

**Regional Inspector General for Audit
Cairo, Egypt**

**Audit of the Source and Origin of
Commodities Purchased under the
Alexandria Wastewater and Cairo
Sewerage II Projects**

**Report No. 6-263-94-003
March 8, 1994**





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

March 8, 1994

MEMORANDUM FOR USAID/Egypt Director, Henry H. Bassford

FROM: RIG/A/C, *Philippe L. Darcy*

SUBJECT: Audit of the Source and Origin of Commodities Purchased under the
Alexandria Wastewater and Cairo Sewerage II Projects

This is our report on the subject audit. We considered USAID/Egypt's comments on the draft report and have included the comments as an appendix to this final report. I appreciate the cooperation and assistance that USAID/Egypt and its contractors extended to our staff during the course of the audit.

Recommendation 1.1 is closed upon report issuance. Recommendation 1.2 is resolved and can be closed when planned actions have been implemented. Recommendations 1.3, 1.4, and 2, which deal with questioned and unsupported costs of \$2,478,427, \$230,552, and \$37,869 respectively, are unresolved until we agree on the amounts to be recovered.

Please advise my office within 30 days of any additional actions planned or taken to implement the report recommendations.

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EXECUTIVE SUMMARY

Pursuant to Section 604(a) of the Foreign Assistance Act of 1961, the U.S. Agency for International Development (USAID) has established policies which generally require that commodities financed by USAID have their "source" and "origin" in the United States. To meet the source test, commodities must be shipped to the cooperating country from the United States. To meet the origin test, commodities must be grown, mined, manufactured, or assembled in the United States using predominantly U.S. components. Our audit covered selected purchases of commodities and selected source/origin waivers under two projects: the Cairo Sewerage II Project (No. 263-0173) and the Alexandria Wastewater System Expansion Project (No. 263-0100). Both of these projects are managed by USAID/Egypt's Development Resources Directorate, Urban Administration and Development Office. (Page 1)

The objective of our audit was to answer the following question: Did USAID/Egypt ensure compliance with USAID policies and procedures and contract requirements concerning the source and origin of project commodities? (Page 2)

Our answer to the audit objective is qualified to the extent of the effect, if any, of not having received written representations for the audit from USAID/Egypt officials directly responsible for the audited activities. (Appendix IV)

Source requirements were met for nearly all of the \$18.6 million in commodities we reviewed for compliance with source requirements. Only \$60,240 of the commodities we reviewed (or 0.3 percent of the total) did not meet the source requirements. Our report recommends that USAID/Egypt resolve \$37,869 in questioned costs related to these source violations. (Pages 3 and 9)

Also, for the 12 source/origin waivers we reviewed, USAID/Egypt ensured that the waivers were justified in accordance with the criteria in USAID Handbook 1, Supplement B, Chapter 5 and that the waivers were reviewed and approved by appropriate officials in accordance with USAID Delegation of Authority No. 653 and Mission Order No. 5-4. (Page 3)

However, of the \$17.2 million in commodities we reviewed for compliance with origin requirements, at least \$2.5 million (14 percent) had an ineligible origin. That is, the commodities were required to be manufactured in the United States but instead were manufactured primarily in Canada, Great Britain, Japan, Korea, and Taiwan. These

violations occurred mainly because (1) the contractors who bought the commodities did not understand the origin requirements or did not assign enough importance to complying with them and (2) USAID/Egypt did not have an effective means of verifying that contractors were complying with origin requirements. Our report recommends that USAID/Egypt issue a contractor notice discussing origin requirements, implement a program of physical inspections to verify the origin of the commodities most vulnerable to origin violations, resolve \$2,478,427 in questioned costs, and resolve \$230,552 in unsupported costs. (Pages 3 and 4)

USAID/Egypt issued a contractor notice on origin requirements and agreed to establish a system of physical inspections to verify compliance with origin requirements. USAID/Egypt was in the process of deciding how to resolve the questioned and unsupported costs discussed in the report. (Page 12 and Appendix V)

Office of the Inspector General
Office of the Inspector General
March 8, 1994

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INTRODUCTION

Background

Section 604(a) of the Foreign Assistance Act of 1961 states that:

Funds made available under this Act may be used for procurement outside the United States only if the President determines that such procurement will not result in adverse effects upon the economy of the United States or the industrial mobilization base * * *.

Pursuant to Section 604(a), USAID has established policies which generally require that commodities financed by USAID have their "source" and "origin" in the United States. To meet the source test, commodities must be shipped to the cooperating country from the United States. To meet the origin test, commodities must be grown, mined, manufactured, or assembled in the United States using predominantly U.S. components. USAID's source and origin policies are complex, and readers who are not already familiar with USAID's policies may wish to review Appendix I, which describes these policies in more detail.

Our audit covered selected purchases of commodities and selected source/origin waivers under two projects: the Cairo Sewerage II Project (No. 263-0173) and the Alexandria Wastewater System Expansion Project (No. 263-0100). Both of these projects are managed by USAID/Egypt's Development Resources Directorate, Urban Administration and Development Office.

Our audit covered commodities purchased under 7 of 11 contracts that received more than \$1 million in funding under these projects and that were active as of April 30, 1993. The contracts we reviewed were for construction and construction management services. Our audit tests for measuring compliance with source requirements covered commodities valued at \$18.6 million and our tests for measuring compliance with origin requirements covered commodities valued at \$17.2 million. The audit also covered all 12 of the source/origin waivers approved under the projects from October 1, 1989 through April 30, 1993.

Audit Objective

As part of its fiscal year 1993 audit plan, the Office of the Regional Inspector General for Audit/Cairo performed an audit of the source and origin of project commodities financed under projects in USAID/Egypt's Office of Urban Administration and Development. The objective of the audit was to answer the following question:

Did USAID/Egypt ensure compliance with USAID policies and procedures and contract requirements concerning the source and origin of project commodities?

A complete discussion of the scope and methodology of our audit, including several limitations, is found in Appendix IV.

REPORT OF AUDIT FINDINGS

Our answer to the following audit objective is qualified to the extent of the effect, if any, of not having received written representations for the audit from USAID/Egypt officials directly responsible for the audited activities. Appendix IV includes a discussion of this qualifier.

Did USAID/Egypt ensure compliance with USAID policies and procedures and contract requirements concerning the source and origin of project commodities?

For the commodities we tested, in all significant respects, USAID/Egypt ensured that contractors complied with the source requirements established by USAID policies and included in each contract. Also, for the source/origin waivers we reviewed, USAID/Egypt ensured that the waivers were justified in accordance with USAID policies. However, for the commodities we tested, the Mission did not ensure that origin requirements were met.

Nearly all of the \$18.6 million in commodities we reviewed for compliance with source requirements met the source requirements included in each contract we reviewed. Only \$60,240 of these commodities (or 0.3 percent of the total) did not meet the source requirements. The cases where source requirements were not met are discussed in the section beginning on page 9.

USAID/Egypt ensured that the 12 source/origin waivers we reviewed were justified in accordance with the criteria in USAID Handbook 1, Supplement B, Chapter 5 and that the waivers were reviewed and approved by appropriate officials in accordance with USAID Delegation of Authority No. 653 and USAID/Egypt Mission Order No. 5-4.

However, \$2.5 million (14 percent) of the \$17.2 million in commodities we reviewed for compliance with origin requirements did not meet the origin requirements included in each contract, and another \$230,552 in commodities may not have met these requirements.

USAID/Egypt Did Not Ensure Compliance with Origin Requirements

Summary

The contracts we reviewed required that commodities purchased with USAID dollars have their origin in the United States. However, about \$2.5 million of the \$17.2 million in commodities we reviewed for compliance with origin requirements had an ineligible origin, and another \$230,552 in commodities may have had an ineligible origin. That is, the commodities were required to be manufactured in the United States but instead were manufactured primarily in Canada, Great Britain, Japan, Korea, and Taiwan. These violations occurred mainly because (1) the contractors who bought the commodities did not understand the origin requirements or did not assign enough importance to complying with them and (2) USAID/Egypt did not have an effective means of verifying that the contractors were complying with origin requirements.

