AUDIT OF THE REGIONAL DEVELOPMENT OFFICE/CARIBBEAN INFRASTRUCTURE EXPANSION AND MAINTENANCE SYSTEMS PROJECT NO. 538-0138

Audit Report No. 538-91-011
July 31, 1991

Although the project was progressing and a monitoring system was in place, problems were not always identified, reported, and corrected.

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July 31, 1991

MEMORANDUM

TO: Acting Director, RDO/C, Larry T. Armstrong

FROM: RIG/A/Tegucigalpa, Reginald Howard

R. Howard

SUBJECT: Audit of the Regional Development Office/ Caribbean Infrastructure Expansion and Maintenance Systems Project No. 538-0138

The Office of the Regional Inspector General for Audit/Tegucigalpa has completed its audit of Regional Development Office/Caribbean Infrastructure Expansion and Maintenance Project. Five copies of the final audit report are enclosed for your action.

We have reviewed your comments on the draft report and included them as an appendix to the report. All of the report recommendations are resolved. All parts of these recommendations can be closed after we receive and review evidence that implementing actions have been satisfactorily completed. Please respond to this report within 30 days, indicating any actions planned or already taken to implement the recommendations.

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

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EXECUTIVE SUMMARY

The Infrastructure Expansion and Maintenance Systems project began in September 1985. It was designed to provide and upgrade primary infrastructure for the productive sectors of agriculture, manufacturing and tourism in the Eastern Caribbean. To achieve this purpose, A.I.D. authorized $34 million as of September 1990 of which $33 million has been provided. The three island governments participating in the project are to contribute $4.7 million in local currency equivalent.

We audited the project in accordance with generally accepted auditing standards. Our field work, performed between April and October 1990, found the following:

- After four years of a planned seven-year implementation period the project has made significant progress (see page 5).

- The Regional Development Office for the Caribbean (RDO/C) had established a system in accordance with A.I.D. standards to monitor, report and evaluate the progress. However, because of postponed evaluations and monitoring deficiencies RDO/C:

  -- did not identify the questionable financial sustainability of a subproject after A.I.D. assistance ends (see page 10).

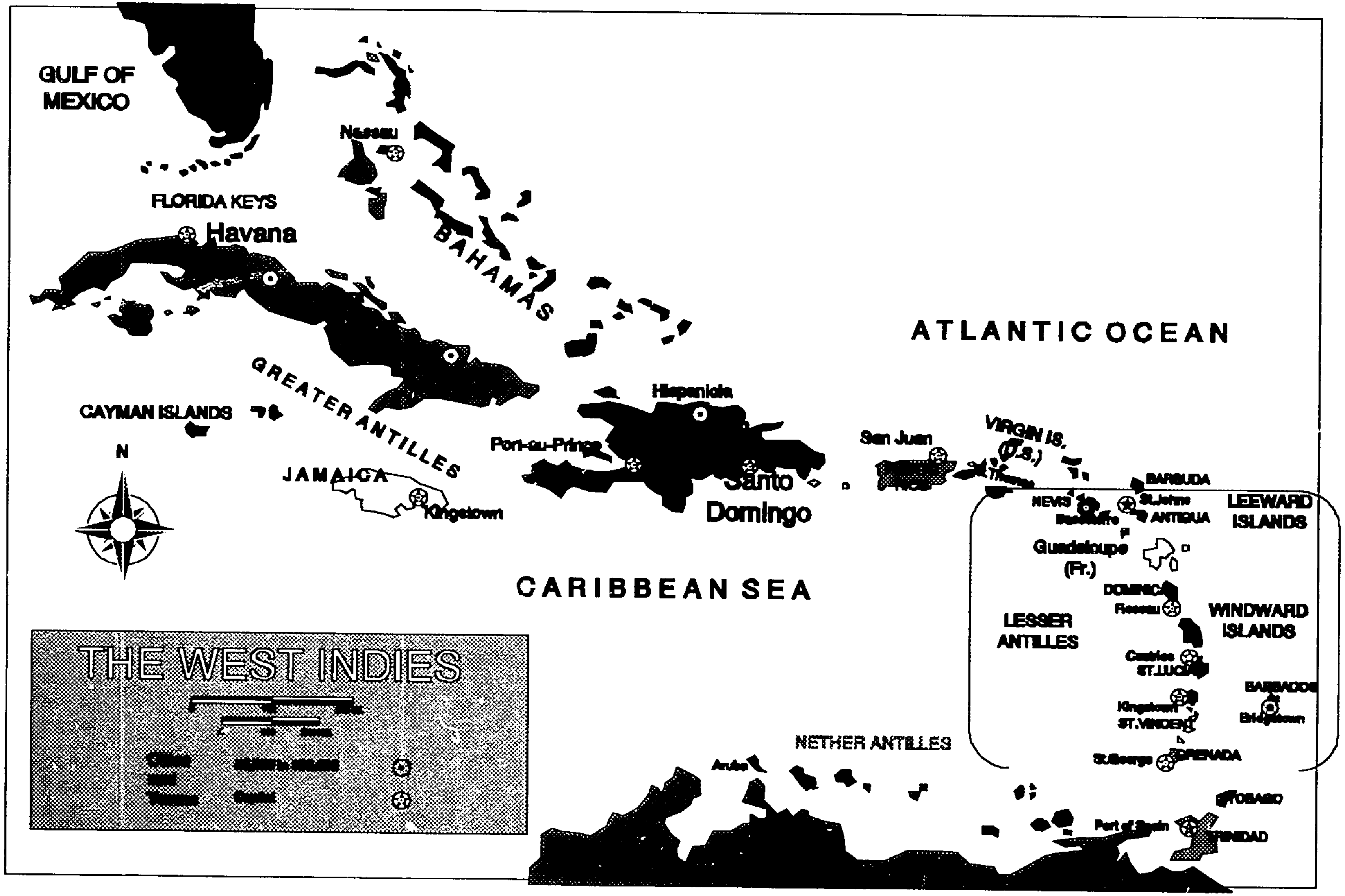
  -- did not timely identify that substantive subproject modifications were made (see page 12).

  -- was not aware of internal control weaknesses (see page 15).

  -- did not identify and correct deficiencies in the Fixed Amount Reimbursable process for infrastructure rehabilitation (see page 17).

The report contains four recommendations. A draft of this report was provided to RDO/C and their comments were considered in preparing our report. A complete text of RDO/C's comments is presented in Appendix II.

