

**AUDIT
OF
CLAIMS AGAINST IRAQ
SPECIFIED PURPOSE ACCOUNT**

SEPTEMBER 2003

Audit Division (SIV)

TABLE OF CONTENTS

AUDIT OBJECTIVE	1
SCOPE AND APPROACH	1
BACKGROUND	1
1.1 Overview of Claims Against Iraq	1
OBSERVATIONS AND RECOMMENDATIONS	3
2.1 Management of the SPA Account	3
2.2 Basis of Accounting	4
3.1 Balance in the Special Purpose Account	5
4.1 Adjustment Required	6
5.1 Plausibility of the Adjusted Balance	7

Note: In December 2003 the Department of Foreign Affairs and International Trade (DFAIT) was split into two Departments – Foreign Affairs Canada (FAC) and International Trade Canada (ITCan). This audit was undertaken under the previous organizational structure, which explains the references to DFAIT throughout the report.

AUDIT OBJECTIVE

The audit objective was to provide management with assurance that the balance in the Claims Against Iraq Special Purpose Account (SPA) is accurate and that the method of accounting used was appropriate.

SCOPE AND APPROACH

The audit of Claims Against Iraq was conducted between July and November 2002. The United Nations, Human Rights and Economic Law Division (JLH) requested that the Audit Division (SIV) undertake a financial audit of Claims Against Iraq. The Audit was included as part of SIV's annual Internal Audit Plan 2002/03, approved by the Department of Foreign Affairs and International Trade (DFAIT) Audit and Evaluation Committee.

DFAIT receives funds from the United Nations Compensation Commission (UNCC) to compensate Canadians for claims arising from Iraq's invasion of Kuwait. DFAIT then pays this compensation to the claimants, less a small processing fee. The Economic Law Section (JLHB) is responsible for processing these claims, with the assistance of the Area Management Office - Legal (JAM). All these financial transactions flow through a "Specified Purpose Account" (SPA) in DFAIT's financial system (IMS). The subject of this audit examination is the appropriateness of the transactions processed in and out of this account and the accuracy of the resulting balance.

The audit reconciled the amounts deposited into the SPA to the schedule of UNCC payments received by JLHB and to UNCC documentation describing the payment. A statistically valid sample of charges to the SPA was tested by matching amount and payee to IMS UNCC documentation. More details on the audit procedures performed are provided below.

BACKGROUND

1.1 Overview of Claims Against Iraq

1.1.1 In 1991, the United Nations Security Council adopted Resolution 687 (1991) which created a mechanism to pay compensation for claims arising from Iraq's unlawful invasion and occupation of Kuwait. The UNCC was established to deal with all international claims for losses directly caused by the invasion and occupation. The Governing Council of the UNCC decided in March 1994 (decision 18) that governments

are authorized to offset their costs of processing claims by deducting processing fee. Treasury Board informed the Department that the UNCC Governing Council decision authorizing the imposition of a processing fee constitutes appropriate authority for the Department to deduct a fee from the payments to claimants.

The UNCC established six categories of claims:

- Category A - claims submitted by individuals who had to depart from Kuwait or Iraq when Iraq invaded Kuwait in 1990;
- Category B - claims submitted by individuals who suffered serious personal injury or whose spouse, child or parent died;
- Category C - claims submitted by individuals for damages up to US \$ 100,000 each for twenty-one different types of losses, such as loss of personal property;
- Category D - claims submitted by individuals similar to those under category "C" for damages above US \$ 100,000;
- Category E - claims of corporations, other private legal entities and public sector enterprises; and
- Category F - claims filed by governments and international organizations.

1.1.2 The United Nations Compensation Commission (UNCC) deadline for filing category "A", "B", "C" and "D" claims was 1 January 1995. The deadline for the filing of category "E" and "F" claims was 1 January 1996, with the exception of environmental claims in category "F" which had to be filed before 1 February 1997. The cost of the compensation is paid by Iraq, through a UNCC Fund. The fund receives up to thirty per cent of the value of Iraq's petroleum exports.

1.1.3 DFAIT's role in this compensation process is transactional. It forwards the claims received from Canadians to the UNCC. The UNCC is solely responsible for assessing the claims. When a Canadian claim is approved, the UNCC remits the approved claim amount to DFAIT via a deposit into its Washington bank account. The deposits are credited to an SPA (General Ledger account 24030 and funds commitment account 5000053784) in IMS. Each deposit is usually for many claimants in numerous classes, all of which are specifically listed in the UNCC's supporting documentation.

1.1.4 JLHB then prepares a payment in IMS to the claimant, net of the processing fee. If JLHB cannot locate the claimant within one year after the receipt of the funds, it returns the funds to the UNCC as required per UNCC decision 48. The payment is charged to the SPA. The processing fee that is withheld remains in the SPA. Out-of-pocket expenditures related to this program are also charged to the SPA. When all of the claims have been settled, the balance in the SPA will be liquidated to the Consolidated Revenue Fund. JLHB maintains separate records of the receipts and payments.

