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AUDIT OF
FIXED AMOUNT REIMBURSEMENT
PROCEDURES AT USAID/INDONESIA

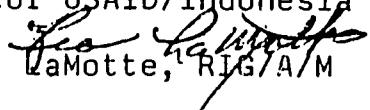
Audit Report No. 2-497-88-05
March 10, 1988

UNITED STATES GOVERNMENT

Memorandum

TO: David Merrill,
Director USAID/Indonesia

DATE: March 10, 1988
RIG/EA-88-150

FROM: Leo L. LaMotte,  RIG/A/M

SUBJECT: Audit Report No. 2-497-88-05
Audit of Fixed Amount Reimbursement Procedures
at USAID/Indonesia

The Office of the Regional Inspector General for Audit/Manila has completed its audit of Fixed Amount Reimbursement Procedures at USAID/Indonesia.

This report contains two recommendations. Please provide written notice to this office within 30 days of actions taken or planned to implement these recommendations.

EXECUTIVE SUMMARY

Fixed amount reimbursement procedures was a method of financing project implementation which was tied to outputs rather than inputs. Under fixed amount reimbursement procedures, the Government of Indonesia used its own resources to implement projects or specified segments. USAID/Indonesia funding was provided after the project or segments had been completed in accordance with design specifications and standards approved by USAID/Indonesia in advance. Reimbursement amounts were also determined in advance based on a fixed amount of the estimated implementation cost. Reimbursement payments were made after the project or segments were inspected to ensure that they conformed to the approved design specifications and standards.

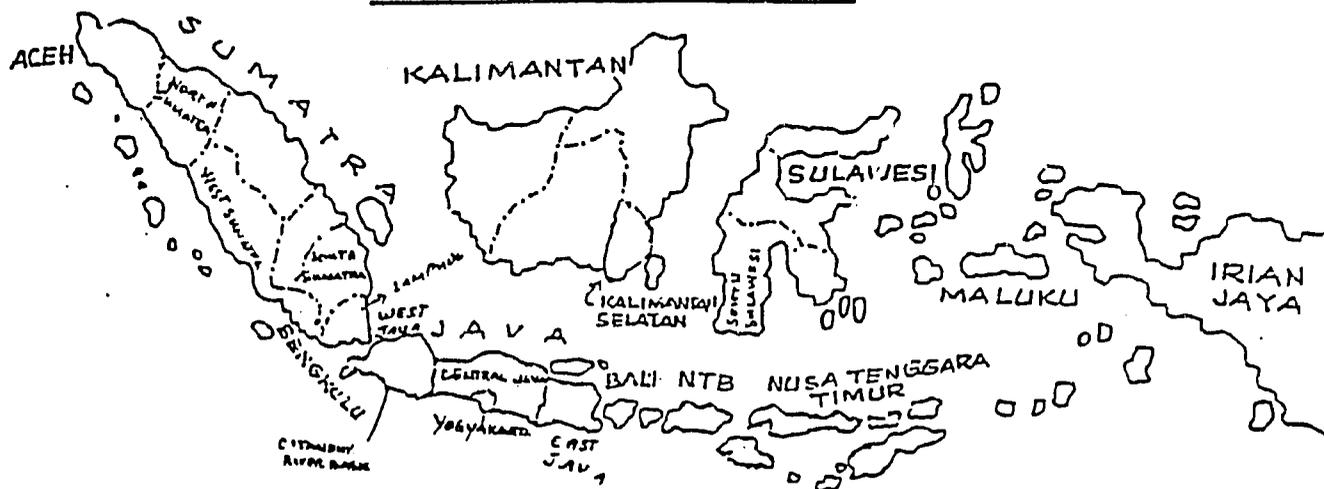
USAID/Indonesia financed segments of six projects at a total cost of \$39.1 million through fixed amount reimbursement procedures. Agricultural research centers were built under the Applied Agricultural Research Project and the Sumatra Agricultural Research Project. Fixed amount reimbursement procedures were used in the Citanduy II Project to construct model farms, irrigation systems and access roads. The Provincial Development Projects I and II implemented small development activities through fixed amount reimbursement procedure. Training centers were built under the Financial Institutions Development Project. Audit work demonstrated that USAID/Indonesia had not complied with Agency regulations concerning the use of fixed amount reimbursement procedures in five of the six projects.

A.I.D. Handbook 3, Project Assistance, Appendix 3J and USAID/Indonesia Mission Order 1900.6 described procedures and guidelines for using fixed amount reimbursement procedures. USAID/Indonesia made inappropriate cost reimbursements for project segments financed through fixed amount reimbursement procedures under the Applied Agricultural Research Project and the Sumatra Agricultural Research Project, and made cost reimbursements for 20 segments under the Citanduy II Project without assurance that the segments met design specifications and standards. These situations occurred because USAID/Indonesia Mission Order 1900.6 did not adequately describe (1) fixed amount reimbursement implementation procedures, (2) guidance on changing from fixed amount reimbursement procedures to other financing methods when necessary, and (3) inspection and documentation requirements for projects or segments financed through fixed amount reimbursement procedures. As a result, USAID/Indonesia made excessive cost reimbursements totalling \$730,042 for activities under the Applied Agricultural

Research and the Sumatra Agricultural Research Projects and could not be sure of the appropriateness of reimbursement payments for 20 project segments under the Citanduy II Project totalling \$225,450. This report recommended that the Mission Order be expanded to provide specific guidance on implementing fixed amount reimbursement procedures and that uninspected activities under the Citanduy II Project be inspected. Management agreed that improvements were needed in the mission order and had taken action to make the necessary revisions. Management also agreed to conduct inspections of the Citanduy II Project segments.

