

Development Fund for Iraq

Appendix

**Matters noted involving internal controls and other
operations issues during the audit of the Fund**

For the period to 31 December 2003

KPMG Bahrain

June 2004

This report contains 16 pages



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To the International Advisory and Monitoring Board of the
Development Fund for Iraq
To the Coalition Provisional Authority

29 June 2004

Ladies and Gentlemen:

We have audited the statement of cash receipts and payments of the Development Fund for Iraq (“DFI” or the “Fund”) for the period from inception (22 May 2003) to 31 December 2003, and have issued our report thereon dated 29 June 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. Our comments and recommendations are critical by their nature and do not reflect the other internal control features of the Coalition Provisional Authority, including changes that have been made during 2004.

During our audit we noted certain matters involving internal controls and other operational matters that are presented in the appendix for your consideration. These comments and recommendations, which have been discussed with remaining senior members of the Coalition Provisional Authority, are intended to improve internal controls or result in other operating efficiencies. Certain minor items involving internal controls were not included in this management report; these were discussed with Coalition Provisional Authority staff as considered necessary. At the end of each section, we have incorporated the CPA’s responses to our comments and recommendations.

Our audit procedures are 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’s organization gained during our audit work to make comments and suggestions that we hope will be useful to you.



Although the Coalition Provisional Authority ceased to exist on 28 June 2004, we understand that to complete transition efforts and continue with Iraqi Reconstruction, an Iraq Reconstruction Management Office (IRMO) was established at that time. Our comments and recommendations may be beneficial to the IRMO in the development and implementation of internal control systems.

We are pleased with the opportunity to discuss these comments and recommendations with the International Advisory and Monitoring Board of the Development Fund for Iraq and the Coalition Provisional Authority representatives at the Board meeting on 14 July 2004 in Washington DC. We thank the Coalition Provisional Authority 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 Coalition Provisional Authority, 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,

A handwritten signature in black ink that reads 'KPMG' in a stylized, cursive font. Below the signature is a horizontal line.

KPMG Bahrain

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

1 Overall Control Environment

1.1 General background

- 1.1.1 The DFI was established during May 2003 by the power delegated by the President of the United States of America, pursuant to the approval of the United Nations Security Council Resolution (UNSCR) 1483, to the Administrator of the Coalition Provisional Authority (CPA).
- 1.1.2 The Fund consists of bank accounts with the Federal Reserve Bank of New York and the Central Bank of Iraq. In accordance with UNSCR 1483, the proceeds from export sales of petroleum, petroleum products and natural gas from Iraq are to be deposited in the DFI. In addition, the surplus funds from the UN Oil for Food program established by UNSCR 986, are to be transferred to the Fund. Furthermore, all Member States are obligated to freeze and transfer funds and other financial assets of the former Iraqi regime to the DFI.
- 1.1.3 Consistent with UNSCR 1483, the Fund is to be used in a transparent manner to meet the humanitarian needs of the Iraqi people, for the economic reconstruction and repair of Iraq's infrastructure, for the continued disarmament of Iraq, for the costs of Iraqi civilian administration and for other purposes benefiting the people of Iraq.

During our work we noted the following issues regarding the general control environment at the CPA.

1.2 Accountability of CPA personnel

- 1.2.1 As mentioned above, the Fund consists only of bank accounts and is not a conventional business. The DFI does not have employees but relies on CPA personnel to operate and control various aspects of the Fund.
- 1.2.2 During the course of our audit work we encountered difficulties in performing our duties and meeting with key CPA personnel. These included a lack of documented defined roles and responsibilities of CPA personnel, the rotation of key CPA personnel, limited access to the CPA Senior Advisor to the Ministry of Finance, in the absence of the CPA Administrator and the dissolution of the CPA on 28 June 2004.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

1.2.3 The CPA Senior Advisor to the Ministry of Finance, who is also the Chairman of the Program Review Board (PRB), was unable to acknowledge the fair presentation of the statement of cash receipts and payments, the completeness of significant contracts entered into by the DFI and his responsibilities for the implementation and operations of accounting and internal controls systems, designed to prevent and detect fraud and error.

