

**Memorandum of Matters Arising from Audit**

*FOR*

*Development Fund for Iraq*

**FOR THE YEAR ENDED  
31 DECEMBER 2006**

**Private and confidential**

30 April 2007

**TO THE GOVERNMENT OF IRAQ AND THE INTERNATIONAL ADVISORY  
AND MONITORING BOARD OF THE DEVELOPMENT FUND FOR IRAQ  
BAGHDAD - IRAQ**

Dear Sirs,

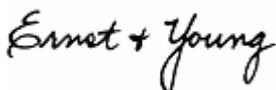
In accordance with our firm's normal practice, we enclose a memorandum of matters arising from our audit visits in connection with our audit of the statement of cash receipts and payments of the Development Fund for Iraq for the year ended 31 December 2006.

We stress that our normal audit procedures are designed primarily with a view to expressing our opinion on the statement of cash receipts and payments and that our comments do not attempt to indicate all possible improvements in internal controls, which a special review might develop.

We will be pleased to provide further information or hold additional discussions on the matters set out in the report, should you so wish.

We take this opportunity to thank the management and staff of the Ministry of Finance, Central Bank of Iraq and Board of Supreme Audit for their co-operation during the course of the audit.

Yours faithfully  
Ernst & Young



Baghdad, Iraq

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**DEVELOPMENT FUND FOR IRAQ  
MEMORANDUM OF MATTERS ARISING FROM AUDIT**

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**KEY ABBREVIATIONS**

|              |   |  |
|--------------|---|--|
| <b>DFI</b>   | - | <b>Development Fund for Iraq</b>                   |
| <b>MOF</b>   | - | <b>Ministry of Finance</b>                         |
| <b>IAMB</b>  | - | <b>International Advisory and Monitoring Board</b> |
| <b>CBI</b>   | - | <b>Central bank of Iraq</b>                        |
| <b>SOMO</b>  | - | <b>State Oil Marketing Organization</b>            |
| <b>BSA</b>   | - | <b>Board of Supreme Audit</b>                      |
| <b>FRBNY</b> | - | <b>Federal Reserve Bank of New York</b>            |
| <b>TBI</b>   | - | <b>Trade Bank of Iraq</b>                          |
| <b>UNSCR</b> | - | <b>United Nations Security Council Resolution</b>  |
| <b>OPRA</b>  | - | <b>Oil Proceeds Receipts Account</b>               |
| <b>COFE</b>  | - | <b>Committee of Financial Experts</b>              |
| <b>CPA</b>   | - | <b>Coalition Provisional Authority</b>             |

## Prior Year Matters Arising from Audit

## **1. FOLLOW UP OF PREVIOUS MANAGEMENT LETTERS RECOMMENDATIONS**

**Risk Rating: High**

### **Observation**

During our audit, we noted that the Board of Supreme Audit (BSA) followed up and requested the concerned parties to improve the weaknesses reported in the audit management letters issued by the external auditors.

To date, we have noted that there is no formal action plan developed by the Central Bank of Iraq (CBI) and the Ministry of Finance (MOF) for timely follow up and implementation of the recommendations of prior period audits.

We have however noted that a committee was constituted in February 2007 to take into consideration the recommendations of our management letter for the period from 1 July 2005 to 31 December 2005 in order to enhance and develop the work procedures of the DFI. This committee is represented by the CBI, MOF, Ministry of Oil and the State Oil Marketing Company (SOMO). The committee held its first meeting during April 2007. We have not yet been provided with a copy of the charter setting out the roles and responsibilities of this committee.

### **Recommendation**

We strongly recommend that action is taken to develop an action plan to address each of the points raised in the audit management letters. This should include details of action to be taken, responsibility for action to be taken and the timetable for taking the action. The timetable should be prepared taking into consideration the assessed risk rating for each point.

We further recommend that a status report is then prepared and reported on a periodic basis, either monthly or quarterly, highlighting the progress made and action still to be taken.

We also recommend that the charter for the newly established committee clearly sets out the above procedures, together with the authority of the committee to take appropriate action where points are not being addressed in line with the agreed timetable.

## **2. OVERALL INTERNAL CONTROL SYSTEMS**

**Risk Rating: High**

### **Observation**

We noted during our audit that the DFI's overall internal control system is not effective, due to the following main factors:

- Formal code of business conduct and ethics to be established.
- Comprehensive policies and procedures manuals to be developed for all areas of the DFI's operations.
- Organizational structure to be re-structured. DFI is currently managed by separate departments at Central Bank of Iraq under the supervision of the Ministry of Finance. However, there is no designated executive and financial controller to take responsibility for the direction of the DFI's overall activities.
- DFI does not yet have a formal risk management process to assess the risks of its operations and to continuously monitor the risk exposures and reduce the risks to acceptable levels.
- DFI personnel need more extensive training to be able to properly execute their responsibilities given the nature and complexity of the DFI's transactions.
- Human resource policies and practices relating to employee training, evaluation, counselling, promoting, and compensation need to be developed
- Not yet an internal audit department dedicated for the DFI. Audit procedures carried by the internal audit departments in both the Central Bank of Iraq (CBI) and the Ministry of Finance (MOF) are limited and only cover part of the DFI operations

### **Recommendation**

We recommend that the DFI undertake a detailed review of the DFI's overall internal control systems and develop a plan and timetable to address the various internal control related issues.

In addition, we recommend that an executive be appointed and made responsible for directing the overall activities of the DFI at all locations, including the MOF, CBI, SOMO, spending ministries, Kurdistan Region, etc. Consideration may also be given to establishing an executive committee (involving executives from the key locations) to oversee the DFI operations and to report to the Committee of Financial Experts (COFE) and the IAMB on a periodic basis.

### **3. DFI ACCOUNTING RECORDS**

**Risk Rating: High**

#### **Observation**

We noted that the DFI accounting records are based on information obtained from the CBI, and monthly statements sent by the CBI to the MOF. This information is limited to the transactions of the DFI's main account at the FRBNY.

As a result, the DFI does not maintain a complete set of accounting records to support the financial statement and the related notes disclosures for the year ended 31 December 2006. The statement of cash receipts and payments is compiled from the monthly statement of cash receipts and payments of the DFI's main bank account managed by the Central Bank of Iraq (CBI), the DFI's sub-account maintained by the U.S. Agencies, the FRBNY bank statements and other financial information maintained by the Ministry of Finance and confirmations received from other parties.

We did however note that the MOF has established and implemented a new database for the DFI during 2006, and the development of this database is in progress and due to be fully completed during 2007.

#### **Recommendations**

We strongly recommend that the CBI and/or the MOF keep complete set of accounting records to account for all DFI approved transactions and reconciled with the bank statements obtained from the CBI and the FRBNY.

Periodic reconciliations should also be performed between the MOF and CBI and any differences should be investigated, reported and resolved on a timely basis.

In addition, we recommend that the COFE issues a resolution to require that the DFI accounting records be separately maintained from the current MOF records, which are maintained in accordance with the government accounting system. The DFI's accounting records should be maintained in accordance with the cash basis under International Public Sector Accounting Standards.

In the meantime, the MOF should continue to develop the DFI's database to support all figures reported in the financial statements and related disclosures. Employees should also receive appropriate training to carry out the preparation of the DFI's financial statements in accordance with the cash basis under International Public Sector Accounting Standards.

#### 4. ACCOUNTING SYSTEMS

**Risk Rating: High**

##### **Observation**

The present accounting system relating to accounting procedures, including management information systems and internal control procedures, are no longer suitable for the present size and structure of the DFI, and have not been updated in line with the new technologies and best practices now available.

