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Audit of USAID/Egypt's Local Development II Program (Project No. 263-0182)

Audit Report No. 6-263-91-04
January 31, 1991

Under LD II's provincial block grant element, USAID/Egypt successfully assisted local government units in implementing literally thousands of activities designed to enhance local government's ability to provide basic services to the rural poor of Egypt. However, USAID/Egypt needs to improve the program's reporting functions, encourage improved local financial management, ensure compliance with procurement guidelines, and improve its monitoring of subproject utilization.

UNITED STATES OF AMERICA
AGENCY FOR INTERNATIONAL DEVELOPMENT
OFFICE OF THE REGIONAL INSPECTOR GENERAL/AUDIT

January 31, 1991

MEMORANDUM FOR D/USAID/Egypt, Marshall D. Brown

FROM : RIG/A/C, F. A. Kalhammer Kalhammer

SUBJECT: Audit of USAID/Egypt's Local Development II Program (Project No. 263-0182)

Ten copies of our audit report No. 6-263-91-04 on the above project have been provided to you and your staff.

We have reviewed your comments on the draft report and considered them in the preparation of the final report. Your comments are included as Appendix II to the report.

The report contains five recommendations, four with more than one part. The status of those recommendations at report issuance is as follows: Recommendation Nos. 1.1 and 1.3 are closed, but because part 1.2 remains open and unresolved, the entire recommendation is carried as such. Rec. No. 2 is resolved. Both parts of Rec. No. 3 are closed. Rec. No. 4.1 is resolved, but part 4.2 remains unresolved. Both parts of Rec. No. 5 are resolved. Please provide a response to this report within 30 days, indicating what further actions you have taken to address the open recommendations.

I appreciate the courtesies and cooperation extended to my staff during the audit.

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EXECUTIVE SUMMARY

The Local Development II Program (LD II) was authorized in August 1985. It followed previous USAID/Egypt local development activities which had provided $600 million to local Egyptian governments since 1978. LD II was designed to support the Government of Egypt's objective of establishing a decentralized system of local government by strengthening the capability of local governments to provide and sustain essential basic services for low-income Egyptians. The Program's objectives were:

- to improve and expand the capacity of local government to plan, finance, implement and maintain locally chosen basic services projects; and

- to improve the capacity of local government to mobilize local resources in order to sustain the provision of basic services.

To achieve these objectives, A.I.D. has now authorized $481 million in life-of-program grant funds. As of December 31, 1989, USAID/Egypt had obligated $341 million and disbursed $256 million. The focus of this audit was on LD II's provincial block grant program under which $196 million had been obligated and $176 million disbursed. The GOE agreed to provide the local currency equivalent of $301 million, of which about $58 million had been provided as of December 31, 1989.

Between February and September 1990, the Office of the Regional Inspector General for Audit/Cairo conducted a performance audit of LD II's provincial block grant program in accordance with generally accepted government auditing standards.

The audit found that the program had successfully assisted local governments to plan and implement many thousands of local subprojects designed to provide basic services to the rural poor of Egypt. Nevertheless, we believe that USAID/Egypt could enhance the effectiveness of the LD II Program by taking steps to:

- improve the accuracy of the GOE's reporting of subproject progress upon which funding decisions are based (see page 7);

- ensure that the GOE submits quarterly cash management reports as required in the Grant Agreement (see page 13);

- encourage local governments to earn and report interest on idle grant funds (see page 14);

- ensure that equipment procurement is in compliance with applicable source/origin guidelines (see page 20); and

- take action and assist local governments to improve the utilization of idle subprojects when these are identified (see page 28).

The report contains five recommendations. Four are procedural in nature while one recommends a cost recovery to the Program of not less than $328,536 in equivalent local currency (see page 19.) The report also (1) discusses our assessment of internal controls and relates problems to weaknesses in internal controls (see page 32), and (2) includes a summary of significant areas of noncompliance with applicable laws and regulations (see page 36.)

A draft of this report was provided to Mission officials for comment. In responding to the draft report, the Mission indicated it concurred with most findings and recommendations, but did not concur with two recommendations which remain unresolved upon issuance of this report. As the Mission's "overview statement" at the beginning of Appendix II indicates, about half the population of Egypt has been beneficially affected by the program's more than 10,000 development activities. The program has been substantially reformed and strengthened as a result of a recent interim evaluation and this audit, which leads the USAID to feel that it is now "on track" in pursuing its ambitious and diverse decentralization and developmental objectives. The Mission's entire response is included as Appendix II to this report.

Office of the Inspector General

Office of the Inspector General

31 January 1991

Glossary

A.I.D.	Agency for International Development
Amana	Technical secretariat under the Ministry of Local Government (Program implementing agency)
DSS I	Decentralization Sector Support Program
FMFIA	Federal Manager's Financial Integrity Act
GOE	Government of Egypt
Governorate	Egyptian province or state
IG	Inspector General
LD II	Local Development II Program
LE	Egyptian Pound (approximate ratios to $1: 1987=2.2, 1988=2.3, 1989=2.6)
Markaz	Egyptian district or county
ORDEV	Organization for the Reconstruction and Development of the Egyptian Village
PACD	Project Assistance Completion Date
PIL	Project Implementation Letter
PLDC	Provincial Local Development Committee
PVO	Private Voluntary Organization
QPR	Quarterly Progress Report
RIG/A/C	Regional Inspector General for Audit, Cairo
USAID	United States Agency for International Development (Mission)

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INTRODUCTION

Background

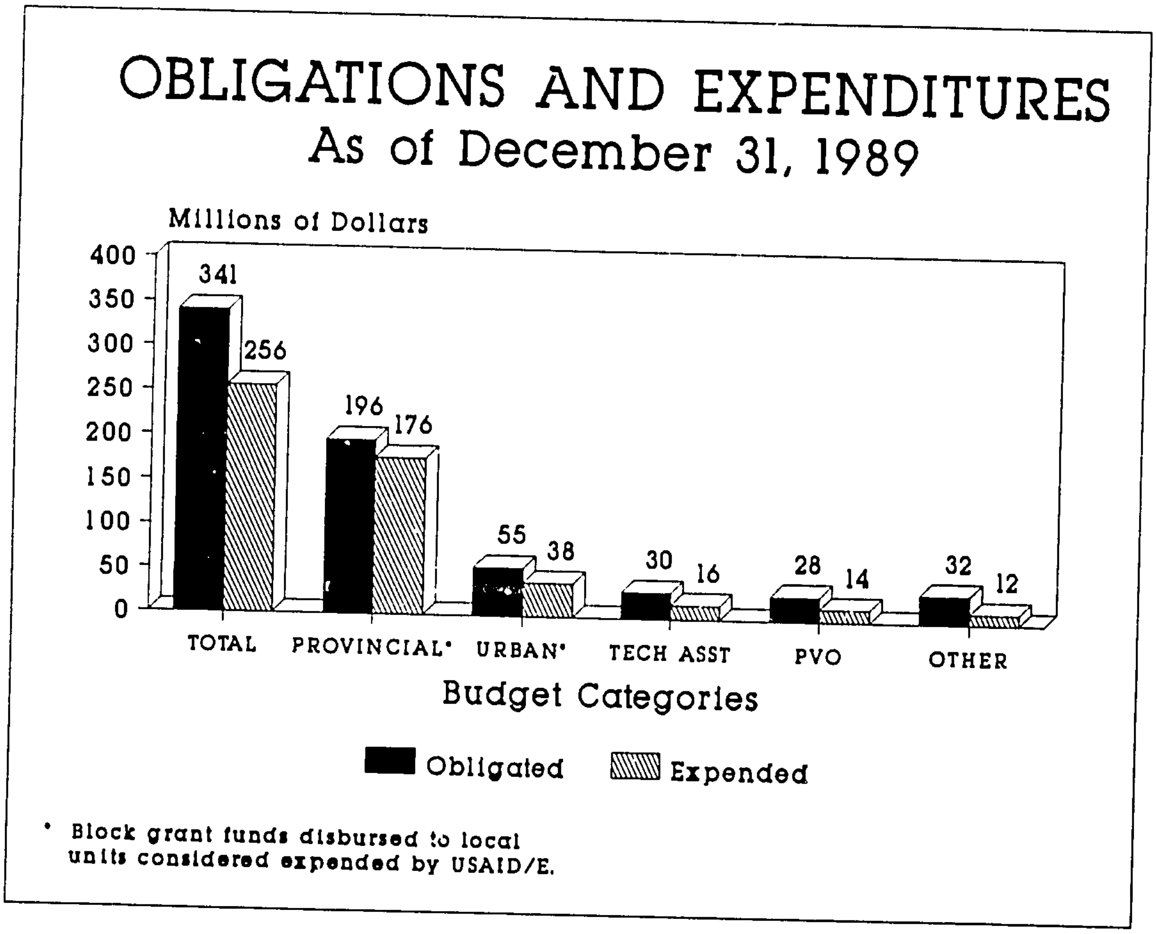
The Local Development II Program (LD II) was designed in the mid-1980's. According to the Project Paper, the quality of life in much of rural and urban Egypt left much to be desired. In 1980, the World Bank estimated that one in three Egyptians had no access to safe water. Water networks that did exist were far more widespread than sewer systems, contributing to serious health problems caused by stagnant water near residences. The absence of clean water, waste disposal and good roads, which provide access to raw materials and markets, also restricted the growth of rural and small urban industry.

The Government of Egypt (GOE) had recognized for some time that the task of meeting the basic needs of most Egyptians was too large to be achieved through central administration. The decentralization of local development had been a major item on the GOE's development agenda for the past decade.

USAID/Egypt began the Decentralization Sector Support Program (DSS I), of which LD II is the second phase, in 1982. Under DSS I, five prior USAID activities -- Development Decentralization I, Basic Village Services, Decentralization Support Fund, Neighborhood Urban Services, and Sector Development and Support -- were grouped into one comprehensive program. These activities provided about $600 million to assist local government units to implement more than 6,000 subprojects to provide improved basic services to their residents.

As investment increased during DSS I, weaknesses in the local government system began to impede long-term economic growth and local development. Major constraints identified were: policy formulation, the planning process, fiscal decentralization, coordination of investment with recurrent costs, subproject design, operation and maintenance of infrastructure, and human resources development.

LD II was designed to address the constraints identified under DSS I. The goal of the LD II Program was to enhance the quality of life of low-income Egyptians through the provision of essential basic services by (1) improving and expanding the capacity of local government to plan, finance, implement and maintain locally chosen basic services projects; and (2) improving the capacity of local government to mobilize local resources in order to sustain the provision of basic services. Planned outputs included: an improved decentralized planning and budgeting system for local government units; a GOE-funded matching block grant system; construction or rehabilitation of 3,150 local projects and provision of 500 pieces of new equipment; a maintenance system at each level of government; a system to integrate private voluntary organizations (PVOs) into the local development process; and increased policy dialogue and reform to provide local governments more authority and capacity to collect, retain and expend additional revenues, user fees, etc.

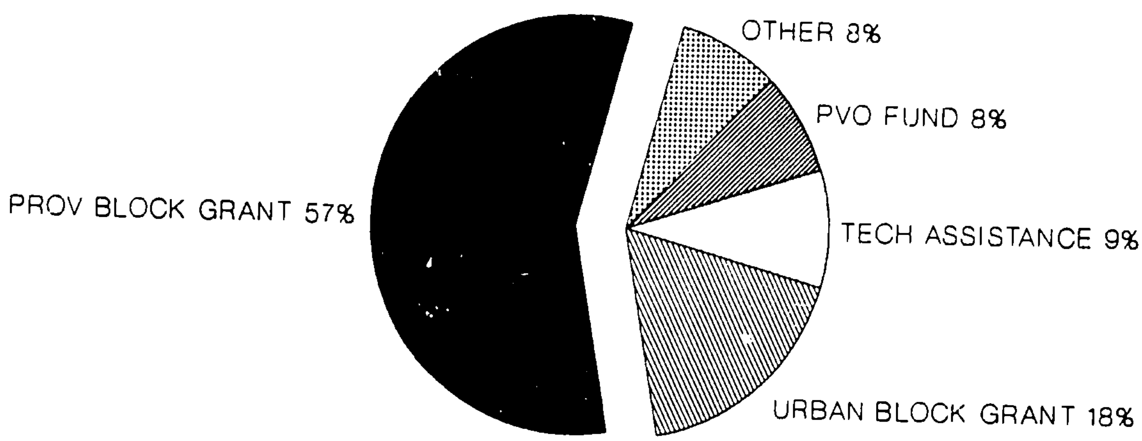


The initial Grant Agreement indicated that A.I.D. would provide $156 million to finance project activities over a four-year period, with the GOE agreeing to provide the equivalent of $72.2 million in local currency. Subsequent amendments to the Program have increased A.I.D.'s and the GOE's anticipated contributions to $481 million and the equivalent of $301 million, respectively, and have extended the Project Assistance Completion Date (PACD) from September 30, 1989 to September 30, 1993. As of December 31, 1989 A.I.D. had provided $256 million and the GOE had provided the equivalent of $58 million.

A mid-term evaluation of LD II was completed in November 1989. While concluding that the Program had been very successful in assisting local government units to carry out a large number of local projects designed to provide basic services to Egypt's rural and urban poor, it also identified problems and constraints that were seriously impeding achievement of the Program's long-term institutional objective of sustainability through local revenue generation. The evaluation provided USAID/Egypt an opportunity to approach the GOE on the need to resolve this fundamental issue. Based on the findings of the evaluation, USAID/Egypt offered to amend the present LD II program if the GOE indicated its willingness to take policy actions to improve local government's fiscal autonomy. The GOE expressed its interest in this approach and the Prime Minister appointed a senior policy committee to discuss it. This resulted in a letter to USAID dated July 8, 1990, in which the GOE stated its commitment to key policy actions. This provided the basis for amending the program.

In September 1990 USAID/Egypt, in conjunction with the GOE, amended the LD II Program in order to support a renewed commitment by the GOE to implement policy reform. The block grant funding mechanism, which provided local government units with local currency purchased with appropriated A.I.D. dollars, was changed to a sector grant which will provide U. S. dollar payments (to be managed under A.I.D.'s rules governing cash transfer assistance) to the GOE based on its performance in achieving predetermined policy reforms. Equivalent amounts of local currency will be provided by the GOE in order to continue the funding of block grants.

OBLIGATIONS BY ELEMENT
As of December 31, 1989



Based on the results of a pre-audit survey, our audit objectives were formulated to focus on the largest element of LD II, the provincial block grant program. This element included $196 million, or 57 percent of total A.I.D. obligations under LD II of $341 million, as of December 31, 1989.

