



USAID
FROM THE AMERICAN PEOPLE

OFFICE OF INSPECTOR GENERAL

AUDIT OF THE FUND ACCOUNTABILITY
STATEMENT OF USAID RESOURCES MANAGED
BY FINANCIAL MARKETS INTERNATIONAL
UNDER AWARD NO. PCE-I-04-99-00010-00
“COMMERCIAL TRANSPARENCY, CAPITAL
MARKETS DEVELOPMENT INITIATIVE PROGRAM”
FOR THE PERIOD FROM OCTOBER 1, 2002, TO
MARCH 31, 2005

AUDIT REPORT NO. 6-294-07-003-N
NOVEMBER 7, 2006

CAIRO, EGYPT

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USAID
FROM THE AMERICAN PEOPLE

Office of Inspector General

Report No. 6-294-07-003-N

November 7, 2006

MEMORANDUM

TO: USAID/West Bank and Gaza Director, Howard Sumka

FROM: Regional Inspector General/Cairo, David H. Pritchard /s/

SUBJECT: Audit of the Fund Accountability Statement of USAID Resources Managed by Financial Markets International Under Award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program", for the Period From October 1, 2002, to March 31, 2005

The Regional Inspector General/Cairo is transmitting one copy of the report that the independent firm, Ernst and Young, prepared on the subject audit.

Ernst and Young conducted the audit in accordance with Generally Accepted Government Auditing Standards except that the firm did not have an external quality control review by an unaffiliated organization because professional organizations in the West Bank and Gaza do not offer such a review program.

USAID/West Bank and Gaza contracted with Financial Markets International under Task Order Number PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program" to support development of an enabling legal and regulatory framework for financial markets in West Bank and Gaza. The audit covered expenditures of \$623,865, for the period from October 1, 2002, to March 31, 2005.

The audit included: (1) expressing an opinion on the Fund Accountability Statement; (2) determining that cost incurred under the contract are allowable, allocable and reasonable; (3) obtaining an understanding of the contractor's internal control structure and assessing control risk; and (4) determining compliance with contract terms and applicable laws and regulations. The audit tested the contractor's compliance with Executive Order 13224 – Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, Or Support Terrorism.

The audit expressed a qualified opinion on the Fund Accountability Statement. The auditors identified questioned ineligible costs of \$52,030 for expenditures that were not in compliance with source and origin requirements for procurement of goods and services. The auditors identified two internal control weaknesses in the field office's procurement practices and safeguarding of program assets. Furthermore, the auditors identified two instances of noncompliance with contract terms and applicable laws and regulations relating to the source and origin requirements.

During the draft report stage, Financial Markets International agreed with the two internal control weaknesses, and took adequate corrective actions to address the weaknesses. Financial Markets International disagreed with the noncompliance findings regarding authorized geographic code procurement and sought a retroactive source waiver from USAID. We agree with the auditors' position and are therefore, including the following recommendation in the Agency's Recommendation Tracking System:

Recommendation No. 1: We recommend that the Contracting Officer, USAID/West Bank and Gaza, make a management decision on the questioned ineligible costs of \$52,030 for the procurement of goods that were not of US origin detailed on pages 20 to 23 of Ernst and Young report and recover from Financial Markets International any amounts determined to be unallowable.

Please advise the Regional Inspector General/Cairo within 30 days of this memorandum of the action planned or taken to implement the recommendation.

Enclosures: a/s

AUDIT OF THE FUND ACCOUNTABILITY
STATEMENT OF USAID RESOURCES MANAGED BY
FINANCIAL MARKETS INTERNATIONAL (FMI)
UNDER AWARD NO. PCE - I - 04 - 99 - 00010 - 00
"COMMERCIAL TRANSPARENCY, CAPITAL
MARKETS DEVELOPMENT INITIATIVE PROGRAM
(CMDI)"

FOR THE PERIOD FROM

OCTOBER 1, 2002 TO MARCH 31, 2005

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December 5, 2005

**U.S. Agency for International Development
Office of Inspector General
Plot 1/A off El Laselky Street
New Maadi
Cairo, Egypt 11435**

Dear Sirs,

This report represents the results of our financial audit of the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005.

Background

Financial Markets International (FMI) is a U.S. consulting firm specialized in financial markets development in emerging markets around the world. On July 5, 2000, the U.S. Agency for International Development (USAID) contracted FMI under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program - CMDI" to support development of an enabling legal and regulatory framework for West Bank and Gaza capital markets. The total obligated amount is U.S. \$ 7,888,893 and the period of performance was from July 5, 2000 to March 31, 2005 in accordance with modification No.6 and 13 to the award, respectively. This work involved technical assistance to the Palestine Securities Exchange and the Palestinian Legislative Council on the draft of Capital Market Authority Law and the Securities Law.

In response to worsening economic conditions in the West Bank and Gaza after September 2000, USAID broadened FMI's scope of work to include Non-Bank Financial Institutions (NBFI) activities, with particular focus on leasing and mortgage finance. USAID also approved the following activities to generate immediate impacts on economic development and employment generation:

- Financial restructuring program
- Private sector liaison
- Emergency loan program

Reference to modification No. 10 to Contract No. PCE-I-00-99-00010-00, the contract number was modified and replaced with "Contract No. PCE-I-04-99-00010-00". The purpose of this modification was to formally modify the subject contract to reflect the system Delivery Order number of "04".

Indirect Costs Rates:

Indirect costs related to the award were maintained in FMI headquarter and were not attributable to local costs.

Audit Objectives and Scope

The objective of this engagement was to conduct an audit of the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005. Revenues and costs incurred that were subject to our audit procedures amounted to U.S. \$ 704,147 and U.S. \$ 623,865, respectively. The cost amount excludes advances paid to expatriates in the amount of U.S. \$ 74,247 that were not subject to our audit, since the final settlements of these payments were held at FMI's headquarter in the United States (Refer to note 6 of the fund accountability statement).

Specific Objectives

1. Express an opinion on the fund accountability statement of USAID resources managed by Financial Markets International under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005.
2. Determine that costs incurred under the award are allowable, allocable, and reasonable in accordance with the terms of the award agreement.
3. Obtain an understanding of the internal control structure of FMI, assess control risk and identify reportable conditions including material weaknesses in relation to the USAID award agreement.
4. Perform tests to determine whether FMI has complied in all material respects with the terms of the award agreement and with applicable laws and regulations.
5. Determine if FMI has taken adequate corrective actions on prior audit findings and recommendations.

Preliminary audit planning procedures began in July 2005. Audit field work commenced during August 2005 and was completed on August 25, 2005 and consisted of:

- A review of the award agreement between USAID and FMI.
- Discussions with the FMI local officials, including interviews with FMI's key personnel concerning the status of the award agreement, accomplishments during the period, the statutory reporting requirements, the award's budget, and procedures governing actual expenditures locally incurred by FMI.
- Review of FMI's organizational structure and its established policies and procedures, and controls related to personnel, procurement, financial accounting and reporting to USAID.

Our tests of local revenues and expenditures included, but were not limited to, the following:

1. Agree balances per general ledger to the fund accountability statement.
2. Agree the funds received to the confirmed balance from FMI headquarter.
3. Obtaining management representation letter.
4. Test, on a sample basis, costs incurred for allowability, allocability and reasonability.
5. Determine whether costs incurred were consistent with the terms of the award agreement and the applicable laws and regulations.
6. Determine whether FMI complied with the provision of Executive Order 13224 Blocking property and prohibiting transactions with persons who commit, threaten to commit, or support terrorism.

