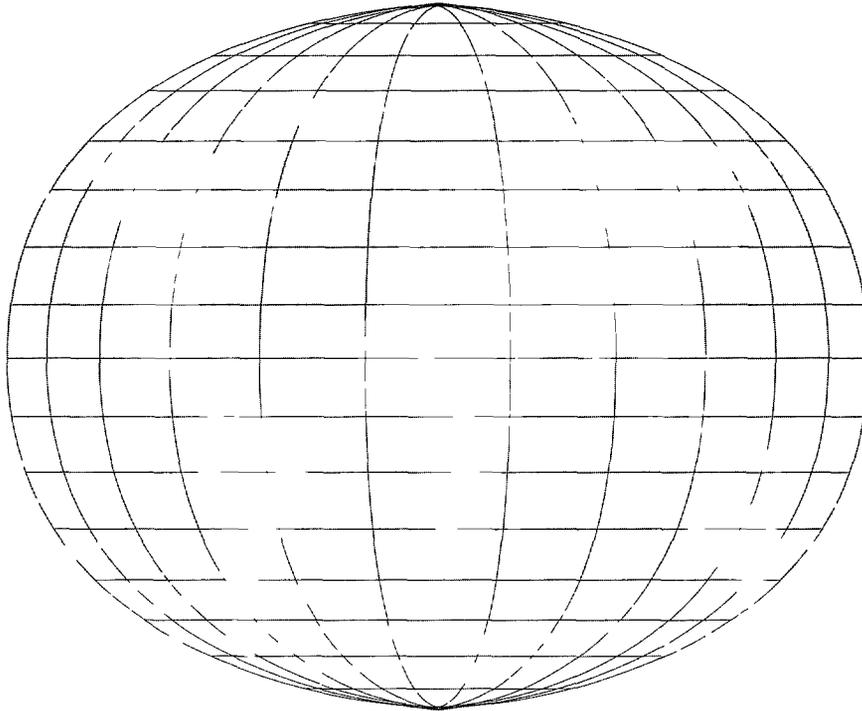


Report of Audit

**Agency-Contracted Audit of Ukraine Bureau of Freedom
House's Habits of the Heart Project for the Period
September 21, 1994 to January 31, 1998,
Cooperative Agreement Nos. 110-0007-A-00-4027,
121-0007-A-00-7040, and 121-0007-A-00-00059**

**Audit Report No B-121-99-001-N
January 14, 1999**



**“Financial information contained in this report may be privileged
The restrictions of 18 USC 1905 should be considered before
any information is released to the public”**

**Regional Inspector General
Budapest, Hungary**

**OFFICE OF INSPECTOR GENERAL
U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT**



UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT
OFFICE OF THE REGIONAL INSPECTOR GENERAL
NYAR UTCA 32 BUDAPEST HUNGARY 1071
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January 14, 1999

MEMORANDUM

TO Director, USAID/Kyiv, Gregory Huger

FROM RIG/Budapest, James R. Bonnell ^{for} *RJB*

SUBJECT Agency-contracted Audit of Ukraine Bureau of Freedom House's Habits of the Heart Project for the period September 21, 1994 to January 31, 1998, Cooperative Agreement Nos 110-0007-A-00-4027, 121-0007-A-00-7040, and 121-0007-A-00-00059 (Audit Report No B-121-99-001-N)

The attached report, prepared by the non-Federal audit firm Ernst & Young of Kyiv, Ukraine, presents the results of a financial audit of USAID resources managed by Freedom House for USAID/Kyiv's Habits of the Heart Project under three cooperative agreements

On September 21, 1994, USAID/Kyiv entered into a cooperative agreement with Freedom House, Inc to cover costs relating to the "Habits of the Heart" project, a project to promote democratic change in Ukraine by developing and working with indigenous public policy research institutions and reform-oriented, non-governmental organizations. The initial agreement provided \$1,225,000 to cover costs through September 30, 1996. Subsequent amendments and agreements increased funding to \$1,807,815 through January 31, 1998. The cooperative agreements included funding both for Freedom House, Inc (an American nonprofit organization) and its field office in Kyiv, Ukraine.

The objectives of the audit were to

- audit the Fund Accountability Statement and express an opinion as to whether the Statement presents fairly, in all material respects and in conformity with the basis of accounting described in the report, the use of funds in accordance with the grant agreement,
- consider the grantee's internal control structure in order to determine the auditing procedures for the purposes of expressing an opinion on the Fund Accountability Statement and to report on significant internal control deficiencies and material weaknesses, and

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MAY BE PRIVILEGED. THE RESTRICTIONS OF
18 USC 1905 SHOULD BE CONSIDERED BEFORE ANY
INFORMATION IS RELEASED TO THE PUBLIC

- test the grantee's compliance with the terms of the grant agreement as part of obtaining reasonable assurance about whether the Fund Accountability Statement is free of material misstatement, and report on any identified material instances of noncompliance

The auditors issued a qualified opinion on the Fund Accountability Statement because they

- were not able to obtain complete assurance that the funds advanced to subgrantees were expended for the purposes intended and that expenditures reported by subgrantees to Freedom House were not also reported to and recovered from other donors or sources of funding,
- were not able to obtain complete assurance concerning the completeness of revenues since Freedom House/U S could not confirm the exact amount of funds transferred to Freedom House/Kyiv for use in the project for the audit period due to inadequacies in its accounting system,
- identified unsupported costs totaling \$29,000, and
- found that Freedom House did not fully comply with Ukrainian accounting, foreign currency, or tax legislation when receiving and disbursing funds related to the project

The report also includes a disclaimer of opinion concerning the auditors' inability to audit \$873,640 in costs incurred in the U S by Freedom House, consisting of \$430,665 in administrative overhead costs and \$442,975 in direct expenses. In addition, the management letter that accompanied the report contained several other issues considered to be of lesser importance, including the lack of a disposition plan for non-expendable property purchased with program funding.