Office of the Inspector General
July 31, 1991



GULF OF MEXICO
FLORIDA KEYS
Havana
Nassau
BAHAMAS
ATLANTIC OCEAN
GREATER ANTILLES
CAYMAN ISLANDS
N
JAMAICA
Kingstown
Port-au-Prince
Hispaniola
Santo Domingo
San Juan
VIRGIN IS. (U.S.)
BARBUDA
NEVIS
ANTIGUA
LEEWARD ISLANDS
Guadeloupe (Fr.)
DOMINICA
WINDWARD ISLANDS
LESSER ANTILLES
BARBADOS
ST.VINCENT
NETHER ANTILLES
Aruba
GRENADA
TOBAGO
Port of Spain
TRINIDAD
CARIBBEAN SEA
THE WEST INDIES

INTRODUCTION

Background

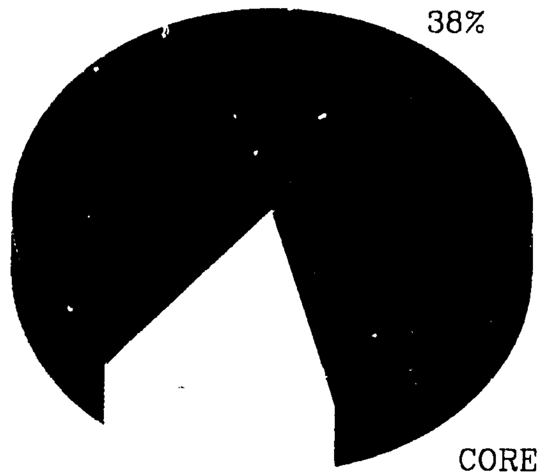
The 10 island nations of the Eastern Caribbean served by A.I.D.'s Regional Development Office for the Caribbean (RDO/C) are former British colonies whose economies are dependent on traditional agriculture. These small island nations lack the institutional base and the public funds needed to improve and maintain their physical infrastructure, which are development constraints that make the islands less attractive to private investors. The Infrastructure Expansion and Maintenance Systems (Infrastructure) project was designed to provide and upgrade primary infrastructure for the productive sectors of agriculture, manufacturing and tourism for three island nations in the Eastern Caribbean.

The Infrastructure project began on September 17, 1985, and is scheduled to end on September 30, 1994. Original life-of-project funding was $80 million, however this was reduced to $38.7 million. To finance project activities A.I.D. is providing a $ 19.5 million grant and a $ 14.5 million loan and the host countries will contribute $4.7 million in local currency equivalent.

The goal of the Infrastructure project is to accelerate the development of productive enterprise in the Eastern Caribbean. This goal will be achieved by implementing four subprojects. Three of these subprojects have their own separate objectives and are being implemented on St. Kitts, Grenada and St. Vincent. The fourth subproject is regional with activities that apply to all 10 islands. RDO/C signed an A.I.D. direct contract with Louis Berger to provide technical assistance to all subprojects except for the Regional Utilities Maintenance subproject.

As of September 30, 1990, A.I.D. has authorized $33.9 million of which $32.9 million has been obligated and $22.6 has been expended. The graphic on the next page demonstrates the percentage of funds obligated by project component and recipient island.

PROJECT OBLIGATIONS
AMOUNT OBLIGATED $32.9 MILLION



RDO/C has primary responsibility for managing this project. Each subproject has its own project manager furnished by the island nation.

Audit Objectives

The Office of the Regional Inspector General for Audit/Tegucigalpa audited RDO/C's Infrastructure Expansion and Maintenance Systems (Infrastructure) project to answer the following audit objectives:

1. What is the progress of the project's outputs?

2. Did RDO/C establish a system to monitor, evaluate and report the project's progress consistent with A.I.D. standards?

In answering these objectives, we performed tests to determine whether RDO/C followed applicable internal control procedures. However, the audit did not follow the Government Auditing Standards for compliance with applicable laws and regulations. We limited our conclusions regarding positive findings to the items actually tested. When we found problem areas we performed additional work as resources permitted to determine the cause and effect of the problems and to make recommendations to correct the condition and the cause of the problems.

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

REPORT OF AUDIT FINDINGS

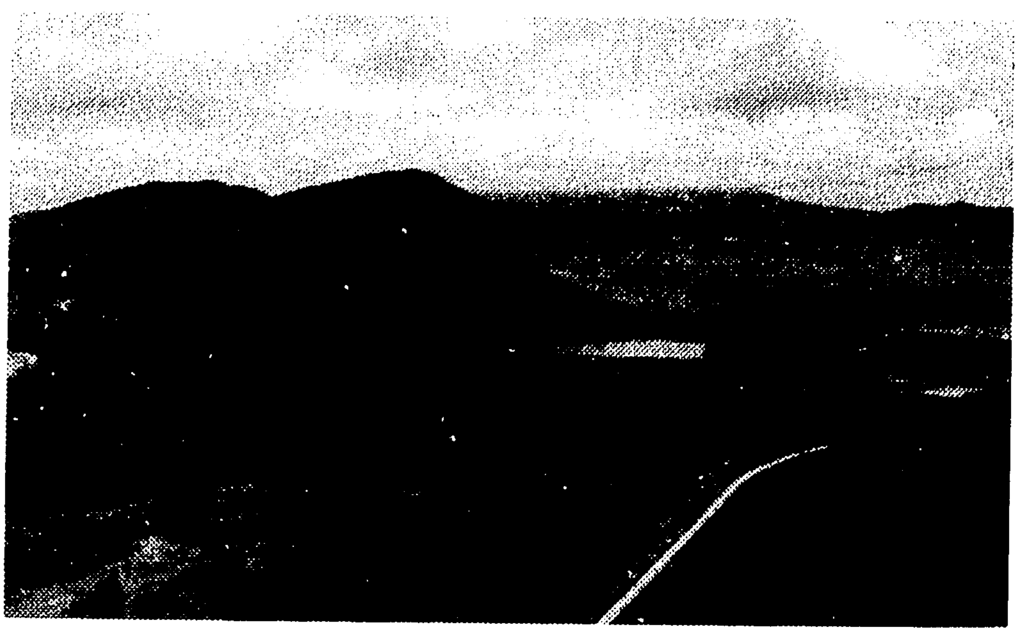
What is the progress of the project's outputs?

The Infrastructure Expansion and Maintenance Systems project is in its fourth of a planned seven years of implementation. Achievements toward reaching planned outputs and the major constraining factors are summarized below for each of the four subprojects.

