

**LUBBOCK FINE
CHARTERED ACCOUNTANTS**

SCIENCE AND TECHNOLOGY

CENTER IN UKRAINE

MANAGEMENT LETTER

FOR THE YEAR ENDED 31 DECEMBER 2007

THIS REPORT HAS BEEN PREPARED FOR THE SOLE USE OF THE BOARD OF GOVERNORS AND THE MANAGEMENT OF THE SCIENCE AND TECHNOLOGY CENTER IN UKRAINE AND MUST NOT BE SHOWN TO THIRD PARTIES WITHOUT PRIOR CONSENT. NO RESPONSIBILITIES ARE ACCEPTED BY LUBBOCK FINE TOWARDS ANY PARTY ACTING OR REFRAINING FROM ACTION AS A RESULT OF THIS REPORT.

Mr A Hood – Executive Director
Mr C Bjelajac – Chief Financial Officer
Science and Technology Center in Ukraine
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Ukraine

Dear Sirs

**SCIENCE AND TECHNOLOGY CENTER IN UKRAINE
FINANCIAL AUDIT FOR THE YEAR ENDED 31 DECEMBER 2007
MANAGEMENT LETTER – EXECUTIVE SUMMARY**

I. Introduction

We have now completed our audit of the financial statements of the Science and Technology Center in Ukraine (STCU), based in Kyiv, Ukraine, for the year ended 31 December 2007.

Our audit was performed in accordance with internationally recognised Auditing Standards. In planning and performing our audit we have considered the STCU's internal control structure in order to assess the level and nature of auditing procedures for the purpose of expressing an opinion on the financial statements.

In conjunction with our review of internal controls in place for the financial year ended 31 December 2007 we have also reviewed the Management Letter which we prepared for the year ended 31 December 2006, to ascertain whether the weaknesses identified in 2006 still exist in 2007.

In general we have noted that a number of improvements have been made by the STCU in the internal control and recording of transactions, however a number of weaknesses still exist where controls and procedures can be improved. Of the 6 Observations noted last year, 4 have been addressed and are no longer considered to be issues. The remaining 2 Observations are still considered to be of significance and require some form of corrective action, although we would point out that in relation to some of these issues improvements have been made. The outstanding matters not yet resolved are all referred to in the body of this letter.

Please find below a summary of the observations, full details of which are set out in section II of the report. These observations were discussed with Curtis "B.J." Bjelajac prior to written comments being obtained, which are incorporated in this report.

II. Observations Summary

1. During the course of our review we noted that a number of contracts concluded with the project beneficiaries were not dated by all signatories of the contract. (See Observation No.1).
2. During the course of our review we noted a number of issues in connection with foreign exchange adjustments processed within Navision. In some cases these were misstating the financial statements at the balance sheet date and in other cases these were misstating certain reports generated from Navision. In addition we have a general concern with the method with which Navision calculates revaluations and the possible impact this may have on the STCU's IT systems in the future. (See Observation No. 2).
3. In relation to the technical and financial audits carried out by the USDCAA, it was noted that a number of issues were raised such as the identification of project staff and a lack of communication between the STCU and the project staff. (See Observation No.3).
4. It was noted during the course of the audit the accounts contain a significant amount of accounts receivable for travel advances which have not been reported back to the STCU. (See Observation No. 4).

You will appreciate that the inherent limitations in any accounting and internal control system mean that errors or irregularities may nevertheless occur and not be detected. Also, the projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

This report has been prepared for the sole use of the Board of Governors and the Management of the Science and Technology Center in Ukraine and must not be shown to third parties without prior consent. No responsibilities are accepted by Lubbock Fine towards any party acting or refraining from action as a result of this report.

Yours faithfully


Lubbock Fine

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I. AUDIT FINDINGS SUMMARY

This report has been prepared for the sole use of the Board of Governors and the Management of the Science and Technology Center in Ukraine. No responsibilities are accepted by Lubbock Fine towards any party acting or refraining from action as a result of this report.

AUDIT FINDINGS SUMMARY

Item No.	Title	STCU Comments (Agreed or Not Agreed)
1.	Contracts not dated.	Partially Agree
2.	Foreign exchange adjustments within Navision	Agree
3.	Technical and financial monitoring of projects	Agree
4.	Travel grants	Agree

II. AUDITOR'S REVIEW

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**Audit of the Science and Technology Center in Ukraine
For the Year Ended 31 December 2007
Management Letter**