1.2.4 Due to the sudden departure of the CPA Administrator, the statement of cash receipts and payments was approved by Mr. Nash, Director of the Iraq Reconstruction Management Office, responsible for completing transition efforts and continuing with the Iraqi reconstruction. Mr. Nash was not involved in the administration of the CPA.

1.3 Accounting system

1.3.1 In accordance with CPA Regulation 2 dated 15 June 2003, the CPA was required to obtain the services of an independent, certified public accounting firm to assist in the accounting function of the DFI. A firm was appointed in October 2003, and began their work during November 2003. The lead consultant represented to us that they are not a certified public accounting firm but a consulting firm. The consulting firm was tasked to develop a functional accounting system, to be run in parallel with the old system during March 2004, and became operational in April 2004.

1.3.2 The CPA had originally implemented spreadsheet-based accounting records that became rapidly insufficient to meet the requirements of the Fund. The revised accounting system consists of excel spreadsheets and pivot tables maintained by one individual from the consulting firm. The accounting system designed and implemented is a cash-based, single entry transaction listing rather than an accrual-based, double-entry bookkeeping system.

1.4 Accounting manual

The CPA issued various policy and procedure documents regarding controls over cash receipts and payments. We noted one case when a significant document was revised on numerous occasions without timely communication to CPA personnel. The consulting firm documented, using a flowchart approach, the main financial internal controls at the CPA with the most recent update having been performed during April 2004. We noted accounting procedures are not documented in a single manual. A manual would better serve to provide up-to-date guidance, eliminate confusion and be especially useful during periods of staff rotation.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

1.5 Inspector General duties

1.5.1 US Public Law 108-106 established an Inspector General (IG) function for the CPA on 6 November 2003, while the CPA was established in May 2003. This law stated that the IG would be appointed within 30 days thereafter, however the IG was appointed only on 20 January 2004. The IG initially visited Baghdad in February 2004 and additional IG staff mobilized during March 2004. The delay in appointment of the IG may have resulted in the loss of performance improvement opportunities. The IG informed us that work had commenced and no reports have been completed to date.

1.5.2 Based on the IG interpretation of the US Public Law, the IG's scope did cover Iraqi Ministries and their expenditures. We were informed by the IG, that the IG staff did not perform any audit work at Iraqi Ministries as they relied on the work performed by internal auditors of the Iraqi Ministry of Finance (MoF) and the Iraqi Board of Supreme Audit (BSA).

1.6 Disbursement controls over Iraqi Ministries

We were informed by the CPA Senior Advisor to the MoF, that the CPA relied mainly on the work performed by the internal auditors of the MoF and the BSA as the main control over Iraqi Ministries' spending of allocated budgets. We understand that due to security issues and non-availability of office premises, the number of visits to Iraqi Ministries by the BSA was limited in the first months post-hostilities.

1.7 Segregation of duties

The CPA Comptroller's office was responsible for recording DFI transactions, having signatory authority over DFI bank accounts and custody of cash with Coalition Forces. A separate department such as a treasury department should be responsible for the custody of cash to ensure a clear and adequate segregation of duties.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

The CPA's responses to the Overall control environment section

We thank KPMG Bahrain Audit and Risk Advisory Services for the completion of this audit reviewing the Coalition Provisional Authority's (CPA) management of the Development Fund for Iraq for the period 22 May to 31 December 2003.

First, and of foremost importance for the people of Iraq, is the positive opinion in the auditors' report that the DFI Statement of Cash Receipts and Payments (the Financial Statement) "*presents fairly, in all material respects, the receipts and payments of the Development Fund for Iraq for the period from 22 May 2003 to 31 December 2003 in accordance with the International Public Sector Accounting Standard 'Financial Reporting under the Cash Basis of Accounting'*". The single qualification to the opinion was that an unknown quantity of oil was smuggled out of Iraq following the war, resulting in a loss of oil revenue to the DFI. While oil smuggling was prevalent under Saddam, KPMG noted the key internal controls CPA put in place to prevent further illegal exports.

In this appendix the auditors identify additional areas that, although not significant enough to affect their overall opinion, nevertheless could be improved. We appreciate these additional insights and have provided our comments, as appropriate, within the various sections of this document.

