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AID'S CONTROL OVER THE FINANCING OF A

BAKERY PROJECT IN EGYPT WAS INADEQUATE

AUDIT REPORT NO. 0-263-84-06

October 18, 1983

U.S. Treasury and AID regulations require the Agency to follow prudent cash management practices. AID Regulation 1 contains specific requirements applicable to financing commodity transactions.

This report discusses what can happen when Agency officials fail to (1) follow sound procedures, (2) take aggressive action to correct obvious deficiencies in financing documents, and/or (3) use all available means to protect the Government's interest.

AID'S CONTROL OVER THE FINANCING OF A BAKERY PROJECT IN EGYPT WAS INADEQUATE

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EXECUTIVE SUMMARY

Background

In February 1978 AID approved the Government of Egypt's (GOE) request for the procurement of 39 bakery lines under an AID funded loan. On November 20, 1979, the General Authority for Supply Commodities (GASC), a GOE agency, awarded a fixed price contract amounting to about $18.1 million, to the American Export Group, Inc. (AEG) located in Washington, D.C. At the request of the GOE, the Agency agreed to make payments to AEG to finance the U.S. dollar costs of the contract. A Letter of Commitment (L/COM), which provided for advance and progress payments, was issued to AEG to cover those costs. Both the contract and L/COM were subsequently amended. (See page 1)

Lessons To Be Learned

The Agency has at its disposal well established policies and procedures to guide its officials in carrying out their duties and responsibilities. This report discusses what can happen when Agency officials fail to (1) follow sound procedures, (2) take aggressive action to correct obvious deficiencies in financing documents, and/or (3) use all available means to protect the Government's interest. (See page 2)

Purpose and Scope

The purpose of this audit was to evaluate the basis upon which AEG claimed--and AID paid--advance and progress payments for supplying the bakery equipment and to identify any other problem areas requiring AID management attention. We reviewed applicable records and discussed the project with pertinent Agency and AEG officials. Our review covered the period April 1980 through May 1983. (See page 2)

The Method Used To Finance This Contract Could Not Be Justified

AID could not justify providing AEG with advance and progress payments. The U.S. Treasury Department has advised AID that lump-sum advances, in lieu of incremental payments, can only be provided if such action results in increased competition in the bidding process and the Government obtains the advantage of reduced contract costs. Neither of these two factors applied to the contract reviewed. The Invitation for Bid contained no mention of advance and progress payments. Rather, it provided for payments on the basis of equipment deliveries. (See page 4)

AEG's Use Of Advanced Funds Was Not Restricted

Treasury regulations require Agencies to assure, except where contrary to law, that interest earned on Federal funds by recipient organizations is promptly turned over to the Treasury. AID's Handbook incorporates these regulations and contains similar requirements. AID's Handbook also provides that advances must not be commingled with other funds and must be accounted for in a manner which will allow their uses to be easily traced. Contrary to these clearly stated Treasury/AID requirements, neither the contract nor the L/COM restricted AEG's use of the funds advanced by AID. In this case the gratutious infusion of Federal Government funds allowed AEG, a profit making organization, the opportunity to invest the funds or to use them for other non-contract purposes. (See page 6)

Advance and Progress Payments Were Made For Commodities Before Their Eligibility Was Approved

Two basic commodities and a commodity-related service are being procured under the bakery contract--eight European and 31 Balady bakery lines, and a building design service. Section 201.11 of AID Regulation 1 requires such items to be approved in writing in order for them to be eligible for AID financing. Despite this requirement, the Agency paid millions of dollars for bakery equipment before establishing its eligibility--and when individual items were being changed. In addition, AID paid $187,700 for the design of a model bakery building to house such equipment--before the actual equipment items to be included therein were determined. The failure to follow commodity eligibility procedures unnecessarily placed the Agency, as well as the GOE, in this case, at considerable risk. (See page 8)

Progress Payments Were Made In Accordance With An L/COM Which Did Not Provide For Adequate Support

It is axiomatic that adequate support for progress payments is necessary to assure that such payments are justified. Treasury and AID cash management regulations require no less. The contract and the financing instrument, in this case a direct L/COM, should specify the type of supporting documentation required--however, it did not. The work progress certificate contained in the L/COM was ambiguous and lacked support requirements. As a result, AID did not follow established procedures on this contract and made five progress payments--totaling about $8.9 million--to AEG on unknown and improper bases without adequate support. This section of the report contains a classic example of what can happen when important financing documents are not clearly written and the damage that can be done to valid concepts of effectiveness, efficiency, and economy when an Agency goes forward with poorly written documents rather than taking timely aggressive action to correct their deficiencies. (See page 10)

Funds Were Advanced To AEG Well In Excess Of Its Needs and Entitlement

Progress payments to AEG should have been based on the sales value of equipment provided. Our analysis of AEG's payments to its equipment suppliers showed that AEG had received funds from AID well in excess of its needs and entitlement. The excess funds ranged from a low of $401,908 to a high of $4,249,757, or an average of about $1,611,949 per month during the entire period April 1980 through May 1983. We estimate that it cost the Government about $679,925 in unnecessary interest charges to provide AEG these excess funds. (See page 21)

Certifications AEG Made For Its Progress Payments Were Questionable

AEG submitted a Supplier's Certificate and Agreement and a work progress certificate with each of its progress payment requests. In doing so, AEG certified that it was entitled to receive the payments claimed. We disagree. AEG's certifications could in no way be valid on the basis of payments to its suppliers at sales value--which is a very liberal basis. AEG's certifications for its first, second, and fifth progress payments were not valid even giving consideration to its unaudited recorded non-equipment costs which we used for comparison purposes.

We view what happened on this contract to be a deliberate effort on the part of AEG to obtain Government funds, for its own use, in advance of its entitlement to such funds. We estimate that it cost the Government about $679,925 to provide these excess funds to AEG. However, since the L/COM provided for an unrestricted advance which was protected by a guarantee until March 4, 1981--AEG may only be liable for interest of about $537,000 that accrued from that point forward. (See page 23)

Conclusions and Recommendations

AID's financial control over the contract to supply commodities for the bakery project in Egypt was inadequate. AID failed to follow Treasury's and its own cash management regulations and procedures, write an adequate L/COM, take timely corrective actions, and follow its own regulations applicable to financing commodities. As a result, the Government incurred unnecessary interest charges of about $679,925 during the period April 1980 through May 1983. In addition, the Agency and GOE were unnecessarily subjected to considerable financial risk in the event the contractor defaulted on the contract.

Although AID's use of an inadequate and ambiguous payment document and the failure of its officials to take adequate corrective action was the major cause of the financial problems on this contract, in our opinion, AEG also contributed to them. AEG obtained its initial advance long before it was needed to carry out the contract and immediately invested the bulk of it in interest earning certificates. AEG made its own liberal interpretation with regard to how it was supposed to be reimbursed, and on what basis, and ignored verbal requests to provide supporting documentation. AEG also certified that it was eligible to receive progress payments before it had expended the funds it already had available and/or before it was otherwise eligible to receive such funds on any supportable basis. (See pages 27 through 29)

Although the problems identified in this report relate specifically to the financial arrangements on the Egyptian bakery contract, we believe that the problems may be indicative of systemic problems. Accordingly, our recommendations are directed towards correcting both. These recommendations provide for:

- The issuance of guidance that reemphasizes the Treasury and AID's cash management regulations and procedures; a review of the language used in L/COMs, work progress certificates and other financing documents to assure that it is specific, clear and adequately protects the Government's interest; and a review of existing L/COM's and amendments where appropriate. (See pages 28 and 29)

- Strict enforcement of Agency regulations related to commodity eligibility and support requirements--prior to making payments to contractors--and for holding officials accountable for their failure to follow them. (See page 29)

- Making a determination, and taking appropriate action, as to whether a bill of collection can be issued against AEG for interests costs amounting to about $537,000 on the excess funds it received in advance of its entitlement. (See page 29)

Management Comments

Copies of the draft of this report were provided to and comments were requested from the Bureau for Management (AA/M), the Office of Financial Management (M/FM), the Directorate for Program and Management Services (M/SER), and the Office of General Counsel (GC). Information copies were also provided to the Bureau for Near East (NE). NE expressed a desire to respond to the report and was granted a two week extension in time in which to do so--however, no comments were received. M/SER also provided copies of the draft to AEG. Any pertinent comments received have been incorporated into the body of the report.

BACKGROUND

In February 1978 AID approved the Government of Egypt's (GOE) request for the procurement of 39 bakery lines under an AID funded loan. On November 20, 1979, the General Authority for Supply Commodities (GASC), a GOE agency, awarded a fixed price contract--GASC/90-78/A.R.E.--to the American Export Group, Inc. (AEG) located in Washington, D.C. The contract, which totaled about $18.1 million, for the most part, covered the purchase and supervision of the installation of bakery equipment and accessories constituting 31 Balady and eight European bakery lines. The bakery lines are to be installed at thirteen different sites in Egypt. The contract also provided for AEG to prepare designs for buildings to house the bakeries. Of the total contract amount, $187,700 was allocated for that function.