1.1.5 The UNCC received approximately 2.6 million claims seeking over US \$ 300 billion. It continues to process these claims. There are approximately 6,000 claims seeking US \$ 172 billion still to be resolved.

Other Figures

1295	Canadian Claims submitted to UNCC
795	Claimants
US \$ 60,407,263	Canadian claims - Categories A, B, C*
US \$ 2,028,332	Amount awarded as of January 2002 - Categories A, B, C*
US \$ 112,957,461	Canadian claims - Categories D, E*
CAD \$ 55,658,655	Government of Canada claims - Category F*
1.5%	UNCC maximum processing fee - on claims below US \$ 100,000 in Categories A, B, C
3.0%	UNCC maximum processing fee - on claims above US \$ 100,000 in Categories D, E, F
US \$ 46,712,659	Total Amount received to July 12, 2002 by DFAIT
50	Approximate number of payments received from the UNCC
CAD \$ 1,558,044	July 12, 2002 balance in SPA

* it is unlikely that the full amount of all these claims will be approved

OBSERVATIONS AND RECOMMENDATIONS

2.1 Management of the SPA Account

2.1.1 The audit found no problems with the JLHB and JAM's processing of individual receipts and payments. However, overall financial management of the program needs to be improved.

2.1.2 Processing the claims, receipts and payments is detailed and burdensome. There are many forms, letters and copies involved. We were impressed with the JLHB's attention to detail. However, as could be expected in such a large number of transactions (over 2,700 payments as there were multiple payments for many claims), there was one case that JLHB brought to our attention where the 1.5% processing fee had not been deducted. It was subsequently recovered.

2.1.3 Financial management of the SPA account was found lacking. The balance in the account is not reconciled to receipts less payments in a way to provide assurance that the balance is accurate. Without this in place, management is not provided with the assurance that the balance in the account is reasonable and that

payments charged to the account are bonafide. As described below, the audit found receipts for over CAD \$ 600,000 that had been credited to the SPA in error and not detected. A similar amount could just as easily been charged to the account, either in error or intentionally, without detection.

2.1.4 Part of the reason for this is that all activity flows through one IMS Commitment Document (CO) which is rolled over at the end of the fiscal year. This means that the balance in the account is an accumulation of many years' receipts less payments. The result is that the balance becomes a very large "bucket" that is very difficult to monitor and reconcile. We are recommending that a separate CO, or CO line, be established in IMS for each UNCC receipt. All payments can then be charged to the specific CO or CO line. When all payments for a given receipt have been processed, the resulting balance should be easy to reconcile and verify.

2.1.5 Note that the audit did not assess the validity of the claims processed or the justification for the amounts paid as this is the responsibility of the UNCC. The audit relied on UNCC documentation in support of its decisions.

Recommendations for JAM

2.1.6 In cooperation with Financial Services - Headquarters (SMFH), establish separate Commitment documents, or line items, for each payment received.

2.1.7 On a quarterly basis, reconcile the balance in each Commitment document and line item of the SPA to JLHB's records of receipts and payments.

JAM Responses

2.1.6 Separate commitments are now being created and controlled by Financial Services.

2.1.7 Quarterly reconciliations are now being done.

2.2 Basis of Accounting

2.2.1 Based on a 1996 memo to the Minister, DFAIT's policy is that "Processing fees would be credited to the Consolidated Revenue Fund." This policy has resulted in leaving all processing fees in the SPA until the end of the program, at which time it is planned that the balance in the SPA will be transferred to the Consolidated Revenue Fund (CRF). Part of the reasoning for this is that unexpected expenses may arise in a year in which there are few receipts and therefore minimal processing fees to access. In this case, these expenses would have to be charged to an operating budget if the accumulated processing fee is not carried forward.

The problems with this approach are:

- The balance becomes difficult to track and reconcile over many years; and,
- It may be against the spirit, if not the letter, of the Treasury Board policy “.

“Once the purpose for which the funds were received has been realized, the balance of the account must be returned in accordance with the *Repayment of Receipt Regulations*. If, in accordance with the statute, trust, treaty, undertaking or contract, there is no obligation to return the funds or the security to the other party(ies), the balance of the account will be transferred to a miscellaneous non-tax revenue account.”¹

2.2.2 According to the 1996 memorandum to the Minister, the purpose of the fee is to “help the Government of Canada to recover some of the costs incurred for the processing of claims filed by Canadians”. As such, it could be argued that the costs have been incurred and recovered and may now be transferred out of the SPA and into the CRF.

Recommendation for JLHB

2.2.3 In cooperation with Financial Services - Headquarters (SMFH), transfer the balance in the SPA that relates to accumulated processing fees (approximately CAD \$ 880,000 as of July 2002) to the CRF. In the future, transfer unused processing fees to the CRF at the end of each fiscal year.

JLHB Response

2.2.3 A total of CAD \$ 800,000 has been transferred to the Consolidated revenue fund. The balance has been retained to offset ongoing payments and transfers will be made at the end of each fiscal year.

3.1 Balance in the Special Purpose Account

3.1.1 Based on the information provided by JLHB, the following analysis of the balance was prepared. For the various aspects making up the balance, the analysis includes additional information and the audit testing that was performed.

