

Background papers | Reform experience

“The 3rd line of defence”

How audits help address
defence corruption

The experience of Ukraine



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The Defence and Security Programme works with governments, defence companies, multilateral organisations and civil society to build integrity and reduce corruption in defence establishments worldwide. The London-based Defence and Security Programme is led by Transparency International UK. Information on Transparency International's work in the defence and security sector to date, including background, overviews of current and past projects, and publications, is available at the TI-UK Defence and Security Programme website: www.ti-defence.org

While acknowledging the debt TI-UK owes to all those who have contributed to and collaborated in the preparation of this publication, we wish to make it clear that Transparency International UK alone is responsible for its content. Although believed to be accurate at this time, this publication should not be relied on as a full or detailed statement of the subject matter.

This publication was made possible thanks to the support from the UK Department for International Development (DFID) and the UK Ministry of Defence.

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First published in March 2012.

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Report printed on FSC certified paper.

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ISBN: 978-0-9569445-5-9

Publisher: Transparency International UK

Design: Maria Gili

© Cover illustration: Luisa Rivera

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Preface

Transparency UK's International Defence and Security Programme works with governments, defence companies and civil society organisations to reduce the risk of corruption in defence and security. Our approach is non-partisan, neutral and focused on constructive ways of addressing the issue of corruption.

Officials and senior officers tell us directly why they care so much about corruption risk in defence and security. In their own words, this is because:

- Corruption wastes scarce resources.
- Corruption reduces operational effectiveness.
- Corruption reduces public trust in the armed forces and the security services.
- Defence budgets, due to their secrecy, are an easy target for politicians seeking funds.
- International companies shun corrupt economies.

We have engaged with Ukraine since 2009, participating in anti-corruption training of defence and security officials, assessments of corruption risk, and leadership reviews. This work has sometimes been in collaboration with NATO, sometimes direct from ourselves.

In addition, we have hosted a number of secondees from Ukraine—officers, officials and experts—to spend some months with us at our offices in London, working on projects of common interest. This hosting has been funded by financial support from the UK's Ministry of Defence.

This report, by Maryna Barynina, Deputy Director of the Internal Audit Department of the Ministry of Defence of Ukraine, arises from this series of secondments. It is based on work performed in our offices in London during the period between October and December 2011.

She has analysed 200 audit reports and 200 law enforcement reports from the period between January 2010 and October 2011. All of these reports are available online at the Ukrainian Audit Office website.

The purpose has been to identify the principal points of connection between the findings of revisors and auditors, and the conclusions of law enforcement bodies about corruption. The report identifies the specific corruption risks within the national defence and security sectors, based on audit and law enforcement reports over the period already mentioned. It proposes ways in which internal audit can better contribute to preventing and reducing corruption.

Ms Barynina has produced an excellent piece of work. It will be helpful not only in Ukraine, but also to defence officials and people around the world who work for transparency and accountability in the defence and security sectors. I commend it to you.



Mark Pyman

Director, International Defence and Security Programme

Transparency International UK

Executive summary

Auditors are at the heart of the corporate governance framework in every public sector organisation.¹

The National Anti-Corruption Strategy of Ukraine for 2011-2015ⁱⁱ states that corruption in Ukraine shows signs of being a "systemic phenomenon"ⁱⁱⁱ. It goes on to say that corruption has spread its negative impact into all spheres of public life, and is increasingly taking root in everyday life as a basic, quick, and effective method for illegally getting things done. The scale of corruption is threatening the national security of Ukraine as espoused by the National Anti-Corruption Strategy.¹ It requires the immediate adoption of systematic and consistent measures that are comprehensive in nature.

It is not a primary role of internal audit to detect corruption, but it is a role people expect internal audit to undertake.

Several important steps in the fight against corruption were taken in 2010 and 2011 in Ukraine. Domestic anti-corruption legislation was reformed; the judicial, tax and administrative

reforms, which have just been implemented, have an anti-corruption focus; and reform of the criminal justice system has been started. Mechanisms for citizens' access to public information and obtaining legal aid have been improved, and systems of public internal financial controls are being reformed. In addition, internal audit functions in the public sector are being heavily reformed for implementation in 2012.

Several international organisations and foreign countries are supporting Ukrainian efforts by providing assistance to government agencies and NGOs to prevent and reduce corruption. The NATO programme 'Building Integrity' (in the framework of the Partnership Action Plan on Defence Institutions Building), the 'Professional Development Programme', and other

initiatives are giving opportunities for representatives of Ukraine to more deeply explore the experience of other countries through working on projects of common interest. Introducing best international practices and recommendations of international organisations into Ukraine is an important part of building integrity, reducing corruption and avoiding mistakes.

This report was prepared as a result of an internship of a representative of the Ministry of Defence of Ukraine with Transparency UK's International Defence and Security Programme and with the Ministry of Defence of the United Kingdom of Great Britain and Northern Ireland. It is based on work done in London in the period October to December 2011.

The theme of the report is the analysis of corruption risks in the financial and economic activities of the defence and security sectors, based on a review of the audit reports and law enforcement bodies' reports published in the period from January 2010 to October 2011. The intention was to combine the approaches of external, governmental, and internal revisors, auditors and law enforcement agencies, in order to highlight 'red flags' and warning of the methods of corruption in a simplified form.

The second purpose of the report is to discuss the role of internal audit in preventing and reducing corruption in the defence and security sectors. It is not a primary role of internal audit to detect corruption, but it is a role more people expect internal audit to undertake. There is, therefore, an expectations gap that needs to be filled given that internal audit has no legal responsibility to counter corruption. Its primary role is to give independent assurance on the effectiveness of the processes put in place by management to tackle the risk of corruption. Any additional activities carried out by internal auditors should be in the context of

¹ Although this strategy is still in effect, the law to create an anti-corruption bureau has been postponed for two years, as there are pending reforms of criminal justice and enforcement bodies which need to take place before this bureau can be created.

internal audit and not prejudicial to this primary role.

Many types of corruption are similar to fraud carried out by officials, and belong to the category of ‘crimes against state (municipal) property’.

This report does not aim to differentiate between crimes under different articles of the Criminal Code (fraud, abuse of office, bribery, theft, negligence, falsification of documents, etc.) or to classify types of special audit (Audit of Fraud, Forensic Audit, Anti-corruption Audit, etc.). The contribution of internal audit should be seen mainly in the context of building integrity, spreading anti-corruption culture, and sustaining an environment of ‘zero tolerance’ to corruption.

The report is structured as follows: A short review of the current three-level system of public financial control and audit in Ukraine is presented in Chapter 1. More detailed information is given in Annex 1. Chapter 2 covers the scope, sources and methods of research. The results are based on an analysis of the audit data published on the official websites of the Accounting Chamber, the Main Control and Revision Office of Ukraine (State Financial Inspection), and the Prosecutor’s General Office of Ukraine for 2010 and for January – October 2011. Findings published on the web pages of other bodies, and the experience of the researcher in conducting revisions and audit (both governmental and internal) in legislative activity and in the harmonisation of public internal financial control were also taken into account.

Findings from the control and audit bodies are categorised into groups depending on the consequences of violations or mistakes, and typical methods to commit them are identified within each group. Each category is evaluated in terms of frequency (how often such findings occur), and of influence. We take into account the financial consequences of a ‘huge’ single violation or mistake, the relatively small, but very common financial violations or mistakes, and also the most socially dangerous misdemeanours, regardless of their cash equivalent (e.g. theft of weapons or drugs).

Law enforcement findings on criminal proceedings are later analysed and assessed in terms of probability of presence of a corruption component in

each case. Attention is paid not to the detail of the criminal legislation but to the connections between the criminal case and fulfilment of functions of the state by suspects (the accused), their organisational and regulatory or administrative and economic responsibilities, and the possibility (probability) of receiving unlawful benefit by them or by third parties. The detailed results of the analysis are presented in Annex 2.

In Chapter 3 we present a wide range of examples extracted from the audit reports. These are grouped into four main categories:

- i) loss (waste) of revenues;
- ii) illegal expenditures;
- iii) violations that did not result in losses;
- iv) inefficient managerial decisions, and other cases.

Each example is annotated with reference to the web sources. The number of published findings and examples given in the report indicate not so much the prevalence of

corruption, but the political will to build integrity, by actively positioning transparent financial control and audit institutions and law enforcement bodies within Ukraine. Whilst most of the examples relate to the defence sphere because it is the primary interest of the researcher, the report also includes examples relating to the activities of other structures which connect with the defence and security spheres.

These examples are not necessarily the result of corruption, but do perhaps suggest that corruption might occur in such cases. It should be noted that the inadequate management and lack of expertise (education, skills or best practices)—but not corruption—often is the true cause of improper activities in public sector bodies. This is confirmed by the experience of other countries.

The number of published findings and examples given in the report indicate not so much the prevalence of corruption, but the political will to build integrity, by actively positioning transparent financial control and audit institutions and law enforcement bodies within Ukraine.



This report aims to assist others in developing the right approaches to helping fight corruption in their national defence and security organisations. Credit: istockphoto

It is important to understand that revisions (audits) are performed in the current year for the previous one to three years (sometimes more). Further, law enforcement agencies need time to investigate the findings of auditors (revisors). For this reason, most examples date from 2001 and 2009. This information may be useful to different managers, auditors, and law enforcement officers.

The principal results of the analysis are described in Chapter 4.

Taking into account the main objectives and limitations of internal audit, Chapter 5 considers some possible measures of internal audit as a contribution to prevention and reduction of corruption at the different stages: prevention, detection, investigation, reporting and monitoring. Anti-corruption policy must cover all time frames (stages) of corruption (from preconditions through to results and impact), and anti-corruption measures must be aimed at prevention, investigation, and prosecution of individuals and legal entities. The report concludes with thoughts on the next steps suggested as the basis of the strategy/road map for the implementation of new internal audit activity at the Ministry of Defence of Ukraine.

It is important to note that corruption has many faces; corrupted people are continuously developing new methods and ways to avoid control and the disclosure of their activities. One well-known external auditor, the author of an anti-corruption audit manual, notes that “an anti-corruption audit is an ever-going fight with a moving target”.^{iv} This is why the report does not cover all possible types of corruption in the defence and security sectors and does not offer universal solutions.

The undeniable fact is that high integrity depends on high expertise (education, skills and best practices). At the same time, the secret of excellence is not in skills only but also in the right approaches. This report aims to assist others in developing the right approaches to helping fight corruption in their national defence and security organisations.

1. Revision and audit in the public sector of Ukraine

Traditionally, control over public finance in Ukraine is accomplished by inspection—revisions and checks. However, experience in auditing public finance in Ukraine over the last eight to ten years is limited.

