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AUDIT OF
THE SMALL FARMER SYSTEMS II PROJECT
USAID/PHILIPPINES
PROJECT NO. 492-0334

AUDIT REPORT NO. 2-492-87-04

December 12, 1986

UNITED STATES GOVERNMENT

Memorandum

TO : Mr. Frederick W. Schieck
Director, USAID/Philippines

DATE: December 12, 1986

RIG/EA-86-060

FROM : Leo L. LaMotte
RIG/A/Manila

SUBJECT: Audit of the Small Farmer Systems II Project
USAID/Philippines, Project No. 492-0334

This report presents the results of audit of the Small Farmer Systems II Project. It was primarily a program results audit. Specific audit objectives were to determine (1) the status of AID's support to the the Farm System Development Corporation, (2) whether USAID/Philippines was adequately monitoring the AID resources provided to the Corporation for development activities, and (3) whether AID payments to the Corporation were valid and supportable.

The audit showed that over a 10-year period the Agency financed $23.9 million of the activities of the Farm Systems Development Corporation which is now virtually insolvent because of internal managerial deficiencies and the withdrawal of funding commitments by the Philippine Government. The audit also showed that USAID/Philippines exercised ineffective monitorship of the project.

The audit report recommends that USAID/Philippines (1) terminate funding of the Corporation until there is evidence that it can become operationally effective, and (2) develop and implement a specific monitoring system for AID resources provided to the Corporation. The report contains a third recommendation that USAID/Philippines recover a minor amount of overpayment.

The Philippine Government has recently decided to dissolve the Corporation, phasing out unproductive corporation enterprises and transferring viable enterprises to other government agencies. Consequently, the recommendations regarding termination of AID funding have been fulfilled and development of a specific Mission system for monitoring the Corporation activities is no longer necessary. Therefore, Recommendations 1 and 2 of the audit report will be considered closed as of the report issuance date.

Please advise our office within 30 days of the action taken or planned to clear Recommendation No. 3. Thank you for the courtesies extended to the audit staff on this assignment and your agreement with the report contents.

Attachment: a/s

EXECUTIVE SUMMARY

The Farm Systems Development Corporation is an autonomous, public corporation which was established in April 1975 by the Government of the Philippines to promote the organization and support of irrigation cooperatives and other farmer-based associations. The primary purpose of this organization is to increase agricultural productivity, raise farmer incomes and promote rural development. Since its creation, the Corporation has been the recipient of $23.9 million from AID including three loans totalling $19.5 million and three grants totalling $4.4 million.

This was primarily a program results audit. Audit objectives were to determine (1) the status of AID's support of the Farm System Development Corporation, (2) whether USAID/Philippines was adequately monitoring the AID resources provided to the Corporation for development activities, and (3) whether AID payments to the Farm System Development Corporation were valid and supportable.

The Foreign Assistance Act of 1961, as amended, and AID regulations are supposed to ensure that United States development resources be effectively and efficiently utilized. Over a 10-year period the Agency financed $23.9 million of the activities of the Farm Systems Development Corporation which is now virtually insolvent because of internal managerial deficiencies and the withdrawal of funding commitments by the Government of the Philippines. The audit also showed that USAID/Philippines exercised ineffective monitorship of the project. As a result of these factors, part of the $23.9 million AID invested in the Farm System Development Corporation was of no benefit and much of the AID-provided assistance will have marginal developmental benefit to the Philippines. We recommended that USAID/Philippines (1) terminate funding of the Farm System Development Corporation until there is evidence that it can become operationally effective, and (2) develop and implement a specific monitoring system for AID resources provided to the Farm System Development Corporation. Because the Government of the Philippines has recently decided to dissolve the Farm System Development Corporation, these recommendations will be closed on the date of report issuance.

USAID/Philippines stated agreement with the report's content.

Office of the Inspector General

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PART I - INTRODUCTION

A. Background

The Farm Systems Development Corporation (FSDC) was established on April 4, 1975 under Presidential Decree No. 681. Administratively under the Office of the Philippine President, it took over the responsibilities of the Barrio Irrigation Service Association that administered 44 irrigation systems. The FSDC was further supported by Presidential Decree No. 1595 of June 11, 1978, which gave it wide latitude in rural development activities, including the ability to loan funds to village-level organizational units for virtually any productive purpose, such as tree farming or fisheries. Since its creation, FSDC has been the recipient of $23.9 million from AID including three loans totalling $19.5 million and three grants totalling $4.4 million.

