USAID
FROM THE AMERICAN PEOPLE

OFFICE OF INSPECTOR GENERAL

CLOSE-OUT AUDIT OF THE USAID RESOURCES MANAGED BY THE COMMERCIAL BANK OF ERITREA AND THE RURAL ENTERPRISE UNIT UNDER PROJECT NUMBER 661-0009 FOR THE PERIOD JANUARY 1, 2004 TO DECEMBER 31, 2005

AUDIT REPORT NO. 4-661-07-002-N
December 19, 2006

PRETORIA, SOUTH AFRICA

Financial information in this report may be privileged. The restrictions of 18 USC 1905 should be considered before any information is released to the public.

USAID
FROM THE AMERICAN PEOPLE

Office of Inspector General

December 19, 2006

MEMORANDUM FOR MISSION DIRECTOR, USAID/East Africa, Cheryl Anderson

FROM: Acting Regional Inspector General/Pretoria, Matthew P. Rathgeber

SUBJECT: Close-Out Audit of the USAID Resources Managed by The Commercial Bank of Eritrea and The Rural Enterprise Unit under Project Number 661-0009 for the period January 1, 2004 to December 31, 2005 (Report No. 4-661-07-002-N)

This memorandum transmits the subject report prepared by Agency-Contracted auditor, PricewaterhouseCoopers (Nairobi, Kenya)

The audit was performed in accordance with the U.S. Comptroller General's Government Auditing Standards. The audit had scope limitations that PricewaterhouseCoopers does not have continuing professional education and external quality control review programs that fully satisfy the requirements set forth in U.S. Government Auditing Standards.

The Investment Partnership Agreement (REIP) program provided $19,332,634 in grant funds to the Government of the State of Eritrea (GSE) over an eight year period with the objective of Increased Income of Enterprises through the Commercial Bank of Eritrea's (CBER) Enterprise Investment Fund (EIF) Lending and small and Medium Enterprise Loan program managed by the Rural Enterprise Unit. On October 1, 2005, USAID terminated funding and support for the REIP, including REU's Program and Operations and the Enterprise Investment Fund (EIF). Although USAID funding was terminated on October 1, 2005, the audited period was from January 1, 2004 to December 31, 2005 as per the requirements of the Statement of Work. The audit covered $1,270,103 in expenditures of USAID funds.

In accordance with the requirements of USAID's Automated Directives System (ADS) 591.3.3.2 (revised 2004) PricewaterhouseCoopers (Nairobi, Kenya) was contracted to perform a close-out audit of the program. The specific objectives of the review included:

- Expressing an opinion on whether the fund accountability statement for the USAID-funded programs presents fairly, in all material respects, revenues received, costs incurred, and commodities and technical assistance directly procured by USAID for the period audited in conformity with the terms of the agreements and generally accepted accounting principles or other comprehensive basis of accounting (including the cash receipts and disbursements basis and modifications of the cash basis).

- Evaluating and obtaining a sufficient understanding of the recipient's internal controls related to the USAID-funded programs, assess control risk, and identify reportable conditions,

U.S. Agency for International Development
100 Totius Street
Groenkloof X5
Pretoria 0181, South Africa
www.usaid.gov

including material internal control weaknesses. This evaluation must include the internal controls related to required cost-sharing contributions.

- Performing tests to determine whether the recipient complied, in all material respects, with agreement terms (including cost sharing, if applicable) and applicable laws and regulations related to USAID-funded programs. All material instances of non-compliance and all illegal acts that have occurred or are likely to have occurred must be identified. Such tests must include the compliance requirements related to required cost-sharing contributions, if applicable.

- Determining if the recipient has taken adequate corrective action on prior audit report recommendations, if any.

The auditors rendered a qualified opinion on the Fund Accountability Statement. The audit disclosed the following:

- Total questioned costs of $286,439 ($177,517 ineligible due to costs that are unallowable by the agreement, cost principles and are in excess of the program's budget; and $108,922 unsupported due to costs not being adequately supported as required by the cost principles).

- Fourteen internal control weaknesses, eight of which were considered material:

  1) The Board of Advisors did not hold meetings once every six months as required by REIP Operational Manual.
  2) Incurred costs not adequately supported.
  3) Failure to maintain a vehicle log book form for project vehicles.
  4) Payment vouchers and other supporting documentation are not stamped "PAID" after payment was processed.
  5) Ineligible costs – International personal costs.
  6) Disbursements in excess of budget.

  The following weaknesses were considered material:

  7) Employees' register is not adequately maintained.
  8) Inadequate monitoring of loans:
     a) Non-compliance with requirements for the submissions of financial statements.
     b) Failure to maintain frequent contact with borrowers.
  9) No quarterly reports prepared to the Advisory Board in 2004 and 2005.
  10) No collateral was obtained for loans over Nakfa 50,000 (US$3,333).
  11) Non-renewal of insurance policies on collateral.
  12) Collateral was not timely valuated.
  13) Misclassification of loans.
  14) Securities were not supported by title documents.

- One instance of material noncompliance related to lack of a timely audit of fiscal year 2004.

Therefore, we are making the following recommendations:

<u>Recommendation No. 1:</u> We recommend that USAID/East Africa determine the allowability of $177,517 in questioned ineligible costs and $108,922 in questioned unsupported costs detailed on page 14 of PricewaterhouseCoopers' audit report, and

recover from the Commercial Bank of Eritrea and Rural Enterprise Unit any amount determined to be unallowable.

Recommendation No. 2: **We recommend that USAID/East Africa ensure that the recipient corrects the fourteen reportable internal control weaknesses detailed on pages 22 - 42 of the PricewaterhouseCoopers report.**

Recommendation No. 3: **We recommend that USAID/East Africa ensure that the recipient corrects the one instance of material noncompliance detailed on page 45 of the PricewaterhouseCoopers report.**

In accordance with USAID's Automated Directives System (ADS) 595.3.1.1.a and 595.3.1.5.a, an audit recommendation without management decision may be elevated three months after issuance. Contract, Grant, or Agreement Officers make management decisions on questioned costs and procedural audit recommendations resulting from Office of Inspector General (OIG) desk reviews of financial audits of contractors and grantees. Mission Directors make management decisions for audit recommendations pertaining to Strategic Objective Grant Agreements that he/she signs. Please have the responsible official provide RIG/Pretoria with written notice within 30 days on any information related to actions planned or taken to implement the recommendations in this report.

AGENCY-CONTRACTED CLOSE-OUT AUDIT OF USAID RESOURCES MANAGED BY THE COMMERCIAL BANK OF ERITREA AND THE RURAL ENTERPRISE UNIT

PROJECT NUMBER 661-0009

FOR THE PERIOD JANUARY 1, 2004 TO DECEMBER 31, 2005

AUGUST 2006

TABLE OF CONTENTS

		Page
1	**Introduction**	**1**
	1.1 Background	1
	1.2 Overall roles and responsibilities of CBER	1
	1.3 Diagrammatic representation of the flow of funds and reporting	3
	1.4 Audit objectives, scope and methodology	6
	1.5 Summary of the audit results	9
	1.6 Summary of management comments	11
2	**Independent Auditor's Report**	**12**
	The Rural Enterprise Investment Partnership (REIP) Board of Advisors	12
	2.1 Fund accountability statement	14
	2.2 Notes to the fund accountability statement	15
	2.3 Findings and recommendations	16
3	**Independent Auditor's Report on Internal Controls**	**17**
	The Rural Enterprise Investment Partnership (REIP) Board of Advisors	17
	3.1 Introduction	20
	3.2 Findings and recommendations	21
	3.3 Detailed findings	22
4	**Independent Auditor's Report on Compliance**	**43**
	The Rural Enterprise Investment Partnership (REIP) Board of Advisors	43
	4.1 Work performed	45
	4.2 Findings and recommendations	45
5	**Report on the Cost Sharing Schedule**	**46**
	The Rural Enterprise Investment Partnership (REIP) Board of Advisors	46
	5.1 Cost sharing schedule for the period January 1, 2004 to December 31, 2005	47
6	**Status of prior year audit recommendations**	**49**

1 Introduction

1.1 Background

On September 30, 1997, the U.S. Agency for International Development (USAID), mission to Eritrea approved the Investment Partnership Agreement (REIP) between the United States of America and the Government of the State of Eritrea (GSE) for the objective of Increased Income of Enterprises, USAID Project No. 661-0009. This program provides $19,332,634 in grant funds to the Government of the State of Eritrea (GSE) over an eight year period for Commercial Bank of Eritrea (CBER) Enterprise Investment (EIF) Lending and small and Medium Enterprise Loan program and for CBER operations ($9,500,000): for the Rural Enterprise Unit's (REU) Program and Operations ($1,649,000): and for additional activities outside of the loan program managed by CBER and REU, which were outside the purview of this audit ($8,183,634). For the purpose of providing technical services and business training to eligible enterprises, the GSE with USAID/Eritrea assistance established the REU.

The bilateral agreement was amended in 2002 (with Amendment No. 6) to reflect the following changes:

(a) The two line items concerning the Enterprise Investment Fund ("Enterprise Investment Fund" and Investment Fund Operations") have been combined into "CBER Lending and Operations".
(b) The two line items concerning the Rural Enterprise Unit ("REU Management" and "Enterprise Assistance") have been combined into "REU Program and Operations".

The Government of the State of Eritrea formed the Rural Enterprise Unit (REU) to implement, alongside CBER, the Investment Partnership Agreement (REIP). The REU in a not-for-profit organisation that is independent of the Commercial Bank of Eritrea and provides technical assistance in business development to beneficiaries under Programme, provides an initial evaluation of potential loan recipients and carries out monitoring and evaluation of loan recipients. The Commercial Bank of Eritrea is a profit making commercial bank that is wholly owned by the Government of the State of Eritrea. CBER disburses funds to customers (loanees) upon recommendation by the REU and satisfaction of its normal credit appraisal process (EIF).

USAID/Eritrea issued Project Implementation Letter (PIL) Number 20 informing that, as of October 1, 2005, USAID terminated funding and support for the REIP, including REU's Program and Operations and the Enterprise Investment Fund (EIF). Although USAID funding was terminated on October 1, 2005, the audited period was up to December 31, 2005 as per the requirements of the Statement of Work. Authority to utilize any excess project funds and non-expendable property to continue the program was granted to the recipient by USAID/Eastern and Central Africa (ECA) in April, 2006.

1.2 Overall roles and responsibilities of CBER

Overall, the CBER was the primary host country's implementing agency and directly implemented the following activities:

- Upgrade and expand banking services in the target region to assisted enterprises.

- The Enterprise Investment Fund (EIF). Notwithstanding a prevalence of excess liquidity in the current accounts among institutions of the financial sector, the availability of capital, investment and working, was a key constraint in rural areas.

In addition, affiliated with the CBER, the REU functions in the areas of monitoring, reporting and evaluation and financial management of the office. The technical staff of REU included personnel to develop and analyze business plans and to identify needs for training and technology transfer in enterprises seeking assistance. Funds for the operation of the REU, for technical assistance and for enterprise assistance were advanced by CBER in 90-day tranches against approved work plans and budgets and were liquidated in 30 day intervals according to procedures described in an implementation letter. The funds were disbursed under a disbursement contract with ACDI/VOCA (Agricultural Cooperative Development International and Volunteers in Overseas Cooperative Assistance) for a negotiated cost of $239.52/transfer, generally charged once a month for transfer instructions directed and authorized by the CTO (Cognizant Technical Officer) and/or the Mission Director.

This unit operated as an autonomous entity according to CBER's management, procurement and financial procedures and reported to the Board of Advisors for this investment partnership. The CBER had temporary supervisory responsibility over the REU. USAID/Eritrea monitored the performance of the REU through regular progress reports and site visits.

The overall REIP program budget was as follows:

Budget Element	**Amount (US$)**
CBER Lending and Operations	4,465,000
REU Program and Operations	1,649,000
ACDI/VOCA Technical Assistance	949,000
Rural Infrastructure/Trade & Investment	4,593,000
Program Modifier*	6,735,000
Monitoring, Evaluation, Audit	330,000
Project Management	611,634
Total	**19,332,634**

Based on the Statement of Work, our audit was to cover only the USAID resources managed by CBER and REU under the following budget lines.

Budget Element	**Amount (US$)**
CBER Lending and Operations	4,465,000
REU Program and Operations	1,649,000
Program Modifier*	5,035,000
Total	**11,149,000**

* The Program Modifier budget was partly implemented by CBER and partly by separate agreements as shown below.