¹Treasury Board of Canada, Secretariat, Chapter 5-7 - Policy on Specified Purpose Accounts, Section 7 (a)

Analysis of SPA Balance

	CAD	Notes
U.S. dollar receipts from UNCC (net of returns to UNCC), converted to Canadian dollars (CAD) at the exchange rate at the time of deposit	\$69,942,943	US \$ 46,712,659 at an average exchange rate of 1.50. Deposits tested by agreeing the US \$ amount to UNCC documentation and the CAD amount to IMS (except for FINEX receipts - see below)
Add: Other credits (primarily returned cheques, and a few exchange rate adjustments)	<u>2,573,590</u>	157 transactions. A judgmental sample of 22 transactions representing 35% of the dollar value was tested. No errors found.
Total Credits	72,516,533	
Less:	-1,074,758	Payments related to UNCC receipts from 1996 and 1997 were recorded in FINEX, the Department's previous financial system. Due to the length of time since these transactions were processed, the difficulty accessing FINEX data and the relatively small portion of total payments that they represent, a decision was taken not to test these transactions.
<ul style="list-style-type: none"> Payments processed in FINEX (Department's old financial system used until March 31, 1998) 		
<ul style="list-style-type: none"> Payments processed through IMS 	<u>-70,558,448</u>	2,750 transactions. A statistical sample of 59 transactions as well as the 15 largest dollar transactions were tested. No errors found.
Expected July 12, 2002 Balance	883,327	
Actual July 12, 2002 Balance	<u>1,558,044</u>	
Difference	674,717	
Difference due to error	670,007	5 deposits incorrectly credited to this account. (adjustment required)
Remaining Difference	<u>\$4,710</u>	Given the insignificance of the amount (.01% of receipts) and the large amount of effort that would be required to further analyze the transactions in the account, the risk of further error in the account does not warrant further work.

4.1 Adjustment Required

4.1.2 In reviewing the amounts credited, we found 5 deposits that were incorrectly posted into this SPA. The receipts were each for US \$ 86,000 (approximately CAD \$ 135,000) and totalled CAD \$ 670,007. The funds were received

from the United Nations (UN) and posted to IMS in error. The receipts relate to a 1992 UN resolution (778) in which member states were requested to contribute to an Iraqi Humanitarian fund. Canada's assessed contribution was CAD \$ 4,005,560 and it was paid in 1993. In 1995, a further UN resolution (986) allowed the member states to be reimbursed from oil money that the UN derived from Iraqi oil sales. These reimbursements are issued on an irregular basis, and will continue until Canada's contribution is paid in full.

Recommendations for JAM

4.1.3 Transfer the current amount of these receipts (CAD \$ 670,007 as of July 12, 2002) out of the SPA and into the proper account.

4.1.4 Notify Cashier and Cheque Distribution (SMFM) of the proper accounting to use for any future receipts.

JAM Responses

4.1.3 A transfer of CAD \$ 670,000 was made by SMFR.

4.1.4 Separate commitments are now being made, controlled by SMRF.

5.1 Plausibility of the Adjusted Balance

5.1.1 The resulting July 12, 2002 balance of CAD \$ 888,037 (CAD \$ 1,558,044 less CAD \$ 670,007 adjustment) is less than we originally expected, but upon more detailed examination, it is plausible. As of July 12, 2002 there were no outstanding amounts that had been received from the UNCC that had not been paid out to claimants. Therefore the balance at that time should be made up of:

- Processing Fees withheld (either 1.5% or 3% on each claim - actual average 1.97%); minus
- Out-of-pocket expenses charged to the fund; plus or minus
- Exchange gains or losses.

	CAD
Processing Fees withheld: (approximately \$ 70,000,000 * 1.97%)	\$1,379,000
Out of pocket expenses: Estimated by JLHB to be \$ 1,000 at most.	- 1,000
Exchange gains or losses (amount computed for the ending balance to be plausible): For the ending balance to be plausible, there must have been significant exchange losses on the funds processed through the account. In our view, it is plausible that these losses occurred. There was a general increase in the value of the US dollar during the period that funds have been processed (from 1.37 CAD in 1996 when the first payment was received to 1.59 in April 2002 when the last payment prior to July was received). The SPA effectively lost money when the value of the Canadian dollar declined from the time of receipt until the time of payment (payments were made in US \$). For example, a receipt of US \$ 100,000 could be received and credited to the SPA at the prevailing rate that month (say of 1.52 or CAD \$ 152,000). In a later month when the payment is made, it is charged to the SPA at the prevailing rate for that month (say 1.54 or CAD \$ 154,000 resulting in a loss of CAD \$ 2,000). An analysis of the 15 largest payments showed that there were exchange gains or losses on every payment and the net impact was a loss of CAD \$ 98,500. These 15 payments make up \$ 13.1 million US \$ or 28% of the dollar value of receipts. Note that in 1999 and 2001, the SPA was credited by the Compensation and Contracting Services Division (SMF) for CAD \$ 89,000 in total to foreign exchange losses. This practice was then discontinued.	-490,000
Plausible ending balance	\$ 888,000