St. Kitts Southeast Peninsula Area Subproject

The purpose of this subproject is to establish the institutional, financial and infrastructural framework for the physical development of the Southeast Peninsula. Planned outputs were a penetration road, utility installation, a land use and environmental management program, and a fiscal recovery program. The status of these outputs follows:

- Construction of the 6.6 mile penetration road began six months later than planned and was completed (see photograph below) fourteen months later than estimated. Final construction cost was $11.4 million -- 44 percent higher than the planned cost of $7.9 million.



- Utility installation at the St. Kitts Penetration Road was completed in December 1989.

- The land use and environmental management program has made progress. It was anticipated that private sector investment in resort facilities along the peninsula would occur when road construction was underway. At the end of our field work in October 1990 no construction had begun. A hotel group from Jamaica had plans to develop a resort but there was no definite date for beginning construction.

  There were two main reasons why resort construction had not begun as planned. First, RDO/C and the Government of St. Kitts did not want to start construction until there were assurances that the environment would be protected and the required environmental studies took longer than planned. Second, the project paper planned that private sector investment in resort facilities would occur before an access road was completed.

  In May 1991, RDO/C officials told us that the Jamaica hotel group was making progress in its plan to begin the resort construction -- work permits and an environmental assessment for the development had been approved by the Government of St. Kitts. It is anticipated that actual construction will begin in August 1991. Furthermore, RDO/C officials told us that it had recently made a cost/benefit analysis of the St. Kitts subproject which indicates that it will achieve the rate of return on investment envisioned in the project paper.

- All aspects of the fiscal recovery program were completed except implementation of a tax administration program.

Grenada Infrastructure Revitalization III Subproject

This subproject's purpose is to improve physical infrastructure that directly supports productive enterprise and increased investment in Grenada. Outputs were to be improved infrastructure in five target areas. Examples of improvements to be made are site leveling, lighting, erect buildings and road repairs. Progress was being made on this subproject with some improvements completed, some in process and some not yet begun.

St. Vincent Infrastructure Subproject

The purpose of this subproject is to improve the physical infrastructure that is directly supportive of productive enterprise and increased investment. Project outputs are to rehabilitate 16.2 miles of access roads and to improve roads maintenance. The cost of this subproject is $4.0 million.

As of October 18, 1990, the rehabilitation of the roads was generally making progress. Of the planned 16.2 miles of access roads 3.7 miles had been rehabilitated. However, monitoring of road rehabilitation work needed improvement because (1) the Fixed Amount Reimbursable process was not properly managed and (2) inspection of road rehabilitation work during and after construction appeared deficient because some roads had deteriorated in less than two years.

Regional Utilities Maintenance Subproject

The purpose of this subproject is to assist 10 Eastern Caribbean electric utilities in developing a common services organization capable of meeting their training and joint service needs. Major outputs were to be trained personnel and the establishment of a self-supporting corporation. The Corporation was set-up, however other aspects of this subproject, particularly training, were not implemented in accordance with the project paper. The cost of the subproject is $5.0 million.

The deficiencies which impeded progress for these subprojects are discussed in detail in the following section of the report.

Did RDO/C establish a system to monitor, evaluate, and report the project's progress consistent with A.I.D. standards?

In our opinion, RDO/C has established a system in accordance with A.I.D. standards to monitor, report and evaluate the implementation of the Infrastructure project. However, the system needs to be improved to ensure that major implementation problems are identified and corrected in a timely manner.

The Agency has adopted a decentralized management structure which places responsibility for establishing project monitoring, reporting and evaluation systems on the missions. Handbook 3, Chapter 11, "Project Monitoring" stipulates that these management systems must:

- oversee borrower/grantee compliance with A.I.D. policies, procedures and regulations;

- ensure the timely and coordinated provision of A.I.D. (and other) financing and/or inputs;

- support the borrower/grantee's efforts regarding the effective utilization of resources and accurate forecasting of future problems;

- identify implementation issues and projects not performing satisfactorily;

- collect data and information for subsequent A.I.D. project analyses and develop a historical record of implementation for the official A.I.D. project files; and

- prepare periodic reports for mission and/or A.I.D./Washington review.

The monitoring and reporting responsibilities of project officers were adequately defined in a mission order. The mission monitored project implementation through a series of monthly, quarterly and semi-annual reviews. Site visits were encouraged, performed and reported.

We found that RDO/C's project monitoring system was deficient in that it did not always identify and correct implementation problems that were affecting the progress of the four subprojects. Specifically, because of postponed evaluations and inadequate monitoring and reporting RDO/C did not identify:

- that sufficient income will not be generated to sustain the Regional Utilities Maintenance subproject after A.I.D. assistance ends;

- substantive subproject modifications being made without required analyses and approvals;

- internal control weaknesses in the Regional Utilities Maintenance subproject; and

- deficiencies in the Fixed Amount Reimbursable process for infrastructure rehabilitation and make needed corrections.

These weaknesses are discussed in detail below.

Sustainability of The Regional Utilities
<u>Maintenance Subproject Appears Questionable</u>

The Regional Utilities Maintenance subproject under the Infrastructure project requires the recipients to generate revenues to fund loan repayments, maintenance requirements and other recurrent costs so that operations will continue after A.I.D. assistance ends. The required planning to generate these revenues was either faulty or was never undertaken. RDO/C's project management systems, including conducting periodic evaluations, did not identify, report and correct this problem. Consequently, it is questionable whether this subproject will be self-sufficient after A.I.D. assistance ends which could place at risk a substantial investment.

<u>Recommendation No. 1</u>: We recommend that RDO/C:

1.1 undertake a project evaluation to determine the reasons why the self sufficiency plan for the Regional Utilities Maintenance subproject has not been successfully implemented; and

1.2 based on the findings of this evaluation, make the appropriate adjustments to ensure the sustainability of the subproject.

The Regional Utilities Maintenance (Utilities) subproject represents a substantial investment in infrastructure. It obligated $5 million to establish a regional non-profit corporation to enable member utilities to: (1) conduct needed training in critical functional areas, (2) develop local resources to conduct needed engineering and management analysis, and (3) provide a vehicle for joint procurement of services. As discussed below, the subproject could have financial sustainability problems which RDO/C's monitoring systems failed to identify and correct.