To implement the provincial block grant program, USAID/Egypt assigned nine employees to this element and contracted with Chemonics International Consulting Division for more than $15 million of technical assistance. At the time of our audit, the Mission was expecting to extend the Chemonics contract an additional two years until September 30, 1992.

Audit Objectives

The Office of the Regional Inspector General for Audit/Cairo audited USAID/Egypt's Local Development II Program (LD II) to answer the following audit objectives:

1. What is the progress of the provincial block grant program and is LD II's management information system a reliable indicator of progress?

2. Is USAID/Egypt's funding mechanism for the provincial block grant component the most suitable alternative available?

3. Did USAID/Egypt ensure that equipment purchases met applicable guidelines?

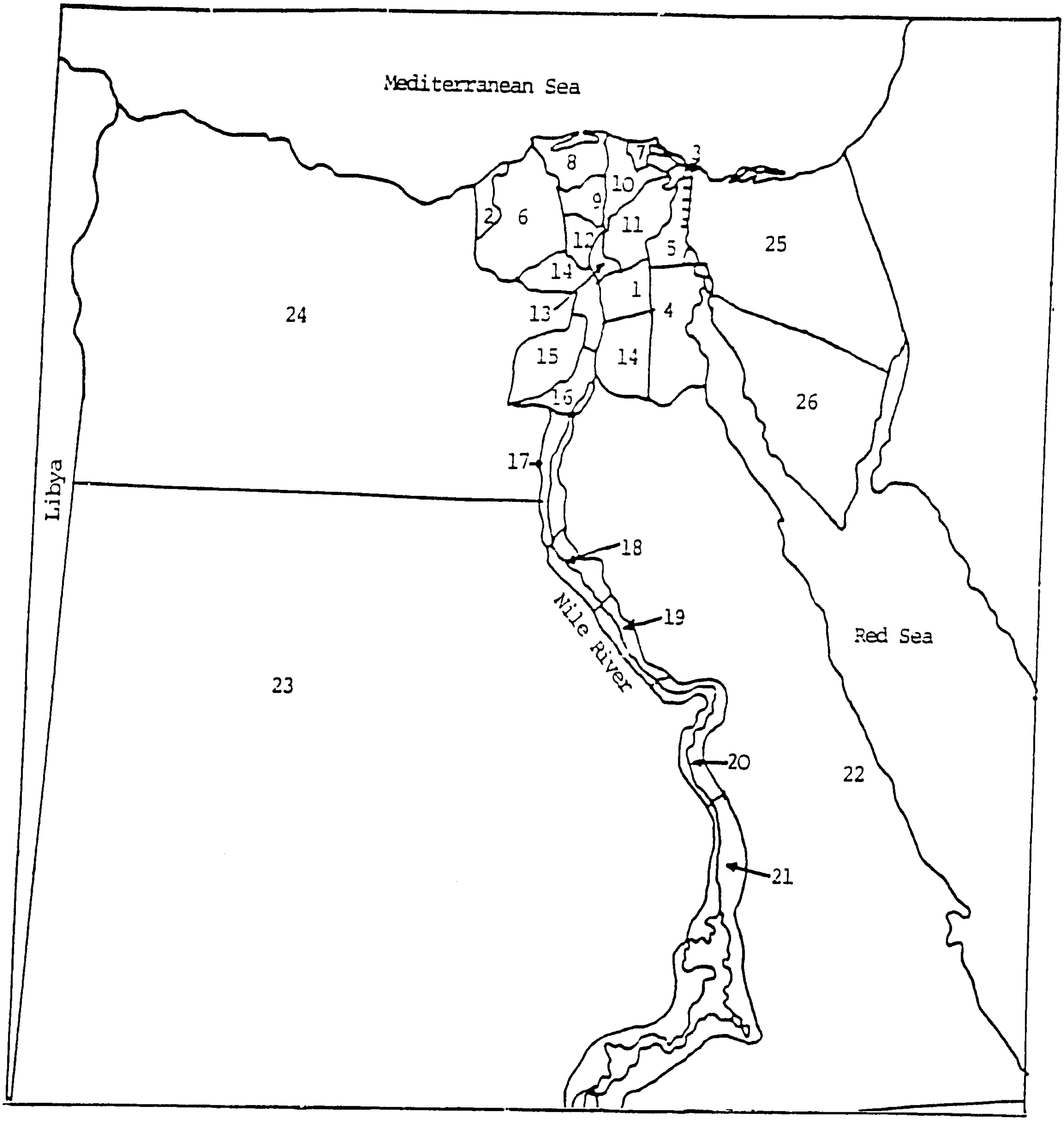
4. Did USAID/Egypt ensure that completed subprojects were being utilized?

These audit objectives included a review of compliance with laws and regulations and an assessment of internal controls relating to the audit objectives. Where deficiencies were found, the audit objectives were broadened to identify causes and recommendations.

No detailed audit work was performed in the urban block grant element because the audit survey phase indicated that the level of control risk was relatively low. The audit did not cover the $30.3 million obligated for technical assistance contracts. Each of the major contractors either has been or will be scheduled for non-federal (financial) audit in the future. Another major element, under which grants were made to local private voluntary organizations (PVOs), was recently audited by RIG/A/Cairo (see Audit Related Memorandum (ARM) No. 6-90-006), and was therefore not included in this audit.

Appendix I contains a complete discussion of the scope and methodology of this audit.

ARAB REPUBLIC OF EGYPT



URBAN GOVERNORATES	PROVINCIAL GOVERNORATES		
1. Cairo	5. Ismailia	12. Menoufia	19. Sohag
2. Alexandria	6. Beheira	13. Qalubiya	20. Qena
3. Port Said	7. Damietta	14. Giza	21. Aswan
4. Suez	8. Kafr El Sheik	15. Fayoum	22. Red Sea
	9. Gharbia	16. Beni Suef	23. New Valley
	10. Dakahlia	17. Minia	24. M. Matrouh
	11. Sharkiya	18. Asyut	25. N. Sinai
			26. S. Sinai

REPORT OF AUDIT FINDINGS

What is the progress of the provincial block grant program and is LD II's management information system a reliable indicator of progress?

The provincial block grant program has been quite successful in assisting local government units to plan and finance many thousands of local subprojects designed to provide basic services to the rural poor in Egypt. In terms of overall A.I.D. funding, the program has achieved a timely rate of disbursement. However, we could not determine the actual rate of expenditure on, or implementation of, local subprojects due to inaccuracies in the Government of Egypt's (GOE) reporting. Further, USAID/Egypt made disbursements based on questionable data in GOE reports.

Under LD II's provincial block grant program, Egyptian local government units have completed three annual planning and budgeting cycles through which more than $176 million in A.I.D. funds were disbursed as local currency grants. These monies, which constitute about 83% of allocated program funds (the GOE provides the balance), have been utilized to construct or rehabilitate over 10,000 subprojects since 1986. The majority of grant funds were allocated to water, road, or sewage subprojects based on locally determined needs.

The audit disclosed that for the items tested, expenditure rates reported in the QPR were overstated and were therefore unreliable indicators of the actual progress of grant-funded projects.

While the disbursement of A.I.D. dollars appears to have been timely, the actual implementation of subprojects occurred at a much slower rate according to the Quarterly Progress Report (QPR) -- produced by the GOE's Organization for the Reconstruction and Development of the Egyptian Village (ORDEV). For the items tested, expenditure rates reported in the QPR were overstated and were therefore unreliable indicators of the actual progress of grant-funded projects. However, USAID/Egypt used the QPR expenditure rates as a measure of past performance in order to determine the eligibility of governorates for subsequent grants. Participating governorates may not have qualified for additional grants at the time they were disbursed by USAID/Egypt had the GOE reported expenditure rates more accurately on the QPR.

USAID/Egypt Disbursed Grants Based <u>On Unreliable Expenditure Reports</u>

The LD II Grant Agreement indicated that the GOE was to maintain a report (the QPR) to show the financial and physical progress of each subproject and that this report was to be made available to USAID/Egypt on a quarterly basis. Based on QPR expenditure rates of prior year grants, USAID/Egypt determined whether provincial governorates were eligible to receive a subsequent year's funding. The Standard Provisions Annex of the Grant Agreement specifies that the GOE will maintain records to adequately show the receipt and use of goods and services acquired under the grant in accordance with generally accepted accounting principles, and that such records will be audited regularly. For the items tested, expenditure rates reported in the QPR were often overstated and were therefore unreliable indicators of the actual progress of grant-funded projects. The lack of clear accounting guidelines and regular audits has allowed reporting discrepancies to distort the expenditure rates in the QPR, thereby causing USAID/Egypt to make funding decisions based on inaccurate data. Participating governorates may not have qualified for additional grants if the GOE had reported expenditure rates more accurately on the QPR. Reporting discrepancies included reporting expenditures before they actually occurred and including in-kind "popular participation" contributions in the expenditure rate calculations.

<u>Recommendation No. 1</u>: We recommend that USAID/Egypt in consultation with ORDEV:

1.1 inform all participating local government units that transfers of grant funds between government entities should not be reported as expenditures on the Quarterly Progress Report;

1.2 have periodic audits of provincial block grant expenditures made by qualified local auditors; and

1.3 devise and implement an expenditure rate formula which excludes in-kind popular participation contributions in order to determine governorates' eligibility for additional grant funding.

Planning guidelines and project implementation letters (PILs) for LD II's provincial block grant program require that grant funding for the 22 participating governorates be conditioned upon prior years' funds utilization Planning guidelines for the second-year grant included the precondition that each governorate meet the following expenditure rates for previous years (including the first year LD II grant and grants under predecessor project, Basic Village Services) in order to be eligible for disbursement:

50 percent of funds received the prior year
85 percent of funds received 2 years previously
100 percent of funds received 3+ years previously.

Each grant disbursement PIL states the same criteria for future funding eligibility. USAID/Egypt has relied on the GOE-produced QPR to determine whether or not governorates met the expenditure rate criteria. USAID/Egypt officials stated that project expenditures reported on the QPR should represent actual goods or services purchased rather than transfers of funds between government entities. One of the main objectives of our audit was to assess the expenditure data being reported on the QPR to determine whether it was a reliable indicator of project progress.

In several instances project funds were reported as expended when they had only been transferred from one government entity to another for implementation purposes. Most such instances occurred with water, road, and sewage projects implemented by a centrally administered authority because local villages lacked the necessary technical expertise. Those three categories of projects comprised more than 67 percent of the LE497 million allocated under the provincial block grant component. Following are several examples of premature reporting of expenditures in the QPR:

The March 1988 QPR reported that two road projects totaling LE131,208 in Balana Village of the Aswan Governorate were 99 percent expended although neither project had begun actual implementation. The governorate had reported the transfer of funds to the Roads and Bridges Authority -- which was to implement both projects -- as expenditures because they no longer controlled the funds.

Two water projects in El Batanon Village in Menoufia Governorate reported expenditures on the QPR upon the village's having advanced checks totaling LE83,262 to the governorate Housing Department which only later implemented both projects.

The Oseim markaz (district) in Giza Governorate reported in the September 1989 QPR that LE110,000 allocated for a bridge project was 100 percent expended although the value of work reported on the same QPR was only 36 percent. The village had sent a check for LE110,000 to the Department of Drainage in Beni Sweif which was responsible for constructing bridges built over drainage canals, and this entire amount was reported as an expenditure. We visited the project site in July 1990 and found it incomplete.

In addition to our field audit findings, a report entitled "Managing LDII-P Project Funds" prepared by the technical assistance contractor in November 1988 noted that the expenditure rates of first-year project funds of all governorates had been exaggerated because:

> it is known that many governorates treat handover of funds to directorates responsible for implementation as if it were actually expenditure, though these funds may sit idle for months thereafter.

Other cases of premature reporting of expenditures involved certain local government units which reported spending funds not yet expended so as to avoid having those funds reallocated elsewhere. The December 1989 QPR reported that El Tal El Kebir markaz in Ismailia Governorate had spent LE1,871,123 on a road project. After finding that expenditure of only LE1,581,789 was documented in the markaz' accounting records, markaz officials admitted that they had purposely reported expending the difference, LE289,334 (an unanticipated savings compared with the budgeted cost of the project), even though the funds had not been spent. They said the funds would be used to extend the original project contract to include paving some side streets. Local officials further stated that had they not reported expending the balance, they feared the governorate would have reallocated those funds to another markaz.

A similar situation existed in El Minia Governorate where a water project in the village of Abu Gerg showed expenditures of LE2,136 more than was actually spent. Village officials intentionally overstated expenditures to prevent governorate officials from transferring unspent funds elsewhere.

In our opinion, expenditure rates reported in the QPR for projects that we audited were generally overstated and did not represent the true progress of project implementation. The reasons for the discrepancies included a lack of understanding by local government officials as to what constituted reportable expenditures as well as conscious attempts to avoid reallocation of unspent funds to other beneficiaries.

GOE controls to ensure the reliability of QPR expenditure data were either not in place or not functioning properly. The Project Paper indicates that responsibility for monitoring the program is shared by appropriate officials in the participating governorates, the "Amana" (a technical secretariat for LD II under the Ministry of Local Government), and USAID/Egypt. The QPR was to be part of the program's Management Information System, which would allow governorates, the Amana, and the Mission to monitor each stage of the local development process. The previously mentioned planning guidelines instructed local government officials on QPR preparation, but did not specifically define expenditures as actual cash outlays or justifiable accruals. This lack of instruction caused a major breakdown in the internal control system for accurately reporting expenditures.

An important internal control that USAID/Egypt has not used under LD II is to have expenditures for local subprojects audited, as provided for in the Standard Provisions Annex of the LD II Grant Agreement. It states that the Grantee will:

> maintain or cause to be maintained, in accordance with generally accepted accounting principles and practices consistently applied, books and records relating to the Project and to this Agreement, adequate to show, without limitation, the receipt and use of goods and services acquired under the Grant. <u>Such books and records will be audited regularly</u>. (underline added)

Project officials claim that all LD II grant expenditures by local government units are subject to audit by the GOE. Past experience has shown, however, that the Central Auditing Organization, which conducts governmental audits for the GOE, is unwilling to share audit results with USAID/Egypt or RIG/A/Cairo. To our knowledge, USAID/Egypt has never obtained any GOE audit reports of LD II activities and is therefore unaware of the results of such audits, if any actually took place. For this reason, we believe that USAID/Egypt and the GOE should periodically obtain an opinion from a professional auditing firm concerning the reliability of expenditures reported on the QPR and correct any significant reporting problems prior to relying on that report for determining the eligibility of governorates for grant funding.