Recommendation No. 1 We recommend that USAID/Egypt:

- 1.1 issue a contractor notice reminding contractors and construction managers of their respective responsibilities for compliance with origin requirements;**
- 1.2 implement a program of physical inspections to verify the origin of those commodities financed by USAID which are most vulnerable to origin violations;**
- 1.3 resolve \$2,478,427 in questioned costs, representing commodities with an ineligible origin purchased by contractors and paid for by USAID; and**
- 1.4 resolve \$230,552 in unsupported costs, representing commodities which may have had an ineligible origin.**

Detailed Discussion

The seven contracts we reviewed required that commodities have their origin in the United States except for certain local purchases.

Of the \$17.2 million in commodities we reviewed for compliance with origin requirements, \$2.5 million had an ineligible origin and another \$230,552 may have had an ineligible origin (see Appendices II and III). The commodities we reviewed included 123 line items, of which 18 items were ineligible and 2 additional items may have been ineligible. That is, the commodities were required to be manufactured in the United States but instead were manufactured primarily in other industrialized countries such as Canada, Great Britain, Japan, Korea, and Taiwan. Some examples follow:

- One contractor bought two generators, for a total of \$19,104, that were made in Japan. The contractor agreed that these items were clearly ineligible and stated it had not paid sufficient attention to USAID's origin requirements.
- Several contractors bought computer equipment, for a total of \$68,261, that was made in Japan, Mexico, and Korea. One contractor explained that they assumed that equipment purchased from U.S. suppliers—and in some cases manufactured by well-known U.S. companies—would be manufactured in the United States. This assumption proved to be incorrect.
- One contractor bought eight electric motors, for \$177,098, that were made in Taiwan. The contractor employed an erroneous line of reasoning to justify this purchase. Upon arrival in Egypt, the motors were attached to U.S.-made pumps costing \$387,441. According to the contractor, this operation created a new commodity containing predominantly U.S. components. We believe that this line of reasoning is incorrect because USAID's componentry rules only apply to commodities manufactured or assembled in eligible source countries. In order to consider the pump sets as an eligible commodity, they would have had to be assembled in the United States, which was the only eligible source country for this procurement.
- Another contractor bought a tunnel boring machine, that was made in Canada, for about \$1.9 million. The contractor believed that this machine met USAID's origin requirements because, according to the manufacturer, at least 50 percent of the value of the machine consisted of U.S. components. This line of reasoning was erroneous since USAID's componentry rules apply only to commodities manufactured in eligible source countries. Since the only eligible source country for this procurement was the United States and the machine was assembled in Canada, the machine was ineligible regardless of how many U.S. components it contained.

A complete list of the items with an ineligible origin is found in Appendix III.

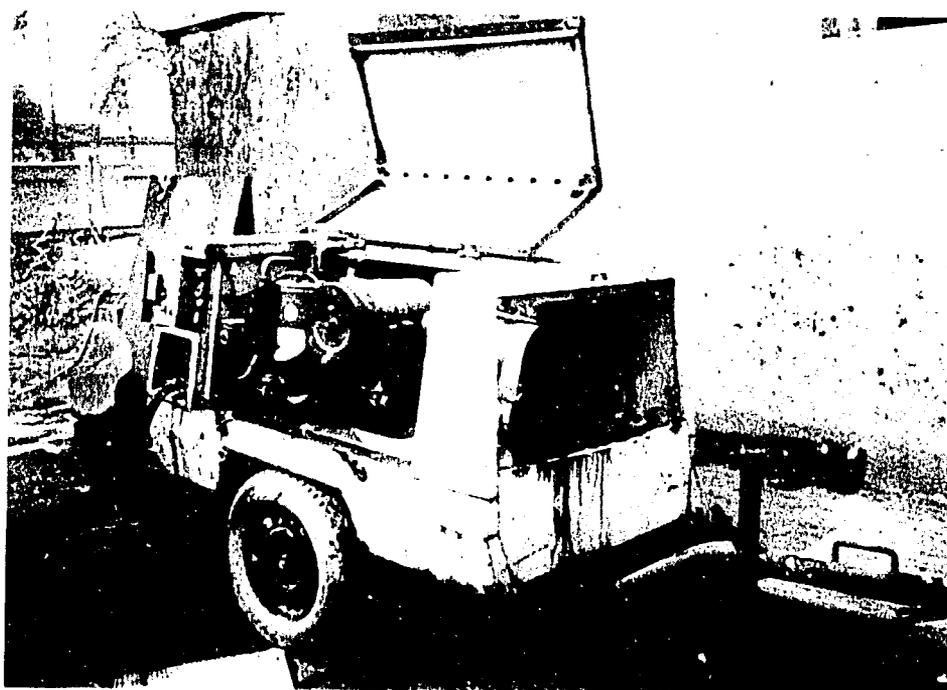
To understand how these violations occurred it is necessary to understand how USAID/Egypt ensures compliance with origin requirements under construction projects. To ensure compliance, USAID/Egypt relies to varying degrees on (1) its construction contractors, (2) its construction managers, and (3) its own staff.

USAID/Egypt includes origin requirements in its contracts with construction contractors. Responsibility for complying with these requirements lies with the contractors themselves, who are bound by the terms of their contracts. However, as the examples discussed above show, many of the contractors either did not understand the source and origin requirements in their contracts or did not place sufficient importance on complying with them.

To verify that construction contractors are complying with origin requirements, USAID/Egypt relies, in part, on its construction managers. The construction managers



This electric motor, one of eight valued at a total of \$177,098, did not meet origin requirements since it was made in Taiwan. (Cairo, Egypt - February 1994)



This compressor, one of two valued at a total of \$23,707, did not meet origin requirements since it was made in Belgium. (Cairo, Egypt - February 1994)

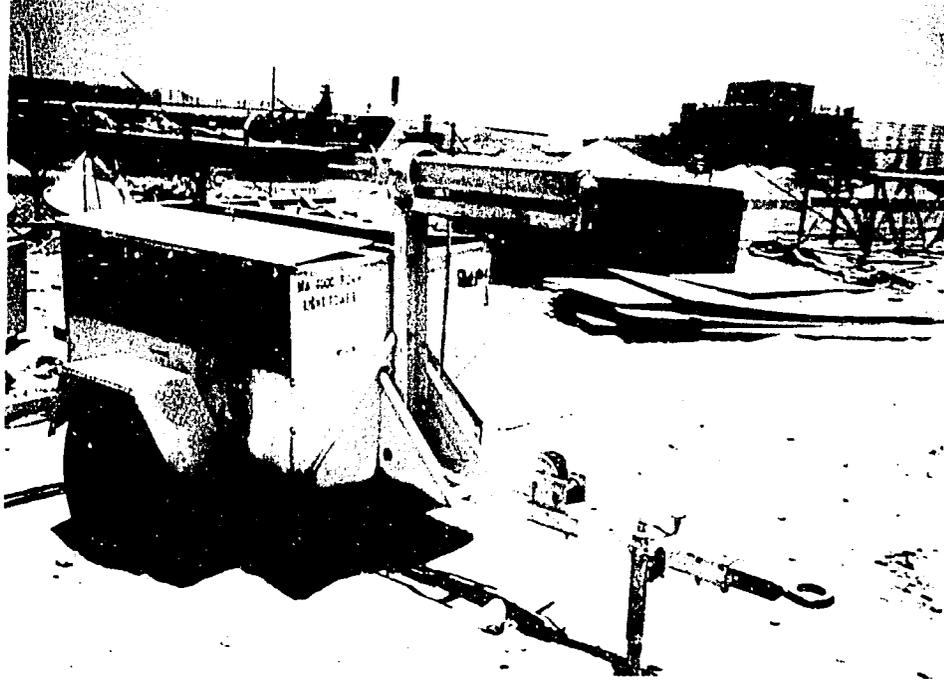
are responsible for monitoring the contractors' adherence to contract provisions, including origin requirements. As part of this responsibility, the construction managers must certify that each payment requested by the contractor is in accordance with the terms of the contract. However, the construction managers had identified only 2 of the 20 items that we found were ineligible because of origin violations and, in following up on these transactions, demonstrated an inadequate understanding of USAID's origin rules. For example, when a construction manager questioned the purchase of the tunnel boring machine discussed above, the contractor satisfied the construction manager with a letter stating that at least 50 percent of the value of the machine consisted of U.S. components. This assertion was beside the point since the machine was manufactured in Canada, an ineligible source country, and was therefore ineligible regardless of how many U.S. components it contained.

