliance with the audit standards by auditors in the country. An auditor whose certificate has been revoked can apply for another qualification certificate after a lapse of at least 6 months unless the court ruling has provided a longer term. As per the provisions, only the SCSFAA has competence to determine whether auditor has not complied with the audit standards.

12.29 The SCSFAA has yet to adopt professional code of ethics for auditors. However, certain aspects of ethics are included in the law. For example, an auditor is prohibited from auditing a company where he has also provided accounting services, or has a close family link, or has shares in the company. In reality, audit firms prepare most IAS-based financial statements of companies and or banks (up until now the companies/banks prepared IAS-based financial statements only when demanded by International Financial Institutions), which may, in certain circumstances, be a threat to the auditors' independence and objectivity.

12.30 To obtain an audit certificate, all applicants need to take an examination conducted by the Attestation Committee of the SCSFAA. In order to take the audit examination, an applicant must have higher education in economics, and not less than three years experience in economics, or applicants not having higher education degree in economics need to have at least five years experience in finance or audit. The written examination covers Advanced Accounting, Auditing, Tax laws, and Financial Management. The number of candidates qualifying as auditors are 24 in 2001; 39 in 2002; and 10 in 2003. The examination structure is on the lines recommended in the International Education Guidelines (IEG) No. 9 issued by the IFAC.

12.31 The main training initiatives in accounting and auditing have been carried out through several USAID projects. The introductory course on Financial Accounting 1 (FA1) covering basics of accounting is 60 hours of classroom training followed by an open book examination of five hour - now administered an external entity called Certification
for International Professional Accountants Examination Network (CIFAEN). To date, about 5,000 accountants have been trained under this course. UAA and CAA now provide necessary classroom training to members for this course. Additionally, two other courses are run by these organizations.

**Recommendations**

12.32 **Conduct review of implementation of IAS by banks, financial institutions, and JSCs.** Considering the fact that there is shortage of accountants who could implement IAS across the spectrum of business enterprises, the SCSFAA should conduct a comprehensive review of the experience in implementation of IAS in the country and based on this review determine the applicability of IAS particularly to the closely-held (private) JSCs, partnership, and sole-proprietory firms which may not have direct public interest in their financial reporting.

12.33 **Considering the mandatory requirement for the banks to fully switchover to IAS-based financial statements, NBKR should issue a decree requiring the commercial banks to follow IAS in entirety.** For prudential supervision purposes NBKR could continue to require compliance with its regulations, however, for general purposes financial statements should comply fully with IAS. Despite training and assistance provided under the USAID-financed project, for a smooth switchover to IAS and for consistent implementation, there is a need for NBKR to prepare a practical guide for implementation of IAS in commercial banks. NBKR should also consider establishing a scholarship fund for enabling accountants in NBKR and commercial banks to obtain internationally recognized accounting qualifications. This would not only facilitate implementation of IAS in the banking sector but would also benefit NBKR by creating a capacity within NBKR to provide effective banking supervision.

12.34 **Considering the mandatory requirement for the JSCs to fully switchover to IAS-based financial statements, MoF should modify the decree regarding insurance companies.** The decree No 126-n dated April 21, 2000 issued by the MoF duplicates several aspects dealt by the IAS and may contradict some provisions in the IAS. With the adoption of the Law on Accounting in May 2002, the decree has been made redundant and needs to be repealed.

12.35 **The SCSFAA should adopt ISA and Code of Ethics.** The SCSFAA should bring the audit standards in line with ISA and adopt Code of Ethics in line with the IFAC Ethics Code. Recently, SCSFAA has issued regulation adopting the ISA per regulation # 235.

12.36 **Strengthen the SCSFAA’s capacity to provide effective oversight over the profession.** A separate disciplinary committee should be established and rules governing working of this committee should be prepared to ensure transparent and objective process. The SCSFAA should develop close working relationship with the SCSM to ascertain proper application of IAS in the financial statements of JSCs. This would require substantial budgetary support from the government until different financing mechanism is established.
12.37 **Strengthen the SCSM’s capacity to ensure compliance with IAS by the JSCs.** Financial statements filed by JSCs with the SCSM should be verified to ensure compliance with IAS.

12.38 **The SCSFAA should ensure that the audit examination process is transparent and objective.** The SCSFAA should prescribe requirements for continuing professional education in accordance with the IFAC Educational Guidelines. Efforts should also be made to improve accounting and auditing capacity by, among other things, reforming the university curricula and examinations particularly by introducing IAS and ISA in the educational curriculum. Support should also be provided to UAA and CAA who are providing training in accounting and auditing and are currently receiving donor support.