Except as discussed in the following paragraph, we conducted our audit of the fund accountability statement in accordance with U.S. Government Auditing Standards issued by the Comptroller General of the United States. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement.

We did not have an external quality control review by an unaffiliated audit organization as required by chapter 3 paragraph 3.52 of U.S. Government Auditing Standards, since no such program is offered by professional organizations in Palestine. We believe that the effect of this departure from U.S. Government Auditing Standards is not material because we participate in the Ernst & Young worldwide internal quality control review program which requires our offices to be subjected, every three years, to an extensive quality control review by partners and managers from other Ernst & Young offices.

As part of our examination, we made a study and an evaluation of relevant internal controls and reviewed FMI's compliance with applicable laws and regulations.

Audit Results

Fund Accountability Statement:

Our audit procedures identified U.S. \$ 52,030 of ineligible costs out of U.S. \$ 623,865 total audited costs. (The amount audited excludes advances paid to expatriates reported in the fund accountability statement in the amount of U.S. \$ 74,247).

Details of questioned costs are shown in findings 1 and 2 of the Schedule of Audit Findings and Questioned Costs – III Questioned Costs.

Local expenditures subject to our audit were supported with copies of the original documents. Original documents are held at FMI headquarter office in the United States, and therefore these were not available for inspection or part of our audit.

According to FMI management, balances and details of assets procured with program funds are maintained at FMI headquarter in the U.S. and, title to such assets is vested in the recipient in accordance with USAID approval.

Internal Control Structure:

Our audit procedures identified the following weaknesses in the internal control of FMI local field office as reportable conditions:

1. Procurement of goods and services. (Schedule of Audit Findings and Questioned Costs, I. Internal Control 1)
2. Not applying effective controls to ensure proper use of program assets. (Schedule of Audit Findings and Questioned Costs, I. Internal Control 2)

Compliance:

Our audit procedures identified the following instances of non-compliance with the terms of the agreement or applicable laws and regulations, which have been reported in the Independent Auditors' Report on Compliance.

1. Non-compliance with geographic code 000. (Schedule of Audit Findings and Questioned Costs, II. Compliance 1)
2. Long term lease. (Schedule of Audit Findings and Questioned Costs, II. Compliance 2)

Follow up on Prior Audit Recommendations:

From our review of prior audit recommendations we noted that the following recommendation was not implemented by FMI:

- A recommendation was made to FMI to prepare and maintain a written procurement manual, to ensure that procurements made are properly approved and in accordance with federal rules and USAID regulations. (Schedule of Audit Findings and Questioned Costs, I. Internal Control 1). However, we noted that subsequent to the audit period, FMI has prepared a Project Management Guidelines that include procurement procedures for FMI purchases.

From our review of prior audit recommendations we noted that the following recommendations were implemented by FMI:

- A recommendation was made to FMI to segregate the duties of recording and custody of cash in order to assign them to different employees to minimize the risks associated with this process. FMI has noted our recommendation and have started to segregate these duties.
- A recommendation was made to FMI local office to open a local bank account and to establish clearly signing limits for its authorised signatories. FMI has implemented our recommendation.
- A recommendation was made to FMI financial manager to evidence his review and approval of the monthly bank reconciliations by signing and dating the reconciliation working papers. FMI has implemented our recommendation.

Compliance with Executive Order 13224:

The result of our audit disclosed no instances of non-compliance with USAID Acquisition and Assistance Policy Directives AAPD 02-04 Implementation of E.O. 13224 - Executive Order on Terrorist Financing (March 20, 2002) and AAPD 04-07 Revised Certification Regarding Terrorist Financing Implementation E.O. 13224 (March 24, 2004) and AAPD 04-14 Certification Regarding Terrorist Financing Implementation E.O 13224 (Revision 2) (September 24, 2004).

Other Matters:

We have made several requests to FMI officials for scheduling the exit conference to formalize the audits findings, but FMI officials confirmed in their email dated August 14, 2006 that they will contact us in the future to schedule for the exit conference at the time the matter of "Requesting a retroactive source of origin waiver" is resolved with USAID. Accordingly, we consulted with the Regional Inspector General Office in Cairo, and advised us to proceed with finalizing the report.

Summary of Recipient's Management Comments

Regarding the internal control No.1 shown above, FMI has indicated that it has completed the preparation of Procurement Manual on October 1, 2005, disseminated to the West Bank & Gaza office personnel, and the project staff received training on the Manual in mid-October 2005. (Refer to the section of internal control I.1 in the Schedule of Audit Findings and Questioned Costs)

Regarding the internal control No.2 shown above, FMI has indicated that under the FMR II project, FMI management implemented measures to ensure that all leased cars have log sheets. Regarding the mobile phone use, FMI has cancelled most mobile phone subscriptions, except for those for the Project drivers' and the Chief of Party use and that the invoices for these phones are currently reviewed by the Project accountant and sent to FMI home office for a second review and authorization by the FMI Chief Financial Officer. (Refer to the section of internal control I.2 in the Schedule of Audit Findings and Questioned Costs)

Regarding the compliance issue No.1 shown above, FMI has indicated that it has relied on the USAID officials' oral approval and authorization for local procurement and that it will seek a retroactive written approval for a source & origin waiver as needed. (Refer to the section of compliance II.1 in the Schedule of Audit Findings and Questioned Costs)

Regarding the compliance issue No.2 shown above, FMI management considered this particular long-term lease to be a local service (and not a local commodity) procurement because all the obligations for the necessary insurance, license and registration fees, risks of loss/damage, title, etc. remained with the lessor of the vehicles, and that it does not need a waiver from the USAID because the contract is less than \$ 250,000. (Refer to the section of compliance II.2 in the Schedule of Audit Findings and Questioned Costs)

Yours faithfully,
Ernst & Young



Sa'ed Abdallah

Independent Auditors' Report

**U.S Agency for International Development
Office of Inspector General
Plot 1/A off El Laselky Street
New Maadi
Cairo, Egypt 11435**

We have audited the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005. The fund accountability statement is the responsibility of FMI's management. Our responsibility is to express an opinion on the fund accountability statement based on our audit.

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

We did not have an external quality control review by an unaffiliated audit organization as required by chapter 3 paragraph 3.52 of U.S. Government Auditing Standards, since no such program is offered by professional organizations in Palestine. We believe that the effects of this departure from U.S. Government Auditing Standards is not material because we participate in the Ernst & Young worldwide internal quality control review program which requires our offices to be subjected, every three years, to an extensive quality control review by partners and managers from other Ernst & Young offices.

As depicted in note 6, an amount of U.S. \$ 74,247 was paid as advances to expatriates during the period from October 1, 2002 to March 31, 2005. This amount was not within our scope of audit; since the final settlement of these advances was held at FMI headquarters office in the United States and therefore we were not able to apply any auditing procedures on these costs.

Local expenditures subject to our audit were supported with copies of the original documents. Original documents are held at FMI headquarter office in the United States, and therefore these were not available for inspection or part of our audit.

The results of our tests disclosed material questioned costs as detailed in the fund accountability statement, U.S. \$ 52,030 of other direct costs that are explicitly questioned because they are prohibited by the terms of the agreement.