At the request of the GOE, the Agency agreed to make payments to AEG, under the AID funded loan, to finance the U.S. dollar costs of the contract. On February 27, 1980, AID issued Letter of Commitment (L/COM) number 263-K05217 to AEG in the amount of $18,126,202 to cover those costs. Under the terms of this L/COM, AID was to provide AEG an advance amounting to 10 percent of the contract amount, and 7 progress payments covering the equipment of 10 percent each. The remaining 20 percent was to be paid upon shipment of the equipment to Egypt. The initial advance provided to AEG on April 3, 1980--$1,812,620--included $18,770 which was for the building designs. The remaining balance due AEG for these designs (about $168,930) was paid in October 1980. The contract was amended on July 13, 1982, and the price was increased to $20,217,157. This increase reflected an estimated amount--not to exceed $2,090,955--to cover costs for ocean freight, insurance, container rental, training and installation supervision. Originally the costs related to shipping were to be paid directly by the GOE. AID subsequently agreed to include them in a new L/COM--number 263-K05508--which was written on September 17, 1982. The original L/COM was also amended on that date to reflect the changes in equipment and other contract terms contained in the contract amendment. It also provided for replenishment payments to the contractor in lieu of progress payments.

The amended contract requires AEG to have shipped or have available to ship all the bakery equipment to Egypt by September 1983--twelve months after receiving the amended L/COM. In addition, AEG and GASC are required to complete contract performance--including shipment of the equipment by AEG, and the installation, and testing/acceptance of the equipment for all 39 lines at the 13 sites by GASC--by September 1984, or 24 months after receipt of the amended L/COM. As of September 27, 1983, AEG had received $17,066,486 out of the $17,363,507 provided in the contract for the bakery equipment. As of that date, an additional $297,021 remained to be paid to AEG for equipment under the contract. A status of all contract payments as of that date is contained in Appendix I.

Lessons To Be Learned

The Agency has at its disposal well established policies and procedures to guide its officials in carrying out their duties and responsibilities. The President's Council on Integrity and Efficiency has placed increased emphasis on internal controls to prevent fraud, waste, and abuse in Government operations and activities. Office of Management and Budget Circular A-123, issued in October 1981, and the recently enacted Federal Managers Financial Integrity Act are all intended to put Government financial practices on a sound, business-like basis.

This report discusses what can happen when Agency officials fail to (1) follow sound procedures, (2) take aggressive action to correct obvious deficiencies in financing documents, and/or (3) use all available means to protect the Government's interest.

Purpose and Scope

In March 1982 we were requested by the Agency's Office of Commodity Management (M/SER/COM) to perform an audit of the advance and progress payments received by the contractor. That office was concerned that the contractor may have received excessive payments under the L/COM. During that audit it became evident that the bakery project was experiencing significant implementation difficulties. A decision was made in mid-1982 to suspend the audit of the financial aspects of the equipment procurement, and to direct our limited resources towards a review of the operational aspects of the bakery project. An audit report (No. 0-263-83-51) entitled "AID-Financed "Egyptian Bakeries" Will They Ever Make Bread?" was issued on March 28, 1983.

Our suspended audit of the financial aspects of the procurement of the bakery equipment was resumed in February 1983. The purpose of this review was to evaluate the basis upon which the contractor claimed--and AID paid--advance and progress payments for supplying the bakery equipment; and to identify any problem areas that required AID management attention.

In meeting these audit objectives, AEG and AID/W records related to financing the bakery equipment were reviewed. We also discussed the financial aspects of this project with pertinent Agency and AEG officials. Our review covered the period April 1980 through May 1983.

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

U.S. Treasury and AID regulations require the Agency to follow prudent cash management practices. AID Regulation 1 contains specific requirements applicable to financing commodity transactions. Our review of the financing of this large bakery project in Egypt disclosed weaknesses in AID's management of cash and procurement of commodities. These weaknesses, for the most part, were caused by AID's failure to follow the Treasury's and its own cash management regulations and procedures. Other problems were caused by an inadequately written Letter of Commitment (L/COM) used to finance the contract, and AID's failure to follow Regulation 1 requirements for financing commodities. We found that AID:

--could not justify the method of financing used;

--did not restrict AEG's use of advanced funds;

--made advance and progress payments for commodities before their eligibility was approved;

--paid five (5) progress payments in accordance with an L/COM which did not provide for adequate support; and

--advanced AEG funds which were well in excess of its needs and entitlement.

As a result, the Government incurred unnecessary interest charges[1/]--of about $679,925--by providing AEG with excess funds during the period April 3, 1980, through May 31, 1983. In addition, AID's failure to follow the requirements of Regulation 1, regarding commodity eligibility, unnecessarily subjected the Agency and the GOE to considerable financial risk in the event that the equipment being provided was determined to be ineligible for AID financing, or AEG defaulted on the contract. The interest costs and financial risk could have been avoided if AID had (1) provided incremental cash advances to AEG--based on disbursements to its suppliers--rather than advance and progress payments, and (2) followed its own regulations. Some of these costs could have also been avoided under the financing method used, if the L/COM had been adequately written, or if Agency officials had taken corrective action--once they became aware of the L/COM's deficiencies.

1/ These interest charges relate to the cost to the U.S. Treasury for borrowing funds to finance Government programs.

AID Regulation 1 requires contractors to submit a Supplier's Certificate and Agreement (AID Form 282) which includes a Personal Certification signed by an authorized official. The person signing and submitting the AID Form 282 acknowledges that he is signing and submitting this certificate for the purpose of receiving payment from AID funds and that AID, in making funds available for such payment, will rely upon the truth and accuracy of the Personal Certification as well as all other representations included therein. We question the validity of the certifications AEG made for the five progress payments it received. Accordingly, AEG may be liable for about $537,000 of the unnecessary interest charges incurred.

TREASURY REGULATIONS REGARDING CASH ADVANCES

The Treasury Fiscal Requirements Manual (TFRM), Section 8050, states that it is the responsibility of Federal agencies to monitor the cash management practices of recipient organizations to ensure that Federal cash is not maintained by them in excess of immediate disbursing needs.1/ The TFRM provides that agencies will establish such systems and procedures as may be necessary to assure that (1) balances are maintained commensurate with immediate disbursing needs, (2) excess balances are promptly returned to the Treasury, and (3) except where contrary to law, interest earned on Federal funds by recipient organizations is promptly turned over to the Treasury.

The TFRM also provides that procedures established by agencies will specify that all contractual arrangements with recipient organizations will provide that advance payments will be made only at times and in amounts necessary to meet immediate disbursing needs. In this regard, the TFRM provides that in monitoring the practices of recipient organizations, agencies will base evaluations on cash payments and not on accrued liabilities.

Finally, the TFRM provides that advance funding arrangements with recipient organizations unwilling or unable to comply with Treasury regulations are to be terminated.

THE METHOD OF FINANCING USED COULD NOT BE JUSTIFIED

The Treasury Department requires that the use of lump-sum advances, in lieu of incremental payments, be justified. AID could not justify using this method of financing for the

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1/ Immediate disbursing needs has been defined by Treasury to mean 30 days from the date the advance is received until it is expended.

contract to supply the bakery equipment in Egypt. The contractor supplying this equipment was provided a lump-sum advance which was to be periodically replenished by progress payments. The Treasury Department has advised AID that lump-sum advances may be provided, in lieu of incremental payments, as long as (1) there is true competition in the bidding process, and (2) the Government--or AID--obtains the advantage of reduced contract costs as a consequence of providing the advance.

Neither of the two reasons given by Treasury as justification for providing lump-sum advances--increased competition and reduced costs--apply to the contract reviewed. The Invitation for Bid for that contract contained no mention of advance and progress payments. Rather, it provided for payments on the basis of equipment deliveries.

AID provided advance and progress payments for this contract because this financing method is routinely used. AID's cash management procedures which implement the Treasury regulations, were cabled to the Agency's principal posts in State 273219 dated October 19, 1979. (As of September 1983 these procedures have not been formally incorporated into AID's Handbook.) This cable stated that AID's policy (regarding advances) had been less restrictive with respect to borrower/grantee contracts (such as the bakery contract) than it had been under AID direct contracts.

The cable stated AID's policy has been that advance or progress payments may be agreed upon under borrower/grantee contracts when such payments are necessary for delivery or performance. It stated that the necessity for such advances most often arise under large contracts for custom-made, specially fabricated equipment, where the supplier or contractor is required to make large cash outlays--perhaps exceeding available cash--for equipment in advance of delivery. The cable stated that AID provides such advances to U.S. contractors based on commercial practice which provides similar financing arrangements.

The cable pointed out that the Treasury Department had agreed that although incremental payments were desirable for purposes of cash management, lump-sum advances could be provided if there was true competition in the bidding process and the Government obtained the advantage of reduced contract costs as a consequence of providing the advance.

In view of Treasury and AID regulations the Agency should not have provided advance and progress payments for the contract reviewed. The advantages to be achieved by making such payments--increased competition and reduced contract costs--were lacking in this instance. AID's action was clearly contrary to the intent and requirements of the Treasury Department's and the Agency's own regulations which were promulgated to provide sound cash management procedures and practices. Incremental advances based on AEG's actual cash requirements would have been a more sound cash management procedure to follow as the basis for financing this contract.