12.39 **As required in the new Law on Audit, NBKR should develop standards for audit of banks and financial institutions consistent with the audit standards.** In addition, considering the inadequate capacity within local firms to carry out audits of IAS-based financial statements and follow ISA, NBKR should determine procedures for ensuring acceptability of auditors to conduct audits of banks. This is important considering several bank failures in the last few years. NBKR may consider requiring mandatory joint audit of banks to be conducted jointly by an international audit firm and a local firm so as to improve the skills of and provide exposure to local firms to international best practices.
ANNEX 1. THE COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO) AND THE MODERN INTERNAL CONTROL CONCEPT

Historical Perspective:
After the Watergate scandal in which illegal payments to foreign governments were uncovered, the US Congress passed the Foreign Corrupt Practices Act (1977). This emphasized internal controls to prevent illegal payments and led to extensive documentation of internal accounting controls. Similarly, the Small Loans and Savings debacle led to the formation of the National Commission on Fraudulent Financial Reporting—led by Mr. Treadway, General Counsel of Paine Weber—known as the Treadway Commission. It called, in 1987, for the sponsoring organizations to work together to integrate the various internal control concepts and definitions, and to develop a common reference point. After several years of research and discussion, the Committee of Sponsoring Organizations of the Treadway Commission (COSO)\(^{36}\) published its report in 1992. The COSO Report has achieved widespread recognition as an authoritative work on internal control concept and evaluation.

There is, however, a major difference between COSO devised in 1992 and the Foreign Corrupt Practices Act of 1977; COSO goes beyond the financial and accounting aspects of governance to focus also on people, their ethical values, integrity and competence, management’s operating style, risk management, staff training and career development. COSO, which had an accounting origin, has now become a general management framework in its own right.

The COSO Framework. The Framework defines internal control as a process that is effected by people and that provides reasonable assurance regarding achievement of the following three objectives:

- Effectiveness and efficiency of operations
- Reliability of financial data and report
- Compliance with laws and regulations

Under “Effectiveness and Efficiency of Operations”, the Framework includes: compliance with policies, procedures and plans, safeguarding assets, economic and efficient use of resources, reliability of operating data and reports, and achieving goals and objectives.

The Framework embodies all the traditional concepts of control. However, it adds a new and important concept that internal control is a process effected by people.

For each of the above objectives, there are five components of control:

- A sound control environment;

\(^{36}\) The original five members of COSO (American Accounting Association, American Institute of CPAs, Financial Executives Institute, Institute of Internal Auditors, and Institute of Management Accountants) continue to work on updating and improving the concept.
• A sound risk assessment process;
• Sound operational control activities;
• A sound information and communications system; and
• Effective monitoring.

Assessment of Internal Control. Internal control can be judged effective if management has reasonable assurance that they understand the extent to which: (i) the organization’s objectives are being met; (ii) financial reports are being reliably prepared; and (iii) applicable laws and regulations are being complied with. This judgment of effectiveness results from an assessment of whether the five components of control are present and functioning effectively. Their effective functioning provides reasonable assurance regarding achievement of the three primary business objectives.

In assessing whether a country (or an organization) needs the Framework and how it would benefit from adopting a control framework such as COSO, the following questions may be asked:

CONTROL ENVIRONMENT

• The degree to which managers and employees possess integrity, competence and ethical values;
• Whether the nature of management’s philosophy and operating style is appropriate;
• Whether there is proper assignment of authority and responsibility;
• Whether there is proper organization of available resources; and
• Whether there is proper training and career development of people.

RISK ASSESSMENT

• Whether management has established a set of objectives that integrate all the entity’s resources so that its parts operate in concert;
• Whether there is awareness and ability to deal with the risks and obstacles to successful achievement of business objectives; and
• Whether management identifies, analyzes, and manages these risks.

OPERATIONAL CONTROL ACTIVITIES

• Whether management has established and executed policies and procedures to help ensure effective implementation of the actions identified as being necessary to address risks and obstacles to achieve of business objectives.
INFORMATION AND COMMUNICATION

- Whether the reports that are produced deal with internal and external activities and conditions and events necessary for informed business decision-making and external reporting;
- Whether the entity's people are able to capture and exchange the information they need to conduct, manage, and control operations;
- Whether information flows in all directions throughout the organization; in particular, whether all employees have the means of communicating significant information upstream; and
- Whether employees understand their own roles in the internal control system, as well as how their individual activities relate to the work of others.

MONITORING

- Whether the entire control system is monitored to assess the quality of the system's performance over time, with the help of measurable performance indicators, if possible;
- Whether internal deficiencies are reported upstream, with serious matters being reported directly to top management; and
- Whether there are separate, independent evaluations of the internal control system.

Although internal control, according to COSO, provides only a reasonable and not an absolute assurance, it has clearly delineated the roles of various players; management at all levels is directly responsible for internal control. Boards of directors or their equivalent in the public sector, provide guidance and oversight. The internal audit function does not have primary responsibility for establishing and maintaining internal controls. Internal auditors evaluate the effectiveness of control systems. External parties (external auditors, regulators, legislators, civil society) may have a significant indirect effect on an entity's internal control, but are not responsible for that process. Responsibility for control rests squarely on the shoulders of management at all levels.

Conclusion

The COSO Framework provides management with a reasonably comprehensive tool to manage and sustain an effective internal control system in a modern environment. It expands management's view beyond that of traditional control, to deal with the "soft" issues of control. Internal control in the past tended to concentrate on "hard" controls, such as formal processes, policy, procedure, and organizational structure. Modern control also deals with "softer" but strategic issues such as shared values, competence, trust, strong leadership, openness, high expectations and ethical standards.

The Framework thus could provide management with a methodology for adding significant value to the organization, and at the same time, satisfying the requirements of Good Governance.