The oversight exercised by the construction managers is supplemented by USAID/Egypt's own staff, who make visits to contractor work sites to monitor the progress of the work and resolve problems. During these site visits, Mission staff may inspect commodities to verify that they were made in the United States. However, Mission staff told us that verifying compliance with origin requirements is not a primary objective of these visits; rather, during site visits undertaken for other purposes, they occasionally take the opportunity to inspect a few items of equipment that are readily at hand. Indeed, given the scope of the construction activities managed by the Urban Administration and Development Office, we believe it would be very difficult for USAID/Egypt staff to perform these inspections in a systematic and thorough fashion.

In its comments on our draft report, USAID/Egypt stated that, given the complexity of origin and componentry rules, compliance with origin requirements can, in most instances, only be verified through audit, where costs can be reviewed and a proper determination made. Also, USAID/Egypt pointed to this audit as an example of accomplishing this internal control objective.

We recognize that audit can provide some measure of internal control, but we caution USAID/Egypt against placing too much reliance on audit to ensure compliance with origin requirements. This is because:

- Financial audits of U.S. contractors are conducted in the United States (where the books and records are kept) and therefore the auditors have no opportunity to physically inspect equipment in Egypt to verify its origin.
- No financial audits are normally required or performed for fixed-price contracts. Yet, 96 percent of the origin violations discussed in this report (by dollar value) occurred under fixed-price contracts.
- Performance audits focusing on source and origin issues cover only a small portion of the commodities funded by USAID/Egypt and are performed perhaps only every three to five years.



This portable lighting plant, valued at \$10,532, may not meet origin requirements because its engine was made in Japan and its generator was made in England. (Alexandria, Egypt - July 1993)



This diesel generator set, one of two worth a total of \$220,020, may not meet origin requirements since it contained an engine made in Great Britain. (Alexandria, Egypt - July 1993)

In conclusion, we found origin violations amounting to 14 percent of dollar value of the sample reviewed. We believe that this finding demonstrates a need to strengthen controls over this area. USAID/Egypt needs to issue a contractor notice discussing origin requirements, implement a program for physically inspecting commodities to verify their origin, resolve \$2,478,427 in questioned costs, and resolve \$230,552 in unsupported costs.

A Few Purchases Did Not Comply with Source Requirements

Summary

The contracts we reviewed required that commodities have their source in the United States. That is, they required that commodities be shipped to Egypt from the United States. Of the \$18.6 million in commodities we reviewed for compliance with source requirements, \$60,240 (0.3 percent) had an ineligible source. These problems, which dated from 1990 and 1991, were due to misunderstandings on the part of the responsible contractors. As a result, USAID funds were spent for items with an ineligible source.

Recommendation No. 2 We recommend that USAID/Egypt resolve \$37,869 in questioned costs representing items with an ineligible source.

Detailed Discussion

The contracts we reviewed required that commodities have their source in the United States, except for certain local purchases.

Of the \$18.6 million in commodities we reviewed for compliance with source requirements, \$60,240 had an ineligible source (see Appendices II and III). The commodities we reviewed included 109 line items, of which 13 items were ineligible. Because of the small dollar amount involved, we did not consider the ineligible items to represent significant non-compliance. Nonetheless, the ineligible items are discussed below so that the Mission can resolve \$37,869 in questioned costs.

Of the \$60,240 in commodities with an ineligible source, \$22,371 represents software that was shipped to Germany and then, reportedly, hand-carried to Egypt. In this case, the source was Germany. But because the software was shipped from a U.S. company and, apparently, was not modified in any fashion in Germany, this could be regarded as a mere technical violation. Therefore, we are not questioning the \$22,371 cost of this software. According to the contractor's project director, the software was hand-carried to Egypt from Germany because this was the fastest way to deliver the software.

The remaining amount, \$37,869, represents purchases from Egyptian suppliers under a USAID direct contract that required that all commodities be purchased in and shipped from the United States. The project manager for this contractor stated that he was not aware of the contract provision restricting all procurement of commodities to the United States.

As a result of the problems discussed above, \$60,240 in USAID funds were spent for items with an ineligible source. Although \$22,371 of these expenditures represented a technical violation which had no ill effect that we could identify, USAID/Egypt needs to resolve the remaining \$37,869 of these expenditures which we are questioning. This \$37,869 was spent for items purchased from Egyptian suppliers (and manufactured primarily in Canada, England, Japan, and Taiwan). Because the ineligible amount represents only 0.3 percent of the amount we reviewed for compliance with source requirements, we are not recommending that USAID/Egypt take any additional steps to improve compliance with source requirements.

MANAGEMENT COMMENTS AND OUR EVALUATION

In its comments on our draft report, USAID/Egypt agreed that most of the origin violations discussed in this report were, in fact, violations. However, the Mission disagreed with our conclusion that USAID/Egypt did not ensure compliance with origin requirements and disagreed with our description of its internal control system for ensuring compliance with origin requirements. USAID/Egypt issued a contractor notice on origin requirements and agreed to establish a system of physical inspections to verify compliance with origin requirements. USAID/Egypt was in the process of deciding how to resolve the questioned and unsupported costs discussed in the report. (Appendix V contains the complete text of the Mission's comments.)

General Comments

USAID/Egypt disagreed with our conclusion that the Mission did not ensure compliance with origin requirements. The Mission stated that the auditors seem to view the term "ensure" as a requirement to guarantee compliance, while the Mission thinks in terms of reasonable assurance.

Our report recognizes that no system of internal control can "guarantee" compliance. As stated in the report section on scope and methodology, we considered errors or violations exceeding 5 percent of the sample reviewed (by dollar value) to represent significant non-compliance. The \$2.5 million in origin violations discussed in this report represent 14 percent of the \$17.2 million in commodities we reviewed for compliance with origin requirements. Since the 5 percent threshold was exceeded, we considered these violations to represent significant non-compliance requiring strengthened internal control procedures. On the other hand, the source violations we found represented only 0.3 percent of the sample we reviewed for compliance with source requirements. We did not consider these violations to represent significant non-compliance and, accordingly, we did not recommend any changes to the Mission's internal control system for ensuring compliance with source requirements.

The Mission also disagreed with the way its internal control system was described in the report and stated that its system relies primarily on audit to ensure compliance with origin requirements. The Mission further stated that this audit had accomplished the internal control objective of ensuring that origin requirements are met.

We believe that we have accurately described the Mission's significant internal controls; that is, the internal controls that have a reasonable chance of preventing or detecting origin violations. We considered the role that audit plays in the Mission's internal control system and concluded that financial audits performed by non-Federal auditors are unlikely to detect origin violations, for reasons that are discussed on page 13. Furthermore, while our audit may have helped identify some origin violations, our audit alone cannot ensure compliance with origin requirements. Our tests for determining compliance with origin requirements covered commodities worth \$17.2 million, which represents only a small portion of the project commodities financed by USAID/Egypt.

The Mission stated that, under host country contracts, where USAID is a financier, the contractor's claim for payment is supported by "The Supplier's Certificate and Agreement with the Agency for International Development for Project Commodities/Invoice and Contract Abstract" (USAID Form 1450-4).

