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SURVEY OF
THE ECONOMIC SUPPORT FUND
PROGRAM FOR THE PHILIPPINES
USAID/PHILIPPINES

AUDIT REPORT NO. 2-492-87-03

November 21, 1986

AGENCY FOR INTERNATIONAL DEVELOPMENT
WASHINGTON, D.C. 20503

Office of the
Deputy Inspector General

November 21, 1986

MEMORANDUM FOR: AA/ANE, Charles W. Greenleaf, Jr.
FROM: D/IG, *James B. Durnil*
SUBJECT: Survey of the Economic Support Fund Program for
The Philippines

Attached for your information and use is our audit survey report of the Economic Support Fund Program for the Philippines. Since its inception in 1980, the Economic Support Fund Program has provided \$459.6 million of American aid to the Republic of the Philippines. In exchange for United States dollars, local funds (Philippine pesos) are made available for development projects, Philippine Government budget support and other economic development purposes.

In the recent months, numerous news media accounts alleged potential abuses and diversion of United States economic assistance funds provided to the Philippine Government. The Regional Inspector General for Audit in Manila therefore surveyed the systems of accountability and controls for the Philippine Economic Support Fund. The survey was performed to examine the methods used to administer this program. The primary survey objective was to identify the systems of accountability and controls underlying the varied components of the program, including the dollar transfers, project and non-project assistance, interest utilization, and operational support of the Philippine Government agency administering the program.

The audit survey showed that the system of accountability and controls established by USAID/Philippines for peso expenditures were generally sufficient to ensure United States economic assistance funds were used for purposes agreed upon between AID and the Philippine Government. While adequate systems were established to account for and control peso expenditures and protect United States interest, the survey revealed some potential programming deficiencies. As a result, we plan to

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issue separate audit reports on the utilization of interest income generated from Economic Support Fund Special Accounts, on the Philippine Government system for monitoring activities of subproject construction contractors, and on the integrity of the local currency expenditure reports for non-project assistance.

Copies of this survey report were provided to both mission officials in Manila and staff members of the Bureau for Asia and Near East in Washington. Although formal written comments were not received from these officials, they basically agreed with the report as presented and offered minor editorial changes.

EXECUTIVE SUMMARY

Since its inception in 1980, the Economic Support Fund Program has provided \$459.6 million of American aid to the Republic of the Philippines. In exchange, local funds are made available for development projects, Philippine Government budget support and other assistance. Of that amount, \$426.7 million has been released to the Philippine Treasury through October 14, 1986. Remaining to be released is \$32.9 million.

The Regional Inspector General for Audit in Manila surveyed the systems of accountability for the Philippine Economic Support Fund. The primary survey objective was to identify the systems of accountability established over the varied components of the Economic Support Fund Program, including dollar transfers, project and non-project assistance, interest utilization, and operational support of the Philippine Government agency that administers the program.

There is no requirement that USAID monitor the use of Economic Support Fund dollar transfers after the equivalent pesos are provided by the Philippine Government. One of the purposes of providing dollars for non-project assistance is to help support the Philippine Government balance of payments position. Accordingly, it is assumed that Economic Support Fund dollars would increase Philippine Government foreign exchange holdings and thus help its balance of payments position.

The Elementary School Construction Project funded at \$18 million was designed to provide Filipino children with access to basic education. The project financed several hundred typhoon-resistant elementary schools. Completed in December 1983, this project was the subject of AID Audit Report No. 2-492-82-12, dated July 14, 1982. As a result of the audit findings, USAID/Philippines established an elaborate system of accountability to track expenditures and monitor development projects financed with Philippine-provided pesos.

Through September 1986, the United States has transferred \$130.2 million to the Philippine Government under Economic Support Fund grant agreements for implementing various construction subprojects in the Philippines. For these dollars, the Philippine Government made available pesos of equivalent value for subproject implementation. The system of accountability over the pesos includes Philippine Government procedures for choosing subprojects and contractors and for approving peso disbursements. It also includes AID procedures for establishing special peso accounts, approving contracts valued at \$.5 million or more and approving withdrawals from peso Special Accounts.

Financial and administrative controls appear adequate to track and verify expenditures from the peso accounts and to offer reasonable assurances that pesos are used for authorized purposes. We are currently reviewing the adequacy of the Philippine Government system for monitoring the activities of the subproject construction contractors. During the course of that audit, the auditors and consultant engineers will inspect several subprojects to determine whether construction met the standards established in subproject construction plans and specifications.

Philippine pesos deposited in most Special Accounts for project assistance generate interest at commercial rates. As of August 1986, the interest accumulated in these Special Accounts totaled \$14.4 million in equivalent pesos. All interest generated by these accounts was closely monitored and controlled by USAID/Philippines. However, since the initial peso Special Account was not interest bearing, project agreements did not directly address the question of interest generated in those accounts. Early in the life of the Philippine Economic Support Fund Program, AID determined that interest generated in the peso Special Accounts was the property of the Philippine Government and need not be transferred to the United States Treasury. The AID/Washington General Counsel believed that as a matter of policy, USAID/Philippines should obtain Philippine Government agreement to use the interest earned in the Special Accounts to assist in financing AID-supported development assistance or Economic Support Fund projects "...or such other activities as may be mutually agreed upon in writing by the (Philippine Government) and A.I.D." USAID and the Philippine Government have not yet reached a formal agreement on use of the interest funds whether for developmental or other acceptable purposes. We plan to issue a separate audit report on interest control and utilization.

The Project Design project agreement called for a \$9 million grant to the Philippine Government spread over ten years beginning in 1980. The project provides financing for technical assistance, feasibility studies, detailed site surveys and planning studies leading to the development of other Economic Support Fund projects. It also finances pilot projects and pays certain management costs of the Economic Support Fund Secretariat, the Philippine Government agency managing the Economic Support Fund Program. USAID/Philippines reviews documents verifying all expenditures under this project. This system appears to account for all project expenditures. We do not currently plan any audit effort for this project.

One Economic Support Fund project which has had numerous implementation problems is the Rural Energy Development Project initially funded at \$18 million. USAID reduced the

project funding by \$14.5 million in response to numerous implementation problems. At the time of our survey, USAID and the Economic Support Fund Secretariat which manages the Project were still awaiting a final report on expenditures from the Farm Systems Development Corporation, the implementing agency. We plan to review this project further to determine whether a full scope audit would be beneficial to USAID/Philippines management.