Office of the Inspector General

INDONESIA



Locations of Project Activities Funded through Fixed Amount Reimbursement Procedures

Applied Agricultural Research Project

Java
Kalimantan
Sulawesi

Citanduy II Project

Citanduy River Basin

Financial Institutions Development Project

East Java
West Sumatra
Yogyakarta
South Sulawesi

Provincial Development Project I

Aceh
Central Java

Provincial Development Project II

Bangkulu
East Java
Kalimantan Selatan
Nusa Tenggara Barat (NTB)
Nusa Tenggara Timur (NTT)
West Java

Sumatra Agricultural Research Project

Aceh
Lampung
North Sumatra
South Sumatra
West Java
West Sumatra

AUDIT OF FIXED AMOUNT
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AUDIT OF FIXED AMOUNT
REIMBURSEMENT PROCEDURES
AT USAID/INDONESIA

PART I - INTRODUCTION

A. Background

Fixed amount reimbursement (FAR) was a method of implementing and financing A.I.D. projects which was tied to project outputs rather than inputs. A.I.D. financing was provided after the project or specified self-sustaining segments were completed in conformance with project design specifications and standards approved by A.I.D. in advance. Estimates of project implementation costs derived from the project design specifications and standards were the basis for the A.I.D. reimbursement. A.I.D. agreed to reimburse the host government a fixed amount of the estimated implementation cost after the project or specified segments were completed. Prior to reimbursement, the project or specified segments should have been inspected by A.I.D. to ensure that they conformed to the approved design specifications and standards.

There were four variations of FAR procedures. Under the first, the pure FAR variation, the percentage of the estimated implementation cost agreed to by A.I.D. became the fixed reimbursement amount and did not vary during project implementation. Costs incurred in excess of the fixed reimbursement amount were absorbed by the host government. If implementation costs were less than the fixed reimbursement amount, A.I.D. reimbursed the full fixed amount.

The second variation was FAR with an advance of funds. Under this variation A.I.D. also reimbursed a fixed percentage of the estimated implementation cost. However, this variation differed from the pure FAR variation in that funds were advanced to the host government to begin implementation. A.I.D. reimbursement payments for completed projects or segments were pro-rated until the advance was liquidated. This variation was particularly appropriate when the host government lacked funds to start the project.

The third variation was the FAR-percentage of actual cost. Under this variation, A.I.D. agreed to pay a fixed ratio of the actual cost for each project activity or segment that was completed. Therefore as costs increased, the amount of the A.I.D. contribution increased although the percentage of total project costs remained the same. Prior to

reimbursement, A.I.D. was to verify actual costs incurred for the project or segments, obtain certification from the host government that the activities were completed in accordance with approved design specifications, and inspect the completed activities on a total or sample basis.

The fourth variation was FAR with escalation negotiated periodically. Under this variation, A.I.D. agreed to reimburse a fixed amount of the estimated cost for the first year of project implementation and could renegotiate the reimbursement amounts for subsequent years. Prior to reimbursement, A.I.D. was to ensure that the activities were completed in accordance with design specifications and standards. This variation was particularly appropriate in countries with high inflation rates and for projects which implemented the same types of activities over a two to three year period. It allowed A.I.D. and the host country to more accurately estimate project costs and agree on more realistic fixed reimbursement amounts.

USAID/Indonesia financed projects or segments under three of the four FAR variations. The pure FAR variation was used to provide \$29.4 million in A.I.D. funds for five projects which were active at the time of the audit. The pure FAR variation financed:

- Construction of 12 research stations in Java, Kalimantan and Sulawesi under the Applied Agricultural Research project at a total A.I.D. cost of \$2 million;
- Building or renovation of eight research centers in six Indonesia provinces on the Islands of Sumatra and Java under the Sumatra Agricultural Research Project at an A.I.D. cost of \$1.7 million;
- Construction of 46 model farms, 10 irrigation systems and 11 access roads in the Citanduy River Basin under the Citanduy II Project for an A.I.D. contribution of \$1 million;
- Construction of four training centers in four provinces under the Financial Institutions Development Project at an A.I.D. cost of \$1.6 million; and
- Implementation of economic development subprojects in 8 of Indonesia's 27 provinces under the Provincial Development

Projects I and II from 1977 until 1985 at a total A.I.D. cost of \$23.1 million.

The FAR with advance of funds variation was used to finance the A.I.D. contribution for partial construction of one irrigation system under the Citanduy II Project totalling \$18,000. The percentage of actual cost variation was to be used to finance the A.I.D. contribution of \$9.8 million to subprojects under the Provincial Development Projects I and II implemented subsequent to 1985.

B. Audit Objectives and Scope

The purpose of this limited financial and compliance audit was to determine whether USAID/Indonesia had complied with Agency regulations concerning the use of fixed amount reimbursement (FAR) procedures for project financing. The audit was made at USAID/Indonesia and included analyses of Mission projects financed through FAR procedures which were active at the time of the audit. These projects were the Applied Agricultural Research Project, the Citanduy II Project, the Financial Institutions Development Project, the Provincial Development Projects I and II and the Sumatra Agricultural Research Project. The audit was limited to \$39.1 million in A.I.D. reimbursements for activities under the six projects funded through FAR procedures. The host government contributions to these projects were not reviewed. Audit work included reviews of project administrative files and financial records, analyses of Agency and USAID/Indonesia guidance on the use of FAR procedures and interviews with USAID/Indonesia officials.

The audit was conducted between October 1986 and September 1987. It was made in accordance with generally accepted government auditing standards. Internal controls and compliance work was limited to the findings discussed in the report.

AUDIT OF FIXED AMOUNT
REIMBURSEMENT PROCEDURES AT USAID/INDONESIA

PART II - RESULTS OF AUDIT

Audit work demonstrated that USAID/Indonesia had not complied with Agency regulations concerning the use of fixed amount reimbursement (FAR) procedures in five of the six projects reviewed. As a result, USAID/Indonesia made inappropriate cost reimbursements for activities financed using FAR procedures under the Applied Agricultural Research Project, the Sumatra Agricultural Research Project, the Citanduy II Project and the Provincial Development Projects I and II. In addition USAID/Indonesia made reimbursement payments for 10 project segments financed by FAR procedures under the Citanduy II Project which had not been inspected to ensure that they conformed to design specifications and standards and could not locate inspection reports for 10 other project segments.

In 1985, USAID/Indonesia appropriately changed the funding methods of the Provincial Development Projects I and II from the pure FAR variation to the FAR-percentage of actual cost variation. This change was made because project officials felt that the projects were unsuited to the pure FAR variation. The diversity of project activities and dispersion of sites created difficulties in meeting the pure FAR variation requirement that all project sites be inspected. Project officials believed that inspection on a sample basis permitted under the FAR-percentage of actual cost variation was more appropriate. A total of \$23.1 million in A.I.D. funds was expended through the pure FAR variation before the funding method was changed. Although the change to the FAR-percentage of actual cost variation was appropriate, there were implementation problems with the revised funding method. Audit Report Number 2-497-88-03, Audit of the Indonesian Provincial Development Projects I and II, dated January 29, 1988, recommended modification to the revised funding procedures.