We understand that the Iraqi Government is currently undertaking an overall change in the computerized accounting system of the Accounting Department.

##### **Recommendation**

We recommend that the DFI undertakes a review of the accounting systems and processes and internal controls related to the DFI at MOF, CBI, SOMO and related ministries; with a view to improving efficiency of operations and effectiveness of controls. This should include, as a minimum:

- Policies and procedures manual.
- Control procedures in connection with the other sections of the accounting department.
- Review of the accounting department's documentation and filing procedures.
- Review of the operating departments' system of internal controls.
- Consider providing online access to automated system to the internal audit department.
- Establishment of procedures for follow up of budget preparation and compliance.

Given the above, we recommend that the DFI consider in developing or sourcing an integrated Accounting and Reporting Package together with Management Information Systems (MIS) and Financial Information Systems (FIS) which fully meets the requirements of the DFI operations at all locations.

## 5. POLICIES AND PROCEDURES MANUAL

**Risk Rating: High**

### Observation

We noted that DFI does not have formally detailed policies and procedures to cover all areas of its operations. The MOF periodically issues accounting instructions to set out the procedures to be applied in performing certain tasks. However, these instructions are not comprehensive as they do not cover all the aspects of the DFI's operations. Furthermore, these instructions have not been formally codified in the form of a comprehensive policies and procedures manual, which is readily available for reference by the staff involved in the DFI activities.

### Recommendations

We recommend that the DFI develops a comprehensive policies and procedures manual to cover all DFI operational, administrative, accounting and financial activities

The manual should also be reviewed on a periodic basis to ensure that it is updated and is relevant for providing operational, administrative, accounting and financial guidance to the DFI's staff.

In addition, detailed monitoring procedures should be developed and applied by the DFI to ensure proper and consistent implementation of the policies and procedures manual.

## **6. AUTHORIZATION OF DISBURSEMENTS FROM THE DFI ACCOUNT**

**Risk Rating: High**

### **Observation**

The payments of the DFI funds are authorized by H. E. Prime Minister together with H. E. Minister of Finance or their representatives. Payments are made through allocating funds that represent the maximum limit of payments to cover financing requirements through the DFI account. These allocations usually range between USD 300 million and USD 800 million for each allocation. The period to be covered by these allocations is not predetermined and the allocations are not immediately withdrawn from the Federal Reserve Bank of New York (FRBNY).

Afterwards, payments orders to transfer the funds from the FRBNY account to the Central Bank of Iraq (CBI) are carried out. These transfers are made out of the allocations of the Ministry of Finance at the FRBNY solely based on written approval by the MOF's Director General of the Accounting Department, with no limit to the amount to be transferred. Given the funds available in the DFI account, this may be considered to be excessive authority.

Considering the DFI's ineffective overall internal control systems, there is no adequate controls to either prevent or detect the risk of unauthorized payments being made on a timely basis.

### **Recommendation**

We recommend that the DFI develop an authorization manual to govern all DFI transactions, including payments from the FRBNY account to the CBI account, to ensure that adequate controls have been put in place.

This authorization manual should include the authorities and limits granted to Director General of the Accounting Department and each person involved in the DFI management, and where appropriate, dual or more signatory requirements.

## **7. DELEGATION & AUTHORITY MANUAL**

**Risk Rating: High**

### **Observation**

Payment orders through the DFI account, issued by the Ministry of Finance, are carried out by the Investment Directorate in the Central Bank of Iraq (CBI) by issuing payment orders approved by three employees from middle management at the CBI. A summary of payment orders is then prepared, indicating payment orders numbers, Ministry of Finance approval numbers and the beneficiary ministry, in order to be approved by the high management level in the CBI.

The CBI's authorized signatories list, however, does not include a formal authority matrix that specifies the role of each of the CBI's authorized persons and their approved limits to authorize and execute the banking transactions of DFI.

### **Recommendation**

We recommend that the MOF develop an authorization matrix to govern all DFI transactions to ensure that adequate and appropriate controls have been put in place.

The authorization matrix should specify the authorized positions, authorized activities and the authorization limit for each type of DFI activities and transactions, including cash transfers and payments.

The types of authorities are as follows:

- Initiate
- Review
- Approve

The authorization matrix of the DFI should be reviewed and approved by the COFE, the IAMB and the Government of Iraq.

Based on the internal control best practices, no individual should have the sole authority to sign and execute bank payment transactions above a pre-determined limit. All transactions above this limit should therefore be signed by two or more signatories based on the approved authorization matrix.

## **8. BUDGET PREPARATION**

**Risk Rating: Medium**

### **Observation**

During our review of the procedures followed by the budget section relating to the review of the departmental budgets, we noted that the budget section does not refer to the prior year budgets and actual expenditure in order to challenge the proper preparation of effective budgets prepared by the various Government departments.

An effective evaluation of budgets prepared by the Government departments and determination is an important control procedure to ensure that the needs of each department are consistent with the activities, past performance and plans for the forthcoming year. This includes assessing performance in prior year against budget to determine why there was either significant over or under spend.

### **Recommendation**

The departmental budgets review process undertaken by the budget section is a significant part of the Finance Department's activities relating to the follow up and review of Government expenditures. Accordingly, it is our belief that the DFI key management should give special attention to the budget compilation and review process undertaken by the budget section to ensure that adequate control procedures exist in such process.

A contemporary budget preparation and review environment would include, but it is not limited to:

- Review by the budget section of procedures undertaken by various departments to prepare their annual budgets. The budget section then ensures that adequate controls have been put in place by the various departments to facilitate an accurate budget preparation and, hence, reduce the time spent by the budget section in their review process of such budgets;
- The budget section should establish a process to identify transfers between different expenditure categories. This information would enable the budget section to identify expenditure items that have been over budgeted by any particular department in prior years and which are being used to finance the expenditure of other unapproved spending, if any;
- The budget section should establish a database of all departmental budgets and expenditures for each department for the purpose of establishing a benchmark for each expenditure item in relation to the activities and size of the related department. Such a database would enable the budget section to review department performance on a periodical basis (e.g. monthly) and investigate any significant variances compared to the benchmark. Such a database should also enable the budget section to identify areas of risk and opportunities for cost saving.
- The review by the budget section of department budgets should include a comparison of prior year budgets and actual expenditure. Such a review would highlight effectiveness of budget preparation process and also any significant changes or developments compared to the prior year.

## 9. REPORTING THE RECOVERED AND REFUNDED AMOUNTS

**Risk Rating: Low**

### Observation

During our audit of the DFI's statements in the CBI's records, we noted that some of the deposited amounts in the DFI account at the FRBNY do not have sufficient supporting documents, except for the transactions executed by SWIFT for FRBNY. The deposited amounts mainly are recovered from letters of credit cancellation, interest on cash margins or excess of funding over the required amount.

The following schedule shows examples of amounts that were deposited in the DFI account during 2006 without sufficient supporting documents:

|   | <b>Date</b>        | <b>Amount<br/>USD</b> | <b>Details</b>  |
|---|--------------------|-----------------------|---|
| 1 | July 27, 2006      | 2,568,018             | No information  |
| 2 | August 3, 2006     | 40,000,000            | Deposited by the International Food Program, but no information is available to identify the nature of this amount. |
| 3 | September 6, 2006  | 10,621,904            | No information  |
| 4 | September 20, 2006 | 63,732                | No information  |
| 5 | November 15, 2006  | 631,200               | No information  |
| 6 | December 4, 2006   | 1,782,044             | No information  |

These recovered amounts were included in other receipts in the DFI statement of cash receipts and payments. As the recovered amounts include refundable cash margins, recording the recovered amounts in other receipts, rather than offsetting against related letter of credit payments in the same period, overstates the cash receipts and payments balances.