The following sections of this report discusses how Agency officials failed to follow other sound cash and commodity management procedures and adequately protect the interest of all concerned. There are no valid reasons why this interest could not have been better protected despite the fact that this was not a direct AID contract.

Management Comments

In responding to our draft report the Office of General Counsel (GC) agreed that AID could have reduced its financial risk had payments been made on the basis of incremental advances--based on the contractor's actual cash requirements--rather than on the advance and progress payments procedure adopted in the contract. We were advised that GC has previously expressed its concern that advances to host country contractors be limited to the absolute minimum. This was done in a January 4, 1983, memorandum to the Office of Financial Management (M/FM). GC also commented that payment could have been made to AEG on the basis of actual shipment of the equipment without any advance or progress payments.

M/SER and M/FM suggested that the report should not be definite in concluding that an agreement with advance and progress payments was not appropriate in this case--if the financing had been more properly structured. (We disagree. As is discussed on pages 4 and 5 of the report, Treasury requires Agencies to justify the use of this form of financing--and the use of such payments could not be justified in this case.)

AEG'S USE OF ADVANCED FUNDS WAS NOT RESTRICTED

As was discussed on page 4, the TFRM requires Agencies to assure, except where contrary to law, that interest earned on Federal funds by recipient organizations is promptly turned over to the Treasury. AID Handbook 19, Appendix 1B, incorporates the Treasury regulations and contains similar requirements. Under AID's normal operating procedures the use of advances by recipients is restricted, and any interest earned thereon must be returned to the Government. In addition, advances must not be commingled with other funds and must be accounted for in a manner which will allow their uses to be easily traced.

Contrary to these clearly stated Treasury/AID requirements, neither the contract nor the L/COM restricted AEG's use of the funds advanced by AID. AEG requested and was provided an advance by AID in the amount of $1,812,620 on April 3, 1980. That amount included a 10 percent advance of $1,793,850 for equipment and accessories, and $18,770 for a building design. On April 4, 1980, AEG invested $1.8 million in a repurchase agreement[1/] from its bank. A repurchase agreement for that amount was in effect for the period April 4, 1980, through May 5, 1980.

AEG officials acknowledged that the bulk of the advance received from AID was invested for a period of time. They stated that they were unaware of any regulations or provisions which precluded them from taking such action and that it was prudent business practice to invest idle cash. We have already noted that neither the AID approved contract nor L/COM apprised AEG to the contrary.

We could not determine the full extent to which AEG invested the funds advanced by AID. Since AEG was not required to establish a separate account for the advance received, or account for it in a manner which would allow easy verification of its uses, such an analysis was not possible. However, we do know that AEG had, at a minimum, $1.2 million of its AID advance available during each of the seven months prior to receiving its first progress payment (see Appendix III). AEG followed the practice of commingling cash for the parent organization and its subsidiaries. Thus the verification of sources and application of funds would have been virtually impossible. AEG officials advised us that they believed the funds advanced by the Government were fully protected by its performance bond and a guarantee that was in effect during the period March 24, 1980, to March 4, 1981, covering the advance.

Despite such guarantees it is improper for AID to provide any contractor the unrestricted use of large amounts of Government funds. In this case the gratuitous infusion of Federal Government funds allowed AEG, a profit making organization, the opportunity to invest the funds or to use them for other non-contract purposes. The application of sound cash management procedures, in accordance with Treasury and AID regulations, would preclude AEG or any other contractor from having that opportunity. Unfortunately in this case, because the use of these funds was not restricted, our legal counsel has advised us that the Government may have little recourse against AEG for using them.

Management Comments

Agency officials did not comment on their failure to restrict AEG's use of Government funds.

1/ Such agreements are short-term investments at a specified interest rate--they can be renewed for periods of one to ninety days at the going interest rate. AEG's agreements generally covered a one week period.

ADVANCE AND PROGRESS PAYMENTS WERE MADE FOR COMMODITIES BEFORE THEIR ELIGIBILITY WAS APPROVED

Two basic commodities and a commodity-related service are being procured under the Egyptian bakeries contract--eight European and 31 Balady bakery lines, and a building design service. Section 201.11 of AID Regulation 1 requires such items to be approved in writing in order for them to be eligible for AID financing. This is done to assure that all items being financed meet with contract requirements. The formal approval is achieved by the execution of an Application for Approval of Commodity Eligibility (AID Form 11). The requirement for approving commodity eligibility as set forth in AID Regulation 1 was incorporated in the contract and referred to in the L/COM. Despite this requirement--as a condition of receiving AID financing--the Agency paid the advance and four of five progress payments for bakery equipment without AID Form 11 coverage. In addition, AID paid the advance and final payment for the building design service before the form for this element was approved.

The second progress payment was the only one made which had an approved AID Form 11; however, the form only covered the bakery equipment for the European lines and its validity was questionable. This form was approved in January 1981 but was cancelled by AID in October 1981--prior to paying the third progress payment. AID cancelled it because the equipment covered by it did not conform to that listed in the contract. A revised AID Form 11 for the European lines and the initial form for the Balady lines were not approved until September 1982. This approval took place after the contract and L/COM had been amended to reflect the actual equipment that would be provided. Consequently, prior to September 1982, all the bakery equipment payments--except that part of the second progress payment related to the European lines--were made without an approved form.

AEG contended that the Agency cannot cancel an AID Form 11 once it is approved. It further contended that the equipment covered by the form in question was already titled to GASC and that no changes were made. The M/SER/COM/CPS[1] official responsible for these forms disagreed with AEG. He told us that the Agency can and did cancel the AID Form 11 for the European line equipment because of the reasons already discussed. He agreed that no substantial changes were made in the equipment covered by the original and revised forms. However, he said the equipment covered by these forms had to agree with that listed in the contract. He said this could not be done until after the contract was amended.

1/ Commodity Procurement Support Division

The advance for the building design service was made in April 1980 and the final payment in October 1980. The AID Form 11 covering this element was not approved until January 1981. As was the case with the bakery equipment, these payments were made without an approved form.

AID made the advance and progress payments for equipment--without approved AID Forms 11--even though there were substantial changes in the equipment being provided. Between the time the contract was awarded in November 1979 and when it was amended in July 1982, several changes in the equipment occurred. These resulted from two tests of Balady equipment held in March and December 1981, and from agreements between AEG and GASC. Many of these changes were from United States to foreign source. The final listing of equipment to be provided by AEG was not approved by AID until the contract was amended in July 1982.

The advance payment was made without approved AID Forms 11 because the Chief of the Banking and Finance Division, M/FM, who approved the advance on April 3, 1980, did not believe the forms were required at that time. This official told us that this was the reason why the AID Form 11 requirement was not specifically delineated in the original L/COM. He said the forms were not required because M/FM and M/SER/COM had informally agreed that the latter would preaudit all contractors' supporting documents prior to approving any payments. We were advised that a waiver of the AID Form 11 requirement was not obtained. The official told us that the informal procedure was dropped in April 1982, and that all direct L/COM's now require approved forms before payments can be made.

The first progress payment was approved by the Chief of M/SER/COM/SE 1/ because he believed that an AID Form 11 submitted by AEG in early November 1980 had been approved. This official acknowledged that he should have withheld payment approval until he was assured of that fact. The third through fifth progress payments were apparently made without approved forms because of efforts which were underway to amend the contract and the L/COM.

What all this means is that AID advanced millions of dollars to AEG for equipment that had not been approved--and when individual items were being changed. In addition, thousands of dollars were paid for a design of a model bakery building to house such equipment--before the actual equipment items to be included therein were determined. Such action by Agency officials shows a total disregard for a procedure which was designed to protect the Government's interest and limit the vulnerability of all concerned parties. Although the L/COM did not specifically require the submission of approved AID Forms 11 with payment requests, it refers to section 201.52 of AID Regulation 1 which requires them. Agency officials had no basis

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1/ Surveillance and Evaluation Division

upon which to informally waive the AID Form 11 requirements for this or any other commodity transaction. The failure to follow commodity eligibility procedures unnecessarily placed the Agency, as well as the GOE, in this case, at considerable risk.

Management Comments

GC advised us that they did not believe the reference in the L/COM to Section 201.52 of AID Regulation 1 was tantamount to a requirement that AID Forms 11 be furnished. They said that section lists documents which are normally required for payment (including the forms) but also allows, as an alternative, "such other documents as may be required in the ... letter of commitment." However, they agree that it is proper for the Agency to require in the L/COM that AID Forms 11 be submitted as a condition for payment, and that the amended L/COM provides for them.

M/SER and M/FM commented that under Article 17 of the contract (between GASC and AEG), AEG was not required to submit approved AID Forms 11 until it requested final payment upon shipment of the equipment. They concluded that this may be appropriate in any procurement where there are advances and progress payments and possible equipment changes during performance. (We disagree. Article 15 of the subject contract clearly states that all provisions of AID Regulation 1 shall apply. As discussed on page 8, Section 201.11 of AID Regulation 1 requires that all commodities be approved in writing in order for them to be eligible for AID financing. Accordingly, it was not prudent for the Agency to finance any items that were not approved--especially the equipment which was being changed.)