The report contains four recommendations concerning one material instance of noncompliance and three internal control weaknesses. It is the responsibility of USAID/Kyiv to ensure appropriate action is taken on all recommendations. However, based on our review we have only included the recommendations listed below in the Office of Inspector General's (OIG) audit recommendation tracking system.

Recommendation No 1. We recommend that USAID/Kyiv require Freedom House/Kyiv to develop and implement a consistent policy on the quality, extent and timeliness of financial reporting and documentation submitted by subgrantees to support their program expenditures.

Recommendation No 2. We recommend that USAID/Kyiv obtain a decision from USAID's Regional Legal Advisor on whether Freedom House is required to be registered with the Ukrainian Government and, if so, whether USAID funding should be contingent on the organization being properly registered.

Recommendation No 3. We recommend that USAID/Kyiv make a determination on the disposition of program-funded, non-expendable property purchased by Freedom House or its subgrantees.

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We did not include a recommendation on recovery of the unsupported costs of \$29,000 as Freedom House's contribution to the program exceeded the planned amount by more than this amount

One reason cited by the auditors for rendering a qualified opinion was that Freedom House/U S could not confirm the exact amount of funds transferred to Freedom House/Kyiv because of inadequacies in its accounting system and the auditors were also unable to review documentation for expenditures in the U S We have referred this matter to the OIG's Financial Audit Division for possible further review

Please respond to this report within 30 days indicating action planned or taken to implement the above recommendations Thank you for the cooperation and assistance extended to the Ernst & Young auditors and the Regional Inspector General representative during the audit

Attachment a/s

Ukraine Bureau of Freedom House's Habits of the Heart Project for the period September 21, 1994 to January 31, 1998, Cooperative Agreement Nos 110-0007-A-00-4027, 121-0007-A-00-7040, and 121-0007-A-00-0059

Ernst & Young, Kyiv, Ukraine

Audited
Fund Accountability Statement

Ukraine Bureau of Freedom House
"Habits of the Heart" Project

Period from September 21 1994 to January 31 1998

Ukraine Bureau of Freedom House
‘Habits of the Heart’ Project

Audited Fund Accountability Statement

Period from September 21, 1994 to January 31, 1998

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Ukraine Bureau of Freedom House
"Habits of the Heart" Project

Audited Fund Accountability Statement

Period from September 21, 1994 to January 31, 1998

Executive Summary

1 Background

Habits of the Heart is a project to promote democratic change in Ukraine by developing and working with indigenous public policy research institutions and reform-oriented indigenous non-governmental organizations ("subgrantees")

On September 21, 1994, the US Agency for International Development ("USAID") Mission to Ukraine approved cooperative agreement number 110-0007-A-00-4027 which provided a total of \$1 225 000 (after subsequent modifications) to cover costs relating to the "Habits of the Heart" Project ("the Project") through to September 30, 1996. Cooperative agreement 121-0007-A-00-7040 after subsequent modifications (including grant number 121-0007-A-00-00059), provided an additional \$582 815 to cover costs relating to the Project through to January 31, 1998. The cooperative agreements include funding for both Freedom House, Inc and the Ukraine Bureau of Freedom House (the Organization) in relation to the Project.

2 Objectives and Scope of the Audit

The objective of the engagement was to conduct a financial audit of the fund accountability statement of the Organization's "Habits of the Heart" Project for the period from September 21, 1994 to January 31, 1998 prepared by management. The audit was conducted in accordance with *US Government Auditing Standards* except as discussed in the accompanying Report of Independent Auditors.

The specific objectives of the audit were to

- Express an opinion as to whether the fund accountability statement presents fairly, in all material respects, project revenues and costs incurred and reimbursed for the period from September 21, 1994 to January 31, 1998 in accordance with the terms of the aforementioned agreements and in conformity with the basis of accounting described in Note 2 to the fund accountability statement.
- Evaluate and obtain a sufficient understanding of the recipient's internal control structure related to the Project and assess control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the fund accountability statement and not to provide an opinion on the internal control structure.
- Perform tests of the Organization's compliance with certain provisions of agreement terms and laws and regulations as part of obtaining reasonable assurance about whether the fund accountability statement is free of material misstatement and not to provide an opinion on the overall compliance with these provisions.

