

LUBBOCK FINE
CHARTERED ACCOUNTANTS

SCIENCE AND TECHNOLOGY

CENTER IN UKRAINE

MANAGEMENT LETTER

FOR THE YEAR ENDED 31 DECEMBER 2008

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22 May 2009

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Dear Sirs

**SCIENCE AND TECHNOLOGY CENTER IN UKRAINE
FINANCIAL AUDIT FOR THE YEAR ENDED 31 DECEMBER 2008
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 2008.

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 2008 we have also reviewed the Management Letter which we prepared for the year ended 31 December 2007, to ascertain whether the weaknesses identified in 2007 still exist in 2008.

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. All of the observations noted last year 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 significant 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.

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.

Partners: Geoffrey Goodyear, Jeff Gitter, Pankaj Shah, Laurence Newman, Naresh Shah, Rohit Majithia, Russell Rich, Mark Turner, Martin Sans*, Philip Blackburn*, Lee Facey, Stephen Banks.

Consultants: Anthony Sober, David Levy, Alan Cushnir.

*All partners are Chartered Accountants except where indicated.

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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. (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 fraudulent claims made by grantees and grantees working in excess of 220 days. (See Observation No.3).
4. It was noted during the course of the audit the financial statements contain a significant amounts of receivables for travel advances which have not been reported back to the STCU in a timely manner. (See Observation No. 4).
5. It was noted during the course of the audit that the interest allocation to funding parties had not been calculated in a consistent manner due to errors in the formula used. (See Observations No. 5).
6. During the course of our review we noted that the STCU has not been maintaining an up to date fixed asset register since moving to the new premises. (See Observation No. 6).
7. It was noted during the course of our audit that for a number of partner projects expenses incurred on the project are in excess of the partners cash contribution to date, exposing the STCU to the risk of bad debts. (See Observation No. 7).
8. It was noted during the course of our audit that a number of administrative invoices could not be located by the STCU staff (See observations No. 8).

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.

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Yours faithfully

Lubbock Fine



I. AUDIT FINDINGS SUMMARY

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
5.	Allocation of interest between funding parties	Agree
6.	Fixed asset register	Agree
7.	Accounts receivable in excess of project DCC	Agree
8.	Filing of administrative invoices	Agree

II. AUDITOR'S REVIEW

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 of the Science and Technology Center in Ukraine
For the Year Ended 31 December 2008
Management Letter

Observation No. 1

Title:	Contracts not dated.
Description:	<p>In the management letters for the years ended 31 December 1999 to 2007 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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For the Year Ended 31 December 2008
Management Letter**

Observation No. 2

Title: Foreign exchange adjustments within Navision

Description: In the management letter for the year ended 31 December 2007 we noted a number of errors with regard to the way in which the Navision system processes foreign currency revaluations. The STCU has implemented a number of our recommendations which has reduced the weaknesses identified in this system, however there are still certain areas that have not been addressed.

- a) 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 accounts receivable (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.
- b) After undertaking the year end revaluation at 1 January 2009 (per Lubbock Fine's previous recommendation), the STCU then revalued the preceding months to December in late January and in February. This has caused some unexpected entries to be created in the accounts, resulting in incorrect balance sheet entries for September, October and November. Whilst this has no impact on the year end financials, it impacts the validity of STCU management accounts for these months.
- c) When a non-USD transaction is posted in 2008 during 2009 and this transaction is settled before the second December revaluation has been run an error occurs. Navision applies the exchange rate at the date the transaction was settled, not at the year end exchange rate. This means that at the year end some balances will not be calculated in compliance with IAS 21 Foreign Currencies.

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

- a) With regard to the revaluation at the year end, the STCU should continue to revalue the accounts as at 31 December or 1 January. After this point no further revaluations should be made to preceding months for the year in question. This will stop the large unexpected entries occurring as happened in 2008.
- 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) When posting items back into the prior year, all efforts should be made to run a revaluation for the year end before payments are made in the following year. We understand that due to the length of time a revaluation takes, this may not always be possible.

It has been noted that the STCU have been unable to rectify a number of problems since the previous year and are still experiencing various difficulties with revaluations. At present the staff do not have the relevant experience to deal with the complex issues that the revaluations are causing. It is suggested that the STCU consult externally with a Navision expert regarding the revaluation difficulties in order to obtain a workable solution for future years .

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

1. The STCU will continue to do a revaluation of December 31st on the first working day of January in order to ensure that transactions are revalued before additional transactions are added. Furthermore, the STCU will not run any additional preceding months revaluations after this revaluation.
2. This procedure for project signature was devised with the help of STCU's Navision provider, thus the STCU consulted with the Navision provider in 2008 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. Unfortunately, according to the Navision provider, it is not possible in Navision to obtain the desired result without making a programming change to Navision. The STCU is hesitant to make this programming change, as it deals with the very foundation of Navision - making general ledger entries. Thus, the STCU will continue to work with Navision specialists to address this issue; however, if a programming change is deemed the only method for addressing this issue, the STCU will continue to address this issue with manual corrections at year end.
3. The STCU will attempt to implement this recommendation, but would like to highlight that this will not always be possible given

the length of time a revaluation takes, as pointed out by Lubbock Fine.