### Recommendation

We recommend that all deposited amounts are adequately supported to assist in determining the nature of the receipts in order to properly classify these amounts in the financial statements.

## 10. DFI RECORDS AT THE CENTRAL BANK

**Risk Rating: High**

### Observation

The DFI's bank accounts at the FRBNY are managed by the CBI on behalf of the MOF and included as part of the CBI's accounting records.

As of 31 December 2006, there is an un-reconciled difference of USD 5.8 million between the balance recorded by the DFI and the related balance (maintained for control purposes) in the CBI records. We are however pleased to note that this has reduced significantly from the un-reconciled difference of U.S. \$ 104 million reported as of December 31, 2005 due to the correction of certain errors during the year.

This difference does not affect the DFI's statement of cash receipts and payments, as this statement was compiled directly from the Excel sheets database maintained by the CBI, the FRBNY statement and other external sources.

### Recommendation

We recommend that the CBI properly reconciles the remaining difference of USD 5.8 million and arranges for the appropriate adjustments to be made to resolve this difference.

We further recommend that the CBI maintains separate records for the DFI with complete and detailed documentation for each transaction. These records should then be reconciled with the FRBNY bank statement and the MOF records on a timely basis and any differences should be investigated, reported and resolved.

Once this process is properly established, the DFI financial statement should be prepared directly from the DFI accounting records, rather than the current Excel sheets database maintained by the investment directorate at the CBI.

## 11. DATA ENCRYPTION AND CONFIDENTIALITY

**Risk Rating: High**

### **Observation**

During our audit, we noted that several payment requests for oil exports are sent by the CBI's Oil Export Department to the correspondent banks of the CBI through internet mail.

This practice may result in security concerns over the integrity and confidentiality of the data as internet mail may not have the encryption and security protection required for such payment requests.

### **Recommendation**

To ensure the protection of confidentiality and integrity of data, we recommend that all payment requests with correspondent banks must be encrypted through CBI secured mailing system or by using SWIFT electronic transfer system.

## 12. INTEREST CALCULATION FOR REPURCHASE AND TREASURY BILLS INVESTMENT

**Risk Rating: Low**

### **Observation**

During our audit in the CBI, we noted that the investment department did not regularly recalculate the interest income from the Repurchase and Treasury bills investment related to DFI, and in the cases when the interest is recalculated, this procedure is neither documented nor reviewed by a supervising employee.

### **Recommendation**

We recommend that all interest received from any source should be recalculated to confirm this is in accordance with the investment agreement, and signed as being reviewed and approved by an authorized person.

### **13. U.S. AGENCIES OUTSTANDING CONTRACTUAL COMMITMENTS**

**Risk Rating: High**

#### **Observation**

We noted that the U.S. Agencies did not maintain a complete database of outstanding contractual commitments for contracts signed by the former CPA.

During our audit for the year ended 31 December 2006, we received Excel sheets extracted from the database showing detailed contracts information (i.e. contract number, contractor name, awarded date, date of completion, closeout date, contract value, amount paid, outstanding balance, contract status, related Ministry, etc). During our audit of these contracts, we noted the following:

- Status of some contracts (31 opened and 48 closed contracts) is not properly stated as certain contracts with completed status are still showing an unpaid balance (i.e. W914NS-04-D-0117 and DABV01-04-M-2247).
- Certain contracts closing dates are in 2007 but they are shown as completed contracts as of 31 December 2006 (i.e. DFIWAT-06-C-0021).

Based on the above, the controls to ensure the completeness of the contract database and the commitments outstanding balance at 31 December 2006 need to be improved.

#### **Recommendation**

We recommend that the U.S. Agencies that are responsible for administering and closing DFI funded contracts should ensure that the database contains all DFI funded contracts signed by the former CPA, together with any other new contracts, and that the status of all contracts are fairly stated in the contracts database.

## 14. U.S. AGENCIES CONTRACTS DATABASE

**Risk Rating: Medium**

### Observation

We noted that the contracts database being used by the contracting department is very simple and does not have any access privileges. Consequently, any of the contracting officers can access the contracts database to add, delete or change data without leaving an audit trail.

In addition, the contracts database is not integrated with the disbursements database.

### Recommendation

The U.S. Agencies should develop security procedures to properly control and monitor access to the database and ensure any additions, deletions or other changes are made only by authorised officers.

We further recommend that the U.S. Agencies consider integrating the contracts and disbursements databases.

## 15. PROJECTS HANDOVER TO THE GOVERNMENT OF IRAQ

**Risk Rating: Medium**

### Observation

The U.S. Agencies have been performing an administrative function on behalf of the Government of Iraq or the beneficiary ministry and following up payments to contractors. For this purpose, the U.S. Agencies use the DD250 form as a control to ensure receiving and inspection of materials or services. However, we noted that this form is not being signed by the representative of the Government of Iraq or the beneficiary ministry.

During the progress of the projects, U.S. Agencies issue letters to the Ministry of Finance to settle the due balance to each contractor. After the completion of the projects, the U.S. Agencies hand over the projects to the beneficiary ministry. We note that the beneficiary ministry does not sign any formal documents to confirm receiving the projects from the U.S. Agencies.

### Recommendation

We recommend that the U.S. Agencies inform the Government of Iraq representatives of the progress of the contracts to ensure all contracts and services administered by the U.S. Agencies are appropriately handed over to the Government of Iraq.

This will help the Government of Iraq to have more information about the status of the projects made for the benefit of the ministries. The DD250 form should be signed by the representative of the Government of Iraq or the beneficiary ministry to confirm this control is being carried out.

Also, the beneficiary ministry should sign the project hand over letter from the U.S. Agencies to confirm receipt of the projects, thus increasing the documented controls over completed projects administered by the U.S. Agencies.

## 16. CASH ON HAND AND DISBURSEMENTS LIMITS

**Risk Rating: High**

### Observation

We noted that the U.S. Agencies have no ceiling limits for either cash on hand and held in the U.S. Agencies vault or for cash payment transactions.

During our audit, we noted certain high value cash payments transactions, e.g. payment of U.S. \$ 10 million on 1 January 2006 to one U.S. Agency in order for that U.S. Agency to pay its suppliers and contractors. We requested but did not receive the supporting documents for the amounts paid to the suppliers and contractors.

### Recommendation

The U.S. Agencies should assess their cash requirements and ensure cash on hand held in the U.S. Agencies vault is maintained below a specified Limit should also be put in place for cash payment transactions in an effort to minimize cash payments to contractors and suppliers.

Also, the U.S. Agencies should ensure supporting documents for all subsequent payments to contractors and suppliers are retained and filed on timely basis.

## 17. DISBURSEMENT DOCUMENTS STAMPED AS PAID

**Risk Rating: High**

### Observation

We noted that the U.S. Agencies do not stamp the payments supporting documents (e.g. invoices) attached to the payment vouchers as “PAID” or otherwise defaced after the payment has been made. Therefore, there is a risk of duplicate payments being made for the same invoice.

### Recommendation

We recommend that the U.S. Agencies should ensure that all payments supporting documents are immediately stamped as “PAID” to reduce the risk of duplicate payments being made for the same documents and for better control over the payments process.