There is a three-level system of control-and-audit bodies in Ukraine.² Their main objectives are to achieve financial control (revisions, checks, audits), analyse revealed violations and shortcomings, and provide suggestions and recommendations to prevent the same in the future. The three levels are as follows:

- i. The Accounting Chamber (the AC) is the supreme audit institution and it was established in 1997. It conducts external audit on behalf of the Verkhovna Rada of Ukraine (the Parliament). In 2004, the territorial representations of the AC were established in the regions. Initially, the AC was only responsible for revisions and checks. In the last few years, the AC has conducted performance and financial audits.
- ii. The State Control and Revision Service of Ukraine (SCRS) was established in 1993 as a centralised government agency of public financial control. In 2010 and 2011 the SCRS was reorganised into the State Financial Inspection of Ukraine (SFI), which consists of the headquarters and 27 regional bodies. For several years, the SCRS performed only revisions and checks. The first performance audits of the budgetary programme's efficiency were conducted between 2001 and 2003. Later the SCRS expanded audit activity and started conducting financial and performance audits of budgetary institutions, public enterprises, local budgets, and so on. Since 2006 the SCRS has been checking public procurement and cooperating with

state agencies to prevent corruption in procurement.

- iii. Internal control and revision units (ICRUs) operate in line ministries and local executive bodies. ICRUs perform revisions, inspections and checks, investigations, evaluations and research. In 2001 the Budget Code came into effect. Article 26 of the Budget Code foresees the need to implement internal control systems and internal audit services in the budget sector. In 2005, the Ukrainian Cabinet approved the concept to develop a public internal financial control system in Ukraine until 2017. This implementation plan contains provisions on the formation of internal audit units in 2012 at a central level—within ministries and other central executive bodies. According to the Decree of the Ukrainian Cabinet of 28 September 2011 N° 1001, ICRUs within ministries and other central executive bodies must be reorganised into the Internal Audit Units (IAUs) from 1 January 2012.

None of the control and audit bodies are specifically authorised to prevent and combat corruption. The law established the obligation to cooperate with state agencies to prevent corruption in procurement only for the SCRS (which was later renamed SFI).

In case of significant violations, signs of abuse or corruption, control measures are passed to the law enforcement bodies. On detection of such facts, the AC informs the Parliament, and the SFI informs the President of Ukraine, the cabinet, the ministry of finance, public authorities and bodies authorised to manage state property, ICRUs (IAUs)—the minister and heads of the relevant central executive body (its territorial authority, budgetary institutions).

² For more detailed goals, objectives and functions of financial control-and-audit institutions see Annex 1.



Previously, all control and audit bodies mainly focused on the identification of violations, but their preventive functions are becoming increasingly important. This widening role cannot be overemphasised. Credit: istockphoto

It is important to note that ministers in Ukraine are civil servants, and the internal auditors are directly subordinated to the ministers. The AC mainly focuses on the activity of the cabinet ministers and the main performers of the state (budget) programmes. The SCRS (SFI) focuses on the activities of ministries, other central executive bodies and key spending units (in part of the state budget), large enterprises, institutions and organisations. ICRUs focus on the activities of organisations, enterprises and their association's subordinated relevant ministry (or other central executive bodies), as well as other structural units of the ministry.

Previously, all control and audit bodies mainly focused on the identification of violations, but their preventive functions are becoming increasingly important. This widening role cannot be overemphasised.

Certainly, the risk of being caught out and the inevitability of punishment for illegal actions (including corruption) is a significant deterrent in the fight against corruption.

Equally important is the participation of control and audit bodies in forming state policy to combat corruption, both through making recommendations aimed at eliminating the causes and conditions that foster corruption, and by providing transparency and purity in the state mechanisms.^v

2. Methodology

2.1. DEFINITION

Corruption is defined by Transparency International as the abuse of entrusted power for private gain. A characteristic feature of corruption is a conflict between the activities of an official and the interests of the body (authority) on whose behalf he/she acts. Many kinds of corruption are similar to fraud carried out by an official, and belong to the category of 'crimes against the state (municipal) property'.

Corruption may occur during the collection, distribution, use or disposition of public resources, provision of administrative and public services, issue of permits or licenses, human resources, and other control and surveillance (including audit) functions.

2.2. SCOPE

Public and internal revisors and auditors are not experts on preventing and combating corruption. They deal with violation of the law, inefficient use of public resources and assets, failure to comply with procedures, neglect of duties, and poor management practices.

It is important that inspectors and auditors are able (by proxy or consent of the head of the body) to evaluate anti-corruption strategies (programmes), provide recommendations to prevent corrupt practices, and recognise signs that may indicate corruption or abuse of power during the control measures, and (if necessary) conduct an appropriate audit.

Therefore, there is a need to identify and analyse the connections between corruption (fighting against corruption is the main task of the specially authorised bodies) and inadequate management, accounting and internal controls, violations of financial, budgetary discipline, failure to achieve goals, and other cases which are uncovered with help from revisors and auditors.

Taking into consideration the specifics of the role of revisors, inspectors and auditors, this study only analyses cases associated with financial and economic activities. Other instances of corrupt conduct and bribery are also dangerous, but lie outside the responsibility of inspectors and auditors (such as bribes for exemption from conscription, positive evaluations in educational institution, promotion, granting leave, etc.).

2.3. VOLUMES AND METHODS OF RESEARCH

This analysis is based on data from the official websites of the Accounting Chamber, the Main Control and Revision Office of Ukraine (the State Financial Inspection), and the Prosecutor's General Office of Ukraine. The period studied is from January 2010 to October 2011. In addition, reports published on the web pages of other organisations are incorporated, as well as the experience of the researcher in conducting revisions and audits (both centralised and internal). The analysis reviews almost 200 inspections/audit reports and more than 200 reports of law enforcement agencies on criminal cases and protection of state interests.

Firstly, the findings from control and audit bodies are reviewed and brought together into four categories depending on the consequences of certain actions or inactivity:

- i. Loss (waste) of revenues;
- ii. Illegal expenditure (including expenditures made in violation of law, non-target costs, losses from lack of or damages of resources);
- iii. Violation of financial and budgetary discipline, which did not result in losses;
- iv. Inefficient managerial decisions.

In each category, some of the most common methods of violations and/or faults and mistakes are allocated. For example, loss (waste) of revenues is often a result of:³

- unreasonable provision of free use of resources to some individuals/entities (no rent, payment for land, etc.);
- unreasonable lowering of a price/value/volume of property sold, services paid for, work performed, rent, unreasonable privileges/discount for some buyers;
- economically disadvantageous contracts, provision of loans, elimination of financial sanctions to some providers/debtors in case of non-contract terms;
- elimination of budget/dividend payment by public enterprises.

Subsequently, each method is evaluated in terms of frequency (how often the messages were published). A three-point scale is used as the criterion for detecting the frequency of violations or mistakes:

- 0 - not detected, or are very rare;**
- 1 - are rare or occasional;**
- 2 - are often or almost regular.**

Each method is then evaluated in terms of significance (influence). Consideration is given to the financial implications of one 'huge' violation or mistake as well as the financial implications of relatively small, but very common violations or mistakes. Socially dangerous misdemeanours, regardless of their monetary equivalent, are also taken into consideration (e.g. theft of weapons or drugs). Again, a three-point scale is used to determine the consequences of certain actions:

- 0 – minor consequences;**
- 1 - substantial consequences;**
- 2 - glaring consequences.**

We then analyse the information available on the websites of law enforcement bodies regarding criminal proceedings and corruption. Attention is not paid to the title of the article of criminal law, but to the links between criminal cases and the state/public functions, organisational and regulatory or administrative and economic responsibilities, and the possibility of obtaining unlawful benefit to the defendants or third parties. Using the 3-point scale, the likelihood of a corrupt element in the commission of specific types of violations of financial and budgetary discipline or mistakes is pictured:

- 0 - probability is very low or low;**
- 1 - probability is at the middle level;**
- 2 - probability is high or very high.**

In the following chapter some typical examples of violations of financial and budgetary discipline and mistakes are given according to the above criteria.⁴

The classification is not exhaustive; it is simply an initial attempt to find connections between the findings of inspectors and auditors and conclusions of law enforcement authorities. These examples only assume that corruption might occur in such cases, not that it necessarily has.

3 A more detailed classification is provided in Chapter 3.

4 For more information, see Annex 2.

3. Examples

3.1. LOSS (WASTE) OF REVENUES

The revenue side of the defence budget needs to be the subject of a detailed study. In Ukraine, a significant portion comprises of a 'Special Fund', which consists of, amongst other elements, sales proceeds, surplus weapons, property, and the income of budgetary institutions derived from services paid. Whilst the share of the Special Fund in the total revenues and expenditures of the defence budget is significant, it is gradually reducing. Whereas in 2010 it was 23.5 per cent, that figure was reduced to 16.14 per cent in 2011, and it is projected to fall to 12.64 per cent in 2012. The total planned amount of special fund revenues decreased from UAH 2.6 billion (£204 million) to UAH 2.2 billion (£173 million).⁵

In addition, public enterprises belonging to the ministry of defence have revenue to cover their own expenditures. Such revenues are not included in the Special Fund, but can be lost through mismanagement as well as corruption.

The typical violations of financial and budgetary discipline, mistakes that lead to the loss (waste) of revenues, and practices that may contain an element of corruption are:

3.1.1. Unreasonable provision of free usage of resources to some individuals / entities (no rent, payment for land, etc.)

- i. In 2009 and 2010, officials of a public enterprise entered into contracts with certain commercial companies to store material. However, the private company actually rented space for the equipment from the government itself. The mismanagement lost the state over UAH 0.9 million (£70,500).^{vi}

- ii. As a result of illegal use of land appropriated to the armed forces (180 ha.) by commercial entities, the government suffered losses amounting to over UAH 1.7 million (£133,000).

^{vii}

3.1.2. Unreasonable lowering of a price/value/volume of property sold, paid services, work performed, rent, unreasonable privileges/ discounts for some buyers

- i. Between 2007 and 2010, employees of a military unit lowered the real cost of the military property they were selling by UAH 5 million (£390,000),^{viii} and officials of another agency similarly lowered costs by UAH 0.55 million (£43,000) in 2010.^{ix}
- ii. Public auditors found evidence of military equipment being sold for UAH 6.7 million (£525,000) below its residual value.^x
- iii. A military forestry unreasonably failed to receive an income of UAH 1.8 million (£141,000), including UAH 1.2 million (£94,000) as a result of wood sales.^{xi}
- iv. Between 2008 and 2010, inspections detected the detraction of rent for the use of non-residential premises by UAH 0.5 million (£39,000).^{xii}
- v. The head of a quartermaster unit received a bribe from one private entrepreneur for allowing temporary use of state property.^{xiii}
- vi. In 2008, the director of a military farm illegally leased 4.6 thousand hectares of land worth more than UAH 45.6 million (£3.5 million) to a commercial company, which was headed by him,^{xiv} and appropriated himself a part of the illegally obtained funds.^{xv}

⁵ Originally, the purpose of this Fund was to secure targeted funding for essential items of expenditure and budget programs, even in the years when it was problematic to implement the state budget. But so far, there is the reverse situation now. In fulfilling the Special Fund budget Ukraine faces great difficulties.