A total of \$92.5 million in non-project assistance was provided to finance the Philippine Government counterpart funding requirements for selected AID, World Bank, and Asian Development Bank development projects. Upon receipt of the dollars (\$47.5 million in December 1984 and \$45 million in December 1985), the Philippine Government deposited into Special Accounts an equivalent amount of pesos, appropriated through its budget process. After USAID/Philippine approval of the projects receiving assistance and the issuance of Advices of Allotment, the Special Account relating to the \$47.5 million was closed and the local currency funds were transferred to the Philippine Government General Fund. As per the agreement covering this program, USAID/Philippines relied on Philippine Government Economic Support Fund Secretariat quarterly expenditure reports to show that the funds were disbursed to the approved projects. The other grant for \$45 million is to be handled in a similar manner. We are currently reviewing the Philippine Government's fulfillment of its commitments for this assistance as well as the integrity of the local currency expenditure reports.

The Budget Support Program grant agreement was signed on June 25, 1986 and provides the Philippine Government the peso equivalent of \$200 million to meet foreign exchange requirements. The pesos are required to be deposited into a Special Account. Prior to the transfer of any pesos from the Special Account to the Philippine Government, the Government is required to provide to AID an implementation plan, a statement of the Calendar Year 1986 budget categories and eligible programs within the categories, and a statement of estimated disbursements through the end of the third quarter of 1986.

Office of the Inspector General

SURVEY OF
THE ECONOMIC SUPPORT FUND
PROGRAM FOR THE PHILIPPINES

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SURVEY REPORT ON
THE ECONOMIC SUPPORT FUND
PROGRAM FOR THE PHILIPPINES

PART I - INTRODUCTION

A. Background

Since its inception in 1980, the Economic Support Fund (ESF) Program provided \$459.6 million of American aid to the Republic of the Philippines. Of that amount, \$426.7 million was released to the Philippine Treasury through October 14, 1986. Authorized by Chapter 4 of Part II of the United States Foreign Assistance Act of 1961, the Philippine ESF Program is intimately tied to the Philippine-American Military Bases Agreement of 1947, with its subsequent amendments and related agreements. Under these agreements, the United States exercises effective command and control over a group of air and naval bases throughout the northern Philippines. The most important of these are the Clark Air Base and the Subic Bay Naval Station.

Concurrently with the signing of a 1979 amendment to the Bases Agreement, the Executive Branch of the U.S. Government agreed that during the subsequent five years, it would make its best efforts to obtain appropriations of \$200 million in Economic Support Fund grant aid for the Philippines from the United States Congress. The two countries agreed that this money would be used to improve economic and social conditions in the areas surrounding the bases. The area was later extended to cover the entire country. In 1982, the Executive Branch of the U. S. Government undertook to make its best effort to obtain an additional \$475 million of ESF monies for the Philippines during the period 1985 through 1989. The money would be used to fund new development projects. It would also provide balance of payments support and budget support for the Philippines during a period of economic crisis.

The Philippine Government has consistently referred to the ESF monies as bases rental payments, although the Military Bases Agreement provides that use of the bases is provided free of rent. The U. S. Government has consistently referred to the ESF Program as development aid which is subject to periodic Congressional approval.

Seven separate projects plus three "programs" which were not directly linked to specific projects received funding through the ESF. The seven projects, jointly managed by the Philippine Government and USAID/Philippines, were:

- 1) Elementary School Construction Project. The Elementary School Construction Project, funded at \$18 million, was

designed to provide Filipino children with access to basic education. The project financed several hundred typhoon-resistant elementary schools. Completed in December 1983, this project was the subject of AID Audit Report No. 2-492-82-12, dated July 14, 1982. As a result of the audit findings, USAID/Philippines established an elaborate system of accountability to track expenditures and monitor development projects financed with Philippine-provided pesos.

- 2) Municipal Development Fund Project. This \$36 million grant project, scheduled for completion in 1988, provides financial and technical assistance to cities and municipalities in the general area of the military bases. The money is being used to provide a) technical assistance to improve administrative as well as project development and management capabilities of municipal personnel, b) infrastructure improvements, such as roads, bridges and flood control structures, and c) public enterprise development, such as markets, hospitals and slaughter houses. (See Results of Survey, section 2.)
- 3) Regional Development Fund Project. This \$85 million grant project is scheduled for completion in 1988. The program provides for construction of high priority, growth-related capital improvement projects, such as hospitals, markets, school classrooms, and local roads throughout the country. (See Results of Survey, section 2.)
- 4) Markets Project. This \$9.2 million grant project, scheduled to end in 1988, provides for construction of new markets, and for the renovation or enlargement of existing markets throughout the Philippines. (See Results of Survey, section 2.)
- 5) Rural Energy Development Project. This \$3.5 million grant project, scheduled to operate through 1990, provides for purchase and installation of gasifier equipment designed to reduce diesel fuel consumption in pump irrigation operations. It also provided credit to develop tree farms to grow feedstock and to construct kilns for charcoal production for industrial, commercial and household use. (See Results of Survey, section 5.)
- 6) Clark Access and Feeder Roads Project. Scheduled for completion in December 1986, this \$4.5 million grant project would construct a twelve kilometer road north of Clark Air Base, and develop a research facility to study soil and water conservation. (See Results of Survey, section 2.)

- 7) Project Design and Operation Support Project. Funded through a \$9 million grant, this project designed and developed projects to be funded under ESF. It also paid certain Philippine Government administrative costs associated with the ESF Program. (See Results of Survey, section 4.)

