KPMG
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Science and Technology Center in Ukraine

Management Letter for the year ended
31 December 2012

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Private and confidential

13 May 2013

Dear Mr. Curtis M. Bjelajac

We have audited the financial statements of the Science and Technology Center in Ukraine (hereinafter "STCU") as at and for the year ended 31 December 2012.

Our audit procedures are designed primarily to enable us to provide an opinion on the financial statements, and therefore will not bring to light all weaknesses in policies or procedures that may exist. We aim, however, to use our knowledge of the STCU gained during our work to make comments and suggestions that we hope will be useful to you.

During the performance of our audit, we noted certain matters that are presented for your consideration. Our comments and recommendations are intended to improve the internal control structure or result in other operating efficiencies and are noted in the attached appendix. This management letter also includes the responses by management to our recommendations.

We would like to express our appreciation to the management and employees of the STCU for their cooperation during the audit.

We would be pleased to discuss these comments and recommendations with you at any time. This report is intended solely for the information and use of the management.

Yours sincerely,
KPMG Baltics SIA

Armine Movsisjana
Partner

Contents

1 Value added tax on "Biosafety and biosecurity improvement at the Ukrainian Anti-Plague station (UAPS) in Simferopol" project expenditure

Observation

In the year 2011 the SCTU has signed 5 project agreements #9800 to #9804, "Biosafety and biosecurity improvement at the Ukrainian Anti-Plague station (UAPS) in Simferopol". The project includes the following steps (1) Securing Existing Facility to Improve Biosecurity Level; (2) Conceptual Design of New Laboratory Facility, Work Estimate and New Site Investigation; (3) Executive Design of New Laboratory Facility, Licensing, Construction and Commissioning; (4) Equipment; (5) Set Up of Management Structure for the Operational Phase, New Facility Procedures Drafting and Staff Training.

The project is financed by the European Union and the total financing amounts to EUR 4 000 000. According to the “General and Administrative Provisions” of the project agreement taxes shall not be considered as eligible costs, unless the STCU is not able to reclaim them.

Currently the STCU does not reclaim any input value added tax incurred on project expenditure as the management of the STCU believes that the Ukrainian government has provided a mechanism for the STCU to reclaim input value added tax which is impractical to implement.

Implication

Although the amount of input valued added tax incurred on project expenditure to date is not significant, taking into account total estimated project expenditure and the fact that the Ukrainian government has provided a mechanism for the STCU to reclaim input value added tax, the European Union could treat input valued added tax incurred on project expenditure as not eligible cost and reduce the amount of final payment (5% of the total project expenses) and attempt to recover the amount incurred from the STCU.

Recommendation

We recommend the management of the STCU to communicate the current situation with respect to the process of reclaiming input value added tax incurred on project expenditure to the state tax authorities with the Funding Party with the aim to reconsider the treatment of input value added tax as non - eligible project expense.

Management response

Agree

On December 20, 2012, the STCU sent the attached letter addressed to Mr. Eddie Maier of the European Commission explaining the VAT situation, and asked Mr. Maier for a VAT exemption for this particular project. As of the printing of this management letter, the STCU has not yet received a response to this letter.

SCIENCE & TECHNOLOGY
CENTER IN UKRAINE

December 20, 2012

ATTN: Mr. Eddie Maier
Deputy Head of Unit
D5- Instrument for Stability, Nuclear Safety
Directorate General DEVCO
European Commission
B-1049 Brussels, Belgium
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Fax: (+32.2) 299 52 06
E-Mail: Eddie.Maier@ec.europa.eu

Reference: IFS/2010/254-942

Dear ~~Mr. Maier~~ Eddie:

With reference to Article 14.3 of Annex II of the Action IFS/2010/254-942 concerning the consideration of irrecoverable VAT as an eligible expense we provide the following explanation.

The STCU Agreement and Statute exempt STCU from paying taxation and the government of Ukraine utilizes two separate mechanisms to administer this requirement. For all administrative expenses of the STCU a mechanism exists and operates successfully to allow STCU to reclaim VAT paid on purchases above a de-minimis threshold.

However, for expenditure on projects the Government of Ukraine does not operate this reclaim mechanism but has an exemption mechanism which:

- Has inherent risks with regard to the Intellectual Property Rights (IPR) of project results,
- Causes undue delay in implementation of projects and achieving non-proliferation goals and;
- Reduces considerably the potential for competition between vendors as many will not work within the confines of this mechanism.

Therefore, for the time being there is no practical process available to the STCU for the recovery of VAT for project purposes.

Numerous approaches by STCU singly and in conjunction with other donors including the EU to request harmonization of the two mechanisms have met with an unsatisfactory response.

Thus, the STCU believes that the EU should consider this VAT as irrecoverable in the current climate and therefore should be an eligible expense of Action IFS/2010/254-942.