This statement is incorrect with respect to the contracts covered by our audit. A contractor is an entity that provides services (and may incidentally provide commodities). A supplier is an entity that provides commodities. For host country contracts for services (such as the contracts we reviewed), USAID normally requires a Contractor's Certificate and Agreement with the Agency for International Development (Form 1440-3). By signing this form, the contractor certifies, to the best of its knowledge and belief, that it has met the source and origin requirements in the contract. A different form (the supplier's certificate referred to in the Mission's comments) is normally used when USAID finances host country contracts for commodities.

The Mission stated that, given the componentry requirements included in USAID's origin policies, it is not feasible to determine if a commodity's origin is the United States until the cost of the components of the commodity are audited.

We believe that the Mission is overstating the difficulties involved in determining compliance with USAID's origin policies. USAID's origin policies require that commodities be produced in an eligible country. (For the contracts discussed in this report, except for certain local purchases, the only eligible country was the United States.) If a commodity is produced in an eligible country, then the commodity must meet additional requirements for componentry. That is, the cost of foreign components may not exceed 50 percent of the lowest price at which the supplier sells the commodity for export. If, however, the commodity is produced in an ineligible country, then the commodity is ineligible regardless of where its components are from. For example, if a generator is manufactured or assembled in Japan, it is ineligible even if most of the components of the generator originally came from the United States. The origin violations discussed in this report are classified as violations because the commodities were produced in ineligible countries. Because they were produced in ineligible countries, componentry was not an issue.

Furthermore, if the Mission wished to have cost audits performed to determine compliance with componentry requirements, the Mission would need to have access to supplier records. For the contracts we audited, the Mission had no such access.

The Mission stated that, because of the difficulty of determining compliance with componentry requirements and other factors, the Mission's primary internal control with respect to verifying the origin of commodities rests with the audit function.

While audit can provide some measure of control, we do not believe that it is appropriate to rely on the audit function as the primary internal control for verifying compliance with origin requirements. This is because:

- Financial audits of U.S. contractors are conducted in the United States (where the books and records are kept) and therefore the auditors have no opportunity to physically inspect equipment in Egypt to verify its origin.
- No financial audits are normally required or performed for fixed-price contracts. Yet, 96 percent of the origin violations discussed in this report (by dollar value) occurred under fixed-price contracts.
- Performance audits focusing on source and origin issues cover only a small portion of the commodities funded by USAID/Egypt and are performed perhaps only every three to five years.

The Mission stated that USAID project officers do not and are not required to verify the origin of commodities during site visits. However, they do play a role in the internal control system, for example, by identifying potential problem areas to be included in the scopes of work for financial or financial-related audits.

We agree that project officers do not and are not required to verify the origin of commodities during site visits. We make the same point on page 7 of this report.

The Mission pointed out that contractors may seek payment or reimbursement for commodities once the commodities are shipped from the United States. By the time the commodities arrive in Egypt, the contractors have already been paid.

We agree with the Mission that it may not be possible to verify the origin of commodities through physical inspection until after the contractor is paid. In such a case, if subsequent physical inspection of the equipment discloses an origin violation, the correct course of action would be for the Mission to issue a bill of collection to the contractor or deduct an equivalent amount from subsequent requests for payment submitted by the contractor.

Regarding the role played by construction managers, the Mission acknowledged that construction managers are required to certify that all payments requested by contractors are in accordance with the terms of their contract. However, the Mission noted that this certification is often made before the equipment has arrived in Egypt and is made without information on the cost of each component of the equipment.

We agree that construction managers may have to certify payments before they have the opportunity to physically inspect the equipment. In such a case, if subsequent physical

inspection discloses an origin violation, the construction manager would need to alert the Mission so that the Mission could obtain a refund from the contractor.

Comments on Recommendation 1.1

This recommendation was that USAID/Egypt issue a contractor notice reminding contractors and construction managers of their respective responsibilities for compliance with origin requirements. The Mission agreed with this recommendation and issued the contractor notice on February 7, 1994.

This recommendation is closed upon report issuance.

Comments on Recommendation 1.2

In our draft report, this recommendation was that USAID/Egypt require construction managers to implement a program of physical inspections to verify the origin of commodities financed with USAID funds and periodically report to USAID/Egypt on this effort. The Mission stated that it would make use of end-use check contractors to identify apparent violations of U.S. origin requirements.

In response to concerns expressed by the Mission, we have modified the recommendation to state that USAID/Egypt should "implement a program of physical inspections to verify the origin of those commodities financed by USAID which are most vulnerable to origin violations." Based on the action the Mission proposes to take, this recommendation is resolved.

Comments on Recommendation 1.3

In our draft report, this recommendation was that USAID/Egypt resolve \$2,708,979 in questioned costs, representing commodities with an ineligible origin purchased by contractors and paid for by USAID. In preparing this final report, we reclassified \$230,552 as unsupported costs which are now covered in recommendation 1.4. Therefore, recommendation 1.3 now deals with \$2,478,427 in questioned costs. The Mission accepted the recommendation as questioned costs but was not able to comment on the total amount to be recovered from contractors until it had made a determination on each item questioned.

Recommendation 1.3 is unresolved until USAID/Egypt and we agree on the amount to be recovered.

The Mission also commented on the specific items questioned due to origin violations as follows:

Tunnel Boring Machine, \$1,950,875 - The Mission said that it would forward this case to the Office of the General Counsel in USAID/Washington to determine an appropriate course of action.

Various Items, Total of \$85,465 - The Mission stated that, absent further documentation indicating that these items had an ineligible origin, it could not assert a claim on these items.

The manufacturer's nameplate identified these commodities as being produced outside the United States. For example, two generators were labeled "Made in Japan," eight computer central processing units were labeled "Made in Mexico," and eight computer monitors were labeled "Made in Korea." All of these items are clearly ineligible, and the Mission should recover the USAID funds spent on them from the contractors.

Telephone System, \$11,677 - The Mission stated that the contracting officer will make a final determination on this item.

Spare Parts for Generator, \$187,132 - The Mission stated that, had an origin waiver been requested for these spare parts, it would have granted the waiver. Therefore, the Mission did not intend to seek a refund for these items.

Various Items, Total of \$198,403 - The Mission stated that, absent further documentation indicating that these items had an ineligible origin, it could not assert a claim on these items.

This group of line items includes eight motors, valued at \$177,098, which were labeled "Taiwan." In addition, a January 16, 1992 letter from the contractor states that the origin of the motors is Taiwan. The other commodities in this group were all clearly labeled as "Made in Japan." The Mission should obtain refunds from the contractors for all the items in this group, which are clearly ineligible.

Pickup Trucks, \$21,168 - The Mission planned to assert a claim for these items but had not made a final determination.

Compressors, \$23,707 - The Mission stated that the contracting officer would make a final determination on these items.

Comments on Recommendation 1.4

This recommendation is that USAID/Egypt resolve \$230,552 in unsupported costs, representing items which may have had an ineligible origin. In our draft report, these were classified under recommendation 1.3 as questioned costs. The Mission stated that, absent further documentation indicating that these items had an ineligible origin, it could not assert a claim on these items.

Recommendation 1.4 is unresolved until the Mission and we agree on the amount to be recovered.

This recommendation includes two line items for which the commodities' major components were labeled as being produced outside the United States. We originally questioned the contractor about several other items which also had major components

made outside of the United States, but the contractor was able to obtain letters from the manufacturers that demonstrated that the items were eligible. However, the letters provided by the contractor did not show that the remaining two items were eligible. These two items are discussed below.

- A portable lighting plant valued at \$10,532 contained an engine made in Japan and a generator made in England. These appeared to be the major components of the portable lighting plant. According to a letter from the manufacturer, these foreign components amounted to only 49.9 percent of the price of the lighting plant. However, the letter did not specify (1) the cost of the foreign components delivered to the point of production or (2) the lowest price at which the supplier makes the lighting plant available for export sale. Therefore, USAID/Egypt should either obtain additional supporting documentation demonstrating that this item was eligible or seek a refund for this item.
- Two generators valued at \$220,020 contained engines made in Great Britain. A letter provided to us by the contractor stated that the U.S. content of the generators, together with a separate switch gear which we were not questioning, was 53.2 percent. This letter was insufficient to demonstrate compliance because it (1) added to the cost of the generators other equipment which we did not question, (2) did not specify the cost of the foreign components of the generators delivered to the point of production, and (3) did not specify the lowest price at which the generators are made available for export sale. The Mission should seek additional supporting documentation or obtain a refund for these items.