Observation No. 1

Title:	Contracts not dated.
Description:	<p>In the management letters for the years ended 31 December 1999 to 2006 we noted that in the majority of cases, contracts concluded with project beneficiaries were not dated by all parties.</p> <p>During the course of our audit it was noted that in some cases, the contracts are still not being dated. However, we would point out that this issue relates primarily to the institutes not dating contracts, and in some instances project partners, the STCU was noted to have dated all contracts.</p> <p>As well as not being in accordance with standard business practice, the issue of not dating contracts creates a further difficulty with respect to capital accounts. The accounting policy of the STCU states that a project becomes designated when the contracts are signed. If all participants do not date the contract, then the accounting policy becomes harder to implement, and increases the risk that capital may be wrongly credited to either designated or undesignated project capital.</p> <p>Whilst we have noted improvements in this respect since this issue was first noted in the management letter for the year ended 31 December 1999, there were still instances during the year where the contracts were not dated by some of the parties.</p>
Recommendation:	All contracts must be dated by all signatories. The project accountant must check that the contract is signed and dated by all parties, before releasing any monies to the institute under the contract.
STCU Comment:	The STCU partially concurs with Lubbock Fine's recommendations, and will continue to work to ensure that all contracts are dated by instructing the STCU Senior Specialists to work with all parties (e.g. lead institutes, participating institutes, and partners) to ensure that they date their signatures. The STCU agrees that the dating of signatures is standard business practice. However, the STCU must weigh the interest of the Parties to see the project agreements signed in a timely manner in order to meet their non-proliferation goals, versus teaching and enforcing a Western standard business practice. Dating signatures was not a general business practice in the former Soviet Union, which hampers the STCU in its efforts to teach the institute directors this Western business practice. Thus, although the STCU agrees that the dating of signatures is a very good practice, it will not return undated contracts to the signatory parties, because this will slow down even more an already lengthy process of starting an STCU project. The STCU feels that any further delays in the starting of STCU projects would be detrimental to the aforementioned non-proliferation goals of the Parties.

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Observation No. 2

- Title: Foreign exchange adjustments within Navision
- Description: During the course of the audit it was noted that there were a number of issues regarding the way in which Navision undertakes foreign currency revaluations.
- Each month a revaluation is made of all the transactions denoted in a currency other than USD (E.g. Euro), using the exchange rate of the last day of the month. Revaluations are often undertaken some weeks after the month end.
- We have identified the following issues:-
- a) Where a non-USD balance has been settled since the month end (for example Euros received, clearing a partner accounts receivable (A/R)) but before the month end revaluation is processed an error occurs. Instead of applying the closing rate at the end of the month, Navision applies the rate at the date the transaction was settled. This means that at the year end some balances will not be calculated in compliance with IAS 21 Foreign Currencies.
 - b) An error was noted regarding the analysis performed for preparation of the Undesignated Contributed Capital (UCC) note. On receipt of BFA funds from the EU the entry Debit cash at bank, credit UCC is made. This entry records the amount received as a prepayment against future project invoices at a certain Euro / USD exchange rate. When a project is approved the entries are to debit A/R, credit Designated Contributed Capital projects (DCC - projects) at the exchange rate on the date of signing of the project. An entry is then made to transfer Euros from the UCC account to clear the A/R for the project. However, the final entry from UCC to A/R is recorded at the exchange rate used on the date of receiving the BFA funds, not the date of signing of the project. Therefore amounts entering DCC and leaving UCC are different (in USD) when they should be equal. Whilst this has no impact on the balance sheet or income statement (the error is corrected in UCC by a subsequent revaluation of the balance) it does misstate the notes that are prepared for the financial statements and a manual adjustment must be made.

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- c) It was noted that the monthly revaluation is creating an ever increasing number of transactions than in previous years. This is due to the fact that all transactions with a source currency other than USD have been re-translated at each month end. For example for a Euro denominated project all transactions are recorded with a source currency in Euros, once a project is complete and the DCC – projects balance is nil Navision will continue to revalue every transaction ever posted to this project every month (all such entries netting each other out each month).

However, this is causing thousands of unnecessary transactions which is slowing the system down. We were informed that the revaluation process now takes two days to complete on one computer terminal. Without any changes this processing time will be increased markedly over the coming years and the processing power required to run each revaluation will have to be increased.

Recommendation: In relation to the above we would make the following recommendations:

- a) With regard to the revaluation using the wrong closing rate, it is suggested that only the year end policy is amended as this issue only effects balances at the year end.

STCU should make a first December revaluation as close to the year end as possible, before January transactions have been posted. This will stop a change in balances between the year end and date of revaluation. A further December revaluation may be undertaken when Navision is ready to be closed down for the year.

- b) When transferring a project out of UCC the exchange rate to be used should be at the date the agreement was approved (equal to the rate used for DCC).

At the year end amounts transferred from UCC to DCC should agree in the UCC and DCC notes to the accounts. Any differences should be fully investigated.

- c) With regard to the large amounts of data being generated at each revaluation, It is recommended that STCU develop a change to the system that will allow transactions which net off against each other to be 'closed' for revaluation purposes.