This report recommended that the Mission Order on use of FAR procedures be expanded to provide the necessary implementation guidance and that such guidance be applied to future projects financed through FAR procedures. The report also recommended that inspections be conducted of activities under the Citanduy II Project and that bills of collection be issued to the Government of Indonesia for activities which do not conform to approved plans and specifications.

A. Findings and Recommendations

1. Revisions Are Needed in the USAID/Indonesia Mission Order on Fixed Amount Reimbursement Procedures

A.I.D. Handbook 3, Project Assistance, Appendix 3J and USAID/Indonesia Mission Order 1900.6 described procedures and guidelines for using fixed amount reimbursement (FAR) procedures. USAID/Indonesia made inappropriate cost reimbursements for project segments financed through FAR procedures under the Applied Agricultural Research Project and the Sumatra Agricultural Research Project, and made cost reimbursements for 20 segments under the Citanduy II Project without assurance that the segments met design specifications and standards. These situations occurred because USAID/Indonesia Mission Order 1900.6 did not adequately describe (1) FAR implementation procedures, (2) guidance on changing from FAR procedures to other financing methods when necessary and (3) inspection and documentation requirements for projects or segments financed through FAR procedures. As a result, USAID/Indonesia made excessive cost reimbursements totalling \$730,042 for activities under the Applied Agricultural Research and the Sumatra Agricultural Research Projects and could not be sure of the appropriateness of reimbursement payments for 20 project segments under the Citanduy II Project totalling \$225,450.

Recommendation No. 1

We recommend that USAID/Indonesia revise USAID/Indonesia Mission Order Number 1900.6 on the use of fixed amount reimbursement procedures to include guidance for implementing activities funded through such procedures, changing from fixed amount reimbursement procedures to other financing methods when necessary and inspection and documentation requirements for projects or segments funded through fixed amount reimbursement procedures. The revisions, which should apply to funds commitments under fixed amount reimbursement procedures made after modifications of the Mission Order, should describe:

- Formats for fixed amount reimbursement agreements and types of information which should be included;
- Guidance on dividing projects into quantifiable segments and establishing fixed reimbursement amounts and percentages;
- Variations of fixed amount reimbursement procedures and circumstances and kinds of

projects appropriate for each;

- Procedures for inspecting and accepting completed activities for reimbursement;
- Conditions which justify deviation from fixed amount reimbursement procedures;
- Alternative funding options; and
- Documentation requirements and procedures when changes from fixed amount reimbursement procedures to other funding methods are necessary.

Recommendation No. 2

We recommend that USAID/Indonesia inspect activities funded through fixed amount reimbursement procedures under the Citanduy II Project which have not been inspected or for which inspection documentation does not exist to ensure that they were completed in accordance with approved design specifications and standards, and issue bills of collection to the Government of Indonesia for the A.I.D. reimbursement for those which do not meet required specifications and standards.

DISCUSSION

A.I.D. Handbook 3, Project Assistance, Appendix 3J titled "Use of Fixed Amount Reimbursement Method For Local Cost Financing" described the overall Agency guidance concerning use of fixed amount reimbursement (FAR) procedures. (See Exhibit No. 1) It described the four variations of FAR procedures and specified when each was appropriate, established in general terms the types of projects appropriate for each variation, and discussed internal controls for ensuring that reimbursement payments were proper.

According to Appendix 3J, the host government used its own resources to implement projects funded under FAR procedures. The FAR funded portion of the project was divided into quantifiable self-sustaining segments which would be useful in their own right when completed. The amounts of the A.I.D. financing, the fixed reimbursement amounts, for the project or specified segments were set in advance based on approved design specifications and standards. These amounts were based on percentages of estimated implementation costs derived from the design specifications and standards. The reimbursement amounts were fixed and did not vary during implementation. Costs in

excess of the fixed amounts were absorbed by the host government. If implementation costs were less than the fixed reimbursement amounts, A.I.D. paid the full fixed amounts. Appendix 3J also directed that A.I.D. inspect the quantifiable segments prior to reimbursement to ensure that they conformed to approved design specifications and standards.

A.I.D. Handbook 3, Project Assistance, Appendix 6B, entitled "Guidance Notes For Preparing Model Project Agreements", directed that FAR procedures be outlined in the loan and grant agreement, if such procedures were used to disburse A.I.D. funds.

USAID/Indonesia Mission Order No. 1900.6 established a written policy for inspection of construction projects or segments funded under FAR procedures. It required engineering inspection reports or a memorandum from the mission engineer certifying that the project or segments were completed and had been inspected by A.I.D. before reimbursements were made.

Inappropriate Reimbursement Payments Were Made - USAID/Indonesia reimbursed costs in excess of the agreed fixed reimbursement amounts for construction funded through FAR procedures under the Applied Agricultural Research Project and the Sumatra Agricultural Research Project. In addition, USAID/Indonesia could not be assured of the propriety of reimbursement payments under the Citanduy II Project.

The Applied Agricultural Research Project financed construction of 12 agricultural research centers in Indonesia's outer islands. In accordance with FAR procedures, the construction was divided into 26 segments with fixed reimbursement amounts established for each. A total of \$2 million in A.I.D. funds was committed by individual project implementation letter (PIL) for reimbursement of the construction activities. The seven PILs specified the fixed reimbursement amounts as 40 percent of the estimated construction cost for each construction segment and stated that the A.I.D. commitment would not vary regardless of fluctuations in actual cost. Also the PILs stated that any unforeseen cost increases would be borne by the Government of Indonesia (GOI).

USAID/Indonesia reimbursed 56 percent of the construction cost for one of the 26 construction segments under the Applied Agricultural Research Project. Construction funds for the Bogor Food Crops Research Institute Phase I were committed by PIL Number 10 issued in July 1983. The PIL stated that the construction plans, specifications and cost estimates for this segment had been reviewed and approved by

USAID/Indonesia and that the Mission agreed to reimburse the GOI 40 percent of the construction cost or \$314,405 (Indonesian Rupiah 314.7 million) under FAR procedures. The construction segment consisted of an auditorium, four warehouses, a workshop, fertilizer storage facilities and green houses. Funds were also included for a drying floor and site preparation. In a subsequent PIL dated September 1983, USAID/Indonesia notified the GOI that an engineering inspection revealed that the auditorium construction deviated from the approved plans and specifications and therefore was unacceptable for reimbursement under FAR procedures. In October 1983, the building was reinspected. Although the auditorium was found to be structurally safe, it still deviated from approved plans and specifications.