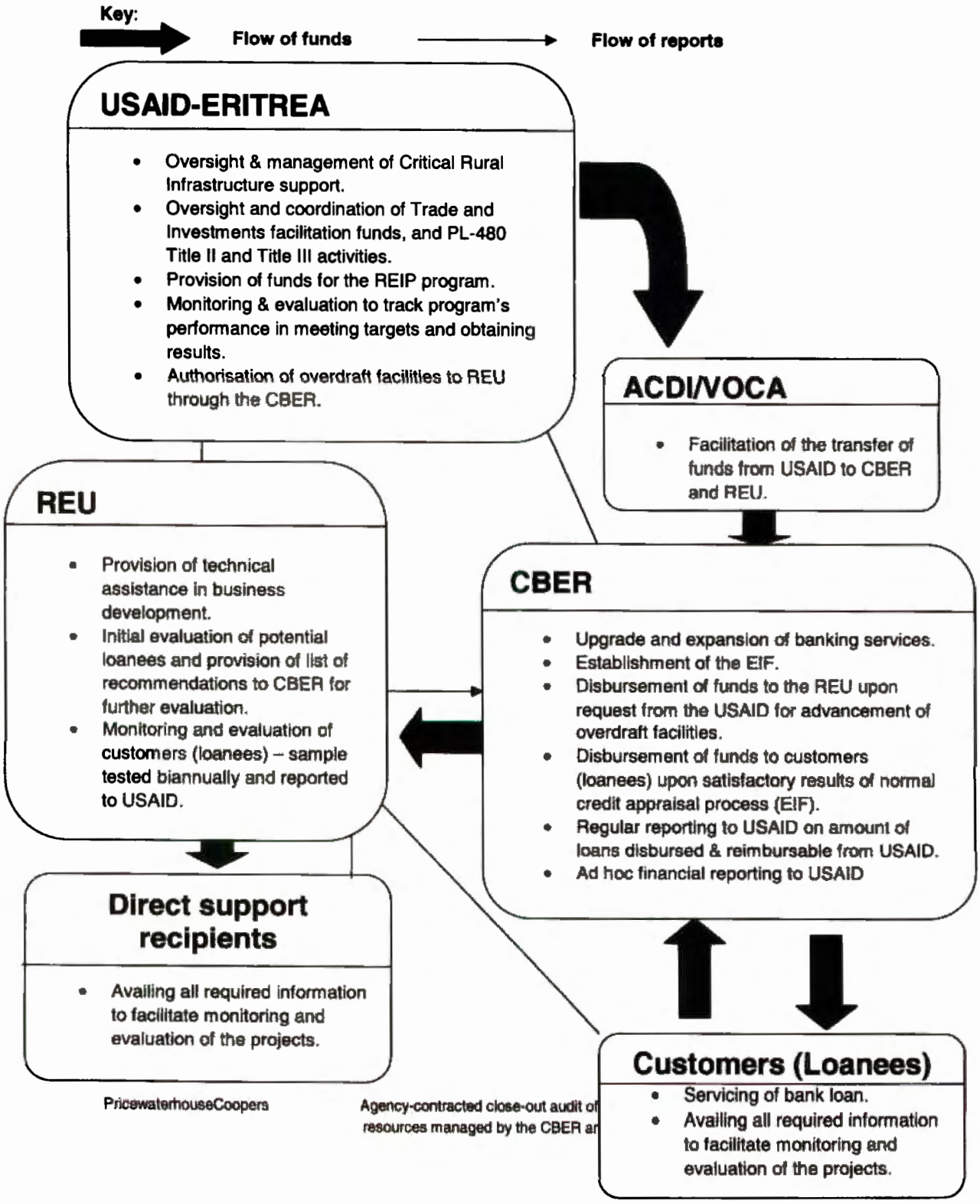
The following budget elements were subject to separate agreements with USAID implemented by entities other than CBER and REU, and were therefore excluded from the audit of USAID Resources managed by CBER and REU.

Budget Element	**Amount (US$)**
ACDI/VOCA Technical Assistance	949,000
Rural Infrastructure/Trade & Investment	4,593,000
Program Modifier**	1,700,000

Monitoring, Evaluation, Audit	330,000
Project Management	611,634
Total	**8,183,634**

** Program Modifier budget not implemented by CBER.

1.3 Diagrammatic representation of the flow of funds and reporting



Comments on Flow of Funds and Reporting

ACDI/VOCA

Funds

The original agreement outlined the involvement of ACDI/VOCA in the program in the following two areas:

1. Assist the CBER in upgrading its banking services to international standards and expanding financial services to enterprises in target areas.
2. Assist the CBER in establishing and managing an Enterprise Investment Fund.

We clarified with USAID/Eritrea that the only practical role that ACDI/VOCA had served in the program was to facilitate the transfer of funds in hard currencies from USAID to the CBER at a fee.

Commercial Bank of Eritrea (CBER)

Funds

The bank utilized its own funds to provide loans to customers who satisfied its loans committee after undergoing a credit appraisal process. During the life of the program, the bank provided funds under two schemes: the Enterprise Investment Fund (EIF) and Eritrean Reconstruction Credit Scheme (ERCS). Following disbursement of the loans, it prepared batch reports of loans granted which were submitted to USAID/Eritrea together with a letter requesting reimbursement of the amounts advanced. Based on these requests, USAID/Eritrea would instruct ACDI/VOCA to reimburse the amounts directly to CBER.

CBER availed an overdraft facility (through account number NTR 7720) to the Rural Enterprise Unit based on quarterly negotiations with USAID/Eritrea. This overdraft account was serviced directly by ACDI/VOCA upon instructions from USAID/Eritrea.

Reporting

Reporting by CBER to USAID/Eritrea was not on a scheduled basis. However, USAID/Eritrea would request for updates and the last such update was requested for the financial year ended December 31, 2003.

Rural Enterprise Unit (REU)

Funds

REU used to pay for its operations using funds drawn from the overdraft account number NTR 7720. The overdraft facility was made available by CBER as explained under the CBER section above.

Reporting

REU sent quarterly and annual performance reports to USAID/Eritrea, quarterly budget forecasts (for approval and onward negotiation of quarterly overdraft facilities), and monthly financial reports (which formed the basis for servicing of the overdraft facilities by ACDI/VOCA).

Loanees

Funds

Following credit appraisal and loan approvals, loan contracts were drawn between CBER and the loanees. Funds were then advanced to the customers by way of cash, transfers to respective accounts or direct payments to suppliers (for instance, where the loanee was purchasing machinery).

Loanees were expected to begin servicing their loan accounts once the agreed grace period elapsed. The repayment rates/terms were specified in each contract.

Reporting

The loanees were required to avail operational information to enable the REU carry out performance evaluations. Performance evaluations were carried out through field visits, which were arranged twice a year. Visiting schedules for the REU were determined through stratified sampling to ensure fair representation of all regions and economic sectors.

Direct Assistance Recipients

Under the direct support program, REU directly provided grants, with the approval of USAID/Eritrea, to deserving businesses. Amounts granted were not repayable. During 2004 and 2005, REU provided direct assistance amounting to USD 3,555 and USD 3,273, respectively.

USAID/Eritrea

Funds

The involvement of USAID/Eritrea in the management of funds was mainly through approval of reimbursements. USAID/Eritrea sent monthly fund requests to ACDI/VOCA based on monthly financial/accounting reports received from the Rural Enterprise Unit (REU). Based on these requests, ACDI/VOCA credited overdraft account number NTR 7720 operated by REU in effect servicing the overdraft facility, which was negotiated on a quarterly basis.

USAID/Eritrea also approved reimbursement, by ACDI/VOCA, of funds advanced to loanees by the CBER.

Reporting

In carrying out the monitoring and evaluation of program performance against targets, USAID/Eritrea received various reports. These included quarterly budget requests (which formed the basis of negotiating overdraft facilities for the REU), monthly financial reports

(which formed the basis for servicing the overdraft facility as described above), quarterly and annual performance reports submitted by the Rural Enterprise Unit.

USAID/Eritrea would also request for reports from CBER on an ad hoc basis.

1.4 Audit objectives, scope and methodology

1.4.1 Audit objectives

PricewaterhouseCoopers was contracted to conduct a close-out audit of the USAID Resources Managed by the Commercial Bank of Eritrea (CBER) and the Rural Enterprise Unit under the Investment Partnership Agreement, USAID Project No. 661-0009 for the period January 1, 2004 to December 31, 2005. The financial audit was to be conducted in accordance with U.S. Government Auditing Standards and the USAID "Guidelines for Financial Audits Contracted by Foreign Recipients (Guidelines)."

A financial audit of the funds provided by USAID must be performed in accordance with U.S. *Government Auditing Standards* and accordingly include such tests of the accounting records as deemed necessary under the circumstances. The specific objectives of the audit of the USAID funds are to:

- Express an opinion on whether the fund accountability statement for the USAID-funded programs presents fairly, in all material respects, revenues received, costs incurred, and commodities and technical assistance directly procured by USAID for the period audited in conformity with the terms of the agreements and generally accepted accounting principles or other comprehensive basis of accounting (including the cash receipts and disbursements basis and modifications of the cash basis).

- Evaluate and obtain a sufficient understanding of the recipient's internal controls related to the USAID-funded programs, assess control risk, and identify reportable conditions, including material internal control weaknesses. This evaluation must include the internal controls related to required cost-sharing contributions.

- Perform tests to determine whether the recipient complied, in all material respects, with agreement terms (including cost sharing, if applicable) and applicable laws and regulations related to USAID-funded programs. All material instances of non-compliance and all illegal acts that have occurred or are likely to have occurred must be identified. Such tests must include the compliance requirements related to required cost-sharing contributions, if applicable.

- Perform an audit of the indirect cost rate(s) if the recipient has been authorized to charge indirect costs to USAID using provisional rates and USAID has not yet negotiated final rates with the recipient. *[If the recipient does not have a USAID authorized indirect cost rate, this fact must be disclosed in the report.]*

- Determine if the recipient has taken adequate corrective action on prior audit report recommendations.

The audit was undertaken in accordance with US Government Auditing Standards and the "*Guidelines for Financial Audits contracted by Foreign Recipients*" (June 2003 Revision).

1.4.2 Audit scope

Our audit covered USAID funds managed by the Commercial Bank of Eritrea (CBER) and the Rural Enterprise Unit (REU) under the Rural Enterprise Investment Partnership Agreement and its Implementation Letters covering the period from January 1, 2004 to December 31, 2005 and consisted of the following:

1 Assessing and documenting internal control for both the implementing agencies (CBER and REU).

2 Examination and testing of supporting documentation for expenses incurred by REU.

3 As part of the audit of the Fund Accountability Statement and review of compliance, we performed a credit review/review of loans portfolio balance, system of advancing and recovery of loans. This included examination and testing of supporting documentation for loans disbursed by CBER under the EIF in 2004 and 2005 and review of loan balances for both the EIF and ERCS loan schemes.

4 A review of CBER and REU transactions under the program for compliance with the REIP Agreement (and subsequent amendments), implementation letters and US laws and regulations and the relevant circulars.

5 Confirmation of income balances transferred to REU and CBER under the program.

6 A review of the status of implementation of prior year audit report recommendations.

7 A review of unliquidated advances to CBER and REU and pending reimbursements by USAID.

8 Preparation of a detailed listing of final inventories of non-expendable property acquired under the Agreement (see Appendix V).

9 Carrying out consultations with USAID/Eastern and Central Africa to determine the treatment of Programme's assets including loan principals and interest.

Other procedures performed were:

10 Obtaining written confirmation of amounts transferred to Mibrak Kahsay (Integrated Farming Project, Aligider, Tesenei) and Small Scale Garment Manufacturing Enterprise (Asmara) through direct assistance from the Rural Enterprise Unit.

In carrying out our audit we did not comply with U.S. Government Auditing Standards as explained below:

We do not have a continuing education program that fully satisfies the requirements set forth in Chapter 3, paragraph 3.45 of *U.S. Government Auditing Standards*. However, we believe that the effect of this departure is not material as the firm requires every member of staff to have a minimum 40 hours of CPE while the professional bodies require a minimum of 37 hours of CPE.

We do not have an external quality control review by an unaffiliated audit organization as required by Chapter 3, paragraph 3.52 of the *U.S. Government Auditing Standards* since no such program is currently offered by professional organizations in Kenya. We believe that the effect of this departure from *U.S. Government Auditing Standards* is not material because we participate in the PricewaterhouseCoopers worldwide internal quality control review, which requires our office to be subjected to an extensive quality control review by partners and managers from other offices every eighteen months.