Ukraine Bureau of Freedom House
"Habits of the Heart" Project

Executive Summary (Continued)

3 Summary of Audit Results

The following is a summary of audit results

- The Report of Independent Auditors expresses a qualified opinion on the fund accountability statement. The reason for the qualified opinion, as more fully described in the Report of Independent Auditors and the Schedule of Findings and Questioned Costs, was because the Auditors
 - i) were not able to obtain complete assurance that the funds advanced to subgrantees were expended by subgrantees for the purposes intended and that expenditures reported by subgrantees to the Organization as incurred were not also reported to and recovered from other donors or sources of funding,
 - ii) were not able to obtain complete assurance concerning the completeness of revenues since Freedom House Inc. could not confirm the exact amount of funds transferred to the Organization for use in the Project for the period from September 21, 1994 to January 31, 1998 due to inadequacies in its accounting system
 - iii) identified unsupported costs totaling \$29,000 and
 - iv) noted that the Organization did not fully comply with Ukrainian accounting, foreign currency or tax legislation when receiving and disbursing funds related to the Project
- In addition, the Report of Independent Auditors includes a disclaimer of opinion relating to administrative overhead and direct charges incurred by Freedom House, Inc. in the United States which were not audited by Ernst & Young Ukraine
- The Auditors identified three reportable conditions, including one considered to be a material weakness, which are identified in the Schedule of Findings and Questioned Costs
- The Auditors identified one material instance of noncompliance which is described in the Schedule of Findings and Questioned Costs

4 Summary of Management's Comments

Management of the Organization did not provide written comments concerning the audit findings

Report of Independent Auditors

The Board of Directors
Freedom House Inc

We have audited the accompanying fund accountability statement of the Ukraine Bureau of Freedom House (the Organization) Habits of the Heart Project (the Project) for the period from September 21 1994 to January 31 1998. The fund accountability statement is the responsibility of the Organization's management. Our responsibility is to express an opinion on the fund accountability statement based on our audit.

Except as discussed in the following paragraphs, we conducted our audit of the fund accountability statement in accordance with *US Government Auditing Standards* issued by the Comptroller General of the United States. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the fund accountability statement. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall fund accountability statement presentation. We believe that our audit provides a reasonable basis for our opinion.

We do not have a continuing education program that fully satisfies the requirement set forth in Chapter 3, paragraph 3.6 of *US Government Auditing Standards*. However, our current program provides for in excess of 80 hours of continuing education and training every two years. We are taking appropriate steps to attend a continuing education program that fully satisfies the requirement.

We did not have an external quality control review by an unaffiliated audit organization as required by Chapter 3, paragraph 3.33 of *US Government Auditing Standards*, since no such program is offered by professional organizations in Ukraine. We believe that the effects of this departure from *US Government Auditing Standards* is not material because we participate in the Ernst & Young International worldwide internal quality control review program which requires our office to be subject to an extensive quality control review by partners and managers from other Ernst & Young International affiliate offices on an annual basis.

As is described in Note 3 to the fund accountability statement, we did not audit the costs reported as administrative overhead and direct expenses incurred by Freedom House, Inc. in the United States. These amounts were provided by Freedom House, Inc. and are presented in the accompanying fund accountability statement in order to reconcile the total expenditure of grant funds. The supporting documentation for these expenses is maintained in the United States and was not made available to us. Therefore, the scope of our work was not sufficient to express, and we do not express, an opinion on the costs reported as administrative overhead and direct expenses totaling \$430,665 and \$442,975 respectively incurred by Freedom House, Inc. in the United States for the period from September 21 1994 to January 31 1998.

Freedom House, Inc. could not confirm the exact amount of funds transferred to the Organization for use in the Project for the period from September 21 1994 to January 31 1998 due to inadequacies in the accounting system. Therefore, we were not able to obtain complete assurance concerning the completeness of revenues and the fund accountability statement reflects revenues as recorded in the Organization's accounting records only.

The majority of the Organization's expenditures were incurred through subgrantees. Our audit procedures included tests to satisfy ourselves that the amounts reported in the accompanying fund accountability statement as subgrants were advanced to subgrantees. However, the subgrantees were not subjected to an independent audit nor did they generally appear to have formalized a system of accounting and internal controls. Therefore, we were unable to obtain assurance that the funds advanced to subgrantees were expended by subgrantees for the purposes intended and that expenditures reported by subgrantees to the Organization as incurred were not also reported to and recovered from other donors or sources of funding.

The results of our tests disclosed the following material questionable costs as detailed in the fund accountability statement: (1) There were no costs that were explicitly questioned because they were not program related, unreasonable, or prohibited by the terms of the agreements, and (2) \$29,000 in costs that were not supported with adequate documentation. In addition, the results of our procedures disclosed that the Organization did not comply with Ukrainian accounting, foreign currency or tax legislation when receiving or disbursing funds related to the Project.

In our opinion, except for the effects of the questionable costs and related adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to revenues and subgrants and had Ukrainian legislation been fully complied with as referred to in the preceding paragraphs, and excluding the costs which were not audited as described above, the fund accountability statement referred to above presents fairly, in all material respects, project revenues and costs incurred and reimbursed for the period from September 21, 1994 to January 31, 1998, in accordance with the terms of the agreements and in conformity with the basis of accounting described in Note 2.

This report is intended for the information of the Organization and the U.S. Agency for International Development ("USAID"). However, upon release by USAID, this report is a matter of public record and its distribution is not limited.


