

**LUBBOCK FINE
CHARTERED ACCOUNTANTS**

SCIENCE AND TECHNOLOGY

CENTER IN UKRAINE

MANAGEMENT LETTER

FOR THE YEAR ENDED 31 DECEMBER 2011

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17 April 2012

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Dear Sirs

**SCIENCE AND TECHNOLOGY CENTER IN UKRAINE
FINANCIAL AUDIT FOR THE YEAR ENDED 31 DECEMBER 2011
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 2011.

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 2011 we have also reviewed the Management Letter which we prepared for the year ended 31 December 2010, to ascertain whether the weaknesses identified in 2010 still exist in 2011.

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. Two of the three observations noted last year are still considered to be of significance and require some form of corrective action. 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, 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 July 2011 the STCU signed agreements in connection with Bio-safety and Bio-security improvement at the Ukrainian anti-plague station (UAPS) in Simferopol. The agreements signed with the EU in relation to the UAPS projects do not consider VAT to be a recoverable expense where there is a mechanism for its recovery. At present the STCU does not recover VAT on project expenditure (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



17.11.12

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.	Eligibility of VAT on project expenditure for Ukrainian Anti-Plague Station (UAPS) project in Simferopol	Agree

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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 2011
Management Letter**

Observation No. 1

- Title:** Contracts not dated.
- Description:** In the management letters for the years ended 31 December 1999 to 2010 we noted that in the significant number of cases, contracts concluded with project beneficiaries were not dated by all parties.
- During the course of our audit it was noted that in a number cases, the contracts are still not being dated.
- We reviewed all new project agreements signed in the year. Of the one hundred and seven (107) (2010 – 110) project agreements signed in the year, sixty-five (65) (2010 – 49) related to project partner agreements. We identified that fourteen (14) (2010 – 7) of sixty-five (65) (2010 – 49) agreements were not dated by the project partner, and eighteen (18) (2010 – 13) of one hundred and seven (107) (2010 – 110) were not dated by the institute. We did note however that all new projects in the year were dated by the STCU.
- 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.
- 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.
- 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 instil this Western practice in the institute directors. Thus,

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Management Letter**

Observation No. 1

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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Management Letter**

Observation No. 2

Title:	Partner project expenses incurred in excess of cash contributions
Description:	<p>During the course of our audit we have noted that as at 31 December 2011, 13 projects had incurred project expenses in excess of the cash the STCU has received for that project from the relevant funding party.</p> <p>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.</p> <p>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.</p> <p>We note that the STCU has entered into project agreements with the European Commission for €4 million of projects at the Ukrainian Anti-Plague Station in Simferopol (projects 9800, 9801, 9802, 9803 and 9804).</p> <p>The terms of payment for this agreement state that 5% of funding will be withheld until the completion of the projects. The initial payment of 95% of the funding was received in the year and the projects commenced in August 2011.</p> <p>The funding terms for these projects 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 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.</p> <p>However it has been noted that the bank interest received on the unspent funding for the Simferopol projects could be sufficient to cover the final 5% of project expenditure before the funding is received from the EU.</p> <p>We further 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</p>

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Management Letter

Observation No. 2

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.

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

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Management Letter

Observation No. 2

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 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).

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, 2009, and 2010 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 European Commission projects at the Ukrainian Anti-Plague Station in Simferopol is understood by the funding parties, and that a procedure is in place (i.e. the use of interest generated on UAPS project funds in hand) to ensure the STCU is not liable for project expenditure it has not received from funding parties.

Audit of the Science and Technology Center in Ukraine
For the Year Ended 31 December 2011
Management Letter

Observation No. 3

Title: Eligibility of VAT on project expenditure for Ukrainian Anti-Plague Station (UAPS) project in Simferopol

Description: In July 2011 the STCU signed 5 projects with the EU for a total of €4million relating to the UAPS at Simferopol. The projects consist of 5 distinct phases which include improving the bio-safety and bio-security in the existing anti-plague station, the design and construction of a new anti-plague station and training the staff at the new anti-plague station.

Initial estimates are that up to 95% of the project expenditure could be subject to Ukrainian VAT at 20%. If 95% of the project expenditure was subject to VAT this may result in the project incurring VAT on project expenditure in the region of €633,000.

Annexe II, point 14.3 of the 'General and Administrative Provisions' for the projects with the EU state that 'the following costs shall not be considered eligible ".....taxes, duties and charges charged to the Organisation (*being the STCU*) (unless the Organisation is not able to reclaim them and if allowed by the applicable regulatory provisions of the European Community)."

Currently the STCU does not reclaim any Ukrainian VAT incurred on project expenditure. However, the Ukrainian government have provided a mechanism for the STCU to reclaim Ukrainian VAT incurred on project expenditure but the STCU have deemed this mechanism too cumbersome and impractical to implement.

Due to a mechanism for reclaiming VAT on project expenditure existing, the EU could deem the VAT incurred on project expenditure as an ineligible project expense and reduce the amount of the final payment (5%) by the VAT and/or the EU could attempt to recover any VAT incurred on project expenditure from the STCU.

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Management Letter**

Observation No. 3

Recommendation: It is recommended that the STCU communicate the current position with regards to reclaiming VAT on project expenditure in Ukraine with the EU and discuss whether the VAT incurred will be treated as an eligible project cost.

If the EU will allow the VAT incurred as an eligible cost then this should be confirmed in writing with the EU for future reference in case the project is audited by the EU.

If the EU will not allow the VAT incurred as an eligible cost the STCU should establish whether the project can continue as a viable project for the STCU to undertake. A number of steps could be taken to remedy this issue:

- Assess whether the method for reclaiming VAT provided by the Ukrainian government could be followed for this project.
- Renegotiate the contract with the EU to allow VAT as an allowable project cost.

STCU Comment: The STCU concurs with Lubbock Fine's recommendations and will work with the EU in the very near future in order to resolve this matter, which may include implementing one of the above recommended approaches.