The STCU concurs that there are a number of revaluation problems related to Navision that are out of the scope of knowledge of the STCU staff, as well as the local Navision provider currently utilized by the STCU. Thus, the STCU will in 2009 look to work with a Navision expert from outside of Ukraine on this issue in the hope that the STCU will be able to find a workable solution for future years.

Audit of the Science and Technology Center in Ukraine
For the Year Ended 31 December 2008
Management Letter

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 FY2008. 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 Project 3596 it was noted that the sub-project manager coerced two grantees to falsify time to increase the levels of grants that they received. These additional grants were then used to purchase additional materials for the project.
 - (b) In relation to Project 3596 it was noted that travel vouchers which had been submitted six months prior to the audit had not been processed by the STCU. Furthermore, there were instances where the travel vouchers had not been submitted yet travel had occurred in excess of six months prior to the audit.
 - (c) It was noted for Project 3631 that four participants had worked in excess of 220 days in a year without gaining approval from the STCU, in breach of Standard Operating Procedure 24.
 - (d) It was noted for Project 3594 that a participant had filled in time cards and his lab journal in advance of undertaking work on the project.
- Recommendation:** In relation to the above we would make the following recommendations:
- (a) With regard to fraudulent time claims, we recommend that the STCU undertake careful monitoring of time cards, paying attention to unexpected and large variances in participant's time. Such variances should be investigated. We recommend that this is undertaken on a quarterly basis by the project accountants.

We appreciate that in the event of collusion, fraudulent activity will be difficult to identify, however the STCU should remain vigilant to this risk.
 - (b) With regard to travel advances and travel vouchers please see our Observation 4 for recommendations.
 - (c) With regard to the 220 day rules being breached, it is recommended that the 220 day report is run on a monthly basis. Where there is evidence that a participant has breached the limit, or is close to the limit (210 days for instance) the participant in question should be informed on a timely basis to gain authorisation if 220 days are to be breached. Where a grantee continues to work above the 220 limit without authorisation, grants in excess of the 220 days should be

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Management Letter**

Observation No. 3

withheld until authorisation is gained.

- (d) With regard to filling in of time cards in advance, we recommend that the STCU stress the terms contained in the Grant Letters to the participant, that clearly state that time cards are to be filled in on a daily basis, when the grant letter is signed.

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

- a) The STCU will continue to review timecards on a sample basis for unexpected and/or large variances as required by Section (a) 2 of STCU Standard Operating Procedure XIX – Project Accountant Manual for Checking Project Quarterly Financial Reports. However, as pointed out by Lubbock Fine, cases of collusion make it very difficult to detect issues with timecards even when timecards are examined closely.
- b) The STCU will review 220 day requirements on a monthly basis and work with grantees to ensure that they acquire permission to work more than 220 days when necessary. In the cases where grantees work more than 220 days without authorization, the STCU will consider withholding the grant amount in excess of 220 days until authorization is finally received.
- c) The STCU agrees with this recommendation and will continue to stress to project participants the terms contained in the grant letter that clearly state that timecards are to be filled in on a daily basis.

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Management Letter**

Observation No. 4

Title: Travel grants

Description: In the management letter for the year ended 31 December 2007, we noted a number of weaknesses in the travel grants system. During the course of our audit work for the year ended 31 December 2008 some of these weaknesses were still apparent, however it is noted that the STCU has made significant improvements in this area.

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.

We have 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;
- d) The STCU will not have accurate information in connection with remaining Designated Contributed Capital under supplemental budgets related to travel.

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 (to be in line with SOP 5)
- 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 remain 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) When an advance is made it must be communicated to the recipient that receipts and a completed travel settlement voucher are to be submitted to the STCU within a specified time period (to be in line with SOP 5).
- b) 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).
- c) On a regular basis, say every two weeks, the travel advance position should be reviewed. Any documents or funds which are overdue should be chased by the treasurer.
- d) 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.

- e) 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 continue to perform the following steps related to these issues:

1. *STCU Grantees*

- d) The STCU will continue to communicate its 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.
- e) The STCU agrees that this recommendation is reasonable, and thus will consider revising its policy and procedures to incorporate advancing 80% of the requested sum; however, given the success of the STCU in 2008 of reducing the amounts outstanding from travellers, it is still not clear to the STCU that this change in procedure is necessary. Thus, the STCU will monitor the situation in 2009, and if necessary, will incorporate this recommendation.
- f) The STCU agrees with this recommendation and thus the Project Accountant will remain responsible for project travel.
- g) The STCU agrees with this recommendation and will continue to include travel dates into the project expense report.
- h) The STCU agrees with this recommendation and will continue the quarterly financial report procedure of reviewing travel advances by the responsible project accountants. For any travel receipts which have not been submitted within the specified time period, the grantee will continue to be contacted directly by the project accountant.
- i) The STCU agrees with this recommendation and has already started withholding grants up to the value of the travel advance from grantees if they repeatedly ignore requests to submit documents.
- j) The STCU agrees with this recommendation and will continue to 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 continue to communicate to travellers their need to adhere to the settlement policy (also seven (7) days).
- b) The STCU agrees with this recommendation and will continue to include travel dates into Navision as well as utilize MS-Excel where deemed necessary.
- c) The STCU agrees with this recommendation and the STCU Project Accountant and Treasurer assigned to the travel review process will continue 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.