Comments on Recommendation 2

This recommendation was that USAID/Egypt resolve \$37,869 in questioned costs representing items with an ineligible source. The Mission stated that the contracting officer would make a final determination on these items.

Recommendation 2 is classified as unresolved until the Mission determines the amount to be recovered.

Additional details on all the questioned items discussed above are included in Appendix III.

Summary of USAID Policies on Source and Origin

Contracts financed by USAID state where the contractor must purchase any commodities needed to perform the contract. Usually, this is done by specifying the eligible "source" and "origin" for commodities purchased under the contract.

"Source" is the country from which a commodity is shipped to the cooperating country. For example, if an automobile is shipped from the United States to Egypt, the source is the United States. If a commodity is shipped to the cooperating country from a free port or bonded warehouse, the source is the country from which the commodity is shipped to the free port or bonded warehouse.

"Origin" is the country in which a commodity is grown, mined, or produced. A commodity is produced when, through manufacturing, processing, or substantial and major assembling of components, a commercially-recognized new commodity results that is substantially different in basic characteristics or in purpose or utility from its components. For example, assembly of an engine, chassis, sheet metal, and so on to make an automobile would constitute production of a commodity. Adding items such as a more powerful engine, radio, and air conditioner to an existing automobile would not constitute production of a commodity because no commercially-recognized new commodity has been created: the automobile is still an automobile. In addition, merely packaging various items together for a particular procurement does not constitute production of a commodity.

"Components" are the goods that go directly into the production of a manufactured commodity. USAID componentry rules for manufactured commodities from eligible source countries are as follows:

- Any component from a non-free world country (e.g., Libya or Vietnam) makes the commodity ineligible for USAID financing.
- Foreign components are limited if the producer acquired them in the same form they were imported. The total cost of such foreign components, delivered to the point of production of the commodity, may not exceed 50 percent of the lowest price (excluding the cost of ocean transportation and marine insurance) at which the supplier sells the commodity for export.

Generally, the componentry rules are applied to each individual commodity. However, for kits such as a tool kit, the componentry rules are applied to the kit as a whole, not to each individual item in the kit. Similarly, for a shipment of spare parts, the componentry rules are applied to the shipment of spare parts as a whole, not to each individual part. Finally, when a "package installation" is procured as a single item (as

in the case of a turnkey contract for a power plant), USAID may authorize the componentry rules to be applied to the installation as a whole.

Information on USAID's source and origin policies is found in USAID Handbook 1, Supplement B, Chapter 5 and USAID Handbook 15, Chapter 2.

Summary of Review of Source

Description	Reviewed	Could Not Determine Source	Complied with Requirements	Did Not Comply with Requirements
<u>Cairo Sewerage II Project</u>				
Contract No. 29	\$6,781,497	\$0	\$6,781,497	\$0
Contract No. 31	6,334,591	0	6,334,591	0
Contract for Consulting Engineering Services	311,490	3,200	308,290	0
Contract No. 263-0173-C-00-8073 ¹	37,869	0	0	37,869
<u>Alexandria Wastewater Project</u>				
Contract No. 4/5	2,703,329	0	2,680,958	22,371
Contract No. 7	2,390,699	0	2,390,699	0
Contract No. 263-0100-C-00-6051	<u>75,688</u>	<u>0</u>	<u>75,688</u>	<u>0</u>
	<u>\$18,635,163</u>	<u>\$3,200</u>	<u>\$18,571,723</u>	<u>\$60,240</u>
<p>(1) The amount reviewed consists of local currency purchases converted at the same exchange rates paid by A.I.D. These rates ranged from L.E. 2.30 to L.E. 2.57 per dollar. The contract required that all commodities be purchased in and shipped from the United States.</p>				

Summary of Review of Origin

Description	Reviewed	Could Not Determine Origin	Complied with Requirements	Did Not Comply with Requirements	May Not Comply with Requirements
<u>Cairo Sewerage II Project</u>					
Contract No. 29 ¹	\$6,603,005	\$4,087,548	\$2,130,059	\$385,398	\$0
Contract No. 31 ²	5,060,156	2,904,040	2,132,409	23,707	0
Contract for Consulting Engineering Services	311,490	63,267	226,918	21,305	0
Contract No. 263-0173-C-00-8073 ³	0	0	0	0	0
<u>Alexandria Wastewater Project</u>					
Contract No. 4/5	2,708,329	2,331,518	369,832	6,979	0
Contract No. 7	2,390,699	95,810	94,358	1,969,979	230,552
Contract No. 263-0100-C-00-6051	<u>109,388</u>	<u>14,828</u>	<u>23,501</u>	<u>71,059</u>	0
	<u>\$17,183,067</u>	<u>\$9,497,011</u>	<u>\$4,977,077</u>	<u>\$2,478,427</u>	<u>\$230,552</u>

- (1) The amount reviewed includes local currency purchases equivalent to \$69,687 using the exchange rates in effect when the purchase orders were issued. These rates range from L.E. 2.65 to L.E. 3.34 per dollar.
- (2) The amount reviewed includes local currency purchases equivalent to \$207,460 using the exchange rates in effect when the purchase orders were issued. These rates range from L.E. 2.18 to L.E. 2.40 per dollar.
- (3) This contract required that all commodities be purchased in and shipped from the United States, but did not include an origin requirement.

Items with Ineligible Source or Origin

Description	Cost (\$)	Comments
Cairo Sewerage II Project		
Contract 29		
Diesel-electric generator system (Purchase order 90388 dated 10/29/90)	187,132	One of the items included in this \$2.3 million procurement, a package of spare parts and tools that contained 100 percent foreign components, had an ineligible origin.
(8) Teco 3 phase induction motors, type AFHCXX (Purchase order 90391 dated 10/17/90)	177,098	The origin of these motors was Taiwan. (During installation in Egypt, the motors were connected to vertical lift pumps made in the United States to form eight pump sets. However, for purposes of determining compliance with source/origin requirements, the motors should be considered separate commodities since the motors and pumps were purchased from separate suppliers through separate purchase orders and were shipped to Egypt separately).
(2) 1990 Chevrolet pickup trucks (Purchase order 56 dated 9/23/90)	21,168	The trucks had a tag that said "General Motors Egypt." We concluded that they were assembled in Egypt. Article 29.3 of the general conditions of the contract restricts procurement of motor vehicles to those manufactured in the United States. Also, Article 29.3 states that parts or subassemblies shipped from the United States for final assembly in other countries are not considered motor vehicles manufactured in the United States. (Local purchase of L.E. 58,000.)

Items with Ineligible Source or Origin

Description	Cost (\$)	Comments
Contract 31		
(2) Atlas Copco compressors, model XA60Dd (Purchase order 143 dated 12/13/88)	23,707	The compressor unit we inspected had a tag stating that it was made in Belgium. The largest component of the compressor was a Deutz engine which said it was made in Germany. (Local purchase of L.E. 55,000.)
Contract for Consulting Engineering Services		
Wang laser printer	4,000	Made in Japan.
(2) Wang dot matrix printers	2,900	Made in Japan.
Sony video camera	10,753	Made in Japan.
Sony portable video recorder	3,652	Made in Japan.
Contract 263-0173-C-00-8073		
Xerox photocopier	12,652	This item was purchased in Egypt. The main unit was made in the United Kingdom and the document feeder was made in Canada. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 29,100.)