In December 1983, USAID/Indonesia issued PIL Number 20 which redistributed funds between the buildings constructed under the Bogor Food Crops Research Institute Phase I segment of the project. (See Exhibit No. 2.) The PIL changed the reimbursement percentages for each building under the segment. The PIL stated that the auditorium construction was unacceptable for reimbursement and, therefore, reduced the A.I.D. reimbursement amount for the building from 40 percent of estimated construction cost to zero. However, the PIL increased the reimbursement amounts for the other buildings under the segment from 40 percent of estimated construction cost to 56 percent. Therefore, the total reimbursement amount for the entire project segment remained unchanged at \$314,405. As a result, USAID/Indonesia reimbursed the total approved fixed reimbursement amount for the project segment even though the auditorium construction was found to be unacceptable.

A.I.D. reimbursed construction costs in excess of the agreed fixed reimbursement amounts for construction activities under the Sumatra Agricultural Research Project. Eight agricultural research centers were built in 14 construction segments under the project. In accordance with FAR procedures, separate design specifications and cost estimates were prepared for each project segment. The design specifications and cost estimates were reviewed and approved by USAID/Indonesia. Separate A.I.D. fixed reimbursement amounts were established for each of the 14 segments based on 29 percent of estimated construction cost with the GOI contributing the remaining 71 percent. Reimbursements for nine of the 14 segments were made at the 29 percent rate. However, contrary to FAR procedures which restricted A.I.D. reimbursements to the approved fixed amounts, USAID/Indonesia changed the reimbursement amounts from 29 percent to 100 percent of the estimated construction cost for the five other project segments. Reimbursements for these five segments were made at the 100 percent rate.

A USAID/Indonesia official said that although the fixed reimbursement amounts for the five segments were set at 29 percent of estimated construction cost, reimbursements at 100 percent were necessary. Construction of the five segments coincided with reductions in international oil prices. Revenues from oil sales dropped dramatically which resulted in major cuts in the GOI budget. As a result, the GOI lacked funds to complete construction of the five project segments or to finance 71 percent of the estimated construction cost. According to the project officer, equipment for the research centers had been purchased and scientists trained under the project had completed their studies. One hundred percent funding of the five segments was necessary to ensure that construction of the research centers was completed so that research work could begin.

Procedures followed by USAID/Indonesia in dividing construction activities under the Citanduy II Project into quantifiable segments were inconsistent. The project contained three types of construction. The project built: 46 model farms which were divided into 102 construction segments; 10 irrigation systems which were divided into 33 segments; and 12 access roads, each of which was considered a separate construction segment. As a result, the construction was divided into a total of 147 quantifiable segments. (See Exhibit 3)

USAID/Indonesia followed different procedures in subdividing the model farms, the irrigation systems and the access roads. Separate design specifications and construction cost estimates were prepared for each of the 102 segments of the 46 model farms. Fixed reimbursement amounts were established at 50 percent of the estimated construction cost for each segment. After the segments were completed, USAID/Indonesia reimbursed the approved fixed amounts to the GOI.

A different approach was used to segment the irrigation construction. Design specifications and cost estimates were prepared for each irrigation system as a whole and fixed reimbursement amounts were established for each system. However, construction and cost reimbursements were accomplished in segments. For example, PIL Number 129 established the A.I.D. fixed reimbursement amount of \$109,000 based on 50 percent of the estimated construction cost of the entire Cimuli irrigation system. However, construction of the system was actually accomplished in seven segments. An inspection by A.I.D. in July 1986 found six segments ready for reimbursement and a payment of \$91,000 was made in August 1986 for the six completed segments. The seventh segment was completed in September 1986 and reimbursement of \$18,000 was paid in November

1986. Although the two payments equalled the fixed reimbursement amount set for the entire irrigation system, reimbursement amounts had not been established for each construction segment. As a result, USAID/Indonesia could not be assured of the reasonableness of amounts paid for the individual segments.

USAID/Indonesia made cost reimbursements for activities funded through FAR procedures under the Citanduy II Project without assurance that payments were proper. The project was implemented in a series of 147 construction segments. As shown in the following table, USAID/Indonesia had made reimbursement payments to the GOI for 136 of these segments at the time of the audit:

Quantifiable Segments Reimbursed by A.I.D.
Under the
Citanduy II Project

<u>Activities</u>	<u>Segments Reimbursed</u>	<u>Segments Inspected</u>	<u>Segments Uninspected</u>	<u>Inspection Report Missing</u>
Model Farms	98	88	10	-
Irrigation Systems	32	22	--	10
Access Roads	<u>6</u>	<u>6</u>	<u>--</u>	<u>--</u>
Totals	<u>136</u>	<u>116</u>	<u>10</u>	<u>10</u>

Final inspection reports or memoranda certifying inspection by USAID/Indonesia prior to reimbursement were available for 116 or 85 percent of the 136 segments. No such documentation was available for 10 irrigation system segments and 10 model farm segments. These 20 segments represented 15 percent of the 136 reimbursed segments under the project.

Project records indicated that inspections had been conducted for the 10 irrigation system segments however project officials could not locate the inspection documentation. Project records indicated that no inspections of the 10 model farm segments had been conducted. Therefore, USAID/Indonesia reimbursed construction costs for 20 project segments without assurance that the construction had been completed in accordance with approved design specifications and standards. As a result, USAID/Indonesia could not be

assured of the propriety of these reimbursement payments.

The Mission Order Was Incomplete - USAID/Indonesia Mission Order 1900.6 did not adequately reinforce guidance from Appendix 3J of A.I.D. Handbook 3 on FAR procedures. As a result, the procedures followed by USAID/Indonesia in implementing three projects funded through FAR procedures did not conform to Appendix 3J requirements.