June 1, 1998

Ukraine Bureau of Freedom House
 "Habits of the Heart" Project

Fund Accountability Statement

Period from September 21, 1994 to January 31, 1998
 (In US Dollars)

	<u>Budget</u>	<u>Actual</u>	<u>Questioned</u>	<u>Unsupported</u>	<u>Reference</u>
Revenues					
Agreement No 110-0007-A-00-4027-00	\$ 1 225 000	\$1,225 000	\$ -	\$ -	
Agreement No 121-0007-A-00-7040-00	582 815	582 815	-	-	
Total Revenues	\$ 1,807,815	\$1,807,815	\$ -	\$ - -	
Costs Incurred					
Subgrants					
Agreement No 110-0007-A-00-4027-00	\$ 410,000	\$ 426,092	\$ -	\$ 29 000	98-1
Agreement No 121-0007-A-00-7040-00	225,000	250,482	-	-	
	635 000	676,574	-	29 000	
Personnel Costs					
Agreement No 110 0007-A 00-4027 00	189,400	26,401	-	-	
Agreement No 121 0007-A-00-7040-00	98 900	71 433	-	-	
	288,300	97 834	-	-	
Travel and Per Diem					
Agreement No 110-0007-A-00-4027-00	90,900	17,763	-	-	
Agreement No 121-0007-A-00-7040-00	32 900	16 380	-	-	
	123,800	34 143	-	-	
Office Equipment and Supplies					
Agreement No 110-0007-A-00-4027-00	52,375	8,245	-	-	
Agreement No 121-0007-A-00-7040-00	8 100	4 868	-	-	
	60,475	13,113	-	-	
Conferences					
Agreement No 110-0007-A-00-4027-00	26,200	5,236	-	-	
Agreement No 121-0007-A 00-7040-00	5,000	2,462	-	-	
	31 200	7 698	-	-	
Communications					
Grant No 110-0007-A-00-4027-00	28 000	19 586	-	-	
Grant No 121-0007-A 00-7040-00	17 400	10 828	-	-	
	45 400	30 414	-	-	
Consultants/Interpreters					
Agreement No 110-0007-A-00-4027 00	7 625	2 450	-	-	
Agreement No 121-0007-A-00-7040-00	1 800	150	-	-	
	9 425	2,600	-	-	
Other Program Costs					
Agreement No 110-0007-A-00-4027-00	21 150	21 640	-	-	
Agreement No 121 0007-A-00-7040-00	23 000	31 438	-	-	
	\$ 44 150	\$ 53 078	\$ -	\$ -	

Ukraine Bureau of Freedom House
 "Habits of the Heart" Project

Fund Accountability Statement (Continued)

Period from September 21, 1994 to January 31, 1998
 (In US Dollars)

	<u>Budget</u>	<u>Actual</u>	<u>Questioned</u>	<u>Unsupported</u>	<u>Reference</u>
Other Direct Costs					
Agreement No 110-0007-A-00-4027-00	\$ 76 200	\$ 10 832	\$ -	\$ -	
Agreement No 121-0007-A-00-7040-00	13 200	7 889	-	-	
	<u>89,400</u>	<u>18,721</u>	-	-	
Independent Audit					
Agreement No 110-0007-A 00-4027-00	50 000	-	-	-	
Direct Expenses Incurred by Freedom House, Inc in the United States (Unaudited – See Note 3)					
Agreement No 110-0007-A-00-4027-00	-	413 605	-	-	
Agreement No 121-0007-A-00-7040-00	-	29 370	-	-	
	<u>-</u>	<u>442,975</u>	-	-	
Administrative Overhead Incurred by Freedom House, Inc in the United States (Unaudited – See Note 3)					
Agreement No 110-0007-A-00-4027-00	273,150	273 150	-	-	
Agreement No 121-0007-A-00-7040-00	157 515	157 515	-	-	
	<u>430 665</u>	<u>430 665</u>	-	-	
Total Costs Incurred	<u><u>\$ 1,807,815</u></u>	<u><u>\$1,807,815</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 29,000</u></u>	

See accompanying notes

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Ukraine Bureau of Freedom House
Habits of the Heart Project

Notes to Fund Accountability Statement

Period from September 21, 1994 to January 31, 1998
(In US Dollars unless otherwise stated)

1 General

The Ukraine Bureau of Freedom House (the Organization) is a not-for-profit organization which was established in Ukraine in September 1994 as an affiliate of Freedom House Inc a not-for-profit non-stock organization incorporated in the State of New York. The Organization's main office is located in Kyiv, Ukraine.

Freedom House Inc is a nonpartisan organization that monitors human rights and political and economic freedom around the world. Established in 1941 by Eleanor Roosevelt and Wendell Willkie, Freedom House was founded to strengthen democratic institutions at home and abroad. Freedom House maintains its offices in New York City and Washington, D.C.

"Habits of the Heart" is a project to promote democratic change in Ukraine by developing and working with indigenous public policy research institutions and reform-oriented indigenous non-governmental organizations (subgrantees). On September 21, 1994, the U.S. Agency for International Development (USAID) Mission to Ukraine approved cooperative agreement number 110-0007-A-00-4027 which provided a total of \$1,225,000 (after subsequent modifications) to cover costs relating to the "Habits of the Heart" Project (the Project) through September 30, 1996. Cooperative agreement 121-0007-A-00-7040 (after subsequent modifications (including grant number 121-0007-A-00-00059), provided an additional \$582,815 to cover costs relating to the Project through January 31, 1998. The cooperative agreements include funding for both Freedom House, Inc. and the Organization in relation to the Project.