3.1.3. Economically disadvantageous contracts, provision of loans, financial sanctions to some providers/debtors in case of non-contract terms

- i. A public enterprise suffered losses of over UAH 2.8 million (£219,000) over a deliberately unprofitable lease contract signed by officials of a public enterprise between 2009 and 2011. They later supplied false documents to justify their decision.^{xvi}

3.1.4. Lack of payments by public enterprises due to budget/dividends

- i. A public enterprise, without a special license, sold weapons to a commercial company and illegally received UAH 33.4 million (£2.6 million), which should have been transferred to the central government.^{xvii}
- ii. Between 2008 and 2010, the head of a public enterprise, who had to transfer UAH 2.2 million (£172,000) dividends, transferred UAH 0.6 million (£47,000) to another company instead.^{xviii}

3.2. ILLEGAL EXPENDITURES

Illegal expenditures usually mean (i) expenditures, conducted in violation of law, (ii) non-target costs, and (iii) losses from lack or damage of resources.

3.2.1. Expenditures made in violation of the law

3.2.1.1. Illegal alienation of property and other assets

3.2.1.1.1. Military towns / cantonments, integral property complexes

- i. The head of a subdivision of a building organisation signed a series of agreements with commercial entities illegally on behalf of the Ministry of Defence of Ukraine regarding the joint construction of military cantonments. As a result, 27 military cantonments worth over UAH 100 million (£7.8 million) were illegally seized.^{xix} This scheme transferred

ownership of state land in Kiev worth UAH 10 million (£783,000).^{xx}

- ii. By decision of the Supreme Economic Court of Ukraine, immovable and movable property of the public enterprise 'Feodosia Ship Mechanical Plant' — an integral property complex valued at more than UAH 70 million (£5.4 million), which in 2010 was acquired illegally^{xxi} by a commercial structure for invalid transaction^{xxii} — was returned^{xxiii} to the Ministry of Defence of Ukraine.

3.2.1.1.2. Land, buildings and structures

- i. In 2008, the heads of two private companies, organised fictitious business disputes in the courts of Dnipropetrovsk and illegally acquired property owned by the Ministry of Defence of Ukraine worth more than UAH 87 million (£6.8 million).^{xxiv}
- ii. Between 2004 and 2006, the director general of a public enterprise destroyed a powerful sanatorium complex and illegally sold state assets worth UAH 36 million (£2.8 million). The enterprise ceased operations as a sanatorium, therefore also ending their provision of treating military personnel.^{xxv}
- iii. In 2007 and 2008, during the delivery of a joint contract between the ministry of defence and four limited liability companies, the entrepreneurs unlawfully seized the property. Commercial structures supposedly 'handed' to the ministry of defence included 82 apartments worth almost UAH 19.5 million (£1.5 million). However, according to the law, they had no right to this accommodation. Subsequently, by a court decision, the commercial structures acquired ownership of 49 buildings totaling more than 15.6 thousand square meters on a residual value of about UAH 5.2 million (£ 407,500). They were located in three military cantonments in Kharkiv.^{xxvi}
- iv. Officials of a quartermaster subdivision (Dnepropetrovsk garrison) illegally transferred 42 buildings worth UAH 20 million (£1.5 million) located on 27.3 hectares of land, to a

commercial structure instead of leasing 20 buildings on the same territory.^{xxvii}

- v. In 2008, the director of a public enterprise in the southern region of Ukraine illegally dismantled the structures and services of an enterprise worth UAH 9.9 million (£775,000). He subsequently sold unlawfully obtained building materials worth UAH 6.9 million (£540,000). In addition, he laundered UAH 5.7 million (£446,000) obtained by crime proceeds.^{xxviii}
- vi. In 2004, a public enterprise signed a commercial agreement on jointly completing construction of a residential building. Under the agreement, 78 apartments worth UAH 7.8 million (£611,000) should have been transferred to the enterprise in 2005. However, the apartments were not obtained, and the former enterprise managers have not made any claims. Two writs of the Military Prosecutor's Office worth UAH 9 million (£705,000, including penalties) were considered by the courts through formal features. Only in 2010 did the situation change.^{xxix}
- vii. The head of a quartermaster unit illegally transferred land from two military cantonments (55 hectares in the Donetsk garrison) worth over UAH 4.2 million (£329,000), to communal ownership. Part of this was subsequently leased to commercial entities.^{xxx}
- viii. The military units of the armed forces and institutions of the ministry of defence are using 42.7 thousand hectares of defence land without legal documents. 248.7 hectares of land were transferred from the state to municipal authority in violation of the law. 2.6 thousand hectares of defence land is misused and 10.2 thousand hectares are not being used at all.^{xxxi}
- ix. A property covering 1.2 hectares of land and costing UAH 1.6 million (£125,000) was divested without the permission of the ministry of defence. A subsequent audit

revealed that illegal transactions resulted in losses amounting to almost UAH 1.2 million (£94,000). However, the budget did not receive more than UAH 1 million (£78,000) due to lax oversight by the plant's former director. Material assets worth UAH 36,000 (£2,800) were written off without supporting documents. The plant paid UAH 16,000 (£1,200) to an insurance company (in Kiev) for subleasing space to accommodate representation of the plant, which did not really exist.^{xxxii}

3.2.1.1.3. Movable property

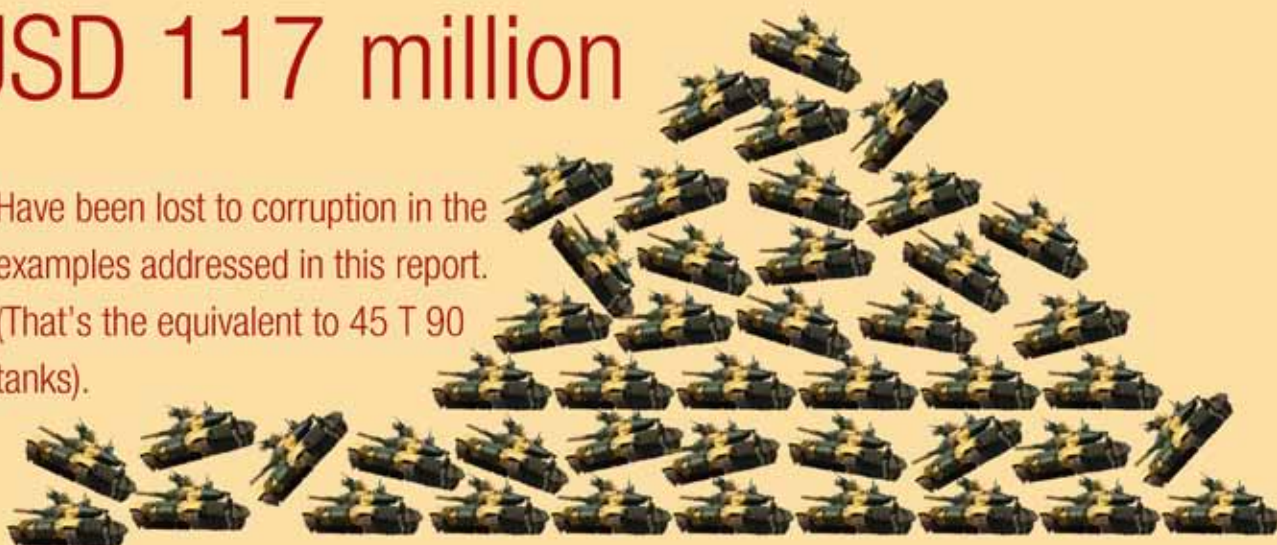
- i. Between 2009 and 2010, officials from a public enterprise exceeded their authority and used funds received from the sale of capital assets during alienation and write-off of specialised equipment. This resulted in damages to the state of up to UAH 40.8 million (£3.2 million).^{xxxiii}
- ii. In the absence of an approved financial plan, a public enterprise illegally used UAH 32 million (£2.5 million) derived from the sale of fixed assets to cover expenses. This caused large-scale damages to the state.^{xxxiv}
- iii. Officials of a public enterprise illegally sold component parts and mechanisms for military equipment worth more than UAH 3 million (£234,000) to foreign customers.^{xxxv}
- iv. Evidence of the illegal sale of public property was found in the western region (UAH 484,000 [£38,000]),^{xxxvi} Feodosia (UAH 150,000 [£11,700]),^{xxxvii} and Kirovohrad region (UAH 100,000 [£7,800]).^{xxxviii}

3.2.1.1.4. Forests

- i. A public enterprise (Dnepropetrovsk garrison), with the aid of hired workers was involved in illegal logging of 129 trees, causing the state losses of more than UAH 114,000 (£8,900).^{xxxix} Another enterprise, Ivano-Frankivsk garrison, allowed illegal logging of 197 trees worth about UAH 600,000 (£47,000).^{xl}

USD 117 million

Have been lost to corruption in the examples addressed in this report.
(That's the equivalent to 45 T 90 tanks).



Credit tank photo: Flickr/cell105

3.2.1.2. Unreasonably overstating amounts/value/ price of obtained works (goods and services), with fictitious transactions

3.2.1.2.1. Construction, acquisitions of housing

- i. The head of a regional branch of capital construction (Feodosia garrison) received 244 apartments from officials of a private company that did not meet health standards and were unfit for habitation. This caused the state damages worth UAH 79.2 million (£6.2 million).^{xii}
- ii. UAH 69 million (£5.4 million) were allocated by the State Budget of Ukraine to the Ministry of Emergencies and Affairs of Population Protection from the 'Consequences of the Chernobyl Disaster'. The money was to be used to purchase apartments to provide housing to citizens affected by the disaster. However, officials of the ministry, acting in the interests of business structures, bought apartments at inflated prices totalling UAH 52.5 million (£4.1 million).^{xiii}
- iii. In 2001 and 2002, the officials of a construction corporation abused their official position and took more than UAH 28 million (£2.2 million) of funds allocated for the construction of a residential complex. They filed deliberately false information in the acts of the work performed. The officials of the Main Directorate of Internal Troops of the Ministry of Internal Affairs of Ukraine fulfilled their duties carelessly, signed the acts and paid for construction work which had not been undertaken.^{xiii}
- iv. Prosecution bodies have recovered UAH 11.5 million (£900,000), which the ministry of internal affairs spent on the purchase of real estate without adhering to tender procedures. According to the court decision, the housing agreement signed between the ministry and the investor was declared invalid and levied to the investor.^{xiv}
- v. In 2008, officials of the Ministry of Emergencies and Affairs of Population Protection from the 'Consequences of the Chernobyl Disaster' spent UAH 17 million (£1.3 million) from their budget for the purchase of 40 apartments which were actually worth UAH 6 million (£470,000).^{xiv}