In our opinion, except for the effects of the issues addressed in the preceding paragraphs, the fund accountability statement referred to above presents fairly, in all material respects, local program revenues, local costs incurred and reimbursed, and commodities for the period from October 1, 2002 to March 31, 2005 in accordance with the terms of the agreement and in conformity with the basis of accounting described in Note 2.

In accordance with U.S. Government Auditing Standards, we have also issued our reports dated August 25, 2005 on our consideration of FMI internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations. Those reports are an integral part of an audit performed in accordance with U.S. Government Auditing Standards and should be read in conjunction with this Independent Auditor's Report in considering the results of our audit.

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



August 25, 2005
Ramallah, Palestine

USAID Resources Managed by
 Financial Markets International Under Award
 No. PCE-I-04-99-00010-00 Commercial Transparency, Capital Markets Development
 Initiative Program (CMDI)"

FUND ACCOUNTABILITY STATEMENT

For the period from October 1, 2002 to March 31, 2005
 (Currency: U.S. \$)

	<u>Questioned Costs</u>			<u>Notes</u>	
	<u>Actual</u>	<u>Ineligible</u>	<u>Unsupported</u>	<u>Fund Statement</u>	<u>Schedule of Audit Findings and Questioned Costs</u>
<u>Revenue</u>	704,147			3	
<u>Costs Incurred</u>					
Workdays Ordered					
Third Country Nationals and Locals	292,510			5	
Advances Paid to Expatriates	74,247	-	-	6	
Other Direct Costs	331,355	52,030	-	7	III.1 ,III.2
Total Costs	<u>698,112</u>	<u>52,030</u>	<u>-</u>		
Fund Balance *	<u>6,035</u>				

* Upon FMI headquarter request to its local field office, the fund balance was transferred to Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program - Phase II.

NOTES TO THE FUND ACCOUNTABILITY STATEMENT

For the period from October 1, 2002 to March 31, 2005

(Currency: U.S. \$)

1. General

Financial Markets International (FMI) is a U.S. consulting firm specialized in financial markets development in emerging markets around the world. On July 5, 2000, the U.S. Agency for International Development (USAID) contracted FMI under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program - CMDI" to support development of an enabling legal and regulatory framework for West Bank and Gaza capital markets. This work involved technical assistance to the Palestine Securities Exchange and the Palestinian Legislative Council on the draft of Capital Market Authority Law and the Securities Law.

In response to worsening economic conditions in the West Bank and Gaza after September 2000, USAID broadened FMI's scope of work to include Non-Bank Financial Institutions (NBFI) activities, with particular focus on leasing and mortgage finance. USAID also approved the following activities to generate immediate impacts on economic development and employment generation:

- Financial restructuring program
- Private sector liaison
- Emergency loan program

2. Accounting Policies

- **Basis of Accounting**

FMI uses the cash basis of accounting in the preparation of the fund accountability statement. Under the cash basis of accounting, revenues are recorded when received, rather than when earned and expenses are recorded when disbursed, rather than when incurred.

The fund accountability statement has been presented in U.S. Dollars (U.S. \$).

- **Foreign Currency Transactions**

FMI deals mainly with U.S. Dollar (U.S. \$) and New Israeli Shekel (NIS). FMI reporting currency is the U.S. \$. Transactions in currencies other than U.S. \$ were translated to U.S. \$ using exchange rates in effect at the time of each transaction.

3. Revenues

This item represents total cash transferred from the FMI headquarter to FMI local field office during the audit period for funding the program operations.

4. Questioned Costs

Questioned Costs are presented in two separate categories, ineligible and unsupported, and consist of audit findings made on the basis of the terms of the contract and applicable laws and regulations, which prescribe the nature and treatment of unallowable costs.

Costs in the column labeled "Ineligible" of the "Questioned Costs" are supported by vouchers or other documentation but are not allowed because they are either unreasonable, not contract related, or are prohibited by the contracts or applicable laws and regulations.

Cost in the column labeled "Unsupported" are also included in the classification of "Questioned Costs" and are related to costs that are not supported by adequate documentation. All questioned costs are detailed in the Schedule of Questioned Costs.

5. Third Country Nationals and Locals

This amount represents FMI's labor costs locally incurred and charged to the program.

6. Advances Paid to Expatriates

An amount of U.S. \$ 74,247 represents advances paid to expatriates by the FMI local field office. However, the final settlement of these payments was held at FMI's headquarter in the United States.

7. Other Direct Costs

Other direct costs comprise the following items:

		<u>Questioned Costs</u>	
	<u>U.S. \$</u>	<u>Ineligible</u>	<u>Unsupported</u>
Office rent	85,165	-	
Leased vehicles	33,367	33,367	
Office furniture and supplies	15,391	-	
Commodities	1,202	-	
Administrative personnel	70,508	-	
Communications	29,516	-	
Program costs	79,525	18,664	
Others	16,681	-	
Total	<u>331,355</u>	<u>52,030</u>	<u>-</u>

SUPPLEMENTARY INFORMATION

Independent Auditors' Report on Internal Control

**U.S Agency for International Development
Office of Inspector General
Plot 1/A off El Laselky Street
New Maadi
Cairo, Egypt 11435**

We have audited the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005, and have issued our report on it dated August 25, 2005.

Except as discussed in the following paragraph, we conducted our audit in accordance with U.S. Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement.

We did not have an external quality control review by an unaffiliated audit organization as required by chapter 3 paragraph 3.52 of U.S. Government Auditing Standards, since no such program is offered by professional organizations in Palestine. We believe that the effect of this departure from U.S. Government Auditing Standards is not material because we participate in the Ernst & Young worldwide internal quality control review program which requires our offices to be subjected, every three years, to an extensive quality control review by partners and managers from other Ernst & Young offices.

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

In planning and performing our audit of the fund accountability statement of USAID resources managed by Financial Markets International under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005, we obtained an understanding of internal control of FMI. With respect to internal control, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the fund accountability statement and not to provide an opinion on internal control. Accordingly we do not express such an opinion.

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

We noted the following reportable conditions:

1. Procurement of goods and services (Schedule of Audit Findings and Questioned Costs, I. Internal Control 1)
2. Not applying effective controls to ensure proper use of program assets (Schedule of Audit Findings and Questioned Costs, I. Internal Control 2)

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

Our consideration of internal control would not necessarily disclose all matters in internal control 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 consider reportable conditions No. 1 and 2 involving the internal control and its operations to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005.

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

A handwritten signature in blue ink that reads 'Ernst + Young'.

August 25, 2005
Ramallah, Palestine

Independent Auditors' Report on Compliance

**U.S Agency for International Development
Office of Inspector General
Plot 1/A off El Laselky Street
New Maadi
Cairo, Egypt 11435**

We have audited the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005.

Except as described in the following paragraph, we conducted our audit in accordance with U.S. Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement resulting from violations of agreement terms and laws and regulations that have a direct and material effect on the determination of the fund accountability statement amounts.

We did not have an external quality control review by an unaffiliated audit organization as required by chapter 3 paragraph 3.52 of U.S. Government Auditing Standards, since no such program is offered by professional organizations in Palestine. We believe that the effects of this departure from U.S. Government Auditing Standards is not material because we participate in the Ernst & Young worldwide internal quality control review program which requires our offices to be subjected, every three years, to an extensive quality control review by partners and managers from other Ernst & Young offices.