2 Significant Accounting Policies

Basis of Presentation

The Organization prepared the accompanying fund accountability statement based upon actual expenditures (cash basis of accounting) incurred that were related to the Project. The fund accountability statement includes expenditures incurred in Ukraine as well as expenditures incurred in the United States by Freedom House Inc. relating to the Project. The fund accountability statement is not intended to be a presentation in conformity with International Accounting Standards, any other generally accepted accounting principles or accounting and tax legislation for statutory reporting in Ukraine.

Foreign Currency Translation

The Organization's fund accountability statement has been presented in US Dollars because it is the Organization's functional currency. The majority of its revenues and costs are either received, incurred or otherwise measured in US Dollars. Accordingly, transactions and balances not already measured in US Dollars (primarily Ukrainian Hryvnia) have been remeasured into US Dollars by applying the actual market exchange rate when the transaction occurred.

The official exchange rate of the National Bank of Ukraine, which was generally considered to approximate the market exchange rate, ranged between approximately UAH 0.7121 for one US Dollar and UAH 1.9297 for one US Dollar for the period from September 21, 1994 to January 31, 1998.

Ukraine Bureau of Freedom House
' Habits of the Heart ' Project

Notes to Fund Accountability Statement (Continued)

3 Expenditures Incurred by Freedom House, Inc in the United States

Freedom House Inc incurred indirect costs and certain direct costs in the United States in relation to the Project Freedom House Inc allocated indirect costs totaling \$472,324 to the Project based on overhead rates of 40.87%, 40.20%, 40.87%, 29.00% and 24.80% for the fiscal years ended June 30, 1998, 1997, 1996 and 1995 respectively. The terms of the cooperative agreements, however, limited the amount of indirect costs to be charged to the Project to \$430,665 and accordingly, this amount was reported in the accompanying fund accountability statement. Freedom House Inc also reported that it incurred \$495,993 in direct costs in the United States relating to the Project. The fund accountability statement reports only \$442,975 of these direct costs in order to reconcile the total expenditure of grant funds. Ernst & Young Ukraine did not audit these direct or indirect costs as the supporting documentation for these expenses is maintained in the United States. However, Ernst & Young Ukraine did sight copies of invoices supporting equipment with a total value of \$48,183 related to purchases by Freedom House Inc. The equipment was provided to subgrantees in Ukraine.

4 Unaudited Schedule of Expenses as Recorded by Freedom House, Inc

The following is a schedule provided by management of Freedom House Inc which summarizes the total grant expenditures as recorded in its accounts for the period from September 21, 1994 to January 31, 1998 (unaudited).

	Agreement 1	Agreement 2			
	Actual	Actual	Total Actual	Total Budget	Difference
Subgrants	\$ 471,792	\$ 234,482	\$ 706,274	\$ 635,000	\$ (71,274)
Personnel costs	221,965	14,960	236,925	288,300	51,375
Travel and per diem	53,717	29,322	83,039	123,800	40,761
Office equipment and supplies	94,093	3,803	97,896	60,475	(37,421)
Conferences	5,540	2,454	7,994	31,200	23,206
Communications	23,432	21,530	44,962	45,400	438
Consultants/					
Interpreters	84,952	86,859	171,811	9,425	(162,386)
Other program costs	12,000	30,438	42,438	44,150	1,712
Other direct costs	23,699	15,130	38,829	89,400	50,571
Independent audit	-	-		50,000	50,000
Total direct costs	991,190	438,978	1,430,168	1,377,150	(53,018)
Administrative overhead	292,914	179,410	472,324	430,665	(41,659)
	\$ 1,284,104	\$ 618,388	\$1,902,492	\$ 1,807,815	\$ (94,677)

This schedule has not been audited by Ernst & Young Ukraine. However, the total expenditures were agreed to Freedom House, Inc's financial statements as of and for the years ended June 30, 1997, 1996 and 1995 audited in accordance with OMB Circular A-133 by Freedom House, Inc's independent auditors in the United States. Expenditures incurred in the period July 1, 1997 to January 31, 1998 have not yet been audited in the United States.

Ukraine Bureau of Freedom House
' Habits of the Heart ' Project

Notes to Fund Accountability Statement (Continued)

**4 Unaudited Schedule of Expenses as Recorded by Freedom House, Inc
(Continued)**

The schedule does not reconcile to the accompanying fund accountability statement due to differences in classification and the timing of certain accounting entries between Freedom House Inc and the Organization. In addition the actual amount of expenses in these categories incurred by Freedom House Inc in the United States exceeded that which was reported in the accompanying fund accountability statement. The excess amount of expenditures was not recoverable from USAID and therefore, for presentation purposes was not included in the fund accountability statement (see Note 3)

Your attention is drawn to the large differences noted between the actual and budgeted amounts in certain categories in the schedule above and in the accompanying fund accountability statement. Ernst & Young Ukraine did not consider whether these differences should result in any of these costs being questioned since it was outside the scope of its audit.

