

Development Fund for Iraq

**Management Letter
on Internal Controls**

For the period from 29 June 2004 to 31 December 2004

KPMG Bahrain

6 April 2005

This letter contains 14 pages



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To the Government of Iraq
To the International Advisory and Monitoring Board of the
Development Fund for Iraq

6 April 2005

Dear Sirs,

We have audited the Statement of Cash Receipts and Payments of the Development Fund for Iraq (DFI or the Fund) for the period from 29 June 2004 to 31 December 2004, and have issued our report thereon dated 6 April 2005. In planning and performing our audit of the financial statement of the Fund, we considered internal controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statement. An audit does not include examining the effectiveness of internal control and does not provide assurance on internal control. We have not considered internal control since the date of our report.

We have also performed Agreed-Upon Procedures on the Fund's Export Sales, Oil Proceeds Receipts Account and Disbursements for the period from 29 June 2004 to 31 December 2004, and have issued our Reports of Factual Findings in connection with these procedures dated 6 April 2005.

During our audit we noted certain matters involving internal control and other operational matters that are presented for your consideration. These comments and recommendations, all of which have been discussed with appropriate officials at Iraqi Ministries and US Agencies, are intended to improve internal control or result in other operating efficiencies. Certain minor items involving internal control are not included in this management letter; minor items were discussed with appropriate officials as considered necessary.

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 gained during our audit to make comments and suggestions that we hope will be useful to you.

We are pleased with the opportunity to discuss these comments and recommendations with representatives of the Government of Iraq and the members of the International Advisory and Monitoring Board of the Development Fund for Iraq at the Board meeting on 18 April 2005 in Paris, France. We thank the officials of the Government of Iraq and their Ministries, especially Dr. Fahmi Jarrallah Rabia, and the US Agencies in Baghdad 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 Government of Iraq and the International Advisory and Monitoring Board of the Development Fund for Iraq, 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,



Michel Picard
Managing Partner
KPMG Iraq Desk

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1 Overall control environment

Following the dissolution of the Coalition Provisional Authority (CPA) on 28 June 2004, responsibility for the Development Fund for Iraq (DFI or the Fund) was transferred to the Government of Iraq. This responsibility includes complying with United Nations Security Council Resolutions (UNSCR) 1483 and 1546, and the maintenance of accounting records for the Fund.

1.1 Accounting records of the DFI

We were informed by the Ministry of Finance (MoF) that subsequent to the transfer of authority to the Government of Iraq, a DFI department (the Cash Management Department) has been established to prepare and maintain accounting records for the DFI. This department became operational in February 2005. Complete accounting records for DFI transactions were not maintained by the MoF for the period from 29 June 2004 to 31 December 2004.

The CPA implemented a spreadsheet-based accounting system which is still utilized for the DFI sub-account, established for CPA contracts signed pre-29 June 2004.

In its role as agent for DFI transactions, the Central Bank of Iraq (CBI) maintains accounting records for the DFI only in connection with payments and related authorizations, and receipts.

The absence of complete accounting records prevent the Government of Iraq from monitoring the receipts and payments for the DFI accounts, affects its ability to manage cash flows through the Iraqi budget and reduces the transparency of the DFI.

The Cash Management Department should prepare a complete electronic record of all DFI transactions from source documentation. They should also reconcile cash balances with the Federal Reserve Bank of New York (FRBNY), the CBI and US Agencies. Payments and funds returned for Letters of Credit (LCs) should be reconciled on a regular basis between the relevant Iraqi Ministry, the Trade Bank of Iraq (TBI) and the LC agent, JP Morgan Bank.

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2 Ministry of Oil & State Oil Marketing Organization

Export sales of petroleum and petroleum products are arranged and invoiced exclusively by the State Oil Marketing Organization (SOMO), the sales arm of the Ministry of Oil.

2.1 Unreconciled exports from Iraq

A reconciliation of the quantity of fuel oil produced, consumed locally, injected into the pipeline and wells, and exported contained unreconciled quantities of 618,203 tons of fuel oil. The implication is that the fuel oil produced was greater than that consumed and exported. Consistent with these unreconciled quantities, we noted that recorded export sales of fuel oil decreased by 561,596 tons during the current period, when compared with export sales for the prior period.