PROGRESS PAYMENTS WERE MADE IN ACCORDANCE WITH AN L/COM WHICH DID NOT PROVIDE FOR ADEQUATE SUPPORT

It is axiomatic that adequate support for progress payments is necessary to assure that such payments are justified. Treasury and AID cash management regulations require no less. The contract and the financing instrument, in this case a direct L/COM, should specify the type of supporting documentation required--however, it did not. The work progress certificate contained in the L/COM was ambiguous and lacked support requirements. As a result, AID did not follow established procedures on this contract and made five progress payments--totaling about $8.9 million--to AEG on unknown and improper bases and without adequate support.

AID established procedures

AID has well established procedures, based on AID Regulation 1, for reimbursing contractors who supply commodities under fixed price contracts which are based on the sales value of the items being provided. Under these financing arrangements AID provides contractors supplying custom-made equipment advance and progress payments. These payments are provided to assist these contractors in meeting their cash flow requirements brought about by their need to make payments to their suppliers. However, the provision of such advances is not intended to eliminate the contractors' responsibility for financing part of the costs of doing such business. Contractors are reimbursed based on the sales value of the equipment they provide. Accordingly, they recoup their non-equipment costs, over the life of the contract, as they provide such equipment.

AID requires that initial advances be secured by a guarantee. When the contractor has expended the advance for authorized purposes--and provides proof of that action to the Agency--the advance is replenished by a progress or some other form of payment. In the case of a non-manufacturer, paid invoices from the contractor's vendors are the support items required as proof that the advance has been expended for authorized purposes. For manufacturers, a cost report supported by paid invoices is used. In either case AID officials have to assure themselves that the total amount of funds paid is protected by a guarantee and/or tangible goods that the Agency can lay claim to if necessary. These requirements are supposed to be specified in the L/COM; however, in this case they were not.

As further assurance that progress payments are justified, AID Regulation 1 requires contractors to execute an AID Form 282. In addition to various certifications, AID Form 282 requires suppliers to promptly furnish AID information requested concerning the purchase price, the cost of any commodity or related services, and/or other facts, data, or business records relating to the supplier's compliance with the provisions in the certificate and agreement. Additional information furnished is required to be in the format specified by AID. The Agency's procedures are sound and if followed provide assurance that the interest of all parties concerned is protected.

What follows is a classic example of what can happen when important financing documents are not clearly written and the damage that can be done to valid concepts of effectiveness, efficiency, and economy when an Agency goes forward with poorly written documents rather than taking timely aggressive action to correct their deficiencies.

The L/COM did not require the submission of necessary support documents with payment requests and contained an ambiguously worded work progress certificate

AID Handbook 15, Chapter 9, and Handbook 19, Appendix 1B, provide that progress payments be made on the basis of actual (1) costs incurred, (2) percentage of completion accomplished, and/or (3) stage of completion reached. These items are all covered by the sales value of equipment under a fixed price contract--such as the bakery contract. The method used and support required to measure progress should be related to the goods or services provided under the contract and should be stated in clear, specific terms not only to avoid misinterpretation but also to assure that such payments are justified.

The method of measuring progress for payment purposes on this contract did not meet the tests for clarity and specificity. The language of the work progress certificate in the original L/COM was ambiguous and did not clearly state how progress was to be measured. In addition, the L/COM did not specify the documentation required to support progress payments. This resulted in confusion and controversy on the part of both AID and AEG officials regarding when, and on what basis, progress payments would be made. This situation existed through the first five progress payments and until the L/COM was amended in September 1982.

Documentation required by the original L/COM

The original L/COM required AEG to submit the following documentation to support progress payments:

--three copies of Voucher SF 1034, prepared by the addressee or by a bank as assignee or agent for the addressee of the commitment;

--one copy of a supplier's invoice indicating that the amount being drawn represented a progress payment of 10% of the amount allocated for the machinery and accessories;

--a Work Progress Certificate: A signed certification by the supplier endorsed on or attached to its invoice as follows:

"The undersigned certifies that (a) the sales value of the equipment covered by this invoice; plus the value of equipment already delivered; plus the sales value of engineering services, labor, and purchased material for which expenditures have been made; plus the amount expended on account of commitments for equipment remaining to be supplied under the subject contract are not less than the total payment already received or claimed against this contract, including payments claimed under this invoice; and (b) it is complying with the terms and conditions of the subject contract;" and

--a signed original and one copy of an AID Form 282.

The most important omission from this L/COM was the requirement that the contractor submit paid invoices--from its suppliers--along with its payment requests as proof that it had expended the advanced funds provided for authorized purposes.

Different interpretations of the work progress certificate

The wording of the work progress certificate created confusion and controversy over the basis upon which progress would be measured. We discussed this wording with the Chief of the Banking and Finance Division, M/FM, who signed this L/COM and many others used to finance commodity procurements. This official could not tell us what the Agency intended each of the work progress certificate elements to mean. He referred us to M/SER/COM officials for their interpretation of the Agency's intention. He concluded that although this work progress certificate had been used for a long time, that its wording was ambiguous.

A discussion of the different interpretations applied to the various segments of the work progress certificate by the Chief of M/SER/COM/SE, who was responsible for approving payments, and other responsible Agency officials, and AEG, follows.

--"sales value of the equipment covered by this invoice; plus the value of equipment already delivered."

Responsible AID officials interpreted this segment to mean that AEG could claim the full contract sales value for an item of equipment if it could demonstrate that the item had been paid for and it had obtained title to it. Paid invoices were required as proof that the advance had been expended and title to the equipment had passed to AEG. This would also serve as evidence to AID that the expended advanced funds had been converted into tangible goods that the Agency could lay claim to in case of default, bankruptcy, or for any other reasons of non-performance by AEG.

AEG interpreted this segment differently. AEG's interpretation was that it could claim the full contract sales value of an item of equipment when title had been obtained--whether the equipment was paid for or not. AEG did not consider the payment arrangements between it and its suppliers as being a concern of AID since the Agency, in AEG's opinion, was protected by having recourse to the titled equipment.

--"sales value of engineering services, labor, and purchased materials for which expenditures have been made."

Responsible AID officials interpreted this segment to mean that a manufacturer could claim the full contract sales value for an item of equipment if it could identify the different costs--

engineering services, labor, materials, etc.--incurred in manufacturing or assembling it. They said manufacturers can usually provide this information through their cost accounting systems. They told us that this basis is used instead of the sales value basis when equipment is manufactured or assembled rather than purchased as complete units. They advised us that this segment--the interpretation of which caused much controversy--could provide AEG with a basis for requesting reimbursement for items of equipment the contractor planned to assemble.

Responsible AID officials told us that in providing the bakery equipment, AEG was, for the most part, procuring end items of custom equipment from other suppliers. They said the only exception to this was the final proofers for the Balady lines which AEG decided to assemble itself. Therefore, they said with that exception, this segment of the work progress certificate did not apply to this contract. They also told us that since AEG was never able to relate its non-equipment costs to specific items of equipment--even the proofers--it therefore could not use this section to support progress payment claims. They said that since the bakery equipment was being provided under a fixed price contract, the sales value is supposed to cover AEG's cost to procure it and all of AEG's other costs. They told us that if AEG was allowed to claim its other costs--in addition to the sales value of the equipment--double counting would result and overpayments would occur.

AEG interpreted this segment to mean that it could claim all non-equipment costs as support for progress payments and recognized that double counting would occur by claiming them. However, it believed that the work progress certificate allowed this--subject to the 80 percent limitation on payments prior to shipment of the equipment. AEG pointed out that it would incur substantial costs not related to procuring equipment, such as test costs of about $1 million, that would not be recovered in a timely manner by only claiming the sales value of equipment for which title had passed. AEG also contended that it was heavily involved in the actual design of the equipment being procured--as opposed to buying shelf items that were readily available. (We disagree with AEG's interpretation, see pages 23 to 26.)

--"the amount expended on account of commitments for equipment remaining to be supplied under the subject contract."

Responsible AID officials interpreted this segment to mean that AEG could claim amounts advanced to suppliers for equipment not yet titled. These advances could be paid by check, bank transfer, letter of credit, or other means as long as the funds were actually expended. On future progress payment requests, AEG was supposed to subtract such advances from the sales value claimed for the related equipment.

AEG interpreted this segment to mean that it could claim not only amounts expended for advances but also payment obligations incurred through irrevocable letters of credit. AEG believed that since these letters of credit tied up its available cash and/or line of credit, they were thus eligible to be included in progress payment claims. The value of letters of credit would be reduced--on future progress payment claims--as they were drawn upon by AEG's suppliers. Cash advances would be offset against invoiced value when AEG paid the suppliers for the equipment. Thus, according to AEG's interpretation, the net cash advances and net letters of credit outstanding--at the time a progress payment was requested--would be eligible to be included in claims. (We disagree with AEG's interpretation, see pages 23 to 26.)