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

Material instances of non-compliance are failures to follow requirements or violations of agreement terms and laws and regulations that cause us to conclude that the aggregation of misstatements resulting from those failures or violations is material to the fund accountability statement. The results of our compliance tests disclosed the following material instances of noncompliance, the effects of which are shown as questioned costs in FMI's fund accountability statement.

We noted the following material noncompliance instances:

1. Non compliance with geographic code 000 (Schedule of Audit Findings and Questioned Costs, II. Compliance 1)
2. Non compliance with source of origin regulations in terms of long-term lease of vehicles (Schedule of Audit Findings and Questioned Costs, II. Compliance 2)

We considered these material instances of non-compliance in forming our opinion on whether FMI's fund accountability statement is presented fairly, in all material respects, in accordance with the terms of the agreement and in conformity with the basis of accounting described in Note 2 to the fund accountability statement, and this report does not affect our report on the fund accountability statement dated August 25, 2005.

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



August 25, 2005
Ramallah, Palestine

SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS

For the period from October 1, 2002 to March 31, 2005

I. INTERNAL CONTROL

1. PROCUREMENT OF GOODS AND SERVICES

We noted the following weaknesses in FMI's procurement procedures:

- FMI did not use pre-numbered purchase orders when procuring goods and services.
- Price quotations and price analysis were not obtained and performed for some procurements, such as the research performed by MASSAR.
- FMI's procurement manual is not maintained in the local field office.

Recommendation

We recommend FMI to consider the preparation and maintenance of detailed written procurements manual for FMI local field office, to ensure that procurements made are properly approved and executed based on price quotations (at least for procurements above \$ 2,500) in accordance with the federal rules and USAID regulations.

In 2005, FMI has drafted a procurement manual and prepared a Project Management Guidelines that includes procurement procedures for FMI's purchases.

FMI Management Comments

As you noted, in January 2005, FMI submitted Project Management Guidelines that include procedures for FMI project office staff to follow when conducting procurements. Also in early 2005, FMI introduced a new requirement that all staff complete a purchase request form, to be reviewed and signed by the Chief of Party, prior to making any non-routine/ordinary supply procurements.

Additionally in October 2005, FMI HQ attorneys drafted a Procurement Manual and disseminated it to the West Bank & Gaza office personnel. The project staff received training on the same in mid-October 2005 from FMI Vice President and attorney Nancy J. Metzger.

For micro-purchases (below \$2500 USD threshold), FMI procures according to reasonable local market prices without extensive efforts to perform price analyses or comparative quotation gathering, in accordance with applicable USAID regulations on the same.

E & Y Response to Management Comments

FMI response indicates that they recognised the finding and they have implemented corrective actions subsequent to the audit period.

SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS

For the period from October 1, 2002 to March 31, 2005

1. INTERNAL CONTROL

2. NOT APPLYING EFFECTIVE CONTROLS TO ENSURE PROPER USE OF PROGRAM ASSETS

We noted the following weaknesses in FMI's controls over the program's assets:

- FMI did not effectively apply controls to limit the personal use of the Program's leased vehicles. FMI has maintained a car log sheet for one of the vehicles only. The other vehicle, which was used by the Chief of Party, had no car log sheet. This weakens the controls over the personal use of the program vehicles.
- FMI did not effectively and consistently apply controls to separate between business and personal calls for its employee's mobile charges. Not applying effective and consistent controls to separate between business and personal calls may result in overcharging the program with non related program expenses.

Recommendation

- We recommend FMI to set effective controls over the use of all of the program's vehicles so as to ensure that they are used only for authorized purposes.

We noted that FMI started using log sheets for its vehicles subsequent to the audit period.

- We recommend FMI to apply effective and consistent controls for separating business and personal employee's mobile charges to ensure that only related communication expenses are charged to the program.

FMI Management Comments

Under the FMR II project, FMI management implemented measures to ensure that all leased cars have log sheets. These log sheets are now consistently maintained by all vehicle users, verified and reviewed by the Senior Project Driver, and then sent to the FMI home office for review and archiving. All logs for such vehicle use are on file in the home office.

Regarding the mobile phone use, FMI reminds the auditors of the context of FMI CMDI project operations. The CMDI project operated during the second intifada outbreak. Security concerns were extremely important while operating in West Bank/Gaza under these conditions. FMI staff routinely encountered troops armed with guns and observed Israeli-Palestinian armed conflict at or near various ad-hoc and permanent checkpoints. When the security situation in the Palestinian

SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS

For the period from October 1, 2002 to March 31, 2005

I. INTERNAL CONTROL

Territories deteriorated during the period in question, FMI issued select staff with mobile phones as a safety measure. However, in doing so, FMI informed all staff that personal calls must be identified on the itemized invoice and reimbursed (including portion of VAT) to the project. Staff reimbursed the project \$2,568.68 representing personal calls during the period in question. Accordingly, FMI HQ reduced billable expenditures/reimbursed to USAID in the amount of \$2,568.68.

Given that there have been recent (limited) improvements to the security situation, FMI has since cancelled most mobile phone subscriptions, except for those for the Project drivers' and the COP's use. The invoices for these phones are currently reviewed by the Project accountant and sent to FMI home office for a second review and authorization by the FMI Chief Financial Officer.

E & Y Response to Management Comments

As mentioned in our recommendation regarding vehicles, FMI started using log sheets for its vehicles subsequent to the audit period.

There was no consistent documentation of the basis used to separate between business and personal calls. In addition management approval is not documented.

SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS

For the period from October 1, 2002 to March 31, 2005

II. COMPLIANCE

1. NON COMPLIANCE WITH GEOGRAPHIC CODE 000 (Schedule of Audit Findings and Questioned Costs III.1)

FMI's local office has purchased equipment with a total cost of U.S. \$18,664. These were not U.S. origin; on the other hand, no waiver has been obtained from USAID for these purchases in accordance with 22 CFR 228.50.

This is considered a noncompliance with the source of origin regulation, and the contract agreement governing this award.

Recommendation

We recommend FMI to purchase U.S. manufactured products or to obtain a waiver from the USAID for any commodities to be acquired from source of origin other than U.S. origin when its costs exceed U.S. \$ 5,000. Refer to 22 CFR chapter II, part 228.40 for procurement rules and 22 CFR chapter II, part 228.50 for waivers.

FMI Management Comments

FMI relied on the USAID officials' oral approval and authorization for local procurement questioned herein, and seeks a retroactive written approval for a source & origin waiver as needed to ratify the USAID officials' actions, pursuant to AIDAR 752.7025 (approvals), 22 CFR 228.51(Subpart F, waivers). Alternatively, if such retroactive waiver is not granted, then FMI asserts that FAR 701.402 (Policy for deviations from the FAR or AIDAR) is applicable, as asserted by the Head of the Contracting Activity -the USAID Mission Director-- at that time. The grounds for this request for approval, along with the background details of this procurement, are set forth below.

The FMI CMDI Project was scheduled to expire on July 3, 2003. On May 7, 2003, FMI reported to USAID a huge success story with its Financial Restructuring Program (FRP) and its pilot test case company, National Carton Industries (NCI). Our USAID CTO at that time, in consultation with other USAID Mission senior officials, urged FMI to replicate, expand and institutionalize this hugely successful training program as rapidly as possible, before any upcoming Project expiration.