Items with Ineligible Source or Origin

Description	Cost (\$)	Comments
Typewriter	1,022	This item was purchased in Egypt. The nameplate says "Sirx; Neuville en Ferrain; France." The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 2,350.)
Telephone system	6,000	This item was purchased in Egypt and made in Japan. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 13,800.)
Air conditioner (split unit)	1,593	This item was purchased and made in Egypt. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 3,665.)
Air conditioner (split unit)	1,113	This item was purchased and made in Egypt. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 2,865.)
Air conditioner (split unit)	1,113	This item was purchased and made in Egypt. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 2,865.)

Items with Ineligible Source or Origin

Description	Cost (\$)	Comments
Air conditioner (split unit)	1,384	This item was purchased and made in Egypt. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 3,565.)
Window air conditioner	780	This item was purchased in Egypt. The origin could not be determined through physical inspection. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 1,795.)
Window air conditioner	734	This item was purchased in Egypt. The origin could not be determined through physical inspection. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 1,890.)
Window air conditioner	734	This item was purchased in Egypt. The origin could not be determined through physical inspection. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 1,890.)

Items with Ineligible Source or Origin

Description	Cost (\$)	Comments
Window air conditioner	582	This item was purchased and made in Egypt. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 1,350.)
IBM computer equipment: CPU, monitor, keyboard, printer, and modem	10,162	This equipment was purchased in Egypt. The CPU was made in Scotland, the monitor in Taiwan, the keyboard in the United Kingdom, and the printer in the Netherlands. The origin of the modem could not be determined. The contract states that, except as specifically approved or directed in advance by the contracting officer, all goods shall be procured in and shipped from the United States. (Local purchase of L.E. 23,575.)
Alexandria Wastewater Project		
Contract 4/5		
Laser printer	1,979	Made in Japan.
Overhead crane (5 ton)	5,000	Made in Germany.
Primavera software	22,371	The software was shipped from the United States to Germany and then reportedly hand-carried to Egypt. Therefore, technically, the source is Germany. (Due to the technical nature of this violation, we are not questioning the cost of this software.)

Items with Ineligible Source or Origin

Description	Cost (\$)	Comments
Contract 7		
Kubota generator	9,552	Made in Japan.
Kubota generator	9,552	Made in Japan.
Coleman portable lighting plant	10,532	The two major components of this equipment were made outside the United States: the engine was made in Japan and the generator was made in England. (Classified as an unsupported cost.)
(2) Cummins diesel generator sets	220,020	No indication where the generator sets were made. For the generator set we inspected, the engine said "Manufactured by Cummins Engine Co., Ltd. Great Britain." The generator itself was made in the United States. (Classified as an unsupported cost.)
Lovat tunnel boring machine, jacking station, and conveyor	1,950,875	We were told that this equipment was assembled in Canada using primarily U.S. components. Equipment assembled or manufactured outside the United States does not meet U.S. origin requirements, regardless of where the components are from.
Contract 263-0100-C-00-6051		

Items with Ineligible Source or Origin

Description	Cost (\$)	Comments
(7) IBM Personal System 2 computer systems (model 55SX-61 including CPU, monitor, and keyboard)	39,711	CPU made in Mexico; monitor made in Korea; keyboard made in United States.
IBM Personal System 2 computer system (model 70-A21 including CPU, monitor, and keyboard)	9,121	CPU made in Mexico; monitor made in Korea; keyboard made in United States.
QMS PS-820 Turbo Laser Printer	4,224	Made in Japan.
HP LaserJet IIIP laser printers	2,994	Made in Japan.
QMS PS-410 printer	2,343	Made in Japan.
HP ScanJet Plus scanner	989	Made in Japan.
Telephone system	11,677	Made in Japan. (Local purchase of L.E. 38,650.)
TOTAL	2,769,219	

SCOPE AND METHODOLOGY

Scope

We conducted our audit in accordance with generally accepted government auditing standards. These standards require auditors to obtain written representations from management when they deem them useful. The Office of Inspector General deems such representations necessary to support potentially positive findings. USAID/Egypt's Director provided us a management representation letter for the audit that contained essential assertions about the activities we audited. However, USAID/Egypt officials directly responsible for these activities did not provide written representations. As a result, our answer to the audit objective is qualified to the extent of the effect, if any, of not having such representations.

We performed the audit from May through October 1993. The audit covered certain contracts that were active as of April 30, 1993 and covered certain waivers of source and origin requirements that were approved since October 1, 1989. We performed the audit in the offices of USAID/Egypt and at the offices and worksites of six contractors in Cairo and Alexandria, Egypt.

Our tests for verifying the source of commodities covered \$18.6 million in commodities, and our tests for verifying origin covered \$17.2 million in commodities. These amounts cannot be readily compared to the universe of all commodities financed by USAID/Egypt because USAID/Egypt does not have an inventory of commodities and its accounting system does not separately account for commodities. Nor can these amounts be readily compared to the universe of all commodities purchased under the contracts we reviewed, since one contractor (which had two contracts) did not have an inventory which included the cost of the commodities purchased. (For the five remaining contracts, where inventories with dollar costs were available, we reviewed \$5.5 million of the total \$17.5 million in commodities purchased by the contractors.)

We limited our conclusions to the items we actually tested. That is, we did not attempt to project the results of our tests to the universe of all commodities purchased by the contractors, to the universe of all commodities financed by USAID/Egypt, or to the universe of all waivers approved by USAID/Egypt.

We conducted an assessment of USAID/Egypt's system of internal controls for ensuring that origin requirements were met. We assessed the specific internal control procedures described on pages 5 and 7 of this report. To perform this assessment, we obtained an understanding of USAID/Egypt's system for ensuring compliance with origin requirements, determined whether the significant controls had been placed in operation, and assessed control risk. We did not assess USAID/Egypt's system of internal controls for ensuring that source requirements were met because the dollar value of the source violations we found was very small and the violations all dated from 1990 and 1991.

For the purpose of testing compliance with source and origin requirements, we drew samples from inventories and other information provided by the contractors. We did not verify that the information they provided us was complete or accurate. However, during our inspections, when we found equipment that was not listed in the inventories, we determined the reasons for the omissions. Also, in a handful of cases, commodities we had selected for review could not be located by the contractors. In our opinion, these limitations did not affect the results of our audit.

Methodology

The tests we performed were based on judgmental samples. We relied on judgmental samples because the results of our tests of the sampled items, in conjunction with our assessment of USAID/Egypt's internal controls, were sufficient to show whether significant source/origin violations existed and to determine why these violations occurred.

Our tests covered two projects managed by USAID/Egypt's Development Resources Directorate, Urban Administration and Development Office: the Alexandria Wastewater System Expansion Project (No. 263-0100) and the Cairo Sewerage II Project (No. 263-0173). According to USAID/Egypt records, these two projects had combined expenditures of \$923.1 million as of March 31, 1993, or 83 percent of the expenditures for all seven projects managed by DR/UAD. These two projects are also the largest active projects in USAID/Egypt's portfolio and account for 25 percent of the expenditures under all mission projects ending in fiscal year 1993 or later. We selected these projects judgmentally, on the basis that they (1) involved the purchase of a substantial amount of equipment and (2) had a wider variety of types of active contracts than other projects we could have selected.

Within these two projects, we selected seven contracts for review. For the Alexandria Wastewater Project, we selected all three active contracts financed by the project. For the Cairo Sewerage II Project, we selected four of the eight active contracts over \$1 million. In consultation with the project officer, we selected those contracts that involved substantial purchases of manufactured equipment as opposed to low value-added products such as gravel, concrete, and pipe.

For each contract we selected, we judgmentally selected equipment for review, aiming to select the higher-risk items. In assessing risk, we primarily considered the dollar value and the type of item purchased. Generally, we reviewed high value-added items with a relatively high cost.

For each item selected, we determined the applicable source and origin requirements by reviewing the relevant contract provisions. We verified the source by examining the relevant shipping document (bill of lading or airway bill). We verified the origin by physically inspecting each item of equipment to see if the manufacturer's nameplate showed where the item was manufactured. Where these steps indicated that an item might have an ineligible source or origin, we discussed the items with the contractors and reviewed additional information such as correspondence from manufacturers describing the U.S. and foreign components of certain items.

