

Development Fund for Iraq

**Management Letter
on Internal Controls**

For the period from 1 January 2004 to 28 June 2004

**KPMG Bahrain
September 2004**

This letter contains 4 pages



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To the International Advisory and Monitoring Board of the
Development Fund for Iraq
To the Project and Contracting Office
(successor to the Coalition Provisional Authority)

30 September 2004

Ladies and Gentlemen:

We have audited the Statement of Cash Receipts and Payments of the Development Fund for Iraq (the "Fund") for the period from 1 January 2004 to 28 June 2004, and have issued our report thereon dated 30 September 2004. In planning and performing our audit of the financial statement of the Fund, we considered internal controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statement. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control. We have not considered internal control since the date of our report.

We have also performed agreed-upon procedures on the Fund's Export Sales, Oil Proceeds Receipts Account and Disbursements for the period from 1 January 2004 to 28 June 2004, and have issued our Reports of Factual Findings in connection with these procedures dated 30 September 2004.

Additionally, we have issued our Management Letter for the period from 22 May 2003 to 31 December 2003 on 28 June 2004, in which we included matters and recommendations noted during our audit of that period. Our comments still apply for the period from 1 January 2004 to 28 June 2004.

Our audit procedures were designed primarily to enable us to form an opinion on the financial statement and therefore may not bring to light all weaknesses in policies or procedures that may exist and should not be relied upon to disclose errors or irregularities, which are not material to the financial statement. We aim, however, to use our knowledge of the Fund gained during our audit work to make comments and suggestions that we hope will be useful to you.

We noted no additional material matters involving internal control that have not been reported to you in our reports mentioned above.

Although the Coalition Provisional Authority ceased to exist on 28 June 2004, a number of United States Governmental organizations have been established to complete transition efforts and continue with Iraqi Reconstruction. Our comments and recommendations may be beneficial to the Project and Contracting Office in the development and implementation of internal control systems.

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We are pleased with the opportunity to discuss these comments and recommendations with the members of the International Advisory and Monitoring Board of the Development Fund for Iraq and representatives of the Project and Contracting Office, at the Board meeting on 11 October 2004 in New York. We thank the staff of the Project and Contracting Office and of the Interim Government of Iraq for their time and efforts during our procedures as we appreciate the unique challenges of working in Iraq.

This report is intended solely for the information and use of the International Advisory and Monitoring Board of the Development Fund for Iraq and the Project and Contracting Office, and is not intended to be, and should not be, used by, or relied upon by, anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited. We do not accept or assume responsibility for any other purpose or to any other person to whom this statement is shown or into whose hands it may come save where expressly agreed by our consent in writing.

Yours sincerely,

KPMG

KPMG Bahrain
Manama, Kingdom of Bahrain

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The response from the Project and Contracting Office to KPMG

We thank KPMG Bahrain Audit and Risk Advisory Services for the completion of this audit reviewing the Coalition Provision Authority's (CPA) management of the Development Fund for Iraq (DFI) for the period 1 January 2004 to 28 June 2004.

First, and of foremost importance for the people of Iraq, is the positive opinion in the auditors' report that the DFI Financial Statement *"presents fairly, in all material aspects, the receipts and payments of the DFI for the period from 1 January 2004 to 28 June 2004 in accordance with the International Public Sector Accounting Standard "Financial Reporting for Cash Basis of Accounting" (Statement of Cash Receipts and Payments, p.2, par.1)* except as qualified on page 1 of the Statement of Cash Receipts and Payments portion of the report.

The DFI was established as a means to transparently manage Iraqi funds to meet Iraq's humanitarian, relief and reconstruction needs. The DFI was used to pay salaries of government workers, fund government operations, and contract for essential services and reconstruction activities through the 2003 and 2004 Iraqi budget cycles. The Fund was also used to provide financing to the Commander's Emergency Response Program and the Regional Rapid Response Program, allowing military personnel and coalition civilians closest to urgent requirements to take immediate remedial action.

The largest portion of DFI funds was disbursed from the Iraqi Ministry of Finance to the individual Iraqi Ministries that used them to pay salaries and fund ministry operations. As confirmed by KPMG procedures of sample disbursements: The payroll disbursements from the Iraqi Ministries were made in accordance with the accounting records and other supporting documentation; and the Iraqi Ministries followed all key internal controls for the contract bidding approving and award processes with only minor deviations. KPMG also states that except for minor deviations, the Iraqi Ministries had adequate documentation for goods received and services rendered. Because the Iraqi ministries lacked basic information technology capabilities, ministries were not able to produce disbursement reports to compare with the Iraqi National Budget. A new Financial Management Information System will be implemented as from 2005 that will address this shortcoming.

The \$1.4 billion dollar June disbursement made by the CPA to the Kurdish Regional Government (KRG) was made pursuant to the "transfer payments" line item of the Iraqi Ministry of Finance budget. The funds were to be applied to critical KRG projects of the kind previously financed pursuant to the Oil for Food program.

KPMG highlighted instances where DFI regulations were followed, but also noted internal control weaknesses relating to the disbursement of funds from the DFI. These weaknesses were caused by a combination of factors: high turnover by senior level staff, a difficult security situation that restricted movement around the country, and an inadequate information technology infrastructure which prohibited the creation and transfer of key documents. The KPMG report notes where appropriate corrective actions have already been taken.

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CERP

The report of factual findings on disbursement highlights, with some deviations noted, that internal controls were generally followed for the Commander's Emergency Response Program (CERP). The general purpose of the CERP fund was to give Coalition military forces the ability to provide immediate assistance as needed for humanitarian, rehabilitation and reconstruction projects. Because of the desire to quickly respond to urgent situations, internal controls were not always followed.

KPMG found cases where CERP funds were used to pay Police Academy Students and Iraqi Police salaries. In those instances, the Coalition forces determined that the DFI funds obligated through the budget for this purpose would not arrive in a timely manner. Therefore, they used CERP funds to pay the salaries and in general reimbursed those funds with DFI operating budget money when it arrived. Management notes that additional guidance was issued to the military commanders reemphasizing the need to follow the established internal controls for this program.

RRRP

KPMG also noted that key internal controls and procedures for the Regional Rapid Response Program (RRRP) were generally followed, with some deviations. RRRP was initially conceived as a civilian equivalent of the CERP fund; a tool for civilian staff posted around Iraq to support the needs of local communities on an immediate basis. Most payments to contractors were made in cash, as Iraqi banks were not capable of executing electronic transactions of funds. The projects financed by RRRP created thousands of jobs for local Iraqis. Small to medium-sized projects made noticeable improvements to local communities. The development of local government in Iraq was strengthened as community leaders worked with CPA personnel to identify development projects and urgent needs.

KPMG raise legitimate concerns with regard to RRRP documentation. Corrective action is underway including:

- An ongoing audit of the RRRP program and financial management by the CPA Inspector General; and

- Design and implementation of a fully integrated database for reconciliation of all receipts, contracts and authorizations. This database will be implemented over the next several months. The first of several new staff hired for this specific task of reconciliation is due to arrive in mid October.