Sincerely,

Ambassador
M. Michael Einik
Executive Director

Cc:Mr. Sorin Popa, European Commission, Devco, Unit D5 – Instrument for Stability - Nuclear Safety

2 Accounting entries to undesignated capital accounts

Observation

1) The STCU receives financing from the Funding parties that may be originally designated for the purposes of specific projects or supplemental budget needs; in addition, part of financing is originally treated as undesignated and is subsequently reallocated to specific budgets upon approval. We noted that currently STCU uses the accounting procedure, whereby funds received or receivable from Funding Parties may be recognized directly against Designated Capital Contributions or originally against Undesignated Capital Contributions and subsequently reallocated through transfer.

2) We also noted that upon project cancellations amounts due from Funding Parties may be eliminated directly against Designated Capital Contributions.

Implication

1) As a result of approach described above, transfers between capital contributions accounts are problematic to reconcile and the transparency of their presentation in the financial statements is undermined. Net cash received from Funding Parties also cannot be directly compared to the amounts reflected in capital movements.

2) Based on the STCU accounting policy, results of finished or terminated projects are to be reallocated from Designated Capital Contributions to Undesignated Capital Contributions. This approach is not fully followed based on the current accounting practice.

Recommendation

To aid the transparency of accounting process and preparation of financial statements, we recommend STCU to:

- Account for all funding received or receivable from the Funding Parties originally through Undesignated Capital Contributions account with further transfers performed based on budgets approved;
- Initially transfer all finished or terminated project net results to Undesignated Capital Contributions account and perform required cancellations of amounts due only thereafter.

Management response

Agree

Given the requirement by KPMG this year to produce a Movement in Capital Accounts statement, the STCU agrees that the only way to easily compile this report is to change the way it accounts for all cash received, as well as closed projects. Thus, the STCU will immediately implement KPMG's recommendation to utilize the UCC as a transit account for all funding received and closed projects.

3 Equipment acquired for project purposes not present at the institutes

Observation

As part of performing audit procedures on project expenditure, we have visited the institutes conducting the projects with the purpose to verify existence of property and equipment acquired by the STCU in the current year for the project purposes. For projects #532, #519 and #P004M, we have identified that the equipment acquired is not located in the institute. As explained by the responsible institute employees, part of the work on the project is performed by the project grantees from their home, therefore, the respective equipment is currently located there. However, we have not been presented with the delivery-acceptance act certifying change of the location of the particular items of equipment.

Implication

The fact that equipment acquired for project purposes is not located in the institute premises where the project is conducted, and the absence of the required delivery-acceptance act may raise doubts on the actual purpose of use of the items of equipment and eligibility of the project expenditure incurred.

Recommendation

We recommend the STCU to monitor equipment existence in the institute premises on a periodic basis as well as introduce a procedure for signing a delivery-acceptance act between the institute and the project grantee, when the project grantee is allowed to locate the equipment in premises other than the institute.

Management response

Partially agree

Equipment purchased by the STCU is often mobile by nature (i.e. laptops, mobile phones, etc.). Thus, in these cases, the STCU views it as acceptable for these items to not always be located at the institute premises and the STCU will not require the signing of a delivery-acceptance act between the institute and project grantee.

However, in those instances where equipment in not mobile in nature (printers, etc.), the STCU agrees that documentation of the movement of the item should be obtained.

If necessary, the STCU will modify its procedures and policies to reflect the aforementioned statements.

4 Annual reconciliations with the Funding Parties

Observation

In the course of performing audit procedures on year-end accounts of the STCU, we have sent out 21 reconciliation letters to the Funding Parties to verify the amount of funding received during the reporting year as well as the balance as at the year-end. We have observed a rather low response rate as out of 21 reconciliation letters sent we have received back only 12 letters. We have identified significant differences between the amounts confirmed by the Funding Parties and the amounts per STCU accounting records in 8 reconciliation letters out of 12 letters received in total.

We have been informed by the management of the STCU that reconciliations with the third parties are not performed by the STCU.

Implication

Confirmation letters with the third parties as a year-end control will enable the STCU to reconcile the amount of cash disbursements during the year and the amounts receivable from Funding Parties as at year-end as well as verify the capital account balances. Such approach is generally considered to be good practice of year end closing procedures.

Recommendation

We recommend the STCU on an annual basis to send out reconciliation letters to the Funding Parties to verify the amount due as at year-end, to confirm the amount of cash received by the STCU during the year as well as to reconcile the list of projects signed during the year.

Management response

Partially Agree

The STCU believes that the low response rate to the confirmation letters obtained by KPMG are related to two (2) factors:

1). The confirmation letters were sent out much too late in the audit process (mid-March '13). In the past, the STCU worked with its previous auditors to send out the letters by mid-January.