KPMG reported, "*During the course of our audit work we encountered difficulties in performing our duties and meeting with key CPA personnel*". Although the auditor encountered difficulties, they were generally the result of the challenging work environment and the precautions the security conditions demanded. For example, retrieving a simple bank statement from the Central Bank of Iraq, or meeting with Ministry of Oil officials, presented significant security issues, as these facilities are located outside of the CPA secured area. A visit to either of these locations required a security detail of at least six persons. Even under these conditions, the CPA provided the data and interviews required to complete the audit.

The auditor stated that "Due to the sudden departure of the CPA Administrator, the statement of cash receipts and payments was approved by Mr. Nash, Director of the Iraq Reconstruction Management Office.... Mr. Nash was not involved in the administration of the CPA." However, both documents in question were also signed by the individuals who had served as the Chief Financial Officer and the Comptroller of the CPA.

The auditor identified an issue with regard to using a cash-based, single entry transaction accounting system, as well as having several separate accounting policies not combined to a

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

single accounting manual. We agree in principle with each of these issues. Immediately following the end of major hostilities, the CPA initiated cash-based accounting processes as a means to control all of the monies used to fund stabilization projects throughout Iraq. This process was an interim measure designed to track the inflows and outflows of the cash while a more robust accounting system was being developed. When 30 June 2004 was established as the projected date of transition to Iraqi sovereignty, the CPA did not believe it appropriate to continue efforts to create an Anglo-Saxon-based accounting system, even though such a system would provide for accrual accounting. An accrual-based system is being developed for Iraqi use. Although the cash-based, single entry system employed by the CPA was an interim solution, the DFI Fund Manager established internal controls to review all entries. It should also be noted that the data obtained from this accounting system was used to prepare the DFI Financial Statement, which received a favorable opinion from KPMG.

With regard to the CPA Inspector General, the auditor raises concerns that the CPA IG did not arrive in Baghdad until February 2004. However, there were other organizations involved in providing oversight. In May and June of 2003, representatives from the Department of Defense Inspector General, the General Accounting Office, the Defense Contract Management Agency and the Defense Contract Audit Agency were sent to Baghdad to provide oversight and support.

KPMG noted some deficiencies in internal controls (including the area of payroll which is the largest expenditure at the ministry level) within the ministries. We acknowledge those deficiencies existed and will provide the findings to the Iraqi Ministry of Finance. The CPA relied on the Iraqi Ministry Internal Auditors and the Iraqi Board of Supreme Audit to monitor disbursements made at the ministry level.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

2 Program Review Board

2.1 General background

The PRB was responsible for recommending expenditure of resources from the Fund and other sources. The PRB was also responsible for reviewing all identified resource requirements, and their subsequent prioritization and integration into a funding plan. The funding plan forecasts available resources, recommends allocation of these resources and justifies the proposed expenditures and the recommended manner of expenditures. All funding plans (programs) were to be recommended for approval by the PRB prior to approval by the CPA Administrator.

During our work we noted the following issues regarding the PRB:

2.2 Minutes

2.2.1 We noted PRB minutes did not always contain detailed, complete or clear documentation to obtain an understanding of discussions and issues. Additionally, the resolution of questions raised by participants was not always documented in PRB minutes. Minutes should be sufficiently detailed to ensure transparency of the fund allocation process.

2.2.2 Additionally, we found that PRB minutes did not include voting details for each PRB program recommended or rejected and justification for the decision. PRB programs are to be recommended on a majority basis, and therefore minutes should include voting details for each PRB program.

2.2.3 CPA Regulation 3 states the PRB may take official action only in formal sessions at which no fewer than 70% of the eleven voting members of the Board are present. We noted one case when a program funded by the DFI was recommended by only four voting members present, one case by only six voting members present and eight cases by only seven voting members present. The PRB should follow the CPA Regulation to ensure that the PRB process remains transparent.

2.3 Iraqi involvement

We noted PRB voting members consisted of ten CPA officials and one official from the Iraqi Ministry of Finance. Of the 43 PRB meetings held during the period to 31 December 2003, we noted the Iraqi official attended two meetings.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

2.4 Approval of programs by the PRB

2.4.1 We noted one case when a contract was awarded prior to the program being recommended for approval by the PRB. Contracts should not be awarded prior to program being recommended for approval by the PRB.