Report of Independent Auditors on Internal Controls

The Board of Directors
Freedom House Inc

We have audited the accompanying fund accountability statement of the Ukraine Bureau of Freedom House (the Organization) Habits of the Heart Project (the Project) for the period from September 21, 1994 to January 31, 1998 and have issued our report thereon dated June 1, 1998.

Except as discussed in the Report of Independent Auditors accompanying the fund accountability statement, we conducted our audit of the fund accountability statement in accordance with *US Government Auditing Standards* issued by the Comptroller General of the United States. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement.

The management of the Organization is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that the assets are safeguarded against loss from unauthorized use or disposition; transactions are executed in accordance with management's authorization and in accordance with the terms of the agreements; and transactions are recorded properly to permit the preparation of the fund accountability statement in conformity with the basis of accounting described in Note 2 to the fund accountability statement. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the fund accountability statement of the Organization for the period from September 21, 1994 to January 31, 1998, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the fund accountability statement and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants ("AICPA"). Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the recipient's ability to record, process, summarize, and report financial data consistent with the assertions of management in the fund accountability statement.

Reportable conditions are described in the accompanying Schedule of Findings and Questioned Costs as items 98-1, 98-3, and 98-4.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the fund accountability statement may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. We consider item 98-1 to be a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of the Organization in a separate letter dated June 1, 1998.

This report is intended for the information of the Organization and the U.S. Agency for International Development (USAID). However, upon release by USAID, this report is a matter of public record and its distribution is not limited.

Ernst & Young Ukraine

June 1, 1998

Report of Independent Auditors on Compliance

The Board of Directors
Freedom House Inc

We have audited the accompanying fund accountability statement of the Ukraine Bureau of Freedom House (" the Organization) Habits of the Heart Project (" the Project") for the period from September 21 1994 to January 31 1998 and have issued our report thereon dated June 1, 1998

Except as discussed in the Report of Independent Auditors accompanying the fund accountability statement, we conducted our audit of the fund accountability statement in accordance with *US Government Auditing Standards* issued by the Comptroller General of the United States. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement.

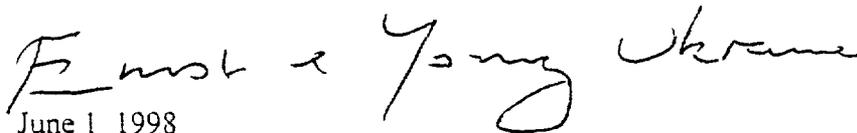
Compliance with agreement terms and laws and regulations applicable to the Organization is the responsibility of the Organization's management. As part of obtaining reasonable assurance about whether the fund accountability statement is free of material misstatement we performed tests of the Organization's compliance with certain provisions of agreement terms and laws and regulations. However our objective was not to provide an opinion on the overall compliance with these provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements or violations of agreement terms and laws and regulations that cause us to conclude that the aggregation of misstatements resulting from those failures or violations is material to the fund accountability statement. The results of our tests of compliance disclosed that the Organization did not comply with Ukrainian accounting, foreign currency or tax legislation when receiving or disbursing funds related to the Project. This noncompliance is described in the accompanying Schedule of Findings and Questioned Costs as item 98-2.

We considered these material instances of noncompliance in forming our opinion on whether the Organization's fund accountability statement is presented fairly, in all material respects, in accordance with the terms of the agreements and in conformity with the basis of accounting described in Note 2 to the fund accountability statement and this report does not affect our report on the fund accountability statement dated June 1, 1998.

We also noted certain immaterial instances of noncompliance that we have reported to the management of the Organization in a separate letter dated June 1, 1998.

This report is intended for the information of the Organization and the US Agency for International Development (" USAID) . However upon release by USAID this report is a matter of public record and its distribution is not limited.


June 1 1998

Ukraine Bureau of Freedom House
Habits of the Heart" Project

Audited Fund Accountability Statement

Period from September 21, 1994 to January 31, 1998

Schedule of Findings and Questioned Costs

98-1 Subgrantee Financial Reporting and Documentation

Description of condition

The quality extent and timeliness of financial reporting and documentation provided to the Organization by subgrantees was inconsistent and in some cases was insufficient for management of the Organization to adequately monitor subgrantee expenditures

Criteria

In the absence of a requirement to have all subgrantees subjected to an annual audit subgrantees should provide the Organization with sufficient financial reporting and documentation to ensure that expenditures are incurred for the purposes intended

Cause of condition

The subgrantees generally do not appear to have the resources or training to provide the required information to the Organization For example in most cases the subgrantees did not employ an accountant or bookkeeper

Effect of condition

We noted significant differences in the quality of financial reporting and supporting documentation provided by the different subgrantees Due to this management of the Organization was required to spend a significant amount of time summarizing and organizing the documentation provided by subgrantees to prepare adequate reporting to Freedom House Inc In many cases, the subgrantees did not provide third-party invoices/receipts in support of expenditures (i.e. internally produced "vouchers" were the only evidence supporting many expenses) In addition, a regular budget-to-actual expenditure analysis was not prepared by subgrantees

Questioned cost

\$20,000 – Expenditures incurred by the Donetsk Center in 1995 were not supported by any documentation or reporting The Organization did not provide any further funding to the Donetsk Center after 1995