The FMI trainers of FRP, Basim Makhool and Ghassan Daas, were professors based at An Najah University (the equipment recipient), who were already scheduled to teach summer courses as early as June 2003 and, thus able to rapidly institutionalize the FRP program, by incorporating it into their MBA curricula. However, the An Najah University computers were outdated, slow, and not able to run the FRP software efficiently for wider audience course instruction. USAID, therefore, authorized a small local procurement to equip the University with a mini-computer lab, as needed, to run the FRP software.

SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS

For the period from October 1, 2002 to March 31, 2005

II. COMPLIANCE

Given the tight deadlines before a possible Project close-out, FMI proceeded expeditiously and on May 15, 2003, FMI purchased the equipment pursuant to USAID authorization to do so. It was (and is) our understanding that local procurement is allowed for commodities purchases of US origin, if the value of the transaction is less than \$100,000. These purchases were of U.S. brand name computers, understood to be of US origin at that time.

On June 5, 2003, the then USAID Mission Director came to award formally the equipment to the recipient, An Najah University. At that time, the USAID Mission Director signed the act transferring title to the property to the University. On June 19, 2003, FMI billed USAID for the equipment.

E & Y Response to Management Comments

We agree that local procurement is allowed for commodities purchases of U.S. origin, if the value of the transaction is less than \$100,000 and we agree also that FMI had obtained USAID approval to transfer the purchased property to Al Najah University; However as defined in 22 CFR 228, source of origin is the country where a commodity is mined, grown or produced. Purchasing American brands commodities does not necessary mean that such commodities are U.S. origin. In cases where commodities of Geographic code 000 are not available, a waiver shall be requested from the USAID based on specific criteria (Refer to Sub part F of 22 CFR 228).

SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS

For the period from October 1, 2002 to March 31, 2005

II. COMPLIANCE

2. LONG-TERM LEASE (Schedule of Audit Findings and Questioned Costs III. 2)

FMI's local office had obtained under a long-term lease agreement (Long-term lease is defined as a single lease of more than 180 days) motor vehicles with a total cost of U.S. \$ 33,366. The leased motor vehicles were not U.S. manufactured to be eligible for USAID financing. In reference to 22 CFR 228.13, any vehicle to be financed by USAID under a long-term lease must be manufactured in the United States, on the other hand, no waiver has been obtained from USAID for these leased motor vehicles in accordance with 22 CFR 228.50.

This is considered a noncompliance with 22 CFR 228.13.

Recommendation

We recommend FMI's local office to obtain motor vehicles under lease agreements that are manufactured in the United States in order to be eligible for USAID financing or to obtain a waiver from the USAID.

FMI Management Comments

FMI management considered this particular long-term lease to be a local service (and not a local commodity) procurement because all the obligations for the necessary insurance, license and registration fees, risks of loss/damage, title, etc. remained with the lessor of the vehicles, and not with FMI. FMI assumed no responsibility for the car, other than filling it up with gasoline from time to time. Maintenance services were also covered by the lessor, not FMI. As the lease amount was less than \$250,000, FMI considered this a permissible local procurement of services, for purposes of complying with source & origin waiver requirements. To clarify, FMI is under no impression that all long-term leases for vehicles are service procurements. On the contrary, for long-term leases of vehicles in the US and elsewhere, it is standard to have the risks and maintenance obligations imposed upon the lessee, and not the lessor. This was not the case in this lease situation.

Notwithstanding the above, FMI did attempt to lease US Manufactured cars, and has done so under the current FMR II project. But again, we remind the auditors of the serious security concerns for staff safety, raised in the context of project operating circumstances during the time period in question. At that time, the FMI Project needed immediately an SUV for security purposes, due to the staff's extensive travel deep inside the West Bank, especially to the Nablus area for training at the Palestinian Securities Exchange. The West Bank area, and especially Nablus, was, and is, considered a danger zone of recurring Palestinian and Israeli armed conflict, and FMI staff frequently had to use dirt roads to by-pass points of such conflict along the main roads.

SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS

For the period from October 1, 2002 to March 31, 2005

II. COMPLIANCE

FMI checked for the availability of US manufactured jeep/SUV vehicles for lease, but were informed that there were no US manufactured vehicles available at that time. Consequently, to meet the security needs in a timely manner, FMI leased locally a Daewoo Jeep for project-related travel within the West Bank, and also leased a Ford Focus Sedan, which it understood was a US manufactured car, for travel within city limits of Ramallah.

FMI asserts that the above circumstances comply with ADS E312.5.3.b(2)(a) on Source/Origin of Motor Vehicles, permitting waiver of the US manufactured vehicle requirement due to special circumstances that can only be met in time by procurement of non-US manufactured vehicles.

As outlined on the previous page, if this particular and unusual lease situation is deemed a commodity procurement and not a service procurement, FMI will seek from USAID a retroactive source/origin waiver approval based on the above circumstances falling within ADS E312.5.3.b(2)(a).

E & Y Response to Management Comments

FMI leased vehicles are not a local service procurement, rather they fall under the category of long-term lease (Long-term lease is defined as a single lease of more than 180 days). Reference to 22 CFR 228.13 leased vehicles must be manufactured in the United States.

SCHEDULE OF AUDIT FINDINGS AND QUESTIONED COSTS

For the period from October 1, 2002 to March 31, 2005

III. QUESTIONED COSTS
 (Currency: U.S.\$)

	<u>QUESTIONED COSTS</u>	
	<u>INELIGIBLE</u>	<u>UNSUPPORTED</u>
1. NON-COMPLIANCE WITH GEOGRAPHIC CODE 00		
FMI's local office has purchased equipment with a total cost of U.S. \$18,664. These were not of U.S. origin; on the other hand, no waiver has been obtained from USAID for these purchases in accordance with 22 CFR 228.50. Accordingly, the total cost of these equipment items is considered ineligible and questioned.	18,664	
2. LONG TERM LEASE		
FMI has obtained under a long-term lease agreement (Long-term lease is defined as a single lease of more than 180 days) motor vehicles with a total cost of U.S. \$ 33,366. The leased motor vehicles were not U.S. manufactured to be eligible for USAID financing. In reference to 22 CFR 228.13, any vehicle to be financed by USAID under a long-term lease must be manufactured in the United States. Accordingly, the total cost of these leased vehicles is considered ineligible and questioned.	33,366	
Total Questioned Costs	<u><u>52,030</u></u>	<u><u>-</u></u>

APPENDIX I: FMI COMMENTS ON AUDIT FINDINGS



Financial Markets International, Inc.

7735 Old Georgetown Road Suite 310 Bethesda, Maryland 20814 Tel: (301) 215-7840 Fax: (301) 215-7838
fmi.hq@fmi-inc.net

Salameh Khalil
Ernst & Young
AABS/Ramallah

September 19, 2006

Re: Audit of the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under award No. PCE-I-04-99-00010-00 "Commercial Transparency, Capital Markets Development Initiative Program (CMDI)" for the period from October 1, 2002 to March 31, 2005.

Dear Mr. Khalil:

FMI respectfully disagrees with your report finding in your letter December 5, 2005, which asserts at page 3 that US \$52,030 of costs are ineligible out of \$623,865. Your rationale is that \$18,664 is ineligible because the computers at issue were not of US origin, and no source waiver has been obtained from USAID; that a vehicle leased for \$33,366 was not of US origin, and no source waiver has been obtained from USAID.