2.4.2 CPA Regulation 3 states the PRB may recommend programs for approval only in formal sessions. We noted one case when a program was delayed pending further justification during a PRB meeting, but subsequently recommended for approval out-of-session by the board members without documentation in subsequent PRB minutes. All allocations of funding to be recommended for approval by the PRB should only be taken in formal sessions and documented in PRB minutes.

2.5 PRB funding

2.5.1 We noted one case when a program was recommended to be funded using Appropriated Funds (APF), with DFI funds to be used only if APF were not approved. The program was subsequently funded by the DFI without further documentation. When DFI funds are used as a secondary source of funding, the reason for not utilizing the primary source of funds should be documented.

2.5.2 Additionally, we noted one case when a program was to be funded by a mixture of seized assets and DFI funds without documentation of the allocation of funds from each source. The two funding sources have separate accounting records and documentation of the funding allocation should be clarified to ensure transparency and prevent funds being utilized in excess of the approved allocation.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

The CPA's responses to the Program Review Board section

CPA took a number of steps to ensure DFI funds were used in a transparent manner and for the benefit of the Iraqi people. CPA established the Program Review Board (PRB) and published on the web its regulations and procedures, the PRB minutes and the status of DFI funds.

The audit report identified several areas that could have been improved. Specifically, the report cites that PRB minutes did not always contain complete detail of PRB discussions. While CPA regulations did not dictate the form minutes should take, we agree that minutes for some of the meetings could have been more detailed. The report also identifies some PRB meetings that did not have a quorum. While the lack of a quorum should have resulted in a postponement of the meeting, minutes were made available at the next meeting and recommendations from these meetings were reviewed by the CPA Administrator prior to his approval.

Overtime this process was improved. For example, adjustments were made to the meeting time and membership of the Program Review Board to significantly increase Iraqi participation. In addition, starting in October of 2003, the PRB minutes were published on the web in both English and in Arabic.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

3 Contracting

3.1 General background

Programs recommended by the PRB and subsequently approved by the CPA Administrator, requiring contractual assistance, are transferred to the CPA Contracting Unit (CU) together with the statement of work prepared by CPA staff. The role of the CU is to issue the Request for Proposal (RFP), evaluate bids received, award the contract and subsequently monitor the performance of the contractor.

During our work, we noted the following issues regarding the contracting process:

3.2 Request for proposal

3.2.1 The deadline given to contractors to prepare bids in response to the RFP was often very short. We noted a number of RFPs with deadlines for submission of bids of less than 5 days. This short deadline may have given potential contractors insufficient time to assemble a comprehensive bid for the contract under tender or may deter contractors from bidding. Furthermore, we noted numerous RFPs were issued several weeks or months after approval of programs and contracts were not awarded for several weeks or months after the submission deadline. While the cause of the delays is not known, a more timely issue of the RFP and award process could lead to improved efficiency. In addition, contractors should be given more time to prepare bids, ensuring all aspects of program requirements are considered.

3.2.2 A Technical Committee, appointed to evaluate bids received, did not always consider key elements when reviewing proposals. We noted one contract where three unsuccessful proposals had included key elements not considered by the successful bidder or by the Technical Committee. After commencement of the contract, terms of the contract were amended to include these key elements at additional cost, as they were necessary to fulfill the original intention of the program. Furthermore, the additional requirements were not tendered, but offered as a sole sourced contract to the original bidder. The Contracting Unit and the Technical Committee should have sufficient technical knowledge to ensure all the objectives of each program are met.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

3.3 Contract awards

3.3.1 We noted that the contract award evaluation criteria and discussions by the Technical Committee on strengths and weaknesses of individual bids were not always documented.

3.3.2 CPA contracting procedures state that financial background checks are to be performed by Contracting Officers (CO) to ensure adequate financial resources are available for performance of the contract. We noted one case when a large contract was awarded to a newly formed company without adequate background checks. A full financial background check helps to ensure that the successful bidder has the necessary resources to perform the contract.

3.4 Sole-source contracts

When contracts are awarded to a sole-sourced bidder, justification is not always documented in the contract file in accordance with the CPA's contracting procedures. Due to a high level of staff turnover, lack of organization in the CU and missing files, COs were unaware whether certain contracts were sole-sourced or had been tendered for. All sole source contracts should be clearly documented in the contract file.