- vi. A unit of capital construction of the ministry of defence unreasonably overstated its accounting on the cost of unfinished construction by nearly UAH 3.9 million (£305,000).^{xlvi}
- vii. The branch director of a public enterprise illegally wrote off construction materials totalling UAH 3.7 million (£289,000).^{xlvii}
- viii. In 2008^{xlviii} the director of a commercial enterprise forged documents and received a contract for sharing participation in housing. He then laundered UAH 3.3 million (£258,000) of seized cash through banks.^{xlix}

3.2.1.2.2. Repairs

- i. One of the deputy commanders of the Naval Forces of Ukraine, acting in the interests of third parties, signed off on warship repair work which was not fully implemented. This caused the state losses worth more than UAH 973,000 (£76,000).ⁱ

3.2.1.2.3. Services

- i. A public enterprise signed a contract for consulting services during the delivery of weapons by Ukraine using a fictitious foreign legal person who was allegedly registered in the Isle of Man (British dependent territory). The court recognised the contract as invalid and a decree prevented the exaction of over £442,000 from a Ukrainian enterprise and returned £80,000 which had already been paid for the fraudulent contract.ⁱⁱ
- ii. In 2007, the head of a limited liability company signed fraudulent services contracts with a public enterprise. Through prior collusion with the management of the public enterprise, he had illegally seized over UAH 2.5 million (£197,000) from the ministry of defence.ⁱⁱⁱ

3.2.1.2.4. Nutrition of the military (prisoners, persons under investigation, others)

- i. In 2010, four officials of the state penitentiary service bought food for the penitentiary system and falsified official documents. This caused the state losses amounting to over

UAH 34 million (£2.6 million).ⁱⁱⁱ

- ii. In 2009, the leadership of the State Department of Ukraine for Execution of Punishment purchased food products which were stale, wasting over UAH 9 million (£705,000) of state funds.^{iv}
- iii. In December 2008, the ministry of defence signed a contract with a commercial food provisions enterprise for the military in four regions (Chernigov, Rivne, Khmelnytsky and Zhitomir). However, this agreement could not start on the date specified in the contract because the company did not have its own production facilities and staff, and was unable to organise them in the short time allotted. That is why another company (instead of the winner of the bid) ended up fulfilling the contract for a period of time. Nonetheless, the original winner of the contract received over UAH 300,000 (£23,000) after mediation.^{iv}

3.2.1.2.5. Goods

- i. A court decree declared the results of a tender on the purchase of 27 ambulances by Ministry of Emergencies and Affairs of Population Protection from 'Consequences of Chernobyl Disaster' to be invalid. Also a court awarded a penalty to the supplier for profiting from the state on UAH 21.5 million (£1.7 million).^{vi}
- ii. Officials of the Ministry of Emergencies and Affairs of Population Protection from the 'Consequences of the Chernobyl Disaster', acting in the interests of commercial structures, purchased aero-speed-boats without tender and pre-transferred UAH 8.3 million (£650,000) of reserve funds from the State Budget of Ukraine to a commercial structure. Suppliers used the money at their discretion.^{lvii}
- iii. In 2008, a former Deputy Minister of Emergencies and Affairs of Population Protection from the 'Consequences of the Chernobyl Disaster' signed contracts for the purchase of diesel for UAH 350,000 (£27,000) more than that specified by the tender committee of the ministry.^{lviii}

3.2.1.3. Illegal payment of salaries, money allowances, scholarships and other types of incentives

- i. Legal violations in carrying out expenditures for salaries and money allowances of the military, as well as overstating deductions to state funds led to unnecessary costs worth UAH 5.6 million (£438,000) from 2008 to 2010.^{lx}
- ii. The chief of the financial and economic unit (an officer) of a military unit of Lviv garrison embezzled UAH 950,000 (£74,000) based on a fictitious court decision.^{lx}
- iii. In 2008, the commander of a military unit of Bilotserkivskiy garrison employed a person and allowed him not to come to work and not perform his duties for three years.^{lxi} Another officer (Vinnitsa region) regularly received bribes from two subordinates soldiers under contract and allowed them not to go out on service and not perform any of the duties as required by their positions between 2009 and 2010.^{lxii}
- iv. In violation of the established order of monthly bonuses, a director and his deputy were paid (by the decision of the director) significantly higher than the institution's average (250 to 900 per cent and 30 to 60 per cent of base salary, respectively).^{lxiii}

3.2.2. Non-target costs of budget fund and unreasonable cancellation of wages of public enterprises

- i. In 2008, a former deputy minister of emergency situations signed contracts which resulted in the diversion of UAH 2.48 million (£194,000) intended for support of civil defence forces, fire fighters and emergency services in Zaporizhia region, to a private company.^{lxiv}
- ii. The commander of a military unit spent over UAH 1.3 million (£101,000) of funds intended for payment of money allowances for the military, on other matters.^{lxv}

- iii. Intentional cancellation of salaries to employees and direction of the available funds to production and other needs were detected in public enterprises in Kiev (UAH 4.6 million [£360,000]),^{lxvi} Kirovograd (UAH 1.4 million [£109,000]),^{lxvii} Kharkov (UAH 1.2 million [£94,000]),^{lxviii} and Chernigov regions (UAH 304,000 [£24,000]),^{lxix} and Sevastopol city (UAH 431,000 [£34,000]).^{lxx} Also, a public enterprise in the Kiev region failed to pay more than UAH 2.5 million (£196,000) in contributions to the Pension Fund of Ukraine.^{lxxi}

3.2.3. Losses (damage) from lack of, or shortages, of resources

3.2.3.1. Weapons and military equipment

- i. An organised criminal group of five military^{lxxii} personnel stole kits for car repair worth UAH 5.2 million (£407,000) from three military units aided by counterfeit documents.^{lxxiii}
- ii. The commander of a military unit stationed in the Mykolaiv region, two of his subordinates, and the director of a limited liability company formed an organised criminal group and stole more than 800 firearms and weapons between 2007 and 2009. The commander, in fact, stole these from the warehouse of the military unit. The cost of the stolen assets is valued at more than UAH 2 million (£157,000).^{lxxiv}
- iii. In the Chernigov region, three former military officers were imprisoned for stealing from military units and selling four self-propelled anti-aircraft plants in 2008. The damage to the state as a result is valued at over UAH 700,000 (£55,000).^{lxxv}
- iv. The technical advisor of the deputy director general of a public enterprise in Kharkov, together with the military, stole components for an anti-aircraft installation from a military unit. They were worth over UAH 700,000 (£55,000).^{lxxvi}

- v. In the Rivne region, the chief of a warehouse stole 160 grenades and primer, some of which he sold to civilians.^{lxxxvii}

- i. In 2009, a quartermaster exceeded the approved budget allocation for utilities by UAH 1.8 million (£141,000).^{lxxxiv}

3.2.3.2. Other military property

- i. Loss of military equipment worth UAH 2.1 million (£165,000) was reported by the military unit of Kiev garrison.^{lxxxviii}
- ii. In a military unit in the southern region of Ukraine, the head of clothing services made property cuts worth over UAH 1 million (£78,000). He involved entrepreneurs in criminal activities and exchanged property for other products whose quality was below state standards.^{lxxxix}
- iii. In 2009, an organised criminal group which included three former police officers, bribed the paramilitary guard and stole over 11 tons of scrap copper worth about UAH 500,000 (£39,000) from a plant.^{lxxx}
- iv. In the Ternopil garrison, a military guard team stole 20 reinforced concrete slabs, and attempted to steal further.^{lxxxi} Another military unit from the same garrison demanded and received bribes from a local resident for assistance in stealing airfield property.^{lxxxii}

3.2.3.3. Cash

- i. Between 2009 and 2010, the chief of the financial and economic service of a military unit appropriated UAH 631,000 (£49,000), which was intended to be money allowance for the military. UAH 180,000 (£14,000) of those funds were laundered by purchasing a car and some household appliances.^{lxxxiii}

3.3. VIOLATION OF FINANCIAL AND BUDGETARY DISCIPLINE WHICH DID NOT RESULT IN LOSSES

3.3.1. Overstatement of payable accounts and liabilities; obligations taken into payment without budgetary appropriations or excess of power

3.3.2. Overstating the need for budget funds; the inclusion of incorrect figures to budget requests

- i. In 2008, a subdivision of the Ministry of Internal Affairs of Ukraine overstated the need for budgetary allocations by UAH 0.3 million (£23,000) through ignoring receivables at the beginning of the year.^{lxxxv}

3.3.3. Understating the value of assets, accounts receivable and payable; surplus assets

- i. Unfinished construction which cost about UAH 700 million (£55 million) was not accounted for in the records of the ministry of defence. This could create conditions for embezzlement of state property.^{lxxxvi}
- ii. Verifications revealed payables were understated by UAH 2.3 million (£181,000) in the accounting of a quartermaster unit between 2009 and 2010. The inventory further revealed a surplus of equipment.^{lxxxvii}

3.3.4. Illegal operations with public funds that did not result in losses (including illegally issued and repaid loans on time; receivables that arose because of a violation of a specified period of receipt of goods and services; budget funds expenditure for the maintenance of extra personnel or items; costs for non-top-priority targets in the presence of payables; improper placement of temporarily available budget funds; improper use of budget classification; overstatement of cost of products and services)

- i. In 2007 and 2008, a subdivision wrote off accounts payables amounting to UAH 0.3 million (£23,000) without approval of the ministry of internal affairs.^{lxxxviii}

3.3.5. Breach of public procurement, which did not result in losses

- i. The Office of Resource Support, under the Department of Civil Service within the Ministry of Internal Affairs of Ukraine, was established to provide a centralised service of commodity and material resources for units of the department. However, the tender committee was not housed in-office, hence from 2007 to 2009 they acquired resources worth over UAH 24 million (£1.8 million) without adhering to proper tender procedures.^{lxxxix}
- ii. The main violations of public procurement are: spending without competitive procedures; dividing the procurement into parts to avoid the procedure of open bidding; systematic prepayment; and taking off-budget liabilities and non-use penalties in case of improper performance in contractual obligations by commercial structures.^{xc}

3.4. INEFFICIENT MANAGERIAL DECISIONS

3.4.1. Services provided

- i. In 2009, the internal affairs bodies received UAH 2.3 billion (£181 million) for services provided in an opaque manner: only 10 per cent of this amount was used to simplify bureaucratic procedures and improve its affordability for citizens. The ministry artificially introduced 'additional' services, without which people could not get basic services. Citizens were forced to apply to company intermediaries that provided adequate services much faster, but at double the price.^{xcii}

3.4.2. Realisation of surplus in weapons and military equipment, or other property

- i. Between 2007 and 2008, a subdivision of Internal Troops in the Ministry of Internal Affairs of Ukraine sold military property without adjusting its residual value at the rate of inflation. This resulted in a UAH 364,400 (£28,000) loss to the state.^{xcii}

3.4.3. Construction and acquisition of housing for military personnel, construction and repair of military facilities; accounting, use and alienation of buildings, structures and unfinished construction