AID first provided support to FSDC in May 1975, under a project entitled Philippines Small Scale Irrigation. For this project, AID obligated $7.6 million over a three-year period. The Government of the Philippines (GOP) was to provide $9.8 million towards the project and the farmers were to contribute labor valued at $1 million. The goals of the project were (1) to increase farmer income, (2) to at least double employment opportunities, and (3) to decrease the rice deficit by 50 percent. These goals were to be achieved by supporting the creation of cooperatively owned and managed small-scale irrigation systems -- Integrated Service Associations (ISAs).

On March 14, 1978, AID initiated action to provide FSDC another $10.5 million for a project entitled Philippines--Small Farmer Systems. The GOP provided $10.5 million in equivalent pesos in support of project activities. The Danish Government also donated $1.9 million to finance irrigation pumping systems. The goals of the second project were to improve the socio-economic conditions of farmers in the project areas and to increase their participation in their own social and economic development. This loan also was designed to support FSDC's program to create and support ISAs.

On September 25, 1981, AID and the GOP signed a third agreement for the Small Farmer Systems II Project. The AID contribution totalled $5.8 million which provided financial and technical assistance for support of four project activities: (1) construction of additional small-scale irrigation facilities and the upgrading, rehabilitation, and improvement of existing irrigation systems; (2) the organization and operation of the provincial federations of ISAs, also known as KAISAs, to promote institutional development for newly formed irrigation associations; (3) financial assistance for the development of cooperatively owned rice mill enterprises managed by KAISAs; and (4) extension of FSDC experience and expertise in lowland irrigation systems to the uplands in support of small farmers in rainfed areas. The resources to be provided by the GOP on these project activities were not to be less than $32.8 million, including costs provided on an "in-kind" basis.

On September 25, 1985, AID agreed that $750,000 of the September 25, 1981 grant could be used to fund technical assistance to FSDC to help install new financial management procedures designed to correct deficiencies noted by the Mission in FSDC's financial status.

B. Audit Objectives And Scope

This was primarily a program results audit. Audit objectives were to determine (1) the status of AID's support to the Farm System Development Corporation, (2) whether USAID/Philippines was adequately monitoring the AID resources provided to FSDC for development activities, and (3) whether AID payments to FSDC were valid and supportable. To accomplish these objectives, we interviewed officials from USAID/Philippines, the Farm Systems Development Corporation, and the National Irrigation Administration. We also reviewed pertinent program and financial records of those organizations and inspected selected subprojects.

The audit of the Mission's monitoring activities and payments made to FSDC was limited to the activities financed by AID under the Small Farmer System II Project. As of December 31, 1985, USAID/Philippines disbursed $3 million for this project. We reviewed vouchers for all the KAISAs Enterprise Development components totalling $461,329, selected vouchers for institutional development totalling $24,216, commodities totalling $369,296, and vouchers for irrigation development totalling $229,197. We surveyed, but did not review in detail, disbursements made under a technical assistance contract with Experience Incorporated totalling $495,000 and participant training totalling $164,214.

The audit was performed during the period July 1985 to April 1986. It was made in accordance with generally accepted government auditing standards.

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PART II - RESULTS OF AUDIT

The audit showed that over a 10-year period the Agency financed $23.9 million of the activities of the Farm Systems Development Corporation (FSDC) which is now virtually insolvent because of internal managerial deficiencies and the withdrawal of funding commitments by the Government of the Philippines (GOP). The audit also showed that USAID/Philippines did not effectively monitor FSDC's activities. Further, the audit showed that USAID/Philippines made reimbursements to FSDC based on estimated rather than actual costs, which resulted in overpayment of $13,895.

The audit report recommends that USAID/Philippines (1) terminate operational funding of FSDC until there is evidence that it can become operationally effective, (2) develop and implement a specific monitoring system for AID resources provided to FSDC, and (3) recover the $13,893 in overpayments made to FSDC.