1.4.3 Audit methodology

The review was performed using the PricewaterhouseCoopers audit approach. Work was carried out in the following distinct stages:

1. Initial survey, which included familiarisation with program conditions by reviewing the REIP Agreement (and seven amendments) and the implementation letters, carrying out an initial assessment of REU and CBER books and records, and identifying areas of audit risk.

2. Discussion with REU and CBER senior management to gain an understanding of the management of the program.

3. Preparation and approval of a detailed work plan.

4. Carrying out tests of control, tests of compliance and detailed audit tests.

5. Issuance of a draft report to USAID RIG Pretoria, USAID/REDSO/ECA, CBER and REU.

1.5 Summary of the audit results

1.5.1 Fund accountability statement

Our audit of revenues and expenditure covered the following:

1 During the period, CBER received US$ 749,443 and disbursed US$ 1,001,291 under the EIF loan scheme. We reviewed 100% of the amounts received and 50% of the amounts disbursed. We questioned the following amount:

Basis of questioning	Amount (US$)	Section Reference
Ineligible - expenditure over budget.	*176,980*	*3.3.7*

2 Of the total loan balances outstanding as at December 31, 2004 of US$ 5,419,849 under both the EIF and ERCS schemes, we sampled US$ 3,790,782 for detailed testing achieving coverage of 70%.

3 Of the total loan balances outstanding as at December 31, 2005 of US$ 4,448,264 under both the EIF and ERCS schemes, we sampled US$ 3,183,631 for detailed testing achieving coverage of 72%.

4 We reviewed 100% of the income received by REU during the period. REU had income of US$ 290,446.

5 Expenditure incurred by the REU from the grant amounted to US$ 268,812. We sampled US$ 246,173 representing 92% of the total expenditure of US$ 268,812. We questioned the following expenditure:

Basis of questioning	Amount (US$)	Section Reference
Unsupported expenditure	699	3.3.2
Unsupported expenditure	108,223	3.3.3
Ineligible expenditure	537	3.3.5
Total	**109,459**	

6 As part of the technical assistance in 2005, USAID/Eritrea made a project donation and transfer title for 6 Pentium III computers and 6 monitors valued at US$ 10,610 to REU to support the USAID funded REIP Programme. We reviewed the related correspondence.

1.5.2 Internal control structure

With regard to REU, overall, the internal controls are satisfactory. We, however, noted five internal control areas for improvement (Sections 3.3.2, 3.3.3, 3.3.4, 3.3.5 and 3.3.6).

For CBER, internal controls operating at the disbursement stage are satisfactory but the systems for managing collateral risk, monitoring, follow-up and recoverability of loans still need improvement. We have detailed our findings in Section 3.3 of this report.

1.5.3 Compliance with the Grant Agreement terms and applicable laws and regulations

Compliance with the Grant Agreement terms and laws and regulations was satisfactory. We have noted one matter on the timeliness of the 2004 audit (item 4.2.1).

1.5.4 Cost sharing contribution

The cost sharing contribution requirement of US $ 3,881,000 over the life of the project has been fulfilled.

1.5.5 Indirect cost rate

REU and CBER are not subject to USAID indirect cost rules under the REIP agreement.

1.5.6 Status of prior audit recommendations

Rural Enterprise Unit – Most of the prior audit recommendations were implemented.

Commercial Bank of Eritrea – The prior audit recommendations were partially implemented.

1.5.7 General purpose financial statements

This was not a requirement of this audit as per clarifications sought during the contracting stage of USAID/PricewaterhouseCoopers audit contract.

1.6 Summary of management comments

Internal Control Recommendations

Findings accepted and necessary action will be taken.

Compliance with the Grant Agreement terms and applicable laws and regulations

Findings accepted and necessary action will be taken in future programmes.

2 Independent Auditor's Report

The Rural Enterprise Investment Partnership (REIP) Board of Advisors
C/O Commercial Bank of Eritrea
P. O. Box 219 Asmara - Eritrea

1 We have audited the Fund Accountability Statement of the USAID resources managed by CBER and REU for the period from January 1, 2004 to December 31, 2005. The Fund Accountability Statement is the responsibility of CBER/REU management. Our responsibility is to express an opinion on the Fund Accountability Statement based on our audit.

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

3 We do not have a continuing education program that fully satisfies the requirements set forth in Chapter 3, paragraph 3.45 of *U.S. Government Auditing Standards*. However, we believe that the effect of this departure is not material as the firm requires every member of staff to have a minimum 40 hours of CPE while the professional bodies require a minimum of 37 hours of CPE.

4 We do not have an external quality control review by an unaffiliated audit organization as required by Chapter 3, paragraph 3.52 of the *U.S. Government Auditing Standards* since no such program is currently offered by professional organizations in Kenya. We believe that the effects of this departure from *U.S. Government Auditing Standards* is not material because we participate in the PricewaterhouseCoopers worldwide internal quality control review, which requires our office to be subjected to an extensive quality control review by partners and managers from other offices every eighteen months.

5 The results of our tests disclosed the following material questioned costs as detailed in the Fund Accountability Statement: (1) US$ 176,980 in costs that are explicitly questioned because they are in excess of the budget and therefore ineligible; (2) US$ 108,922 in costs that are not supported with adequate documentation; and (3) US$ 537 in costs that are of a personal nature and therefore not eligible.

6 In our opinion, except for the effects of the questioned costs discussed in the preceding paragraph, the Fund Accountability Statement referred to above presents fairly, in all material respects, program revenues, costs incurred and reimbursed, and commodities and technical assistance directly procured by USAID 2 for the years then ended in accordance with the terms of the agreements and in conformity with the basis of accounting described in Note 2.2.2.

7 In accordance with *U.S. Government Auditing Standards,* we have also issued our report dated August 30, 2006, on our consideration of CBER and REU internal controls over financial reporting and our tests of its compliance with certain provisions of laws and regulations. Those reports are an integral part of an audit performed in accordance with *U.S. Government Auditing Standards* and should be read in conjunction with this Independent Auditor's Report in considering the results of our audit.

8 This report is intended for the information of CBER/REU and USAID. However, upon release by USAID, this report is a matter of public record and its distribution is not limited.

PricewaterhouseCoopers

Certified Public Accountants
Nairobi

August 30, 2006

2.1 Fund accountability statement

FOR THE PERIOD JANUARY 1, 2004 TO DECEMBER 31, 2005

	Overall Program Budget*	Actual Costs 2004 to 2005	Questioned Costs		Notes
	USD	USD	Ineligible	Unsupported	
Revenue:					
USAID Grant	11,588,347	1,035,198	-	-	
Total Revenue	**11,588,347**	**1,035,198**	-	-	
Costs Incurred:					
CBER Lending and Operations (See Appendix I)	4,904,347	1,001,291	176,980	-	2.2.7
REU Program and Operations (See Appendix II)	1,649,000	268,812	537	108,922	2.2.7
Program Modifier (See Appendix III)	5,035,000	-	-	-	
Total Costs Incurred	**11,588,347**	**1,270,103**	**177,517**	**108,922**	
Outstanding Fund Balance	-	**(234,905)**	-	-	**2.2.5**
In-kind donation by USAID					
REU - Computers (2005)		10,610			2.2.6
Total USAID Donation		**10,610**			

* This is the budget for the life of the program. Actual costs for the period up to December 31, 2003 were audited in the previous audit. A detailed analysis of budget versus actual costs is in Appendix III.

The Fund Accountability Statement on pages 14 to 16 was approved for issue by the Program management on August 24, 2006 and was signed on its behalf by:

Yemane Tesfay
GENERAL MANAGER (CBER)

Kifle Teclay, Ph.D.
PROGRAM MANAGER (REU)

2.2 Notes to the fund accountability statement

2.2.1 Currency translation

Local currency transactions are translated into U.S. dollars at the official rate ruling on the date of the transaction.

The Fund Accountability Statement is prepared using the official average monthly exchange rate. The fund balance as at December 31, 2005 has been translated at Nakfa 15/USD 1.00.

2.2.2 Basis of accounting

The Program uses a cash basis of accounting.

2.2.3 Grant funds received

It is the policy of the program to account for revenue as and when cash is received.

2.2.4 Expenditure

The costs incurred on program activities recorded herein represent actual costs.

2.2.5 Outstanding fund balance

The fund balance is represented by:

Description	Nakfa	US$ Equivalent
Petty cash:		
*REU Asmara Office	1,613	108
*REU Zoba Anseba	1,516	101
Bank balance:		
* REU Account Number NTR 7720	10,582	705
* REU Account Number 8386 (dormant account)	240,414	16,028
Pending reimbursements by USAID:		
CBER Loan Batch Number 24	(3,382,725)	(225,515)
CBER Loan Batch Number 25	(394,995)	(26,332)
Fund balance	**(3,523,595)**	**(234,905)**

* The outstanding bank balances of USD 705 (Account Number NTR 7720) and USD 16,028 (Account Number 8386) were not remitted to USAID on closure of the program because the recipient was given authority by USAID/Eastern and Central Africa, in April 2006, to utilize the cash for the originally intended program purposes only.

2.2.6 Donated equipment under Technical Assistance

In the year 2005, USAID/Eritrea made a project donation and transfer title for 6 Pentium III computers and 6 monitors valued at US$ 10,610 to REU to support the USAID funded REIP Programme.

2.2.7 Questioned costs

US$ 176,980 is questioned because it is in excess of the Program's budget and therefore ineligible (see item 3.3.7); US$ 108,922 is not supported with adequate documentation (see items 3.3.2 and 3.3.3); and US$ 537 is ineligible because of the personal nature of the expense (see item 3.3.5).

2.3 Findings and recommendations

The Fund Accountability Statement prepared from records maintained by the Rural Enterprise Unit and the Commercial Bank of Eritrea is on page 14 of this report.

2.3.1 Sample Selection Criteria

Rural Enterprise Unit (REU)

Total expenditure incurred by the REU during the period amounted to US$ 268,812. We sampled US$ 246,173, representing 92% of this expenditure.

Commercial Bank of Eritrea (CBER)

The loan balances outstanding under both the EIF and ERCS schemes as at December 31, 2005 amounted to US$ 4,448,264. We sampled US$ 3,183,631 (72%). We tested outstanding loan balances over US$ 13,000 and US$ 47,000 each under EIF and ERCS respectively.

Of the total loans of US$ 1,001,291 disbursed during the period under the EIF scheme, we sampled US$ 418,457 achieving coverage of 42%.

2.3.2 Review results

1. All receipts are properly supported.

2. Our detailed testing of transactions revealed some questioned expenditure as indicated in the Fund Accountability Statement.

3 Independent Auditor's Report on Internal Controls

The Rural Enterprise Investment Partnership (REIP) Board of Advisors
C/O Commercial Bank of Eritrea
P. O. Box 219 Asmara - Eritrea

1. We have audited the Fund Accountability Statement of the USAID resources managed by REU and CBER for the period from January 1, 2004 to December 31, 2005 and have issued our report on it dated August 30, 2006. We also reviewed the separate cost-sharing schedule.

2. Except for not having a fully satisfactory continuing education program and not conducting an external quality control review by unaffiliated audit organization (as described in our report on the Fund Accountability Statement), we conducted our audit in accordance with US Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the Fund Accountability Statement is free of material misstatement.

3. The management of REU and CBER is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control policies and procedures. The objectives of internal control are to provide management with reasonable, but not absolute assurance that the assets are safeguarded against loss from unauthorized use or disposition; transactions are executed in accordance with management's authorization and in accordance with the terms of the agreements; and transactions are recorded properly to permit the preparation of the Fund Accountability Statement in conformity with the basis of accounting described in Note 2.2.2 to the Fund Accountability Statement. Because of inherent limitations in internal control, errors or fraud may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

4. In planning and performing our audit of the Fund Accountability Statement of REU and CBER for the period from January 1, 2004 to December 31, 2005, we obtained an understanding of internal control. With respect to internal control, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the Fund Accountability Statement and not to provide an opinion on internal control. Accordingly, we do not express such an opinion.