STCU Comment: The STCU concurs with Lubbock Fine's recommendations and will perform the following steps related to these issues:

1. The year-end closing procedure will be amended, and a revaluation of December 31st will occur the first working day of January in order to ensure that transactions are revalued before additional transactions are added. Furthermore, the STCU will

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run an additional December 31st revaluation when Navision is ready to be closed down for the year (under current operating procedures this is usually around the end of February).

2. This procedure for project signature was devised with the help of STCU's Navision provider, thus the STCU will consult with the Navision provider to determine if there is a way to perform this procedure in a different manner in order to generate the revaluation as of the date of project signature.
3. The STCU will consult with the Navision provider to determine a method for reducing the amount of revaluation transactions, which should subsequently reduce the time required to perform the revaluations (which are currently taking approximately 20 hours).

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Observation No. 3

- Title:** Financial and Technical monitoring of projects
- Description:** At the request of the U.S. Department of State, the STCU completed 6 U.S. sponsored technical and financial project audits in FY2007. The STCU worked closely with the U.S. D.O.S., Defence Contract Audit Agency (USDCAA), and a select group of technical auditors to perform integrated financial and technical audits.
- In relation to these audits the following issues were noted:
- (a) In relation to Projects P-129, it was noted that the project manager's daughter was working on a project without this relationship being disclosed in the project agreement. It should be noted that the STCU were aware of this relationship and the participant had positively contributed to the project.
 - (b) In relation to Project P-144 it was noted that grant letters for new participants and disclosure of family relationships were not held by the STCU in the project file. These documents were held by the institute but not provided to the STCU in a timely manner.
 - (c) It was noted for Project P-144 that a travel advance of \$2,500 had been advanced to a grantee in quarter 1 and the trip was subsequently cancelled. The advance had not yet been returned to the STCU although the project was now in quarter 12 at the time of the audit report.
- Recommendation:** In relation to the above we would make the following recommendations:
- (a) With regard to family members' participation in projects, we would recommend that the STCU identify and justify family members' participation in projects as part of their proposal submission. We also recommend that the STCU include guidance that institutes must inform the STCU in writing of all family relationships which exist between participants, sub-managers and project managers.
 - (b) With regard to documentation not being sent to the STCU, we would recommend that the STCU reviews the project file when preparing quarterly reports to assess if all documents have been received. In instances where documents are found to be missing the STCU should contact the institute and request they are forwarded.
 - (c) With regard to travel advances please see observation no 4 for recommendations.
- STCU Comment:** The STCU concurs with Lubbock Fine's recommendations and will perform the following steps related to these issues:
1. On September 24, 2007, the STCU received the signed permission letter for the daughter of the project manager of project P129 and forwarded the letter to DCAA. DCAA informed

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Observation No. 3

- the STCU that this action closed this issue.
2. The STCU has instructed the responsible project accountant for each project to ensure that the necessary documentation is in the project file while preparing the quarterly report for each project. In those instances where documents are missing, the project accountant will contact the project manager and request those documents to be passed on to the STCU as quickly as possible.
 3. This observation is addressed in Observation No. 4.

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Observation No. 4

Title: Travel grants

Description: During the course of our review we noted a number of issues in relation to the accounting for and managing travel advances made to Scientists.

Currently the system within the STCU is to advance travel grants to Scientists for subsistence while abroad and other small travel expenses. Normally large hotel and airfares are paid directly by the STCU.

The accounting at the point of advance is to Debit Accounts receivable (Project Grantee), Credit Cash / Bank.

On receipt of the completed travel settlement voucher the STCU will Debit travel expense, Credit Accounts receivable (Project Grantee). Any amount owed back to the STCU will be recovered from the scientist and any amount due to the Scientist will be recorded as a payable (usually paid with the next grant payment).

For supplemental budget travel the system is the same but the receivable is recorded under Accounts receivable from Non STCU/Non Project.

In principal this system will materially correctly state the financial statements at the balance sheet date. However, we noted some weaknesses in the operation of this system:-

1. During the course of the review we noted a number of cases where travel settlement vouchers had been received but no entries have been posted onto Navision. In some of these cases the final settlement with the Scientist has not been made (whether this is money owed to or from the Scientist). This will lead to a misstatement of the financial statements and an underreporting of travel expenses.
2. We also noted significant time delays between when travel has taken place and when travel is being reported back to the STCU. This leads to a number of issues:-
 - a) For travel that has taken place within a financial year but has not been reported under the following the expense of travel will be understated with a corresponding overstatement of Designated capital for projects;
 - b) There exists a possibility that the amount advanced will prove to be irrecoverable;
 - c) The Scientist could be out of pocket should they be owed money from the STCU;

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- d) The STCU will not have accurate information in connection with remaining Designated Contributed Capital under supplemental budgets related to travel.
3. It was noted that no policy appeared to exist regarding who is responsible for chasing receipts/settlement vouchers and by when items are to be remitted to the STCU.