Non-project assistance, commonly referred to as "program" funding, began in 1984. Two programs were funded with ESF monies through 1985. A third program agreement was signed in June 1986. These programs are:

- 1) Rural Productivity Support Program. This program provided a \$47.5 million grant to the Philippine Government in 1984. The program was designed to provide balance of payments support at a time when Philippine international foreign exchange reserves were low and also was designed to provide 1985 budget support to maintain the pace of implementation for selected on-going World Bank, Asian Development Bank and AID projects which had been affected by Philippine Government budget cuts. (See Results of Survey, section 6.)
- 2) Development Support Program. This program provided a grant of \$45 million to the Philippine Government in 1985. These monies were intended to provide both balance of payments support and budget support for selected foreign assistance projects. (See Results of Survey, section 6.)
- 3) Budget Support Program. Signed in June of 1986, this program provides \$200 million to the Philippine Government. Funding sources of this program will be from current and prior years' ESF resources. Current fiscal year resources of \$119.62 million are available for the program. In addition, deobligation from Rural Energy and Clark Access Road Projects and other existing ESF projects amounting to \$12.5 million and \$67.875 million, respectively, will be reobligated for this purpose. The program was designed to assist the Philippine Government to finance peso expenditures in its 1986 budget in selected budget categories, with priority given to education, agriculture and health sectors. (See Results of Survey, section 7.)

Although the United States provides dollars to the Philippines under the ESF Program, the bulk of project costs are paid with Philippine pesos. Under the terms of the various project agreements, the Philippine Government provides appropriated pesos in an amount equivalent to the dollars provided by the United States. The pesos are deposited by the Philippine Treasury into "Special Accounts"

in the Philippine National Bank and withdrawn as project costs are incurred. The Special Accounts generate interest at commercial rates. Through August 1986, the funds in the ESF Special Accounts had earned interest of about \$14.4 million in equivalent pesos of which about \$1.38 million in equivalent pesos had been returned to the Philippine Treasury. The balance remained in the Special Accounts while the Philippine and United States governments attempted to reach a mutually agreeable plan for its disposition. Interest has continued to accumulate in the Special Accounts.

B. Survey Objectives and Scope

This survey was performed to explain and clarify the administration of the Economic Support Fund (ESF) Program in the Philippines. The survey objective was to describe the present and planned systems of accountability for the ESF program. To accomplish this objective, we reviewed Philippine Government and AID documents implementing the program and establishing systems of accountability, interviewed Philippine Government and AID officials implementing the program, reviewed and analyzed Philippine bank and Philippine Treasury statements and documents, and tested Philippine Government and AID systems for verifying expenditures and withdrawals from ESF accounts. All survey work was performed in the Philippines. Prior audit findings of the AID Inspector General's Office and the United States General Accounting Office were considered during the course of the survey.

This audit survey was performed during the period October 1985 to July 1986 and was made in accordance with generally accepted government audit standards.

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PART II - RESULTS OF SURVEY

The Regional Inspector General for Audit in Manila surveyed the systems of accountability and controls over the Philippine Economic Support Fund financed by the U. S. Government. The primary survey objective was to review the administration of this program and to identify the systems of accountability and controls underlying the varied components of the program, including project and non-project assistance, interest utilization, and operational support of the Economic Support Fund Secretariat, the Philippine Government agency which administers the program.

The audit work showed that the accountability and controls established by USAID/Philippines for peso expenditures were generally sufficient to ensure United States economic assistance funds were used as intended and for purposes agreed upon between AID and the Philippine Government. There were no requirements established for USAID to monitor the use of Economic Support Fund dollar transfers after the equivalent pesos were provided by the Philippine Government. When United States dollars were transferred, the funds were comingled with other Government receipts. The dollar transfers became part of the general pool of funds of the Philippine Government. Since these funds were fungible and comingled with other dollar holdings, it would be difficult to determine how the portion pertaining to the Economic Support Fund dollar transfers were utilized.

We found the system of accountability and controls over peso expenditures to be adequate in protecting the United States' interest. However, the survey identified some potential programming deficiencies. As a result, we plan to issue separate audit reports on the utilization of interest income generated from Economic Support Fund Special Accounts; the Philippine Government system for monitoring activities of subproject construction contractors; and the Philippine Government fulfillment of its non-project assistance commitments.

A. Findings and Observations

1. Dollar Transfers

Requirements were not established and USAID has not monitored the use of Economic Support Fund (ESF) dollar transfers once equivalent pesos are provided by the Philippine Government. USAID oversight has been concentrated on the utilization of the Philippine pesos.

Under the ESF program, AID has transferred United States dollars to the Philippines for project and non-project assistance.

-- The amount transferred to the Philippine Government for project assistance is equivalent to the estimated local currency needed to carry out project activities during the upcoming quarter. The Philippine Government appropriates and deposits the equivalent amount of its local currency (pesos) into Special Accounts for financing the local costs of ESF activities.

-- The entire dollar amount of non-project assistance is transferred to the Philippine Government once certain conditions are met, irrespective of how quickly funds are utilized. There is an exception in that in the last transfer of \$200 million for Philippine Government budget support, USAID exchanged the dollars for pesos and the pesos were provided to the Philippine Government.

Until December 1984, the dollars were transferred in the form of checks to the Philippine Government. Since December 1984, all dollar transfers have been made through electronic fund transfers. The dollars are deposited into Philippine Government accounts at either the Philippine National Bank or the Federal Reserve Bank of New York. At the same time as the dollars are received, the Philippine Government is required to deposit an equivalent number of pesos into Special Accounts. The exchange rates for the required peso deposits are based on the highest legal exchange rate when the United States dollar funds are transferred. There is no requirement as to how the Philippine Government obtains the pesos. For example, the required pesos could be borrowed, created, purchased with foreign exchange or provided from Philippine Government peso holdings.

When United States dollars have been transferred, the funds are commingled with other Philippine Government receipts and made available for legitimate Philippine Government foreign exchange needs. Since these funds have been commingled with other dollar holdings, it would be difficult to determine how the specific dollars pertaining to the ESF dollar transfers were utilized.

There is no requirement that ESF dollars be monitored once the pesos Special Accounts are established. With ESF project assistance, the dollars are provided to meet a requirement for an equivalent amount of pesos during project implementation. For Rural Productivity Support Program (RPSP) and Development Support Program (DSP) ESF non-project assistance, the dollars are intended for two purposes: 1) to provide balance of payments support to the Philippine Government, and 2) to provide budget support to selected on-going foreign-assisted activities. With respect to the second program purpose, the Philippine Government is required to report on the utilization of pesos for counterpart on AID-approved development activities. It should be noted that for the Budget Support Program (BSP) pesos are provided to the Philippine Government for budget support purposes only.