USAID/Egypt's calculation of governorate expenditure rates for determining grant eligibility included "popular participation," which consists of voluntary in-kind or cash contributions by local government units. Examples of such in-kind contributions include land for project sites and labor. The value of such contributions is reported immediately as an expenditure in the QPR. This obviously distorts the true rate of grant fund expenditures in favor of governorates trying to meet the rates needed for subsequent LD II disbursements.

The Director of the Local Development Department in the Red Sea Governorate informed us that he did not think the popular participation contributions represented actual expenditures. He stated that such contributions were usually land rather than cash.

Currently the QPR does not distinguish between in-kind and cash contributions. We believe that USAID/Egypt should request the GOE to report in-kind contributions separately from cash contributions so that the in-kind portion can be excluded from the expenditure rate calculation. As of December 31, 1989 the total popular participation reported was over LE41 million, or 8.3 percent of the total funds allocated under the provincial block grant program.

USAID/Egypt officials noted that they had recognized the need to improve the reliability of the QPR. They further stated that they had already contracted a local consulting firm to perform a study of methods to improve the management and reporting of program funds. USAID/Egypt objected to our position that program funds be reserved for regular audits of QPR expenditures, stating that the program already had a budget for "Audits and Evaluations." Also, they asked that Recommendation 1.3 differentiate between cash and in-kind "popular participation" as cash should be included in the expenditure rate calculation. RIG/A/Cairo formulated the draft recommendations accordingly.

Management Comments and Our Evaluation

USAID/Egypt stated that it agreed with Recommendations Nos. 1.1 and 1.3. The Mission sent a letter dated January 14, 1991 to the Chairman of Egypt's Provincial Local Development Committee (PLDC) requesting that provincial governorates participating in the LD II program be notified that the transfer of grant funds between different local government entities should not be reported as an expenditure on the QPR and documenting a revised expenditure rate formula. We consider these parts of the recommendation closed upon report issuance.

USAID/Egypt did not agree with Recommendation No. 1.2 or the finding that provincial block grant expenditures should be audited periodically by a local audit firm. According to the Mission, the GOE system mandates governmental organizations to follow certain financial control procedures which independent consultants have concluded are being followed diligently. The Mission also asserted that the GOE already performs an independent audit function to ensure the accuracy of financial information of all GOE activities including LD II subprojects. While acknowledging that the GOE has consistently refused to share the results of such audits with A.I.D., the Mission reported that those results are given to senior governorate managers who are responsible for implementing and following up on audit recommendations. USAID/Egypt requested that this audit recommendation be withdrawn.

As the results of GOE audits are unavailable to USAID/Egypt or RIG/A, we cannot determine whether those audits are conducted in accordance with generally accepted auditing standards. We therefore conclude that such audits, if any, do not satisfy the Standard Provisions Annex of the LD II Grant Agreement. Furthermore, since the GOE audits expenditures rather than "the books and records" specifically relating to the LD II program, USAID/Egypt cannot be assured that any recommendations or corrections made as a result of GOE audits will be properly reflected in the LD II QPR. We consider this part of the recommendation unresolved because USAID/Egypt's position in this matter is not in accordance with Federal government policy which places the responsibility for conducting audits of Federal grants on grant recipients.

Is USAID/Egypt's funding mechanism for the provincial block grant component the most suitable alternative available?

The audit found that the funding mechanism used to disburse provincial block grants may not have been the most suitable alternative available in order to accomplish the objectives of the program.[1] USAID/Egypt's ability to monitor the transfers of cash to each local government unit has been hampered due to the lack of GOE reporting. Furthermore, the current funding mechanism has resulted in an accumulation of large idle balances of local currency held by local government units subject to loss of purchasing power due to the relatively high inflation rate of the Egyptian pound.

USAID/Egypt's ability to monitor the transfers of cash to each local government unit has been hampered due to the lack of GOE reporting.

The current funding mechanism was an effective means of delivering local currency block grants to recipients. Over $176 million was converted to local currency and disbursed to governorates in three annual cycles of the provincial block grant program. The Project Paper explained the justification for disbursing local currency block grants annually (as opposed to quarterly tranches or periodic advances) by pointing out that the primary purpose of LD II was to promote a decentralized planning and budgeting process. Accordingly, local government units were to be afforded full control over local currency block grant funds. Furthermore, the nationwide scope of the project, with numerous scattered accounting stations, rendered a conventional USAID cash advance mechanism difficult to implement. Finally, according to the Project Paper, a U. S. Comptroller General's ruling of November 28, 1984 concurred in the use of this disbursement mechanism when the project purpose requires it.[2]

In order to monitor the transfer of grant funds, the GOE was to provide USAID/Egypt a quarterly cash management report, as required under the Grant Agreement. USAID/Egypt has yet to receive such a report. Despite this lack of accountable reporting by the GOE, USAID/Egypt continued to disburse millions of dollars worth of block grants to local government units during the first three annual cycles of the

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[1] A recent Program amendment will change the disbursement of fourth-year block grants to a U. S. dollar performance payment or "sector grant" based on policy reforms to be enacted by the GOE regarding local government fiscal autonomy. (See page 3 of this report.)

[2] See additional discussion of this ruling on page 16 of this report.

program. Because provincial block grants were disbursed to local government units in annual lump sums, these units would consequently hold large idle balances of local currency for months or even years before expending the funds. With annual inflation exceeding 20 percent, this practice resulted in a substantial loss of purchasing power of the unspent grant funds. USAID/Egypt did little to encourage local government units to earn interest on idle grant funds even though this would have partially offset losses due to inflation. The audit found that some local units did earn interest on idle grant funds but USAID/Egypt did not require that the earned interest be reported, even though the Grant Agreement stipulates that interest generated from the use of block grant funds "will be retained for program use." Therefore, USAID/Egypt had no means by which to ensure that the interest earnings were being used for program purposes.

USAID/Egypt Had Not Received
Required Host Country Reports

Section 5.3 of the Grant Agreement requires the GOE to provide a cash management report to USAID/Egypt on a quarterly basis. Five years after the start of LD II, USAID/Egypt has still not received such a report. Despite not receiving this report, USAID/Egypt disbursed over $176 million for local currency grants during three annual program cycles. Project officials claim that the report is currently under development in conjunction with a cash management study being performed by a third-party consultant. Without this report, USAID/Egypt's ability to monitor the transfers of grant funds to the various implementing units has been hampered.

> **Recommendation No. 2:** **We recommend that USAID/Egypt obtain quarterly cash management reports from ORDEV as required in Section 5.3 of the Grant Agreement.**

Section 5.3 of the Grant Agreement includes the following Special Covenant:

> The Grantee will maintain a quarterly financial and physical progress report on each individual subproject and will maintain a quarterly cash management report showing the dates of transfers of Block Grant and Maintenance Funds to each implementing entity. These reports will be made available to A.I.D. on a quarterly basis, within 60 days after the end of the quarter. (underline added)

The Organization for the Reconstruction and Development of the Egyptian Village (ORDEV) currently provides quarterly financial and physical progress reports (QPR's) to USAID/Egypt on a regular basis. However, it has not provided USAID/Egypt with the required quarterly cash management report. This fact was recognized in the LD II

Covenant Report, dated January 31, 1990. USAID/Egypt notified ORDEV of the deficiency in April 1990, but still had not received a report as of September 1990.

USAID/Egypt Did Not Encourage Local Governments To Earn And Report Interest

USAID/Egypt's method of disbursing provincial block grants to Egyptian local government units under LD II has created large idle balances of Egyptian pounds which have generally been kept by grant recipients in non-interest-bearing accounts. Since 1987, USAID/Egypt has disbursed appropriated A.I.D. dollars totalling over $176 million in the form of local currency block grants to Egypt's provincial governorates as "payment" for locally prepared development plans. To give the local governments experience in cash management, USAID/Egypt disbursed the funds in annual lump sums even though the governorates were not expected to completely expend the funds for up to three years. With an annual inflation rate over 20 percent, unspent grant funds suffer a substantial loss of purchasing power. To partially offset that loss, local government units could have placed their idle grant funds in interest-bearing time accounts. The Grant Agreement stipulates that all interest earned on grant funds should be used for program purposes. USAID/Egypt did not require that local government units report interest earned on grant funds, however. Consequently, it has no way to determine whether or not interest that is earned is used as intended. A quarterly cash management report is required under the Grant Agreement, but has not yet been produced by the GOE. It would provide a potential means of reporting interest earned as well as the transfer of block grant funds.

Recommendation No. 3: We recommend that USAID/Egypt in conjunction with ORDEV:

3.1 encourage provincial block grant recipients to earn interest on idle grant funds; and

3.2 require that earned interest be reported in the quarterly cash management report.

USAID/Egypt's mechanism for disbursing grant funds under LD II's provincial block grant component has been to issue project implementation letters (PIL's) authorizing local currency checks to be sent to each provincial governorate upon receipt of approved locally developed project implementation plans and budgets. Those funds are then commingled with GOE contributions and redistributed to districts, village councils, or other agencies to implement the approved projects. The local currency checks are drawn by the U. S. Disbursing Officer in Cairo from a local account maintained at a commercial bank. LD II local currency disbursements are charged to A.I.D.'s dollar appropriations for Egypt.

According to the Project Paper, the rationale for using the PIL disbursement mechanism was to support LD II's primary purpose -- developing the capacity of local government units to participate fully in planning, managing, and financing local development projects. The designers of LD II believed it necessary that local government units be afforded full control over the local currency grant funds in order to support the project purpose. The Project Paper states that:

> Any effort to limit the control of local units over these funds would result in a diminishing of the project purpose. Furthermore, the nationwide scope of the project ... means that project sites and accounting stations are so numerous and so widespread that it would be virtually impossible to implement the program if funds were subject to a conventional USAID cash advance mechanism.

Since February 1987, USAID/Egypt has exchanged more than $176 million for LE410 million which represented about 83 percent of all LD II funds allocated to the 22 provincial governorates. As of December 31, 1989 those governorates reported that over LE200 million (about 40%) of their LD II funds remained unspent. For those three years, unspent grant funds averaged about LE81 million, with A.I.D.'s share equal to about $28.3 million at the rate at which appropriated A.I.D. dollars were converted to Egyptian pounds to make the annual block grant disbursements. This cost the U. S. Treasury an estimated $7 million in interest expense.[3]

With an overall inflation rate above 20 percent, holding Egyptian pounds becomes very costly in terms of reduced purchasing power for grant recipients. While the value of the Egyptian pound has been deteriorating, grant recipients have been building up unexpended pound balances which are generally held in non-interest-bearing accounts.

The fact that local government units have held large amounts of unspent grant funds is evident by examining the rate of expenditure[4] of those funds once they were received by the respective governorates. For example, the Red Sea Governorate received LE3 million in USAID grant funds in May 1988 to implement 50 approved projects. As of December 31, 1989 that governorate reported that 25 of those projects were still incomplete and nearly LE500,000 remained unspent. The following graph shows the increasing idle cash balances controlled by all provincial block grant recipients.

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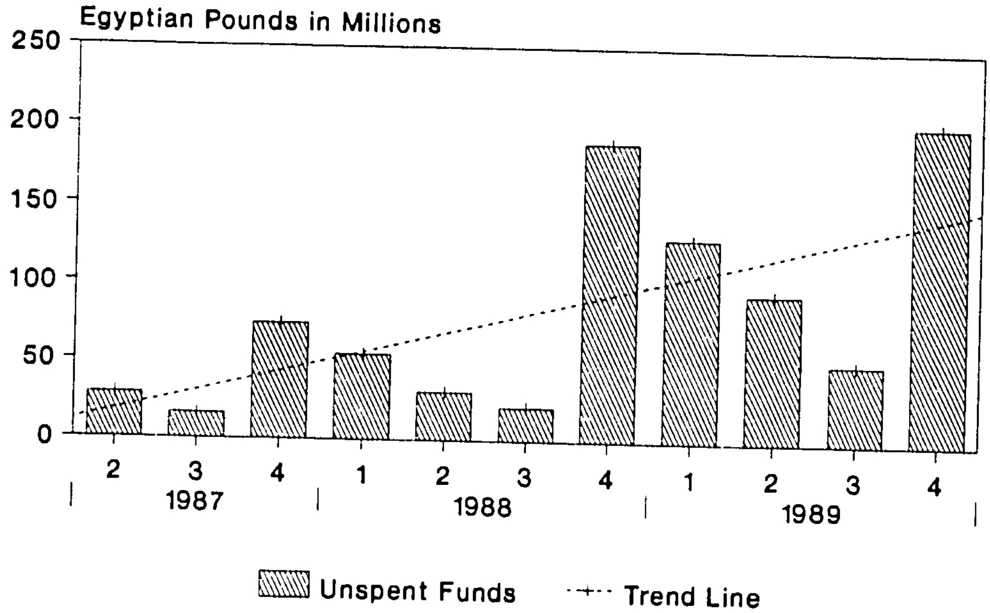
[3] Calculated as "opportunity cost" with the assumptions that A.I.D.'s share of unspent funds is the same percentage as A.I.D.'s contribution (83%), and that the cost of USG funds was 9 percent.

[4] Rates of expenditure were taken from LD-II's Quarterly Progress Reports (QPR's) which our audit samples found to substantially overstate actual expenditure rates of subprojects.

UNSPENT BLOCK GRANT FUNDS
By End of Quarter



Source: LD II Quarterly Progress Reports

A partial hedge against inflation would be achieved by placing idle local currency funds in interest-bearing accounts. At the request of the A.I.D. Inspector General, the U. S. Comptroller General issued a decision on November 28, 1984 which allowed the GOE to retain interest earned on grant funds awarded through the Basic Village Services Project, a predecessor of LD II. This decision also states that:

> a governorate or village council that did not keep [idle] funds in an interest-bearing account until they were needed would not appear to be acting responsibly toward achieving the primary stated purpose of the grant--developing a capacity "to plan, manage, fund, implement, and maintain" locally chosen projects.

A cash management study prepared by the technical assistance contractor in 1988 identified a "significant opportunity cost" of provincial block grant funds due to the poor investment practices of local government units. That study projected annual savings over LE3 million if local government units had adopted a better cash management strategy.

Despite the obvious benefits of placing idle grant funds in interest-bearing accounts, USAID/Egypt did little to ensure that local government units took advantage of this practice. Annual guidelines suggested that 70 percent of the initial grant fund be placed in interest-bearing accounts, but USAID/Egypt did not enforce the guidelines or even require that earned interest be reported.

The December 1989 QPR shows that only the following five provincial governorates reported allocating earned interest to subprojects during the first three years of the provincial block grant program.