Recommendation: In relation to the above we would make the following recommendations:

1. *STCU Grantees*

- a) When an advance is made it must be communicated to the grantee that receipts and a completed travel settlement voucher are to be submitted to the STCU within a specified time period (for example 45 days).
- b) When a travel grant is agreed, only a proportion of this money should be sent to the grantee, 80% being a figure we consider reasonable. It will now be likely that the grantee will have to use a small amount of personal funds when travelling and will therefore have an incentive to submit travel documents in a timely manner.
- c) Project Accountants should be made responsible for the travel grant procedures concerning STCU Grantees.
- d) The date of intended travel should be noted on Navision so it will appear on the quarterly expense report which is included on the project file.
- e) As part of the quarterly reports prepared by the project accountants, a review of travel advances should be made. For any travel receipts which have not been submitted within the specified time period, the grantee should be contacted directly.
- f) Consider implementing a policy where grants are withheld from grantees, up to the value of the travel advance, if they repeatedly ignore requests to submit documents (120 days for instance).
- g) When the documents are received from the grantee any amounts due to/from the grantee should be settled in the next grant payment.

2. *Non STCU Grantees*

- a) The treasurer is currently responsible for these advances. Assistance should be provided to the treasurer by another accountant.
- b) When an advance is made it must be communicated to the recipient that receipts and a completed travel settlement

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voucher are to be submitted to the STCU within a specified time period (for example 45 days).

- c) The date of intended travel should be noted on Navision so the time from the date of travel can easily be referred to. It may be clearer to the staff involved if some information were stored on Excel instead of Navision (for example, name, contact number, amount, date of travel, and days since travel).
- d) On a regular basis, say every two weeks, this travel advance situation should be reviewed. Any documents or funds which are overdue should be chased by the treasurer (or assisting accountant).
- e) When the travel settlement vouchers are received they should be posted to Navision immediately. Reasons for late submission of vouchers must be noted so STCU can consider the recoverability of amounts due.
- f) At the year end, STCU should review the amounts outstanding regarding these advances to ensure that when supplemental budget lines are written back there will be enough left to cover outstanding travel advances.

STCU Comment: The STCU concurs with Lubbock Fine's recommendations and will perform the following steps related to these issues:

1. *STCU Grantees*

- a) The STCU does have a policy related to the timely settlement of project travel (SOP V - Project Participants Travel), within which states that the project participant is required to submit a travel settlement to the STCU within seven (7) working days of travel completion. Thus, the STCU will take additional steps to ensure that project grantees adhere to this policy.
- b) The STCU agrees with this recommendation and will revise its policy and procedures to incorporate advancing 80% of the requested sum.
- c) The STCU agrees with this recommendation and will transition the responsibility for project travel from the Treasurer to the responsible Project Accountant.
- d) The STCU agrees with this recommendation and will work with its Navision provider to include travel dates into the project expense report.
- e) The STCU agrees with this recommendation and will revise the quarterly financial report procedure to incorporate a review of travel advances by the responsible project accountants. For any travel receipts which have not been submitted within the specified time period, the grantee will be contacted directly by the project accountant.

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- f) The STCU agrees with this recommendation and will carefully consider implementing a policy where grants are withheld from grantees, up to the value of the travel advance, if they repeatedly ignore requests to submit documents.
- g) The STCU agrees with this recommendation and will ensure that upon receipt of settlement documents, the STCU will move to settle any amounts due to/from the grantee in the next grant payment.

2. *Non-STCU Grantees*

- a) The STCU agrees with this recommendation and will instruct the responsible senior specialist, an additional project accountant and the general accountant to assist the Treasurer with settling these travels.
- b) The STCU agrees with this recommendation and will take additional steps to ensure that these travelers adhere to the settlement policy (also seven (7) days).
- c) The STCU agrees with this recommendation and will work with its Navision provider to include travel dates into Navision and then investigate installing a system (possibly within Navision, or within MS-Excel as recommended by Lubbock Fine) to track the data related to each traveler.
- d) The STCU agrees with this recommendation and the STCU staff (senior specialist, project accountant, and general accountant) assigned to the travel review process will be instructed to meet every two weeks in order to ensure timely settlement of travels. Any delinquent travels will be dealt with on a case by case basis to ensure timely settlement.
- e) The STCU agrees with this recommendation and will ensure that upon receipt of settlement documents, the STCU will move to settle any amounts due to/from travelers as quickly as possible.
- f) The STCU agrees with this recommendation and will carefully review the settlement situation at year end for these travellers in order to ensure that when supplemental budget lines are written off to Designated Capital Supplemental accounts, that there will be enough remaining budget to cover outstanding travel advances.