2. Project Assistance.

Through September 1986, the United States transferred \$130.2 million to the Philippine Treasury under Economic Support Fund (ESF) grant agreements for implementation of construction projects in the Philippines. As a consequence of the transfer of these dollars, the Philippine Government has made available pesos of equivalent value for subproject implementation. The system of accountability over the pesos includes Philippine Government procedures for choosing subprojects and contractors, and for approving peso disbursements. It also includes AID procedures for approving withdrawals from the peso Special Accounts. Financial and administrative controls appear adequate to track and verify expenditures from the peso accounts and to offer reasonable assurances that pesos are used for authorized purposes. We are currently reviewing the adequacy of the Philippine Government system for monitoring the activities of subproject construction contractors. During the course of that audit, auditors and consultant engineers will inspect several subprojects to determine whether construction met the standards established in subproject construction plans and specifications.

AID has signed four construction-oriented ESF project agreements with the Philippine Government through December 1985 ^{1/}. As described in the Background section of this report, the Municipal and Regional Development Funds, the Markets Project, and the Clark Access and Feeder Roads Project called for eventual transfer of \$136.6 million to the Philippine Treasury. Under the terms of the various agreements, AID transfers United States dollars to the Philippine Government for the Philippine Government's use as free foreign exchange to meet legitimate Philippine Government foreign exchange needs. The number of dollars transferred is equivalent to the estimated local currency requirements of the ESF Project activities for the ensuing quarter, as agreed upon by AID and the Philippine Government. As a consequence of the dollar transfer, the Philippine Government deposits in Special Accounts an equivalent amount of pesos to finance the local costs of the agreed-upon project activities. Peso transfers from the Special Accounts require the concurrence of USAID/Philippines. The Special Accounts themselves are

^{1/} A fifth construction project, the \$18 million Elementary School Construction Project, was completed in 1983. As that project was the subject of AID Audit Report No. 2-492-82-12, dated July 14, 1982, it will not be discussed in this report.

Philippine Treasury accounts kept at the Philippine National Bank (PNB), a commercial institution. Only ESF project funds are kept in the designated Special Accounts.

The Philippine Government set up an Economic Support Fund Secretariat (ESFS) under the Office of the Philippine President to plan, monitor and manage the ESF projects. The ESFS has a staff of about 125 full time professional, administrative, secretarial and clerical personnel.

Most activity under these Projects involves small-scale construction of roads, markets, schools, slaughterhouses, etc. The ESFS, with AID assistance and approval, established procedures to choose such subprojects, award contracts, pay contractors, and monitor implementation.

Subproject Development and Implementation - The four ESF projects have followed similar development and implementation procedures. Implementing agencies, which could be local or national government units or Philippine Government corporations, drew up a list of proposed subprojects and submitted proposals for those subprojects to the ESFS. The ESFS screened the proposals and determined whether the proposals met selection criteria set out in project grant agreements. If a proposal was acceptable, the ESFS and the implementing agency drafted a Project Identification Document which was submitted to both the Economic Support Fund Council (the ESFS' parent agency) and USAID/Philippines for approval.

If the proposal was approved, the ESFS and implementing agency prepared a project paper which presented the results of various studies and analyses carried out to evaluate the subproject's viability. These could include market demand, technical, administrative, financial, and socio-economic studies. Where the implementing agency did not possess the resources to produce such studies, the ESFS could hire consultants to perform the work, under guidelines approved by USAID/Philippines. After the project paper was completed, it was submitted to the ESF Council for the endorsement of the Philippine President. USAID/Philippines reviewed project papers for subprojects exceeding a specified amount (\$1 million or 25 million pesos depending upon the grant agreement under which the subproject was implemented).

Once the project paper was approved, the implementing agency or consultants hired under USAID/Philippines approved guidelines developed detailed engineering plans and specifications for the actual road or building to be constructed. The engineering plans were reviewed by the ESFS. USAID/Philippines also reviewed the engineering plans for all subprojects.

Once approved, the subproject was or is being executed by the implementing agency, under the terms of a project agreement between the implementing agency and the ESFS. This agreement specifies the conditions under which the ESFS agrees to obligate project funds and the responsibilities of the implementing agency.

Contracting and Contract Administration - The contracting of the four ESF-assisted projects was undertaken by the implementing agency through public competitive bidding. This process involved the prequalification of prospective contractors. The conduct of the bidding and the preparation of draft contracts recommending award to successful bidders as determined by the implementing agency were carried out under procedures approved by USAID/Philippines. These contracts involved procurement of construction materials or various services such as actual construction or architectural and engineering (A&E) services. The ESFS performed an initial review of the draft contracts. USAID/Philippines reviewed all construction contracts exceeding \$500,000 in equivalent pesos.

Construction contracts were let under the following procedures. Based upon the subproject proposal, the ESFS used its own engineering resources or consultants to develop an "Approved Agency Estimate" (AAE), the "fair" price of construction in the ESFS' estimation. The ESFS prequalified construction contractors based upon their financial standing and resources to perform work of varying size and complexity. After developing the AAE, the local Government unit requested bids from five or more contractors on the approved list. Originally, bids were considered for award only if they fell within a range of 15 percent above to 30 percent below the AAE. In 1985, these procedures were altered for all construction contracts. Since that time the AAE has been the "ceiling" cost. Bids must fall at or below the AAE to be considered for award. There was no longer a "floor" cost. If less than two bidders submitted qualified bids, the procedures were considered a "failure" and the contract was re-bid. If two "failures" occurred, the contract was negotiated by the ESFS. Through April 23, 1986, only one contract had been negotiated. AID approved these procedures. AID officials, including the Regional Inspector General for Investigations and Inspections, attended bid openings, which were publicly held, and reported seeing no irregularities.

The implementing agencies administered the day-to-day operations of the contracts through a Project Management Office (PMO). The ESFS monitored implementation through private Construction Management and Engineering Services (CMES) firms hired under USAID/Philippines approved guidelines. The CMES firms provided both monitoring and

technical support to the ESFS and the implementing agency. The CMES engineers submitted periodic progress reports to the ESFS which consolidated the reports for periodic review by USAID/Philippines. The ESFS also had a staff of project managers which monitored construction.

