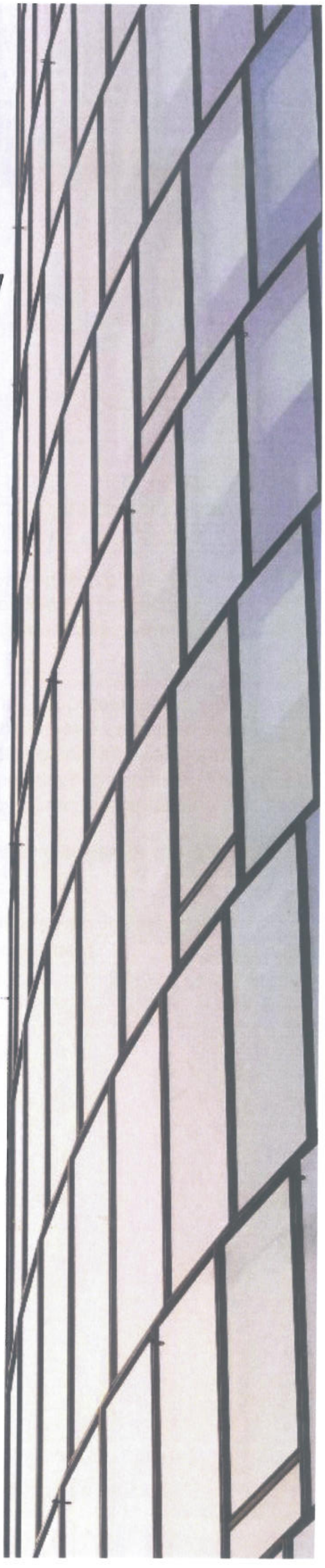
KPMG

Science and Technology Centre in Ukraine Management Letter

For the year ended 31 December 2016



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Private and confidential

28 April 2017

Dear Mr. Curtis M. Bjelajac and Mr. Anthony Nichol,

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 2016.

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, all of which have been discussed with the appropriate members of management, 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

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1 Grant advance payments to the scientists

Observation

During the course of the audit, we have discovered instances when individual project members received double advance payments. On a rare occasion one of the project members shares incorrect bank details, which resulted in the first prepayment never being debited to his account, and since the advances are sent to the whole project participants, another batch of payments was mistakenly sent. As an example, we have reviewed project P671 and several project participants, where participants received two advances in two months.

Implication

Based on the internal policies, advances are sent to the project members at the beginning of the project, and the amount sent is equal to 1/3 of the quarterly pay. Although at the end of the quarter the amount is netted, the double advance transactions are against the internal policy.

Recommendation

We recommend the management to establish a tighter control over payment processing to identify and avoid cases as such in the future.

Management response

These occurrences are due to problems within the banking sector and payments not reaching the respective scientists, STCU will introduce measures to ensure that any replacement advance is only paid to those scientists who have not received payment and not to all scientists on the project and that the first advance payments are recovered through the bank

2 Partner fee and deferred revenue calculation

Observation

During 2016 the STCU has designed and started to use automatic application for partner fee recognition. During our audit we have discovered that the application does not accurately calculate the partner fees, as the partner fees were calculated based on the total incurred project expenses and recognised Designated Capital Contributions up to the date when the automatic calculation is run. Since the partner fees allocation was calculated on 10th of March 2017, partner fees were recognised in the statements of Revenue and Expenditure for 2016 on the financial data for the period from 1st January 2016 till 10 March 2017.

Implications

Developed application does not fully support the STCU accounting policy which says that the partner fees are recognized in the Statement of Revenue and Expenditure proportionally to the initially deferred and subsequently recognized expense incurred during the reporting period.

Recommendation

We suggest the management to update the application for partner fee recognition to ensure that only reporting period items are taken into account. Updating the software would ensure a more accurate revenue recognition, matching it with deferred and recognized expenses.

Management response

The accounting for partner fee revenue on deferred basis was introduced in 2015's financial statements and the calculations were prepared manually. In 2016 this function was added to our accounting software and therefore the 2016 financial statements were the first time the application was used. We will work with our software support consultants to correct the errors in the function.