The Mission Order only briefly described FAR implementation procedures in the background section. According to the Order, projects or segments funded through FAR procedures should be self-sustaining units generally of a capital nature. It also stated that the amount of reimbursement should be fixed in advance, based on cost estimates reviewed and approved by the Mission. The body of the Mission Order, entitled "Policy/Procedures," required that an inspection report or certification of inspection by the USAID/Indonesia engineer be included in the reimbursement documentation. The inspection report or certification should indicate that the project or segments had been inspected, determined to be complete, and were eligible for reimbursement.

The purpose of the Mission Order was to establish a written policy for inspection of construction projects or segments funded through FAR procedures and for reporting the results of engineering inspections to project officers. The Order did not address many key aspects of FAR procedure implementation. For example, since the Order applied only to construction activities, it provided no guidance on non-construction projects or segments funded through FAR procedures such as the Provincial Development Projects I and II. The Order did not provide formats for FAR agreements or identify the types of information that should be included in such agreements. The Order did not contain guidance on dividing projects into quantifiable segments or establishing fixed reimbursement amounts. It contained no guidance on reviewing and approving design specifications and cost estimates for activities funded through FAR procedures. The Order did not describe the FAR variations or the circumstances and kinds of projects or segments appropriate for each. There was little guidance in the Order on conducting and documenting inspections of completed projects or segments and accepting them for reimbursement. An example of a Mission Order containing such guidance was provided to USAID/Indonesia for consideration.

In general, mission officials believed that Handbook 3, Appendix 3J provided guidance concerning project design and implementation rather than mandatory requirements. As a result, they believed deviations were permitted based on changing requirements and conditions. They also believed

that the deviations from FAR procedures which occurred under the Applied Agricultural Research Project, the Sumatra Agricultural Research Project and the Citanduy II Project were justified. Decreases in international oil prices and devaluations in the Indonesian currency resulted in shortfalls in GOI budgets. Therefore, deviations from FAR procedures were necessary to accomplish the objectives of these three projects. However, the officials agreed that the Mission Order did not provide the guidance necessary when such deviations were required. Officials stated that they would consider amending the Mission Order.

Fixed Reimbursement Payments - USAID/Indonesia made inappropriate cost reimbursements for three projects totalling \$955,492. Under the Applied Agricultural Research Project, the Mission paid \$89,763 in excess of the approved fixed reimbursement amount for a construction segment. Under the Sumatra Agricultural Research Project, USAID/Indonesia reimbursed 100 percent of estimated construction cost for five project segments when the original intent was to pay only 29 percent of estimated cost. As a result, the Mission paid \$640,279 in excess of the reimbursement amount originally specified. Under the Citanduy II Project, the Mission made reimbursement payments for 20 project segments which had not been inspected or for which inspection documentation could not be located. As a result, USAID/Indonesia made reimbursement payments totalling \$225,450 for 20 project segments without assurance that the segments were completed in conformance with design specifications and standards.

Management Comments

Management comments, included in their entirety at Appendix A, agreed with two recommendations contained in the draft audit report requiring modifications to Mission Order 1900.6 on fixed amount reimbursement (FAR) procedures and stated that management was in the process of revising the Mission Order. One recommendation concerned specifying formats for FAR agreements and types of information to be included in such agreements. The other recommendation required that the Mission Order provide guidance for changing from FAR procedures to other financing methods when necessary. Since the two recommendations were related, management requested that they be combined.

Office of the Inspector General Comments

The two recommendations were combined in the final report as Recommendation Number 1.

Management Comments

The draft audit report recommended that USAID/Indonesia review and modify as necessary on-going projects funded through FAR procedures to ensure that they conform to revisions in Mission Order 1900.6. Management believed that modifying on-going projects would require too much time and work considering the advanced implementation stages of these projects.

Office of the Inspector General Comments

The recommendation that on-going projects funded through FAR procedures be reviewed and modified was not included in the final report. However, to ensure that revisions to the Mission Order were implemented, this report recommended that all commitments of funds made after revision of the Mission Order conform to the new procedures.

Management Comments

Management agreed with the recommendation that activities under the Citanduy II Project funded through FAR procedures be inspected. Management said it had taken action to conduct such inspections and would provide copies of inspection reports.

Office of the Inspector General Comments

Recommendation Number 2 in the final report which required inspection of activities funded through FAR procedures under the Citanduy II Project can be closed upon submission of inspection reports to the Office of the Regional Inspector General for Audit, Manila.

B. Compliance and Internal Controls

Compliance

The audit identified non-compliance with A.I.D. regulations concerning the implementation of fixed amount reimbursement (FAR) procedures in five USAID/Indonesia projects. Under the Applied Agricultural Research Project and the Sumatra Agricultural Research Project, USAID/Indonesia reimbursements for several project segments exceeded approved fixed reimbursement amounts. This was contrary to guidance contained in A.I.D. Handbook 3 - Project Assistance, Appendix 3J, concerning the implementation of FAR procedures. Inspections conducted by USAID/Indonesia in reimbursing for activities funded through FAR procedures under the Citanduy II Project and the Provincial Development Projects I and II did not conform to guidelines contained in Appendix 3J of Handbook 3. Nothing came to the auditors' attention as a result of specific procedures that caused them to believe untested items were not in compliance with applicable laws and regulations.

Internal Controls

USAID/Indonesia Mission Order Number 1900.6 on the use of fixed amount reimbursement procedures did not adequately reinforce guidance on FAR procedures contained in Appendix 3J of A.I.D. Handbook 3, Project Assistance. The Mission Order briefly discussed inspection procedures for construction activities. It did not discuss non-construction activities funded under FAR procedures or prescribe formats and implementation procedures for FAR agreements.

The audit also disclosed that inappropriate payments were made for activities funded through FAR procedures under the Citanduy II Project. Reimbursements were made for 10 activities which had not been inspected to ensure that the activities conformed to approved design specifications and standards. Inspection documentation for 10 other project segments could not be located.

AUDIT OF
FIXED AMOUNT REIMBURSEMENT
PROCEDURES AT USAID/INDONESIA

PART III - EXHIBITS AND APPENDICES

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APPENDIX 3J

USE OF FIXED AMOUNT REIMBURSEMENT
METHOD FOR LOCAL COST FINANCING

A. Policy

It is AID policy to use the fixed amount reimbursement method where the project structure and available qualified personnel in the Mission or from the host country meet the criteria discussed in Section C, below. While the criteria and preconditions for using the fixed amount reimbursement method may be difficult to meet, the benefits from the method are such that field Missions should seek to apply the method as often as possible. The "pure" Fixed Amount Reimbursement (FAR) Method described in Section 3 and the variations described in Section D are acceptable alternatives, even though not all of the latter provide for the reimbursement of a fixed amount.