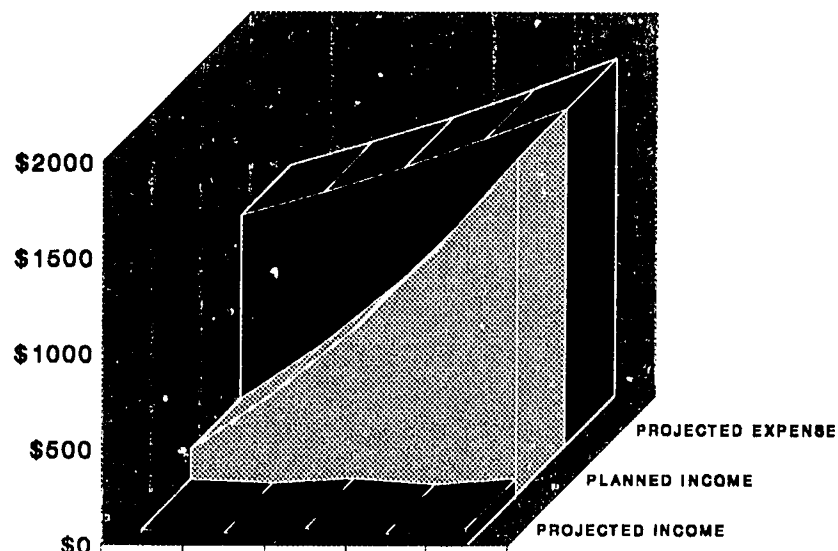
The Utilities subproject established an organization (referred to as the Corporation) which was to assist 10 Eastern Caribbean nations to improve their capability, efficiency and viability. A.I.D. financial assistance was to be phased-out gradually over the life of the project. The Corporation was to to become self-sustaining from income generated through fees for services and dues from participating utilities.

To ensure the sustainability of the Corporation the project paper envisioned the following phase-out plan for A.I.D. financial support.

Year	A.I.D. Financial Support	Corporation Financial Support
1	100%	0%
2	80%	20%
3	60%	40%
4	40%	60%
5	20%	80%
6	0%	100%

To determine whether sustainability was likely to occur we estimated the projected income and expenses of the Corporation. The graphic below demonstrates our projections:

COMPARISON PROJECTED INCOME AND EXPENSE
AND PLANNED PROJECT INCOME



	1990	1991	1992	1993	1994
PROJECTED EXPENSE	$1200	$1320	$1450	$1600	$1760
PLANNED INCOME	$240	$630	[illegible]71	$1280	$1760
PHOJECTED INCOME	$79	$62	$66	$56	$87

(IN THOUSANDS)

As the chart shows, projected income falls far short (by approximately $1.7 million) of both projected expenses and the planned income from the project paper. This precarious financial position is exacerbated by the fact that the Corporation has not analyzed their operations, prepared a budget of future needs, or determined how to obtain the income to become self sufficient. Instead, their attitude is one of expecting A.I.D. to continue to fund their operation beyond the completion of the project.

We believe RDO/C did not identify the Corporation's financial problems because it did not conduct project evaluations. A mid-term evaluation was scheduled for the end of the second year of the project, however, this was not done. If it had been performed at this point in time it could have flagged the failing planning assumptions and set in motion corrective adjustments. We feel an evaluation should still address these issues to try to prevent the Corporation from disbanding or the need for A.I.D. to continue funding activities beyond 1994.

Management Comments and Our Evaluation

Management agreed with this finding and the recommendations. They pointed out that they have not yet implemented the phaseout plan for A.I.D. financial support which was included in the project paper. They also informed us of recent actions taken by the Corporation to address the financial viability problem. RDO/C officials suggested we modify our projected income figures and our assessment of the Corporation's attitude toward continued A.I.D. funding as a result of this action. They had also drafted a scope of work for the project evaluation which we recommended be undertaken. See Appendix II for a complete text of RDO/C's comments.

We cannot modify our projected income figures or assessment of the Corporation's attitude because the reported actions were taken subsequent to our audit and are not readily subject to verification. We concur with the reported action to draft a scope of work and contract with a firm to do the evaluation. Recommendation No. 1 is resolved.

Substantive Modifications to a Subproject were made without Required Analyses or Approvals

A.I.D. Handbook 3 provides guidance concerning the procedures, analyses and approvals which must be conducted when a substantive modification is made to a project design once it has been approved. The Corporation created by the Utilities subproject made substantive modifications when they changed training inputs/outputs and postponed indefinitely two other project components. These modifications were made without either the benefit of an evaluation or project paper amendment and approval. RDO/C's project monitoring systems did not identify these modifications when they occurred nor did they perform required project modification procedures. As a result, this $5 millon subproject is not fully complying with A.I.D. regulations and it is not known whether the present activities are the most desirable ones or whether they will lead to the attainment of project objectives.

<u>Recommendation No. 2</u>: We recommend that RDO/C:

2.1 include in the scope of work for the planned evaluation of this subproject worksteps to determine whether the modifications made by the Corporation are appropriate and whether additional changes are necessary to successfully complete this subproject; and

2.2 based upon the results of this evaluation, perform the necessary modifications required by A.I.D. Handbook 3, Chapter 13.

Section 13 A.3 of A.I.D. Handbook 3, Chapter 13 on Project Modification States:

> When problems are suspected or confirmed, B/G and/or A.I.D. Project Committee members should evaluate the condition and, as appropriate, recommend alternative approaches and mechanisms, prepare justifications for the changes and obtain prompt approval to incorporate such changes into the project.

Chapter 13 also cites numerous conditions which constitute a "Substantive Modification". Section 13 D - Documentation of Design Modifications - gives further guidance on what a mission must do when a design modification is necessary following project paper approvals.

The project paper for the $5 million Utilities subproject envisioned establishing a regional non-profit corporation (Corporation) to assist member utilities to (l) conduct critical training, (2) perform engineering and management analysis, and (3) provide joint procurement services. The successful implementation of these three components would lead to meeting the project purpose of developing a Corporation capable of meeting training and other common service needs of the targeted electric utilities.

Our audit found that the planned-for Corporation was established. However, the Corporation Board, in July 1989, altered or postponed the above three components--actions which could substantially affect reaching the project purpose. These changes were made without an analysis of the need for changes, without assessments of alternatives, and without amending the project paper or authorization or obtaining any approvals from RDO/C.

The first component, critical training, was to be accomplished in two phases. The training planned for phase I was never done. The training inputs for phase II were changed. It was anticipated that most of the training would focus on technical skills. However, actual training concentrated on management and supervision and other unplanned training.

The second component was to develop an engineering and management analyses capability in the region so that targeted utilities needing these services could obtain them through the Corporation. This component was to begin in the first year of the project. However, the Corporation Board indefinitely postponed this component without conducting any analysis of why it was not longer necessary.

The third component, joint procurement services, envisioned that the Corporation would conduct joint purchasing for the targeted utilities. It was also planned that this component would develop contractual relationships among the utilities, identify suppliers and assist in bid preparation, etc. This component was to begin in the first year of implementation; however, like the second component, it was postponed and there were no indications of when or if it would start.