These differing interpretations of the L/COM provisions, as discussed above, were the direct result of a poorly written document. What is hard to understand is why or how this was allowed to happen--in view of the number of years of experience that AID has had in financing transactions. Sound financial guidance and procedures are available to assist Agency officials in carrying out their duties and responsibilities. An experienced Agency like AID should have the ability to formulate clearly stated financial documents.

Why progress payments were made without adequate support

Between November 1980 and August 1982, M/SER/COM made five progress payments to AEG on the basis of the documentation called for in the L/COM--which included the ambiguously worded work progress certificate. As discussed on pages 10 through 13, the L/COM did not require AEG to submit paid invoices from its suppliers along with its payment requests--as proof that it had expended the advance funds it had received from AID for authorized purposes. The support provided by AEG did not meet the Agency's requirements as discussed on pages 10 and 11. Verbal attempts by the Agency to obtain proper support for the first two progress payments, which were made in November 1980 and March 1981, were unsuccessful. AEG refused to voluntarily provide the Agency with any documentation that was not specified in the L/COM. Controversy over the support issue came to a head when the Chief, M/SER/COM/SE, refused to approve AEG's third progress payment request, that was submitted in February 1982, until AEG provided adequate support for the two payments it had received in November 1980 and March 1981. AEG's outside legal counsel became involved in this controversy and the Director, M/SER/COM then requested a legal opinion from his General Counsel (GC) advisor. This legal advisor provided an opinion which stated, in effect, that payments to AEG should be made on the basis of the support requirements contained in the L/COM, including the AID Form 282--which he stated established a contractual basis for future refund actions against AEG, if appropriate.

The GC legal advisor's opinion was interpreted by the Director, M/SER/COM to mean that AID could not require AEG to provide any support--not specified in the L/COM--as a precondition to receiving progress payments. Accordingly, AEG's third, fourth, and fifth progress payments were approved and paid on the basis of this GC legal opinion. Following is a description of the controversy that surrounded the support issues. The failure of Agency officials to take timely and adequate corrective action to protect the Government's interest, and to document their instructions and requests for supporting data from AEG, is also discussed.

Responsible Agency officials1/ acknowledged that the wording of the work progress certificate was ambiguous and subject to differing interpretation. However, they told us that numerous meetings and telephone conversations were held with AEG between November 1980 and April 1982 (when the first and third progress payments were made), regarding support issues. They contend that AID's established procedures were clearly explained to AEG including the need for the Agency to assure that the funds paid out were protected by a guarantee and/or tangible goods that the Agency could lay claim to if necessary. These officials told us that AEG was clearly made aware that the documents it submitted with its progress payments provided no proof that AEG had expended the funds it had received for authorized purposes.

These officials further contend that AEG was well aware that the need for AEG to supply paid invoices from its suppliers as proof of its expenditures was the main point at issue. The Director, M/SER/COM agreed with this latter statement. He told us that he did not become aware of the controversy regarding the support issue until he was advised by the Chief, M/SER/COM/SE that he was refusing to pay AEG's request for the third progress payment because of the lack of support for the two payments that had already been made. However, he told us he attended meetings in March 1982 with AEG where the support issue was clearly discussed. He said the controversy over the support issue was what led him to get the legal opinion from his GC advisor. Unfortunately, many of the meetings and telephone conversations between the Agency and AEG, regarding the support issue, were not covered by Memos to File. While some correspondence existed between AID and AEG during the period all this activity took place--the support issues were not clearly defined. What follows is a more detailed description of how AEG's progress payments were made by the Agency.

1/ These officials include the Chief, M/SER/COM/SE, the Acting Chief, M/SER/COM/NEA2/ (including the prior Chief who is now retired), the former Chief, M/SER/COM/CPS (now the Acting Chief, M/SER/COM/NEA) and a staff member from each of M/SER/COM/SE and M/SER/COM/CPS.

2/ Near East and Asia Division.

The Chief, M/SER/COM/SE approves payment requests under all L/COMs handled by AID/Washington. He and one of his staff members contend that when AEG's first progress payment was approved (which in their opinion was not properly supported) in November 1980, they verbally provided AEG with their interpretation of the work progress certificate and instructed it to support future progress payment claims on that basis. They contend that they also told AEG how the advance was supposed to be used, and how it could be rolled over by progress payments supported by paid invoices from AEG's suppliers. They contend that AEG initially objected to providing the support requested on the basis that it was not required by the L/COM. They contend, however, that when they pointed out that the AID Form 282 required contractors to submit data to AID upon request, AEG agreed to provide support for future claims as instructed. They further contend that despite repeated verbal attempts to get AEG to do so, it never supported progress payment claims in accordance with their instructions. These officials acknowledged that their instructions to AEG and their requests for additional support documents in accordance with the provisions contained in the AID Form 282 were not put in writing. However, as was already discussed, the fact that AEG was clearly advised as to AID's support requirements and that it was requested to submit paid invoices from its suppliers was corroborated by several other responsible Agency officials.

AEG denied receiving instructions regarding how the advance was supposed to be used or that the Agency had requested it to provide additional support. However, an ex-AEG employee (the former bakery project manager) agreed that numerous discussions had been held between AEG and AID regarding the support issue and that AID officials had made their position regarding support requirements very clear. However, he told us that he could not recall any specific instances in which AID requested that additional support be presented before AID would approve and pay AEG's progress payment requests. He said he also was unaware of any instances where AID sent back AEG's progress payment requests because of the lack of support. (We were advised that AID had not done this.) He told us that he believed the support issues were being resolved by the AID auditors who were at the AEG office conducting an audit. (It is not a function of the auditors to approve payments.)

AEG also stated that any Agency advice regarding the use of the advance should have been given at the time the advance was originally received--not several months later. It further stated that such advice and any requests for support documents should have been committed to writing. (We agree it would have been better if AEG had been advised regarding the use of the advance when it was initially received. However, the initial advance was paid by M/FM without any involvement of M/SER/COM/SE. The latter office became involved when AEG submitted its progress payment claims so the advice by

M/SER/COM/SE was timely when given. We have already pointed out that Agency officials were remiss by not committing their instructions and requests to writing.)

The Chief of M/SER/COM/SE told us that in early February 1981, AEG presented an invoice and supporting documentation requesting payment of the final 20 percent for some European line equipment which AEG said was ready to ship to Egypt. He said that he explained to AEG that the final 20 percent payment for equipment could not be paid unless GASC authorized its shipment, which had not been done. He said that he further explained that if the equipment was ready to ship and the proper notification of this had been made to GASC, AEG could be paid for the cost of storing the equipment until GASC authorized shipment. He said that he told AEG that he would process payments as specified in the L/COM (10 percent advance, seven progress payments of 10 percent each, and final 20 percent when the equipment was shipped), but would not process fragmented payments on any other basis. Since the equipment could not be shipped at that time, he suggested that, if the progress warranted it, AEG submit a request for a progress payment instead.

The Chief, M/SER/COM/SE said that AEG resubmitted a progress payment request in late February 1981. He said the support accompanying the request for progress payment was the same as that provided for the previous request based on the equipment being ready to ship to Egypt. Thus, the support provided served a dual purpose. He said that he approved the second progress payment after a quick and cursory review of the supporting documentation indicated that it covered equipment valued at least $1.8 million. He contended that AEG was again told that before he would approve its third progress payment claim, the documentation provided with the second would have to carefully reviewed. He alleged that AEG was also advised that the third progress payment claim would have to be supported in accordance with his prior instructions. He told us that he expected the support for AEG's third progress payment to also cover that which had been lacking for the first two payments.

The Chief of M/SER/COM/SE said that a detailed review of the documentation provided with the second progress payment claim showed no evidence that AEG had made any payments to its equipment suppliers. He said the documentation received consisted of warehouse receipts and other documents provided when equipment is ready to ship. Since all the documentation provided was AEG generated, and included nothing from any suppliers, he requested that an auditor be assigned to him to determine if the equipment was in fact in AEG's warehouse awaiting shipment as claimed. This was subsequently found to be true. However, he still questioned the validity of the second progress payment because it had not been supported by paid invoices as previously instructed.

The Chief of M/SER/COM/SE told us that he refused to approve AEG's request for a third progress payment in February 1982, because AEG had not supported its first two payments by paid invoices from its suppliers. He told us that AEG's outside legal counsel then became involved in the issue. He said that during this period the GC advisor to M/SER/COM advised the Director that the payment should be approved because the L/COM only required a work progress certificate--not detailed support. He told us that he disagreed with the counsel's position and still refused to approve the payment. He said the Director of M/SER/COM then approved the payment in April 1982 over his objections.

The Chief of M/SER/COM/SE stated that AEG submitted a fourth progress payment request in July 1982. This request was supported by schedules that accumulated various cost elements comprising what AEG believed to be its progress through the first four progress payments. Among other things, AEG claimed the sales value of equipment as well as its non-equipment costs--which resulted in double counting. He said AEG's claim was discussed within M/SER/COM and the consensus was that it should not be allowed. He said, however, that the GC advisor to M/SER/COM again advised that there was no basis for withholding payment. In addition, the Director and Deputy Director of M/SER/COM had discussed the question of whether or not the payment should be approved with the auditor performing the audit of the contract. The auditor advised them that he had no basis for recommending that the payment not be made. Despite the GC advisor's advice and the "clearance" by the auditor, the Chief of M/SER/COM/SE told us that he still objected to approving the payment on the basis that it was not adequately supported. He nevertheless approved the payment but, according to him, did so under duress from his supervisor--the Director of M/SER/COM.