To determine whether waivers were justified and approved in accordance with USAID procedures, we reviewed all 12 waivers approved under the Alexandria Wastewater and Cairo Sewerage II projects since October 1, 1989. (For comparison, 36 waivers were approved under all mission projects since October 1, 1989.) We determined whether each waiver was reviewed and approved by appropriate officials as required by USAID Delegation of Authority No. 653 and Mission Order No. 5-4. We also verified the factual basis for 10 of the 12 waivers by comparing the information in the waivers to other correspondence and documentation we obtained from the contractors, the Office of Procurement in USAID/Washington, and manufacturers and suppliers in the United States.

In reaching conclusions based on our tests, we considered errors or violations exceeding 5 percent of our sample (by dollar value) to represent significant non-compliance. We considered errors or violations amounting to less than 5 percent of our sample to be insignificant. This threshold reflects our judgment concerning the degree of compliance that is practical and achievable.



UNITED STATES AGENCY for INTERNATIONAL DEVELOPMENT

CAIRO, EGYPT

January 23, 1994

MEMORANDUM

RECEIVED
23 JAN 1994

TO: Philippe L. Darcy, RIG/A/C
CD

FROM: Christopher D. Crowley, D/DIR

SUBJECT: Audit on the Source and Origin of Commodities Purchased Under the Alexandria Wastewater and Cairo Sewerage II Projects - *Draft Report*

The Mission has reviewed the audit report and disagrees with the auditors' statement that USAID did not ensure that origin requirements were met. We disagree with the auditors description of our internal control system as documented on pages 11 and 12 of the report and accordingly, their conclusions with respect to origin requirements. We do agree that commodities of ineligible origin valued at approximately \$2.2 million were purchased under the project. However, we believe that the internal control procedures as presented below provide cost effective and reasonable assurance that origin requirements are met. Due to the nature of our business, the internal control system instituted is reactive in nature, and relies predominantly on the audit function. This audit has accomplished this internal control objective. We shall evaluate each violation to determine the damages suffered by the U.S. Government as a result of non-compliance with this contract provision, and the cost/benefits of asserting a claim against the contractor. Where the projected benefits exceed the projected cost of asserting a claim, we shall seek reimbursement from the contractor.

The audit objective, "Did USAID/Egypt ensure compliance with USAID policies and procedures and contract requirements concerning the source and origin of project commodities," is subject to different interpretations, especially with respect to what is meant by the word "ensure." The auditors seem to view this as a requirement to guarantee, while management thinks in terms of reasonable assurance.

The Mission has established an internal control system (not properly reflected on pages 11 and 12 of the report) based on its understanding of the business and the relevant risks. These were enumerated at the exit conference, but have not been fully incorporated in this report. They are presented below.

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As stated in the audit report, USAID has established policies which require that all commodities procured with AID funds have their source and origin in the U.S., in response to Section 604(a) of the Foreign Assistance Act. Accordingly, USAID/Egypt has ensured that all Grant Agreements include a source/origin clause. In recognition of the fact that the assistance takes place in Egypt, and the fact that local cost financing is envisioned in our project documents, Egypt is also included as an eligible country for source/origin purposes, in accordance with AID regulations and policies. Commodities are usually procured from U.S. suppliers by U.S. contractors. A contract is classified as a direct contract when AID is a party to the contract and a host country contract when the Government of Egypt (GOE) is the contracting party, and AID a financier, and accordingly not a party to the contract. In either case, AID usually ensures that there is an explicit or implicit understanding that all commodities financed by AID must be of U.S. (or in certain cases Egyptian) source and origin. In all contracts the source/origin requirement is implicit and AID ensures that this clause is explicitly stated, when possible.

When commodities are financed by AID, the shipping terms usually state "FOB" (Free on Board) where title passes to the GOE when the commodities are placed on a common carrier. Commodities are usually sent by sea, and the commodities arrive at the site approximately 45 to 60 days after the issuance of the bill of lading. By the time the goods come into Egypt, the contractors have received payment. (Shipping FOB makes economic sense to AID as AID would have to pay finance charges if the shipping terms were changed to ensure that payment was made only after the goods were inspected.)

All AID direct contracts call for a certified statement from the contractor in order to support their claim for payment submitted to AID. Under host country contracts, where AID is a financier, the contractor's claim for payment or reimbursement is supported by "The Supplier's Certificate and Agreement with The Agency For International Development For Project Commodities/Invoice and Contract Abstract" (AID Form 1450-4). These certificates provide USAID a basis for asserting a claim against the supplier should it be determined that they contain false information or certifications. Payment documents required of the contractors also call for submission of copies of bills of lading which satisfy the AID shipping requirements. However, they also provide information on the source of commodities.

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Contracts have a myriad of clauses, source/origin being merely one of them. While source is often easily determined, origin is not. Appendix 1 provides a basic synopsis of USAID's policies on Source and Origin. However, given the definition of componentry, it is not feasible to determine if a commodity's origin is in fact, the U.S., until the cost figures are audited. Handbook 11 Chapter 2 Section 2.5.4.1c(2)b), and in all material respects in Appendix 1, states: "The total cost of such components to the producer of the commodity (delivered to the point of production of the commodity) may not exceed 50 percent of the lowest price (excluding the cost of ocean transportation and marine insurance) at which the supplier makes the commodity available for export sale (whether or not financed by AID)" Under this definition, a producer could purchase all components for a product from any free world or Code 935 country for say \$50, assemble them in the U.S. and still meet the origin requirement provided that the export price, excluding the cost of ocean transportation and marine insurance is \$101.

At the time of payment, USAID, for all intents and purposes, is able to verify the source of goods. However, given the complexity of origin and componentry rules, the origin requirements can, in most instances, only be verified through audit, where costs can be reviewed and a proper determination made.

Given the above, USAID's primary internal control with respect to verifying the origin of commodities rests with the audit function. The statements made on pages 11 and 12 of the report with regard to AID'S internal control system with respect to commodities is at best incomplete. USAID project officers do not, and are not required to verify the origin of commodities during site visits, simply because it is not feasible, nor a cost effective use of time. (The auditors were unable to determine the origin of over 50% of the commodity costs reviewed.) Construction Managers (Engineer) or the Contracting Agency usually provide the following certification with respect to all vouchers submitted by the host country construction contractors: "The (Name of Contracting Agency or Engineer) certifies that (1) the services or equipment and materials) for which payment is requested have been satisfactorily performed (delivered) and (2) the payment requested is in accordance with the terms of the contract."

As stated before, the Engineer's certification is often provided before the goods arrive at the work site and without the benefit of many of the pertinent facts, including cost accounting information. Due to cost/benefit considerations, USAID does not require compliance with construction contract provisions as a specific deliverable under construction management contracts, and accordingly, do not finance specialists to monitor source/origin and other contract provisions. Project officers, through site visits, and Engineers by virtue of their presence, do play a role in USAID's internal control system with respect to compliance with source/origin requirements. They are charged with project implementation and expected to identify potential problems to be included in the scopes of work for financial or financial related audits.

Recommendation No. 1: We recommend that USAID/Egypt:

- 1.1 issue a contractor notice reminding contractors and construction managers of their respective responsibilities for compliance with origin requirements,
- 1.2 require construction managers to implement a program of physical inspections to verify the origin of commodities financed with USAID funds and periodically report to USAID/Egypt on this effort, and
- 1.3 resolve \$2,708,979 in questioned costs, representing commodities with ineligible origin purchased by contractors and paid for by USAID.

Mission Response:

- 1.1 The Mission agrees with this recommendation and will issue a contractor notice shortly.
- 1.2 The Mission disagrees with this recommendation. As stated earlier, origin cannot be determined by physical inspections alone. It is not possible for a project officer or a construction manager to determine origin of commodities solely through visual inspections. To make this a construction manager responsibility would be costly and unlikely to result in commensurate benefits. We believe this is best performed through audit function where the expertise and the responsibility currently lies.