B. Definition of Fixed Amount Reimbursement Method

1. The primary distinction between this method and other disbursement methods is that the reimbursement is made for outputs rather than inputs; AID is, therefore, not concerned about the procedures used by the B/G in acquiring the inputs. It is merely concerned about the conformance of the outputs to previously agreed specifications or standards. In the "pure" FAR method, a further distinction from other disbursement procedures is that AID's payments are not based on actual cost. Rather, the amount of reimbursement is fixed in advance based upon reasonable cost estimates reviewed and approved by AID. Reimbursement is made upon physical completion of a project or subproject or a quanti-

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liable element within the project. There are two essential aspects of this method:

- a. The definition of a total project (subproject or a quantifiable element within a project), the preparation of cost estimates and an agreement in advance on the amount of AID's contribution, and
- b. Reimbursement upon satisfactory completion of the agreed upon work.

2. Determination of Project Costs and Amount of AID Contribution

- a. The recipient government and AID identify the project for which U.S. assistance is desired, together with estimated financial requirements for the total project as well as subprojects. The recipient government may include in its estimates of costs an amount for inflation for the expected time period for project implementation not to exceed 2 years, based on available information and study. The recipient government submits design specifications and cost estimates for review and approval by AID.

- b. AID determines the amount of its contribution to the total project and the allocation of its contribution to specific subproject and/or elements.

The amount of AID's contribution to the total project will be controlling. If unforeseen cost increases are encountered, these will be borne by the recipient. If costs are less than those estimated, AID's contribution will not be reduced.

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3. Reimbursement Method

The recipient government using its own funds proceeds with implementation of the project. The AID Mission, with its own staff or consultants, monitors and conducts periodic inspections to satisfy itself that the project is being implemented in accord with agreed specifications in order to facilitate final inspection and acceptance. When the project, subproject or element has been completed, AID makes a final inspection and if acceptable AID reimburses the recipient the agreed amount for the project, subproject or element. (See:

C. Criteria and Procedures for description of subproject or element.)

C. Criteria and Procedures

1. Based on AID experience to date it has been concluded that the fixed amount reimbursement method can be successfully utilized for many AID-financed projects, capital or noncapital. However, because of the financial burdens placed on the executing agency, the fixed amount reimbursement method seems to be the most appropriate for low cost, short-term projects (generally two years or less), or projects which can be made divisible into segments small enough to enable the executing agency to complete subprojects or quantified elements within the project, before receiving AID disbursement. Subprojects or elements should be generally of such nature that they may be completed in no more than 9 to 12 months from the date of initiation of work.

2. Subprojects or elements should be self-sustaining units that will be useful and desirable in their own right, regardless of whether other subprojects or elements are completed.

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3. The reimbursement method lends itself particularly well to projects under which a large number of physically separate construction activities are to be carried out, or where a specific quantity of a commodity (such as textbooks) are to be produced.

4. Where AID disbursements are not related to identifiable goods or services but to other criteria, such as budgetary or administrative performance, the fixed amount reimbursement method is not applicable.

5. It is particularly important that the Mission assure itself that the recipient organization has sufficient qualified staff and experience to proceed with effective implementation of the project.

6. Use of the fixed amount reimbursement method requires that the Mission either through its own staff or through contract can provide periodic inspections of the project as well as certification that the subprojects or elements have been completed in accordance with plans and specifications. As AID reimbursement is based upon completed subprojects rather than actual costs, savings from the estimated costs will accrue to the recipient country or organization. It is, therefore, particularly important that attention be given to guaranteeing that the projects be implemented in accordance with agreed plans and specifications and that any possible collusion between implementing and inspection personnel concerning modifications in inputs be avoided.

7. An important criterion that must be met relates to the requirement that AID make a determination that a subproject or element has been completed prior to reimbursement. It is quite probable that there will be cases where this determination will not be appropriate

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due to a failure to meet previously agreed upon specifications. In such cases reimbursement must be refused. It is necessary that the Mission carefully evaluate the implications of such action on the relationships between AID and the host government. The host country should be fully apprised of the risk involved in the procedures that will be followed before deciding to use the fixed amount reimbursement system.

8. The fixed amount reimbursement method assumes that the recipient country and organization has sufficient financial resources to provide necessary working capital so that delays in reimbursement until completion of a subproject or element will not have a detrimental effect on project implementation. The Mission should thoroughly analyze the financial standing and resources and budgetary procedures of the recipient organization prior to recommending the use of the fixed amount reimbursement method.

9. The use of this method or of the variations described in Section D, below, should be discussed in the Project Paper. The paper should also explain the method which will be followed to secure local currency resources.

D. Alternative Procedures

There are a number of acceptable variations in reimbursement methods which may be adopted. While these variations differ in important aspects from the fixed amount reimbursement method, their

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use meets some of the objectives and advantages of the fixed amount reimbursement method. The variations include the following:

1. Advance of AID Funds

From time to time there will be situations when the host country does not have the budget to provide working capital on a current basis so as to permit projects/subprojects to get underway expeditiously. This may particularly be true in a number of Relatively Least Developed Countries (RLDC's) where budget funds are in short supply. Under these circumstances and following a thorough review of the host country's/ recipient's financial position and budgetary procedures, AID could consider advancing funds to permit work to begin. When reimbursement is made for completed subprojects, AID would deduct a pro rata amount from each payment until the advance is completely worked off with final reimbursement. All other criteria and procedures set forth for fixed amount reimbursement (C. above) will apply.

2. Fixed Amount Reimbursement with Escalation Negotiated Periodically

When inflation is a major problem, AID can consider negotiating periodic increases in its fixed amount contribution to the subproject(s). This arrangement would be most applicable where AID is financing many small subprojects of the same type over a number of years; e.g., construction of 150 schools over a period of 2 to 3 years. In this situation, AID would agree to a fixed amount reimbursement for, say, 50 schools to be completed during the first year and renegotiate the fixed amount contribution for the schools to be constructed during subsequent years. The advantage of this approach would be to permit AID and the borrower to price project costs more realistically and reach agreement on a realistic

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fixed amount contribution. It would avoid including substantial escalation in the AID fixed amount contribution. All other criteria and procedures set forth for the fixed amount reimbursement (C. above) will continue to apply.