As FMI has explained at length, please note that no such computers are manufactured in the United States. FMI could not possibly buy United States manufactured computers that do not exist. It was in the interest of the United States Government for cost savings and efficiencies for the project to proceed, and the USAID Mission Director urged us to proceed with these computers for An Najah University. FMI has also sought a retroactive source origin waiver from USAID, and that request has been pending on this item since January 26, 2006. As it was in the interest of the United States Government, and as no such US manufactured computers exist, USAID would have granted the waiver at the time. We note that no computers are unaccounted for, no funds lost, and that FMI could not perform an impossible act.

Regarding the vehicle leased, please note that no such US origin vehicle was available in the region at the time, and FMI staff were seeing rockets, shooting, and accordingly often forced to travel on back roads. The safety and security of FMI/USAID employed expats and local was at serious risk, and we desperately needed the vehicle at issue. Had we sought US source origin waiver, USAID would have granted it for these obvious reasons. FMI sought the retroactive waiver on this item on January, 27, 2006.

We request that this letter comment be included as additional comment in your report, at pages 21-22 (computers) and pages 23-24 (vehicle) on the "Non-Compliance Geographic Code" under "FMI Management Comments."

We respectfully request that you revise your "Response to Management Comments" in each instance to note the fact that no such US computers exist, and that FMI has sought the retroactive waiver; no such vehicle was available in the region and that FMI has sought the retroactive waiver. Accordingly, please state that you have reconsidered these two ineligibility items, find there are no ineligible funds, and deem this to be a non-issue.

As a separate attachment, I am providing the signed representation letter that you have requested.

Sincerely,



Charles M. Seeger
Chairman and CEO

Cc: Roy Plucknett USAID/WBG
Rami Houry, FMI/WBG

AUDIT OF THE FUND ACCOUNTABILITY
STATEMENT OF USAID RESOURCES MANAGED BY
FINANCIAL MARKETS INTERNATIONAL (FMI)
UNDER TASK ORDER NO. PCE-I-806-99-00010-00
FINANCIAL MARKETS REFORM PROGRAM - PHASE
II FOR USAID/WEST BANK AND GAZA
FOR THE PERIOD FROM
SEPTEMBER 26, 2003 TO SEPTEMBER 25, 2004

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February 14, 2006

**U.S. Agency for International Development
Office of Inspector General
Plot 1/A off El Laselky Street
New Maadi
Cairo, Egypt 11435**

Dear Sirs,

This report represents the results of our financial audit of the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program - Phase II for USAID/West Bank and Gaza for the period from September 26, 2003 to September 25, 2004.

Background

Financial Markets International (FMI) is a U.S. consulting firm specialized in financial markets development in emerging markets around the world. On September 26, 2003, the U.S. Agency for International Development (USAID) contracted FMI under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program - Phase II for USAID/West Bank and Gaza to assist in promoting the mobilization of capital to private sector in the West Bank and Gaza. The credibility of mobilizing capital from domestic and international sources would be enhanced by the creation of an overall legal and regulatory framework, including the creation of regulatory institutions with appropriate financial market monitoring, surveillance, disclosure and enforcement mechanism. The total obligated amount is U.S. \$ 6,631,087 and the period of performance is from September 26, 2003 to September 25, 2006 in accordance with modification No. 3 to the award. The period under audit was from September 26, 2003 to September 25, 2004.

The program is comprised of six main components:

- Support the development of the legal and regulatory framework for financial markets.
- Provide for a focused, demand-driven technical assistance to the Capital Market Authority (CMA), or other appropriate authorities.
- Address the legal, regulatory and capacity impediments to debt restructuring as an alternative to insolvency.

- Develop and implement an educational and promotional campaign on financial market opportunities and instruments.
- Facilitate the flow of capital to financial institutions during the intifada to benefit the private sector.
- Support the development of the legal and regulatory framework to support land reform and mortgage finance.

Indirect Costs Rates:

Indirect costs related to the contract were maintained in FMI headquarter and were not attributable to local costs.

Audit Objectives and Scope

The objective of this engagement was to conduct an audit of the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program – Phase II for USAID/West Bank and Gaza for the period from September 26, 2003 to September 25, 2004. Revenues and costs incurred that were subject to our audit procedures amounted to U.S. \$ 611,841 and U.S. \$ 475,941, respectively. The cost amount excludes advances paid to expatriates in the amount of U.S. \$ 121,395 that were not subject to our audit, since the final settlements of these payments were held at FMI's headquarter in the United States (Refer to note 6 of the fund accountability statement).

Specific Objectives

- Express an opinion on the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program – Phase II for USAID/West Bank and Gaza for the period from September 26, 2003 to September 25, 2004.
- Determine that costs incurred under the contract are allowable, allocable, and reasonable in accordance with the terms of the contract agreement.
- Obtain an understanding of the internal control structure of FMI, assess control risk and identify reportable conditions including material weaknesses in relation to the USAID contract agreement.
- Perform tests to determine whether FMI has complied in all material respects with the terms of the contract agreement and with applicable laws and regulations.
- Determine if FMI has taken adequate corrective actions on prior audit findings and recommendations.

Preliminary audit planning and procedures began in June 2005. Audit field work was commenced during August 2005 and was completed on August 30, 2005 and consisted of:

- Review of the contract agreement between USAID and FMI.
- Discussions with the FMI local officials, including interviews with FMI's key personnel concerning the status of the contract agreement, accomplishments during the period, the statutory reporting requirements, the contract's budget, and procedures governing actual expenditures locally incurred by FMI.
- Review of FMI's organizational structure and its established policies and procedures, and controls related to personnel, procurement, financial accounting and reporting to USAID.

Our tests of local revenues and expenditures included, but were not limited to, the following:

- Agree balances per general ledger to the fund accountability statement.
- Agree the funds received to the confirmed balance from FMI headquarter.
- Obtaining management representation letter.
- Test, on a sample basis, costs incurred for allowability, allocability and reasonability.
- Determine whether costs incurred were consistent with the terms of the contract agreement and the applicable laws and regulations.
- Determine whether FMI complied with the provision of Executive Order 13224 Blocking property and prohibiting transactions with persons who commit, threaten to commit, or support terrorism.

Except as discussed in the following paragraph, we conducted our audit of the fund accountability statement in accordance with U.S. Government Auditing Standards issued by the Comptroller General of the United States. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement.

We did not have an external quality control review by an unaffiliated audit organization as required by chapter 3 paragraph 3.52 of U.S. Government Auditing Standards, since no such program is offered by professional organizations in Palestine. We believe that the effect of this departure from U.S. Government Auditing Standards is not material because we participate in Ernst & Young worldwide internal quality control review program which requires our offices to be subjected, every three years, to an extensive quality control review by partners and managers from other Ernst & Young offices.

As part of our examination, we made a study and an evaluation of relevant internal controls and reviewed FMI's compliance with applicable laws and regulations.

Audit Results

Fund Accountability Statement:

Our audit procedures identified U.S. \$ 7,515 of ineligible costs out of U.S. \$ 475,941 total cost incurred by the local field office (The amount excludes advances paid to expatriates reported in the fund accountability statement in the amount of U.S. \$ 121,395).

Details of questioned costs are shown in finding 1 of the Schedule of Audit Findings and Questioned Costs – III Questioned Costs.