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- 1.3 We accept this recommendation regarding questioned costs. However, we are unable to determine the resultant savings that will accrue to the U.S. Government until the appropriate determinations are made. We provide the following information with respect to the origin violations.

Alexandria Waste Water Project:

Contract # 7:

Tunnel Boring Machine, \$ 1,950,875¹: This contractor owned item accounts for approximately 70% of all the questioned costs. The tunnel boring machine was procured by the contractor for his use on the project and remained his property after the work was completed. Under the terms of the contract this item had to be of U.S. source and origin. The machine was shipped out of the U.S. but it was manufactured in Canada. Therefore, it meets the source, but violates the origin requirement. The supplier provided the contractor with a statement indicating that the goods met USAID's origin requirements. This was incorrectly deemed adequate by the Contractor, who certified that origin requirements were satisfied. The Engineer questioned the origin requirement, reviewed the supplier's certification and administratively approved the voucher for payment. AID effected payment under this host country fixed price contract, based on these certifications.

What damage has the U.S. suffered as a result? This question can only be answered by a close examination of the facts. The intent of the origin requirement as stated in Handbook 1 Sup B 5B states that: "To make the 'Source' rule a meaningful economic measure, in assisting U.S. producers and labor and the U.S. balance of payments, AID prescribed an 'origin' test in 1960." The auditors have not contested the assertion of the manufacturer that over 50% of the value of the goods came from the U.S. and therefore, accomplished the primary objectives of the origin test as stated above. Furthermore, the USG received value, even though the tender was imperfect, in that the work was performed using this

¹ While this was the original cost of the item, the value expended on the contract would be equal to its depreciation during the contract.

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piece of equipment. Although the Mission is unable to quantify the damage borne by USAID, the contractor did violate an AID Policy enacted to implement a law. The Mission will therefore forward the case to USAID/W/GC to determine an appropriate course of action.

In addition, the contractor has made certifications as to origin which have proved to be incorrect. We shall notify RIG/I of this fact and ask that they take appropriate action.

Based on this analysis and these proposed actions we request that this recommendation be closed.

Contract # 7:

Kubota Generator -	\$ 9,552.00
Kubota Generator -	\$ 9,552.00
Coleman portable Lighting Plant -	\$ 10,532.00
2 Cummins Diesel Generator Sets -	\$ 220,020.00

Contract # 4/5:

Laser Printer -	\$ 1,979.00
Overhead Crane -	\$ 5,000.00

Contract # 263-0100-C-00-6051:

7 IBM Personal System 2 Computers -	\$ 39,711.00
IBM Personal System 2 Computers -	\$ 9,121.00
QMS PS-820 Turbo Laser Printer -	\$ 4,224.00
HP LaserJet IIIP Laser Printer -	\$ 2,994.00
QMS PS-410 Printer -	\$ 2,343.00
HP ScanJet Plus Scanner -	\$ 989.00

These commodities were of U.S. source. However, we have conflicting views with respect to their origin. The suppliers have certified that these items have met the U.S. origin requirements. On the other hand, the audit states that these items were labeled as having been made in various 935² countries

² Had they been labeled as being made in non-Free world countries, they would have been ineligible for financing under USAID's componentry rules.

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and therefore, do not meet the U.S. origin requirements. The Mission does not believe labeling is a clear indication of origin. A label may relate to only one component, not the product as a whole. A product manufactured by a non-U.S. firm may have been "produced" in the U.S. and met the componentry rules. Therefore, absent further documentation that the suppliers have not met the origin requirements (see AIDHandbook 1 5B1c. and the definition contained in Appendix 1 of the draft report), we are unable to assert claims on these items. We believe that this determination can best be made by, and is required of, non-Federal auditors as part of their audit function.

We shall notify IG/I/CFO of these procurements and ask that they take appropriate action to determine if false certifications were provided to AID by the contractor or suppliers.

Contract # 263-0100-C-00-6051:

Telephone System - \$ 11,677.00

This item is a local procurement which exceeds the \$5,000 limitation. The contractor should have requested the Contracting Officer's prior approval. Before we assert a claim, we need to determine if appropriate justification exists for a retroactive waiver. If the waiver cannot be adequately justified by the contractor, a claim shall be asserted. The Contracting Officer shall make a final determination with respect to these items later and forward his/her decision to you requesting resolution and closure of this audit recommendation.

Cairo Sewerage II Project:

Contract # 29:

Diesel-Electric Generator - \$187,132

The U.S. source/origin generator, procured under this project included a British engine. The spare parts package for this project included parts for this British made engine. The contractor has violated contract requirements which call for AID prior approval. However, had a waiver been requested it would have been granted as the parts for the British engine are not manufactured in the United States. We shall not assert a claim with respect to this violation.

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8 Teco 3 Phase induction motors	- \$177,098.00
Wang laser Printer	- \$ 4,000.00
2 Wang Dot Matrix Printers	- \$ 2,900.00
Sony Video Camera	- \$ 10,753.00
Sony Portable Video Recorder	- \$ 3,652.00

These commodities were of U.S. source. However, we have conflicting views with respect to their origin. On one hand, the suppliers have certified that these items have met the U.S. origin requirements. On the other hand, the audit states that these items were labeled as made in various 935³ countries and therefore, do not meet the U.S. origin requirements. As previously stated the Mission does not believe labeling can be considered conclusive proof of origin. Therefore, absent documentation that the supplier's have not met the origin requirements (see AID Handbook 1 5B1c. and the definition contained in Appendix 1 of the draft report), we are unable to assert a claim against. We believe that this work can best be performed by, and is required of non-Federal auditors as part of their audit function.

We shall notify IG/I/CFO of these procurements and ask that they take appropriate action to determine if false certifications were provided to AID by the contractor or suppliers.

2 1990 Chevrolet Pickup Trucks - \$21,168.00

We intend to assert a claim on this item. On initial review, it appears that we would not have provided a waiver for the procurement of non-U.S. vehicles. We need to communicate with the contractor prior to asserting a claim.

Contract # 31:

2 Atlas Copco Compressors	-	\$ 23,707.00
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Contract 263-0173-C-00-8073

Xerox Photocopier	-	\$ 12,652.00
Typewriter	-	\$ 1,022.00
Telephone System	-	\$ 6,000.00

³ See Footnote 2.

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Air Conditioner (split unit)	-	\$	1,593.00
Air Conditioner (split unit)	-	\$	1,113.00
Air Conditioner (split unit)	-	\$	1,113.00
Air Conditioner (split unit)	-	\$	1,384.00
Window Air-Conditioner	-	\$	780.00
Window Air-Conditioner	-	\$	734.00
Window Air-Conditioner	-	\$	734.00
Window Air-Conditioner	-	\$	582.00
IBM Computer Equipment	-	\$	10,162.00

These are all local procurements that may have been approved by the Contracting Officer, if appropriately justified. The Contracting Officer shall obtain pertinent information from the contractor and make a final determination as to whether a retroactive approval is appropriate for each of these items.



CAIRO EGYPT

03 MAR 1994

MEMORANDUM

RECEIVED
6 MAR 1994

TO: Philippe L. Darcy, RIG/A/C

FROM: Christopher D. Crowley, ^{ITC} A/DIR

SUBJECT: Audit on the Source and Origin of Commodities Purchased Under the Alexandria Wastewater and Cairo Sewerage II Projects - Addendum to Response Provided on January 23, 1994

REF.: Wijesooriya/Darcy Meetings of February, 1994

Based on the referenced discussions, it has been brought to my attention that we had not fully addressed the issue of identifying potential origin violations through end-use checks. Please be informed that we shall amend the reports and/or scopes of work of our end-use check contractors to identify apparent violations of U.S. Origin requirements. Based on the materiality of these amounts, we shall take action to resolve them by notifying AID/IG/I or AID/IG/A.

APPENDIX VI**REPORT DISTRIBUTION**

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