

LUBBOCK FINE
CHARTERED ACCOUNTANTS

SCIENCE AND TECHNOLOGY

CENTER IN UKRAINE

MANAGEMENT LETTER

FOR THE YEAR ENDED 31 DECEMBER 2010

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19 April 2011

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Dear Sirs

**SCIENCE AND TECHNOLOGY CENTER IN UKRAINE
FINANCIAL AUDIT FOR THE YEAR ENDED 31 DECEMBER 2010
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 2010.

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 2010 we have also reviewed the Management Letter which we prepared for the year ended 31 December 2009, to ascertain whether the weaknesses identified in 2009 still exist in 2010.

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. Three of the four observations noted last year are still considered to be of significance and require some form of corrective action, although we note that improvements have been made in respect of observation 1. 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.

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

Associates: Andrew Noton, Neil Williams.

Consultants: Anthony Sober, David Levy.

*All partners, associates and consultants 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. 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. 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 including travel reimbursement not related to project expenses and procedural errors in filling out timesheets. (See Observation No.3).

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

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AUDIT FINDINGS SUMMARY

Item No.	Title	STCU Comments (Agreed or Not Agreed)
1.	Contracts not dated	Partially Agree
2.	Partner project expenses incurred in excess of cash contributions	Partially Agree
3.	Financial and technical monitoring of projects	Agree

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II. AUDITOR'S REVIEW

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**Audit of the Science and Technology Center in Ukraine
For the Year Ended 31 December 2010
Management Letter**

Observation No. 1

Title:	Contracts not dated.
Description:	<p>In the management letters for the years ended 31 December 1999 to 2009 we noted that in the significant number 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 a number cases, the contracts are still not being dated.</p> <p>We reviewed all new project agreements signed in the year. Of the one hundred and ten (110) project agreements signed in the year, forty-nine (49) related to project partner agreements. We identified that seven (7) of forty-nine (49) agreements were not dated by the project partner, and thirteen (13) of one hundred and ten (110) were not dated by the institute. We did note however that all new projects in the year were dated by the STCU.</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) on dating their signatures. The STCU agrees that the dating of signatures is a 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 efforts to instill this Western practice in the institute directors. Thus, although the STCU agrees that the dating of signatures is a very good

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Management Letter**

Observation No. 1

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: Partner project expenses incurred in excess of cash contributions
- Description: During the course of our audit we have noted that as at 31 December 2010, 18 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 Accounts Receivable (A/R) from funding partners is in excess of Designated Capital Contributions – Projects (DCC - Projects) for each of these projects 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.
- Additionally, we did note during the year that for a single project (P242) it appears that expenses have been incurred and paid in excess of funds received, although we note that this occurred in 2007, before the procedure above was fully implemented.
- We note that the STCU currently has a number of ongoing projects with project partners indirectly financed through European Commission Seventh Framework agreements. In this case, the project partner itself may have funding withheld until the project is complete. Although this does not directly affect the STCU as the project funding is due from the project partner, it may lead to a number of projects where the final tranche of funding cannot be received unless other methods of temporary funding are found by the project partner, or the STCU allows costs to be accrued before it has received cash from the partner to meet these expenses.
- We further note that the STCU has entered into an agreement with the European Commission for €4 million of projects at the Ukrainian Anti-Plague Station in Simferopol. The terms of payment for this agreement state that 5% of funding will be withheld until the completion of the projects. Although these projects have yet to commence, these funding terms would imply that the final 5% of project expenditure is initially financed out of STCU funds, with external funding only being received after disbursement of the project funding. It is unclear how the STCU will fund this 5% as the STCU does not hold any funds other than those

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Observation No. 2

belonging to existing funding parties and partners. Therefore such project funding terms may expose the existing funding parties to bad debts of up to 5% of €4 million, i.e. €200,000, until completion of the projects.

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 immediately suspended if it appears the partner will delay in providing the STCU with the next cash payment to fund the project, unless assurance can be received that funding is forthcoming (e.g. in Seventh Framework funding situations).
- 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.

Additionally we recommend that the funding of the European Commission projects in Simferopol is discussed with the funding parties to ensure that the potential funding shortfall is understood by the funding parties and that a procedure is in place to ensure the STCU is not liable for project expenditure it has not received from funding parties.

STCU Comment: The STCU partially concurs with Lubbock Fine's recommendations because of the following two reasons:

- a) *De Jure* – All STCU project agreements contain the following condition:

Article 9.2 – The Center shall not be liable for non-performance by the Partner or the Recipient(s) of their obligations under the Agreement.
- b) *De Facto* – As pointed out by Lubbock Fine above, there have been occasions where Partners have refused to make payments for work performed by institutes and grantees. In all cases, the STCU has not been obligated to step in and pay for these expenses; in the end, the grantee(s) and institute(s) suffered the loss. The STCU agrees with Lubbock Fine that

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Management Letter**

Observation No. 2

simply because it has not happened in the past, does not mean that it cannot happen in the future. However, the STCU believes that the wording in the STCU project agreement is very clear on this matter (see point a. above). In the case of project P242, there is the potential for a small loss (\$1,645), but as the auditors point out, this only occurred because the proper programming change had yet to be implemented in the STCU newly installed finance system. The STCU has since added this feature and management is confident that the necessary tools are in place to ensure that this does not occur again.