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

- The REIP Board of Advisors did not meet over the period reviewed as per REIP operational requirements (see item 3.3.1).
- Payment vouchers and supporting documents are not cancelled upon payment at REU (see item 3.3.4).
- Monitoring of fuel consumption at REU is not satisfactory (see item 3.3.3).
- Employee activity reports were not prepared in support of salaries at REU (see item 3.3.6)
- The monitoring of all loans, including those disbursed under the REIP program, needs improvement. Financial statements of the borrowing entities are not received and reviewed as required by the EIF policy. Additionally, the bank, in some cases, does not maintain frequent contact with the borrowers (see item 3.3.8).
- The EIF policies require that loans above Nakfa 50,000 be secured. We noted some instances whereby loans above this threshold were advanced without security (see item 3.3.10).
- From our credit review, we noted that the bank had accepted various assets as collateral against loans advanced to customers. Whereas it is bank policy to have such assets insured and valued by external parties, we noted some instances whereby insurance policies had not been renewed (see item 3.3.11) nor professional valuations carried out as outlined in the bank's policy (see item 3.3.12).
- We noted deterioration in the performance of the loan portfolio for both the EIF and ERCS schemes (see item 3.3.9).
- The Bank of Eritrea, through Directive No. 3/2002, issued criteria for asset classification and provisioning. There were instances whereby loans had been misclassified as at December 31, 2005 (see item 3.3.13).
- We noted that some loans were given without CBER obtaining title documents for the related securities. In other cases, the title documents obtained were photocopies of the original title documents (see item 3.3.14).

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

7. Our consideration of internal control would not necessarily disclose all matters in internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we noted the following matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing and extent of the procedures to be performed in our audit of the Fund Accountability Statement of CBER/REU for the period January 1, 2004 to December 31, 2005.

   - Employee activity reports were not prepared in support of salaries at REU (see item 3.3.6)
   - The monitoring of all loans, including those disbursed under the REIP program, needs improvement. Financial statements of the borrowing entities are not received and reviewed as required by the EIF policy. Additionally, the bank, in some cases, does not maintain frequent contact with the borrowers (see item 3.3.8).
   - The EIF policies require that loans above Nakfa 50,000 be secured. We noted certain instances whereby loans above this threshold were advanced without security (see item 3.3.10).

- From our credit review, we noted that the bank had accepted various assets as collateral against loans advanced to customers. Whereas it is the bank's policy to have such assets insured and valued by external parties, we noted certain instances whereby insurance policies had not been renewed (see item 3.3.11) nor professional valuations carried out as outlined in the bank's policy (see item 3.3.12).
- We noted deterioration in the performance of the loan portfolio for both the EIF and ERCS schemes (see item 3.3.9).
- The Bank of Eritrea, through Directive No. 3/2002, issued criteria for asset classification and provisioning. There were instances whereby loans had been misclassified as at December 31, 2005 (see item 3.3.13).
- We noted that some loans were given without CBER obtaining title documents for the related securities. In other cases, the title documents obtained were photocopies of the original title documents (see item 3.3.14).

8. This report is intended for the information of CBER/REU and USAID. However, upon release by USAID, this report is a matter of public record and its distribution is not limited.

PricewaterhouseCoopers

Certified Public Accountants
Nairobi

August 30, 2006

3.1 Introduction

3.1.1 Definition

The American Institute of Certified Public Accountants (AICPA) Codification of Auditing Standards, Section 319, defines an organization's internal control structure as consisting of the policies and procedures established to provide reasonable assurance that a specific entity's objectives will be achieved. The internal control structure comprises three elements:

- the control environment
- the accounting system
- control procedures.

The control environment reflects the overall attitude, awareness and actions of management. The accounting system consists of methods and records established to identify, assemble, analyze, classify, record and report transactions. Control procedures are those policies and procedures in addition to the control environment and accounting system that management has established to safeguard the organization's resources.

In section 3.2 below, we have classified our findings and recommendations by these categories, as they apply to REU and CBER internal control structures.

3.1.2 Work performed

We reviewed the internal control structure of REU and CBER and obtained an understanding of the design, relevant procedures and assessed control risk. Our review considered the significant internal control structure and procedures categorized as follows.

Control environment

- financial management capabilities
- personnel policies and practices
- familiarity with USAID rules and guidelines

Accounting system

- budgeting and funds management
- general record keeping
- reporting to USAID
- disbursement of funds

Control procedures

- adherence to written down procurement procedures
- control over usage/disposal of equipment and capital expense items
- bank reconciliation statements

- authorization of transactions and activities

3.2 Findings and recommendations

3.2.1 Control environment

The overall control environment was generally considered to be effective as the staff charged with responsibility for the financial management of USAID resources are qualified, capable of managing USAID funds, and familiar with USAID rules and regulations concerning its grants. Personnel policies and practices are clearly defined.

We have, however, provided a recommendation on the meeting intervals of the REIP Board of Advisors (see item 3.3.1).

3.2.2 Accounting system

Both REU and CBER do not have a computerized accounting system. Their general ledgers are maintained on electronic spreadsheets. However, financial information relating to the program is clearly distinguished from that of other programs.

Funds from USAID are disbursed in accordance with budget provisions that are duly authorized by USAID. However, we noted that the budget line 'CBER Lending and Operations' had been exceeded by US$ 176,980 (see item 3.3.7).

The general record keeping was considered good as there was an orderly filing system in place. Supporting documentation for transactions was retrieved efficiently.

REU sends quarterly and annual performance reports to USAID/Eritrea, quarterly budget forecasts (for approval and onward negotiation of quarterly overdraft facilities), and monthly financial reports (which form the basis for servicing of the overdraft facilities by ACDI/VOCA).

Reporting by CBER to USAID/Eritrea is not on a scheduled basis. However, USAID/Eritrea may request for updates. During the program period, one such update was requested for the financial year ending December 31, 2003.

3.2.3 Control procedures

Both the REU and CBER follow USAID procurement procedures as outlined in USAID's Country Contracting Handbook (Formerly Handbook 11) and from our testing, we did not find any instances of deviations from pre-set guidelines.

There are well-documented procedures on the disposal of capital assets. Various controls have been implemented to monitor use of the organization's assets. These include fixed asset registers and fixed asset movement cards.

Preparation of bank reconciliation statements is not relevant to the CBER because the bank does not operate bank accounts dedicated to the disbursement of loans and receipt of reimbursements. The Rural Enterprise Unit prepares monthly bank reconciliation statements. Based on our testing, we found these to have been properly prepared and reviewed.

REU has properly documented authorization procedures, as detailed in the Policy and Procedure Manual for Administration and Finance.

Overall, the internal control systems for both REU and CBER are operational but need improvement to make them effective as noted in Section 3.3 (Detailed findings) below.

3.3 Detailed findings

General Matters

3.3.1 Meetings of the REIP Board of Advisors

Criteria

The REIP Operational Manual on page 31 states that the REIP Board of Advisors will oversee the entire program implementation and make adjustments where necessary. The Advisory Board will meet, at a minimum, every six months to decide on policy matters related to the program. The General Manager of CBER and the REU Program Manager will attend meetings held by the Advisory Board. The main duties of the Board include:

a) Issuing guidelines regarding policy matters related to REIP implementation.

b) Approval of annual plans and budgets.

c) Resolving problems and bottlenecks related to program implementation and coordination.

d) Monitoring and reviewing progress of the program.

Condition

The Board of Advisors did not meet between October 21, 2003 and March 31, 2005, a period of 17 months.

Cause

No particular reason was given.

Effect

Given that the Board of Advisors is the highest body in the organisational structure of REIP, we could not establish its involvement in the control environment of the Programme during the period that it did not meet.

Recommendation

The Board of Advisors role in the program's control environment cannot be overemphasised. It should meet as prescribed for it is through their deliberations that policy direction is given to the Programme and other issues are addressed.

Management comments

Auditors note as of August 10, 2006:
REU and CBER officials present in the Exit conference mentioned that comments under this issue can only be issued by the REIP Board of Advisors once they meet. They have not yet met.

Rural Enterprise Unit

3.3.2 Unsupported expenses

Criteria

OMB A122, Basic Considerations, Section A, Subsection 2G states that to be allowable under an award, costs must be adequately supported.

Condition

The following costs were not adequately supported.

Date	Voucher no	Zone	Description	Amount on voucher (Nakfa)	Unsupported amount (Nakfa)	Unsupported amount (USD)
2004						
27/08/2004	132	SKB 01/06/04 to 30/06/04 financial report zobas.	Fuel and lubricants	2,576	2,576	191
12/08/2004	180	SK Bahri financial report 01/07/04 to 31/07/04.	Fuel and lubricants	3,785	894	66
30/08/2004	173	Zoba S.K. Bahri.	Utilities for 1 August to 6 September 2004	4,844	41	3
		Total		**11,205**	**3,511**	**260**
2005						
25/01/2005	018	SK Bahri financial report for 1 Jan to 31 Jan 2005.	Fuel and lubricants	2,599	679	45
25/02/2005	044	Zoba Massawa financial report for 1st to 28th February 2005.	Fuel and lubricants	1,731	55	4
30/05/2005	112	Zoba SKB financial report for 26 April to 27 May 2005.	Fuel and lubricants	2,755	2,755	184
30/06/2005	138	Financial report for 27 May to 25 June 2005 for Zoba SKB – Massawa.	Fuel and lubricants	2,552	2,552	170
25/08/2005	184	Financial report for Zoba SKB Massawa for 1 to 29 August 2005.	Fuel and lubricants	4,982	509	34
30/05/2005	112	Zoba SKB May 2005.	Utilities for 26 April to 27 May 2005	2,007	38	3
		Total		**16,626**	**6,588**	**439**

Date	Voucher no	Zone	Description	Amount on voucher (Nakfa)	Unsupported amount (Nakfa)	Unsupported amount (USD)
		Grand total		27,831	10,099	699

Cause

For fuel and lubricants, management explained that it is difficult to obtain proper supporting documents in remote areas. Management further explained that, in some of these cases, project staff forgot to obtain the supporting documents.

Recommendation

Expenses should be properly supported with third party documents. Where suppliers do not have invoices or receipts, the project staff should ensure that the suppliers sign cash payment vouchers as evidence of their receipt of payment.

Management comment

Expenses amounting to USD 699 for which supporting documentation could not be found were ruled as unsupported. This, we agree, is acceptable. However, we want to qualify it with the statement that sometimes it is near impossible to get the right kind of supporting documents.

3.3.3 Controls over fuel

Criteria

Section 4.2 of REU's Policy and Procedures Manual for Administration and Finance requires that a vehicle log book form be maintained for each vehicle indicating the date, mileage, official's name, place of destination and signature for each trip.

The USAID Guidelines for Financial Audits Contracted by Foreign Recipients state in Paragraph 4.5 (i) the auditors should determine whether commodities exist or were used for their intended purposes in accordance with the terms of the agreements, and whether control procedures exist and have been placed in operation to adequately safeguard the commodities. The cost of all commodities whose existence or proper use in accordance with the agreements cannot be verified must be questioned in the fund accountability statement.

Condition

Vehicle log book forms were not maintained for the project vehicles during the period reviewed.

Cause

The drivers did not complete the forms and the officials who were traveling did not ensure that this was done.

Effect

It is difficult to reconcile the fuel purchased to the mileage covered. In addition, it is difficult to link the vehicles' mileage to project trips and activities.

Recommendation

We have questioned an amount of USD 108,223 in the Fund Accountability Statement. The breakdown is given below:

Description	Amount (USD)
Cost of vehicles:	
Toyota Double Cabin LN 166-0021952 (Chassis Number), 364685126 (Engine Number), ER-03-10444 (Plate Number)	20,881
Toyota Double Cabin LN 1060133401 (Chassis Number), 3L-4084436 (Engine Number), ER-03-09782 (Plate Number)	19,000
Toyota Double Cabin LN 1060134554 (Chassis Number), 3L-4100369 (Engine Number), ER-03-09783 (Plate Number)	19,000
Toyota Land Cruiser H 2580-0029391 (Chassis Number), IH2-0193597 (Engine Number), ER-03-0984 (Plate Number)	33,000
Sub-total	**91,881**
Fuel, lubricants, repairs and maintenance:	
Cost of fuel and lubricants 2004	4,875
Cost of motor vehicle repairs and maintenance 2004	3,754
Cost of fuel and lubricants 2005	4,639
Cost of motor vehicle repairs and maintenance 2005	3,074
Sub-total	**16,342**
Total	**108,223**

Vehicle log book forms should be maintained for all project vehicles. The Administrative Officer should check adherence to this provision by checking the log book forms every two weeks.

Management comment

Fuel consumption was not properly monitored since project vehicle drivers did not fill the Vehicle Log Book Forms in 2004 and 2005. This was largely due to the fact that drivers are semi-literate lacking the capacity to fill the forms as required. However, we have taken action effective CY 2006 to rectify the problem by instructing traveling employees to assist the drivers in filling the Forms and in seeing to it that the Administrative Officer checks daily that travels are logged in as required.

3.3.4 Cancelling of supporting documents

Criteria

Section 4 - "Procedures on Finance" of REU's Policy and Procedure Manual for Administration and Finance requires that vouchers are stamped "PAID" by the Finance Officer after payment is processed.