	LE
Beheira	7,000
Beni Sweif	299,163
Ismailia	314,052
Mersa Matrouh	70,499
Minia	87,574

Many other governorates earned interest on idle project funds but did not report such earnings, as this was not required. An Aswan governorate official stated that no grant funds were placed in interest-bearing accounts during the first and second years of LD II because the head of the governorate Finance Department believed earning interest was against Ministry of Finance regulations. The official confirmed that funds were placed in interest-bearing accounts during the third year but the interest was not reported.

In Giza governorate officials claimed no interest was earned until the third year, but records of one Giza markaz showed that a total of LE37,547 had been earned on grant funds by that markaz during the past three years. Markaz officials claimed that most of the interest had been used to supplement provincial block grant projects, but could not provide supporting documentation.

Mersa Matrouh Governorate reported only LE70,499 in interest on the QPR, but our audit of governorate bank accounts revealed about LE350,000 which had been earned on grant funds. Governorate officials stated that the difference was because they only report interest when it is allocated to specific projects.

In the Red Sea Governorate the director of the Local Development Department provided documentation for LE88,245 in interest earned on grant funds during the first two years. He stated that all the interest was kept in the governorate bank account because he did not know what to do with it. That governorate did not report any interest on the QPR.

The Grant Agreement requires all interest generated from block grant funds to be used for Program purposes. Since earned interest was not being reported, USAID/Egypt had no way of knowing whether or not it was being used as intended. In one case, we found that LE1,415 in unreported interest earned on grant funds was used to complete the construction of a police station. The police station was not an LD II project. Such use of program funds is questionable in view of Section 660 of the Foreign Assistance Act which prohibits the use of A.I.D. funds for general police assistance.

The issue of earning and reporting interest was not well understood by local government officials interviewed during our audit. We believe that USAID/Egypt should ensure that the appropriate GOE authorities issue clearer instructions to all participating governorates to encourage that interest be earned on idle funds, accurately reported, and used for program purposes.

USAID/Egypt agreed with our position concerning the earning and reporting of interest, but asked that the recommendation be modified to require that the interest be reported on the quarterly cash management report rather than the QPR. As the quarterly cash management report had never been made available to USAID/Egypt by the GOE, we added Recommendation 2 to ensure that this reporting vehicle became available.

<u>Management Comments and Our Evaluation</u>

USAID/Egypt stated that it concurred with Recommendation No. 2. It is currently working with the GOE to develop this report and will request closure of Recommendation No. 2 as soon as it approves the report format. Although we consider Recommendation No. 2 to be resolved, we would also note that the GOE has yet to comply with a key Grant Agreement covenant several years after project operations have been underway. We will close the recommendation when we receive a copy of the cash management report approved by USAID/Egypt.

USAID/Egypt also responded that it was in agreement with Recommendations Nos. 3.1 and 3.2 regarding the earning and reporting of interest on idle block grant funds. It sent a letter to the Chairman of the PLDC encouraging participating governorates to collect interest on uncommitted block grant funds and requesting that governorates separately report all interest earned along with the QPR until the cash management report is ready. It expected the latter report to be ready in about six months. USAID/Egypt requested that the Chairman of the PLDC send copies of the letter to each governor. Based on these actions we consider Recommendations Nos. 3.1 and 3.2 closed upon report issuance.

Did USAID/Egypt ensure that equipment purchases met applicable guidelines?

USAID/Egypt, through the use of a technical assistance contractor and in conjunction with the GOE, provided guidelines to local government units for equipment procurement in the form of Project Implementation Letter (PIL) 5, dated April 26, 1987, later amended by PIL 5A on July 26, 1989. USAID/Egypt ensured compliance with some of the guidelines in those PIL's but failed to ensure compliance with others.

Project files indicated that USAID/Egypt had monitored local Egyptian newspapers for bid openings placed by local government units to procure equipment with provincial block grant funds. On several occasions, USAID/Egypt helped correct requests for bids which were not in compliance with PIL 5 or 5A. For example, advertisements which stated that bidders were allowed a four-month delivery time to procure equipment were not in compliance with the "shelf item" definition. USAID/Egypt contacted the local officials responsible for the advertisements and required that they be corrected.

Despite USAID/Egypt's efforts, at least $328,536 of procured equipment in our opinion did not comply with applicable source/origin guidelines. Furthermore, we believe that equipment procurements did not reflect A.I.D.'s "Buy America" policy.

USAID/Egypt Did Not Ensure That Source/Origin Guidelines Were Met

The procedures under which goods and related services would be procured using LD II block grant funds were documented in PIL 5, later amended to PIL 5A. These PILs specifically prohibited the procurement of any commodity whose source or origin was non-Free World countries. Two participating provincial governorates procured 37 tractors with provincial block grant funds totalling LE762,204 (about $328,536) the main components of which, at least, were made in Romania -- a non-Free World country. This came about because local government procurement officials considered the tractors, which were assembled in Egypt, to be of Egyptian origin, notwithstanding the fact that the words "MADE IN ROMANIA" were clearly visible on the major components of the tractors. LD II files indicate that substantial additional equipment of non-Free World origin may have been procured with provincial block grant funds. Section D.2 of the Standard Provisions Annex to the Grant Agreement allows USAID/Egypt to require a grantee to refund any disbursements "not made or used in accordance with this Agreement." We believe USAID/Egypt should identify all source/origin violations under the provincial block grant program and ensure that affected provincial grant funds are "made whole" for the cost of the 37 tractors identified by the audit at a minimum, as well as for all other ineligible items subsequently identified.

<u>Recommendation No. 4</u> We recommend that USAID/Egypt:

4.1 review all equipment procurement transactions by participating provincial governorates to identify any equipment procured with provincial block grant funds that may not have adhered to applicable source/origin regulations; and

4.2 obtain evidence that affected provincial grant funds have been "made whole" for the cost of the 37 Romanian tractors identified in this report, as well as any additional items identified under Recommendation No. 4.1 above.

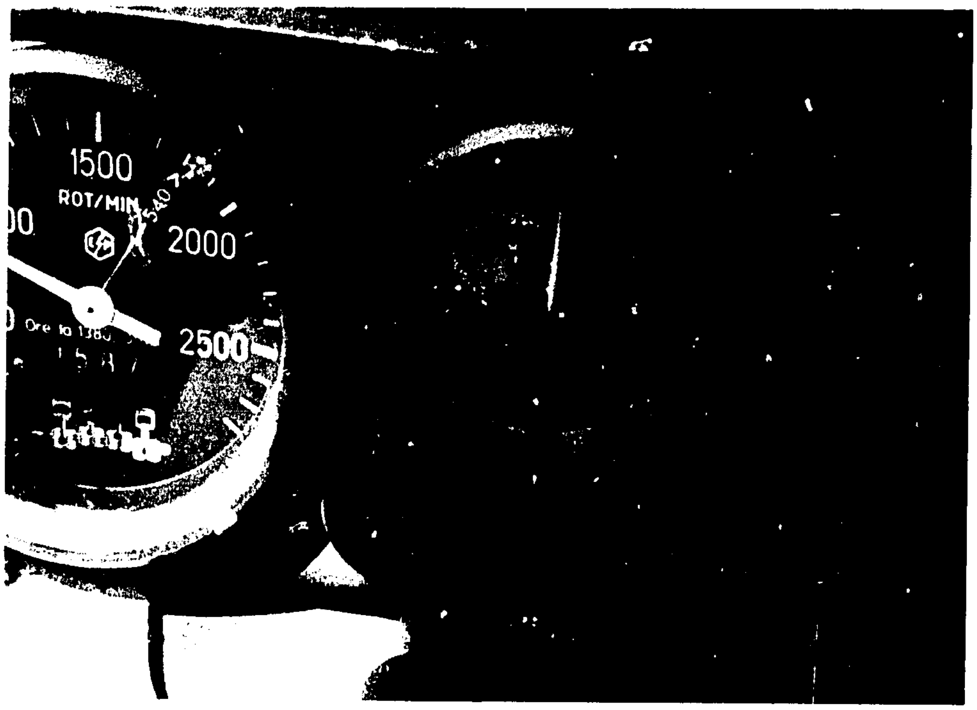
USAID Handbook 15 defines "source" as the country from which a commodity is shipped and "origin" as the location where a commodity is produced. "Components" are the goods that go directly into the production of a manufactured commodity. Handbook 15 also states that if a manufactured commodity contains any component from a non-Free World country, the commodity is ineligible for A.I.D. financing.

Project implementation letter (PIL) 5, dated April 26, 1987, established the guidelines under which goods and related services would be procured using LD II block grant funds. It stated that with the exception of "shelf items" from Free World countries, Egyptian pounds made available to the GOE would be used exclusively to finance costs of goods and services having their source and origin in Egypt. PIL 5 specifically prohibited the procurement of any commodity whose source or origin was a non-Free World country. Attached to PIL 5 was a list of non-Free World countries which included Romania.

Thirty-seven agricultural tractors with the marking "MADE IN ROMANIA" clearly visible on them had been purchased locally with program funds.

In Menoufia and Beheira, two of the three governorates audited for compliance with equipment procurement guidelines, 37 agricultural tractors with the marking "MADE IN ROMANIA" clearly visible on them had been purchased locally with program funds. Markings on the major components of the tractors -- the dashboard, electrical system, and engine block -- indicated that they were of Romanian origin. (See Photographs 1-4 on pages 21-22.) Although the tractors were assembled in Egypt, 85% of their value consisted of component parts manufactured in Romania.

<u>Photograph No. 1</u> - One of 37 agricultural tractors assembled with Romanian components. Beheira - July 1990.



<u>Photograph No. 2</u> - Dash board of above tractor. Beheira - July 1990.

Photograph No. 3 - Electrical system box cover of agricultural tractor indicating Romanian origin. Beheira - July 1990.

Photograph No. 4 - Engine block plate of same agricultural tractor. Beheira - July 1990.

Of the 37 tractors identified by the audit, 31 were procured by Menoufia officials on June 28, 1989 for a total value (including spare parts and maintenance contracts) of LE638,220. In Beheira, officials purchased 6 tractors for LE123,984 during the period May to November 1989. The total cost of all 37 tractors was LE762,204 (about $328,536 based on the exchange rate at which the respective grant dollars were converted to Egyptian pounds.) According to the technical assistance contractor, Menoufia and Beheira procured equipment worth LE5.3 million out of a total equipment allocation for all 22 participating governorates of LE30.9 million.

Officials in Menoufia claimed that they had procured those tractors because they considered them to be locally manufactured. They stated that they were unaware that procuring equipment assembled with Romanian components was in violation of PIL 5 source and origin requirements. However, USAID/Egypt's files indicate that USAID/Egypt and contractor officials held a meeting with representatives from Menoufia prior to the purchase of the 31 tractors. A subsequent USAID/Egypt fieldtrip report states that, during that meeting, the specific point was made regarding agricultural tractors to the effect that "no Eastern block [source or origin] is allowed for the equipment <u>or components</u>." (underline added)

Technical assistance contractor officials stated that they were not aware of this specific source/origin procurement violation in Menoufia or Beheira until it was disclosed by our audit. Since the tractors were assembled in Egypt, they felt they were in essence Egyptian tractors. They further stated that all 37 tractors were procured under PIL 5 which did not specifically indicate that commodities were ineligible for LD II funding if they contained any component from a non-Free World country. This componentry rule was made explicit in PIL 5A, which amended PIL 5 on July 26, 1989. PIL 5A stated that commodities procured under LD II "are not to contain any component the origin of which is a non-Free World country."

Following our initial discovery of Romanian tractors, the technical assistance contractor, in conjunction with participating governorates, began collecting data from all 22 participating governorates in order to prepare the first equipment procurement status report. Although this report had been required on a semiannual basis by PIL 5A, which was signed on July 26, 1989, it has still not been finalized.

Preliminary results of that study have identified further potential source/origin violations regarding equipment procured under the provincial block grant program. For example, a contractor team surveying program equipment procurement in Damietta Governorate reported finding two tractors made in the USSR, seven tractors made in Czechoslovakia, and five more tractors with components from Romania. Upon learning of the above ineligible procurement, the governor of Damietta, who also serves as chairman of the Provincial Local Development Committee (PLDC) which approves all provincial subproject plans funded by LD II, agreed that the cost of the tractors should be refunded from the governorate's budget.

Section D.2 of the Standard Provisions Annex to the Grant Agreement allows USAID/Egypt to require a grantee to refund any disbursements "not made or used in accordance with this Agreement." Accordingly, we believe USAID/Egypt should take appropriate action to recover LE762,204 in Program funds disbursed for the 37 tractors identified by the audit as well as for other ineligible items subsequently identified.

The Mission agreed that the cost of equipment procured in violation of source/origin guidelines should be refunded to the program. However, Mission officials made the point that the violative procurements identified by the audit were made "in good faith" by the local government units and that they should not be penalized because USAID/Egypt's original PIL 5 instructions, later clarified in PIL 5A, were deficient. They did agree that such violations made after the issuance of PIL 5A should result in refunds, but to the program rather than to A.I.D. Recommendation 4.2 was formulated with this in mind.

USAID/Egypt Did Not Ensure That Equipment Procurement Practices <u>Benefited American Manufacturers</u>

The LD II Project Paper indicated that approximately 25% of A.I.D.'s block grant contribution was expected to be retained by USAID/Egypt in U. S. dollars to finance off-shore procurement of U. S. source and origin equipment. As of December 31, 1989 about $176 million had been disbursed under the provincial block grant program, none of which was used to procure equipment off-shore. USAID/Egypt did initially set aside $3 million in grant funds to procure equipment off-shore, but participating governorates later requested and received this money in local currency in order to procure desired equipment locally as "shelf items." The main reason the governorates changed their procurement strategy was that they believed shelf items could be procured faster and cheaper than equivalent items imported from the USA. According to project officials, nearly LE31 million (about $13 million) has been allocated for equipment procurement. Our review of LE4.6 million (about $1.8 million) in locally procured equipment showed that most of the equipment was of European or Japanese origin. We believe that this does not meet the intent of A.I.D.'s "Buy America" policy. However, due to the previously mentioned program amendment which will change local currency block grants to U. S. dollar sector grants that will be used for specified eligible purposes only, we have not made a recommendation in this regard.

According to project officials, nearly LE31 million have been allocated for procurement of equipment. We visited three governorates that accounted for LE5.7 million in equipment purchases, and physically inspected LE4.6 million worth of equipment. This represented about 81% of the total equipment purchased with program funds in the three governorates. All purchases were from the local market using Egyptian pounds. Most of the equipment was of European or Japanese origin. Governorate officials claimed that such off-the-shelf procurement was faster, cheaper, and in accordance with GOE regulations that require selecting the lowest bidder for an award. They also stated that off-the-shelf procurement allowed them to inspect the equipment prior to delivery and to ensure the availability of spare parts and service.