3. Percentage of Actual Cost Reimbursement

a. From time to time certain projects financed by AID will not permit completion of design specification at the outset so as to be able to establish reasonable cost estimates for individual subprojects. For example, a rural works project, which is labor intensive, includes a large number of small diverse subprojects (feeder roads, bridges, small irrigation, etc.) and where many of these subprojects are scattered over a wide geographic area, is a good case in point. Projects of this type do not lend themselves to "fixed amount" reimbursement because design specifications and cost estimates for individual subprojects are made during the life of the project. However, it is possible to identify design criteria and construction procedures which will be used and on which cost estimates will be based. Thus, while the fixed amount reimbursement procedure cannot be applied, AID could reimburse for a fixed percentage of actual costs of completed subprojects. Under these circumstances, prior to reimbursement AID would require documentation and evidence which would verify actual costs expended for the subproject(s) and a certification by the borrower that the subproject(s) has been completed in accordance with agreed on design specifications and other criteria. In addition, AID would provide for inspection of the facilities under construction and final inspection of the completed subproject(s). Such

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inspection could be done on a total or sample basis, depending on our assessment of the capability of the Borrower/Implementing agency.

b. At the outset, AID would agree to financing a fixed ratio; e.g., 50% of the actual cost of each subproject completed. If subproject costs increase, AID would be financing a larger amount than expected although the ratio would remain the same. Unless the Borrower is prepared to increase his contribution, cost escalation would lead to a reduction in the number of subprojects financed with AID resources, because AID's contribution to the overall project is fixed.

c. This alternative is not as attractive as the fixed amount reimbursement procedure; however, there are still a number of advantages in its use:

- (1) AID's overall dollar commitment to the total project remains the same;
- (2) AID does not increase its percentage contribution to an individual subproject which will remain fixed; and
- (3) AID only reimburses for completed subprojects. If the subproject is not completed, AID does not pay.

d. Each of the methods, of course, has advantages and disadvantages which should be considered in making a determination of the method to be followed.

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UNITED STATES OF AMERICA
AGENCY FOR INTERNATIONAL DEVELOPMENT

AMERICAN EMBASSY
JAKARTA, INDONESIA

December 9, 1983

Mr. H.A. Abdullah
Project Leader AARP
Proyek Penelitian dan Pengembangan
Pertanian RI-USAID
Jl. Ragunan 29
Pasar Minggu
Jakarta Selatan

Subject AID Project No. 497-0302
Loan No. 497-T-064 (L)
Applied Agricultural Research Project Construction
Project Implementation Letter No. 20

Dear Mr. Abdullah:

Reference is made to your letter request No. 346/P4U/10/83 dated 1 October 1983 concerning the auditorium now being constructed under the Bogor Phase I Package I contract. As our PIL No. 13 indicated, USAID will be unable to accept the auditorium for reimbursement payment when it is completed. However, we agree to reprogram the funds committed in PIL No. 10 as follows:

Bogor Food Crops Research Institute Phase I:

Package	Item	Estimated Cost (Rp) Amount	Maximum Reimburs- able (Rp)	Reimburse- ment (%) Approx.
I	Auditorium	224,332,968	0	0
	Warehouse I (post harvest)	83,366,272	46,670,940	56%
	Warehouse II (germ plasm)	65,080,567	36,434,054	
	Drying floor	24,770,092	13,867,041	
	Building Site	5,445,825	3,048,736	
	preparation			
	Totals	402,995,724	100,020,771	25%
II	Warehouse III (common goods)	31,329,780	17,539,351	56%
	Warehouse IV (mech's tools)	81,503,856	45,628,304	

-2-

Workshop	82,681,153	46,287,390)	
Fertilizer	27,190,349	15,221,973)	
Storage)	
New Green Houses	141,641,279	79,295,032)	56%
Add. to existing Green Houses)	15,634,754	8,752,804)	
Building Site Preparation	3,522,310	1,973,975)	
	<hr/>	<hr/>	<hr/>
Totals	383,503,481	214,698,829	56%
Grand Total	786,499,205	314,719,600	40%

Please note that funds committed to Package I have decreased from Rp.161,311,200 to Rp.100,020,771 and funds committed to Package II have been increased from Rp.153,408,400 to Rp.214,698,829, the total funding for both packages remains at Rp.314,719,600.

In accordance with the agreed procedures, when each of these structures has been completed and accepted as meeting the mutually agreed specifications by USAID, reimbursement will be made, on your request, for each line item up to approximately 56 percent of actual cost but not to exceed the maximum reimbursable amount shown above and in no case will the grand total for Packages I and II inclusive exceed Rp.314,719,600. Commitments for Bogor Food Crops Research Institute Phase II, Banjarbaru Food Crops Research Institute Phase I and Maros Food Crops Research Institute Phase I remain unchanged.

If further clarifications are desirable, my staff will be available to discuss them with you.

With kind regards.

Sincerely,



William P. Fuller
Director

cc:
3-DEPLU
1-BAPPENAS
2-DOA

Clearances:

AGR:KAPrussner (in fact)
PRO/DES:DO'Riordan (in fact)
RLA:LChiles (in fact)
PRO:JSperling (in fact)
DD:RClark NE
FIN:RMacClure (in fact)
FIN/B:RALbores (in fact)

AGR/PRO/DES:AHur¹¹ ~~11~~ DO'Riordan¹¹ ~~11~~ :wr:12/09/83

26

Division of Projects Into
Quantifiable Segments

	<u>Number of</u> <u>Activities</u>	<u>Number of</u> <u>Quantifiable Segments</u>
<u>Applied Agricultural</u> <u>Research Project</u>		
Research Centers	12	26
<u>Citanduy II Project</u>		
Model Farms	46	102
Irrigation Systems	10	33
Access Roads	12	12
<u>Sumatra Agricultural</u> <u>Research Project</u>		
Research Centers	8	<u>14</u>
		TOTAL <u>147</u>

UNCLASSIFIED JAKARTA 01503

ACTION: AID-6 INFO: AMP DCM AA ECON/10

VZCZCMLO896
RR RUEEML
DE RUEEJA #9553 3510339
ZNR UUUUU ZZB
R 170339Z DEC 87
FM AMEMBASSY JAKARTA
TO AMEMBASSY MANILA 0109
BT
UNCLAS JAKARTA 19553