RDO/C's project monitoring systems failed to react to these changes and postponements and begin the process of analyzing them and, if deemed necessary, formalize project modifications. An important element of project monitoring--periodic evaluations--could have detected and analyzed these changes. Although two evaluations of this subproject should have been made, none were undertaken by RDO/C. The project paper required an evaluation to be undertaken at the end of the second and the end of the fifth year. The first evaluation should have been started around July 1990. RDO/C stated that this evaluation was postponed because the Project was off to a late start.

$5 million was authorized for this project with the hopes of achieving a specific purpose. As result of these changes, this subproject is being implemented without knowing whether the present inputs and level of project activity can reach the desired objectives. Additionally, with the present mix of inputs and postponed components there is little opportunity to measure accomplishments against planned outputs.

Management Comments and Our Evaluation

RDO/C did not make any comments on the content of this finding. They informed us that a scope of work was drafted for the recommended evaluation and that discussions were held with a small business firm to do the work. RIG/A/T concurs with the reported action and considers Recommendation No. 2 to be resolved.

Accounting Systems and Internal Controls for the Regional Utilities Maintenance Subproject are Inadequate

Generally accepted accounting principles and a condition precedent in the project agreement require the recipient of program funds to (1) establish adequate accounting records, (2) safeguard program funds, and (3) perform required independent audits. Our review disclosed that the accountant who was to establish the accounting system was not hired, and other internal control weaknesses existed because RDO/C did not ensure that these deficiencies were corrected. As a result, program funds may not be properly accounted for and are susceptible to fraud, abuse and mismanagement.

Recommendation No. 3: We recommend that the Regional Development Office for the Caribbean:

3.1 enforce the provision in the project agreement to ensure that adequate accounting systems and internal controls are established;

3.2 follow-up to ensure the adequacy of the accounting systems and internal controls; and

3.3 ensure that a financial audit of the funds advanced for the Regional Utilities Maintenance subproject is performed.

Under the terms of the Project Agreement RDO/C was to provide $5 million in grant funds to the Regional Utilities Maintenance (Utilities) subproject for the purpose of establishing a regional non-profit corporation (Corporation). Under a Cooperative Agreement the National Rural Electric Cooperative Association (Cooperative Association) was to initially assume primary responsibility for the implementation of the project. The Cooperative Association was to provide a project program advisor to work at the Corporation's offices. The Corporation was to develop indigenous training capabilities and provide common services on a cooperative basis for electrical utilities in 10 Eastern Caribbean countries. The funds were to be used to finance technical assistance, training and commodities.

Because of the high risk environment for these funds the Project Agreement contained the following condition precedent:

> Prior to signing a Grant Agreement, the Corporation shall, except as A.I.D. may otherwise agree in writing, furnish to A.I.D. in form and substance satisfactory to A.I.D. evidence that the Corporation has established an adequate accounting system and financial controls acceptable to A.I.D. and which will enable it to operate efficiently.

To help ensure further accountability, the following special covenant concerning the Utilities subproject was added to the Cooperative Agreement:

> The Corporation, except as A.I.D. may otherwise agree in writing, shall covenant to provide to A.I.D. during the second phase of the subproject, annual audited financial statement prepared by an independent accounting firm acceptable to A.I.D.

Our audit found that the above requirements were not met. Specifically:

-- the Corporation has operated since the beginning of the subproject without an accountant or adequate accounting procedures,

-- serious internal control deficiencies existed such as one person having sole responsibility for making and recording payments, doing the bank reconciliation and writing checks, and

-- the required independent audits were not performed.

The Cooperative Association project program advisor told us the above requirements were not implemented because of the possible relocation of the Corporation to another island. In our opinion, the uncertainty over a possible move does not obviate the requirement for adequate financial management systems and accountability.

RDO/C was aware that accounting systems and internal controls in the Utilities subproject needed to be improved. For example, RDO/C reviewed the Corporation's accounting procedures manual and suggested that several changes be made. Although RDO/C's project management system identified and reported that improvements needed to be made, RDO/C did not ensure that the Corporation took corrective action to fully implement such improvements.

Because of these deficiencies a substantial amount of program funds were not properly controlled and thus are susceptible to fraud, abuse and mismanagement. Additionally, RDO/C advanced $934,966 to the Corporation when they did not have an acceptable system for controlling and accounting for such funds.

We believe RDO/C should ensure that adequate financial management systems are established. Furthermore, a financial audit is needed to ensure funds are accounted for and were only used for intended purposes. A lack of adequate accounting procedures and internal controls in a high risk environment increases the possibility for misuse of funds.

Management Comments and Our Evaluation

RDO/C agreed with the facts and recommendations for this finding. Since our draft report was issued, they conducted two reviews which identified weaknesses in the Corporation's accounting system and internal controls. RDO/C stated they will send a letter to the Corporation requiring these weaknesses to be resolved as soon as possible and that adequate accounting systems and internal controls be established. They also informed us that a financial audit had been completed for the funds advanced to the Regional Utilities Maintenance subproject. RIG/A/T considers the reported actions to be sufficient to resolve all parts of Recommendation No. 3.

Monitoring of Fixed Amount
Reimbursable Process was Inadequate

A.I.D. project monitoring guidelines require project officers to establish monitoring systems and internal controls which ensure the effective and efficient utilization of resources. Our review disclosed that RDO/C's monitoring of the Fixed Amount Reimbursable (FAR) process in the St. Vincent subproject for road rehabilitation was inadequate because control weaknesses existed in the approval of estimates for road rehabilitation, funds advanced for FAR projects were commingled with other monies, these advances were not settled in a timely manner, and inspection and acceptance of roads rehabilitated were not done in accordance with prescribed practices. RDO/C's monitoring system failed to identify, report and correct these weaknesses because a mission order had not been written concerning monitoring the FAR process. As a result, there is not adequate assurance that FAR estimates are reasonable, advances to finance the rehabilitation work are used for agreed-to purposes and construction work complies with acceptable standards.

> Recommendation No. 4: **We recommend that the Regional Development Office for the Caribbean modify its monitoring system for the Fixed Amount Reimbursable process by issuing a mission order to ensure that (a) the project officer attests to the acceptance of the cost estimates and documents this in the appropriate records; (b) confirmation of deposit of advances to separate accounts is required in Project Implementation Letters for Fixed Amount Reimbursable projects; (c) amounts advanced are settled in accordance with prescribed guidelines; and (d) the project officer attests that the items financed met the standards and were completed and he/she will document this in the official records.**

A.I.D. guidelines state that the Fixed Amount Reimbursable (FAR) method is a preferred mode to be used for low-cost, short-term projects. Under the FAR method, the amount to be reimbursed by A.I.D. is fixed in advance based upon a cost estimate developed by the cooperating country and reviewed and approved by A.I.D. The FAR method places the responsibility on the host government to complete the job; however, it requires careful monitoring on the part of A.I.D. to ensure that cost estimates are reasonable and that work is performed to prescribed standards.