Condition

Payment vouchers and other supporting documents reviewed for financial years 2004 and 2005 were not stamped "PAID" after payment was processed.

Cause

Oversight by management.

Effect

There is a risk that supporting documents may be represented for payment under the same project or under a different project.

Recommendation

All vouchers and supporting documents should be stamped "PAID - REIP PROGRAMME" after payment is processed.

Management comments

We accept the finding that payment vouchers and other supporting documents should always be stamped paid.

3.3.5 Ineligible Expenditure

Criteria

Paragraph 4 (Basic Considerations) of the cost principles outlined in A-122 states that:

A cost is allocable to a particular cost objective, such as a grant, contract, project, service, or other activity, in accordance with the relative benefits received. A cost is allocable to a Federal award if it is treated consistently with other costs incurred for the same purpose in like circumstances and if it:

(1) Is incurred specifically for the award.

(2) Benefits both the award and other work and can be distributed in reasonable proportion to the benefits received, or

(3) Is necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown.

OMB Circular A-122, Attachment B, Principle 18 titled 'Goods or services for personal use' states that costs of goods or services for personal use of the organization's employees are unallowable regardless of whether the cost is reported as taxable income to the employees.

Condition

Personal international phone calls were made by an official of the REU during the two year period reviewed. The costs of these phone calls to the project were US$ 537.

Cause

The phone calls were made by the REU Programme Manager whose employment contract with the Government of the State of Eritrea provides for communication allowances as a benefit.

Effect

The cost of US$ 537 to the project has been questioned in the Fund Accountability Statement as being ineligible.

Recommendation

REU should liaise with USAID to resolve the questioned amount.

Management Comments

This refers to international phone calls that the Program's Manager made during the period. The expenditure that the Unit incurred was ruled as ineligible since OMB Circular A-122 provides that costs of goods or services for *personal* use are unallowable. The expenditure incurred was, therefore, ruled as ineligible. We have two comments regarding this. First, the Program Manager has an employment contract with the Government of the State of Eritrea which provides for communication allowances. Such a policy exists in Eritrea. Second, the Management has never been made aware of the existence of the cited provision ruling the expenditure as ineligible.

3.3.6 Employee activity reports

Criteria

OMB A-122, Attachment B, cost principle number 7 (m) on support of salaries and wages states that charges to awards for salaries and wages, whether treated as direct costs or indirect costs, will be based on documented payrolls approved by a responsible official(s) of the organization. The distribution of salaries and wages to awards must be supported by personnel activity reports, except when a substitute system has been approved in writing by the cognizant agency.

Reports reflecting the distribution of activity of each employee must be maintained for all staff members (*professionals* and non-professionals) whose compensation is charged, in whole or in part, directly to awards.

Condition

Although the REU has a mechanism whereby employees register at the reception every time they enter or leave the office, detailed records of each employee's activities in a day or pay period are not maintained.

Cause

The REIP Agreement provides for quarterly reporting of REU's activities to the USAID Mission. The reports normally cover activities of the organization for the quarter. Management were not aware

that, in addition to the mechanism for monitoring employee hours, they were required to record daily activities of the employees especially given that they work full-time on the REIP Programme.

Effect

Difficulty in establishing whether employees were engaged in activities related to the Programme.

Recommendation

REU should maintain activity reports for all its employees. The reports should satisfy the following standards:

(a) The reports must reflect an *after-the-fact* determination of the actual activity of each employee. Budget estimates (i.e., estimates determined before the services are performed) do not qualify as support for charges to awards.

(b) Each report must account for the total activity for which employees are compensated and which is required in fulfillment of their obligations to the organization.

(c) The reports must be signed by the individual employee, or by a responsible supervisory official having first hand knowledge of the activities performed by the employee, that the distribution of activity represents a reasonable estimate of the actual work performed by the employee during the periods covered by the reports.

(d) The reports must be prepared at least monthly and must coincide with one or more pay periods.

Management Comments

Reference is made to OMB A-122, Attachment B to state that it is difficult to establish whether employees were engaged in activities related to the Program. Here we would like, first, to comment that we were not made aware of the existence of the OMB A-122. Second, we relied on our internal Administrative and Financial Manual to track employees' activities through Employee Performance Score Card and Attendance Sheet.

Commercial Bank of Eritrea (CBER)

3.3.7 Disbursements in excess of budget

Criteria

Annex 1, Attachment A of Amendment No. 8 to the REIP Agreement sets out the budget limit for CBER Lending and Operations (EIF Loans Scheme) as US$ 4,904,347.

Condition

CBER had disbursed a total of US$ 5,081,327 (over the life of the Programme) under the CBER Lending and Operations (EIF Loans Scheme) as of 31 December 2005. Given that the budget provided for US$ 4,904,347, a total of US$ 176,980 was disbursed in excess of budget (See Appendix III for detailed analysis).

We also noted that, out of the total loans disbursed (US$ 5,081,327), there were two pending claims of US$ 225,515 and US$ 26,333 relating to loan batches 24 and 25 respectively, which had not been reimbursed by USAID/Eritrea.

Cause

According to the minutes of the REIP Advisory Board Meeting held on March 31, 2005, there was a budget discrepancy in the CBER Lending and Operations Line. This discrepancy may have contributed to exceeding the budget. Management explained that the pending claims were disputed by USAID/Eritrea.

Effect

Amounts that are over budget are considered ineligible and we have therefore questioned them.

Recommendation

CBER should liaise with USAID/US Embassy to resolve the issue of the questioned amounts and the pending claims.

Management comments

The management of the bank will ask the representative of USAID/US Embassy in writing to approve the excess budget of US $ 176,980 and request reimbursement for batch # 24 and 25 amounting to US $ 225,515 and 26,333 respectively. Further, we will mention that the discrepancies in the budget and the actual disbursement was occurred due to letter of information for increment of additional fund written by Dr. Michel L. Wizen dated 8 December, 2004.

3.3.8 Monitoring of loanees

a) Review of financial statements

Criteria

Section IV, Sub-section I (Financial Reporting Requirements of Participants) of the Policies and Procedures for the Operation of the EIF requires that, for assistance amounting to less than Nfa 50,000, participants will be required to produce a balance sheet and income statement annually within 120 days of the end of their financial year. For assistance over Nfa 50,000, this requirement is semi annual within 90 days after the end of the period in question and must include a variance analysis report on actual cash flows versus the projections involved at the beginning of the relationship.

This is in line with Section V (Credit Decision Process), Sub-section E "Your negotiation, documentation and follow up" of the Commercial Bank of Eritrea Credit Policy Manual which states that periodic reports should be obtained from the borrower, including financial statements which should be spread, analyzed and interpreted. The trend of the borrower's business should be continually evaluated so as to identify developing problems early.

Condition

For the sample of loan files reviewed, it was noted that none of the participants sent financial statements as required by the EIF policies and procedures. Financial statements were only obtained at the point of loan disbursement.

Cause

Management explained that most of the participants cannot prepare financial statements.

Effect

It is difficult to monitor the performance of the borrowers' businesses in the absence of periodic financial statements.

Recommendation

Financial statements should be obtained as specified in the above EIF policies. This will assist in monitoring the performance of the borrowers' businesses and aid in detecting potential delinquent loans on a timely basis.

Management comments

Because of the limited capacity and know-how of the beneficiaries of the program, presentation of periodic financial statements of borrowers is not practicable. The management of the bank will discuss the issue with the representative of the USAID/US Embassy to amend the EIF policies.

b) Maintaining frequent contact with borrowers

Criteria

Section IV; Sub-section A (Credit/Documentation Files) of the Policies and Procedures for the Operation of the EIF requires the maintenance of accurate credit/documentation files with written call memos evidencing frequent contact with the client and the results.

This is also in line with Credit Policy No 39 (Credit Policy Manual for Commercial Bank of Eritrea) on credit and document files, which requires every discussion and correspondence with the client including customer calls to be recorded in a written or typed memo to the file.

Condition

There was no evidence of frequent contacts with some of the participants. In the examples provided below, there was no evidence of frequent contact in the form of reminder letters or site visits reports in the credit file from the time the loans were disbursed.

Branch	Name of borrower	Amount granted (Nakfa)	Amount outstanding as at 31 December 2005 (Nakfa)	Classification	Comment
Liberty Avenue	Abera Amare Bayene	3,000,000	3,001,797	Loss	No evidence of frequent contact with client since disbursement of loan.
Liberty Avenue	Asmara Footwear	2,025,168	2,025,168	Loss	No reminder letter sent in 2004 and 2005. Warning letter sent to client on 26/01/06.
Liberty Avenue	Hidru & Family PLC	3,000,000	2,312,666	Loss	No evidence of frequent contact with client since disbursement of loan.
Liberty Avenue	Mereb Corporation	1,287,500	969,679	Doubtful	No reminder letter sent in 2004 and 2005. Reminder letter sent on 26/01/06.
Liberty Avenue	Radaezaghi G/Medhin	1,500,000	1,474,164	Loss	No evidence of frequent contact with client since disbursement of loan.
Liberty Avenue	Zeray Araya Mirach	520,000	509,830	Loss	No evidence of frequent contact with client since disbursement of loan.
Liberty Avenue	Tekie Berhe Tesfagiorgis	497,610	481,814	Loss	No evidence of frequent contact with client since disbursement of loan.
Edaga Berai	Al Keder Salt Works	2,264,530	2,720,662	Loss	No reminder letter sent in 2005 or evidence of frequent contact.
Edaga Berai	Luchia Ataklti	1,292,000	1,436,530	Doubtful	No evidence of frequent contact with borrower. Last reminder letter sent on 11/05/04.
Keren	Adal Poultry Farm	748,248	537,647	Doubtful	No evidence of frequent contact with client and no reminder letter sent in 2005. Reminder letter sent on 05/04/06.
Keren	Tsigereda Amleson	700,000	515,097	Substandard	Last sent reminder letter on 01/11/03. No evidence of frequent contact with borrower in 2004 and 2005.
Keren	Meso Farm	400,000	378,885	Doubtful	No evidence of frequent contact with client and no reminder letter sent in 2004 and 2005.
Edaga Berai	Essayas Desale B.	1,500,000	1,426,784	Substandard	No evidence of frequent contact with client since disbursement of loan

Branch	Name of borrower	Amount granted (Nakfa)	Amount outstanding as at 31 December 2005 (Nakfa)	Classification	Comment
Edaga Beral	Tesfagabir Ghebreakiak	650,000	705,476	Loss	No evidence of frequent contact with client since disbursement of loan.
Liberty Avenue	Tsigeroma Eyob Ghebemariam	200,000	213,875	Substandard	No evidence of frequent contact with client since disbursement of loan.
Liberty Avenue	(Keshi) Melake G/Kristos Tekle	200,000	174,029	Substandard	No evidence of a reminder letter to client in 2005. Installments for 2 quarters in 2005 outstanding as at 31/03/06.
Liberty Avenue	Yohannes Zerezghi Adhanom	200,000	125,879	Substandard	No evidence of frequent contact with client since disbursement of loan.

Cause

Management explained that verbal contact is maintained with clients whenever they visit the branch to make a repayment and at times, site visits are made. However, this is not documented in the credit file.

Effect

Borrowers may delay in paying their loan installments increasing the risk of default.

Recommendation

Frequent contact with the loanees will encourage timely repayment of loan installments and enable early detection of repayment problems.

Management comments

Though there is no written evidence for contacts made with borrowers, we have made contacts with borrowers and discussed about their problems in detail, in some cases there is evidence written in tigrega (National language). The management of the bank will inform branches to make frequent follow up and to keep written records in English language for individual borrowers.

3.3.9 Non-performing loans

Criteria

Section IV, Sub-section J - "Delinquent Liabilities" of The Policies and Procedures for the Operation of the EIF require CBER to report quarterly to the REIP Board of Advisors (AB) any case where a client is more than 90 days past the due date for loan repayment with an explanation as to the causes and actions being taken by CBER/REU.

Condition

As at 31 December 2005, out of the outstanding loans of US$ 4,448,264, only 24% (US$ 1,087,812) were classified as Pass. The remaining 76% of the outstanding loans were more than 90 days past their due dates for repayment. We noted that most of the non-performing loans classified as doubtful and loss were old and large. The new small-scale loans advanced in 2004 and 2005 were, however, performing.

There was no evidence of the quarterly reports to the Advisory Board in 2004 and 2005.

Cause

CBER management explained that the responsibility of preparing the quarterly report lies with the REU, which prepares quarterly reports and sends a copy to USAID and CBER. In addition, the AB did not meet in 2004 and only met once in 2005, on March 31, 2005.

Management also explained that economic factors are largely responsible for the poor debt repayment performance.