Local expenditures subject to our audit were supported with copies of the original documents. Original documents are held at FMI headquarter office in the United States, and therefore these were not available for inspection as part of our audit.

Internal Control Structure:

Our audit procedures identified the following weaknesses in the internal control of FMI local field office as reportable conditions:

1. Procurement of goods and services. (Schedule of Audit Findings and Questioned Costs, I. Internal Control 1)
2. Not applying effective controls to ensure proper use of program assets. (Schedule of Audit Findings and Questioned Costs, I. Internal Control 2)

Compliance:

Our audit procedures identified the following instances of non-compliance with the terms of the agreement or applicable laws and regulations, which have been reported in the Independent Auditors' Report on Compliance.

1. Non-compliance with geographic code 000. (Schedule of Audit Findings and Questioned Costs, II. Compliance 1)

Follow up on Prior Audit Recommendations:

From our review of prior audit recommendations, we noted that the following recommendation was not implemented by FMI:

- A recommendation was made to FMI to prepare and maintain a written procurement manual, to ensure that procurements made are properly approved and in accordance with federal rules and USAID regulations. (Schedule of Audit Findings and Questioned Costs, I. Internal Control 1). However, we noted that subsequent to the audit period, FMI has prepared a Project Management Guidelines that include procurement procedures for FMI purchases.

From our review of prior audit recommendations we noted that the following recommendations were implemented by FMI:

- A recommendation was made to FMI to segregate the duties of recording and custody of cash in order to assign them to different employees to minimize the risks associated with this process. FMI has noted our recommendation and has started to segregate these duties.
- A recommendation was made to FMI local office to open a local bank account and to establish clearly signing limits for its authorised signatories. FMI has implemented our recommendation.
- A recommendation was made to FMI financial manager to evidence his review and approval of the monthly bank reconciliations by signing and dating the reconciliation working papers. FMI has implemented our recommendation.

Compliance with Executive Order 13224:

The result of our audit disclosed no instances of non-compliance with USAID Acquisition and Assistance Policy Directives AAPD 02-04 Implementation of E.O. 13224 - Executive Order on Terrorist Financing (March 20, 2002) and AAPD 04-07 Revised Certification Regarding Terrorist Financing Implementation E.O. 13224 (March 24, 2004) and AAPD 04-14 Certification Regarding Terrorist Financing Implementation E.O. 13224 (Revision 2) (September 24, 2004).

Other Matters:

We have made several requests to FMI officials for scheduling the exit conference to formalize the audits findings, but FMI officials confirmed in their email dated August 14, 2006 that they will contact us in the future to schedule for the exit conference at the time the matter of "Requesting a retroactive source of origin waiver" is resolved with USAID. Accordingly, we consulted with the Regional Inspector General Office in Cairo, and advised us to proceed with finalizing the report.

Summary of Recipient's Management Comments

Regarding the internal control issue No.1, FMI has indicated that it has completed the preparation of Procurement Manual on October 1, 2005, disseminated to the West Bank & Gaza office personnel, and the project staff received training on the same in mid-October 2005. (Refer to the section of internal control I.1 in the Schedule of Audit Findings and Questioned Costs)

Regarding the internal control issue No.2, FMI has indicated that it has cancelled most mobile phone subscriptions, except for those for the Project drivers and the Chief of Party and that the invoices for these phones are currently reviewed by the Project accountant and sent to FMI home office for a second review and authorization by the FMI Chief Financial Officer. (Refer to the section of internal control I.2 in the Schedule of Audit Findings and Questioned Costs)

Regarding the compliance issue No.1, FMI has indicated that the computers purchased were U.S. brand name computers (Hewlett Packards), that were understood by the FMI to be of U.S. origin at the time of purchase. (Refer to the section of compliance II.1 in the Schedule of Audit Findings and Questioned Costs)

Yours faithfully,
Ernst & Young

Saeed Abdallah

Sa'ed Abdallah
Executive Manager

Independent Auditors' Report

**U.S Agency for International Development
Office of Inspector General
Plot 1/A off El Lase lky Street
New Maadi
Cairo, Egypt 11435**

We have audited the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program - Phase II for USAID/West Bank and Gaza for the period from September 26, 2003 to September 25, 2004. The fund accountability statement is the responsibility of FMI's management. Our responsibility is to express an opinion on the fund accountability statement based on our audit.

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

We did not have an external quality control review by an unaffiliated audit organization as required by chapter 3 paragraph 3.52 of U.S. Government Auditing Standards, since no such program is offered by professional organizations in Palestine. We believe that the effect of this departure from U.S. Government Auditing Standards is not material because we participate in Ernst & Young worldwide internal quality control review program which requires our offices to be subjected, every three years, to an extensive quality control review by partners and managers from other Ernst & Young offices.

Local expenditures subject to our audit were supported with copies of the original documents. Original documents are held at FMI headquarter office in the United States, and therefore these were not available for inspection or part of our audit.

As depicted in note 6, an amount of U.S. \$ 121,395 was paid as advances to expatriates during the period from September 26, 2003 to September 25, 2004. This amount was not within our scope of audit; since the final settlement of these advances was held at FMI headquarter office in the United States and therefore we were not able to apply any auditing procedures on these costs.

The results of our tests disclosed material questioned costs as detailed in the fund accountability statement: U. S. \$ 7,515 of other direct costs that are explicitly questioned because they are prohibited by the terms of the contract agreement.

In our opinion, except for the effects of the issues addressed in the preceding paragraphs, the fund accountability statement referred to above presents fairly, in all material respects, local program revenues, local costs incurred and reimbursed, and commodities for the period from September 26, 2003 to September 25, 2004 in accordance with the terms of the contract agreement and in conformity with the basis of accounting described in Note 2.

In accordance with U.S. Government Auditing Standards, we have also issued our reports dated August 30, 2005 on our consideration of FMI internal control over financial reporting and our tests of its compliance with certain provisions of laws and regulations. These reports are an integral part of an audit performed in accordance with U.S. Government Auditing Standards and should be read in conjunction with this Independent Auditor's Report in considering the results of our audit.

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



August 30, 2005
Ramallah, Palestine

USAID Resources Managed by
 Financial Markets International (FMI) Under Task Order
 No. PCE-I-806-99-00010-00 Financial Markets Reform Program – Phase II for
 USAID/West Bank and Gaza

FUND ACCOUNTABILITY STATEMENT

For the period from September 26, 2003 to September 25, 2004
 (Currency: U.S. \$)

	<u>Questioned Costs</u>			<u>Notes</u>	
	<u>Actual</u>	<u>Ineligible</u>	<u>Unsupported</u>	<u>Fund Statement</u>	<u>Schedule of Audit Findings and Questioned Costs</u>
Revenue	<u>611,841</u>			3	
Costs Incurred					
For Workdays Ordered					
Third Country Nationals and Locals	166,383			5	
Advances Paid to Expatriates	121,395			6	
Other Direct Costs	<u>309,558</u>	<u>7,515</u>	<u>-</u>	7	III. 1
Total Costs	<u>597,336</u>	<u>7,515</u>	<u>-</u>		
Fund Balance	<u>14,505</u>			8	

NOTES TO THE FUND ACCOUNTABILITY STATEMENT

For the period from September 26, 2003 to September 25, 2004
(Currency: U.S. \$)

1. General

Financial Markets International (FMI) is a U.S. consulting firm specialized in financial markets development in emerging markets around the world. On September 26, 2003, the U.S. Agency for International Development (USAID) contracted FMI under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program - Phase II for USAID/West Bank and Gaza to assist in promoting the mobilization of capital to private sector in the West Bank and Gaza. The credibility of mobilizing capital from domestic and international sources would be enhanced by the creation of an overall legal and regulatory framework, including the creation of regulatory institutions with appropriate financial market monitoring, surveillance, disclosure and enforcement mechanism.