The St. Vincent Infrastructure subproject provides $2.4 million to rehabilitate and maintain selected roads for the propose of creating an infrastructure that will stimulate investment and productive activity. As of October 23, 1990, the Government of St. Vincent and RDO/C signed two FAR agreements for the rehabilitation of five roads on the island.

A.I.D. Handbook 3 stipulates that the cooperating government will submit design specifications along with cost estimates for each road to be constructed under a FAR to A.I.D. for review and approval. Our review found the cost estimates for this subproject were not always prepared by the Government of St. Vincent. Rather, they were prepared and reviewed by engineer advisors working on an A.I.D. direct contract. In most cases RDO/C approved these estimates based upon the verbal concept of these engineer advisors. This situation represents a lack of proper control because one person is both the preparer and reviewer of the estimate.

This lack of control was further exacerbated because of our inability to determine what analysis, if any, RDO/C did of the cost estimates. The official files did not contain any analysis of the estimates submitted nor could project officials provide us with a cost analysis of these estimates. Without adequate documentation in the file we could not determine whether RDO/C had properly verified the reasonableness of the FAR estimates.

Inadequate monitoring of the FAR process also contributed to (1) the failure to liquidate advances in a timely manner and (2) the commingling of advances with other loan funds. Also, the lack of adequate monitoring could have led to problems with the supervision of road construction. These deficiencies are discussed below.

FAR advances made to the Government of St. Vincent were not liquidated in accordance with the requirements of Project Implementation Letters (PIL). Two examples:

- PIL number 12 advanced $204,393 (37.5 percent) of the total amount approved for this FAR. The PIL stated the advance was to be liquidated within three months after the completion of work. A second advance could not be made until the first one was cleared. RDO/C granted a second advance of $231,646 without clearing the initial one and without the engineering advisor's certification of completion. Both advances were still outstanding as of September 30, 1990.

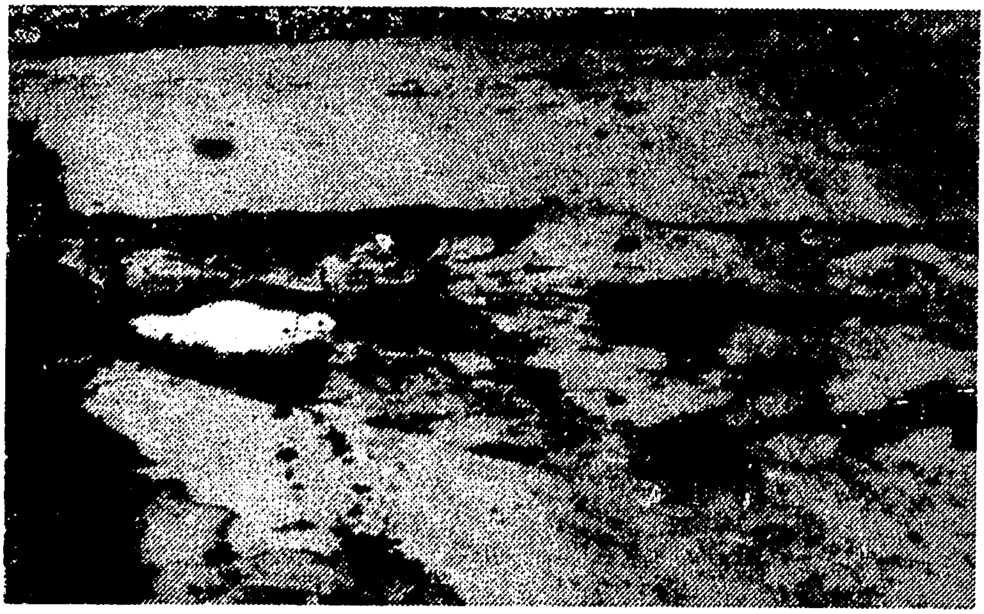
- PIL number 9 advanced $422,541 on August 24, 1988, for the rehabilitation of two roads. This advance was to be liquidated through a proportionate completion or work over a three-month period. The advance was not cleared until December 18, 1989 -- nearly 16 months after the advance was made.

Also, the advances made to the Government of St. Vincent were commingled with loan funds from other donors and were not deposited in a separate account. Such commingling diminishes RDO/C's capability to determine how the A.I.D. funds were used.

Lack of monitorship was also evident in the supervision of road construction for FAR projects. Tests of materials used in the rehabilitation of the roads were not made as required. For each road project we visited we asked the engineer advisor whether the materials were tested. Their reply was that the country had good masons and that it was not necessary to inspect and test the materials.

Our visits to selected rehabilitation works indicated that the roads were quickly deteriorating. For example, we visited the Vermont/Paradise road in St. Vincent which was completed in November 1989 at a cost of $260,825. This road showed excessive deterioration only eleven months after rehabilitation was finished--the majority of the drainage was destroyed and the road had many potholes.

We noted similar conditions of inadequate supervision of road maintenance in Grenada. Roads which were rehabilitated by this project were deteriorating after a short period of time. For example, on our visit to the Red Mud Road in October 1990 we found several instances of damage like that shown in the photograph below. Rehabilitation work was completed on May 27, 1988. We could not determine the reasons for the poor condition of this road.



Red Mud Road, Grenada - October 1990

As the chart shows, projected income falls far short (by approximately $1.7 million) of both projected expenses and the planned income from the project paper. This precarious financial position is exacerbated by the fact that the Corporation has not analyzed their operations, prepared a budget of future needs, or determined how to obtain the income to become self sufficient. Instead, their attitude is one of expecting A.I.D. to continue to fund their operation beyond the completion of the project.

We believe RDO/C did not identify the Corporation's financial problems because it did not conduct project evaluations. A mid-term evaluation was scheduled for the end of the second year of the project, however, this was not done. If it had been performed at this point in time it could have flagged the failing planning assumptions and set in motion corrective adjustments. We feel an evaluation should still address these issues to try to prevent the Corporation from disbanding or the need for A.I.D. to continue funding activities beyond 1994.