The STCU would like to point out to the readers of this management letter that in order to work with certain partners (i.e. European Commission/CORDIS/7th Framework Programme, EOARD, etc.), the STCU has to accommodate payment systems that require work to be done by the scientific team in advance, which is then reviewed by the Funding Party, and then approved for payment.

The STCU agrees to continue implementing the recommendations set forth by Lubbock Fine listed above, and in the 2008 and 2009 management letters, in order to further reduce the risks of non-payment by partners, as this is good business practice in any case. However, the STCU will continue the practice of allowing partners to accrue expenses in excess of cash received (but not pay cash out in excess of cash received), because as highlighted above, STCU requires some flexibility in order to accommodate the requirements of its many different partners.

Finally, the STCU agrees to continue discussions with the funding parties to ensure that any potential funding shortfall related to the upcoming European Commission projects at the Ukrainian Anti-Plague Station in Simferopol is understood by the funding parties, and that a procedure is in place to ensure the STCU is not liable for project expenditure it has not received from funding parties

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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 2 U.S. sponsored technical and financial project audits in FY2010. 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 4610 the project manager was reimbursed \$642 for travel not related to project expenditure.
 - (b) In relation to Project 4912 one participant's time card was not completed for July 2010.
 - (c) In relation to Project 4912 two participants stated that they work a full work day but actually work two partial days.
 - (d) In relation to Project 4912 and Project 4610 one sub-project manager and the project manager respectively had time cards that did not contain the required signature of two other participants.
 - (e) In relation to Project 4610 seven participants completed time cards based on budget rather than actual hours worked.
 - (f) In relation to Project 4610 five participants completed subtotals and/or totals on time cards before the hours were worked.
 - (g) In relation to Project 4610 seven participants filled out time cards on a less than daily basis.
 - (h) In relation to Project 4610 two participants and the project manager stated that another participant fills out part of their time cards.
 - (i) In relation to Project 4610 two participants had not signed their time cards and six had time cards not signed by the project manager.
 - (j) In relation to Project 4610 six current month time cards were signed in advance.
 - (k) In relation to Project 4610 three participants did not complete subtotals for first two months of the quarter.
 - (l) In relation to Project 4610 time cards were not being sent to STCU on 10th of the month.
 - (m) In relation to Project 4610 time cards are not prepared on serially

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Management Letter**

Observation No. 3

numbered stock.

- (n) In relation to Project 4610 the project manager's notebook was completed in advance.

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

- (a) With regard to the non-project travel expenses, we note the STCU's response to the USDCAA audit report that it considered the travel to be consistent with the goals of the STCU, and that it retains the ultimate power to approve or disapprove such adjustments. The STCU also notes that approval for the additional travel was obtained from the responsible Senior Specialist.

We recommend that the STCU stresses to participants that reimbursement of travel expenses is only allowed for valid project expenses and, while the authorisation process seems to be working as intended, further emphasis should be provided to authorising parties to ensure that only valid project expenses are approved.

- (b) – (k) With regard to issues with timekeeping inadequacies, we recommend that the STCU stress the terms contained in the Grant Letters to the project participants, that clearly state that:

- Time cards should be filled out on a daily basis, personally, for actual hours worked
- Time cards should be signed by the participant and project manager, and for the card of the project manager, two participant signatures should be obtained

- (l) In relation to the issue of time cards not being sent to the STCU by the 10th of the following month, we recommend the STCU reminds all project participants of the rules contained within SOP VII "Participation and Recording Hours Worked on STCU Projects", that requires time cards to be sent to the STCU by this date.

- (m) In relation to time cards not prepared on serially numbered stock, we highlight Section B of SOP VII "Participation and Recording Hours Worked on STCU Projects" which states that the "...STCU will provide time cards to project managers and participating institution managers for use on STCU projects. Such time cards will be printed on card stock and will be serially numbered."

- (n) In relation to the project manager's notebook being completed in advance, we recommend the STCU remind project participants that these notebooks should be filled out as work is done, not in advance.

- STCU Comment: The STCU concurs with Lubbock Fine's recommendations and will perform the following steps related to these issues:
- a) The STCU agrees and will continue to stress to participants and authorizing parties that reimbursement of travel expenses is only allowed for valid project expenses.
 - b) – k) The STCU agrees with these recommendations and will continue to stress to project managers and project participants the terms contained in the Standard Operating Procedure VII, which clearly state that:
 - Time cards should be filled out on a daily basis, personally, for actual hours worked
 - Time cards should be signed by the participant and project manager, and for the card of the project manager, two participant signatures should be obtained
 - l) The STCU agrees and will remind all project participants of the rules contained within SOP VII "Participation and Recording Hours Worked on STCU Projects", that requires time cards to be sent to the STCU by the 10th of the following month.
 - m) The STCU agrees and will strive to provide serially numbered time cards to project managers and participating institution managers for use on STCU projects.
 - n) The STCU agrees and will continue to remind project participants that laboratory notebooks should be filled out as work is done, not in advance.