- i. The Accounting Chamber concluded that the use of funds allocated for construction (purchase) of housing for soldiers and officers, the military, law enforcement agencies, and the Armed Forces of Ukraine was inefficient between 2007 and 2009. In particular, it noted the existence of unproductive agreements on joint investment housing; chaotic financing and dispersal of funds; growing of the number of military personnel in need of housing; and the creation of a fund for service housing and its improper accounting. As a result, two thirds of the service housing were removed from the service status and privatised in the subsequent two years.^{xciii}

3.4.4. Nutrition

- i. In 2009 and 2010, the courts decided to write off UAH 53.8 million (£4.2 million) as a compensation for the cost of food rations that were not accounted for during the planning phase. As a result, every year accumulated unaccounted payables to the nutrition managers and its recovery mechanisms are not covered by current legislation.^{xciv}
- ii. A Vice Minister of Economy and the Director of the Public Procurement Department of a ministry were suspended from their positions in connection with the adoption of illegal decisions in the implementation of public procurement. In particular, it was a ministry of defence decision to continue sourcing nutrition services for military personnel for the second quarter of this year with the same supplier, instead of calling for new procurement procedures.^{xcv}

3.4.4. Non-defence sphere

- i. The Ministry of Internal Affairs of Ukraine, the Security Service of Ukraine, and the State Border Guard Service inefficiently diverted funds allocated for scientific research to the maintenance of institutions that had little to do with research between 2008 and 2009. For example, two thirds of the scientists of one of the research institutes of the ministry worked on drafting monographs, analytical reports, and newsletters instead of conducting research.^{xcvi}
- ii. Between 2008 and 2009, the Ministry of Internal Affairs of Ukraine dissipated budgetary funds allocated to education. About 40 per cent of higher educational establishments of ministry of internal affairs have not been accredited for the status of higher education institutions, despite having received the corresponding funding. Budget appropriations were directed not at optimising departmental training system, but at increasing the spending in 12 educational institutions. Educational institutions committed budget violations of more than UAH 35 million (£2.7 million) and inefficiently used more than UAH 48 million (£3.8 million). The appointment

of a number of heads were—by the principle of employment opportunities—for retired colonels and generals of the interior.^{xcvii}

- iii. Between 2008 and 2010, educational services in the state customs service did not meet certain licensing requirements. An audit exposed that 835 customs officers were issued with a training certificate when, actually, they had not studied the programme.^{xcviii}
- iv. Between 2009 and 2011, priorities and urgent measures to ensure security of Euro 2012 were not set and funding was incomplete and untimely. As a result, budget funds were spent mostly on major repairs of buildings of the Ministry of Internal Affairs of Ukraine and the Security Service of Ukraine, purchase of audio and video equipment, cars, fuel and lubricants, and other such items.^{xcix}

3.4.5. Management of public enterprises

- i. In previous years, the ministry of defence—instead of improving the organisation of production, construction, repair and service for the armed forces—carried out unnecessary structural changes of governance of public enterprises.



Research of public information revealed other cases which include corruption risks, which have not been explored by auditors/inspectors: confidential information, peacekeeping operations, and permits and refusal of payment.

Business associations of public enterprises which had illegally been formed as corporations were actually acting as resellers and creating conditions for uncontrolled alienation of property and implementation of corruption schemes. Over 50 per cent of public enterprises worked unprofitably. Lack of reasonable economic policy and the concept of a 'corporate industry' led to military enterprises being aided by the funds received from the sale of property transferred to their statutory funds.^c

- ii. Due to inadequate budget funding for utilities in the State Department of Ukraine, private enterprises took responsibility for medical needs and food provision for prisoners and detained people. In 2008 and 2009, these enterprises had provided goods and services amounting over UAH 226 million (£17 million) to penitentiary institutions, and had been paid fees of more than UAH 60 million (£4 million). As a result, on 1 January 2010, receivables of enterprises were more than UAH 97 million (£7 million) and current liabilities were more than UAH 205 million (£16 million), including more than UAH 125 million (£9 million) corresponding to the budget, and nearly UAH 39 million (£3 million) from the funds of state insurance. Enterprises significantly reduced volumes of production and sold products at prices below their cost, which resulted in UAH 5.3 million (£418,000) of losses. Financial and economic activities of insolvent public enterprises, and the relationship both between them and the penal colonies, evidenced the economic irrationality of their operations. It is proposed that these enterprises be liquidated. This activity might be done as part of a 'Special Fund' of budgetary institutions. It will help prevent violation of financial and budgetary discipline, to use budget funds more efficiently, and reduce the burden on the state budget.^{ci}
- iii. Ineffective management by the insolvency manager of a public enterprise of the Ministry of Defence of Ukraine in the Zaporizhzhya region, led to a significant loss of income and

extra expenses between 2008 and 2011. A public plant now rents out the facilities which had been sold to a private company. The cost of renting the premises for two years will exceed revenue from its sale by UAH 1.1 million (£86,000), (roughly 1.3 times). The plant made divestitures, which were in the tax lien, without the written approval of the tax authority. Public assets were sold during the restoration of the plant solvency at a price lower than evaluated by a number of experts (through gradual reduction of prices of trading), resulting in losses of over UAH 2.4 million (£189,000). The plant provided the services at prices below cost and did not apply the penalties to contractors for failure to fulfil obligations. Also, the same plant paid land tax for the premises of another business.

^{cii}

3.5. OTHER EXAMPLES

Research of public information revealed other cases which include corruption risks, which have not been explored by auditors and inspectors:

3.5.1. Confidential information

- i. The official of a public enterprise entered into a criminal conspiracy with representatives of a foreign institution and gave information about Ukrainian development and export potential of arms and military equipment. This is confidential information which belongs to the state.^{ciii}

3.5.2. Peacekeeping operations

- i. In 2008 and 2009, the Chief of Fuel and Lubricants of the Ukrainian Peacekeeping Contingent in Kosovo abused his authority by providing a local private company with 1.2 million liters of fuel worth more than £522,000 without payment of customs duties for the KFOR peacekeeping troops.^{civ} For these actions he received a bribe of almost £50,000, which was then laundered.^{cv} Acquisition, storage and sale of fuel was not displayed in the accounting and reporting

of the incident. Contracts for the supply, transportation and storage of fuel were absent from the military unit.^{cvii}

- ii. A Deputy Commander of the Ukrainian Peacekeeping Contingent in Kosovo and a senior soldier left a patrol area without permission and went on official vehicles outside Kosovo to the Republic of Macedonia, where they bought 400,800 packs of cigarettes to smuggle to the Republic of Bulgaria. The cigarettes and the vehicle were confiscated by Bulgarian law enforcement agencies.^{cvii}

3.5.3. Permits and refusal of payment

- i. A representative of the ministry of defence 'won' second place in the ranking of bribe-takers in 2011 by receiving £31,700 for resolving an issue of cancellation of debt repayment owed by one entrepreneur to the military department.^{cviii}
- ii. The chief of a financial and economic department of a military unit (Hmel'nitskiy garrison) requested and received a bribe from Praporshik amounting to over UAH 20,000 (£1,500) for resolving the issue of a compensation payment over food cost rations decided by the court.^{cix}
- iii. An officer of a military unit (Feodosia garrison) demanded and received bribes from six subordinates for permission to pay the costs of business trips.^{cx}

4. Discussion of results

4.1. CATEGORISATION OF ILLEGAL AND IMPROPER ACTIONS

There are four main types of input conditions to committing violations of financial and budgetary discipline and the adoption of inefficient managerial decisions:

- 1) mismanagement, lack of expertise, education, skills or best practices;
- 2) inadequate accounting and control systems (no rules or vague rules), gaps in legislation or legal collisions;
- 3) human factor: error, inattention, large amounts of work, fatigue, illness, negligence, failure to fulfil obligations of officials;
- 4) conflict of interest, selfish goals (the presence of intention).

The types of improper financial and economic activities can be grouped by the following three main characteristics:

- 1) actions which violate the laws, other regulations, standards, rules, procedures;
- 2) inactivity instead of actions in accordance with the laws and other regulations, standards, rules, procedures;

- 3) inefficient managerial decisions.

The consequences (products) of such actions are divided into the following:

- 1) loss (waste) of revenues;
- 2) illegal expenditures (including expenditures made in violation of law, non-target costs, losses from lack of or damages of resources);
- 3) violation of financial and budgetary discipline, which did not result in losses;
- 4) failure to achieve goals; ineffective, inefficient or unproductive activity.

Finally, the results of such actions are rated in two fields—public and personal:

- A person receives (accepts the offer to receive) unlawful benefit or encourages third parties to obtain unlawful benefit;
- A person does not receive (does not accept the offer to receive) unlawful benefit and does not encourage third parties to obtain unlawful benefit;
- Impact on a reputation of an authority (ministry, organisation), public confidence in it and its representatives.