Management Comments and Our Evaluation

Management agreed with this finding and the recommendations. They pointed out that they have not yet implemented the phaseout plan for A.I.D. financial support which was included in the project paper. They also informed us of recent actions taken by the Corporation to address the financial viability problem. RDO/C officials suggested we modify our projected income figures and our assessment of the Corporation's attitude toward continued A.I.D. funding as a result of this action. They had also drafted a scope of work for the project evaluation which we recommended be undertaken. See Appendix II for a complete text of RDO/C's comments.

We cannot modify our projected income figures or assessment of the Corporation's attitude because the reported actions were taken subsequent to our audit and are not readily subject to verification. We concur with the reported action to draft a scope of work and contract with a firm to do the evaluation. Recommendation No. 1 is resolved.

Substantive Modifications to a Subproject were made without Required Analyses or Approvals

A.I.D. Handbook 3 provides guidance concerning the procedures, analyses and approvals which must be conducted when a substantive modification is made to a project design once it has been approved. The Corporation created by the Utilities subproject made substantive modifications when they changed training inputs/outputs and postponed indefinitely two other project components. These modifications were made without either the benefit of an evaluation or project paper amendment and approval. RDO/C's project monitoring systems did not identify these modifications when they occurred nor did they perform required project modification

REPORT ON INTERNAL CONTROLS

We have audited RDO/C's Infrastructure Expansion and Maintenance Systems Project No. 538-0138 for the period May 6, 1986 through September 30, 1990. We have issued our report thereon dated July 31, 1991.

The management of A.I.D. including RDO/C, is responsible for establishing and maintaining adequate internal controls. Recognizing the need to re-emphasize the importance of internal controls in the Federal Government, congress enacted the Federal Manager's Financial Integrity Act (the Integrity Act) in September 1982. This Integrity 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. Also, the General Accounting Office 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 Integrity Act, the Office of Management and Budget 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 because (1) changes in conditions may require additional procedures or (2) the effectiveness of the design and operation of policies and procedures may deteriorate.

Our review of internal controls was limited to the issues contained in this report. We found a problem that awe consider reportable under standards established by the Comptroller General of the United States. Reportable conditions are those relating to deficiencies in the design or operation of the internal control structure which we become aware of and which, in our judgment, could adversely affect RDO/C'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 is obtained, maintained and fairly disclosed in reports. We noted the following reportable conditions:

Audit Objective 2: RDO/C did not ensure that required project modification procedures were performed before substantive modification to a subproject were made (see page 12).

RDO/C did not ensure that the Corporation Created by the Utilities subproject fully established accounting procedures and internal control systems and conducted financial audits as required (see page 15).

RDO/C did not properly control advances made under the Fixed Amount Reimbursable process (see page 17).

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 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. However, we believe the reportable conditions described under audit objective number two are material weaknesses.

SCOPE AND METHODOLOGY

Scope

We audited the RDO/C Infrastructure Expansion and Maintenance Systems project in accordance with generally accepted government auditing standards except as described in the fifth paragraph of this section of the report. We conducted the audit from April 18, 1990 through October 23, 1990 and covered the systems and procedures relating to RDO/C project management from May 6, 1986, (project inception) through September 30, 1990. As noted below, we conducted our field work in the offices of RDO/C and implementing entities in St. Kitts, Grenada, St. Lucia, St. Vincent and Barbados.

Our audit covered project implementation from May 1986 through September 1990 during which period $20.6 million of project expenditures were incurred. This represents 55 percent of the $37.5 million for this project. We did not audit contributions from host governments.

In answering our audit objectives we relied on progress reports from RDO/C and implementing entities. We did not audit these reports. However, we did verify substantial information in these reports through site visits and interviews.

Our capability to determine the adequacy of RDO/C's analysis of FAR cost estimates was limited. We attempted to resolve this by searching project files and interviewing project officials. However, the official files did not contain any analysis of estimates submitted by the host government nor could project officials provide us with an analysis of these estimates.

Our audit did not follow the Government Auditing Standards applicable to assessing compliance with applicable laws and regulations.

Methodology

The methodology for each audit objective follows:

<u>Audit Objectives One and Two</u>

These objectives entailed determining the progress of the project and whether RDO/C established a system to monitor, evaluate and report the project progress consistent with A.I.D. standards. For our determination no sampling was required since we were not reviewing individual transactions, but were looking at RDO/C's systems to monitor, evaluate and report on project progress. We reviewed documentation and the project paper to determine requirements for comparison. We compared planned outputs as set forth in the logical framework of the project paper with project progress. To obtain information for this comparison, we visited the road and land use office in St. Kitts, and the infrastructure sites in St. Vincent and Grenada, and interviewed local officials as to project progress. Our review of project requirements showed that evaluations were not performed in accordance with the project paper. We discussed this situation with responsible mission personnel to determine why these evaluations were not done and what effect this lack of evaluations had on project implementation.

We reviewed project documentation such as the project paper to determine the manner a subproject would be sustained after completion. This review consisted of comparing project paper financial projections with actual income and future income generations projected by the Corporation. These projections were discussed with RDO/C and project officials. We obtained project officials views and understanding as to how the project would be sustained after A.I.D. funding was terminated.

A comparison of project planned objectives with actual implementation was made to determine the status of these objectives. The purpose of this review was to determine whether project objectives had been changed or remained the same. This comparison showed that objectives had been changed and as a result a determination was made as to whether the project paper had to be changed. To make this determination we reviewed applicable regulations and concluded that the project paper had to be changed. We discussed this condition with RDO/C and other project officials to determine why these changes were made and the reason why the project paper was not changed. Project documentation was reviewed to ascertain what conditions or events caused the changes in project objectives. Also, the project agreement was reviewed to determine requirements for evaluations and discussions were held with RDO/C officials to determine the reasons why evaluations were not performed.

For the Regional Utilities Maintenance subproject we reviewed the accounting and management procedures of the subgrantee to determine if it complied with the terms of the project agreement. Project agreement requirements were compared with subgrantee procedures and systems. Discussions were held with RDO/C officials and subproject officials to determine the reasons for non-compliance with the terms and requirements of the project agreement. Project documentation was reviewed to determine RDO/C involvement with the sub- project and what action had been initiated by RDO/C to correct subproject deficiencies.

We reviewed RDO/C policies and procedures used in the implementation of the Fixed Amount Reimbursable (FAR) process. This review consisted of comparing the actual implementation of the FAR process with the A.I.D. regulation requirements. To determine actual implementation we visited 8 of 17 completed or in-process road rehabilitation sites in St. Vincent and Grenada. Also, we held discussions with contractor and government officials responsible for the road rehabilitation to obtain their views regarding their responsibilities and duties in the implementation of the FAR process. Our road observation also included a visual determination as to whether the road had been completed and in good condition. For the roads visited we also reviewed construction estimates and the method used to calculate these estimates. In those instances where we identified differences between actual and planned implementation we discussed these variances with RDO/C and Project personnel to determine the reasons why.