Clearly, procurement actions thus far under LD II have fallen short of the intent of A.I.D.'s "Buy America" policy.

The importance of A.I.D.'s "Buy America" policy was recently emphasized in a communication dated August 10, 1990 to all Mission Directors by the Agency Administrator. The Administrator urged Missions to take a common sense approach to the issue of "Buy America" by supposing they had to explain their procurement actions to an American taxpayer. Clearly, procurement actions thus far under LD II have fallen short of the intent of A.I.D.'s "Buy America" policy. However, the previously mentioned program amendment, which will change local currency block grants to U. S. dollar sector grants, should ensure that future grant funds are spent by the GOE on U. S. debt payments or as foreign exchange for U. S. goods. Accordingly, we have not made a recommendation in this regard.

Management Comments and Our Evaluation

USAID/Egypt stated that it agreed with Recommendation 4.1. It reported that all governorates have submitted draft equipment status reports to the Chairman of the PLDC which identify some ineligible equipment and appropriately reimburse the governorate project accounts. USAID/Egypt has received a draft copy of the report and will request closure of Recommendation 4.1 when it has reviewed the final report. Based on these actions we consider Recommendation 4.1 resolved and will close it when we receive a copy of the final report approved by USAID/Egypt.

USAID/Egypt agreed with the part of Recommendation 4.2 which requires that provincial grant funds be "made whole" for ineligible items identified under Recommendation 4.1. However, USAID/Egypt stated that it did not agree that the 37 tractors identified in Recommendation 4.2 were ineligible because the defective guidelines in effect at the time of their procurement (PIL 5) did not specifically state that equipment with non-Free World components was ineligible.

We consider the 37 tractors to be of a non-Free World origin. Simply because they were assembled in Egypt does not change the fact that the major components originated from Romania. Nor has the Mission identified any manufactured components in these machines which are not of ineligible origin. At least 85 percent of the value of the subject tractors consisted of Romanian components with permanent markings which clearly identified them as such. These components include the engine, chassis, dashboard, and electrical parts. USAID/Egypt's failure to specifically address the eligibility of components in PIL 5 does not, in our opinion, excuse cognizant local officials from complying with the PIL 5 provision that "procurement of goods from non-Free World countries is strictly prohibited." We consider the procurement of the 37 tractors, as well as any other equipment manufactured in non-Free World countries, to be ineligible for funding under the LD II program. We therefore consider this recommendation unresolved.

USAID/Egypt stated that the audit portrays a misunderstanding of the LD II project paper concerning the 25% of the block grant being retained for off-shore procurement. It pointed out that the project paper states that governorates would have the option of using up to 25% of the A.I.D. portion of their annual block grant allocation as foreign exchange for importing capital equipment which is unavailable on the local market. According to USAID/Egypt, this clause in the project paper was to make it clear that LD II block grant funding was not envisioned to be used primarily to import capital equipment, or to require that a certain amount of such procurement occur. The Mission response also stated that equipment procured under the predecessor project, DSF, should be considered along with LD II equipment since governorates have drawn on both programs to meet their equipment requirements.

The Financial Plan section of the original Project Paper (page 64) states that, "approximately 25%, or $30.7 million, of the USAID Block Grant contribution is expected to be disbursed in U.S. dollars." (underline added) It goes on to say, "U.S. dollar disbursements would be used to finance importation of equipment of U.S. source and origin." Since **none** of the $30.7 million budgeted for this purpose was ever used to import equipment of U.S. source and origin, this represented a substantial change in the expected financing plan of the program. Although the recently approved program amendment precludes the need for an audit recommendation, we believe this matter should be reported, particularly in light of A.I.D.'s recent emphasis on "Buy America" procurement.

Did USAID/Egypt ensure that completed subprojects were being utilized?

Most of the subprojects we visited were being utilized and met the basic service needs of the rural population. However, in two governorates a certain number of subprojects were not being utilized following their completion. While USAID/Egypt appeared to be aware of the non-utilization problems, we found no indications that the resolution of these specific problems had been addressed.

To test the utilization of completed subprojects we visited 86 sites where subprojects had been funded during the first and second years of the program. We found that 13 of those subprojects in two of the nine governorates we visited were not being utilized for various reasons. As similar subprojects appeared to be well utilized in other governorates visited, this problem is thought to be specific to certain governorates rather than program-wide.

Many of the above non-utilization problems were described in field trip or progress reports submitted to USAID/Egypt by the technical assistance contractors, but the subprojects remained unutilized at the time of our audit. The following subsections discuss this problem area in detail.

USAID/Egypt and Its Contractors Did Not Ensure That Idle Subprojects Were Utilized

Thirteen of the 86 subprojects visited had not been utilized even though those subprojects, costing about LE424,500, were reported as completed by local government units. Non-utilization resulted from a variety of causes which included: shortage of funds or skilled labor, no actual need for the subproject, and problems with contractors. In many cases, the problems were made known to USAID/Egypt by the technical assistance contractors in site visit and progress reports. However, we found no indication that USAID/Egypt had acted to resolve these specific problems. According to the Project Paper, the benefits expected from LD II are derived from the flow of services resulting from its subprojects, which are assumed to be operational and maintained. USAID/Egypt, in cooperation with the GOE, should act on reports of non-utilization and assist the governorates in resolving this problem.

<u>Recommendation No. 5:</u> We recommend that USAID/Egypt in consultation with ORDEV:

5.1 review the unutilized subprojects, identify actions required to make them operational, and encourage the respective governorates to implement those actions; and

5.2 include a requirement in the provincial block grant program's annual guidelines that all completed subprojects be fully operational as a precondition for submitting future subproject plans.

The 13 unutilized subprojects were located in two governorates, Red Sea and Mersa Matrouh, and consisted of six maintenance centers, three latrines, two water projects, a sewage truck and a market. As similar subprojects appeared to be well utilized in other governorates visited, this problem is thought to be governorate-specific rather than program-wide.

According to LD II guidelines, maintenance centers were a top priority for the first year and a mandatory criterion for subsequent year funding. The guidelines required that a maintenance workshop be established in every major local village unit. They further stated that: "In the absence of such a facility no other subprojects will be approved until one is developed." The logical framework of the Project Paper stated that appropriate maintenance facilities in place and functioning at all levels of local governments would be an indication that the project purpose had been achieved. We found certain villages in which this policy could not be applied.

For example, in Mersa Matrouh Governorate, all the villages we visited as well as the capital city itself had maintenance centers that were completely constructed and supplied with the necessary tools, but had never been used. Village officials claimed they did not have the technicians to run these workshops, or funds to hire staff. (See Photograph No. 5 on page 30)

In Safaga, a city in the Red Sea Governorate, the maintenance center itself had been completed, but its grounds were not paved or levelled to allow vehicles easy access. This center was funded with first-year grant funds (1987), but because of a shortage in funds to complete the job and hire staff, it had not been put into operation at the time of our audit.

Three latrines visited in Mersa Matrouh Governorate were all completed but not in use. Local councils decided to keep one of them locked for the purpose of keeping it clean, as some builders were working in the area. The other two had no running water.

Despite being relatively costly improvements of some importance to the public, two water projects were not being used. In the Red Sea Governorate, a water pipeline had been installed and tested but had not yet been turned on even though the contractor's last payment was in November 1988. In Mersa Matrouh, the contractor had received all payments as of February 1989 but had not turned the pipeline over to the village for operation because it was still "being tested."

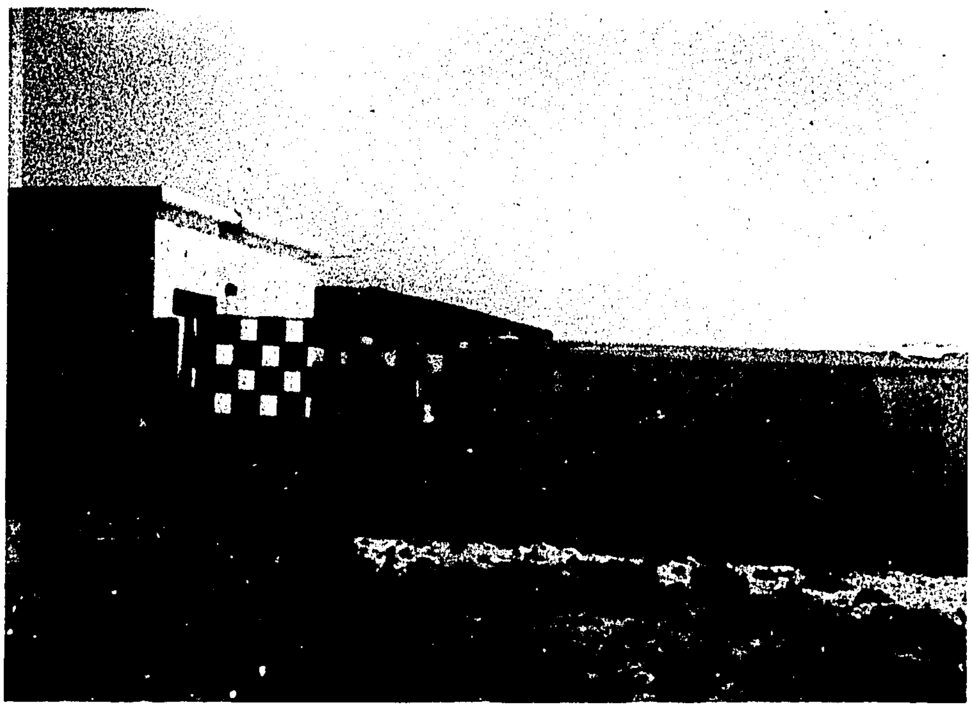
Finally, a sewage truck in the Red Sea Governorate was kept at the capital, Hurghada, and not delivered to Omel Howeytat village which had received approval to purchase the truck with its provincial block grant allocation. The Secretary General who made the decision to retain the truck at Hurghada claimed that the village did not need it. According to village officials, they had to borrow a truck from Safaga once or twice a week. The village's truck was parked at the governorate motor pool and had never been used. The market at the same village had been constructed and was ready for operation, but no one we spoke with could explain why it was not being used or when it would be used. (See Photograph No. 6 on page 30)

Despite being relatively costly improvements of some importance to the public, two water projects were not being used.

Many of the problems in these two governorates were identified by the technical assistance contractor and reported in field trip reports and monthly progress reports. While the number of unutilized projects among those we sampled was only 15 percent, more significant in our view was the fact that such non-utilization had been identified previously but remained uncorrected. We believe that with additional involvement from USAID/Egypt, the GOE could be encouraged to put all or most of these unutilized projects into operation, and benefits derived as expected.

USAID/Egypt officials questioned the significance of this finding due to the relatively small number of unutilized subprojects. The Mission stated that all subprojects would be reviewed for non-utilization during the fourth annual provincial block grant planning cycle.

Photograph No. 5 - Unutilized Central Maintenance Center. Mersa Matrouh - July 1990.



Photograph No. 6 - Unutilized market. Red Sea Governorate - July 1990.

Mission Comments and Our Evaluation

USAID/Egypt stated that it agreed with Recommendation No. 5.1 and that Fourth Cycle Planning Guidelines call for governorates to review all LD II funded projects, and develop plans for the completion, operation, or rehabilitation of all existing projects prior to planning new projects. The Mission requested closure of the recommendation based on the above action. We consider Recommendation 5.1 resolved. We will close the recommendation when we receive evidence that the governorates have satisfactorily completed their fourth cycle reviews.

USAID/Egypt did not agree with Recommendation 5.2 which recommended that all completed subprojects be operational as a precondition for submitting future subprojects plans. USAID/Egypt believes that compliance with this recommendation would weaken the performance of the LD II program and impede accomplishment of the LD II purpose. The Mission requested that this recommendation be closed based on the actions taken under Recommendation 5.1. We agree that the Mission's actions under Recommendation 5.1 should greatly improve its ability to identify and correct unutilized projects. We consider Recommendation 5.2 to be resolved upon report issuance and will close the recommendation when we receive evidence that the governorates have completed their fourth cycle reviews.

REPORT ON INTERNAL CONTROLS

We have audited certain aspects of USAID/Egypt's Local Development II Program for the period September 12, 1985 through December 31, 1989.

We conducted our audit in accordance with generally accepted government auditing standards, which require that we plan and perform the audit to fairly, objectively, and reliably answer the objectives of the audit. Those standards also require that we:

- assess the applicable internal controls when necessary to satisfy those audit objectives, and

- report on internal controls, the scope of our work, and any significant weaknesses found during the audit.

In planning and performing our audit, we considered A.I.D.'s internal control structure to determine our auditing procedures in order to answer each of the four audit objectives, but not to provide assurance on the internal control structure.

The management of A.I.D., including USAID/Egypt, is responsible for establishing and maintaining an internal control structure. Recognizing the need to reemphasize the importance of internal controls in the Federal Government, Congress enacted the Federal Manager's Financial Integrity Act (FMFIA) in September 1982. This Act, which amends the Accounting and Auditing Act of 1950, makes the heads of executive agencies and other managers, as delegated, legally responsible for establishing and maintaining adequate internal controls. The General Accounting Office (GAO) has issued "Standards for Internal Controls in the Federal Government" to be used by agencies in establishing and maintaining such controls.

In response to the FMFIA, the Office of Management and Budget (OMB) has issued guidelines for the "Evaluation and Improvement of Reporting on Internal Control Systems in the Federal Government." According to these guidelines, management is required to assess the expected benefits versus related costs of internal control policies and procedures. The objectives of internal control policies and procedures for federal foreign assistance programs are to provide management with reasonable, but not absolute, assurance that resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data is obtained, maintained, and fairly disclosed in reports. Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Moreover, predicting whether a system will work in the future is risky given that conditions may change or the system itself may not be properly administered. In implementing the FMFIA, the Mission evaluated the internal control structure in place in October 1989 and noted certain weaknesses.

For the purposes of this report, we have classified significant internal control policies and procedures according to each of the audit objectives by categories. For each objective, we obtained an understanding of the design of relevant policies and procedures and determined whether they have been placed in operation, and we assessed control risks to detect any reportable condition. USAID/Egypt provided RIG/A/Cairo with a summary of applicable LD II internal controls at our request and we selected and tested those controls which were applicable to our audit objectives. Reportable conditions are those relating to significant deficiencies in the design or operation of the internal control structure which, in our judgment, could adversely affect USAID/Egypt's ability to assure that resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data are obtained, maintained, and fairly disclosed in reports. In doing this audit, we found certain problems that we consider reportable under the above standards.

Audit Objective One

The first audit objective was to gather and verify information concerning the progress of the Program. The sources of information included the 1989 evaluation report, USAID/Egypt financial reports, ORDEV progress reports, and interviews.