FIGURE 1: INPUT, ACTIONS AND INNACTIONS IN CORRUPTION

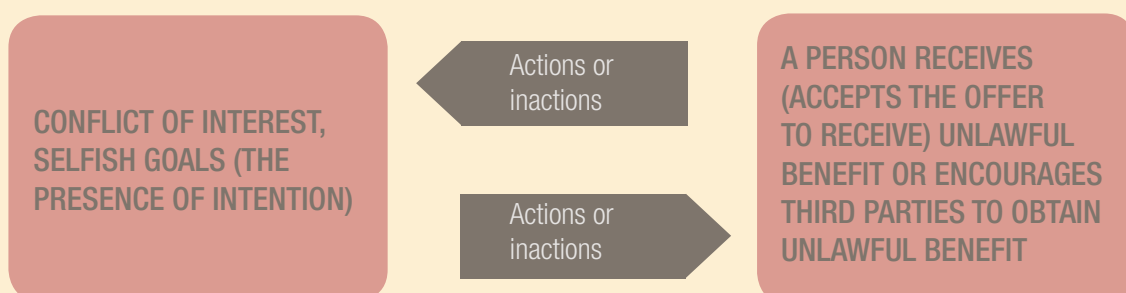
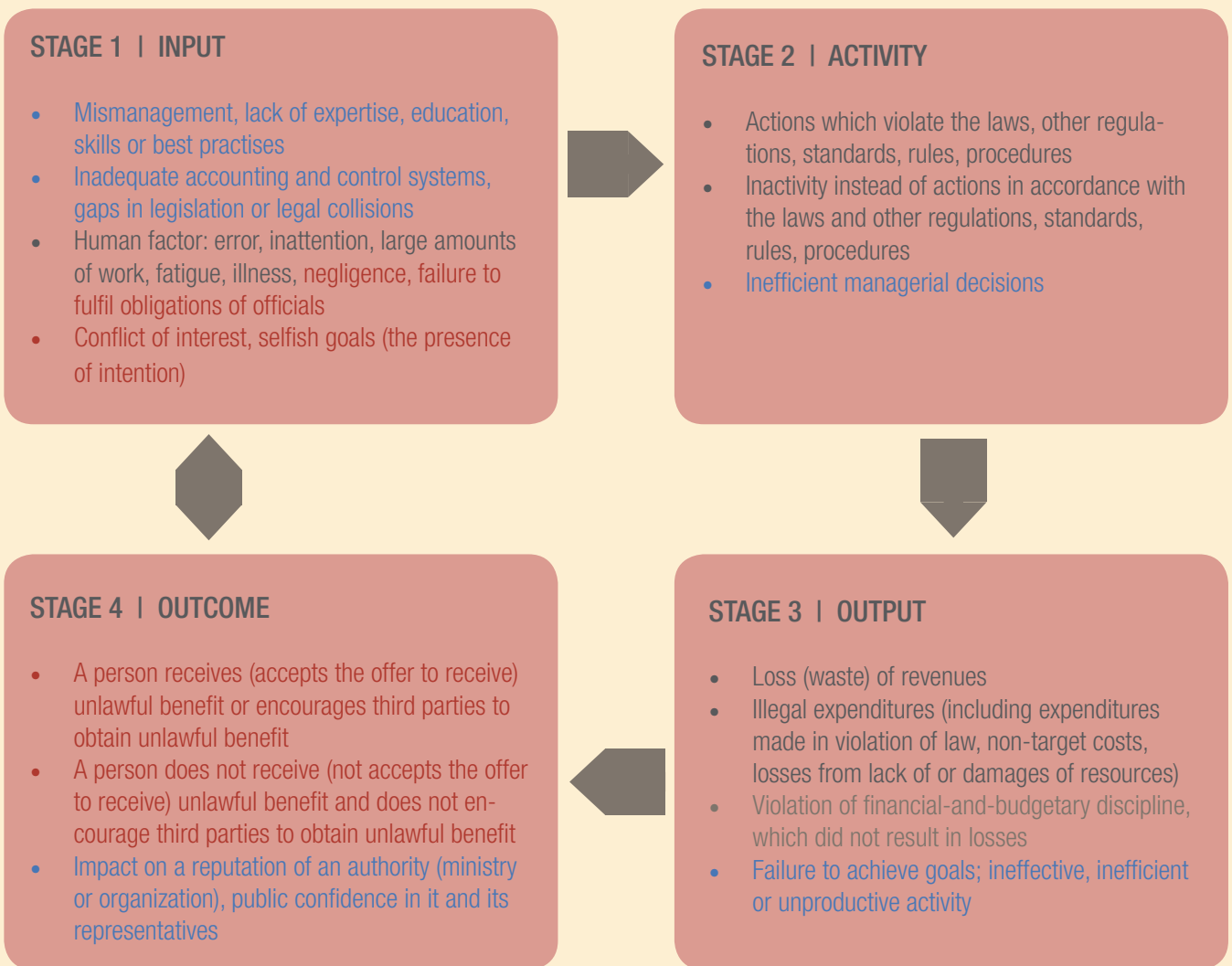


FIGURE 2: LINKS BETWEEN PRECONDITIONS AND RESULTS OF IMPROPER ACTIVITIES



Blue: sphere of audit

Red: sphere of law enforcement

Brown: spheres for study by auditors and law enforcement

Talking about corruption is only possible in cases where there is a strong link between preconditions (input), actions (inactions) and personal results. The results of the research are depicted schematically in Figure 2 above. It is also possible to look at these improper actions according to who is engaged in tackling them. In Figure 2, the actions are split according to the role of audit bodies, law enforcement, and areas covered by both. The investigation of cause and effect links described above do not fall under the authority of auditors/inspectors, but are the task of law enforcement.

4.2. CATEGORISATION OF THE CORRUPTION RISK AREAS

The key areas of corruption risks in the financial and economic activities in the defence sphere are shown in Figure 3. The most common risk areas for the on-budget and off-budget spheres are:

- Public procurement;
- Use of property, equipment and other assets (abuse, misuse, theft);
- Financial systems, accounting and reporting;
- Cash.

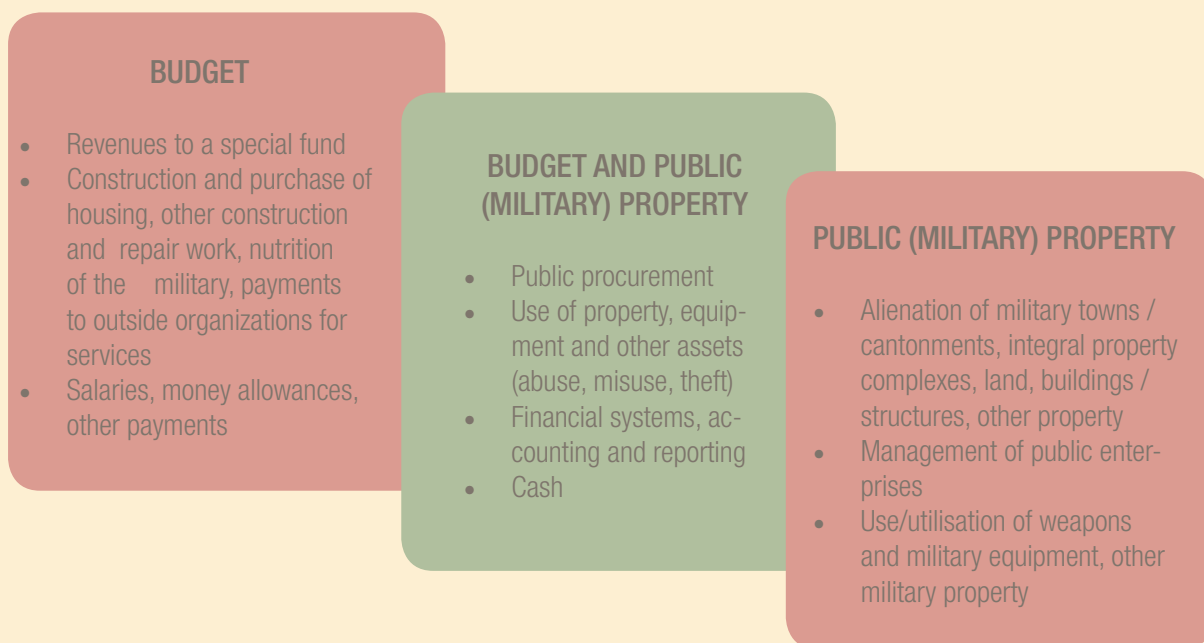
The most risky areas for the budget are:

- ◆ revenues to a special fund;
- ◆ construction and purchase of housing, other construction and repair work, nutrition of the military, payments to outside organisations for services;
- ◆ salaries, money allowances, other payments.

The biggest risks in the economical activities include:

- ◇ alienation of military towns/cantonments, integral property complexes, land, buildings / structures, other property;
- ◇ management of public enterprises;
- ◇ use/utilisation of weapons and military equipment, other military property.

FIGURE 3: THE MAIN AREAS OF CORRUPTION RISKS IN THE FINANCIAL AND ECONOMIC ACTIVITIES IN THE DEFENCE SPHERE



5. How internal audit can help to prevent and reduce corruption in the defence and security sector

5.1. PLACE OF INTERNAL AUDIT IN INTERNAL GOVERNANCE AND ASSURANCE

The National Anti-Corruption Strategy for 2011-2015^{cxii} (hereinafter—the National Anti-Corruption Strategy), indicates the scale of corruption that threatens the national security of Ukraine. However, it requires the immediate adoption of systematic and consistent measures which must be comprehensive and based on the united National Anti-Corruption Strategy.⁶

Anti-corruption policy must cover all time frames (stages) of corruption (from preconditions until its results/influence), and anti-corruption measures must be directed towards prevention, detection and investigation of corruption cases and towards prosecution of individuals and legal entities in accordance with the law.⁷

The main task^{cxiii} of internal audit units is to provide objective and independent conclusions and recommendations about:

- The functioning of the internal control system and its improvement;
- Improving governance;
- The prevention of facts of illegal, inefficient and non-effective use of funds;
- The prevention of errors or other deficiencies.

It is important to understand that internal audit is just one of the sources of assurance, as part of the so-called "third line of defence"^{cxiv} as shown in Figure 4.

The first line of defence consists of management controls and internal control measures (operational or line management has ownership, responsibility and accountability for assessing, controlling and mitigating risks).

The second line of defence 'holds' the risk management function, compliance, inspection, quality and others that facilitate and monitor the implementation of effective risk management practices by operational management. They also assist the risk owners in reporting adequate risk related information up and down the organisation.⁸

The first and second lines of defence support the senior management. The third line consists of internal audit, external audit, and supervisory authority.⁹ It is based on risk approach and assurance of the governing body and senior management on how effectively the organisation assesses and manages its risks—including how the first and second lines of defence operate. The assurance tasks cover all elements of the organisation's risk management framework, from risk identification, risk assessment and response, to communication of risk related information (through the entire organisation, to senior management and governing bodies).

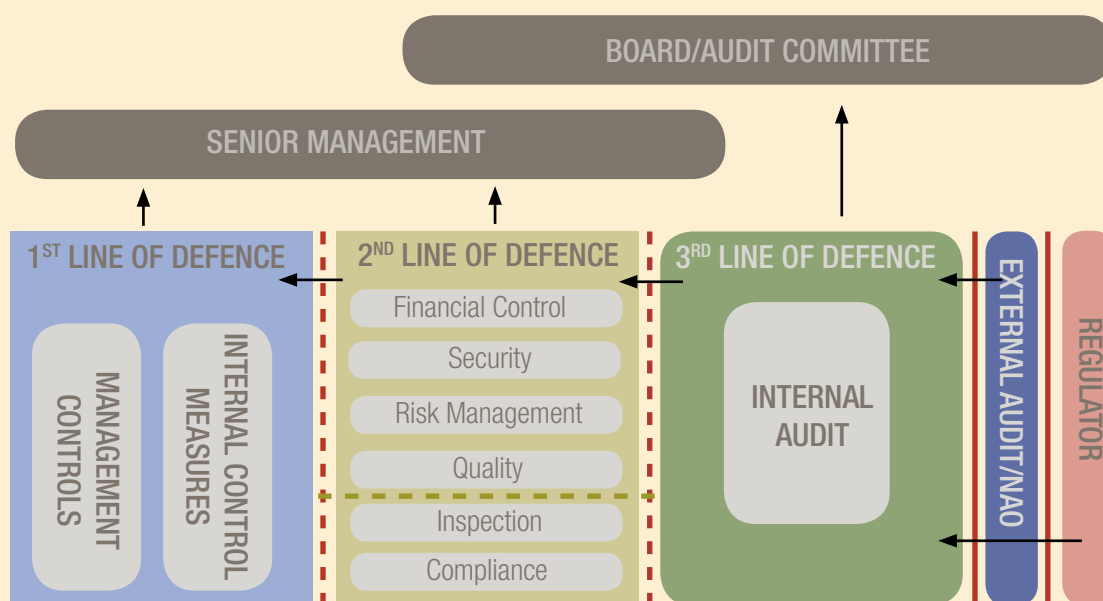
6 Although this strategy is still in effect, the law to create an anti-corruption bureau has been postponed for two years, as there are pending reforms of criminal justice and enforcement bodies which need to take place before this bureau can be created.