The estimated sale value of the unreconciled quantities is approximately \$69,000,000, when calculated using an average price per ton for fuel oil export sales for the current period. We were not provided with a satisfactory explanation for these differences.

The Government of Iraq should investigate these differences.

2.2 Metering system

A complete and operational metering system to monitor production, local consumption and exports of petroleum and petroleum products, has not been in place in Iraq since post hostilities.

The absence of a fully operational metering system reduces the ability of the Ministry of Oil to ensure that all exports of petroleum and petroleum products are recorded and invoiced.

We were informed by the Ministry of Oil that a tender to perform a study of the current systems in Iraq is ongoing, with the objective of implementing a metering system. Once a metering system is in place, the Ministry of Oil should undertake reconciliation, on a regular basis, of production, local consumption and exports of petroleum and petroleum products.

2.3 Proceeds of export sales and barter transactions

In accordance with UNSCR 1483, all proceeds from export sales of petroleum and petroleum products are to be deposited in the Oil Proceeds Receipts Account (OPRA) at the FRBNY, and immediately thereafter, 95% of proceeds are required to be deposited in the DFI, with the remaining 5% to be deposited in the Compensation Fund. We found that during the period from inception to 31 December 2004, \$97,762,019 of proceeds from the export sales of petroleum and petroleum products was deposited into two Iraqi bank accounts and one Jordanian bank account controlled by SOMO, bypassing the requirements of UNSCR 1483.

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We also found that during the period from inception to 31 December 2004, SOMO entered into barter transactions amounting to \$461,208,631, whereby exports of petroleum and petroleum products were exchanged for electricity and light petroleum products, bypassing the requirements of UNSCR 1483. Furthermore, as SOMO received cash allocations from the MoF to purchase light petroleum products for import, SOMO should no longer engage in barter transactions.

In accordance with US Executive Order 13303, dated 22 May 2003, proceeds from export sales of petroleum and petroleum products should be deposited into OPRA and held in the US, to ensure that proceeds are immune from attachment or other judicial process.

As a consequence of proceeds not being deposited into the OPRA account, and the use of barter transactions, payments were not made to the Compensation Fund. Based on the value of these transactions as recorded by SOMO, additional payments of \$27,948,533 should have been transferred to the Compensation Fund for the period from inception to 31 December 2004.

2.4 Accounting records

We found that accounting transactions for the import of light petroleum products are not recorded on a timely basis. We were informed by SOMO that the Distribution Company (a division of the Ministry of Oil) can take several months to remit documentation, preventing SOMO from recording transactions on a timely basis.

We were also informed by SOMO that an Iraqi company has recently been appointed to undertake the monitoring of quantities and qualities of imports of light petroleum products. SOMO should ensure that appropriate reconciliations are made between the information supplied by this company, information supplied by the Distribution Company and SOMO accounting records.

2.5 Pricing

SOMO's Official Selling Price (OSP) for petroleum, for European and American destinations, is mainly calculated using an average of PLATTS quotations for five consecutive days starting on the 15th day from the date of the bill of lading. OSP for Far East destination is calculated using a monthly average of PLATTS quotations for the calendar month of loading.

SOMO should consider adopting the monthly average of PLATTS quotations for the calendar month of loading for European and American destinations, to reduce the complexity of each invoice price calculation.

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3 Disbursements from the DFI

In accordance with UNSCR 1546, the proceeds from export sales of petroleum and petroleum products are to be utilized through the Iraqi budget. Funds are transferred from the DFI to the MoF and subsequently distributed by the MoF to other Iraqi Ministries in accordance with their individual budgets.

In addition, payments for letters of credit (LCs) are made directly from the DFI on behalf of the Iraqi Ministries, as the Iraqi banking system does not have the capability to execute wire transfers for LCs to international suppliers. LCs are facilitated by the TBI, in consultation with relevant Iraqi Ministries, and paid through JP Morgan Bank.

3.1 Commercial transactions

We found that the DFI was used for commercial purposes by Iraqi banks, offering international wire transfer services to customers, using the DFI as an intermediary.