## 18. CLOSED CONTRACTS WITH OUTSTANDING BALANCES

**Risk Rating: Medium**

### Observation

We obtained a list from the U.S. Agencies includes contracts with “Closed Status”. Based on our review, we noted that there are 2 contracts still having outstanding balances due to two suppliers amounting to U.S. \$ 2,581,128 for contracts number DFIWAT-06-M-0003 and DABV01-04-C-9019

### Recommendation

We recommend that the contract database and contracts files should be revised to ensure the completeness and accuracy of the information and to ensure management reports are up to date and fairly reflect the current status of the contracts.

## Matters Related to Ministry of Finance

## 19. REPORTING AND FINANCIAL STATEMENTS PREPARATION

**Risk Rating: High**

### Observation

During the course of our audit, we noted that the MOF and the CBI do not prepare a complete set of DFI's statement of cash receipts and payments as part of the monthly management reporting. The CBI currently prepares a monthly report including the cash payments and cash payments of the main DFI account only, excluding the sub-account managed by the U.S. Agencies

In addition, we noted that there are no formally documented policies and procedures for the preparation of the DFI's financial statements and the related disclosures.

Moreover, the MOF does not maintain records for all financial information that should be reported and disclosed in the DFI's statement of cash receipts and cash payments as required by the International Public Sector Accounting Standards / Financial Reporting on Cash basis.

### Recommendation

For management reporting purposes, we recommend that the COFE issue a resolution to require both the CBI and the MOF to prepare a full set of the DFI's statement of cash receipt and cash payments on a more periodic basis, either quarterly or monthly.

We further recommend that formally documented policies and procedures are developed for the preparation of the DFI's financial statement, include the related disclosures.

**20. OLD OUTSTANDING CASH MARGINS AT JP MORGAN CHASE BANK**

**Risk Rating: High**

**Observation**

During the course of our audit, we noted a large number of old outstanding cash margin balances with JP Morgan Chase for letters of credit that were opened through the Trade Bank of Iraq (TBI) for the benefit of the Iraqi ministries that are financed by the DFI.

The following are examples of these outstanding balances as of 31 December 2006 according to the confirmation received from JP Morgan Chase.

| L/C #     | Ministry       | L/C Amount (USD) | Outstanding Amount (USD) | L/C Opening Date  | L/C Validation Date | Last Payment Date |
|-----------|----------------|------------------|--------------------------|-------------------|---------------------|-------------------|
| 160/2003  | Health         | 1,350,000        | 181,811                  | January 19, 2004  | April 28, 2004      | December 29, 2004 |
| 220/2004  | Electricity    | 3,867,559        | 203,161                  | March 2, 2004     | February 11, 2005   | October 13, 2005  |
| 225/2004  | Communications | 300,000          | 48,900                   | March 19, 2004    | August 9, 2004      | March 4, 2005     |
| 226/2004  | Electricity    | 7,412,370        | 799,896                  | March 17, 2004    | 31 December 2006    | March 4, 2005     |
| 1222/2004 | Health         | 1,870,457        | 374,091                  | December 16, 2004 | April 1, 2005       | June 5, 2005      |
| 1306/2004 | Oil            | 14,391,721       | 14,391,721               | March 17, 2005    | February 4, 2006    | N/A               |
| 1316/2004 | Agriculture    | 615,284          | 615,284                  | February 19, 2005 | October 20, 2006    | N/A               |
| 1345/2004 | Health         | 145,040          | 69,276                   | February 28, 2005 | November 28, 2005   | October 13, 2005  |
| 1453/2004 | Agriculture    | 3,900,000        | 3,900,000                | February 1, 2005  | September 1, 2005   | N/A               |

The above are only examples, as JP Morgan Chase confirmation includes a large number of similar old outstanding balances.

**Recommendation**

We recommend that the MOF and CBI coordinate with the Trade Bank of Iraq and the respective ministries to analyse the current status of each outstanding letter of credit cash margin and follow up and resolve all old outstanding balances.

Also, we recommend the CBI and MOF to follow up with the TBI and beneficiary ministries to ensure Letter of Credits are executed on a timely basis.

## 21. CASH MARGIN AT CORRESPONDENCE BANKS

**Risk Rating: High**

### Observation

During our audit, we noted that the CBI and the MOF do not maintain any records of the outstanding cash margins paid from the DFI on behalf of the Iraqi ministries.

According to the confirmations received from JP Morgan Chase and Citibank; the outstanding cash margin balances at these banks was USD 2,842,952,957 and USD 321,589,553 respectively as of 31 December 2006.

The letters of credit cash margins at the correspondent banks are not included as part of the DFI cash balances as they are not controlled by the DFI and are restricted for the payment of the outstanding letters of credit to the suppliers. However, the cash margins are considered DFI assets and any extra cash at the end of the letter of credit is to be refunded to the DFI account.

### Recommendation

We recommend that the DFI maintain complete records of the cash margin transfers to the TBI's correspondent banks and all related transactions, as these cash margins are considered as part of the DFI assets until being paid to the suppliers.

## **22. LETTERS OF CREDIT ISSUED FOR SELF-FINANCING ENTITIES**

**Risk Rating: Medium**

### **Observation**

We noted that self-financing government entities related to some ministries are transferring funds to the MOF current account at the CBI, and the letters of credit (LCs) are then being opened from the DFI funds at the FRBNY.

During the year ended 31 December 2006, payments were made from the DFI funds to cover letters of credit for certain self-financing government entities that are not covered by the federal state budget, which is financed by the DFI, amounting to U.S. \$ 363,781 thousand. Conversely, the MOF received advance payments from these ministries to fund the payments of their letters of credit amounting to U.S. \$ 534,554 thousand, which have not been deposited in the DFI accounts. These advances were deposited in the MOF account at the CBI.

The following are examples of these institutions:

- General Company for Irrigations / Ministry of Industry
- General Directorate for Water and Sewers / Ministry of Municipalities
- General Company for Agricultural Supplies / Ministry of Agriculture
- General Company for Medical Industries / Ministry of Health
- South Oil Company / Ministry of Oil

These arrangements may result in some confusion or disputes arising between the DFI funds and the MOF funds.

### **Recommendation**

We recommend that arrangements be made for the self financing entities to open their letters of credit directly at the Trade Bank of Iraq or other banks.

## 23. DFI DISBURSEMENTS FOR THE IRAQI MINISTRIES

**Risk Rating: High**

### Observation

Certain payments from the DFI account at the FRBNY are transferred to the MOF current account at the CBI to be paid at a later date to the Iraqi ministries and related entities and Kurdistan region in Iraqi Dinars in accordance with the allocated budget for each ministry. In the DFI's statement of cash receipts and payments, this transfer is reported immediately as cash payments, before actually being paid to the intended ministries and related entities.

Transfers from the DFI's account at the FRBNY amounted to USD 18 billion during 2006, while the total payments from the MOF to the ministries and related entities and Kurdistan Region was USD 17.72 billion.

The MOF current bank account at the CBI is used to deposit transfers from DFI and transfers relating to MOF own transactions that are not related to the DFI. The payments from this account that are related to DFI are not separated recorded from other transactions. As a result, it is not possible to identify the total payments related to the DFI and the beginning and ending cash balances related to the DFI.

### Recommendation

We recommend that the MOF consider opening a separate DFI sub-bank account at the CBI to deposit transfers from DFI bank account in the FRBNY, that are designated to finance the Iraqi ministries and related entities. That would assist in identifying the amounts paid from the DFI account and the remaining balance out of total transfers received from the DFI account at the end of each period. This would also enhance tracking all payments made to the respective Iraqi ministries and related entities, as well as managing the available cash balances and enhancing the reconciliation process with the beneficiary ministries.