Other factors responsible for the poor debt repayment performance include inadequate credit monitoring staff, poor monitoring infrastructure and poor management of the credit monitoring system.

Effect

The deterioration in the performance of the EIF loan book may hinder the achievement of the Programme's overall objective of strengthening CBER's capital base and strengthening its financial services capacity. Lack of timely reporting on non-performing loans may worsen the situation.

Recommendation

CBER should report to the Advisory Board as stipulated in the EIF policies. This will enhance monitoring of loan performance. Strengthening of the bank's monitoring capacity may also assist in sustaining a culture of on-time debt repayment.

Going forward, the Advisory Board should consider revising the programme's lending strategy to target small-scale borrowers as these are the kinds of loans that are proving manageable and therefore performing. By lowering the ceiling for lending, the bank will also be managing the risk of financial loss in the event of default.

Management comments

Agreed with recommendation

3.3.10 Unsecured loans

Criteria

Section A (Direct Loans) of the Policies and Procedures for the Operation of the EIF stipulates that collateral will be taken whenever possible but unsecured loans are acceptable within limits defined by the Advisory Board - recommended at present to be Nfa 50,000. Collateral may include the working capital assets of the company, fixed assets or collateral from outside sources.

In addition, Section V, Sub-section E of the Commercial Bank of Eritrea Credit Policy Manual states that collateral enhances the bank's bargaining power.

Condition

Collateral was not obtained for the following EIF loans (above the recommended threshold), some of which are classified as loss or doubtful.

Branch	Name of borrower	Amount granted Nakfa	Amount outstanding as at 31 December 2005 Nakfa	Classification	Comment
Liberty Avenue	Mereb Corporation	1,287,500	969,679	Pass	Loan issued on clean basis.
Liberty Avenue	Radaezahi G/Medhin	1,500,000	1,474,164	Loss	Loan issued on clean basis.
Edaga Berai	Kasete Solomon	1,494,561	1,728,777	Doubtful	Loan issued on clean basis.
Tessenei	Yemane Tekeste	3,000,000	3,341,519	Substandard	Loan issued on clean basis.
Tessenei	Gash Agro Industrial	1,500,000	1,672,975	Loss	Loan issued on clean basis.
Tessenei	Gash Agro Industrial	748,000	818,496	Loss	Loan issued on clean basis.

Cause

Management explained the above loans were issued on a clean basis as the risk was considered low and the related projects viable.

Effect

Large unsecured loans expose the bank to the risk of financial loss.

Recommendation

Collateral should be obtained for all loans over Nfa 50,000 as specified in the EIF policies and procedures.

Management comments

The above loans were issued on a clean basis as the risk was considered low and the related projects viable.

3.3.11 Insurance of collateral

Criteria

Credit Policy No 37 - "Insurance" of the Commercial Bank of Eritrea Credit Policy Manual requires that property and goods offered to the bank as security to a credit extension be covered by appropriate insurance policies in the joint names of the customer and the bank. Account officers must ensure that such policies are appropriate and that premiums of the right amounts have been paid. The rationale provided by the policy for insuring collateral is that property or goods mortgaged to the bank to secure loans and other credit facilities become meaningless if destroyed in fire or stolen without being covered by appropriate insurance policies. This is because the bank recovers nothing from such collateral if the borrowers default on the loans. Securing insurance cover on all collaterals with the bank is therefore a basic function in securing the bank's interest on its loans.

Condition

From our credit review, we noted that the bank had accepted various assets as collateral against loans advanced to customers. Whereas it is bank policy to have such assets insured we noted some instances whereby insurance policies had not been renewed as summarized below.

Branch	Type of Loan	Name of borrower	Amount granted Nakfa	Outstanding balance as at 31 December 2005 Nakfa	Security	Issue
Liberty Avenue	EIF	Abera Amare Beyene	3,000,000	3,001,797	Building valued at Nfa 550,550	Insurance not renewed since 15/04/04.
Liberty Avenue	EIF	Asmara Footwear	2,025,168	2,025,168	Constructed building valued at Nfa 923,000	Not insured.
Liberty Avenue	EIF	Hidru & Family PLC	3,000,000	2,312,666	Plant building valued at Nfa 4,251,900	Not insured.
Addi Keih	EIF	Solomon Asfaha	500,000	473,785	Building of Nfa 860,380	No confirmation from 1st degree collateral holder that building is insured.
Edaga Berai	EIF	Al-Keder Salt Works	2,264,530	2,720,662	Loader and building valued at Nfa 4,650,000	Not insured.
Liberty Avenue	EIF	Tekie Berhe Tesfagiorgis	497,610	481,814	Building valued at Nfa 514,350	Insurance expired on 17/10/04.
Edaga Berai	EIF	Afewerki Tekeste	432,200	434,363	Building valued at Nfa 280,125	No insurance for building.
Edaga Berai	EIF	Berhe Kibram Sibhatu	200,000	30,967	Building valued at Nfa 350,000	No insurance.
Liberty Avenue	EIF	Tsigeromat Eyob Ghebemariam	200,000	213,875	Son's truck valued at Nfa 250,000	Insurance expired on 01/01/05.
Liberty Avenue	EIF	Tohannes Zerezghi Adhanom	200,000	125,879	Building valued at Nfa 351,700	Insurance expired on 02/04/05.
Liberty Avenue	EIF	Mesghina Teklu Kidane	200,000	67,650	Vehicle valued at Nfa 75,000	Insurance expired on 27/01/05.
Liberty Avenue	EIF	Samuel Afeworki Kidane	200,000	160,000	Pickup valued at Nfa 160,000	Insurance expired on 07/10/05.
Addi Keih	ERCS	Suleiman Omeredin	450,000	legal case	3 buildings valued at	No insurance for buildings.

Branch	Type of Loan	Name of borrower	Amount granted Nakfa	Outstanding balance as at 31 December 2005 Nakfa	Security	Issue
		Ahmed			Nfa 750,400	
Addi Keih	ERCS	Tiebe Ghebrehiwet	500,000	172,927	Building valued at Nfa 400,000	Requested National Insurance Corporation of Eritrea to insure buildings on 13/03/06 to 12/03/07 but premium not paid to date and no policy received.
Edage Berai	EIF	Luchia Ataklti	1,292,000	1,436,530	Caterpillar loader Nfa 1.3 m.	Endorsement letter sent to insurance company on 21/03/05 but premium not paid and there is no insurance policy for the loader in the credit file.

Cause

Shortage of staff to follow up on these aspects.

Effect

The bank may be exposed to financial loss on collateralized credit facilities if it fails to adequately insure its collateral.

Recommendation

We recommend that the bank strictly follows its policy on insurance of loan collaterals.

Management comments

The management of the bank will inform branches to review loan files and make the necessary action to renew insurance policies regularly.

3.3.12 Valuation of collaterals

Criteria

Credit Policy No 34 - "Valuation" of the Commercial Bank of Eritrea Credit Policy Manual requires that property already mortgaged with the bank is regularly inspected and appraisals on such property updated. Reports should be submitted to the approving committees or officers concerned.

Condition

For most of the loans reviewed, collateral was only appraised at the time the loans were disbursed. There was no regular inspection and appraisal of the mortgaged properties. Examples noted include:

BRANCH	COMPANY OR INDIVIDUAL NAME	LOAN CLASSIFICATION	AMOUNT GRANTED NAKFA	OUTSTANDING BALANCE NAKFA	SECURITY TYPE	SECURITY VALUE	LAST VALUATION DATE
Liberty Ave	Abera Amare Beyene	Loss	3,000,000	3,001,797	Building	550,550	19-Sep-03
Liberty Ave	Asmara Footwear PLC	loss	2,025,168	2,025,168	Building	923,000	01-Oct-03
Liberty Ave	Hedru & Family PLC	Loss	3,000,000	2,312,868	Plant building	4,251,900	25-Jun-03
Liberty Ave	Zeray Araya Mirach	Loss	520,000	509,830	Building	290,000	18-Jul-03
Addi-Ugri	Efrem G/giorgis	Pass	1,300,000	842,940	Building	1,800,000	01-Oct-03
Addi-Ugri	Yosuf Abdela	Doubtful	3,000,000	2,911,407	Building	8,527,100	26-Feb-03
Addi Keih	Solomon Asfaha	Doubtful	500,000	473,785	Building	860,380	17-Sep-03

Cause

Shortage of staff.

Effect

This increases the bank's collateral risk as the mortgaged properties may decrease in value or get damaged thereby hindering the bank from recovering the full values of the debts in case of default.

Recommendation

The bank should manage its collateral risk by regularly inspecting and appraising securities pledged against loans as stipulated in its credit policies.

Management comments

Agreed with recommendation

3.3.13 Classification of loans

Criteria

Bank of Eritrea's Directive No 3/2002 on asset classification and provisioning, states that medium term (above 2 years and up to 5 years) and long term (above 5 years) loans may be classified by banks by adopting the following criteria:

Pass - Loans in this category are those which are regular and are not subject to any criticism and in which there are no arrears of interest and/or installment of principal for 180 days.

Sub-standard - Loans shall be classified under this category if interest and/or installment of principal are past due for more than 180 days and up to 1 year.

Doubtful - Loans under this category are those where interest and/or installment of principal are past due for more than 1 year and up to 2 years.

Loss - Loans shall be classified under this category, if the interest and/or installment of principal have remained past due for more than 2 years.

Condition

From our review of loan movements, we noted certain loan misclassifications as at December 31, 2005. These were noted at the branches. Examples include:

	COMPANY OR INDIVIDUAL NAME	TERM OF LOAN	AMOUNT GRANTED (NAKFA)	OUSTANDING AS AT 31 DECEMBER 2005 (NAKFA)	CBER BRANCH CLASSIFICATION	EXPECTED CLASSIFICATION PER DIRECTIVE 3/2002	COMMENTS ON LOAN STATUS
EIF Loans							
Addi Ugri	Tibletse Butsuamlak	5 years	500,000	466,347	pass	doubtful	Interest and instalment of principal are past due for more than 1 year
Addi Ugri	Yosuf Abdela	4 years	3,000,000	2,911,407	pass	doubtful	Interest and instalment of principal are past due for more than 1 year
Edaga Beral	Eassayas Desale B.	4 years	1,500,000	1,426,784	substandard	doubtful	Interest and instalment of principal are past due for more than 1 year
Edaga Beral	Luchia Atakiti	4 years	1,292,000	1,436,530	substandard	doubtful	Interest and instalment of principal are past due for more than 1 year
Massawa	Denroba Hort.Farm	5 years	500,000	561,931	substandard	loss	Interest and instalment of principal are past due for more than 1 year
Massawa	Mancuso Agr.Plc	5 years	700,000	603,309	pass	substandard	Interest and instalment of principal are past due for 9 months
Addi Keih	Solomon Astaha	5 years	500,000	473,785	substandard	doubtful	Interest and instalment of principal are past due for 18 months
Liberty Avenue	Mereb Corporation	5 years	1,287,500	989,679	pass	doubtful	Interest and instalment of principal are past due for more than 1 year
ERCS							
Addi Ugri	Ghebru G/Hiwat	4 years	300,000	327,781	doubtful	loss	Interest and instalment of principal over 2 years past due

Cause

Lack of adequate guidance on loan classification at the branch level.

Effect

The bank may not establish proper loan loss provisions if the classifications are not performed correctly. This may, in turn, affect management's assessment of the bank's credit risk.

Recommendation

The need to have loan ratings or classifications for individual credits done accurately should be re-emphasized to the branch staff and regularly reviewed for accuracy as senior management at Head Office rely on branch summaries for monitoring and decision-making purposes.

Management comments

The management of the bank will inform branch staff to make the classification according to Bank of Eritrea Directives.

3.3.14 Lack of title documents

Criteria

Credit Policy No 11 - "Acceptable Securities" of the Commercial Bank of Eritrea Credit Policy Manual stipulates the kinds of securities that are suitable to collateralize a loan. In particular, the security must have a legal title so that the interest in it will pass on to the lender safely, unquestionably, without much complication and without undue trouble and expense. It should also be free of any encumbrances or claims by third parties.

Condition

We noted the following securities that were either supported by photocopies or lacked title documents.