The use of the DFI for non-governmental transactions may result in criminals, or associates of criminals, being able to conceal the source of funds transferred and their identity. The immunities afforded to the DFI may result in correspondent banks being unaware of the process by which monies are transferred and consequently, bypass anti-money laundering procedures.

The use of the DFI for non-governmental payments should cease immediately. The Government of Iraq should reiterate the purpose of the DFI to the CBI, and all transactions should be scrutinized prior to authorization, ensuring only governmental transactions are processed.

3.2 Funding policy for LCs

LCs are currently funded through two methods.

The first method involves payments being made directly from the DFI account at the FRBNY to JP Morgan Bank and charged against the relevant Iraqi Ministry budget. The second method involves cash being deposited by the relevant Iraqi Ministry, from cash received from the MoF for its own budget, or from cash directly deposited by the MoF on behalf of the Iraqi Ministries, into the TBI, then transferred to the DFI account at the CBI account in Baghdad and finally paid from the DFI account at the FRBNY to JP Morgan Bank.

The number of transactions required to fund LCs using the second method causes delays to contract performance. The second method has caused delays for the delivery of urgent goods, including essential food supplies.

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Disbursements for all LCs should be made directly from the DFI account at the FRBNY to JP Morgan Bank, and charged against the relevant Iraqi Ministry budget. This policy would reduce the accounting and administrative burden on the MoF and other Iraqi Ministries, accelerate the LC process, improve the controls over LCs and reduce bank fees.

3.3 Use of unauthorized LC providers

We were informed by the Ministry of Trade that certain LCs were issued through three Lebanese banks due to delays caused by the existing LC issuance process. These LCs were authorized by the MoF for urgent food supplies, however, we noted that payments to suppliers were not always made on a timely basis.

The use of unauthorized LC providers results in reduced control over the Iraqi Ministries by the Government of Iraq. Additionally, funds outside the protection of US Executive Order 13303 may be subject to attachment or other judicial process.

Adherence to the new LC funding policy, as noted in 3.2, should eliminate the delays in issuance of LCs and reduce the risk of attachment and other judicial process. Accordingly, the use of LC providers other than JP Morgan Bank should be prohibited immediately.

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4 The Iraqi Ministries

During our work at the MoF and the other Iraqi Ministries visited (Oil, Trade, Electricity and Construction & Housing), we noted the following matters:

4.1 Accounting records maintained by Iraqi ministries

We found that the Iraqi Ministries have mainly manual accounting records, with limited outdated financial software and computer equipment.

The absence of reliable electronic accounting records increases the risk of errors being recorded and remaining undetected. In addition, electronic accounting records facilitate timely financial reporting for consolidation by the MoF.

We were informed that a new financial management information system will be implemented for all Iraqi Ministries later this year, replacing manual accounting records. We recommend that as part of the implementation, the new system should be run in parallel with existing manual systems, especially while staff training and familiarization is ongoing, to ensure the completeness and accuracy of the new system. Additionally, data integrity, IT security, asset management and disaster recovery plans should be prepared and tested before manual systems are discontinued.

4.2 Bank reconciliations

We noted that certain Iraqi Ministries do not follow up on reconciling items noted in bank reconciliations on a timely basis. We also noted that the MoF records journal entries from bank statements received.

Accounting records should be prepared based on information from payment orders issued by the MoF, and remittance advice slips and other financial documents received from third-parties. Subsequently, accounting records should be reconciled against bank statements on a timely basis. The performance of timely bank reconciliations ensures completeness and accuracy of accounting records, and ensures that only authorized payments are made.

4.3 Reconciliation of funds transferred to the Iraqi Ministries

We noted that reconciliation of funds transferred by the MoF to receipts recorded in the accounting records of the Iraqi Ministries is not performed on a timely basis.

Monthly reconciliations should be performed on a timely basis by the Iraqi Ministries and submitted with the required monthly financial information to the MoF, to ensure that all funds disbursed by the MoF are appropriately recorded by both the MoF and the Iraqi Ministries.