3.5 Post-award monitoring

3.5.1 We noted COs do not always document justification for progress payments in the contract file regarding contracts for services, in accordance with the CPA contracting procedures. If contracts performance is not monitored, payments may be made to a contractor on the basis of invoices issued to the CPA rather than on performance of the contract.

3.5.2 We noted one case when an advance payment was made without a guarantee being obtained from the contractor for non-performance. To date, the contracted goods have not been delivered and are more than five months overdue. A bank guarantee should be obtained for all advance payments to contractors that cannot clearly demonstrate their reliability, based on previous experience and reputation.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

3.6 Other contracting issues

- 3.6.1 We noted the filing system in the CU was not well organized. The CU took substantial time to locate files and, in certain cases, was not able to locate several files we requested for our procedures. A filing system should be implemented without further delay, including a file tracking system.

- 3.6.2 We noted contract files did not always include documentation in accordance with the requirements of the CPA contracting procedures.

- 3.6.3 We noted contracts were not always re-assigned to another CO on a timely basis after CO rotation. The high level of staff turnover in the CU resulted in a significant loss of knowledge on re-assigned contracts. During our work, we were informed by re-assigned COs that they did not have sufficient knowledge of the contract history to address all our queries. All contracts should be re-assigned on a timely basis to ensure a comprehensive transfer of knowledge.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

The CPA's responses to the Contracting section

The CPA contracting unit was incredibly busy in the period following the end of major hostilities. Through 31 December 2003, the unit issued more than 800 contracts under difficult circumstances. The unit responded to the need for immediate procurements for pressing reconstruction activities. As part of this effort, the CPA frequently required rapid response for the procurement of services and equipment. While it would have been ideal to allow bidders a longer time to respond to proposals, the circumstances did not always permit them to do so. The environment and workload created some challenges, particularly, as the auditors indicated, in the area of maintaining organized and complete documentation.

CPA recognized the need for additional contracting resources. The US Army deployed an expanded contracting team to CPA in early 2004. The team assisted the Iraqi Ministries in establishing and defining requirements that were incorporated into solicitations for non-construction contracts covering a wide range of items. Other procedures were put in place to improve the processing and oversight of construction contracts.

Development Fund for Iraq
Appendix, continued
Matters noted involving internal controls and other
operations issues during the audit of the Fund

4 Other Issues

During our work, we noted the following additional issues:

4.1 Cash on hand

4.1.1 The CPA cash instruments were not reconciled to accounting records by the CPA Comptroller until April 2004. A formal reconciliation process is necessary to maintain control over cash balances.

4.1.2 Since the CPA Comptroller took over the custody of cash, independent parties (e.g. officials from other departments) did not verify cash held in the CPA vault. Independent cash counts improve the control over cash balances held in the CPA vault.

4.2 Payments

4.2.1 We noted three cases when the total value of signed contracts and disbursements exceeded the total allocation approved for PRB programs. Evidence that an increased allocation had been requested was not documented on the contract file.

4.2.2 We noted one case when funds had been transferred to an Iraqi Ministry as part of a project to equip police. To date, no supporting documentation has been received from the Ministry for disbursement of these funds. Documentary evidence for all disbursements made on behalf of the Iraqi Ministries should be retained on the contract file.

4.2.3 We noted one case when a PRB was allocated, approved and funds disbursed on the basis of several quotes without evidence of goods being delivered or invoice being issued.

4.2.4 The World Food Program (WFP) and the CPA agreed that the Iraqi Ministry of Trade (MOT) should act as the procurer for the 2003 Iraqi wheat and barley harvest. We were informed by CPA Advisors to the MOT that they lacked supporting documentation for disbursements made by the MOT. In accordance with the agreement between the WFP, the CPA and MOT, an audit is to be performed by an international accounting firm. To date, an audit has not been contracted for by any parties.

Development Fund for Iraq
Appendix
Matters noted involving internal controls and other
operations issues during the audit of the Fund

The CPA's responses to the Other issues section

The CPA Comptroller established internal controls over the receipt and disbursement of funds. As noted by the auditor, there should also have been an independent verification of cash on-hand. KPMG, as part of its audit, performed that verification and found no discrepancies.

We recognize the other issues raised by the auditors, in particular two cases requiring additional supporting documentation from the ministries, and will refer them to the appropriate Iraqi ministry or contracting official.