About two weeks later, in July 1982, AEG submitted a fifth progress payment request that was supported in the same manner as the fourth. The Chief of M/SER/COM/SE told us that he also refused to approve this payment on the basis that it was not adequately supported. He said that the Deputy Director of M/SER/COM then approved this payment.

We see no reason why this contract should have been treated any differently than other AID contracts for payment purposes--particularly in the support required. We also cannot understand why Agency officials allowed the controversy over the support issue to continue for over two years. When it was recognized that the L/COM did not provide for adequate support--immediate steps should have been taken to correct the situation. The Agency had more than sufficient time to act.

There was a seven month period between the original advance and the first progress payment; a four month period between the first and second progress payments; and over a year between the second and third progress payments. These first three payments were not only made without adequate support--the Agency did not know what AEG was using as the basis for claiming payments. This was not known until AEG submitted its fourth progress payment request in July 1982. The Agency had at least two options available to it to solve this problem--amend the L/COM to clarify its ambiguous provisions or formally require AEG to provide additional support beyond that required in the L/COM through the provisions contained in the AID Form 282. If AEG refused such a formal request it could have been held in default and payments could have been legitimately withheld. The Director of M/SER/COM was remiss in not assuring that corrective action was taken. The Chief of M/SER/COM/SE was also remiss in not documenting the verbal instructions he contended were given to AEG regarding how the advance was supposed to be used and what support was to be required for payments, and his verbal requests for additional information under the provisions of AID Form 282.

Management Comments

GC agreed that the "Works Progress Certificate" required in the L/COM for progress payments was ambiguous and that they would participate in a review and revision of that language. They commented that our statement in the draft report that progress payments were made without adequate support was not a legal characterization. They said that as far as they were aware, progress payments were made in accordance with the terms of the L/COM between AID and the contractor. They stated that such a commitment is a binding agreement enforceable in court by the contractor and is not altered, as a legal matter, by the oral instructions of an Agency official.

(The point we are making in the report is that the L/COM was deficient because it did not provide for adequate support. Accordingly, the payments were made without adequate support--regardless of whether or not the terms of the L/COM were followed. The fact that the Agency is legally bound by the terms of a L/COM--that in this case was known to be deficient--points out the need for these documents to be carefully written in the first place, or amended in a timely manner once found deficient, or for other corrective action to be taken to assure the Government's interest is protected. We further believe that Agency officials had the right, under the provisions contained in the AID Form 282, to require AEG to provide support for payments <u>that had already been made</u>. We have pointed out that requests for such data should have been made in writing.)

M/SER and M/FM commented that they were aware of deficiencies in the payment provisions contained in the contract, (between GASC and AEG) that had been approved by the AID Mission in Cairo without their prior review. (However, they failed to provide adequate reasons for M/FM writing a deficient L/COM when it had knowledge that the contract was deficient.) M/SER/COM justified its actions regarding making progress payments without adequate support on the basis that it took a "three-pronged defense" to protect the Government's interest in trying to implement the documents it inherited. These were (1) seeking legal guidance from AID's General Counsel, (2) requesting an IG audit, and (3) seeking an amendment to the contract. (The first two of these actions were not initiated until almost two years after the initial advance was made to AEG. While actions were underway to amend the contract and L/COM for an extended period--this was not accomplished until over two years after the original documents were executed and not until over $10 million had been paid in advance and progress payments. Corrective action should have been taken before the first monies were advanced to AEG. We cannot understand why this was not done since the Agency was aware that the contract was deficient before the L/COM was written. The request for an audit did not negate Agency officials' responsibility for taking timely corrective action and carrying out their duties in a manner which would assure that the Government's interest was protected.)

FUNDS WERE ADVANCED TO AEG WELL IN EXCESS OF ITS NEEDS AND ENTITLEMENT

AID Regulation 1 contains provisions for providing contractors advance and progress payments for supplying custom-made commodities--such as the bakery equipment which was being provided in the contract reviewed. This regulation authorizes such payments when (1) the total purchase price exceeds $200,000, (2) the initial advance does not exceed 10 percent, (3) each progress payment is at least 10 percent, and (4) all payments made prior to shipment do not exceed 80 percent. By providing for advance and progress payments in the L/COM, AID intended that AEG could--at various points in time--have an amount up to the original advance on hand. However, AEG considered the advance to be liquidated shortly after receiving its second progress payment in March 1981. At that time AEG cancelled the instrument guaranteeing the amount of the advance. Accordingly, from that point forward AEG would not be eligible for an advance and would have to justify its entitlement to AID funds on the basis of the sales value of equipment provided.

We analyzed the amounts of advanced funds AEG had available during the contract. We compared the funds provided during the period covered by our review against what AEG needed (and should have been able to draw subsequent to the initial advance) under this fixed price contract on the basis of payments to its suppliers. Our analysis showed that AEG had been advanced Government funds that were well in excess of its needs and entitlement during each of the 38 months between April 1980 and

May 1983. In making our analysis, we applied a factor[1/] which allowed AEG credit for the sales value of all cash payments made to its equipment suppliers--regardless of whether or not titled had passed. This method is essentially the same as that used by AID on other contracts according to responsible AID officials including the Chief, M/SER/COM/SE who is responsible for approving payments--except for the specific point at which title passed. Our basis was more liberal than that usually followed by AID because we applied the factor to all payments to suppliers.

Our analysis showed that the amount of the excess funds provided to AEG ranged from a low of $401,908 to a high of $4,249,757, or an average of about $1,611,949 per month during the entire period covered by our review. It is obvious from these figures that the initial advance provided by AID was too large and that the Agency provided funds to AEG at a much faster rate than AEG made payments to its suppliers or was otherwise entitled to the use of such funds. We estimate that it cost the Government as much as about $679,925 in unnecessary interest charges[2/] to provide AEG these excess funds. Appendix II contains a list of the excess funds by each month and shows how these unnecessary interest charges were computed.

The Government could have avoided unnecessary interest charges if AID had provided incremental cash advances to AEG--based on its immediate disbursements to suppliers--rather than advance and progress payments. Some of these costs could have also been avoided, under the financing method used, if the L/COM had been adequately written to provide adequate support or it had been amended as soon as it was found to be deficient.

Management Comments

As discussed on page 6, GC agreed that AID could have reduced its financial risk had payments been made on the basis of incremental advances based on the contractor's actual cash requirements rather than on the advance and progress payments

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1/ This factor was derived by dividing AEG's equipment costs into the contract sales value. At AEG's request the factor used for the period April 1980 through June 1982, was based on the equipment provided at that point in the contract. Thus, a higher factor was used for that period than for the subsequent period.

2/ See footnote 1/ page 3.

procedures adopted in the contract. GC further stated that payment could have been made to AEG on the basis of actual shipment of the equipment without any advance or progress payments.

CERTIFICATIONS AEG MADE FOR ITS PROGRESS PAYMENTS WERE QUESTIONABLE

The AID Regulation 1 requirement regarding contractors' certificates was already discussed on page 4. AEG submitted an AID Form 282 along with the work progress certificate shown on page 12 with each of its progress payment requests. In doing so, AEG certified that it was entitled to receive the payments claimed. We disagree.

This was a fixed price contract and payments should have been made to AEG based on the sales value of equipment provided. AEG's cash advances to its suppliers could also be claimed. AEG set a billing system into action early in this contract which resulted in it obtaining Government funds in excess of its entitlement on any supportable basis. AEG accomplished this by submitting requests for progress payments before it had fully expended the advanced funds it had already received. By following this practice AEG was able to consistently obtain Government funds which were excess to the needs of the project. We measured the excess funds in two ways. As was discussed on pages 21 and 22 we determined AEG's actual payments to contractors; we then applied a factor which gave AEG credit for the sales value of those payments; and then we compared AEG's entitlement on that basis against the funds it had received from AID. The results of that test are shown on page 22. We then compared the funds received from AID to the total of AEG's cash payments to its suppliers, plus its recorded non-equipment costs, prior to when it requested progress payments (see Appendix III). This latter method was only used for comparison purposes. AEG's recorded non-equipment costs were unaudited and therefore their validity is not known. Furthermore, these costs are covered by the sales value AEG receives for the equipment items being provided.

AEG received an initial advance of $1,812,620 on April 3, 1980. This amount consisted of $1,793,850 for equipment and $18,770 for a building design. On November 17, 1980, AEG requested its first progress payment for equipment in the amount of $1,793,850. This progress payment was paid by AID on November 20, 1980. AEG was not entitled to this progress payment when it was requested because AEG had not fully expended the funds it already had available. At the end of October 1980, AEG's payments to its suppliers at sales value (which is about 21-30 percent above actual cash outlays) were only $486,366, or about $1.3 million less than the advance funds it had already received from AID. AEG's actual payments to its suppliers plus its recorded non-equipment costs as of

October 31, 1980, only totaled $711,601. The latter amount is the maximum cash expenditure AEG could have had--related to the contract--at that point in time. The amount of AID funds AEG still had available exceeded a million dollars using either of the two figures cited above as the basis for measurement.