System for Budgeting Pesos for Approved Projects - The United States Congress approves, pursuant to the provisions of the Foreign Assistance Act of 1961, as amended, the amount and terms of the ESF dollar grant to be made available to the Philippine Government in a given fiscal year. The ESFS submits a budgetary request to the Philippine Office of the Budget and Management (OBM) on which basis the expected peso equivalent of the ESF is provided in the Philippine General Appropriations Act for that year. The OBM then grants to the ESFS the authority to obligate the ESF pesos to cover life-of-project costs through its issuance to the ESFS of an Advice of Allotment (AA). (Please note that while the AA is issued to cover life-of-project costs, it must be revalidated annually.) Upon the ESFS's receipt of the AA and the fulfillment of all of the conditions precedent in the Project Agreement between the United States and the Philippine Government, USAID/Philippines transfers United States Treasury Warrants to the Philippine Government in anticipation of peso requirements for the project for the coming three months.

The Philippine Government is to deposit the United States Treasury Warrant with the Philippine Central Bank and credit the equivalent pesos to the appropriate Philippine Treasury-ESF Special Account for that project, at an authorized Philippine Bank, generally the Philippine National Bank (PNB). Upon the Philippine Treasury's notification that the transfer has been completed, the Philippine Office of the Budget and Management issues a Notice of Cash Disbursement Ceiling (CDC) up to the equivalent amount of the fund transfer. Project costs are initially paid from the Philippine Government General Fund. The General Fund is reimbursed from the ESF Special Accounts after AID review and approval.

Procedures for Disbursement - The ESF pesos are released as capital outlay by the OBM to the ESFS. The ESFS releases the ESF project funds to contractors under one of two methods.

- a) Actual Cost Reimbursement. Under this method, allowable project costs incurred by the contractors are charged to the ESF. This is the most commonly used disbursement method.

- b) Fixed Amount Reimbursement. Under this method a fixed lump-sum project cost, as agreed upon by the ESFS and the implementing agency prior to implementation and approved by USAID/Philippines, is charged to the ESF. Any cost overruns are borne by non-ESF sources while savings inure to the implementing agency.

Except for project mobilization costs (generally 15 percent of contract value), no advance payments are made from ESF under these project agreements.

Philippine Government Internal Controls - The subproject implementing agency must submit periodic liquidation reports to the ESFS. These include

- a Report of Treasury Warrants Issued,
- a Report of Checks Issued by Deputized Disbursing Clerks,
- a Report of Checks Issued,
- a Report of Disbursements by Disbursing Officers, and
- a Summary of Disbursements detailing the specific expenses incurred per subproject.

According to ESFS guidelines, these reports are to be certified by the implementing agency's Disbursing Officer or Treasurer, noted by its Chief Accountant, approved by the Head of Office, and verified by the resident auditor of the Philippine Commission on Audit, an independent Philippine Government auditing agency. The original reports remain with the Commission on Audit, while copies are reviewed by the ESFS. Banks disbursing original funds must provide the Philippine Treasury with monthly account status reports. Copies of these reports are also sent to the ESFS for review. After reviewing the reports, the ESFS certifies approved costs for reimbursement from the ESF Special Accounts to the General Fund of the Philippine Treasury.

AID Internal Controls - USAID/Philippines reviews all disbursements from the ESF Special Accounts to reimburse the General Fund. The Mission Controller reviews supporting documents, including progress reports and certifications submitted by contractors, construction management and engineering services firms, and local implementing agencies. The Mission's Office of Capital Development has a staff of four American and 13 Filipino engineers who periodically inspect ESF construction sites. The Mission Controller does not authorize release of monies from the Special Accounts until such releases have been reviewed and approved by the Mission Project Officer and until a corroborating field site

inspection report has been received from a Mission engineer. The Mission Controller also reviews, on a regular basis (monthly or more often as required), bank records of activity in the ESF Special Accounts.

Conclusion - Through March of 1986, USAID/Philippines and the ESFS programmed 207 subprojects plus the Clark Access And Feeder Roads Project through this process. Thirty-five subprojects were completed. An additional 2,384 schools and roads were begun under the Regional Development Fund (RDF). The United States General Accounting Office (GAO) reviewed this system in late 1985 and early 1986.^{2/} The GAO reviewed selected financial transactions and verified that approved amounts had been disbursed and received by subproject contractors. The GAO determined that financial and administrative controls were adequate to ensure that ESF local currency disbursements for project activities were justified. RIG/A/M reviewed and analyzed a sample of bank account documents for the Special Accounts. No unauthorized withdrawals from those accounts were identified. We also analyzed approval documents for a selected sample of subprojects. All subprojects tested conformed to the selection criteria contained in the project agreements signed by the United States and Philippine Government.

Based upon audit work performed by both RIG/A/M and the United States General Accounting Office, we are tentatively concluding that the control systems presently in place are adequate to account for proper expenditure of funds from the project-related ESF local currency Special Accounts.

We are currently auditing the system for contractor selection to determine whether selection procedures have been properly implemented. During the course of that audit, the auditors and independent engineers will inspect a selected sample of subprojects to determine whether construction has met the standards established in subproject construction plans and specifications.

^{2/} GAO Report titled "The Philippines, Accountability and Control of United States Economic Assistance", dated May 2, 1986, No. GAO/NSIAD-86-108BR.

3. Interest on Project Assistance Pesos

Philippine pesos deposited in most Special Accounts generates interest at commercial rates. As of August 1986, the interest accumulated in these Special Accounts totaled \$14.4 million in equivalent pesos. All interest generated by these accounts was closely monitored and controlled by USAID/Philippines. However, since the initial peso Special Account was not interest bearing, project agreements did not directly address the question of interest generated in those accounts. Early in the life of the Philippine ESF Program, the AID General Counsel determined that interest generated in the peso Special Accounts was the property of the Philippine Government, and need not be transferred to the United States Treasury. As a matter of policy, AID believed that USAID/Philippines should obtain Philippine Government agreement to use the interest earned in the Special Accounts to assist in financing AID-supported development assistance or ESF projects "...or such other activities as may be mutually agreed upon in writing by the (Philippine Government) and A.I.D." The Mission and the Philippine Government have not yet reached a formal agreement on use of the interest funds for developmental or other acceptable purposes. We plan to issue a separate audit report on interest control and utilization.