BRANCH	COMPANY OR INDIVIDUAL NAME	LOAN CLASSIFICATION	AMOUNT GRANTED (NAKFA)	OUTSTANDING BALANCE (NAKFA)	SECURITY TYPE	SECURITY VALUE	COMMENT
Liberty Avenue	Asmara Footwear PLC	loss	2,025,168	2,025,168	Building	923,000	Loan was for completion of a factory building which was also the collateral. Construction of the building is complete but the borrower has not forwarded registration documents for the building to the bank.
Liberty Avenue	Hedru & Family PLC	Loss	3,000,000	2,312,666	Plank building	4,251,900	No title documents for this building. The credit file only contains a copy of the title for plot no 17, parcel no 07-1.
Liberty Avenue	Zaray Araya Mirach	Loss	520,000	509,830	Building	290,000	There are no title documents for the building.
					Pick up	50,000	The borrower collected the log book for the vehicle on 04/07/05 for registration but has not returned it to date.
Edaga Berai	Adem Said Bege	Pass	546,400	558,758	Agricultural field	634,425	Branch only has photocopies of original plan and certificate from Ministry of Agriculture.
Edaga Berai	Al-Kader Said Works PLC	Loss	2,264,530	2,720,369	Building	2,800,000	The credit file only contains a copy of certificate no 3050201-003685 for this building.

Cause

Shortage of staff and oversight by loan officers.

Effect

In the absence of proper title documents, it may be difficult to liquidate and realize the securities in case of default.

Recommendation

Management should ensure that original title documents are maintained for all collateral.

Management comments

It is the daily practice of the bank to keep original documents of the collateral. In some cases when the collateral is held on 2nd degree basis the original collateral document is kept with the bank or branch of the first claimant. In this regard, the management of the bank will inform branches to check their files and make the necessary collection of original documents of the collateral.

4 Independent Auditor's Report on Compliance

The Rural Enterprise Investment Partnership (REIP) Board of Advisors
C/O Commercial Bank of Eritrea
P. O. Box 219 Asmara - Eritrea

1 We have audited the Fund Accountability Statement of the USAID resources managed by REU and CBER for the period from January 1, 2004 to December 31, 2005, and have issued our report on it dated August 30, 2006. We also reviewed the separate cost-sharing schedule.

2 Except for not having a fully satisfactory continuing education program and not conducting an external quality control review by unaffiliated audit organization (as described in our report on the fund accountability statement), we conducted our audit in accordance with U.S. Government Auditing Standards issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the fund accountability statement is free of material misstatement resulting from violations of agreement terms and laws and regulations that have a direct and material effect on the determination of the fund accountability statement amounts.

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

4 Material instances of non-compliance are failures to follow requirements or violations of agreement terms and laws and regulations that cause us to conclude that the aggregation of misstatements resulting from those failures or violations is material to the fund accountability statement and the cost-sharing schedule. The results of our compliance tests disclosed the following material instances of non-compliance.

- The annual financial audit of the REIP Program for the year 2004 was carried out in April 2006, more than one year after close of the fiscal year (December 31, 2004). This is contrary to the provisions of the Agreement which require that each audit be completed no later than one year after the close of the GSE's fiscal year (see 4.2.1).
- The results of our tests disclosed material questioned costs, as detailed in the Fund Accountability Statement, of US$ 176,980 that are explicitly questioned because they are in excess of the budget and therefore ineligible in the budgetary terms of the Agreement (see 3.3.7); US$ 537 that is ineligible because of the personal nature of the expense (see item 3.3.5) and US$ 108,922 that is not supported by adequate documentation (see items 3.3.2 and 3.3.3).

5 We considered these material instances of non-compliance in forming our opinion on whether CBER/REU December 31, 2005 Fund Accountability Statement is presented fairly, in all material respects, in accordance with the terms of the agreement and in conformity with the basis of

accounting described in Note 2.2.2 to the Fund Accountability Statement, and this report does not affect our report on the Fund Accountability Statement dated August 30, 2006.

6 We noted one immaterial instance of non-compliance that we have reported to the management of REIP Programme in a separate letter dated August 30, 2006.

7 This report is intended for the information of CBER/REU and USAID. However, upon release by USAID, this report is a matter of public record and its distribution is not limited.

PricewaterhouseCoopers

Certified Public Accountants
Nairobi

August 30, 2006

4.1 Work performed

Our audit of the contract agreement included obtaining assurances that REU and CBER management complied with the contract agreement provisions. Procedures performed to test such compliance included the following:

- a review of the contract agreement (including subsequent amendments), implementation letters and related regulations to identify those provisions and regulations, which could have a material effect on the Fund Accountability Statement.

- audit procedures including detailed testing to confirm REU and CBER management's compliance with these provisions and regulations.

4.2 Findings and recommendations

4.2.1 Timing of the 2004 financial audit

Criteria

Under the Standard Provisions contained in Annex 2 of the Investment Partnership Agreement, Section B.5 (C,2), it is stated that an audit of the funds provided under the Agreement shall be conducted for each fiscal year of the GSE. The audit shall determine whether the receipts and expenditure of the funds provided under the Agreement are presented in accordance with generally accepted accounting principles agreed to and whether the GSE has complied with the terms of the Agreement. Each audit shall be completed no later than one year after the close of the GSE's fiscal year.

Condition

The annual audit for the year 2004 was carried out in April 2006, more than one year after close of the fiscal year (December 31, 2004).

Cause

Management explained that it was generally understood that requests for audits were to be made by USAID/Eritrea.

Effect

Non-compliance with terms of the Agreement. However, this has no material effect on the Fund Accountability Statement.

Recommendation

Parties to the Agreement should comply with all its provisions.

Management comments

It is generally understood that requests for audits were to be made by USAID/Eritrea.

5 Report on the Cost Sharing Schedule

The Rural Enterprise Investment Partnership (REIP) Board of Advisors

C/O Commercial Bank of Eritrea
P. O. Box 219 Asmara - Eritrea

1. We have reviewed the accompanying cost-sharing schedule of CBER/REU for the period January 1, 2004 to December 31, 2005. Our review was conducted in accordance with standards established by the American Institute of Certified Public Accountants (AICPA). The purpose of our review was to determine if the cost-sharing schedule is fairly presented in accordance with the basis of accounting described in the notes to the cost-sharing schedule. We also considered internal control related to the provision of and accounting for cost-sharing contributions.

2. A review consists principally of inquiries of recipient personnel and analytical procedures applied to financial data. It is substantially more limited in scope than an examination, the objective of which is to express an opinion on the cost-sharing schedule. Accordingly, we do not express such an opinion.

3. Based on our review, nothing came to our attention that caused us to believe that CBER/REU did not fairly present the cost-sharing schedule, in all material respects, in accordance with the basis of accounting used to prepare the cost-sharing schedule. Furthermore, nothing came to our attention that caused us to believe that the recipient has not provided and accounted for cost-sharing contributions, in all material respects, in accordance with the terms of the agreement.

4. This report is intended for the information of CBER/REU and USAID. However, upon release by USAID, this report is a matter of public record and its distribution is not limited.

PricewaterhouseCoopers

Certified Public Accountants
Nairobi

August 30, 2006

5.1 Cost sharing schedule for the period January 1, 2004 to December 31, 2005

5.1.1 Introduction

As per the agreement entered into between the United States of America and the Government of the State of Eritrea on 30 September 1997(Section 3.2), the total estimated planned contribution of the Government of the State of Eritrea (GSE) towards Rural Enterprise Investment Partnership is not less than US$ 3,881,000. The GSE's contribution includes allocation of part of the Commercial Bank of Eritrea's (CBER) liquidity in excess of its loan portfolio requirements and in-kind contributions, subject to availability of funds to the GSE for this purpose. Alternatively, PL-480, Title III, local currency proceeds transferred to the Ministry of Construction for the purpose of rehabilitating secondary rural roads can be included in GSE's contribution.

5.1.2 The cost sharing schedule

COST SHARING SCHEDULE						
Item	Budget	Actual	Shortfall	Questioned Costs		Notes
	(USD)	(USD)	(USD	Ineligible	Unsupported	
PL-480, Title III, local currency proceeds from monetization		14,685,268	-	-	-	1
Commercial Bank of Eritrea's lending		40,800,096	-	-	-	2
In kind contributions by CBER to the REIP		-	-	-	-	3
Total	**3,881,000**	**55,485,364**	-			

Management availed to us a letter dated February 11, 2005 written by the USAID/Eritrea Mission Director to the Regional Inspector General/Pretoria explaining that the above costs were allowed as cost share from the Government of the State of Eritrea.

1. PL-480, Title III local currency proceeds from monetization

This represents the local currency contribution from monetized Title III wheat which was sold and the proceeds utilised for the rehabilitation of secondary rural roads. The local currency proceeds from PL-480 Title III were transferred to the Ministry of Construction for the purpose of rehabilitating the secondary rural roads and, by 2002 a total of 221 Kilometers of road had been rehabilitated with the Title III funds.

2. CBER lending

This represents CBER's lending in the REIP target areas (excluding EIF & ERCS loans) during the life of the REIP Programme.

3. In-kind contributions by CBER to the REIP

These include salaries of employees seconded to the project, office space, equipment, telephones, and covering of computing costs. We could not assign values to the contributions in-kind because the requisite financial analysis was not readily available from CBER.

6 Status of prior year audit recommendations

We have tabulated the audit recommendations and their implementation status arising from the Agency-contracted audit of USAID resources managed by CBER and REU under project number 661-0009 for the period September 30, 1997 to December 31, 2003.

Recommendation	Implementation Status	Management Comments
Rural Enterprise Unit:		
Review of bank reconciliation statements: Bank reconciliation statements are a key cash management tool and should be reviewed by an appropriate official of the organization who is independent of their preparation.	Implemented. Subsequent to the 2003 audit, monthly bank reconciliation statements are prepared by the Finance Manager and reviewed by the Programme Manager.	Matter closed.
Documentation of minutes of meetings: Minutes form a record of discussions held at staff meetings and should therefore be documented. Any milestones or action points agreed upon during these meetings should be documented for follow-up at subsequent meetings. Without such records, the trail of agreed action points may be lost to the participants.	Implemented. Minutes of technical committee meetings now documented and filed.	Matter closed.
Tagging of fixed assets: The tagging should be done in a more permanent manner. For example, indeligible ink may be used.	Implemented. Fixed assets now marked with indeligible ink.	Matter closed.
Commercial Bank of Eritrea:		
Monitoring of loan performance: The banks loan committee or a newly established credit committee, reporting directly to the Board of Directors, should be charged with the express responsibility of monitoring the bank's credit risk after initial loan approvals have been granted. Additionally, in carrying out its monitoring, the REU should liaise with local CBER branches to establish individual loan movements in order to corroborate information obtained from the loan recipients.	Not implemented. We did not see any documented evidence of monitoring the loan performance at the head quarters level. Management explained that this was a role left to branch managers. See item 3.3.8 of this report.	At the beginning of 2005, the management of the bank decided to place two additional staff in the Credit Administration Division. They joined in March 2005 and were both assigned work in monitoring and debt recovery functions.

Recommendation	Implementation Status	Management Comments
Computerization of the bank's systems: Banks need reliable management information on their financial performance. Large transaction volumes, the need for accuracy, the rapid development of new products and the integration of a wide range of services has created a need for increasingly sophisticated computerized systems. CBER should consider investing in computer and telecommunications technology to support operations and provide timely information. Alternatively, in the short-run, the bank may, with the help of experts, design simple databases or redesign the current electronic spreadsheets in order to produce appropriate credit management information for monitoring and decision-making.	Partially implemented. As part of its computerization efforts, the bank has installed computers at some of its branches (e.g. Massawa, Edaga, Keren, and Adi Keih). There is still need for computerizing the banking system and training the end users. This is, however, a long term project.	Computerization of the bank's systems needs a long time to implement. For the time being, the management of the bank has started installing computers at the branch level, which will be very important in handling and monitoring of loan records.
Minimization of collateral risk: We recommend that the bank strictly follow its policy on valuation and insurance of loan collateral. In particular - The Bank of Eritrea issued Directive No. 3/2002, Paragraph 6 on Treatment of Collateral. Sub-paragraph 6.3 states, "Collateral can be valued with reference to audited financial statements of the borrower or by using approved valuation experts or through on-site inspection and appraisal by the bank concerned. Since provisioning requirement in respect of Non Performing Assets (NPAs) is assessed, taking into account the value of the collateral, duly discounted, it is necessary that the bank's management should give utmost importance to the valuation of the collateral".	Partially implemented. Collateral risk is, in many cases, still considered at the point of lending. We noted instances whereby the collateral pledged had not been inspected or insured subsequent to the loan disbursements. See items 3.3.11 and 3.3.12.	The management of the bank considers collateral as a secondary source of loan repayments. Upon sanctioning of the loans, lending officers, in collaboration with the bank's engineer, make conservative property estimations in order to minimize loan risk.
Rating and categorization of loans: The need to have loan ratings or classifications for individual credits done accurately should be emphasized to the branch staff and regularly reviewed for accuracy as senior management at Head Office rely on branch summaries for monitoring and decision-making purposes.	Partially implemented. The errors noted as at 31 December 2003 were corrected. We, however, noted some new instances of loan misclassifications (see item 3.3.13).	As mentioned in the prior year's audit report, classification and rating of loans are done at the branch level and the misclassifications made as at 31 December 2003 were corrected.