A. Findings And Recommendations

1. Continued AID Operational Support c° the Farm Systems Development Corporation Should Be Terminated Unless It Can Become Financially and Operationally Viable

The Foreign Assistance Act of 1961, as amended, states and AID regulations are supposed to ensure that United States development resources be effectively and efficiently utilized. Over a 10-year period the Agency has financed $23.9 million of the activities of the Farm Systems Development Corporation (FSDC), which is now virtually insolvent because of internal managerial deficiencies and withdrawal of funding commitments by the Government of the Philippines (GOP). Also, USAID/Philippines did not adequately monitor FSDC's activities. As a result of these factors, part of the $23.9 million AID invested in FSDC was of no benefit and much of the AID-provided assistance will have marginal developmental benefit for the Philippines.

Recommendation No. 1

We recommend that USAID/Philippines terminate operational funding of the Farm Systems Development Corporation until there is evidence that the Corporation can become operationally effective.

Recommendation No. 2

We recommend that USAID/Philippines develop and implement a specific monitoring system for AID resources provided to the Farm Systems Development Corporation to ensure such resources are used effectively and efficiently.

The GOP has recently decided to dissolve FSDC, phasing out unproductive corporation enterprises and transferring viable enterprises to other government agencies. Consequently, the recommendations regarding possible termination of AID funding have been fulfilled and development of a specific the Mission system for monitoring FSDC activities is no longer necessary. Therefore, Recommendations 1 and 2 of the audit report will be considered closed as of the report issuance date.

Discussion

The survey of FSDC in July 1985 indicated that this organization was experiencing major financial and managerial difficulties. Because of survey work, an in-depth audit of FSDC's operations relating to AID-financed resources was planned. However, USAID/Philippines requested that the audit be delayed until completion of a management consultant's evaluation of FSDC's financial condition and internal operations. This request was granted and the consultant's evaluation, which was completed in August 1985, noted FSDC was indeed insolvent and that this condition as well as managerial deficiencies were detrimental to AID-financed development activities.

Based on the consultant's report and subsequent audit work performed by us, we presented to USAID/Philippines in April 1986 several draft audit findings and recommendations. Due to the Mission response to these observations and due to recent events, notably the GOP's decision to dissolve FSDC, many of the draft findings were deleted from the audit report. However, we believe it is important to disclose the events leading to the the dissolution of FSDC. These issues as well as a recovery action required by USAID/Philippines are discussed below.

The Foreign Assistance Act of 1961, as amended, states that the Congress declares that United States development resources should be effectively and efficiently utilized. In this regard, the Agency has established regulations and systems of accountability, control and monitoring of AID-financed development resources. AID Handbook 3, Chapter 11 leaves it to bureaus and missions to establish project monitoring oversight systems. Chapter 11 states that these systems must have procedures to oversee borrower/grantee compliance with AID policies, procedures and regulations in order to ensure the effective utilization of AID-financed resources, to collect data for an historical record, and to prepare periodic reports. The Handbook also says that physical inspection of the activity by AID is an essential monitoring tool. Appendix 11E of Chapter 11 also lists verifying compliance with project agreement covenants and provisions as a specific monitoring responsibility.

Farm Systems Development Corporation is Virtually Insolvent

Between 1975 and the funding of the Small Farmer Systems II Project in 1981, AID and the GOP signed two project agreements under which funding was provided to support FSDC activities. These project agreements required that in addition to the AID funds, the GOP provide all funds and all other resources required by the FSDC to carry out AID-supported activities. The GOP complied with this requirement until recently when its support for FSDC was reduced. As a result, FSDC has become virtually insolvent. This decision on the part of the GOP, coupled with internal managerial deficiencies, caused the FSDC to ineffectively carry out development activities and may prevent continuation of some of those activities already implemented.

Until August 1983, according to USAID/Philippines officials, the GOP support for FSDC was forthcoming. USAID/Philippines officials stated that AID assistance provided under the Small Farmer Systems II Project was initiated at a time when continued GOP support was reasonably anticipated to continue at levels sufficient to sustain the project. However, when the Philippines encountered economic difficulties, the GOP subsidies to all government corporations, including FSDC, were cut back. In addition, the Mission officials noted that these financial problems were exacerbated by the FSDC's poor management practices.