\$9,000 – The invoice supporting equipment received by the Ukrainian-American Bureau for Human Rights Protection in April 1995 was deficient (e.g. addressee was not noted, and other essential terms were missing)

Recommendation

The Organization should determine whether any of the subgrantees should undergo an annual audit Subgrantees should be trained to prepare regular budget-to-actual expenditure analyses A consistent policy should be put into place as to the format of summarization and level of supporting documentation that is adequate for the Organization A consistent policy should be put into place to provide guidance on circumstances where third-party invoices cannot be obtained (e.g. taxi fares, business trip expenses, salaries, office rent other minor expenses, etc)

Ukraine Bureau of Freedom House
"Habits of the Heart" Project

Schedule of Findings and Questioned Costs (Continued)

98-2 Compliance with Ukrainian Accounting, Foreign Currency and Tax Legislation

Description of condition

The Organization did not comply with Ukrainian accounting, foreign currency and tax legislation. In addition, although the extent of our procedures did not include procedures to assess the subgrantees' degree of compliance with Ukrainian legislation, the quality and nature of supporting documentation provided by subgrantees indicated that the subgrantees were also not fully complying with Ukrainian legislation.

Criteria

The Organization should be appropriately registered with the Ukrainian taxation authorities and comply with all aspects of Ukrainian accounting, foreign currency and tax legislation. The Organization should only provide funding to subgrantees which can demonstrate that they are in compliance with Ukrainian legislation.

Cause of condition

The costs of fully complying with Ukrainian legislation are significant. Ukrainian financial reporting and filing requirements are onerous and require significant resources to comply, foreign currency and petty cash restrictions are significant and can often impede the basic operations of an organization, the level of taxation is significant and certain taxes apply to not-for-profit organizations (e.g. payroll taxes). Ukrainian legislation changes frequently and requires substantial management resources to ensure continued compliance. It is our understanding that management did not register with the Ukrainian taxation authorities in order to reduce the costs and resources necessary for compliance and rather devoted resources to establish the Organization and its activities. Uncertainties in the legislation and the applicability to the Organization of USAID's privileged status under Ukrainian legislation also contributed to management's decision not to register.

Effect of condition

The Organization is in violation of Ukrainian accounting, foreign currency and tax legislation. Because the Organization has not paid any payroll taxes, there is a potential liability for unpaid taxes and related fines and penalties. Foreign currency restrictions generally prohibit transactions in foreign currency on the territory of Ukraine, and therefore substantially all of the Organization's expenses incurred and funds advanced to subgrantees were not in accordance with Ukrainian legislation. Grant funds from Freedom House Inc. were either received through a personal bank account in Ukraine or were brought in by the Organization's representatives without customs clearance for use by the Organization; therefore, the grant funds received cannot have been officially used by the Organization in accordance with Ukrainian legislation.

Questioned cost

N/A

Recommendation

The Organization should register with the appropriate State authorities and comply with Ukrainian legislation. This will require additional resources. The Organization should establish a policy in this respect for subgrantees.

Ukraine Bureau of Freedom House
"Habits of the Heart" Project

Schedule of Findings and Questioned Costs (Continued)

98-3 Bank Accounts

Description of condition

The Organization received funds through a personal bank account in Ukraine and a separate bank account for the Project did not exist

Criteria

Bank transactions should not be conducted through personal bank accounts and all funds received and disbursed should be segregated between projects

Cause of condition

To open a bank account in the name of the Organization requires the Organization to register with the appropriate Ukrainian authorities (refer item 98-2) Freedom House, Inc wire transferred the majority of the Organization's funding without specifically distinguishing between the funds related to the 'Habits of the Heart' Project and the funds related to other projects

Effect of condition

A precise reconciliation of funds received, funds disbursed and balance remaining at January 31, 1998 in respect of the Project was not possible (although an organization-wide reconciliation has been performed), and therefore it is difficult for management to ensure that funds are allocated properly between projects

Questioned cost

N/A

Recommendation

A bank account should be opened in the name of the Organization. A separate bank account for each major project should be maintained, or, if not practical or possible (i.e. due to Ukrainian banking restrictions), all funds received and disbursed should be clearly identified as to which program they relate to

Ukraine Bureau of Freedom House
"Habits of the Heart" Project

Schedule of Findings and Questioned Costs (Continued)

98-4 Accounting and Internal Control System

Description of condition

The Organization does not have a formal accounting and internal control system

Criteria

Once a not-for-profit organization has reached a certain threshold of activity a formal accounting and internal control system is required to ensure the organization meets its objectives, complies with relevant agreements, laws and regulations, and is able to provide accurate financial and management reporting on a timely basis

Cause of condition

The organization is relatively small in size and in relation to the activities carried out. Since inception in September 1994, there has typically not been more than two representatives employed at any one time. The "Habits of the Heart" Project accounted for the majority of the Organization's activities. Management determined that the costs of establishing a formal accounting and internal control system exceeded the benefits during the early stages of the Organization's history.

Effect of condition

The accounting system was not capable of producing complete financial statements (i.e. balance sheet and income statement) and other information for management or for statutory financial reporting purposes in Ukraine. However, Excel spreadsheets were used to summarize expenditures and prepare information which was required for grant reporting purposes and which was suitable for management to monitor expenditures on a timely basis.