AEG requested a second progress payment of $1,793,850 on February 23, 1981, which was paid by AID on March 2, 1981. At the end of February 1981, AEG's payments to its suppliers at sales value were only $3,041,441, or $2,340,110 less than the AID funds it had available. AEG's payments to its suppliers plus its recorded non-equipment costs at that time were $3,446,229, or $328,761 less than the amount of AID funds it still had available. As a matter of fact, the combined total of AEG's recorded non-equipment costs and its cash payments to suppliers did not exceed the amount of funds provided by AID until October 1981, or about 19 months after the initial advance had been received.

AEG requested a third progress payment of $1,793,850 on February 5, 1982. As of the end of January 1982, AEG's payments to its suppliers at sales value were $4,946,684, or about $434,867 less than the AID funds it already had on hand. At that point in time AEG's cash payments to its suppliers, plus its recorded non-equipment costs exceeded the amount of AID funds already provided by about $908,533. This negative position was largely attributable to about $1 million in costs which AEG recorded on its books as a result of equipment tests it conducted in March and December 1981.

AEG requested a fourth progress payment of $1,793,850 on July 1, 1982, which was paid by AID on July 7, 1982. As of the end of June 1982, AEG's payments to suppliers at sales value amounted to $6,564,115, or about $611,286 less than the AID funds it had available. AEG requested its fifth progress payment of $1,737,125 about two weeks later, on July 13, 1982. At the end of June 1982, AEG's payments to its suppliers at sales value were $6,564,115, or $2,405,146 less than the AID funds it had available after receiving the fourth progress payment. AID paid the fifth progress payment on August 3, 1982, increasing the funds provided to AEG for equipment to $10,706,376. As a result of these two progress payments the amount of funds AEG had available was vastly increased. By the end of August, AEG's payments to its suppliers at sales value were only $6,456,619, or about $4,249,757 less than the funds it had available. (Note: the decrease in the sales value of AEG's payments to its suppliers between the end of June and August 1982, resulted from an adjustment in the factor applied to those payments.)

At the end of June 1982, AEG's payments to suppliers plus its recorded non-equipment costs were $8,030,562--or about $665,411 more than the AID funds it had received. At end of July, after receiving the fourth progress payment, AEG's payments to suppliers plus its recorded non-equipment costs were $8,213,758, or about $945,243 less than the AID funds it had received. At the end of August 1982, AEG's payments to suppliers plus its recorded non-equipment costs were $8,422,684, or about $2,473,442 less than the AID funds it had received.

We believe that AEG's practice of requesting progress payments before it had expended all available funds was done deliberately to provide it with Government funds for its own use. AEG's certifications could in no way be valid on the basis of payments to its suppliers at sales value--which is a very liberal basis. AEG's certifications for its first, second, and fifth progress payments were not valid even giving consideration to its unaudited recorded non-equipment costs which we used for comparison purposes.

AID made the first three progress payments to AEG without knowing what the latter's basis was for requesting them. As was discussed on page 15, prior to making the third progress payment in March 1982, M/SER/COM's GC legal advisor had expressed an opinion that progress payments had to be made on the basis of documentation (which included the certification) called for in the L/COM. The third through fifth progress payments were approved based on that opinion.

It was not until July 1982, when AEG submitted its billing for the fourth progress payment, that it disclosed to AID--for the first time--its basis for claiming such payments. This basis included

--the sales value of equipment which had been titled to AEG;

--cash advances to suppliers;

--obligations incurred as a result of irrevocable letters of credit; and

--all of AEG's non-equipment costs including overhead.

AEG later contended that since AID made this payment, on the basis of documentation which clearly showed AEG's basis for billing, that the Agency had accepted its method.

We strongly disagree both with AEG's contention that the Agency accepted its method for billing and with the items it claimed. To begin with, AID approved and paid AEG's fourth and fifth progress payments on the basis of the legal opinion it received at the time of the third progress payment--not because it accepted or approved AEG's method of billing. Secondly, we see no validity to AEG's claim for its non-equipment related costs--especially overhead--or its claim for obligations resulting from its decision to use irrevocable letters of credit as a means for paying its suppliers. AEG had been provided

Government funds to pay its suppliers. The decision to use irrevocable letters of credit as a financing mechanism was AEG's choice, and one which, if allowed, would provide AEG the opportunity to obtain large amounts of cash before it was actually needed to pay suppliers.

An ex-AEG employee, who had been the project manager on the bakery project, told us that AEG interpreted the language in the L/COM--as simply as possible and to its benefit--in order to obtain the maximum amount of advance funds. He told us that AEG steadfastly held to that interpretation, and was paid on that basis, throughout the five progress payments in question. He further acknowledged that the use of the irrevocable letters of credit was used by AEG as a means to obtain maximum funds.

We view what happened on this contract to be a deliberate effort on the part of AEG to obtain Government funds, for its own use, in advance of its entitlement to such funds. We estimate that it cost the Government about $679,925 to provide these excess funds to AEG. However, since the L/COM provided for an unrestricted advance--which was protected by a guarantee until March 4, 1981--AEG may only be liable for interest of about $537,000 that accrued from that point forward. AEG terminated the guarantee on the advance on March 4, 1981, on the basis that the advance had been satisfied by equipment which was then titled to GASC. As was discussed on page 21, from that point forward AEG was not entitled to an advance and had to justify its entitlement to AID funds on the basis of the sales value of equipment provided. Accordingly, we question AEG's right to the full amount of the progress payments it claimed and received.

AEG responded that its certifications, with the exception of the second progress payment, were based on its interpretation of how progress was to be measured. AEG contended that the Agency instructed it to submit a second progress payment in lieu of its payment claim for equipment that was titled to GASC. AEG also submitted figures which it said summarized AEG's measurement of progress at the time it received the progress payments. (We have already explained why we disagree with AEG's interpretation. AEG's contention that it only requested a progress payment because the Agency instructed it to do so lacks merit. The Chief of M/SER/COM/SE told us that he advised AEG to submit a claim--if progress warranted it (see page 18). AEG also had to certify that it was entitled to receive the second progress payment--such certification should not have been made by AEG if the payment could not be justified. In addition, figures related to cost data, advances to suppliers, and letters of credit submitted by AEG to support its measurement of progress did not agree with those we obtained from AEG's records during our audit. Also, the accounting time periods used were in some cases erroneous. (This information submitted by AEG further supports our opinion that its certifications were questionable). After reviewing its response, we advised AEG of these inconsistencies and told it that we were not going to include those figures in our report.)

CONCLUSIONS AND RECOMMENDATIONS

AID's financial control over the contract to supply commodities for the bakery project in Egypt was inadequate. AID failed to (1) follow Treasury's and its own cash management regulations and procedures, (2) adequately write the L/COM used for financing the contract, (3) clarify the L/COM or take other timely corrective action, and (4) follow its own regulations applicable to financing commodities. Because of these weaknesses, AID provided AEG funds in excess of its immediate disbursement needs to its suppliers and in excess of its entitlement, allowed AEG unrestricted use of Government funds, and made payments for commodities that had not been approved for financing. As a result, the Government incurred unnecessary interest charges of about $679,925 during the period April 1980 through May 1983. In addition, the Agency and GOE were unnecessarily subjected to considerable financial risk in the event the contractor defaulted on the contract.

The financial weaknesses identified in our review demonstrates the need for the Agency to pay closer attention to Treasury's and its own cash management regulations and procedures in determining financing methods, and administering them once they are selected. In addition, AID needs to assure that payments are not made for commodities until (1) their eligibility is approved, (2) the basis for making such payments is clearly defined, and (3) the requirements for the support of the payments are clearly stated.

The weaknesses identified may not be isolated. AID routinely follows the practice of providing advance and progress payments for custom made equipment. The work progress certificate contained in the original L/COM--though ambiguous and needlessly subject to differing interpretations--apparently has long been used in both bank and direct L/COMs. Other weaknesses--the failure to restrict the use of advanced funds and to clearly define the basis for making payments and clearly state documentation requirements, and AID's failure to take immediate corrective action and to require approved AID Forms 11 as a condition for payment--may also be indicative of systemic problems with AID's cash and commodity management.

Sound procedures and guidance are available in the form of Treasury and AID regulations to assist Agency officials in carrying out their duties and responsibilities. Officials should be held accountable for their failure to follow these procedures. The financing problems related to this contract could have been avoided if the Treasury/AID regulations had been followed, or at least minimized if, at several points throughout the period of the advance and first five progress payments, the responsible officials had taken decisive action to enforce AID regulations. Adequate action was not taken.