Interest generated in the ESF Special Accounts totaled \$14.4 million in equivalent pesos through August 1986. Except for \$1.3 million in equivalent pesos transferred to the General Fund of the Philippine Treasury in 1983 and 1984 and some additional amounts for taxes on interest earned, all interest generated in the peso Special Accounts remains in those accounts.

USAID/Philippines monitored activity in the Special Accounts, including accumulated interest, through an agreement with the Economic Support Fund Secretariat. Reproduced copies of the Special Account passbooks (all interest bearing Special Accounts were "passbook" demand deposit accounts) were sent by the Philippine National Bank (PNB), where the accounts were located, through the Philippine Treasury to USAID/Philippines on a monthly basis. USAID/Philippines reconciled the passbook statements to its formal notifications to the Secretariat allowing withdrawal of funds from the accounts and on a test basis recomputed some of the interest earnings posted to the Special Accounts passbooks to establish the accuracy thereof. USAID/Philippines then noted interest activity in the accounts, but did not recompute all interest.

We performed a recomputation of interest for a sample period. Interest was properly computed and deposited in the Special Accounts for that period. USAID/Philippines is

adequately monitoring peso-generated interest through its periodic review of bank passbooks recording activity in the Special Accounts.

As stated above, the Philippine and U. S. Governments were unable to decide upon a mutually agreeable means of utilizing the interest-generated pesos. As the two parties continued to discuss options, interest continues to accumulate at about \$3.3 million annually.

We are currently reviewing the peso-generated interest and plan to issue an audit report dealing solely with the interest issue. That report will address in greater detail the USAID/Philippines internal control system for monitoring interest and various alternative methods of utilizing the interest accumulating in the ESF Special Accounts.

4. Project Design and ESF Operational Support

The Project Design Project calls for a \$9 million grant to the Philippine Government spread over ten years beginning in 1980. The Project finances technical assistance, feasibility studies, and certain ESF management costs. USAID/Philippines reviews documents verifying all expenditures under this Project. This system appears to adequately account for all project expenditures. We do not currently plan any audit effort for this project.

The Project Design Project finances local currency costs of detailed site surveys, pre-feasibility and feasibility studies, planning studies and other consulting services needed for planning and project development under other ESF projects. In addition to normal technical and financial considerations, these studies can require an analysis of the capability of the responsible national or local government entity to provide funds and personnel to effectively maintain and operate completed subprojects. The Project Design Project also pays certain management costs of the Economic Support Fund Secretariat (ESFS). These include salaries for full-time and temporary employees, travel and certain office expenses.

ESFS expenses are funded by USAID/Philippines through quarterly peso advances based upon an annual operating budget approved by AID. The ESFS submits monthly expenditure reports to USAID/Philippines to liquidate these advances. Through May 1986, USAID/Philippines had provided the peso equivalent of \$3.9 million to the ESFS under this grant.

In October 1985, the Philippine Government began transferring peso advances from a non-interest bearing to an interest bearing account. The peso equivalent of \$12,648 in interest accrued in the project account before the principal was transferred, at USAID/Philippines' insistence, to a non-interest bearing account in April of 1986. This interest differed from the interest accruing under other ESF Projects which are discussed elsewhere in this report. The Project Design Project principal is provided by the United States. It does not arise from Philippine Government appropriated funds as was the case with other ESF Projects. Under the terms of the project grant agreement between the United States and Philippine governments, therefore, this interest had to be returned to AID. The peso equivalent of \$12,648 was deducted from an ESFS payment request on October 14, 1986 and the dollar equivalent was returned to the United States Treasury.

USAID/Philippines reviews all documentation evidencing liquidation of Project Design Project advances. RIG/A/M tested the ESFS payroll and salary disbursement system which

controls the largest single management cost item paid through ESF under this project. The system was adequate to ensure that salary disbursements were properly controlled.

The Project Design Project was one of only two Projects in the Philippine ESF Program which was funded through advances and liquidations rather than reimbursements for previously incurred costs. The other such project, Rural Energy Development, is discussed separately in this report. USAID/Philippines is adequately monitoring financial activity under the Project Design Project.

5. Rural Energy Development Project

One Economic Support Fund (ESF) project which has been plagued with implementation problems is the \$18 million Rural Energy Development Project. At the time of our survey, USAID and the Economic Support Fund Secretariat (ESFS) which manages the project were still awaiting a final report on expenditures from the Farm Systems Development Corporation (FSDC), the implementing agency. We plan to monitor the activities of this project to determine whether an audit would be beneficial to USAID/Philippines management.

In 1984, the Farm Systems Development Corporation (FSDC) launched a Gasifiers for Irrigation program to provide an alternative source of energy for its small scale pump irrigation projects which were jeopardized by ever increasing costs of diesel fuel. In 1983, FSDC entered into an agreement with the ESFS to assist the Gasifiers for Irrigation and Woodlot subprojects under the Rural Energy Development Project.

At the time the project paper was prepared, the suggested approach as well as the economic and technical analyses were basically sound. However, FSDC installed charcoal-burning gasifiers in the field rather than the wood-chip models given primary consideration in the project paper. This shift, combined with changing fuel costs and inadequate technical and management support, led to the subproject's current problems.

As of December 31, 1985, 282 gasifiers were installed, of which only about 40 percent were working. Another 102 gasifiers were in storage at FSDC warehouse facilities.

The Charcoal Production subproject had planted 3,940 hectares of trees as of December 31, 1985. The wood from the trees was to be harvested and processed into charcoal in project-constructed wood kilns. However, no harvesting took place in 1986 because of an insect infestation. The insects were eating all of the leaves off the trees. Because of the infestation, charcoal and woodlot development had stopped.

The project was designed as a \$25 million project. A total of \$18 million was obligated. However, after implementation problems developed, the USAID deobligated \$12 million. Out of the \$6 million that remained, ESFS received a \$4 million advance. ESFS loaned about \$1.6 million to FSDC for Rural Energy Development activities. FSDC is required to submit a report to the Secretariat accounting for the use of these funds. FSDC officials stated that a report was being

compiled based on the Philippine Commission on Audit (COA) audited reports. As of May 1986, COA had not started auditing any project transactions due to a large backlog.