We also recommend that the MOF prepares clear and complete documentation to define all sources of cash receipts and types of payments relating to the DFI.

## 24. RECONCILIATION BETWEEN THE MOF AND OTHER MINISTRIES

**Risk Rating: Medium**

### Observation

During the course of our audit, we noted that the MOF does not carry out monthly reconciliations of the payments transferred from the DFI to the ministries and government entities between the MOF records and the records of the other ministries and government entities records.

### Recommendation

We recommend that the MOF carry out monthly reconciliations with the records of the ministries and other government entities for payments transferred to cover their operating and capital costs, according to the budget allocated to each ministry. This will help the MOF ensure that all payments made to the ministries were properly recorded in the MOF records and would enhance the control over those payments.

We also recommend the MOF to send confirmations to the respective ministries and other government entities on a periodic basis in order to ensure the receiving and proper recording of amounts that have been funded, as well as to identify and reconcile any differences arising.

## 25. RECONCILIATION OF THE MOF'S CURRENT ACCOUNT AT THE CBI

**Risk Rating: Medium**

### Observation

The MOF's current account held at the CBI in Iraqi Dinar represents the main account of the MOF that is being used to finance the ministries and related entities and Kurdistan Region in accordance with the allocated budget for each ministry to cover their operating and capital expenditure in Iraqi Dinars.

During the course of our audit, we noted that the reconciliation carried out by the Ministry of Finance for its current account # 70009 held at the CBI is not being properly performed, as this reconciliation only compares the transactions per the CBI statement of account to the MOF statement of account and determines the outstanding amounts without agreeing / reconciling the balances.

### Recommendation

We recommend that the MOF prepares the reconciliation of the MOF current account in a proper manner that would properly reconcile the outstanding balances as recorded by the CBI and the MOF.

We further recommend that the reconciliation of the MOF's current account at the CBI should be carried out on a periodic basis, e.g. monthly, and all reconciling differences should be investigated, reported and resolved on a timely basis.

In addition, the reconciliation should be reviewed and approved by an independent person from the preparer of the reconciliation.

## **26. CBI TRANSFERS TO THE MOF'S CURRENT IQD ACCOUNT**

**Risk Rating: High**

### **Observation**

During the course of our audit, we noted that there is currently no written agreement between the MOF and the CBI as to the arrangements to be followed to finance the MOF's Iraqi Dinar current account at the CBI from the DFI.

The CBI is financing the MOF's current account, held at the CBI, by withdrawing the amount from the DFI account at the FRBNY in USD and then transferring an equivalent amount in Iraqi Dinar to the MOF's current account at the CBI. The exchange rate used is the CBI formal exchange rate on the date of transfer minus IQD 15 for each U.S. \$ 1 as commission charged by the CBI.

### **Recommendation**

We recommend the MOF and the CBI to prepare an agreement setting out the arrangements to be followed to finance the MOF's current account in Iraqi Dinars. This agreement should also include the date of the exchange rate applied by the CBI to purchase the USD from the DFI and the basis of commission to be charged to the MOF.

## 27. PAYMENTS FROM DFI SUB-ACCOUNT MANAGED BY U.S. AGENCIES

**Risk Rating: High**

### Observation

During the course of our audit, we noted that there is no party responsible for monitoring the U.S. Agencies sub account to check the accuracy of the payments and agree the amounts to the contract terms. Payment orders are issued from the U.S. Agencies and sent to the CBI for the contracts that are executed for the benefit of the Iraqi ministries and other U.S. Agencies after approval by the MOF, but there is no evidence of a review being carried out on these contracts and the related supporting documents.

We did however note that in early 2007 the MOF has started sending statements with the payments carried out from DFI sub-account to the ministries and other governmental institutions in order to ensure the receipt of goods or services.

### Recommendation

In addition to the above, we recommend that the following procedures be performed by the MOF:

- Follow up the receipt of the confirmations from the ministries and other government institutions to check the receiving of goods by the respective ministries.
- Check to ensure all payments are agreed to the supporting documents.
- Check that payments have been recorded properly by the respective ministries.
- Reconcile amounts paid with the CBI and FRBNY records.
- Check that all payments are in compliance with the contract terms.
- Ensure that all contracts' invoices have been stamped as paid, in order to avoid any duplicate payments.

## 28. SUSPENDED PAYMENT

**Risk Rating: High**

### Observation

During the course of our audit, we noted that an amount of U.S. \$ 46,000,000 was paid to Inter-Arab Investment Guarantee Corporation for partial settlement of the total amount of U.S. \$ 120,983,000 that is due to the Corporation based on the agreement with Ministry of Finance signed during December 2005. However, this paid amount has been recorded by the Ministry of Finance as a suspended advance payment, due to the fact that there is no allocation for such payment in the budget of 2006, and until the completion of further investigation and approvals.

### Recommendation

We recommend the MOF follow up and to try to conclude the investigation and resolve this issue on a priority basis.

## 29. UNITED NATIONS' COMPENSATION FUND

**Risk Rating: High**

### Observation

According to UNSCR 1483 (2003), the proceeds of export sales of oil and oil products shall be deposited into the Oil Proceeds Receipts Account (OPRA) at FRBNY and immediately thereafter 95% is required to be deposited in the DFI account at the FRBNY and the remaining 5% is to be deposited in the United Nations' Compensation Fund that was established in accordance with UNSCR 687 (1991) and subsequent relevant resolutions as a result of the Iraqi invasion of Kuwait during 1990.

We noted the MOF has no information about the following matters:

- Amount of disbursements made from the Compensation Fund to each beneficiaries and payments details and supporting documents.
- The balance available at the Compensation Fund as of 31 December 2006.
- The remaining outstanding amounts due to the United Nations Compensation Fund that should be deposited in the Compensation Fund subsequent to 31 December 2006.
- The estimated date of the final payment to the Compensation Fund.

### Recommendation

The Government of Iraq should consider taking necessary actions to address the above issues and to maintain sufficient information about the United Nations Compensation Fund for the purpose of making suitable disclosure in the notes to the DFI's financial statements.

### 30. COLLECTION OF AMOUNTS RESTRICTED ABROAD

**Risk Rating: Low**

#### **Observation**

During the course of our audit, we noted that an amount of USD 10,886,400 of the petroleum export sales was seized based on a seizure order issued by Court of Roma – Italy on 23 March 2006 as a result of a lawsuit against the Iraqi Ministry of Planning. We understand that the Government of Iraq believes that the court order violates UNSCR 1483 (2003).

#### **Recommendation**

We recommend the MOF coordinate with the Ministry of Justice and the Ministry of Foreign Affairs to follow up on this matter and take whatever action is required and justified to recover this seized amount.

## Matters Related to Central Bank of Iraq

### 31. AUTHORIZED SIGNATORIES ON THE DFI BANK ACCOUNT

**Risk Rating: High**

#### Observation

Based on our review of the confirmation received from the FRBNY on 10 January 2007, we noted the names of the following authorized persons continued to be listed even though they retired from the CBI during 2006.

- Former Deputy Governor.
- Former General Manager of the Investments Directorate.
- Former Manager of the Investment Directorate.
- Former Manager in the Letters of Credit Directorate.

#### Recommendation

We recommend that the CBI implement a process to immediately inform the FRBNY to cancel the authorization of any persons who retire or leave the CBI in order to avoid the risk exposure of any unauthorized payments being made by ex-management or ex-employees.