7 Since the latter task does not belong to financial control and audit institutions and internal auditors, attention in this section is given to only the first three stages of anti-corruption activities.

8 For example, in-house inspections, checking teams, functional reviews are part of the second line in the Ministry of Defence of the United Kingdom of Great Britain and Northern Ireland.

9 For example, the appropriate Parliament committee. Also assumed that civil society provides some supervision over the activities of public sector authorities.

FIGURE 4: THE THREE LINES OF DEFENCE MODEL^{CXV}



Therefore, the following are some proposed measures that internal audit could play in preventing and reducing corruption.

5.2. PREVENTION MEASURES

At the highest declared level, the priority areas of anti-corruption policy should be (i) identification and elimination of conditions that contribute or could contribute to corruption and (ii) prevention of attempts to create the same.^{CXVI}

The main groups of preconditions for committing violations of financial and budgetary discipline, mistakes and the adoption of inefficient managerial decisions were identified in Chapter 4. In order to help minimise their influence, internal audit units should:

1. Include in the annual programme (based on risk assessment) the conducting of internal audits in the spheres most vulnerable to corruption, and / or specific audits.
2. Periodically assess the degree of implementation of measures and goals identified in the anti-corruption strategy (programme, annual plan).
3. Periodically assess the risks (including risks of corruption), which negatively affect performance of the functions and tasks.
4. Assess, in the first instance, areas most vulnerable to corruption:
 - i. efficient functioning of the internal control system;
 - ii. efficient planning and implementation of budget programmes and the results of their implementation;
 - iii. quality of administrative services and implementation of control and supervisory functions and tasks of certain legislative acts;
 - iv. state of preservation assets and information;
 - v. management of state property;
 - vi. accuracy of accounting records and the reliability of financial and budget reports;
5. Conduct a preliminary analysis of draft orders and other documents (standards, regulations, procedures) associated with the use of budget funds and state (military) assets;

6. Participate in training activities (as trainers) on accounting, internal control systems, and other matters in accordance with the responsibility of internal audit;
7. Actively promote and spread knowledge about the code of ethics (conduct) of civil servants, military personnel and other persons holding public office;
8. Promote the development and spread of anti-corruption culture and environment, and to support 'zero tolerance' towards corruption;
9. Provide consultation to the managers on request, particularly in the form of:
 - i. workshops for 'brainstorming'/identifying risks and controls in a particular area/activity;
 - ii. special consultations on specific risks and controls, for example, on the development of new systems or modification of existing ones.

- falsified documents;
- destruction of accounting documents before the deadline;
- lack of accounting;
- making deliberately/obvious economically disadvantageous agreements;
- understating the price of sold goods and services;
- overstating the price of purchased goods and services.

In particular, one of the consequences of corruption is higher prices due to the inclusion of a bribe as a mandatory component of the pricing formula for goods and services.^{CXXVII}

When an abnormality (so-called 'red flag') is detected in the audit, an auditor should assess the likelihood of corruption (for example, using the table in Annex 2, or another method).

A criteria should be developed by which agreements and transactions must be evaluated in terms of likelihood of corruption in a respective institution (enterprise, organisation), or in an activity or process.

Another important issue is the documentation of findings. Depending on the purpose of the audit, there is the danger of finding deviations which may be included in a general audit report or be singled out in a separate or special report destined to the head of the appropriate level. This will depend on the purpose and type of audit, the kind of findings, and how dangerous they could potentially be. In any case, documentation must be in accordance with the standards of an internal audit.

At the same time the legislation^{CXXVIII} requires that internal auditors must immediately inform the head of the central executive body (its territorial agency, budgetary institutions) about signs of fraud, corruption or misuse of budget funds, waste, abuse and other violations of financial and budgetary discipline that led to the loss or damages. Internal auditors must also provide recommendations on the measures required.

5.3. DETECTION - RED FLAGS

As mentioned in previous chapters, searching and detecting instances of corruption are not the main tasks of internal audit. However, the internal auditor should:

- Consider the possibility that corruption could be present in the course of each audit.
- Be able to recognise signs of agreements and transactions that may be associated with corruption.

These symptoms usually include:

- unofficial reporting;
- presence of unaccounted transactions;
- unaccounted revenues;
- recognition of non-existent (fictitious) costs;
- improper identification or evaluation of accounting objects;

5.4. INVESTIGATION

Usually the investigation lies within the remit of law enforcement. However, in some cases the agencies require assistance to determine which legal acts have been violated, the consequences of those violations, amount of losses (damages), and so on.

The authority to carry out special types of internal audits depends on national legislation. It may be the same as inspections or checks conducted by the State Financial Inspection and internal control-and-auditing units. The results of revisions and checks are the basis to probe infringement and pursue a criminal investigation.

A considerable proportion of corruption can be documented through compliance audits which evaluate compliance legislation, plans, procedures, contracts on safe keeping of assets, and information and management of state property.

Specific audits can be fraud audit (audit of fraud), forensic audit or audit of conflict of interest, or other types of anti-corruption audit.

Internal auditors can be involved as experts in official or criminal investigations which are being conducted by the Military Service of Law and Order in the Armed Forces of Ukraine, the General Inspectorate of the Ministry of Defence of Ukraine, and divisions of the Military Prosecutor's Office, and other law enforcement agencies. In such cases, internal auditors express their professional opinions (judgments) as to the essence of the violation (which of the legal acts that govern defined issues of financial and economic activities were violated), its consequences and scope.

5.5. REPORTING AND MONITORING

Reporting of the Internal Audit Service may include:

1. separate audit reports (assignments) on the following issues:
 - i. identified signs ('red flags') of corruption;
 - ii. inadequate accounting systems and controls;

- iii. vague rules, lack/redundancy of rules;
- iv. gaps in the law or legal conflicts;
- v. degree of compliance of education and experience of employees to perform certain functions or tasks;
- vi. problems in the organisation of labour and the distribution of duties between departments or employees, etc.

2. special reports (assignments) on specific areas (activities, processes), the main findings from monitoring the implementation of recommendations;
3. specific (consolidated) annual report on corruption findings (cases) from monitoring the implementation of recommendations;
4. a special chapter (paragraph) in the annual report on the activities of internal audit.

It is important to give recommendations for making managerial decisions together with the reports, as well monitor their implementation.

In the future, at a more advanced stage of internal audit in Ukraine, it would be advisable to include not only the recommendations (as provided to domestic law), but the concrete administrative actions, which have been agreed with the head of the appropriate level (as is done in the Ministry of Defence of the United Kingdom and Northern Ireland).

6. Next steps

It is not the primary role of internal audit to fight corruption, but it is a role more people expect internal audit to undertake. There is, therefore, an expectation gap that needs to be filled. Internal audit has no legal responsibility for corruption but is required to give independent assurance on the effectiveness of the processes put in place by management to address the risk of corruption. Any additional activities carried out by internal auditors should be in the context of internal audit and not prejudicial to this primary role.

The contribution of internal audits should be seen mainly in the context of building integrity, the spreading of anti-corruption culture, and sustaining an environment of 'zero tolerance' to corruption.

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Taking into account the main objectives and limitations of internal audit services which will begin operations in 2012, it is considered appropriate to develop a strategy for internal audit implementation in the Ministry of Defence of Ukraine and other state

authorities which belong to the defence and security sector. This will serve as a road map in the next three to five years. A separate chapter (paragraph) of the strategy should be devoted to issues of building integrity, including training, code of conduct (ethics), etc.

It is also possible to develop an action plan to implement the strategy. An internal audit, to this extent, should be spread into three levels:

- staff (people);
- operations and processes;
- organisation(s).

The main practical steps for internal audit services for the next one to two years could include the following measures:

1. seminars ('brainstorming') for the management of risk, including risks of corruption;
2. annual internal audit programme based on risk assessment and prioritisation of risk (including risk of corruption).
3. development of the internal list of signs ('red flags') that may indicate corruption;
4. development of criteria by which agreements and transactions must be evaluated in terms of the likelihood of corruption in the respective institution, enterprise or organisation;
5. development of an internal algorithm for conducting and documenting special types of internal audit, which aim to confirm or disprove the violations that may contain corrupt elements;
6. establishment of clear procedures for monitoring proposals and recommendations of internal audit;
7. cooperation with the Accounting Chamber, the Ministry of Finance of Ukraine, the State Financial Inspection of Ukraine, educational and research institutions, and professional organisations (including international and foreign);
8. promotion of the development of anti-corruption culture, and supporting 'zero tolerance' towards corruption (including use of military media);
9. education and training of internal auditors, including under the auspices of the Ministry of Finance of Ukraine and the State Financial Inspection of Ukraine and with support from international organisations and foreign countries.

Supporting the establishment of internal audits by international organisations and foreign countries in Ukraine is very important. Therefore it is expedient to use the opportunities provided by various programmes and initiatives (such as NATO's 'Building Integrity', and 'Professional Development' Programmes), or those implemented in accordance with intergovernmental agreements. For example, it is possible to include the internal audit issues in the defence and security sectors in the annual national cooperation programmes between Ukraine and NATO in the coming years, as well as the action plans for their implementation.

In the future, the establishment of separate units for combating fraud within the internal audit services of the defence and security sectors should also be considered, as is done in the Ministry of Defence of United Kingdom and Northern Ireland, the central government of the United States of America and elsewhere.

Information about building integrity should be included in White Papers in following years. Further, the creation of electronic databases of internal audit and spread the use of modern software (eg, Galileo Audit Management^{cxiv}) for the management of internal audits would be additional steps in the right direction.

ANNEX 1 | INSTITUTIONS OF FINANCIAL CONTROL AND AUDIT IN UKRAINE

1. The Accounting Chamber (the AC, the Supreme Audit Institution)

Established in 1997, conducts external audit on behalf of the Verkhovna Rada of Ukraine (the Parliament).

^{xxx} In 2004 the territorial representations of the AC were established in the regions. At first, the AC used to accomplish only revisions and checks. In recent years, the AC also conducts performance and financial audits.

According to Article 29 of the law 'About Accounting Chamber',^{xxxi} the tasks of the Accounting Chamber are:

- i. financial control for:
 - implementation of the expenditure of the state budget and its spending;
 - internal and external debt of Ukraine, the expenditure of public funds, currency, credit and financial resources;
 - financing of national programmes;
 - legality of Ukraine's loans and economic aid to foreign countries and international organisations;
 - motion of the State Budget of Ukraine and the extra-budgetary funds at the National Bank of Ukraine and the authorised banks.
- ii. analysis of deviations from established parameters of the State Budget of Ukraine and preparation of proposals for their elimination, as well as improving the budget process as a whole;
- iii. regularly informing the Parliament of Ukraine and its committees on the implementation of the state budget and state of maturity of internal and external debt of Ukraine and on the results of other control functions;
- iv. performing other tasks under the law.