An additional \$2.5 million was deobligated from this project on June 19, 1986, consisting of \$2 million of unobligated funds and \$500,000 of returned advance funds.

Because of the poor implementation and management practices at FSDC and the large number of gasifiers that were not working, we will be examining this activity further to determine if a full scale audit would be beneficial to USAID/Philippines management.

6. Non-Project Assistance

A total of \$92.5 million in non-project assistance was provided to finance the Philippine Government counterpart funding requirements for selected AID, World Bank, and Asian Development Bank development projects. As a consequence of the transfer of the dollars (\$47.5 million in December 1984 and \$45 million in December 1985), the Philippine Government deposited an equivalent amount of pesos, appropriated through its budget process, in Special Accounts. After USAID/Philippines approval of the projects receiving assistance and the issuance of Advices of Allotment (AAs), the Special Account containing the \$47.5 million was closed and the local currency funds were transferred to the Philippine Government General Fund account. USAID/Philippines relied on Philippine Government Economic Support Fund Secretariat (ESFS) quarterly expenditure reports to show that funds from the Economic Support Fund (ESF) were disbursed to the approved projects. We are currently reviewing whether the Philippine Government has met its commitment for this assistance. In addition, we are reviewing the integrity of the local currency expenditure reports.

Non-project assistance is a method of providing resources to a country on either a loan or a grant basis under circumstances where the amount of resources provided, rather than their particular use, constitutes the primary United States concern. Cash transfers are a form of non-project assistance utilized for budget support purposes and/or balance of payments support.

On December 22, 1984, the United States signed a \$47.5 million grant agreement with the Republic of the Philippines for the Rural Productivity Support Program (RPSP). The grant was designed to assist in meeting foreign exchange needs of the Philippines (balance of payments support) and assist the Philippine Government in maintaining a satisfactory pace of implementation of selected development activities by providing sufficient amounts of pesos for this purpose.

The balance of payments support consisted of the transfer of the \$47.5 million to the Philippine Government. As a consequence of the transfer of the dollar assistance the Philippine Government made available an equivalent amount of pesos to support selected development assistance activities within the 1985 National Government Expenditure Program component of the 1985 General Appropriations Act and the Public Works Act. The ESF pesos were programmed to support selected projects of the International Bank for Reconstruction and Development, the Asian Development Bank, and AID.

On December 24, 1984, the entire \$47.5 million was deposited in the Federal Reserve Bank of New York account of the Central Bank of the Philippines. On January 31, 1985, the Philippine Government made available 940,571,250 pesos and deposited these pesos into a Special Demand Deposit Account. In determining the peso equivalent, the rate of conversion utilized was that which was in effect when the dollars were received on December 24.

On September 30, 1985, the United States and the Republic of the Philippines signed another grant agreement (\$45 million) for the Development Support Program (DSP). The intended purpose of this grant was similar to the RPSA grant, namely, to provide peso support for the Philippine Government budget for this program and augment the balance of payments position of the Philippine Government. This grant was handled in a similar manner to the RPSA grant in that an equivalent amount of pesos was deposited into a Special Account as a consequence of receipt of the dollars.

The mechanisms for disbursing and monitoring RPSA and DSP funds were the same. In order for the pesos to be released from the Special Account, the Philippine Government had to provide certification that the AAs in the total amount of the respective RPSA and DSP budgets had been issued. For the RPSA, the required certification was provided and the USAID approved release of the pesos from the Special Account on April 9, 1985. All \$47.5 million in pesos were released to the Philippine Government's General Fund on the promise that the Philippine Government would spend the money on selected projects in 1985. The pesos in the DSP Special Account were not released because the Philippine Government did not fully spend the RPSA pesos in 1985 as planned.

The Philippine Government was required to monitor the implementation of the RPSA and report quarterly on its progress. The grant agreement stated that the quarterly reports should contain the following information:

- the status of RPSA implementation covering physical progress over and above what had originally been planned and funded in the budget for the time period in question in terms of the percentage completion of the RPSA;
- the summarized status of RPSA implementation covering financial progress of the entire RPSA. This would be accomplished by summarizing RPSA expenditures of all financial resources available for projects in the program, including pesos generated under the grant, Philippine Government budgeted counterpart contributions, and the grant/loan proceeds by recipient and by relating

the expenditures to the funding levels provided under the AAs. Although loan proceeds for activities of public corporations were not part of the RPSA, a memorandum item in the report would indicate the rate of utilization; and

- specific examples of any projects completed ahead of schedule due to the availability of the additional counterpart or other information which indicates improved rates of project implementation.

A final closeout report was due by September 30, 1986, in the same format as discussed above. The report was supposed to provide a more definitive indication of the achievement of the RPSA objectives and contain a Commission on Audit (COA) certified financial statement on the status of funds expended under the auspices of the RPSA. This would indicate the level of disbursement related to the AAs under the RPSA for all Philippine Government counterpart and grant/loan proceeds during the 1985 budget cycle.

In accordance with Agency policy, AID relied mainly on the Secretariat's certification through the quarterly reports that the local currency funds were disbursed to the designated activities and the undisbursed balances remained on deposit. A Philippine Government quarterly report stated that as of March 31, 1986, a total of \$35.1 million had been disbursed for the RPSA program under Fiscal Year 1985 authorizations. No details to support this figure were required by AID. However, the ESFS provided a detailed listing for Regional Inspector General auditors.

We are currently reviewing the RPSA and DSP programs to determine if controls are adequate and to test the integrity of the Philippine Government expenditure reports.

7. New Non-Project Assistance Program

The Budget Support Program (BSP) grant agreement was signed on June 25, 1986, and provides to the Philippine Government the peso equivalent of \$200 million for budget support for the Philippine Government fiscal year 1986 budget. To obtain the equivalent amount of \$200 million in Philippine pesos, USAID stated that arrangements have been made to purchase the pesos from the Central Bank of the Philippines through the transfer of \$200 million from the United States Treasury to a Philippine Government account in the United States. The pesos are required to be deposited into a Special Account. Prior to the transfer of any pesos from the Special Account, the Philippine Government is required to provide to AID an implementation plan, a statement of the Calendar Year 1986 budget categories and eligible programs within the categories, and a statement of estimated disbursements through the end of the third quarter of 1986.