3 Project approval process

Observation

During 2016 the STCU had engaged in an unusual project 9910, related to Arctic 650 foam procurement in Iraq. The project was initiated as a result of the request of one of the funding parties – the US State Department. The project was realized in a couple of days, including the procurement process.

During our audit we have identified that the official project approval by the Governing Board was received subsequently to the project roll-out. In our view, such approach is not in line with the STCU internal policies as documented for 2016. From discussion with the management, we understood that the practice for signing and commencing the projects without all approvals from all Governing Board members is likely to continue due to limited frequency of the Governing Board meetings (twice a year in 2016).

Implications

Because projects are approved by the Governing Board only on a post factum bases, this provides grounds for possible conflicts of interest, for instance between the Governing Board, and put under risk of subsequent questioning the decisions made by the STCU management. It also rises question when the project should be recognised in the Designated Capital Accounts.

Recommendation

We suggest the Company to adjust the internal policies to better reflect the needs of the Centre and avoid possible future conflicts if any of such project arise. For instance, negative confirmation procedure can be implemented whereby all Governing Board members are notified of the project being considered and given a certain number of days to object, after which potential continuation of the project become de facto approved.

Management response

Management agrees that project 9910 is extremely unusual, and more than likely will not occur in the future (success or failure of this particular project was measured in mere hours). Management also agrees that the STCU should discuss this matter further with the Governing Board to determine whether the funding parties would require an opportunity through negative concurrence to give prior approval to such projects and if so include such provision into our procedures. As the STCU continues to transform itself into a more efficient and nimble tool for use by the Parties to address their CBRN security priorities, Management wants to ensure that the Governing Board is comfortable with the changes required to facilitate this transformaion.

4 Bank charges

Observation

During the course of audit we have discovered differences in reconciliation of cash received between the STCU and the Partners We suspect the issue to be caused by bank charges. Based on the project agreements reviewed, the project Partner does not include a separate funding budget for the bank charges. Instead the STCU should have treated these bank charges as expenses and recognised in the Statement of Revenues and Expenditure upon cash receiving. For example, for the following projects: P672, P674, P003R, P554, there are difference between account receivables as of 31 December 2016stated by Partners and the STCU records. Possible reason for difference might be bank charges for which the STCU has not accounted for.

Implications

Bank charges are not budgeted separatly in the Project agreement; therefore the STCU should treat bank charges as expenses and recognise in the Statement of Revenues and Expenditure as soon as transaction arises.

Without having a clause on action regarding unspent cash resources of closed projects, the STCU puts itself into risk.

Recommendation

We suggest to the STCU to establish control over reporting to unspent amount from the project to the Project Partner and/or the STCU can add a condition in the Project agreement stating that after certain period of time after project closure all unspent cash resources are redirected to Undesignated Contribution capital and the STCU can decide how to allocate these resources.
We also suggest to establish weekly/monthly control over bank charges recognition in the Statement of Revenues and Expenditure.

Management response

Agreed bank charges incurred on receipt of payments from partners will be charged only to income and expenditure in future. Partners do not always pay whole invoices, however when invoices are paid in "full" these should be reconciled and any differences taken to bank charges.

The amounts involved are usually minimal and partners consider that once monies are paid to STCU that those monies are the total expenditure and do not request refunds. The exception to this is for projects that are terminated early or do not start for various reasons in which case the full amount of unspent monies are refunded. Management are of the opinion that for the amounts involved change to the partner agreement and paying refunds is not cost effective

5 Expense periodisation

Observation

We have noted that certain purchase transactions foresee deliveries of the equipment. Purchases of equipment are expensed in full at the moment of the invoice receipt from the Institute or Vendors, while the equipment itself might not be delivered until few months later.

Implications

The above approach to record project expenses, when all risks and rewards related to the purchased goods have not passed to the recipient, results in a misstatement of purchase expenses of the reporting period and does not follow accounting accrual basis.

Recommendation

We suggest to the Company to introduce a control over equipment delivery, and/or require the project managers to report as soon as the equipment is received, especially with an emphasis on purchases done around year end. Recognition of project expenses would then be done at the corresponding point of time.

Management response

Agreed, the expenses were primarily for the purchase of scientific equipment which had to be manufactured to order and part payment in advance was required. We will review project purchases prior to the year to determine whether prepayments are required to be raised at the year end.

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