We noted two reportable conditions that related to the Quarterly Progress Report (QPR) produced by ORDEV's Management Information System:

- USAID/Egypt did not ensure that the QPR reported accurate expenditure information; and

- USAID/Egypt used inaccurate data in the QPR to justify subsequent grants based on reported past expenditures.

These deficiencies resulted in the use of unreliable reporting of Program progress and the award of grants to potentially ineligible recipients.

Audit Objective Two

This objective relates to the suitability of USAID/Egypt's funding mechanism for delivering block grant funds to local government units. We found two reportable conditions which hampered USAID/Egypt's ability to monitor and ensure the proper use of grant funds:

- A key quarterly cash management report which was to track the transfers of grant funds to individual implementing units was not being supplied by the GOE as agreed to in the Grant Agreement. This hampered USAID/Egypt's ability to monitor and track grant funds once they were delivered through the funding mechanism; and

- USAID/Egypt did not require that interest earned on idle grant funds be reported even though the Grant Agreement stipulated that such interest be used for Program purposes. Without such reporting, USAID/Egypt could not determine whether or not interest was properly used.

Audit Objective Three

This objective relates to the procurement of equipment within guidelines agreed upon by USAID/Egypt and the GOE. There was a material weakness or lack of internal controls regarding the origin of equipment procured during the first two years of the program, but USAID/Egypt has since implemented several additional controls which in our opinion should provide reasonable assurance of compliance in the future. Specifically, PIL 5A, which amended the earlier but deficient PIL 5, added a more complete definition of "origin" including the componentry rule. It also stipulated that the GOE would produce a semiannual Equipment Procurement Status Report which would disclose the origin of its major components as well as the equipment itself.

Audit Objective Four

This objective relates to the utilization of subprojects upon completion of A.I.D. grant funding. Although an appropriate internal control -- periodic field and progress reports from the technical assistance contractor -- was in place, in certain regional areas USAID/Egypt did not take steps to have problems identified by those reports corrected.

A material weakness is a reportable condition in which the design or operation of the specified internal control 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 financial reports on project funds being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of internal controls would not necessarily disclose all matters 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.

REPORT ON COMPLIANCE

We have audited certain aspects of USAID/Egypt's Local Development II Program for the period September 12, 1985 through December 31, 1989. We conducted our audit in accordance with generally accepted government auditing standards, which require that we plan and perform the audit to fairly, objectively, and reliably answer the objectives of the audit. Those standards also require that we:

- assess compliance with applicable requirements of laws and regulations when necessary to satisfy the audit objectives (which include designing the audit to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objectives); and

- report all significant instances of noncompliance and abuse and all indications or instances of illegal acts that could result in criminal prosecution that were found during or in connection with the audit.

Noncompliance is a failure to follow requirements, or a violation of prohibitions, contained in statutes, regulations, contracts, grant agreements and binding policies and procedures governing entity conduct. Noncompliance constitutes an illegal act when the source of the requirement not followed or prohibition violated is a statute or implementing regulation. Noncompliance with internal control policies and procedures in the A.I.D. Handbooks generally does not fit into this definition and is included in our report on internal controls. Abuse is furnishing excessive services to beneficiaries or performing what may be considered improper practices, which do not involve compliance with laws and regulations.

Compliance with laws, regulations, contracts, and grants applicable to the Program is the overall responsibility of USAID/Egypt's management. As part of fairly, objectively, and reliably answering the audit objectives, we performed tests of USAID/Egypt, and host-government compliance with certain provisions of Federal laws and regulations, and grants. However, our objective was not to provide an opinion on overall compliance with such provisions.

The results of our tests of compliance disclosed the following significant instances of noncompliance:

- Audit objective No. 1 - The Government of Egypt has failed to comply with a clause in the Standard Provisions Annex of the LD II Grant Agreement which requires that the grant recipient, the GOE, have the books and records relating to the program audited regularly.

- Audit objective No. 4 - Grant funds given to Government of Egypt entities were used to pay for equipment with components from an ineligible point of origin (Romania).

Except as described, the results of our tests of compliance indicate that, with respect to the items tested, USAID/Egypt, contractors, suppliers, and the Government of Egypt complied, in all significant respects, with the provisions referred to in the fourth paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that USAID/Egypt, contractors, suppliers and the Government of Egypt had not complied, in all significant respects, with those provisions.

SCOPE AND METHODOLOGY

Scope

We have audited certain aspects of USAID/Egypt's Local Development II Program in accordance with generally accepted auditing standards. We conducted the audit from February through September 1990 and covered the systems and procedures relating to the Provincial Block Grant component from August 1985 (program inception) through December 31, 1989. As noted below, we conducted our field work in the offices of USAID/Egypt, in the offices of technical assistance contractors, and at various village, markaz and governorate offices and project sites.

Methodology

Audit Objectives One and Four

Audit objectives one and four consisted of gathering and verifying information to determine the status of the provincial block grant program as well as the utilization of completed subprojects. To determine the progress of the program, we relied primarily upon a 1989 evaluation report, GOE progress reports, USAID/Egypt financial records, and interviews with USAID/Egypt, contractor and local government officials.

To test the reported expenditures of local subprojects, and determine the utilization of completed subprojects, we made field visits to review bank statements and accounting documents for 86 local development projects implemented in nine provincial governorates during the first two years of the grant program. We selected the projects using a judgmental sampling technique which we feel provided a representative sample of LD II projects. However, it should be noted that our sample did not, nor was it designed to, represent a statistically valid sample, as this would have required time and effort well beyond RIG/A/C's resource capabilities given the scope of the nationwide LD II program. Provincial block grant funds allocated to those sampled projects totaled nearly LE9 million compared to total allocations of about LE126 million for the nine governorates as follows:

Audit Coverage of LD-II Provincial Block Grant
1st and 2nd Year Allocations in Egyptian Pounds

Governorate	Amount Audited	Total Allocation
Aswan	1,448,306	14,235,741
Beni Sweif	311,864	18,027,307
Giza	747,900	15,160,505
Ismailia	1,871,123	13,847,723
Menoufia	706,213	15,983,978
Mersa Matrouh	1,115,889	8,687,979
Minia	962,200	15,582,196
Red Sea	466,591	7,016,775
Sharqiya	1,324,700	17,852,910
Total	8,954,786	126,395,114

Audit Objective Two

To accomplish the second objective, we relied on interviews with cognizant USAID/Egypt and GOE officials, GOE progress reports (which under objective number one we determined to be unreliable, but for which we could come up with no alternative), and field visits to determine the extent of interest earned by grant recipients. We selected four governorates to visit which had reported allocating earned interest to subprojects, and five governorates which had reported no interest.

Audit Objective Three

To accomplish the third objective, we relied on PIL's 5 and 5A which set forth the agreed upon procedures and policies under which LD II equipment would be purchased. We selected three of the governorates with the highest amount of reported procurements and sampled approximately 81 percent of the value of the procured equipment in those governorates. We conducted site visits of the sampled equipment, examining procurement documents and physically inspecting the equipment. For the equipment outside of our sample, we will rely on the Equipment Procurement Status Report being prepared by all participating governorates. Information from that report, if available, will be included in this audit report.

APPENDIX II

UNITED STATES AGENCY for INTERNATIONAL DEVELOPMENT

CAIRO, EGYPT

RECEIVED JAN 21 1991

M E M O R A N D U M

To: Frederick A. Kalhammer, RIG/A/C

From: Marshall D. Brown, DIRECTOR/USAID/Egypt

Subject: Mission response to Local Development II draft audit

Attached is the Mission response to the Local Development II draft audit.

Note: Only Attachments B and C are included in the audit report.

Mission Overview Statement

The objectives of this major GOE program assisted by USAID are to provide basic services to rural and urban residents; to decentralize the planning, management and financial responsibilities to local governments and to strengthen the capacity and systems of local governments to carry out locally chosen development activities. Local governments have selected and implemented over 10,000 development projects under the decentralized planning and management systems and procedures established by the Local Development (LD II) program. These locally chosen projects have reached and helped approximately 25 million people, about half the population of Egypt. Over 3,000 provincial projects are funded and implemented each year by LD II.

The Mission is pleased with the progress and success of the LD II program. The LD II program Mid-Term Assessment (Nov. 1989) and the audit have independently concluded that the program has been successful in assisting local governments carry out a large number of local projects that provide essential services for the urban and rural population. Basic, decentralized management systems and technical capacity are in place and are being strengthened. The LD II program is on track. Furthermore, USAID/Egypt and the GOE have restructured the program to address key policy issues which will further strengthen management and fiscal decentralization, enhance sustainability, and democratic pluralism program objectives.

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Audit Recommendation No. 1.1:
We recommend that USAID/Egypt in consultation with ORDEV inform all participating local government units that transfers of grant funds between government entities should not be reported as expenditures on the Quarterly Progress Report (QPR).

Mission Response:
Our reviews and discussions with financial as well as senior management personnel in several governorates indicate that reporting transfers as expenditures in the QPR is not a routine or common practice. However, while the audit finding is not statistically significant, that is, the finding cannot be accurately applied to other local projects funded under LD II, the Mission's concern for the integrity of QPR management and financial information dictates action on the recommendation. We agree with this recommendation and have asked the Chairman of the Provincial Local Development Council (PLDC) to send a letter re-emphasizing the policy to each governorate on this subject. Further, at the next PLDC meeting, we will request the PLDC Chairman to inform all governorate representatives of the audit findings, and specifically note that GOE accounting practices and LD II program eligibility criteria prohibit the reporting of transfers as expenditures. 1/

In December 1989, the GOE and Mission decided to strengthen the QPR after Mission reviews identified management information and reporting problems. The revised QPR format presents physical as well as financial progress information. Training and verification of the management information in the revised QPR has now been completed in 22 governorates. The revised QPR will be operational in June 1991.

Furthermore, the revised QPR is part of a governorate-based management information and follow-up system that will also be established in 1991. The QPR enhancements will enable the GOE (and USAID/Egypt) to monitor and review discrepancies between physical and financial progress. A copy of the relevant portions of the revised QPR report format, the Fourth Cycle Planning Guidelines and the letter to the PLDC Chairman re-emphasizing the policy on transfers are attached (Attachment A).

USAID/Egypt requests Recommendation No. 1.1 be closed.

Audit Recommendation 1.2:
We recommend that USAID/Egypt in consultation with ORDEV have periodic audits of provincial block grant expenditures made by qualified local auditors.

Mission Response:
The Mission fully endorses the need for and usefulness of independent audits to ensure the veracity of financial

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information and to review the control environment. As the GOE financial system accomplishes the above, we do not agree with the audit finding and therefore the recommendation.

The GOE's financial management and management control procedures are codified in GOE Budgetary Law 127. Independent consultants and CPA's have concluded that the GOE internal control procedures enumerated in Law 127 are sound and are followed diligently by governmental organizations. An independent, LD II, financial management review carried out in one governorate has also corroborated the effective operation of systematic financial controls and inspections. LD II financial reviews and verification analyses will also be replicated in other governorates. Furthermore, while not discussed in the audit report, several RIG auditors who spent in excess of a month in one governorate concluded that all block grant expenditures were properly accounted for and documented and audited by an independent representative of the GOE Ministry of Finance. 2/

Additionally, the GOE Central Accounting Organization (CAO) regularly performs compliance and program audits of governorate activities, including LD II local projects. It is regrettable that CAO audit reports are not shared with USAID/Egypt or RIG/A/C. The CAO reports directly to the People's Assembly, the equivalent of the U.S. House of Representatives. Security and other concerns of this sovereign nation dictate that CAO audit reports not be released to outside parties. However, the results of these audits are appropriately shared with senior management in the governorate and specifically the governor who is charged with implementing and following up audit recommendations.

We request that audit Recommendation No. 1.2 be either withdrawn or closed.

Audit Recommendation No. 1.3:
We recommend that USAID/Egypt in consultation with ORDEV devise and implement an expenditure rate formula which excludes in-kind popular participation contributions in order to determine the provincial governorates' eligibility for additional grant funding.

Mission Response:
USAID/Egypt agrees with the recommendation. As previously planned, the Mission is changing the procedures for calculating expenditure percentages in the revised QPR that will be operational in June 1991. The revised QPR calculates expenditure rates by excluding popular, in-kind (non cash) contributions. The expenditure rate formula and a letter to the Chairman of the PLDC explaining this change are attached (Attachment B and Attachment C, para 5).

We request that Recommendation No. 1.3 be closed.

Additional Comments:
The Mission's view of popular contributions differ from the auditors's view. Popular contributions in our view are an integral element of project costs. These contributions for locally identified project activities are an important program component and are encouraged under LD II. Cash contributions are common. Land that is donated or other in-kind contributions for the project are costs that do, in fact, represent tangible, real expenditures and cost savings . Furthermore, popular contributions represent substantial added monetary value and, above all, community commitment to local projects and the LD II program. Popular contributions provide a significant component of local control and accountability under the program. Popular contributions are meaningful opportunities for beneficiary participation and will continue to be emphasized. 3/

Audit Recommendation No.2:
We recommend that USAID/Egypt obtain quarterly cash management reports from ORDEV as required in Section 5.3 of the Grant Agreement.

Mission Response:
USAID/Egypt agrees with this recommendation. We have been and are working with the GOE to develop a Cash Management Report for the LD II program drawing on current GOE procedures. Technical support for the development of the report is being provided. This report will also fully satisfy the Project Agreement Covenant requirement.

We will request closure of Recommendation No. 2 as soon as the Mission approves the Cash Management Report format.

Audit Recommendation No. 3:
We recommend that USAID/Egypt in conjunction with ORDEV:

3.1 encourage provincial block grant recipients to earn interest on idle grant funds;

3.2 require that earned interest be reported in the quarterly cash management report.

Mission Response:
USAID/Egypt agrees with the recommendations. MLA/ORDEV and USAID have consistently encouraged governorates to collect interest on block grant funds. Interest collection and reporting has been part of the PLDC approved guidelines for provincial block grants and is also part of the training and orientation program given to governorate officials. Furthermore, the PLDC Chairman has written all governors to remind them of the LD II program interest collection guidelines. A copy of this letter is attached (Attachment C) for RIG/A/C review.

We request both Recommendations Nos. 3.1 and 3.2 be closed.