In recognition of these problems, the Mission financed a contract with a U.S. public accounting firm for a management consultant's evaluation of the financial and management status of FSDC. The consultant's assessment, which was completed in August 1985, concluded that FSDC required major operational changes in order to stay in business. The consultant's report noted that it was time either to justify FSDC's continued existence or to provide massive subsidies so that its program might continue. The consultant's report concluded that both the GOP and the donor community should carefully reassess FSDC's role in rural agricultural development and to act on the results of that assessment.

Subsequent to the consultant's report, USAID/Philippines approved the use of grant funds for contracting technical services to help resolve FSDC's technical, financial and management problems, and to provide necessary training and auxiliary assistance to meet project objectives. An amendment to the Project Agreement, dated September 25, 1985, contained a condition precedent to the disbursement of further assistance for capital improvements or projects. That condition precedent required FSDC to adopt an interim policy plan for implementing needed financial and management improvements. It further required the GOP to agree to necessary policy changes, acceptable to AID and FSDC, and to ensure the financial soundness of FSDC.

In compliance with the condition precedent, FSDC transmitted an interim plan on November 29, 1985, which set forth strategies and specific measures it would undertake to address the management and financial problems affecting its operation. USAID/Philippines considered the proposal of this interim plan by FSDC to be an important first step towards (1) implementation of the consultant's recommendations, and (2) improvement of FSDC's overall financial and management policies, systems and procedures. However, as a result of the February 1986 change in the GOP administrations, the Philippine Ministry of Agriculture and Food, to which FSDC was recently attached, directed that there be a new assessment of the relevance of ongoing FSDC activities to the new government's priorities.

The purpose of this assessment was to help the Ministry determine which of FSDC activities should be continued and in what manner. This assessment was concluded in July 1986. The consulting firm that performed the assessment recommended that FSDC be phased-out and non-viable activities, including special projects and subsidiary operations, be discontinued. It also made recommendations for the transfer of certain FSDC functions in support of the ISAs to other units in the Ministry of Agriculture and Food.

Based on the assessment, on August 1, 1986 the Ministry informed USAID/Philippines that FSDC would be dissolved. The Ministry also requested AID grant funds to finance technical assistance needed for the estimated 18-24 month phase-out period. It noted that what would be developed in terms of phasing-out and prioritization of FSDC activities might also be applicable to the phasing out of other similar GOP corporations. The Mission officials told us that the grant funds probably would be provided as requested by the Ministry.

USAID/Philippines Monitoring of Farm Systems Development Corporation Activities was Inadequate

Feasibility Studies and Technical Assistance - As a condition precedent to the disbursement of funds for the Small Farmer Systems II Project Agreement which was signed on September 25, 1981, the GOP was required to furnish to AID, in form and substance satisfactory to AID, specific feasibility studies approved by the FSDC governing body. Another condition precedent to disbursement required the GOP to furnish AID, in form and substance satisfactory to AID, an executed contract between FSDC and a technical assistance consulting firm, for a duration of at least one year subject to renewal. The feasibility studies were poorly done, the technical contract was not executed prior to disbursement, and once it was executed, the FSDC did not readily accept the advice of the technical assistance team. A relevant circumstance here was the failure of USAID/Philippines to effectively monitor project activities. Due in part to these factors, all of the project-funded cooperative rice mill operations, costing $450,000, were losing money and close to closing down.

Feasibility Studies - The Small Farmer Systems II Project provided financial and technical support for (1) six pilot rice mill operations under the direction of the provincial Federations of Integrated Services Associations (KAISA), and (2) six pilot upland development projects, which were designed to support income-producing activities for upland farmers. The feasibility studies for the six KAISA rice mills were submitted to the Mission on May 13, 1982. However, the USAID/Philippines engineer field trip reports indicated that construction work on some of the mills had begun as early as December 1981 -- before the feasibility studies were submitted to the Mission for review and approval.

There was no evidence in USAID/Philippines files that an in-depth technical review was made of the feasibility studies. Such technical reviews probably would have pinpointed some of the deficiencies in the studies. For instance, according to project technical consultants, the feasibility assumptions for income generation from the mill operations were questionable, especially given the poor site location of the mills.