### 32. CLASSIFICATION OF DFI'S CASH RECEIPTS AND CASH PAYMENTS

**Risk Rating: High**

#### Observation

During the course of our audit, we noted that the CBI maintains an Excel database for all the DFI cash receipts and cash payments, where we noted the following:

- Cash payments are not classified in the CBI database in accordance with the presentation of each category of cash receipts and cash payments in the DFI financial statement.
- The CBI database is missing clarification information such as the MOF's payment order number, letter of credit number, beneficiary's name, the destination account number where the money was transferred and the description of each transaction.
- Some errors were encountered in the 'details' field of the database, e.g. the name of the ministry.
- Some receipts were misclassified, e.g. the interest received from JP Morgan Chase that was classified as other receipts instead of being classified as interest received.

#### Recommendation

We recommend that the CBI develop procedures to ensure the DFI cash receipts and cash payments are properly recorded and classified in accordance with the presentation of the DFI annual financial statement, which has been prepared in accordance with International Public Sector Accounting Standards / Financial Reporting on Cash basis.

### **33. INTEREST PAID ON CASH MARGINS**

**Risk Rating: Low**

#### **Observation**

During our audit on cash receipts, we noted that interest payments received from JP Morgan Chase on funds deposited as cash margins against opened Letters of Credit amounted to USD 118,387,943 during 2006 and the cash margin balance was USD 2,842,952,957 as of 31 December 2006, as stated in the confirmation received from JP Morgan Chase.

Interest payments are transferred to the DFI on a quarterly basis. However, there is no documented evidence that the interest received is recalculated by any party to ensure the accuracy and reasonableness of the amount of interest received.

These interest payments are recorded in the monthly statement of cash receipts and payments prepared by the CBI, although the source of these payments is not documented.

In addition, we noted that no interest was recorded in the DFI cash receipts against the cash margins held at Citibank amounting to USD 321,589,553 as of 31 December 2006.

#### **Recommendation**

We recommend that the CBI re-computes all interest received from the correspondent banks on a timely basis to ensure the amount is fairly stated.

Also, we recommend that the CBI follow up to investigate the reason for the interest related to the cash margins held at Citibank not being recorded.

### 34. PAYMENTS FROM THE DFI SUB-ACCOUNT

**Risk Rating: Low**

#### **Observation**

During the course of our audit, we noted that a detailed monthly statement is not being prepared by the CBI to record the details of the cash payments from the DFI sub-account at the FRBNY managed by the U.S. Agencies. The CBI only prepares a summary letter on a daily basis showing the cash receipts and cash payments of the sub-account.

#### **Recommendation**

We recommended that the CBI prepares a detailed monthly statement for all the payments made from the DFI sub-account showing the amounts paid, payment order numbers and the beneficiary name, in addition to the description of the nature of the transaction.

## Matters Related SOMO and Ministry of Oil

### 35. IMMUNITY

**Risk Rating: High**

#### Observation

In accordance with UNSCR 1483 (2003), certain Member States have taken legal steps, as considered necessary, to ensure immunity from legal proceedings for the purchase of petroleum and petroleum products originating in Iraq, until title passes to the initial purchaser, so as not to be subject to any form of prior judicial, administrative or arbitral lien or judgment. This immunity expires on 31 December 2007 unless the United Nations Security Council decides otherwise.

#### Recommendation

We recommend the Government of Iraq to consider what action is required to ensure the continuity of the immunity over the petroleum and petroleum products or to find out and assess any alternative procedures to protect the Member States.

### 36. COMPLETENESS OF PETROLEUM AND PETROLEUM PRODUCTS SALES

**Risk Rating: High**

#### **Observation**

During the course of our audit, we noted that the internal controls over the Iraqi oil industry were not sufficient to ensure the completeness of the export sales of petroleum and petroleum products for the year ended 31 December 2006, whereby the Ministry of Oil did not operate a full operational loading and metering system at loading points in order to determine loaded quantities accurately. Instead, the Ministry of Oil depends on the measures taken by the North Oil Company and the South Oil Company to determine the quantity of each shipment by referring to the Ullage report.

During January 2007, we noted that new metering systems were installed at the loading points only, but still no metering systems have been installed at the oil wells, storage facilities and refineries. However, these systems have yet not been calibrated and formally handed over to the Ministry of Oil.

#### **Recommendation**

We recommend that the Ministry of Oil follow up and accelerate the proper installation of the metering systems at the loading points, oil wells, storage facilities and refineries in order to enhance the controls over the Iraqi oil industry and ensure the completeness of the export sales of petroleum and petroleum products.

### 37. PETROLEUM PRODUCTS SALES

**Risk Rating: High**

#### Observation

During the course of our audit, we noted that the State Oil Marketing Company (SOMO) policy is to sell fuel oil through cash advances made by customers before shipping. Cash received from export sales of petroleum products during the year ended 31 December 2006 amounting to U.S. \$ 638,192,881 has been deposited in bank accounts controlled by SOMO.

According to UNSCR 1483 (2003), 95% of the proceeds of export sales of petroleum and petroleum products should be deposited in the DFI account. Accordingly, the cash receipts in the DFI financial statement for the year ended 31 December 2006 and the cash balance as of 31 December 2006 are understated by U.S. \$ 606,283,237.

Also, we noted that according to SOMO's records, the export sales of petroleum products excluding barter transactions during 2006 amounted to U. S. \$ 647,651,302, while the total proceeds deposited into local banks amounted to U.S. \$ 638,192,881. We were not provided with a reconciliation for the difference of U.S. \$ 9,458,421 between the total sales and total collections.

#### Recommendation

We recommend, in order to comply with UNSCR 1483 (2003), SOMO should arrange to deposit the proceeds of export sales of petroleum products in the DFI account on a timely basis.

We further recommend SOMO to reconcile all advances received with the related sales ledger and sales invoices on a monthly basis. Any reconciling differences should be investigated, reported and cleared on a timely basis.

### 38. BARTER TRANSACTIONS

**Risk Rating: Medium**

#### Observation

During the course of our audit, we noted that SOMO engaged in barter transactions with the Syrian Government for exports of petroleum and petroleum products. Barter transactions consist mainly of exports of fuel oil in exchange for petroleum products, and exports of petroleum in exchange for electricity and petroleum products. The total barter transactions during 2006 amounted to U.S. \$ 175,537 thousand. According to UNSCR 1483 (2003), 95% of the proceeds of export sales of petroleum and petroleum products should be deposited in the DFI accounts. As these were non-cash transactions, these barter transactions are not recorded in the DFI's statement of cash receipts and payments.

Also, according to the agreement between SOMO and the Syrian Government, when the amount due from the Syrian Government exceeds U.S. \$ 10 million for more than three months, a cash payment covering 75% of the due amount should be transferred to the other party. However, during the year, we noted that the amount due from the Syrian Government exceeded U.S. \$ 10 million for more than three months and no cash transfer was received during 2006.

The total amount due amount from the Syrian Government as of 31 December 2006 according to SOMO's records amounted to U.S. \$ 92,324,823. This amount has not been confirmed by the Syrian Government.

#### Recommendation

We recommend SOMO to send a statement of barter transactions on a monthly basis to the Syria Government, in order to minimise any disputes that may arise with respect to any amounts relating to exchanged products.

In addition, we recommend SOMO to request a confirmation of the balance outstanding from the Syria Government on a monthly basis and reconcile this confirmation to SOMO's records. Any reconciling differences should be investigated, reported and cleared on a timely basis.