Additional Comments:
As a matter of record, the audit is inconsistent in the treatment of interest recommendations. Page 21 of the audit draft has reported large idle cash balances of local currency held by local governments. However, page 31 of the draft report has reported many governorates placing block grant funds in interest bearing time deposit accounts. Our own reviews carried out at the governorate level, combined with discussions with senior governorate management personnel, and an independent financial review carried out in one governorate, corroborate that many governorates are indeed collecting interest from block grant funds as requested in the program guidelines. Furthermore, the revenues have been properly accounted for and reported at the governorate. We believe interest collection at the governorate level is substantial. The problem, however, is one of QPR reporting. Many governorates have consistently not disclosed interest and other revenue collection such as penalties, etc., as required in the QPR. The GOE previously required all revenue collected to be forwarded to the central government. Therefore, many governorates were uncertain if they had programmatic control of these funds. This issue has now been resolved. Mission policy dialogue efforts have resulted in the Prime Minister instructing all governors to collect and retain revenues and user fees for local government development projects. Our reviews indicate that interest earned has been appropriately reprogrammed for development activities by the governorates that believed they had programmatic control of these funds. 4/

Recommendation No.4.1:
We recommend that USAID/Egypt review all equipment procurement transactions by participating provincial governorates to identify any equipment procured with provincial block grant funds that may not have adhered to applicable source/origin regulations;

Mission Response:
USAID/Egypt agrees with Recommendation No. 4.1. The Mission has issued two Project Implementation Letters (PIL), PIL 5 and PIL 5A, to the Chairman of the PLDC and governors on equipment source/origin procurement guidelines.

The following background information is necessary to complete the picture contained in the audit report with respect to the LD II source/origin issue. LD II followed and built on the Decentralization Support Fund project under which approximately 98 million dollars of US source/origin commodities were procured for local governments. The focus of LD II is decentralized decision making. Planning, management, financial control and accountability are key to decentralization. Accordingly, up through 1990, Egyptian pounds were purchased with US appropriated dollars and disbursed to the GOE when USAID/Egypt accepted development plans submitted by the governorates to the PLDC for approval. The local currency then belongs to the GOE. AID

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source/origin rules do not apply to procurements made by the GOE with their funds. However, early in the life of LD II, USAID/Egypt decided to incorporate source/origin requirements into LD II, GOE owned local currency purchases. PIL 5 states:

> For your information, this source-origin restriction is necessary because of the high visibility of the local development projects accomplished under the Local Development II Program and because of <u>our desire to stimulate the use of goods from Egypt, the United States</u> and other "Free World" countries. (Underlining added).

Therefore, PIL 5 and PIL 5A constitute the source/origin compliance criteria for GOE local currency procurement in LD II.

PIL No.5 prohibited the procurement of non-free world equipment under the LD II program. PIL 5 did not explain non-free world componentry to the governorates nor did it state that any commodity with non-free world components would be ineligible for block grant financing. PIL 5A corrected this oversight which our field monitoring detected. PIL 5A also included procurement management and reporting responsibilities necessary to assess and improve both the governorate procurement capabilities as well as the equipment management capacity at the governorate level. These reports will be used to review compliance with LD II procurement guidelines and to support the development of equipment databases for subsequent management and utilization analyses.

The governorates have submitted the draft equipment procurement reports to the PLDC Chairman. These reports identify some ineligible equipment and appropriately reimburse the governorate project accounts. The GOE, Mission and TA contractor will verify the reimbursements and sample the equipment reports for compliance. The Mission has received a draft copy of the report.

USAID/Egypt will request closure of Recommendation No. 4.1 when we have reviewed the final equipment report.

<u>Recommendation No. 4.2:</u>
We recommend that USAID/Egypt obtain evidence that affected provincial grant funds have been "made whole" for the cost of the 37 Romanian tractors identified in this report, as well as any additional items identified under Recommendation 4.1 above.

<u>Mission Response:</u>
USAID/Egypt disagrees with the section of Recommendation No. 4.2 concerning the 37 tractors, but agrees with the remaining portion of the recommendation regarding any additional item which may have been improperly procured under the controlling procurement PIL. The governorates have agreed to reimburse their project block grant account for equipment not complying with either PIL 5

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or PIL 5A guidelines, whichever is applicable. (See discussion of source/origin under Mission response to Recommendation No. 4.1.)

The preliminary equipment procurement report confirms that the governorates purchased 37 NASR Tractors assembled in Egypt using Romanian components. This equipment was purchased under the guidelines set out under PIL 5, which did not explain the ineligibility of equipment with non-free world components.

The draft equipment report indicates that the non-free world component problems occur almost exclusively in NASR tractors assembled in Egypt. The governorates purchased these tractors operating under PIL 5 guidelines. The manufacturer's certification states that the tractors were manufactured in Egypt. Since PIL 5 had no procurement guidelines for non-free world components, the governorates are in compliance with the LD II guidelines with regard to the tractors. They have acted in good faith and have complied with applicable program guidelines for procurement.

As such, USAID/Egypt requests the first part of Recommendation No. 4.2 regarding the tractors be withdrawn. The Mission will request closure of the remaining part of the recommendation after appropriate refunds are made to the governorate LD II block grant account for any procurement improperly undertaken.

Additional Comments: "Buy America"
The draft audit report portrays a misunderstanding of the LD II project paper concerning the 25% of the block grant being retained for off-shore procurement. The project paper states:

> Governorates would have the option of using up to 25% of the USAID portion of their annual block grant funds allocation as foreign exchange for importing capital equipment which is unavailable on the local market. (Underlining added)

The concern during the development of the LD II program was that the governorates would attempt to use LD II as a continuation of one of its predecessor and contemporary projects, the Decentralization Support Fund (DSF). Under DSF, a U.S. source/origin equipment procurement project, provincial governorates have procured approximately $98 million of U.S. source/origin heavy equipment. The LD II program has provided technical and follow-up technical support for DSF equipment and has provided limited equipment procurement for governorates for specialized, immediate needs. The purpose of the "up to 25%" limitation clause in the project paper was to make it clear that LD II block grant funding was not envisioned to be used primarily for importation of capital equipment. The purpose of the clause was not to require that a certain amount of capital equipment procurement occur. Both DSF and LD II program equipment should

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be considered together because governorates have drawn on both programs to meet equipment requirements. The facts do not support the audit conclusion that local governments' procurement activities have not benefitted U.S. manufacturers.

Audit Recommendation No. 5.1:
We recommend that USAID/Egypt in consultation with ORDEV review the unutilized subprojects, identify actions required to make them operational, and encourage the respective governorates to implement those actions;

Mission Response:

USAID/Egypt agrees with the recommendation. The thirteen (13) 5/
incomplete or non operating projects from a universe of 4,232 projects represent approximately 0.3% of the projects and 0.4% of the funding provided through the LD II program to the nine (9) governorates selected by the auditors. This finding attests to the growing capacity of the local governments and LD II's success.

ORDEV, MLA, PLDC and the Mission are committed to ensuring that all Egyptian pounds expended benefit the populace. As such, and as discussed in the Audit Entrance Meeting, Fourth Cycle Planning Guidelines call for governorates to review all LD II funded projects, develop plans for the completion, operation, or rehabilitation of all existing projects prior to planning new projects. A copy of the relevant portions of the guideline instructions to the governorates and data gathering formats to assist them to review all LD II projects are attached (Attachment D).

The Mission requests closure of Recommendation No. 5.1.

Recommendation No. 5.2:
We recommend that USAID/Egypt in consultation with ORDEV include a requirement in the provincial block grant program's annual guidelines that all completed subprojects be fully operational as a precondition for submitting future subproject plans.

Mission Response:
USAID/Egypt agrees that all completed projects should be made fully operational however this should not be a precondition to future funding. The precondition will weaken the performance of the LD II program and impede accomplishment of the LD II purpose.

The purpose of the LD II program is to strengthen the capacity of local governments to plan, finance, implement and maintain locally chosen basic services projects. While some LD II projects are relatively simple activities, funded and completed within one year, others are multi-year activities, that involve a series of investments by local governments. An example, is the rehabilitation of a potable water pump station. The pump station may be complete, but will not be fully operational until the extension of pipeline networks to outlying areas are completed. For planning, allocation, and program management reasons, USAID/Egypt does not wish local communities to consider the pump station operational until all planned system extensions are fully operational.

Restricting funding for other development activities until all projects are fully operational in the governorate in question or in the 22 governorates, greatly reduces the ability of the program to accomplish its purpose. The strengthening of the planning, financing and management capabilities of local governments is achieved in the LD II program primarily through the experience of project planning, design and implementation. The audit recommendation will reduce the minimum acceptable level of project activity below what is needed to provide a basis for adequate training, and will unduly penalize governorates by not permitting any new projects.

We believe that we don't have a serious management problem. The 13 incomplete projects identified by the audit out of a total of 4,232 in nine governorates, do not represent a significant implementation problem warranting the stoppage of other LD II strengthening activities and projects. The two (2) governorates with incomplete or inoperable projects are making satisfactory progress in correcting specific management problems. Drawing on worldwide experience, most development projects encounter implementation delays and often require additional time and/or resources to bring projects to full operational status. Those that don't - are rare indeed. The large LD II program is no exception to this rule. However, the number of projects requiring either additional time and/or funds for completion is substantially below what one would expect for a complicated, decentralized development program of this type, and certainly not of sufficient magnitude to warrant curtailment of all other developmental activities -- and incur the associated serious consequences for the program.

The Mission requests that this recommendation be closed based upon the actions taken in Recommendation No. 5.1.

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USAID/Egypt Comments on the Internal Controls Report

USAID/Egypt has summarized the Internal Controls applicable to the LD II program (Attachment E). The internal controls plan and options identify systematic control points that are exercised by the central GOE, governorates, USAID/Egypt, and the technical assistance contractor. USAID/Egypt does not rely on any single control to determine the adequacy or compliance with project activities. For example, in addition to the QPR information, USAID/Egypt weighs information from field visits by the technical assistance contractors. Information from USAID/Egypt staff field visits and monitoring activities are gathered regularly on governorate progress. The MLA/ORDEV also follow-up governorate progress and join with the technical assistance contractor on field visits. The Chairman of the PLDC, reviews progress of the governorates. Finally, the PLDC, MLA/ORDEV, USAID/Egypt and the technical assistance contractors carry out special analyses as necessary to identify and resolve governorate implementation and progress issues. One such special analysis is the development of a Survey of Project Operational Status Report now being conducted to assist governorates to plan for completion and operation of all LD II funded projects. Other routine reports such as the Equipment Procurement Status Report have been developed to regularly provide information on equipment procurement during the year. Financial management reviews and verification analyses, carried out by an independent, private sector accounting firm are another secondary control. These special reviews and reports strengthen the controls provided by management information systems that are under development or not fully operational. The special reviews and reports also provide the basis for future spot checks, and verification activities. 6/

Audit Finding: (Page 56)

USAID/Egypt did not ensure that the QPR reported accurate expenditure information;

Mission Response:

The development of an effective management information system for local governments is an objective of the LD II program and is being accomplished. The Mission has systematically reviewed the QPR information and governorate capabilities to manage a decentralized information system. In our view the governorates have made extensive progress toward developing an effective project information system. The governorates are now capable of strengthening the QPR and further decentralizing this management tool.

In the Fourth Cycle Planning Guidelines, the PLDC, MLA/ORDEV and USAID have required the governorates to develop a management information system to effectively monitor and evaluate the status of LD II funded projects (Attachment F). In addition as we have indicated in the Mission Response to Recommendation No. 1.1, a completely revised QPR plan has been developed prior to the beginning of the LD II audit. The revised QPR and the Fourth Cycle Guidelines both require substantial improvements in the governorate reporting and management systems. We would like to point out however, that no reporting system is ever fully effective. This is especially true in a developing country environment. There will be a continuing need for the governorates to upgrade and modify their management and reporting systems to reflect local requirements.

Audit Finding: (Page 56)

USAID/Egypt used inaccurate data in the QPR to justify subsequent grants based on reported past expenditures.

Mission Response:

As the Mission internal control summary indicates, the Mission does not rely on any single control point for verification of the QPR information or as a basis for block grant allocations. The Mission reviews field reporting information, spot checks progress information, has requested technical assistance contractors to review progress status and has requested governorates to carry out their own reviews and verify the status of LD II projects. 7/

Audit Finding: (Page 57)

A key quarterly cash management report which was to track the transfer of grant funds to individual implementing units was not being supplied by the GOE as agreed to in the Grant Agreement. This hampered USAID/Egypt's ability to monitor and track grant funds once they were delivered through the funding mechanism;

Mission Response:

The Mission has previously indicated that the development of a governorate Cash Management Report was required and a high priority activity. This report requirement is also a Covenant in the LD II Project Agreement. However, other control systems have been used to supplement information about the status of project funds. For example, the QPR provides a complete list of the funds allocated to projects by markaz and village. Detailed planning forms corroborate this information. Additionally, the GOE carries out its own audit reviews, the governorates also carry out special inspections of accounts at the village and markaz levels, and verify account balances and project activities. Finally, as we have indicated, the Mission has carried out a financial management review in one governorate which will be replicated in other governorates to systematically review cash management practices and verify funds transfers. 8/

Audit Finding: (Page 57)

USAID/Egypt did not require interest earned on idle grant funds be reported even though the Grant Agreement stipulated that such interest be used for Program purposes. Without such reporting, USAID/Egypt could not determine whether or not interest was properly used.

Mission Response:

We do not agree with the first part of this finding. The Mission did require in the QPR that interest earned on block grant funds be reported. In addition, project guidelines and orientation material instructed governorates to report on this information. However as indicated in our comments on the Cash Management Report (page 4) the governorates were reluctant to report on interest information because of prior central government policies. This problem has been resolved in Mission policy dialogue discussions. Finally, from our own field trip and monitoring information, the governorates are collecting information on interest and have accounted for interest funds collected on block grants. 9/

General Comments on the Audit:

Page 15: USAID/Egypt would like to point out that the audit finding is based on the results of five (5) projects and LD II allocations of LE 224,470. This finding was drawn from a non-random sample and therefore not statistically representative sample of projects totalling 3,070 and allocations in the amount of LE 126,395,114. The finding is based on less than 0.2% of the number of the projects and funds allocated for the nine (9) governorates selected by RIG/A. 10/ Finally, the reference to sewage and water projects administered centrally is misleading. Work on most sewage and water projects are competitively contracted to private sector firms. We are also increasingly finding that many road projects are being contracted to private sector firms. Therefore, the reference to the sectoral funding levels of approximately 67% is not only inappropriate statistically but also an inaccurate summary of governorate administered projects. 11/

Page 20: We do not believe that the comments from the newly assigned Director of the Local Development Department in the Red Sea Governorate on whether land contributions should be considered as expenditures are representative of other governorates. The audit report should note that the Red Sea Governorate is a desert governorate and not representative of the densely populated, delta governorates where land is scarce and land values are consequently substantially higher. Also, if land were not contributed for the project use in most governorates, land would have to be purchased or acquired through eminent domain procedures both greatly increasing the expenditures to the project and time necessary to implement development projects. 12/

Finally, methodologically it is inappropriate to report the opinion of one newly assigned officer from one governorate without noting the responses to the same question in the eight (8) other governorates.