The program is comprised of six main components:

- Support the development of the legal and regulatory framework for financial markets.
- Provide for a focused, demand-driven technical assistance to the Capital Market Authority (CMA), or other appropriate authorities.
- Address the legal, regulatory and capacity impediments to debt restructuring as an alternative to insolvency.
- Develop and implement an educational and promotional campaign on financial market opportunities and instruments.
- Facilitate the flow of capital to financial institutions during the Intifada to benefit the private sector.
- Support the development of the legal and regulatory framework to support land reform and mortgage finance.

2. Accounting Policies

- **Basis of Accounting**

FMI uses the cash basis of accounting in the preparation of the fund accountability statement. Under the cash basis of accounting, revenues are recorded when received, rather when earned and expenses are recorded when disbursed, rather than when incurred.

The fund accountability statement has been presented in U.S. Dollars (U.S. \$).

- **Foreign Currency Transactions**

FMI deals mainly with U.S. Dollar (U.S. \$) and New Israeli Shekel (NIS). FMI reporting currency is the U.S. \$. Transactions in currencies other than U.S. \$ were translated to U.S. \$ using exchange rates in effect at the time of each transaction.

3. Revenues

This item represents total cash transferred from the FMI headquarter to FMI local field office during the audit period for funding the program operations.

4. Questioned Costs

Questioned Costs are presented in two separate categories, ineligible and unsupported, and consist of audit findings made on the basis of the terms of the contract and applicable laws and regulations, which prescribe the nature and treatment of unallowable costs.

Costs in the column labeled "Ineligible" of the "Questioned Costs" are supported by vouchers or other documentation but are not allowed because they are either unreasonable, non contract related, or are prohibited by the contracts or applicable laws and regulations.

Costs in the column labeled "Unsupported" are also included in the classification of "Questioned Costs" and are related to costs that are not supported by adequate documentation. All questioned costs are detailed in the Schedule of Questioned Costs.

5. Third Country Nationals and Locals

This amount represents FMI's labor costs locally incurred and charged to the program.

6. Advances Paid to Expatriates

An amount of U.S. \$ 121,395 represents advances paid to expatriates by the FMI local field office. However, the final settlement of these payments was held at FMI's headquarter in the United States.

7. Other Direct Costs

Other direct costs comprise of the following items:

		<u>Questioned Costs</u>	
	<u>U.S. \$</u>	<u>Ineligible</u>	<u>Unsupported</u>
Office rent	69,423	-	-
Vehicles	27,518	-	-
Office furniture and supplies	44,107	-	-
Commodities	38,002	7,515	-
Administrative personnel	72,120	-	-
Communications	15,823	-	-
Program costs	34,367	-	-
Others	8,198	-	-
Total	<u>309,558</u>	<u>7,515</u>	<u>-</u>

8. Fund Balance

	<u>U.S. \$</u>
Fund balance	14,505
Add: Outstanding checks	3,912
Outstanding bank transfer	23,085
Employees income tax *	1,962
Less: Expenses not charged to USAID	<u>(6,813)</u>
Cash at Bank	<u>36,651</u>

* This amount represents the income tax withheld from employees' salaries, not yet paid to the Income Tax Department.

SUPPLEMENTARY INFORMATION

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Independent Auditors' Report on Internal Control

**U.S Agency for International Development
Office of Inspector General
Plot 1/A off El Laselky Street
New Maadi
Cairo, Egypt 11435**

We have audited the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program – Phase II for USAID/West Bank and Gaza for the period from September 26, 2003 to September 25, 2004, and have issued our report on it dated August 30, 2005.

Except as discussed in the following paragraph, we conducted our audit in accordance with U.S. Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement.

We did not have an external quality control review by an unaffiliated audit organization as required by chapter 3 paragraph 3.52 of U.S. Government Auditing Standards, since no such program is offered by professional organizations in Palestine. We believe that the effect of this departure from U.S. Government Auditing Standards is not material because we participate in the Ernst & Young worldwide internal quality control review program which requires our offices to be subjected, every three years, to an extensive quality control review by partners and managers from other Ernst & Young offices.

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

In planning and performing our audit of the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program - Phase II for USAID/West Bank and Gaza for the period from September 26, 2003 to September 25, 2004, we obtained an understanding of internal control. With respect to internal control, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the fund accountability statement and not to provide an opinion on internal control. Accordingly we do not express such an opinion.

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

We noted the following reportable conditions:

1. Procurement of goods and services (Schedule of Audit Findings and Questioned Costs, I. Internal Control 1)
2. Not applying effective controls to ensure proper use of program assets (Schedule of Audit Findings and Questioned Costs, I. Internal Control 2)

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

Our consideration of internal control would not necessarily disclose all matters in internal control 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 consider reportable conditions No.1 involving the internal control and its operations to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program - Phase II for USAID/West Bank and Gaza for the period from September 26, 2003 to September 25, 2004.

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

A handwritten signature in blue ink that reads 'Ernst + Young' in a cursive, script font.

August 30, 2005
Ramallah, Palestine

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Independent Auditors' Report on Compliance

**U.S Agency for International Development
Office of Inspector General
Plot 1/A off El Laselky Street
New Maadi
Cairo, Egypt 11435**

We have audited the fund accountability statement of USAID resources managed by Financial Markets International (FMI) under Task Order No. PCE-I-806-99-00010-00 Financial Markets Reform Program - Phase II for USAID/West Bank and Gaza for the period from September 26, 2003 to September 25, 2004, and have issued our report on it dated August 30, 2005.

Except as described in the following paragraph, we conducted our audit in accordance with U.S. Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement resulting from violations of agreement terms and laws and regulations that have a direct and material effect on the determination of the fund accountability statement amounts.

We did not have an external quality control review by an unaffiliated audit organization as required by chapter 3 paragraph 3.52 of U.S. Government Auditing Standards, since no such program is offered by professional organizations in Palestine. We believe that the effect of this departure from U.S. Government Auditing Standards is not material because we participate in the Ernst & Young worldwide internal quality control review program which requires our offices to be subjected, every three years, to an extensive quality control review by partners and managers from other Ernst & Young offices.

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

Material instances of non-compliance are failures to follow requirements or violations of contract agreement terms and laws and regulations that cause us to conclude that the aggregation of misstatements resulting from those failures or violations is material to the fund accountability statement. The results of our compliance tests disclosed the following material instances of non-compliance, the effects of which are shown as questioned costs in FMI's fund accountability statement.

We noted the following material non-compliance instance:

1. Non compliance with geographic (Schedule of Audit Findings and code 000 Questioned Costs, II. Compliance 1)

We considered this material instance of non-compliance in forming our opinion on whether FMI's fund accountability statement is presented fairly, in all material respects, in accordance with the terms of the contract agreement and in conformity with the basis of accounting described in Note 2 to the fund accountability statement, and this report does not affect our report on the fund accountability statement dated August 30, 2005.

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



August 30, 2005
Ramallah, Palestine