Recommendation	Implementation Status	Management Comments
		Further, with the establishment of the monitoring unit within the Credit Administration Division, the controlling function in this area will be strengthened.
Requirement for annual audits: Parties to the Agreement should comply with all its provisions. The Investment Partnership Agreement requires an annual audit if US$ 250,000 or more is disbursed directly under the program. We were not presented with any written waivers of the condition.	Partially implemented. The financial audit for 2004 was not performed within the time limits. See item 4.2.1.	It is generally understood that USAID requests for the REIP audits.
Cost sharing contribution: Before the end of the Agreement period (September 30, 2005) the Government of the State of Eritrea through the REIP Advisory Board should produce evidence that they have attained the cost share contribution and present this to USAID.	Implemented. Cost share approved by USAID/Eritrea.	Matter closed.

Appendix I – CBER Lending and Operations

	Overall Budget	Actual 2004	Actual 2005	Total
	USD	USD	USD	USD
Income:				
USAID grant	4,904,347	545,320	204,123	749,443
Total income	**4,904,347**	**545,320**	**204,123**	**749,443**
Expenditure:				
CBER lending and operations	4,904,347	545,320	455,971	1,001,291
Total expenditure	**4,904,347**	**545,320**	**455,971**	**1,001,291**

Appendix II – REU Program and Operations

	Overall Program Budget	Actual	Notes
	USD	USD	
Revenue:			
USAID Grant	1,649,000	285,606	
Gain on exchange rates	-	148	1
Total Revenue	**1,649,000**	**285,754**	
Costs Incurred:			
REU – Program Management	1,312,000	261,983	
Assistance to Enterprises	337,000	6,829	2
Total Costs Incurred	**1,649,000**	**268,812**	
Outstanding Fund Balance	-	**16,942**	
Represented by:			
Cash Account No. NTR 7720	-	705	
Cash Account No. 8386	-	16,028	
Petty cash (REU Asmara Office)	-	108	
Zoba Anseba	-	101	
Total	-	**16,942**	

Notes

1. The exchange gains (and losses) arise due to the fact that funds are transferred in US Dollar and received by REU in Nakfa. The reimbursement of monthly claims made by REU may be more or less depending on exchange rates on the date of making the claim and the exchange rates on the date of actual receipt of the reimbursement. REU also revalues its expenses at the end of the year and gains or losses may arise.

2. These are grants which were given to Mibrak Kahsay (Integrated Farming Project, Aligider, Tesenei) and Small Scale Garment Manufacturing Enterprise (Asmara) through direct assistance from the Rural Enterprise Unit. US$ 3,556 and US$ 3,273 were advanced in 2004 and 2005, respectively.

Appendix III – Budget Vs Actual Analysis

	Overall Program Budget	Actual to 2003	Actual 2004/2005	Budget Vs Actual
	USD	USD	USD	USD
Revenue:				
USAID Grant	11,588,347	10,063,158	1,035,198	489,991
Total Revenue	**11,588,347**	**10,063,158**	**1,035,198**	**489,991**
Costs Incurred:				
CBER Lending and Operations (See Appendix I)	4,904,347	4,080,036	1,001,291	(176,980)*
REU Program and Operations (See Appendix II)	1,649,000	987,385	268,812	392,803
Program Modifier (See Appendix III)	5,035,000	4,999,863	-	35,137**
Total Costs Incurred	**11,588,347**	**10,067,284**	**1,270,103**	**250,960**
Outstanding Fund Balance	-	**(4,126)**	**(234,905)**	**239,031**

* Total excess of disbursements over budget is US$ 176,980. We understand from management that reimbursement claims amounting to US$ 251,848 have been submitted to USAID and are still pending. We, however, did not obtain any official communication on the pending claims.

** This budgetary allocation is considered by management to have been exhausted by CBER through the USAID Technical Assistance. It is shown here as a budget surplus because the donations were made in-kind by USAID.

Appendix IV – Summary of Loan Reflows and Non-expendable Assets as at December 31, 2005

a) Balances of loan reflows from EIF and ERCS held at CBER branches.

Branch	Principal	Interest	Principal	Interest
	Nakfa	Nakfa	USD	USD
ERCS:				
Adi Keih	10,147,377	1,882,650	676,492	125,510
Adi Ugri	403,698	139,933	26,913	9,329
Agordat	1,273,651	272,703	84,910	18,180
Barentu	12,134,893	1,878,988	808,993	125,266
Edagaberai	147,000	13,906	9,800	927
Liberty Avenue	1,759,057	307,874	117,270	20,525
Tessenei	14,950,192	3,422,740	996,679	228,183
Sub-total	**40,815,868**	**7,918,794**	**2,721,058**	**527,920**
EIF:				
Adi Keih	41,832	89,668	2,789	5,978
Adi Ugri	1,687,701	986,776	112,513	65,785
Agordat	693,608	383,102	46,241	25,540
Barentu	1,223,110	258,157	81,541	17,210
Edagaberai	1,020,702	683,680	68,047	45,579
Liberty Avenue	3,694,638	1,364,217	246,309	90,948
Tessenei	517,205	340,824	34,480	22,722
Afabet	142,215	39,685	9,481	2,646
Massawa Main	979,594	392,128	65,306	26,142
Assab Main	348,018	74,330	23,201	4,955
Dekemhare	16,447	2,873	1,096	192
Keren	4,094,961	1,103,252	272,997	73,550
Sub-total	**14,460,031**	**5,718,692**	**964,002**	**381,246**
Total	***55,275,899***	***13,637,486***	***3,685,060***	***909,166***

b) Non-expendable assets (USAID Technical Assistance)

Description	Cost
	USD
Grant for purchase of equipment:	
REU – Equipment	17,488
Sub-total	**17,488**
Direct purchase	
Contingency – REU	20,881
Sub-total	**20,881**

Description	Cost
REU establishment & operation	
Equipment	44,655
Furniture	18,843
Sub-total	**84,379**
Donations by USAID in kind	
REU – Vehicles	71,000
REU – Equipment	14,704
REU – Furniture	4,814
REU – Computers	10,610
CBER – Equipment	183,833
Sub-total	**284,961**
Total*	**386,828**

* See Appendix V for a detailed analysis.

Appendix V – Detailed Listing of Non-expendable Assets

Description	Quantity	Cost in Nakfa	Cost in USD	Location
Rural Enterprise Unit				
Direct purchase under the REU contingency:				
Toyota Double Cabin LN 166-0021952 (Chassis Number), 364685126 (Engine Number), ER-03-10444 (Plate Number)	1	147,529	20,881	Massawa Branch of REU
Sub-total		**147,529**	**20,881**	
In-kind donations by USAID - vehicles:				
Toyota Double Cabin LN 1060133401 (Chassis Number), 3L-4084436 (Engine Number), ER-03-09782 (Plate Number)	1	136,800	19,000	Barentu Branch of REU
Toyota Double Cabin LN 1060134554 (Chassis Number), 3L-4100369 (Engine Number), ER-03-09783 (Plate Number)	1	136,800	19,000	Keren Branch of REU
Toyota Land Cruiser H 2580-0029391 (Chassis Number), IH2-0193597 (Engine Number), ER-03-0984 (Plate Number)	1	237,600	33,000	REU Head Office, Asmara
Sub-total		**511,200**	**71,000**	
In-kind donations by USAID - Furniture:				
Conference table chairs (12) and swivel chairs (4)	16	-	1,452	REU Head Office, Asmara
Conference table	1	-	598	REU Head Office, Asmara
Desks with extension	4	-	2,164	REU Head Office, Asmara
Filing cabinets	3	-	600	REU Head Office, Asmara
Sub-total			**4,814**	
In-kind donations by USAID - Computers:				
Dell Optilex GXI Pentium III CP (Barcode 639)	1	-	1,455	Massawa Branch of REU
Dell Optilex GXI Pentium III CP (Barcode 723)	1	-	1,455	REU Head Office, Asmara
Dell Optilex GXI Pentium III CP (Barcode 743)	1	-	1,455	REU Head Office, Asmara
Dell Optilex GXI Pentium III CP (Barcode 740)	1	-	1,455	Keren Branch of REU
Dell Optilex GXI Pentium III CP (Barcode 877)	1	-	1,455	Barentu Branch of REU
Dell Optilex GXI Pentium III CP (Barcode 1046)	1	-	1,455	REU Head Office, Asmara

Description	Quantity	Cost in Nakfa	Cost in USD	Location
Dell Monitor Model No. M780 (Barcode 744)	1	-	320	Massawa Branch of REU
Dell Monitor Model No. M780 (Barcode 827)	1	-	300	Barentu Branch of REU
Dell Monitor Model No. M780 (Barcode 913)	1	-	300	Keren Branch of REU
Dell Monitor Model No. M780 (Barcode 1460)	1	-	320	REU Head Office, Asmara
Dell Monitor Model No. M780 (Barcode 1461)	1	-	320	REU Head Office, Asmara
Dell Monitor Model No. M780 (Barcode 1462)	1	-	320	REU Head Office, Asmara
Sub-total			**10,610**	
REU establishment & operation: Furniture:				
Chairs	62	42,021	4,082	REU Head Office, Asmara
Desks	5	30,250	2,938	REU Head Office, Asmara
Tables	20	13,709	1,332	REU Head Office, Asmara
Assorted furniture	21	28,005	2,720	REU Head Office, Asmara
Assorted Furniture	26	23,905	2,322	Massawa Office of REU.
Assorted Furniture	56	26,256	2,550	Keren Office of REU.
Assorted Furniture	57	31,511	2,899	Barentu Office of REU.
Sub-total		**195,857**	**18,843**	
REU Equipment:				
Canon 6216 Copier	1	28,800	3,186	Keren Branch of REU
Canon L-90 Fax Machine	1	9,800	1,084	Massawa Branch of REU
APC. Smart Back Up, UPS 650 VA	6	31,470	3,481	Asmara/Keren/Massawa/ Barentu
Canon NP-6317 Desktop Copier, NP Toner, 10	1	-	3,257	Massawa Branch of REU
Canon NP-6035 Desktop Copier	1	-	14,500	REU Head Office, Asmara
Components of NP-6035		24,500	2,710	REU Head Office, Asmara
Desktop Pentium 4	4	178,600	19,755	REU Head Office, Asmara
Server Pentium 4	1	97,000	10,729	REU Head Office, Asmara
UPS 1000 VA	2	23,000	2,544	REU Head Office, Asmara
Vision Graphic 14"	4	-	500	Asmara/Keren
HP Printer	1	-	500	REU Head Office, Asmara
UPS	4	-	2,050	REU Head Office, Asmara
Dell Optiplex G x M 5133	5	-	8,075	REU Head Office, Asmara
Dell Optiplex GL 5133	1	-	1,129	REU Head Office, Asmara

Description	Quantity	Cost in Nakfa	Cost in USD	Location
IBM G-70 Colour Monitor	1	6,275	694	REU Head Office, Asmara
Toshiba Lap top	1	23,980	2,652	REU Head Office, Asmara
Sub-total		**423,425**	**76,847**	
Total REU Assets			**202,995**	
Commercial Bank of Eritrea:				
Office Equipment (Program Modifier):				
Note Counting Machines	18	409,500	30,221	CBER, Asmara
Adler Desk Top Calculators	20	50,000	3,690	CBER, Asmara
Photocopy Machine – NB6020.	1	41,600	3,070	CBER, Asmara
Sub-total		**501,100**	**36,982**	
USAID-ACDI/VOCA Technical Assistance:				
Computers and Software	Various	1,512,925	111,655	Dispersed in all branches of REU. Full list of individual items availed.
Furniture and fittings	Various	137,550	10,151	Dispersed in all branches of REU. Full list of individual items availed.
Assorted Electronic Equipment	Various	160,397	11,837	Dispersed in all branches of REU. Full list of individual items availed.
Note Counting Machines	10	169,780	13,208	CBER, Asmara
Sub-total			**146,851**	
Total CBER Assets			**183,833**	
GRAND TOTAL			**386,828**	

U.S. Agency for International Development
Office of Inspector General
1300 Pennsylvania Ave, NW
Washington, DC 20523
Tel: (202) 712-1150
Fax: (202) 216-3047
www.usaid.gov/oig