Pages 23 and 31: USAID/Egypt disagrees with the draft audit report comment that USAID/Egypt did not require that interest be reported or that we had no means of ensuring that interest earnings were being used for program purposes. The QPR report requires governorates to report interest earnings and project expenditures. 13/

Page 34: USAID/Egypt is concerned with the inappropriate use of the word significant in the draft audit report. This particular word provides a reaction that the Mission does not feel is justified in this audit. The word significant implies that a major amount of procurement has violated the terms of the guidelines, which is clearly not the case. Additionally, in statistical sampling the term significant implies that the sampling was done in a such a manner that valid conclusions can be projected to the universe from the characteristics of the drawn sample. This involves analysis of the universe, taking statistically correct random samples and testing the valid attributes. Only after proper statistical sampling techniques have been used and proper interpretations of sample conclusions have been drawn can the word significant be properly used. As the auditors have informed Mission officials that statistical sampling techniques were not used in performing this audit, we request the word significant be removed in the context of page 34 of the draft report. 14/

Page 41: In the same vein, the word substantial is misused in the draft audit report. The preliminary equipment report indicates that less than one percent (1%) of the procurement may have violated the applicable guidelines. A potential failure rate of less than one percent seldom brings the word substantial to mind. The Mission requests the word substantial be withdrawn from page 41 of the draft report. 15/

Page 43: The draft audit finding that out of LE 4.6 million local government equipment procured, only 11% was of U.S. origin is misleading. The audit failed to disaggregate equipment purchased from local Egyptian subsidiaries of U.S. firms. Procurement from Egyptian subsidiaries of U.S. firms represents a relatively large portion of the rolling stock and heavy equipment purchased with LD II funds. While this equipment will contain other free-world components, U.S. firms have benefitted from local government procurement substantially more than the 11% reported in the audit report. 16/

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Attachment B

Revised Expenditure Elegibility
Formula
Fourth Cycle Block Grant Planning

The revised expenditure formula will be calculated against block grant funding including the 5% Ministry of Planning contribution, the 5% Governorate contribution and all cash (popular contributions) contributed by participants and beneficiaries. In-kind popular contributions will not be used in the expenditure rate formula, but will be listed in the QPR and included in the overall project costs contributions.

The formula is as follows:

$$\frac{\text{Expenditures excluding Transfers}}{\text{Block Grant Funds + Cash Popular Contributions}}$$

ldexpendl
diskll
1-13-91

5H

Attachment C

UNITED STATES AGENCY for INTERNATIONAL DEVELOPMENT

CAIRO, EGYPT

c/o American Embassy
8 Kamal El Deen Salah St.
Garden City, Cairo

January 14, 1991

Excellency:

As we have discussed on a number of occasions, the Regional Inspector General's Office for Audits (RIG/A) has been carrying out an independent, systematic audit of the Local Development II (LD II) Program with emphasis on the Provincial component. I am pleased to inform you the RIG/A draft audit report has concluded that LD II is a successful program. However, the audit has recommended a number of important management improvements to the provincial program. Many of the actions recommended by the audit team confirm program improvements already initiated by the Provincial Local Development Committee (PLDC), Ministry of Local Administration (MLA) or identified in the revised Fourth Cycle Provincial Planning Guidelines.

The purpose of this letter is to review a summary of the draft LD II audit recommendations and to request that provincial governorates be informed of the importance of complying with the management improvements already established by the PLDC and MLA and also recommended by the audit. I would like to suggest that a copy of this letter be sent to each provincial governor and secretary general and that they follow-up with appropriate staff within the governorate to confirm and clarify needed actions to comply with the relevant LD II audit recommendations listed below:

1. Transfers of Funds Reported as Expenditures in the Quarterly Progress Report (QPR).

The audit found that a number of governorates they visited (Aswan, Menoufia, and Giza were specifically mentioned) had reported transfer of funds to another government entity as an expenditure. Both Government of Egypt and LD II procedures require that LD II funds be reported as an expenditure only when the funds are actually disbursed or costs incurred for legitimate project activities by the implementing entity.

His Excellency
Governor Ahmed Goueli
Chairman, PLDC

LD II orientation programs, QPR training and block grant planning guidelines have required that project expenditures be recorded in the QPR only when project costs have actually been incurred, not when funds are transferred from one entity to another. We would like to request that all governorates review their LD II expenditure recording and QPR reporting procedures and confirm that transfers are not treated as expenditures in future QPR reports. I would also like to suggest that the issue of transfers and the recording of expenditures be placed on the agenda of the next PLDC meeting, so that governorate representatives can clarify any questions they may have on how or when to report expenditures. In addition, the MLA and Chemonics can similarly reinforce this issue with governorate staff at the Fourth Cycle Planning and Technical Review Committee Workshop scheduled for early February 1991.

2. Review of Completed Projects.

The LD II audit found some projects in two governorates they visited (Red Sea and Mersa Matrouh) were listed as completed in the QPR, but in fact were not complete or were not operational. The audit review confirms the importance the PLDC, MLA and ORDEV have placed this year on improving the QPR and the management information system at the governorate. It also reaffirms the requirement we have jointly established in the Fourth Cycle Planning Guidelines, that as a condition to submission of the Fourth Cycle Plans, each governorates must:

1) review and update their QPR system;
2) complete a Survey of the Status of Operational LD II Projects, and;
3) plan for the completion, operations or rehabilitation of all projects in their Fourth Cycle Plans.

Completion and operation of projects is the highest priority for Fourth Cycle Block Grant funds.

I would like to suggest that all governorates rapidly and carefully complete the comprehensive Survey of the Status of Operational Projects funded under LD II. This Survey was initiated in November 1990, and some governorates have done well but others have delayed the completion of their Survey. We would like to urge all governorates to complete this Survey so that they can use this information in developing their Fourth Cycle Plans. The Survey and the satisfactory planning for completion, operation and/or rehabilitation of all LD II Projects will be a critical factor in the review and approval of each governorate's Fourth Cycle Plans.

This audit recommendation also points to the importance the PLDC, MLA and USAID have placed in the Fourth Cycle Planning Guidelines to develop adequate follow-up, monitoring and management information systems at the governorate. We would like to urge all governors to place careful attention on the management information, follow-up and review guidelines we have jointly developed for the Fourth Cycle.

3. Interest Collection and Reporting.

The audit found that most governorates were not effectively reporting, and in some cases collecting interest on LD II Block Grant balances. Although the current QPR guidelines require governorates to report interest earned from Block Grant funds and reprogrammed, some governorates have not reported the collection and use of this interest from LD II funds.

As you know, based on the LD II policy discussions, the Prime Minister is instructing all governors to collect and retain user fees and other revenues from local development projects. The collection of interest from LD II uncommitted block grant funds and the improvement of cash management practices by governorates are encouraged in the LD II Program and should be considered part of their strengthening of the management capacity. All reprogrammed interest from LD II block grant funds, penalties and revenues from the sale of project procurement documents, etc., should be reported in the current QPR and used for LD II Program activities.

As we have discussed with the MLA and ORDEV, we are jointly developing a Cash Management Report as required in the LD II Program Agreement (Section 5.3). This report will build on existing governorate reporting requirements and procedures. We expect the new Cash Management Report will be ready in about six (6) months. Until this report is implemented, we would like to request that all governorates report interest, penalties, etc., totals separately along with the current QPR. We would also like to suggest that all governorates review their procedures for reporting interest and other related LD II revenues and ensure that interest and other funds are reprogrammed for approved LD II Program activities.

4. Funds Available for Financial Reviews.

As a follow-up from a related audit finding, we would like to bring to the attention of the governorates, that LD II funds are available for financial reviews and verification by independent, and qualified private accounting firms to enhance the financial management of LD II Program activities. These funds will be in addition to the regular LD II Block Grants and can be used by governorates for improving the review of funds management, verifying expenditures, enhancing or streamlining internal controls and strengthening the financial systems required for management of block grant funds. Fayoum Governorate is currently successfully pilot testing a financial review and verification activity. This review can be replicated in other governorates.

5. Expenditure Rate Calculation.

In a related finding, the audit recommended that we change the expenditure rate formula for LD II projects. The audit recommended that we exclude popular in-kind contributions from the expenditure rate calculation because it tended to inflate the expenditure amounts. We have agreed to exclude popular in-kind contributions from the expenditure rate formula recognizing that it will not detract from the importance we place on popular contributions. Since the change in the expenditure formula calculation may affect some governorates eligibility for block grant funds, we will wish to discuss with you and the governorates appropriate expenditure rate eligibility levels.

Finally, we would like to take this opportunity to call attention to the progress achieved under the broader local development program. Under the LD II and its predecessor activities over 20,000 local development projects have been implemented. The basic conclusion of both the LD II audit and the LD II Mid-term Assessment (November 1989) is that the Program is successful and providing improved basic services. All of us associated with LD II can take pride in the fact that the Program is achieving many important objectives.

While recognizing the important accomplishments under LD II and the growing strength of local governments, we should also note that there are still many opportunities for strengthening their technical and management capabilities. I am confident that the successful implementation of the recommendations of the audit team, which closely parallel improvements we have previously initiated in the Fourth Cycle Planning Guidelines, will significantly strengthen the LD II Program.

We urge each governorate to carefully carry out the management recommendations of the audit team, to rapidly complete the Survey of Projects needed for the planning of Fourth Cycle Block Grants and to continue strengthening project and local government management capabilities. We are also requesting that the MLA and ORDEV with support from Chemonics, assist the governorates follow-up these management improvements and the Fourth Cycle Planning Guidelines.

Sincerely,

Don F. Wadley
Director, Office of Local Administration
and Development

cc Mr. Ezzat Mohammed Ali, Sec. Gen., MLA

IG RESPONSE TO MANAGEMENT'S COMMENTS

1/ The audit objective under which this finding was developed sought to ascertain whether USAID/Egypt's monitoring of completed subprojects was adequate, not to establish statistically valid data on the subprojects themselves, as we do not have the resources to make such a sample, given the size of the universe. We note that the Mission has accepted the recommendation.

2/ This statement errs regarding the scope and conclusions of field work conducted by RIG/A auditors. Two auditors made seven trips to one governorate over the period of a month. Their work required several return visits because local officials were only available for three hours each day during the Islamic month of Ramadan, and they were often unable or unwilling to provide bank statements, receipts and other supporting records in a timely manner. Tests of expenditures were limited to one village, not an entire governorate. The auditors did not observe that any expenditures had been audited by Ministry of Finance officials, but they did ultimately conclude that all block grant funds for that village had been spent for program purposes.

3/ RIG/A does not take the view nor have we alleged that popular contributions are an unimportant part of the program. However, we believe that in-kind contributions, by their nature, require separate accounting and reporting procedures.

4/ The audit is <u>not</u> inconsistent in the treatment of interest recommendations. Many governorate officials told us during interviews that they did not place grant funds in interest-bearing accounts, particularly during the first years of the program, thereby maintaining large idle balances of local currency. More recently, governorates have begun earning interest on grant funds but failing to report the earned interest on the QPR. These are two separate issues which we believe are fairly presented in the audit report.

5/ The audit report clearly states that the 13 incomplete or non-operating projects were from a selected sample of <u>86 projects</u>, the number RIG/A felt it could visit within the time and resources available for fieldwork. While we did not seek or attempt to project these limited sample results onto the universe, neither do we feel that the Mission can prudently assume that those 13 were the only incomplete or non-operating projects in a universe of 4,232.

6/ At the time of our audit, many of the internal controls mentioned in this section of the Mission's response were under development or being updated. The first Equipment Procurement Status and Quarterly Cash Management reports have not yet been published, and QPR and cash management procedures are currently being revised. While the Mission's efforts to produce new controls as well as improve existing ones are laudable, we believe that the fact that such important systems and reports are not fully operational this far into the program is cause for concern.

7/ Based on our review of the LD II program files and interviews with Mission officials, we believe that expenditure rates reported on the QPR were the primary criteria upon which subsequent grants were made.

8/ This financial management review was initiated during our audit and still underway when the draft audit report was issued.

9/ During the audit we reviewed the project paper, grant agreement, and annual guidelines to governorates, as well as other project documentation, and found no indication that governorates were required to report interest earned on grant funds. The QPR does have a column to report interest that is reprogrammed for specific projects, but does not require that interest which is earned but not reprogrammed be reported. As only five of the 22 provincial governorates reported any interest on the QPR, we suspect that even this partial reporting of interest was not widely utilized.

10/ As stated in the audit report, this finding was based on a sample of 86 projects from nine governorates. The five projects noted in the audit report were reported as examples of the problem area and did not constitute all such instances encountered during the audit.

11/ The 67% figure was taken from the December 31, 1989 QPR which summarized all subprojects into various categories including water, road, and sewage. Based on interviews with cognizant officials in various governorates, we determined that subprojects under those three categories were usually administered by government authorities above the village level. We found that such centrally administered subprojects were likely to receive transfers of grant funds from villages which the villages would report as being expended when transferred. This had nothing to do with whether or not subprojects were contracted to the private sector.

12/ The comments of the Red Sea Governorate official were not reported as being representative of all governorates. They were used to support a finding that we had already developed.

13/ See RIG/A comment number 9 above.

14/ Due to the number and extensive geographical spread of LD II activities, we determined that limited judgmental sampling techniques were all that we could employ. This allowed us to focus our audit efforts on three governorates with the highest amount of reported equipment procurement. However, because the total amount of ineligible equipment procured under LD II is still unknown, we have changed the phrase "a significant amount" to "at least $328,536" in the final audit report.

15/ The preliminary equipment report apparently does not apply the same criteria to determine the eligibility of equipment procurement as does the audit report. It is therefore irrelevant to use figures derived from the former to comment on the latter. However, as per RIG/A comment number 14, we have modified the text of the final audit report.

16/ The text of the final report has been modified to indicate that most of the equipment reviewed was of European or Japanese origin. Over LE3 million of the LE4.6 million consisted of "Bedford" trucks produced locally by a subsidiary of General Motors. About 52% of the value of those trucks can be attributed to Japanese parts; the remainder, according to a company representative, is from Egypt. The company itself is owned 31% by GM/USA, 20% Isuzu Motors (of which GM is a minority stockholder), and certain Saudi and Egyptian investors who make up this joint venture. It would be difficult to convince the average American taxpayer that this substantial vehicle purchase complied with the Agency's "Buy America" policy, in our opinion.

APPENDIX IV

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