The Accounting Chamber shall execute an external audit of public finances and is not a law enforcement agency responsible for combating corruption. At the same time, the Article 29^{xxxii} of 'About the Accounting Chamber'^{xxxiii} establishes a duty: 'In the case of

appropriation of money or material resources, as well as the facts of corruption and other abuses are found during revisions and checks, the Accounting Chamber is obligated upon the decision of its Board to deliver immediate inspections or checks to the law enforcement bodies and inform the Parliament of Ukraine'.

The Paragraph 4.5 of the Standard of the Accounting Chamber of 28 December 2004, number 28-b explains the preparation and delivery of audits and registration of its results:^{xxxiv} 'In the case of detection of the facts of misuse of budget funds and other offenses for which the criminal or administrative punishment is foreseen by decision of the Accounting Chamber Board, the inspection is transmitted to the General Prosecutor's Office of Ukraine, other law enforcement authorities or to a court as established by the law'.

2. The State Control and Revision Service of Ukraine (the SCRS)

This institution was established in 1993 as a governmental centralised agency of public financial control. In 2010 and 2011 the SCRS was reorganised into the State Financial Inspection of Ukraine (the SFI), which consists of the SFI headquarters and 27 regional bodies.

The article 2 of the law 'On State Control and Revision Service of Ukraine'^{xxxv} defines the following main tasks of this body:

- i) the state financial control for:
 - use and safety of public financial resources and other assets in the controlled organisations;
 - proper determination of the need for budgetary funds and obligations which have been undertaken by controlled organisations;
 - efficient use of funds and property by controlled organisations;
 - accuracy and reliability of accounting and financial statements of controlled organisations;
 - implementation of local budgets.

- ii. development of proposals to evaluate shortcomings and violations in order to prevent them in the future.

The SCRC coordinates its work with local council deputies, local authorities' executive and financial institutions, state tax service, prosecutors' offices, interior and security service.

The SCRC is not a law enforcement agency authorised to fight corruption. Article 12 of the SCRS law^{cxxxvi} obliges the SCRS' employees to transfer the revision materials to law enforcement agencies in case of abuses and violations of the law, as well as to report abuses and violations to the state bodies, and bodies authorised to manage public property.

For several years, the SCRS performed only revisions and checks. Between 2001 and 2003, the first performance audits of the efficiency of budgetary programmes were conducted.^{cxxxvii cxxxviii} Later, the SCRS expanded its audit activity and started conducting financial and performance audits^{cxxxix} of budgetary institutions,^{cxxx} public enterprises,^{cxxxi} local budgets, etc.

In late 2005, new functions were added to the Article 8 of the SCRS law. Since 2006, the SCRS has been checking public procurement and cooperating with state agencies to prevent corruption in procurement.

3. Internal control-and-revision units (ICRUs)

By 1993, ICRUs were functioning within line ministries and local executive bodies, performing revisions and checks. After the formation of SCRS, most of ICRUs were liquidated^{cxxxii} and leaders of public sector bodies stopped receiving the necessary information about financial and budgetary discipline. Because of this, between 1996 and 1998 the ICRUs were formed again.^{cxxxiii cxxxiv}

The main tasks of the ICRUs are:^{cxxxv}

- i. control over financial and economic activities of controlled organisations;
- ii. determination of a person who is guilty of law violations;
- iii. analysis of the conditions, causes and consequences of law violations and deficiencies identified during control measures, development of proposals for their elimination and prevention in the future;

- iv. provision of executive authorities, legal entities and individuals with reliable information about the state of financial and budgetary discipline in the relevant area.

In cases where there is evidence of misuse of budget funds, waste, abuse and other violations of financial and budgetary discipline which have led to large amounts of loss or damage, these should be transferred to the law enforcement bodies. If there is any findings with elements of crime, they should be transferred to law enforcement bodies.

In 2001 the Budget Code came into effect.^{cxxxvi} In its Article 26 it foresees the need of implementing internal control and internal audit in the budget sector. In 2005, the Cabinet of Ministers of Ukraine approved the concept of developing Public Internal Financial Control in Ukraine until 2017.^{cxxxvii} The action plan^{cxxxviii} of its implementation contains provisions on the formation of internal audit units in 2012 at a central level—within ministries and other central executive bodies. According to the Decree of the Cabinet of Ministers of Ukraine of 28 September 2011,^{cxxxix} ICRUs within ministries and other central executive bodies must be reorganised into the Internal Audit Units (IAUs) from 1 January 2012.

The main task of IAUs is to provide the head of the central executive body with objective and independent conclusions and recommendations about:

- functioning of the internal control system and its improvement;
- improving governance;
- prevention of illegal, inefficient and non-effective use of budget funds;
- prevention of errors or other deficiencies in the activity of the central executive body.

According to their tasks, IAUs:

- i. evaluate:
 - efficiency of the internal control system;
 - level of implementation and achievement of goals set in strategic and annual plans;
 - efficiency of planning and execution of budget programmes and the results of their implementation;

- quality of administrative services and the implementation of control and supervisory functions and tasks of certain legislative acts;
 - level of preservation of assets and information;
 - level of public property management;
 - accuracy of accounting records and the reliability of financial reporting and budget;
 - risks that affect the performance of the functions and tasks of the central executive body;
- ii. Analyse the draft orders and other documents related to the use of budget funds to ensure their targeted and effective use;
 - iii. Plan, organise and conduct internal audits, document the results, prepare audit reports, findings and recommendations and monitor the implementation of recommendations;
 - iv. Interact with other departments of the central executive body, other state bodies, enterprises, associations, institutions and organisations on issues of internal audit;
 - v. Provide the head of the body with the audit reports and recommendations for the adoption of appropriate managerial decisions;
 - vi. Report on results of operations and perform other functions according to its competence.

IAUs employees must immediately inform the head of the central executive body about signs of fraud, corruption or misuse of budget funds, waste, abuse and other violations of financial and budgetary discipline that could lead to losses or damage. Internal auditors must also provide recommendations for taking necessary measures in these scenarios.

ANNEX 2 | TYPES OF VIOLATIONS OF FINANCIAL-BUDGETARY DISCIPLINE, MISTAKES AND SPHERES OF INEFFICIENT MANAGERIAL DECISIONS WHICH HAVE UNCOVERED BY CONTROL MEASURES, AND THE LIKELIHOOD OF ELEMENT OF CORRUPTION

Groups and types of violations	Violations detected by means of the Accounting Chamber, SCRS (SFI) and ICRUs (IAUs)		Likelihood of corrupt element
	Frequency	Significance	
I. Loss (waste) of revenues as a result of:			
1) Unreasonable provision of free use of resources to some individuals (free rent, payment for land, etc.)	2	2	2
2) Unreasonable lowering of a price / value / volume of property sold, paid services, work performed, rent, unreasonable privileges / discounts for some buyers	2	2	2
3) Not paying to the budget's appropriate amounts; public enterprises not paying the amounts due to the budget / dividends	1	1	1
4) Economically disadvantageous contracts, provision of loans, non-use of financial sanctions to some providers / debtors in case of non-contract terms	2	2	2
II. Illegal expenditures as result of:			
1) Illegal alienation of property and other assets; improper write-off of property, other assets and accounts receivable	2	2	2
2) Writing-off of outstanding receivables which originated from pre-payment for goods, works or services in violation of the Budget Code of Ukraine	1	1	1
3) Unreasonable overstating of amounts / value / price of obtained works (goods and services), without-goods (fictitious) transactions	2	2	2
4) Illegal payment for expenditures which must be paid by lease providers	2	2	2
5) Illegal payment of salary, money allowances, scholarships and other types of incentives	2	2	2
6) Unreasonable overpayment of reimbursement for travelling expenses and sum paid out on account	2	1	2
7) Borrowing of budgetary institutions in any form or lending	1	1	2

8) Expenditure which must be carried out from the other budget	0	0	1
9) Expenditure without budget assignments or above assignment; budgetary money directing to the lower level spending units or recipients without its reasons at the stage of financing (expenditures not foreseen by budget, estimates, documents about limits);	1	1	2
10) Direction of budgetary funds to extrabudgetary funds or extra-budgetary accounts	1	1	2
III. Misuse of budgetary funds			
1) As a result of non-compliance to the budget assignments (law), directions of use of budget funds (passport, order the use of budgetary funds), budget allocation (schedule, budget estimate, plan for the use of budgetary funds);	1	1	2
1) Unreasonable lack of payment of wages in public enterprises	2	2	2
IV. Losses from lack (damage) of cash, securities and monetary documents, fixed assets, intangible assets and other inventory items			
V. Violation of financial-budgetary discipline, which did not result in losses:			
1) Overstatement of accounts payable and liabilities	2	2	2
2) Obligations taken into payment obligations without the budgetary appropriations or excess of power	2	2	2
3) Overstating the need for budget funds, and/or the inclusion of incorrect figures to the budget requests	1	1	2
4) Understating the value of assets, accounts receivable and payable in the accounting; surplus assets	2	2	2
5) Illegal operations with public funds that did not result in losses (including illegally issued and repaid loans on time; receivables that arose because of a violation of a specified period of receipt of goods and services; budget funds expenditure for the maintenance of extra personnel or items; costs for non-top-priority targets in the presence of payables; improper placement of temporarily available budget funds; improper use of budget classification; overstatement of cost of products and services)	2	1	2
6) Breach of public procurement, which did not result in losses (on the stage of the procurement procedures, at the stage of concluding and implementing agreements)	2	2	2
VI. Inefficient managerial decisions in spheres:			
1) Public Procurement	2	2	2
2) Realisation of surplus weapons and military equipment, other property	2	2	2
3) Accounting, use and alienation of land	2	2	2
4) Nutrition of the military	2	2	2
5) Construction and acquisition of housing for military personnel, construction and repair of military facilities	2	2	2

6) Accounting, use and alienation of buildings, structures and unfinished construction	2	2	2
7) Management of public enterprises	2	2	2
8) Procurement, modernisation, rehabilitation readiness, maintenance, operation and repair of weapons and equipment	2	2	2
9) Medical treatment and rehabilitation, sanatorium cure	2	2	2
10) Military education and science	2	2	2
11) Intercommunication and automated control systems	2	2	2
12) Utilisation of munitions and rocket fuel components	2	2	2
13) Participation in international peacekeeping operations and enforcement of international agreements in the military sphere	1	2	2
14) Ensuring vitality, explosion and fire safety arsenals, bases and depots of arms, rockets and ammunition	1	2	2
15) Reforming and development of armed forces	1	1	1
17) Social and professional adaptation of the military that released in the reserve or retired	2	2	2
17) Protection of important public objects	1	1	1
18) Mobilisation and recruitment to the armed forces	1	1	2
19) Planning, financing, accounting and reporting	1	2	2

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