Internal controls were informal and a lack of segregation of duties existed over the approval and processing of transactions. In many cases documented approvals over expenditures and cash transactions did not exist as they would in a large organization. For example, there was no formal and documented approval of expenditures and equipment received. In some cases, expenditures were not supported by third-party invoices/receipts (i.e. internally produced vouchers were the only evidence supporting the expense).

Questioned cost

N/A

Recommendation

As the Organization matures and its activities expand management should consider the need to formalize the accounting and internal control systems. This should be carefully considered in light of the additional costs of implementing formal systems.

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PRIVATE and CONFIDENTIAL

June 1 1998

Ms Svitlana Franchuk
Freedom House Ukraine
5 Mala Zhytomvrska apt 55
Kyiv 252001
Ukraine

Dear Ms Franchuk

RE UKRAINE BUREAU OF FREEDOM HOUSE - MANAGEMENT LETTER

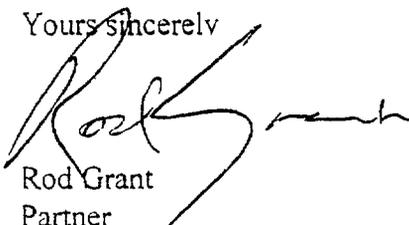
In planning and performing our audit of the fund accountability statement of the Ukraine Bureau of Freedom House ("the Organization") Habits of the Heart' Project (the "Project") for the period from September 21, 1994 to January 31, 1998 we considered the Organization's accounting policies and procedures, internal control structure and compliance with certain provisions of agreement terms and laws and regulations. The most significant issues were brought to the Organization's attention in our Report of Independent Auditors on the Fund Accountability Statement dated June 1, 1998, Report of Independent Auditors on Internal Controls dated June 1 1998 Report of Independent Auditors on Compliance dated June 1 1998 and the Schedule of Findings and Questioned Costs ("the Reports"). For the sake of brevity, this management letter does not include issues which were discussed in the Reports. This management letter briefly outlines the additional issues which have come to our attention.

Our consideration of the internal control structure would not necessarily disclose all matters that might be a material weakness as our audit is based on selective tests of accounting records and supporting data and is not intended to provide specific assurance on the internal control structure.

This letter is intended as a communication to the executive and senior management of the Organization and USAID and should not be shown to other persons without our express consent as the matters contained herein may be misunderstood if not placed in the total context of the audit. We wish to thank the officers and employees of the Organization for the co-operation and courtesy extended to us during our audit. We appreciate the opportunity to present these recommendations for your consideration.

If you require any further information please contact me

Yours sincerely


Rod Grant
Partner

The following matters are in addition to the issues identified in our Reports dated June 1 1998 For the sake of brevity, we have not included the issues discussed in the Reports in this management letter

Compliance with Agreement Terms and Laws and Regulations

We noted the following matters in relation to compliance with certain provisions of the cooperative agreement terms and relevant laws and regulations

- We noted one instance in which a subrecipient used funds to purchase a software program which was not licensed The standard provisions to the cooperative agreement require the Organization to use only published copyrighted computer software and likewise the Organization should enforce the same standard upon its subrecipients
- We noted that the quarterly progress reports submitted to USAID did not always include cumulative expenditures and cost to complete projections issues and problems and status of scheduled actions The cooperative agreement requires this information to be submitted
- There were several instances where subgrantee publications did not refer to the grant number under which funds were received Although USAID funding in general was acknowledged in the publications we were shown the standard provisions to the cooperative agreement require that all publications acknowledge the specific grant number as well
- The terms under which equipment is transferred by the Organization to subgrantees should be reviewed to determine whether custody is to be retained by the subgrantee when the grant expires An appropriate disposition plan should be determined in accordance with the USAID Mission Order on Management of Program-Funded Non-Expendable Property

Accounting and Internal Control System

We noted the following examples of inadequacies in the accounting and internal control system and documentation

- Changes to budget items in the cooperative agreements combined with the timing of grant disbursements between periods resulted in actual to budget variances
- There were several instances where subgrantees overspent in certain periods and this resulted in reconciliation differences between the expense subledger and the financial statements Subgrantee financial reports should only account for grant funds disbursed to them and subsequently expensed

- The contracts for the 1994/95 year concluded between the Organization and two subgrantees Media Outreach and Equal Access did not include a project description and budget. Project descriptions and budgets should be available to allow management to ensure that program activity and grant funds allocated are in accordance with the stated objectives and estimated expenditure in the cooperative agreement. We did not note any such subgrantee contract deficiencies since 1995.
- In certain instances the Organization's representatives did not document the authorization for grant fund disbursements to subgrantee organizations and third parties on the related receipts. Each expense is required to be approved. Documentation of authorization is a requirement of Freedom House's Federal Award Accounting Policies and Procedures. However, we did note that the Organization had improved this procedure from November 1997.
- There were several instances where Blue Form's expense cover sheets were not used. These forms should be used as a cover sheet for every expense paid out of grant funds and are a requirement of Freedom House's Federal Award Accounting Policies and Procedures.
- The Organization does not maintain an off-site back-up of computer data. Back-up routines should be implemented to minimize any data loss in case of computer system failure, damage, or theft.