**Matters Related to Contracts Administered By U.S.  
Agencies**

**DEVELOPMENT FUND FOR IRAQ  
MEMORANDUM OF MATTERS ARISING FROM AUDIT**

**39. U.S. AGENCIES NEW CONTRACTS**

**Risk Rating: Medium**

**Observation**

The DFI sub-account was established at the FRBNY during 2004 to be managed by the U.S. Agencies and monitored by the Iraqi MOF. The purpose of this sub-account is to facilitate disbursements for contracts signed by the former Coalition Provisional Authority (CPA), requiring payments subsequent to 28 June 2004. U.S. Agencies management of the DFI sub-account expired on 31 December 2006.

However, U.S. Agencies have signed new contracts during 2006 and which are still in progress during 2007. The total number of these contracts is 26, which include 19 contracts that were still in progress as of 31 December 2006, and amount to a total of U.S. \$ 41,741,783 as follows:

| <b>Award Date</b> | <b>Status</b> | <b>Contract number</b> | <b>Contract amount<br/>U.S. Dollar</b> | <b>Paid amount<br/>U.S. Dollar</b> |
|-------------------|---------------|------------------------|--|------------------------------------|
| 3 February 2006   | Completed     | DFIWAT-06-M-0004       | 130,930                                | -                                  |
| 26 February 2006  | In progress   | DFIWAT-06-C-0008       | 34,900                                 | -                                  |
| 15 March 2006     | In progress   | DFIWAT-06-C-0020       | 3,449,707                              | 2,783,636                          |
| 1 April 2006      | In progress   | DFIGRS-06-C-0001       | 1,421,000                              | 1,002,000                          |
| 10 April 2006     | In progress   | DFIWAT-06-C-0001       | 187,190                                | -                                  |
| 4 May 2006        | Completed     | DFIWAT-06-M-0001       | 63,000                                 | -                                  |
| 20 May 2006       | In progress   | DFIWAT-06-C-0014       | 2,195,963                              | -                                  |
| 1 June 2006       | In progress   | DFIWAT-06-C-0017       | 989,688                                | 94,500                             |
| 6 June 2006       | Completed     | DFIWAT-06-C-0018       | 205,000                                | 140,000                            |
| 6 June 2006       | Completed     | DFIWAT-06-C-0019       | 20,000                                 | 16,700                             |
| 6 June 2006       | In progress   | DFIWAT-06-C-0016       | 802,896                                | -                                  |
| 12 June 2006      | In progress   | DFIWAT-06-C-0022       | 989,000                                | -                                  |
| 14 June 2006      | In progress   | DFIWAT-06-C-0012       | 975,500                                | 943,099                            |
| 17 June 2006      | Completed     | DFIWAT-06-C-0021       | 891,456                                | 483,236                            |
| 17 June 2006      | In progress   | DFIWAT-06-C-0015       | 2,422,072                              | 1,667,994                          |
| 8 July 2006       | In progress   | DFIWAT-06-C-0023       | 2,439,700                              | -                                  |
| 11 July 2006      | Completed     | DFIWAT-06-M-0002       | 95,050                                 | -                                  |
| 13 July 2006      | In progress   | DFIWAT-06-C-0024       | 2,615,000                              | 769,000                            |
| 13 July 2006      | In progress   | DFIWAT-06-C-0025       | 185,238                                | -                                  |
| 20 July 2006      | In progress   | DFIWAT-06-C-0026       | 1,749,363                              | -                                  |
| 26 July 2006      | In progress   | DFIWAT-06-C-0027       | 4,621,937                              | 1,341,120                          |
| 14 August 2006    | Completed     | DFIWAT-06-C-0003       | 110,000                                | 32,500                             |
| 14 August 2006    | In progress   | DFIWAT-06-M-0003       | 1,609,230                              | 132,405                            |
| 17 October 2006   | In progress   | DFIWAT-07-M-0001       | 6,992,988                              | 6,194,078                          |
| 1 November 2006   | In progress   | DFIWAT-07-C-0001       | 372,550                                | -                                  |
| 30 December 2006  | In progress   | DFIWAT-07-C-0002       | 6,172,425                              | -                                  |
| <b>Total</b>      |               |                        | <b>41,741,783</b>                      | <b>15,600,268</b>                  |

**Recommendation**

We recommend that the U.S. Agencies develop a plan for the completion of all outstanding contracts and to hand over these contracts to the beneficiary Iraqi ministry on a timely basis.

#### 40. HAND OVER OF U.S. AGENCIES DOCUMENTS TO THE BSA

**Risk Rating: High**

##### **Observation**

During the course of our audit, we noted that on 11 December 2006, the U.S. Agencies submitted the contracts files and other supporting documents of the former CPA and the U.S. Agencies to the Iraqi Board of Supreme Audit (BSA).

According to the BSA letter dated 25 February 2007 to the U.S. Agencies, the BSA informed the U.S. Agencies that they found financial and legislative violations, which lead the BSA to review all the submitted documents. As a result of these findings, and the Government of Iraq has retained its right to request compensation for any financial damage to the Iraqi budget due to any financial or administrative actions taken by the U.S. Agencies during the execution of the contracts.

##### **Recommendation**

We recommend the findings of the BSA are followed up to determine what action is required to be taken.

**41. RECONCILIATION OF PAYMENTS MADE FROM DFI SUB-ACCOUNT**

**Risk Rating: Medium**

**Observation**

During the course of our audit, we noted that the CBI receives the MOF approval together with the U.S. Agencies statement that shows a summary of the payment order numbers requested by the CBI. The responsible person in the CBI then records this approval and supporting statement in a separate file. Subsequently, these orders are executed according to the payments orders issued by the U.S. Agencies.

We noted that an official documented reconciliation is not being carried out periodically on a monthly basis by the CBI and MOF of the payments orders issued by the MOF and the payments made from the DFI sub - account at the FRBNY managed by the U.S. Agencies. Based on our review, we noted that the following retrieved amounts were not taken into consideration in the CBI and MOF records during the year 2006:

|    | <b>Retrieval Date</b> | <b>Amount (USD)</b> |
|----|-----------------------|---------------------|
| 1  | January 4, 2006       | 311,523             |
| 2  | January 11, 2006      | 200,506             |
| 3  | January 11, 2006      | 104,179             |
| 4  | January 11, 2006      | 33,705              |
| 5  | January 11, 2006      | 106,663             |
| 6  | December 12, 2006     | 977,806             |
| 7  | December 13, 2006     | 59,480              |
| 8  | December 25, 2006     | 17,500              |
| 9  | February 7, 2006      | 24,700              |
| 10 | February 7, 2006      | 386,440             |
| 11 | February 8, 2006      | 109,429             |
| 12 | May 16, 2006          | 16,112              |
| 13 | October 20, 2006      | 86,467              |
| 14 | October 20, 2006      | 87,602              |
| 15 | November 16, 2006     | 208,786             |
| 16 | November 20, 2006     | 174,718             |
| 17 | December 11, 2006     | 208,759             |
| 18 | December 12, 2006     | 87,574              |
| 19 | December 12, 2006     | 86,440              |
| 20 | December 13, 2006     | 1,097,982           |
| 21 | December 13, 2006     | 321,726             |
| 22 | December 13, 2006     | 25,175              |
| 23 | December 13, 2006     | 840,625             |
| 24 | December 13, 2006     | 130,905             |
| 25 | December 27, 2006     | 53,489              |

**Recommendation**

We recommend that the U.S. Agencies investigate the reasons for such a high number of retrieved amounts. We also recommend that the CBI carries out a periodic reconciliation on a monthly basis of the payment orders issued by the MOF and the payments made from the DFI sub-account at the FRBNY managed by the U.S. Agencies in order to ensure the accuracy of all payments from the account and to reconcile all outstanding amounts on a timely basis.