Although AID's use of an inadequate and ambiguous payment document was the major cause of the financial problems on this contract, in our opinion, AEG also contributed to them. AEG obtained its initial advance long before it was needed to carry out the contract and immediately invested the bulk of it in interest earning certificates. AEG readily acknowledged that the advance had been invested--on the basis that it was sound business practice to do so. AEG was verbally advised on how the advance was supposed to be used and what documents were required to support progress payments to replenish it. AEG did not respond to these instructions and made its own liberal interpretation with regard to how it was supposed to be reimbursed and on what basis. AEG refused verbal requests, of the official responsible for approving the payments, to provide supporting documentation for its progress payments. This was done despite explicit requirements set forth in AID Form 282 which AEG executed with each payment request. Rather, AEG maintained that such detailed support was not required by the L/COM. AEG certified that it was eligible to receive progress payments before it had expended the funds it already had available and/or before it was otherwise eligible to receive such funds on any supportable basis. Some of the financing problems encountered on this contract would have been avoided if AEG had followed AID's method of measuring progress, and had responded to AID's verbal requests for support of its progress payments.

Although the problems identified in this report relate specifically to the financial arrangements on the Egyptian bakery contract, we believe that the problems may be indicative of systemic problems. Accordingly, our recommendations are directed towards correcting both.

Recommendation No. 1

That the AA/M require M/FM in coordination with M/AAA/SER to:

1. Provide guidance to all activities engaged in AID financing which reemphasizes the Treasury and the Agency's cash management regulations and procedures, including the requirement to justify various financing methods, particularly that of providing advance and progress payments.

2. Review the language used in L/COMs, work progress certificates, and other financing documents to assure that it is specific, clear, and adequately protects the Government's interest in accordance with Treasury and AID's cash management procedures and the Agency's regulations applicable to commodity transactions.

3. Review existing L/COMs and amend those identified which contain inadequate controls over advances and ambiguous measures of progress for payment purposes.

Recommendation No. 2

That the AA/M instruct M/FM and M/AAA/SER to strictly enforce Agency regulations which require commodity eligibility to be approved--and adequate support to be provided--prior to making payments to contractors. Such instructions should specify that officials will be held accountable for their failure to follow them.

Recommendation No. 3

That the AA/M require M/AAA/SER in coordination with M/FM and GC to make a determination, and take appropriate action, as to whether a bill of collection can be issued against AEG for the interest cost--amounting to about $537,000--on the excess funds that the contractor obtained in advance of its entitlement.

Management Comments

M/SER and M/FM commented that they supported our recommendations in principle. They expressed the belief that all three of the points mentioned in Recommendation No. 1 would be covered by a new Commodity Financing Task Force which was instituted by M/AAA/SER earlier this year. They said this committee held its first meeting on August 25, 1983, and is chaired by an official from GC and has representatives from both M/AAA/SER and M/FM.

STATUS OF CONTRACT PAYMENTS AS OF SEPTEMBER 27, 1983

Description	Amended Contract Amount	Payments Through September 27, 1983	Balance Remaining To Be Paid
L/COM 263-K05217 ($18,126,202)			
Building design	$ 187,700	$ 187,700	$ -0-
Bakery equipment	17,363,507	17,066,486	297,021
Storage, inspection, freight, insurance, and container rental (estimate)	574,995	144,139	430,856
L/COM Total	$18,126,202	$17,398,325	$ 727,877
L/COM 263-K05508 ($2,090,955)			
Training and erection supervision	$ 879,540	$ 87,954	$ 791,586
Freight, insurance, and container rental (estimated)	1,211,415	1,211,415	-0-
L/COM Total	$ 2,090,955	$ 1,299,369	$ 791,586
Contract Total	$20,217,157	$18,697,694	$1,519,463

AEG'S PROGRESS FROM APRIL 1980 THROUGH MAY 1983 BASED ON ESTIMATED EQUIPMENT SALES VALUE

Month		Cumulative Equipment Payments From AID	Cumulative Estimated Equipment Sales Value 1/	Excess	Interest Cost Of Excess 2/
April	1980	$ 1,793,850	$ 48,987	$ 1,744,863	$ 15,446
May		"	56,092	1,737,758	17,663
June		"	278,734	1,515,116	14,903
July		"	279,386	1,514,464	13,469
August		"	334,445	1,459,405	12,979
September		"	385,127	1,408,723	12,124
October		"	486,366	1,307,484	11,628
November		3,587,700	1,966,980	1,620,720	13,949
December		"	2,273,781	1,313,919	11,685
January	1981	"	2,517,746	1,069,954	11,941
February		"	2,850,759	736,941	7,428
March		5,381,551	3,041,441	2,340,110	26,116
April		"	3,239,315	2,142,236	31,236
May		"	3,602,343	1,779,208	26,807
June		"	4,343,771	1,037,780	15,132
July		"	4,570,867	810,684	11,147
August		"	4,707,525	674,026	9,268
September		"	4,745,278	636,273	8,467
October		"	4,720,814	660,737	10,298
November		"	4,774,621	606,930	9,154
December		"	4,890,396	491,155	7,655
January	1982	"	4,946,684	434,867	5,315
February		"	4,975,712	405,839	4,480
March		"	4,979,643	401,908	4,912
April		7,175,401	5,927,294	1,248,107	13,562
May		"	6,267,834	907,567	10,190
June		"	6,564,115	611,286	6,642
July		8,969,251	6,276,979	2,692,272	32,606
August		10,706,376	6,456,619	4,249,757	51,469
September		"	7,272,981	3,433,395	40,241
October		"	7,526,061	3,180,315	32,359
November		"	7,915,991	2,790,385	27,476
December		11,433,187	9,026,853	2,406,334	24,484
January	1983	12,633,187	9,794,315	2,838,872	31,344
February		"	10,209,356	2,423,831	24,172
March		12,990,775	11,206,154	1,784,621	19,704
April		14,148,210	11,557,940	2,590,270	27,677
May		14,868,130	12,622,181	2,245,949	24,797
Total for full period					$679,925
Total for March 1981-May 1983 3/					$536,710
Average for full period				$ 1,611,949	
Average for March 1981-May 1983 3/				$ 1,697,212	

1/ Estimated equipment sales value = the margin between the contractor's equipment costs and the contract sales value x the contractor's equipment payments.

2/ Interest costs = excess funds x the applicable monthly U.S. Treasury interest rate charged for the use of Federal funds.

3/ The advance payment was covered by a guarantee which AEG cancelled on March 4, 1981, on the basis that it had been satisfied by equipment titled to GAMC. Accordingly, from t... point forward AEG was not entitled to an advance and had to justify its entitlement to AID funds on the basis of sales value of the equipment provided. The interest cost of $536,710 was based on the excess funds provided by AID for the period March 1981 through May 1983.

AID FUNDS AVAILABLE COMPARED TO AEG'S ESTIMATED DISBURSEMENTS JUST PRIOR TO REQUESTING PROGRESS PAYMENTS

Month		Cumulative AID Funds Available	Cumulative Estimated Disbursements 1/	Excess Available
April	1980	$ 1,812,620	$ 44,816	$1,767,804
May		"	136,155	1,676,465
June		"	426,494	1,386,126
July		"	433,957	1,378,663
August		"	501,864	1,310,756
September		"	583,196	1,229,424
October		1,981,550	711,601	1,269,949
February	1981	3,775,400	3,446,229	328,761
January	1982	5,569,251	6,477,784	(908,533)
June		7,365,151	8,030,562	(665,411)
July		9,159,001	8,213,758	945,243
August		10,896,126	8,422,684	2,473,442

Dates Progress Payments Requested and Paid

	Requested	Paid
First	November 17, 1980	November 20, 1980
Second	February 23, 1981	March 2, 1981
Third	February 5, 1982	April 28, 1982
Fourth	July 1, 1982	July 7, 1982
Fifth	July 13, 1982	August 3, 1982

Note 1/: In calculating the contractor's estimated cash disbursements, we considered all payments to suppliers as well as all other non-equipment costs such as labor, consultants, travel, bank charges, test site and other costs. We assumed that all such costs were paid on a current basis and therefore represented outlays of cash. AEG's recorded equipment costs are unaudited and therefore their validity is not known.

AID'S CONTROL OVER THE FINANCING OF A
BAKERY PROJECT IN EGYPT WAS INADEQUATE

List of Report Recipients

Assistant to the Administrator For Management, AA/M	1
Associate Assistant to the Administrator for Management Services, M/AAA/SER	5
Assistant Administrator, Bureau For Near East, AA/NE	5
Director, USAID/Egypt	5
Office of General Counsel, GC	5
Office of Financial Management, M/FM/ASD	2
Office of Public Affairs, OPA	1
Office of Legislative Affairs, LEG	1
Office of Inspector General, IG	1
Office of Development Information and Utilization, S&T/DIU	2
Audit Liaison Office, M/AAA/SER/SA	1
Audit Liaison Office, AA/NE/PMC	1
RIG/A/Nairobi	1
RIG/A/Manila	1
RIG/A/Cairo	1
RIG/A/Karachi	1
RIG/A/Dakar	1
AAO/New Delhi	1
RIG/A/LA	1
IG/PPP	1
AIG/II	1
IG/EMS/C&R	16