UNITED STATES GOVERNMENT

memorandum

DATE: June 28, 1991

REPLY TO ATTN OF: Aaron S. Williams, Mission Director ASW

SUBJECT: IEMS Audit Response

TO: Mr. Darryl Burris, RIG/A/T

We thank you for the copy of the draft IEMS audit report left during your visit on May 31, 1991. We believe that the audit report is basically accurate and reflects the collaborative spirit demonstrated in the exit conference by your staff. Below are comments on a few of the more important areas where problems might be more clearly defined, followed by the actions we have taken towards the closure of your recommendations.

A. **Fixed Amount Reimbursement (FAR)** - On page 21 in reference to the approval of cost estimates for the St. Vincent roads constructed under FAR, you state that "RDO/C approved these estimates based upon the verbal concept of these engineering advisors". As we have previously discussed, we agree that the documentation substantiating the review of the cost estimates within RDO/C could have been more detailed. However, in spite of the absence of written cost analyses, we wish to restate what was the RDO/C review procedure for the roads. The AID engineer who served as project officer along with the Chief of the Infrastructure office, and a staff member of the Controller, Program, and PDO office reviewed and cleared the PIL which approved the cost estimates - one cost estimate was rejected and returned to the government of St Vincent (GOSV) during this process and four were approved. While we accept that better documentation is advisable, we think it is important to remember that these estimates are for relatively short stretches of road and that the estimates are only two pages in length. Extensive cost analysis is just not necessary to determine their reasonableness.

B. **Road Construction** - You note on page 23 and 24 that roads in St. Vincent and Grenada have deteriorated excessively. An RDO/C engineer who was not involved with this project during construction of the Vermont/Paradise road visited the roads subsequent to the exit conference and concluded that it had deteriorated due to a complete lack of maintenance on the part of the GOSV. All of the drains and ditches were blocked with debris and earth. As a result, drainage water flows along the middle of the road resulting in various pot holes. Vandalism by an individual who was angry about non-employment during road construction apparently accounts for the worst section of about 50 feet at the beginning of the road (he dug up the road after it had been finished). Troumaca, Francois, Questelles and Camden Park roads which were also visited, were in good condition even though no maintenance had been carried out.

This issue of maintenance is serious and has been taken up with the GOSV; we acknowledge that we should have addressed this issue previously. In view of this, the appropriate sections of the draft report should be modified to reflect this continuing maintenance problem.

C. **Sustainability of the Corporation** - The Corporation was formed in July 1989, about one year before the initiation of the audit. During your visit, we advised you of the myriad of problems which the Corporation encountered when it attempted to set up its office in Barbados. As we discussed during the exit conference, we have not yet implemented the phaseout plan for AID financial support as included in the project paper. Nevertheless, since transferring its offices to St. Lucia in December 1990, the Corporation has moved quickly to address its financial viability and fee structure. As a result, the Corporation expects to collect $95,000 in dues and $80,000 in course fees in 1991. In addition, the Corporation should save approximately $50,000 in operating expenses due to an agreement to share per diem costs of trainees with the regional utility companies. Although we realize that the audit covers only until October 1990, we suggest that you consider an adjustment to your projected income chart on page 12 and also a modification of your assessment of the Corporation's attitude towards continued AID funding of their operations in the first paragraph of page 13.

D. **St. Kitts Road** - Please note with regard to the statements on pages 5 and 6, that hotel construction was not anticipated in the project paper until after the road was completed. The statement that private sector investment will occur immediately after road construction is underway on page 14 of the project paper refers to land purchases which did, in fact, take place.

E. **Auditors' Recommendation**

1. **Recommendation No. 1**: We recommend that RDO/C:

1.1 undertake a project evaluation to determine the reasons why the self-sufficiency plan for the Regional Utilities Maintenance subproject has not been successfully implemented; and

1.2 based on the findings of this evaluation, make the appropriate adjustments to ensure the sustainability of the subproject.

Action Taken

A scope of work has been drafted to carry out the evaluation of this project. In addition RDO/C has had preliminary discussions with an 8A small business firm to carry out the evaluation. RDO/C now requests that you list recommendation 1.1 as resolved.

2. **Recommendation No. 2**: We recommend that RDO/C:

2.1 perform an evaluation of this subproject to determine whether the modifications made by the Corporation are appropriate and whether additional changes are necessary to successfully complete this subproject; and

2.2 based upon the results of this evaluation, perform the necessary modifications required by A.I.D. Handbook 3, Chapter 13.

Action Taken

A scope of work has been drafted to carry out the evaluation of this project. In addition RDO/C has had preliminary discussions with an 8A small business firm to carry out the evaluation. RDO/C now requests that you list recommendation 2.1 as resolved.

3. **Recommenation No. 3**: We recommend that the RDO/C:

3.1 enforce the provision in the project agreement to ensure that adequate accounting systems and internal controls are established; and

3.2 initiate a financial audit of the funds advanced for the Regional Utilities Maintenance subproject.

Action Taken:

3.1 Since the subject report RDO/C has conducted two reviews of the Corporation's accounting system and internal controls. The reviews identified weaknesses in the system and recommendations were made for rectification thereto. RDO/C will send a letter to the Corporation requiring that the recommendations be resolved as quickly as possible, and that adequate accounting systems and internal controls be fully established and maintained. We will work with the Corporation to ensure the necessary actions are taken.

3.2 A financial audit has now been completed by the CPA from Price Waterhouse. RDO/C is now awaiting a copy of the Audit Report.

In view of the above, it is requested that recommendations 3.1 be listed as resolved and 3.2 as closed.

4. **Recommendation No. 4:** We recommend that RDO/C:

4.1 Establish a monitoring system for the Fixed Amount Reimbursable process that will ensure that (a) cost estimates are reviewed and approved by someone other than the preparer, (b) funds advanced for projects are not commingled with other monies, (c) amounts advanced are settled in accordance with prescribed guidelines and, (d) roads are financed and constructed in accordance with prescribed standards.

Action Taken

RDO/C will prepare a Mission Order to establish rules and regulations for the Fixed Amount Reimbursable process. An effective monitoring system has been established to resolve the weaknesses highlighted in this recommendation and will be codified in the Mission Order.

RDO/C now requests that you list this recommendation as resolved.

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