The intended objective of the BSP is to provide ESF funds as budget support. Providing \$200 million to the Philippine Government for the purchase of pesos would also have a considerable impact on the Philippine balance of payments position. The budget support program would assist the Philippine Government in ameliorating its current budget crisis by providing peso support to ensure continued financing of basic services in the priority sectors of education, health and agriculture, as well, as other priority budget areas mutually agreed upon by AID and the Philippine Government.

Funds for planned BSP disbursements during the second and third quarters of 1986 would be transferred to the Philippine Government once the Philippine Government meets certain conditions. Subsequent releases from the BSP Fund Account would be made available for the following quarter's needs once the Philippine Government reports on disbursements from prior releases. BSP would assist in the financing of peso expenditures in selected priority budget categories. The program would give priority to education, agriculture and health sectors. However, other budget categories could be given consideration based upon mutually agreed upon priorities. This approach provides flexibility to allocate and/or reallocate scarce budget resources as budget priorities become clear.

BSP pesos are to be included in a level of expenditures for identified priority budget categories. Additionality is not a requirement of BSP. USAID and the Philippine Government agreed on the minimum peso amount to be spent in total by the Philippine Government for the budget categories eligible for assistance. This minimum amount would be large enough to

cover the amount of disbursements to be made against BSP pesos, as well as allow for items in those categories that may have dubious economic development impact. Any doubtful budget items would be attributed to resources other than those made available under BSP for these budget categories. For example, if 100 million BSP pesos were to be spent on the agriculture budget, the USAID could set the minimum level of Philippine Government disbursements at 135 million. Any disallowance would be attributed to the extra 35 million pesos disbursed by the Philippine Government.

The Philippine Government is required to submit to AID quarterly reports on cumulative disbursements in BSP budget categories. Books and records on BSP activities are required to be regularly audited by the Philippine Government Commission on Audit. The Philippine Government is to monitor the implementation of BSP and report quarterly on its progress. The quarterly reports are to provide a cumulative summary of disbursements in the agreed upon budget categories for the stated time period. A final report is to be provided in the same format and contain a Commission on Audit certified financial statement on the status of BSP.

The BSP was designed to provide a large amount of funds to the Philippine Government over a short period of time. Because of the very large Philippine Government deficit projected for Fiscal Year 1986, the Philippine Government certainly has the capacity to utilize the \$200 million in ESF pesos.

SURVEY OF
THE ECONOMIC SUPPORT FUND
PROGRAM FOR THE PHILIPPINES

PART III - EXHIBITS AND APPENDICES

Economic Support Fund Program
Summary of Signed ESF Project and Program Agreements
 (Millions of Dollars)

| | Fiscal Year | | | | | | | TOTAL | USAID Transfer Thru 5/86 |
|--|-------------|-----------|-----------|-----------|-----------|--------------|-----------------------------|----------------|--------------------------------|
| | <u>80</u> | <u>81</u> | <u>82</u> | <u>83</u> | <u>84</u> | <u>85</u> | <u>86</u> | | |
| I. PROJECT ASSISTANCE | | | | | | | | | |
| Project Design | 2 | 3 | 2 | 0 | 0 | 2.0 | 0 | 9.000 | 3.9 |
| Elementary School Construction | 18 | 0 | 0 | 0 | 0 | 0 | 0 | 18.000 | 18.0 |
| Municipal Develop- ment Fund | 0 | 22 | 13 | 20 | 0 | 0 | (19.000) | 36.000 | 24.2 |
| Clark Access and Feeder Roads | 0 | 5 | 0 | 0 | 0 | (0.5) | 0 | 4.500 | 3.1 |
| Rural Energy Devel- opment | 0 | 0 | 11 | 7 | 0 | (12.0) | (2.500) | 3.500 | 3.4 |
| Regional Develop- ment Fund | 0 | 0 | 20 | 15 | 50 | 36.5 | (34.575) | 86.925 | 72.3 |
| Markets | <u>0</u> | <u>0</u> | <u>4</u> | <u>8</u> | <u>0</u> | <u>9.0</u> | <u>(11.800)</u> | <u>9.200</u> | <u>9.2</u> |
| Sub Total | <u>20</u> | <u>30</u> | <u>50</u> | <u>50</u> | <u>50</u> | <u>35.0</u> | <u>(67.875)</u> | <u>167.125</u> | <u>134.1</u> |
| II. PROGRAM ASSISTANCE | | | | | | | | | |
| Rural Productivity Support Program ¹ | 0 | 0 | 0 | 0 | 0 | 47.5 | 0 | 47.500 | 47.5 |
| Development Support Program ¹ | 0 | 0 | 0 | 0 | 0 | 45.0 | 0 | 45.000 | 45.0 |
| Budget Support Program ² | <u>0</u> | <u>0</u> | <u>0</u> | <u>0</u> | <u>0</u> | <u>0.0</u> | <u>200.000</u> ³ | <u>200.000</u> | <u>200.0</u> |
| Sub Total | <u>0</u> | <u>0</u> | <u>0</u> | <u>0</u> | <u>0</u> | <u>92.5</u> | <u>200.000</u> | <u>292.500</u> | <u>292.5</u> |
| T O T A L | <u>20</u> | <u>30</u> | <u>50</u> | <u>50</u> | <u>50</u> | <u>127.5</u> | <u>132.125</u> | <u>459.625</u> | <u>426.6</u> |

Note: Amounts in parentheses indicate deobligations.

- 1/ These programs provide resources to the Philippine Government for both balance of payments support and budget support for a select group of USAID, ADB and IBRD rural development projects.
- 2/ This program provides resources to support the Philippine Government's 1986 budget in selected agreed-upon categories, with priority for the agriculture, health and education sectors.
- 3/ The \$200.000 million obligation consists of the reobligated FY85 and FY86 deobligations and an additional FY86 obligation of \$119.625 million.

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THE ECONOMIC SUPPORT FUND PROGRAM
FOR THE PHILIPPINES

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