2). The STCU confused the confirmation process early on, because instead of preparing the confirmation letters in the manner that KPMG requested (providing the STCU numbers for confirmation by the funding party), the confirmation letters were instead done in a manner similar, but not exactly (i.e. asking open questions about projects funded, funds sent during the year to the STCU, etc.) to that as done by the STCU's previous auditors.

Thus, the STCU feels that as a result of the aforementioned factors, the confirmation letter response rate was much lower than in previous years. In previous years, the response rate was usually 70% – 80% or better.

For the December 31, 2013 year end financial statement audit, the STCU will prepare the confirmation letters as originally requested by KPMG wherein the STCU will provide the funding party with the beginning and ending A/R, as well as funds received during the year, and then ask that the funding party to confirm or revise these amounts. Furthermore, the STCU will provide this information to KPMG by mid-January 2014 so that the confirmation letters can be sent out as early as possible.

5 Contribution in kind of office premises

Observation

From March 2009, the STCU have occupied office premises provided by the Ukrainian government for which the STCU does not pay rental or utility charges. The management is not able to reliably estimate the fair value of the rental and utility benefit provided by the Ukrainian government in the reporting year.

Implication

The contribution in kind by the Ukrainian government, being one of the Funding Parties, is not reflected in the STCU financial statements' capital accounts. In accordance with International Financial Reporting Standards, any contribution in kind received from Funding Parties should be measured at fair value and reflected as capital contribution to Administrative Budget transferred to Statement of Revenue and Expenditure. Offsetting accounting entry to recognize the fair value of rent and utility expenditure should be recognized. In our view, current treatment by the STCU does not reflect fairly the participation of the Ukrainian government in the operations of the entity.

Recommendation

We recommend the STCU to estimate the rental and utility charges contributed by the Ukrainian government by reviewing the rental fees for similar office premises in the market. Reflecting the rental and utility charge contributed by Ukraine as the Funding Party in the Designated Capital Contributions – Administration and the rental and utility expenses incurred in Administrative Expenditure will disclose the substance of the transaction to the readers of the financial statements.

Management response

Partially Agree

The STCU acknowledges that IFRS is clear on reflecting fair value of in kind contributions in the STCU financial statements.

However, the STCU is currently in temporary non-commercial space located on and integrated into a University campus, and does not feel that it could determine a reliable estimate of the fair value of the rental and utility benefit of the facility provided by the Government of Ukraine that would improve the quality of STCU financial statements.

6 Non-current amounts due from Funding Parties not discounted

Observation

As at 31 December 2012 the STCU has recognized non-current amounts due from Funding Parties in the amount of USD 3 820 thousand (2011: USD 1 320 thousand). Such amounts are treated as loans and receivables under IAS 39 and should be carried at amortized cost using the effective interest rate. The management believes that due to the minimal prevailing funds placement interest rates, the estimated amortized values of the financial instruments of the STCU do not differ materially from their carrying amounts as at 31 December 2012 and 2011 and has not performed a detailed calculation of the estimated amortized values.

Implication

In accordance with the International Financial Reporting Standards the management is expected to estimate amortized values of all financial assets and liabilities of the entity carried at amortized cost, which are calculated using discounted cash flow techniques based on estimated future cash flows and discount rates for a similar instrument at the reporting date.

Recommendation

We recommend the STCU to estimate the amortized value of the non-current amounts due from Funding Parties as at the year-end date by discounting the future cash disbursements from the Funding Parties with the applicable market discount rate. As a result, unwinding of discount would be reflected as income in the Statement of Revenue and Expenditure throughout the collection period of amounts due.

Management response

Disagree

It is the STCU's understanding that the objective of IAS 39 in the case of receivables with "extended credit terms" is to ensure that an organization's revenue is not overstated because it granted credit terms that are overly generous (i.e. outside of industry norms) and used as a tool to "inflate" revenues. Thus, IAS 39 requires organizations that are providing "extended credit terms" to amortize their receivables by reducing their A/R and charging their Statement of Revenue and Expenditure.

In the case of the STCU, its receivables are promises to pay from its capital holders. Any increase in accounts receivable are offset by a corresponding increase to its capital accounts. Revenue is neither overstated nor understated, because it is not the offsetting entry to the accounts receivable entry, as is the norm for most commercial entities.

The STCU is providing credit terms (not all Funding Parties can pay 100% in advance) which match the forecasted expenditures of the projects.

Thus, the STCU disagrees with the observation of KPMG on this matter, and believes that all non-current receivable amounts are shown at fair value and are in compliance with IAS 39 and do not require amortization as outlined in IAS 39.

Finally, the STCU will work closely with KPMG over the course of the next year to clarify its position on this matter as the STCU also understands that because of the current minimal prevailing funds placement interest rates, this issue is now only a management letter item; however, if interest rates were to rise over the course of the next year, the STCU will still not amortize its receivables as requested, which may put the STCU and KPMG in an untenable position vis á vis the provision of audited financial statements for December 31, 2012 and 2013.

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