- d) The STCU agrees with this recommendation and will continue to ensure that upon receipt of settlement documents, the STCU settles any amounts due to/from travellers as quickly as possible.
- e) The STCU agrees with this recommendation and will continue to 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.

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Observation No. 5

Title:	Allocation of interest between funding parties
Description:	<p>During the course of our audit it was noted that the formula being used to allocate bank interest received between the funding parties was being applied incorrectly.</p> <p>This arose as the model used did not take into account where an expected positive parameter became negative.</p> <p>As a result the amount of interest receivable which is allocated to each funding party has not been calculated in accordance with the level of cash held by the STCU in respect of each funding party.</p>
Recommendation:	<p>We recommend that the formula used to calculate the interest allocation is amended to perform the calculation regardless of whether a parameter is positive or negative.</p> <p>We further recommend that these calculations are checked, on a sample basis, each month to ensure that the automatic calculation is working as expected.</p>
STCU Comment:	The STCU concurs with Lubbock Fine's recommendations and in 2009 will amend the formula used to calculate the interest allocation between funding parties, as well as check on a sample basis each month that the amended automatic calculation is working as expected.

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Observation No. 6

Title:	Fixed asset register
Description:	<p>It was noted during the course of our audit that the STCU does not have an up to date fixed asset register, nor has an asset inventory been undertaken since the STCU moved to their new premises at 7A Metalistov Street.</p> <p>As a consequence the STCU does not have a record of where its fixed assets are currently held, which will make it difficult to assess if the assets of the STCU are being appropriately safeguarded.</p> <p>We appreciate that due to the STCU moving buildings in 2009 it has not been possible to keep this information up to date, however STCU should seek to rectify this at the earliest possible opportunity.</p>
Recommendation:	<p>We recommend that a full fixed asset inventory is undertaken during 2009. This is to include the following;</p> <ul style="list-style-type: none">a) Agreeing that items that were held at 21 Kameniariv Street are now held at 7A Metalistov Street. Where items have not been transferred, these items should be investigated and removed from the register if appropriate.b) Ensuring that all additions to fixed assets made since the 24 December 2008 (the date the last register) have been included on the fixed asset register.c) Verification of all fixed assets, noting their location and identification number displayed on the asset.
STCU Comment:	The STCU concurs with Lubbock Fine's recommendations and at the earliest possible opportunity will implement recommendations a, b, and c listed above.

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Observation No. 7

- Title:** Partner project expenses incurred in excess of cash contributions
- Description:** During the course of our audit we have noted that as at 31 December 2008, 36 projects had incurred project expenses in excess of the cash the STCU has received for that project from the relevant funding party.
- This means that the amounts receivable (A/R) from funding partners is in excess of Designated Capital Contributions – projects (DCC - projects) for certain project which exposes the STCU to the risk of bad debts. This risk exists as the STCU is the contracting body with the project grantees and may therefore be obliged to make grant payments in excess of cash receipts from partners. It should be noted that this situation has yet to arise.
- The STCU currently has a procedure which stops payments being made for projects when DCC - projects is equal or less than accounts receivable. However, this safeguard still allows expenses to be accrued for a project, which could potentially create an obligation for the STCU to settle these amounts, whether or not the cash is ever received from the funding partner.
- Recommendation:** In relation to the above we would make the following recommendations:
- a) As part of the quarter end procedures the amount of available funds remaining for the project should be noted by the project accountant on the project file (Being DCC - project less A/R).
 - b) This should be compared to the budgeted spend for the following quarter to ascertain if it is likely that the project will go into a 'negative' funding position in the next quarter.
 - c) Where a project does go into a negative funding position, the funding partner should be contacted immediately and informed of the situation. The project should be suspended if it appears the partner will delay in providing the STCU with the next cash payment to fund the project.
 - d) Where it is expected that project funding will become negative in the next quarter, the STCU should contact the partner and remind them of the expected due dates for project funding.
- STCU Comment:** The STCU concurs with Lubbock Fine's recommendations and during 2009 will implement recommendations a, b, c and d listed above.

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Observation No. 8

Title:	Filing of administrative invoices
Description:	<p>During the course of our audit it was noted that a number of invoices relating to administrative and supplemental cost could not be located by STCU staff.</p> <p>There appears to have been a breakdown in the way in which such invoices are filed, which will make it increasingly difficult to trace supplemental and administrative expenditure to source documentation.</p>
Recommendation:	It is recommended that the STCU implement a consistent policy for the filing of administrative and supplemental invoices. This system should be designed to allow any individual to trace a purchase made Navision to the invoices utilising referencing and a systematic method of filing the invoices.
STCU Comment:	The STCU concurs with Lubbock Fine's recommendations and will implement a consistent policy to ensure that administrative and supplemental invoices are filed in a manner that allows them to be found consistently