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4.4 Trial balances

We noted that certain Iraqi Ministries did not provide the MoF with trial balances and other financial information on a timely basis, while other Iraqi Ministries did not provide any financial information to the MoF. Accordingly, the MoF is unable to prepare consolidated trial balances for the Government of Iraq. As at the date of this report, the most recent consolidated trial balance was for the period from 1 January 2004 to 31 August 2004.

A reporting timetable should be initiated, to ensure that the MoF obtains trial balances from the Ministries on a timely basis, enabling the MoF to monitor and control Ministry disbursements.

Furthermore, funds should only be released to the Iraqi Ministries when monthly financial reports have been submitted to the MoF.

4.5 Monitoring of budgets

We noted that the MoF and Iraqi Ministries did not perform a formal comparison of actual disbursements to the 2004 Iraqi budget.

The absence of a budget monitoring process reduces the accountability of Iraqi Ministries and the ability of the MoF to exert control over Ministries' cash management. Additionally, the absence of a budget monitoring process affects the ability of the MoF to forecast future cash requirements for the continued reconstruction of Iraq.

A formal budget monitoring process should be implemented, enabling the MoF to exert control over the disbursements of the Iraqi Ministries and accurately forecast future funding requirements.

4.6 Monitoring of US Agencies

A DFI sub-account was established at the FRBNY and managed by US Agencies to facilitate disbursements for contracts signed by the former CPA.

We noted that details of payments regarding these contracts were submitted by US Agencies to the MoF and other Iraqi Ministries, but were not included in their accounting records or budgeting processes.

All payments made on behalf of the Iraqi Ministries should be recorded in the accounting records of both the MoF and the relevant Iraqi Ministry, and allocated against Ministry budgets.

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4.7 Foreign Exchange

We were informed by the MoF that due to unforeseen demand for the new Iraqi Dinar note, the CBI exhausted their supply of the new note during 2004. Accordingly, as an interim measure, the MoF transferred US dollars to fund the Iraqi Ministries.

The Central Bank of Iraq should ensure that sufficient Iraqi Dinar cash reserves are maintained to cover periods of unforeseen demand, to reduce potential foreign exchange exposure to the Iraqi Ministries and avoid a negative impact on the confidence of the Iraqi people in the new Iraqi Dinar.

4.8 Employee evaluation

We were informed by the Iraqi Ministries that they do not have a comprehensive, documented employee performance evaluation system. Employee development is vital to improve the level of transparency and accountability in the budgeting and accounting functions. Additionally, implementation of effective evaluation systems will assist the Government of Iraq to hire and retain the best staff.

4.9 Staff handbook and training

We were informed by the Iraqi Ministries that there are no widely distributed manuals or documented guidance for employees regarding their duties and other organizational matters. Staff training to levels equivalent to their international counterparts is essential to ensure that modern systems and controls can be effectively implemented, especially given the isolation of Iraq for the past several decades. An effective training program and up-to-date manuals with modern procedures should be prepared and implemented.

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5 Contracting at the Iraqi Ministries

During our work at the MoF and the other Iraqi Ministries visited, we noted the following matters:

5.1 Requests for proposal

We found cases where solicitations for proposals to provide goods or services were only issued to suppliers selected by the relevant Iraqi Ministry. Additionally, we found that one solicitation required a non-refundable payment of \$10,000 to participate in the tender. For solicitations where competition is limited, there should be documented justification by the responsible committee, ensuring transparency of the contract award process.

5.2 Contract awards

We found that the contract award evaluation criteria and Technical Committee analysis are not always documented. Contract files should contain documentation of all analysis and evaluation details for contract awards, ensuring transparency of the contract award process.

5.3 Contracts awarded on a non-competitive basis

We noted that contracts were awarded on a non-competitive basis, without documented justification in the contract file. The policy of competitive, transparent and documented tendering should be reinforced to all Ministries. Where, in rare cases, non-competitive awards are made, the justification of contract award should be clearly documented, even for contracts awarded to Iraqi state-owned entities, to ensure transparency of the contract award process.

5.4 Letters of guarantee

We noted that although the Ministry of Trade contracts require letters of guarantee from their suppliers, letters were not obtained by the Ministry in most cases. Certain LCs for these contracts were funded by the Ministry of Trade and subsequently cancelled without penalty to the suppliers. We also found that contract extensions requested by suppliers were granted without penalty.