## General Matters Arising from Audit

## **42. INTERNAL AUDIT DEPARTMENT**

**Risk Rating: High**

### **Observation**

During the course of our audit, we noted there is not yet an internal audit department dedicated for the DFI. Audit procedures carried by the internal audit departments in both the Central Bank of Iraq (CBI) and the Ministry of Finance (MOF) are limited and only cover part of the DFI operations.

The main objective of the Internal Audit Department should be to assist the DFI management to monitor the internal control systems over the DFI activities and focus on key issues or higher risk areas that require special attention to improve the controls over the accounting and operating activities of the DFI.

### **Recommendation**

We recommend that consideration is given to developing the following for the DFI:

1. Establish a dedicated internal audit department for the DFI.
2. Policies and procedures should be in accordance with the International Standards for the Professional of Internal Auditing as issued by the Institute of Internal Auditors (IIA).
3. Develop a risk-based audit work plan and internal audit programs approved by the COFE and the IAMB.
4. Develop an internal audit charter to clearly set out the organizational structure and to clarify authorities and responsibilities, including reporting.
5. Ensure that the internal audit staff have been trained properly and are qualified with appropriate levels of experience with the International Standards for the Professional of Internal Auditing.
6. Ensure that sufficient financial and operational resources are allocated to the internal audit department in order to enable the internal audit function to be effectively carried out.

### **43. CORPORATE GOVERNANCE**

**Risk Rating: High**

Corporate Governance is the system by which entities are directed and controlled, in the interests of stakeholders.

We consider the following to be essential elements of a Corporate Governance structure:

- An active Board of Directors;
- A proactive Audit Committee;
- A sound internal control framework;
- A relevant code of conduct defining ethical behaviour;
- Clear, enforced policies and procedures;
- Effective management of risk;
- An objective, well resourced internal audit function;
- An independent effective external audit;
- Systems that ensure transparent disclosure, effective communication and corporate accountability.

#### **Recommendation**

We recommend that the MOF performs a review of the DFI current Corporate Governance framework to identify any areas where improvements are required.

#### 44. SERVICE LEVEL AGREEMENTS

**Risk Rating: Low**

##### **Observation**

Service level agreements are agreements between related entities to provide key services and deliverables according to a pre-determined timetable. These are established to ensure that inter-related activities between all related entities are carried out in an effective and timely manner.

As there are many government entities involved in the DFI activities, the DFI may want to consider the implementation of service level agreements with the CBI, MOF, Trade Bank of Iraq (TBI), SOMO, and all other ministries.

In this case, the service level agreement would document the nature of documents and information that are to be exchanged and the time by which such documents should be exchanged. The service level agreement would also include other key interactions between these parties. Once an agreement is executed between these parties, it would be the responsibility of a designated individual / heads of each party to ensure that the terms of the service level agreement are adhered to. The MOF should then, on a periodic basis, perform an assessment to ensure compliance with the service level agreements.

##### **Recommendation**

We recommend that the DFI management consider the merits of introducing and implementing service level agreements with the CBI, MOF, TBI, SOMO, and all other ministries.

## **45. CONTROLS SELF ASSESSMENT**

**Risk Rating: Medium**

In recent years there has been a growing concern amongst large organisations that internal controls exceptions and breaches are not being escalated and resolved in a timely manner.

Controls Self Assessment (CSA) is a relatively new and growing methodology which places the responsibility for compliance reporting in the department or organisation unit, supported by clear guidelines as to what is defined as an internal control exception and the timeframe for reporting and resolving such exceptions.

This methodology is built on the following concepts:

- Exceptions and errors are clearly defined within the policies and procedures;
- Instructions on the escalation of errors and exceptions, i.e. to who such matters are to be reported, and the time frame by which such matters have to be reported, are specified;
- Actions to be taken by the person to whom such exceptions and errors are reported and the timeframe for resolution/escalation are also specified.

The application of CSA will mean that the responsibility for monitoring compliance with DFI's policies and procedures is entrusted to the individual departments on a full time basis. The role of the internal audit function would be to assess the effectiveness of the identification and reporting process.

In the absence of clear specific guidance on what constitutes an internal control error or an exception, and specific policies and procedures on how these are to be escalated and resolved, the decision whether to escalate a potential internal control exception is determined by lower level staff. Such staff may, either through poor judgment or out of fear of reporting bad news, not report the internal control exceptions to senior management. The absence of specific procedures for staff in respect of internal control errors, including deadlines for resolution or reporting to the directors of department levels, increases the risk that reported internal control exceptions are not addressed.

Finally in the absence of a structured reporting framework, the Director General of the Accounting Department does not receive a regular report on the current status of internal control compliance so that he is aware of any internal control issues which may arise and impact on the financial reporting.

### **Recommendation**

We recommend that management consider measures to implement a system of controls self assessment across all DFI activities and develop a structured framework to report all controls exceptions on a timely basis.

#### **46. AWARENESS OF CONTROLS**

**Risk Rating: High**

##### **Observation**

Given the complex nature of the DFI activities and the involvement of employees from different government entities, to the DFI should take action to raise the awareness of their employees of internal control and risk management concepts.

Training of this type is an integral part of employee induction or career development programs. Such practices go a long way to improving the internal control environment of an entity.

The objective is to help employees understand and appreciate the importance of internal control and risk management practices. This would assist the employees in complying with the DFI's policies and procedures and the Government of Iraq regulations in a more effective manner.

A better understanding of internal controls and risk management practices by the employees would also contribute to improving the overall control environment within the DFI. The process would help employees understand the risks involved and consequently understand the importance of complying with laid down policies and procedures. Employees may also be encouraged to contribute suggestions to improvements in the internal control system as employees who are in direct charge of a particular function would be more able to identify relevant control weaknesses

##### **Recommendation**

We recommend that management consider measures to increase the awareness of internal controls and risk management practices for all management and employees involved in the DFI's activities.

## **47. FRAUD REPORTING**

**Risk Rating: High**

### **Observation**

Fraud is a broad concept that refers generally to any intentional act committed to secure an unfair or unlawful gain. Financial fraud falls under four broad categories:

- Fraudulent financial reporting
- Misappropriation of assets
- Expenditures and liabilities for improper purposes (example: improper payment schemes)
- Fraudulently obtained revenue and assets, and costs and expenses avoided.

We note that the DFI does not have a formally documented policy to deal with fraud should it arise, or to prevent a fraud from occurring.

### **Recommendation**

We recommend that management consider the merits of establishing a “whistleblower” program which should provide employees and others a means of:

- Communicating concerns, anonymously if preferred, about potential violations of the Government of Iraq regulations, including unethical behaviour and actual or suspected fraud, without fear of retribution
- Obtaining advice before making decisions that appear to have significant legal or ethical implications

This program should operate independently of management. This independence can be achieved through administration of the program by establishing an independent party within the MOF, such as an ethics or compliance officer or internal auditor with appropriate experience and objectivity, who reports directly to the COFE.

We further recommend that management assess (a) the current level of fraud awareness within the employees involved in the DFI activities and (b) the potential for a fraud occurring and being identified and reported. Current procedures should also be reviewed to assess their sufficiency in addressing the risk of fraud, and amendments should be made to ensure that identification and reporting of a fraud is as timely as possible.