17-DEC-87 TOR: 03:42
CN: 56622
CHRG: AID
DIST: AID
ADD:

AIDAC FOR RIG/A/M

E.O. 12356: N/A

SUBJECT: MISSION COMMENTS ON DRAFT REPORT OF FIXED
AMOUNT REIMBURSEMENT AGREEMENTS AT USAID/INDONESIA
(RIG/EA-88-2)

BELOW ARE MISSION RESPONSES TO THE FOUR RECOMMENDATIONS
AS STATED IN THE SUBJECT REPORT:

A. RECOMMENDATION NO. 1: WE RECOMMEND THAT
USAID/INDONESIA REVISE USAID/INDONESIA MISSION ORDER
NUMBER 1900.6 ON THE USE OF THE FAR AGREEMENTS TO
PRESCRIBE IMPLEMENTATION PROCEDURES APPLICABLE TO BOTH
CONSTRUCTION AND NON-CONSTRUCTION ACTIVITIES BY PROVIDING
GUIDANCE ON:

- FORMATS FOR THESE AGREEMENTS AND TYPES OF INFORMATION WHICH SHOULD BE INCLUDED IN SUCH AGREEMENTS; DIVIDING PROJECTS INTO QUANTIFIABLE ELEMENTS AND ESTABLISHING FIXED REIMBURSEMENT AMOUNTS AND PERCENTAGES;
- TYPES OF THESE AGREEMENTS AND CIRCUMSTANCES AND KINDS OF PROJECTS APPROPRIATE FOR EACH; AND
- INSPECTING AND ACCEPTING COMPLETED ACTIVITIES FOR REIMBURSEMENT.

RECOMMENDATION NO. 2: WE RECOMMEND THAT USAID INDONESIA
REVISE MISSION ORDER NUMBER 1900.6 ON THE USE OF FAR TO
PRESCRIBE PROCEDURES TO BE FOLLOWED WHEN A CHANGE FROM
THESE PROCEDURES TO ANOTHER FINANCING METHOD IS NECESSARY
BY PROVIDING GUIDANCE ON:

- CONDITIONS WHICH JUSTIFY DEVIATION FROM THE FAR PROCEDURES;
- ALTERNATIVE FUNDING OPTIONS; AND
- DOCUMENTATION REQUIREMENTS AND PROCEDURES.

COMMENTS: USAID/I AGREES WITH RECOMMENDATIONS NO 1 & 2.
SINCE THESE TWO RECOMMENDATIONS ARE CLOSELY RELATED, WE
REQUEST THAT THEY BE COMBINED. WE ARE IN THE PROCESS OF
REVIEWING AND REVISING USAID/I MISSION ORDER NUMBER
1900.6 ON THE USE OF THE FIXED AMOUNT REIMBURSEMENT (FAR)
PROCEDURE. THIS REVISION WILL BE IN ACCORDANCE WITH AID
HANDBOOK 3 - APPENDIX 3J AND WILL ALSO BE TAILORED TO THE
INDONESIAN SITUATION.

DIV IACLINE	
OD	<input checked="" type="checkbox"/>
E	<input type="checkbox"/>
FE	<input type="checkbox"/>
RL	<input type="checkbox"/>
PO	<input type="checkbox"/>
TD	<input type="checkbox"/>
EO	<input type="checkbox"/>
PER	<input type="checkbox"/>
CSD	<input type="checkbox"/>
LOG	<input type="checkbox"/>
GSC	<input type="checkbox"/>
TRV	<input type="checkbox"/>
CO	<input type="checkbox"/>
DND	<input type="checkbox"/>
CCD	<input type="checkbox"/>
ORAD	<input type="checkbox"/>
OPM	<input type="checkbox"/>
OFFENS	<input checked="" type="checkbox"/>
RIG/A	<input checked="" type="checkbox"/>
RIG/II	<input type="checkbox"/>
AR	<input type="checkbox"/>
DUE DATE	



E. RECOMMENDATION NO. 3: WE RECOMMEND THAT USAID/INDONESIA REVIEW AND MAKE MODIFICATIONS AS NECESSARY TO ON-GOING PROJECTS TO ENSURE THAT THE PROJECTS CONFORM TO REVISIONS IN MISSION ORDER NUMBER 1900.6 ON THE USE OF FAR AGREEMENTS.

COMMENTS: USAID/I BELIEVES GOING BACK IS TOO EXTENSIVE AT THIS STAGE OF THE LIFE OF THESE PROJECTS. WE REQUEST RECONSIDERATION OF THIS RECOMMENDATION.

C. RECOMMENDATION NO. 4: WE RECOMMEND THAT USAID/INDONESIA INSPECT ACTIVITIES UNDER THE CITANDUY II PROJECT WHICH HAVE NOT BEEN INSPECTED BUT WERE REIMBURSED UNDER FAR AGREEMENTS TO ENSURE THAT THESE WERE COMPLETED IN ACCORDANCE WITH APPROVED DESIGN SPECIFICATIONS AND STANDARDS AND ISSUE BILLS OF COLLECTION TO THE GOVERNMENT OF INDONESIA FOR THE A.I.D. REIMBURSEMENT FOR THOSE WHICH DO NOT MEET REQUIRED SPECIFICATIONS AND STANDARDS.

COMMENTS: USAID/I AGREES WITH RECOMMENDATION NO. 4. WE HAVE COMPLIED WITH THE RECOMMENDATION BY INSPECTING THE REST OF THE MODEL FARM ACTIVITIES, AND THE REPORT INDICATED THAT THESE ACTIVITIES WERE COMPLETED IN ACCORDANCE WITH APPROVED DESIGN SPECIFICATIONS AND STANDARDS. POUCHING COPY OF THE INSPECTION REPORT.

CONNORS

BT

#9553

NNNN

APPENDIX B

Report Distribution

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IG/LC	1
IG/ADM	12
IG/II	1
RIG/I/M	1
RIG/A/Cairo	1
RIG/A/Dakar	1
RIG/A/Nairobi	1
RIG/A/Singapore	1
RIG/A/Tegucigalpa	1
RIG/A/Washington	1
RIG/PSA	1