The Ministry of Trade should obtain letters of guarantee in accordance with contracts and these letters should be presented to correspondent banks in the event of non-performance. Letters of guarantee should reduce the costs incurred to the Ministry for LCs cancelled due to non-performance of contracts.

5.5 Post-award monitoring

We noted that the Iraqi Ministries do not always document the status of a project or include completion reports in contract files. All contracts should be monitored, with contract files containing material / services received reports, invoices and file notes, ensuring payments are made only for work performed.

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5.6 Internal audit

We found that the scope of the internal audit function at the Iraqi Ministries does not include the bidding and awarding processes. Internal audit should examine all Ministry activities to ensure that implemented procedures are followed.

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6 Contracts administered by the US Agencies

In July 2004, a DFI sub-account was established at the FRBNY by the Government of Iraq to fund contracts of the former CPA, requiring payment after 28 June 2004. The CBI has signing authority over this account and processes instructions received from the US Agencies after receiving approval by the MoF.

DFI contracts entered into by the former CPA are administered by US Agencies including the Project and Contracting Office (PCO), the US Army Corps of Engineers (USACE) and Coalition Forces in Iraq. The accounting function is performed by the DFI Disbursing Office, formerly the CPA Comptroller's Office. During the course of our work at the US Agencies, we noted the following matters:

6.1 Administration

We noted that contract administration involves several US Government Agencies and Departments (Defense, Treasury, and State) with departments separately performing budgeting, project management, contract administration, legal, accounting, finance and the inspector general functions.

A single US Agency should be granted ultimate responsibility for all contracts signed by the former CPA and paid through the DFI sub-account. Clear lines of reporting should be established to ensure central oversight and coordination of contract administration.

We received a draft plan by a US Agency for the coordinated administration of the remaining DFI-funded contracts administered by US Agencies. We were informed that this plan is expected to be approved and implemented during April 2005.

6.2 Contractual Commitments

We noted that the former CPA and the US Agencies had not maintained complete accounting records in respect of contractual commitments. We were informed by a US Agency that they provided the Government of Iraq with a list of contractual obligations as at 31 December 2004 of \$1,386,181. We were further informed that the MoF believes that the list is incomplete and inaccurate.

We noted that another US Agency has been appointed, and is in the process of compiling a new list of all financial obligations, using what it considers to be an appropriate methodology. We were informed by the appointed US Agency that they intend to ensure that all DFI-funded contract files are properly documented by 30 September 2005.

The completion of a comprehensive list of contractual obligations is essential to the Government of Iraq to allow them to effectively oversee management of the DFI sub-account by the US Agencies, and to ensure that additional funds required, if any, are appropriately budgeted.

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6.3 US Army Corps of Engineers

The US Army Corps of Engineers (USACE) administers several large projects funded by the DFI. We were informed by the USACE that they do not monitor and report the use of DFI funds to other US Agencies on a regular basis. We noted that the USACE does not specifically monitor the amount of cash received from the DFI against project disbursements and remaining obligations on DFI-funded contracts and task orders.

At our request, the USACE performed a reconciliation of cash received from the DFI per USACE accounting records to the accounting records of the DFI Disbursing office. We were informed that as at the date of this report, the amount received by the USACE of \$2,243,984,978 for the period from inception to 31 December 2004, was \$9,700,000 more than the amount transferred by the DFI Disbursing Office. We were informed by the DFI Disbursing Office that they are investigating these reconciling items.

We were informed that the finalization of completion costs on large construction contracts will take several years. Additional costs are expected, including cost over-runs. We were informed by the USACE that costs to complete are estimated to be between 2% - 4% of the final contract value. The funding source of these additional costs has not yet been determined.

We were informed by two US Agencies that repair and maintenance costs for large projects may not be clearly budgeted for by the Iraqi Ministries. Further, the expected costs to operate these facilities may not include appropriately skilled management.

We recommend that the Government of Iraq discuss with the USACE completion costs on long term projects and, accordingly, review their budgeting process to ensure that appropriate repair, maintenance and staffing costs are included in the annual budgeting process for the 2005 Iraqi budget and subsequent years.