AID approved the KAISA feasibility studies on June 22, 1982, and the Cost Reimbursement Agreement on March 13, 1983. In approving the Agreement, USAID/Philippines concurred in the reimbursement for the sites selected even though the construction of some warehouse facilities had commenced prior to the date of the Agreement and without prior Mission approval. USAID/Philippines's approval was based on data furnished by FSDC which indicated that (1) the costs for the six sites were reasonable, (2) acceptable competitive procedures had been used to procure the services, and (3) the site feasibility studies had been approved by FSDC's Board of Directors.

An April 1984 project evaluation report concluded that the projections in the feasibility studies were based on overly optimistic assumptions regarding market demand and technical requirements. The expected supply of materials from member Integrated Services Associations as well as demand for enterprise outputs were generally overestimated. In addition, the marketing practices of competitors were not examined. A summary of the project rice mills and the reasons for failure follows.

KAISA	Reason For Failure
Antique ($81,571)	1. Market not within Province. 2. Peace and order problems in the area. 3. Low working capital.
Laguna ($77,194)	1. Too many rice mills in the area. 2. A strong GOP sales program existed in this area, offering domestic and imported rice at very low prices. 3. Low working capital.
South Cotobato ($75,926)	1. Far from both suppliers and markets. 2. Drought in 1984.
Misamis Occidental ($76,014)	1. Poor management due to heavy turnover of Operations Supervisors. 2. Low working capital.
Nueva Ecija ($68,719)	1. Warehouse destroyed by 1985 typhoon (no storm insurance). 2. Low working capital.
Isabela ($69,011)	1. Peace and order problems in the area. 2. Low working capital.

Many of the problems encountered in the KAISA Enterprise component could have been avoided if the Mission had done a better job of reviewing the feasibility studies before approving them.

The Mission stated that with regard to the feasibility studies, FSDC hired consultants at the provincial level to gather data from the proposed sites and to assess assumptions based on knowledge of local conditions. FSDC then established a Technical Review Committee to evaluate KAISA enterprise development loan applications and all feasibility studies were approved by FSDC's Board of Directors. It was only after this approval that the studies were submitted to USAID/Philippines for technical review and approval.

Technical Assistance - FSDC was required to sign a contract for project technical assistance in operating the rice mills before USAID/Philippines committed any money for their construction. However, the Mission waived this requirement. As previously stated, the construction of the mills started as early as December 1981. The contract for the technical assistance was signed in October 1983 -- about one year after completion of the construction of the rice mills. As a result, the mills were all operating before the technical assistance team arrived.

The technical advisors (two rural enterprise specialists and two farm systems specialists) arrived at FSDC in early 1984. However, FSDC had much difficulty accepting their advise. For instance, technical assistance team's first six month report stated that numerous trip reports, memoranda, and proposals had been prepared for FSDC management review, but that such documents often went unacknowledged or unrecognized by the FSDC management staff. Members of the technical assistance team also stated that a plan for bi-monthly meetings with the FSDC management staff dissolved by the second scheduled meeting when FSDC staff would not set aside time to meet with them.

While USAID/Philippines was aware of the poor relationship between the technical assistance team and FSDC, the Mission did little in the way of direct assistance to smooth out the team's relationship with FSDC during its early months there according to team members. The Mission project officer stated that informal discussions were held with FSDC officials on the concerns of the technical assistance team, but these discussions were not documented in USAID/Philippines files.

Mission officials acknowledged that there had been a lack of communication and some cultural differences between the FSDC staff and the technical advisors during the first year of the technical assistance contract. They said that FSDC personnel were initially suspicious and apprehensive about having to work with U.S. consultants, and that unfortunately this situation continued well into the fourth quarter of the first year. They said, however, the better working relationships and utilization of the consultants was developed during the first quarter of the second year of the contract.

The technical assistance team members expressed the opinion that had they been on board at the time the KAISA rice mill operations were being planned, FSDC would have been able to avoid a number of mistakes. For example, they said the location of the rice mills and the commercial practices of other mills would have been considered in determining the feasibility of the projects.

USAID/Philippines's approval to reimburse FSDC for construction already underway only applied to six pilot projects which had been identified in the Project Paper. FSDC was advised that any future requests for reimbursement would be subject to Mission approval before construction. The timing of AID's release of funds for the KAISAs was at FSDC's request. FSDC's request was based on the desire to strengthen small farmer groups and on its belief that the immediate establishment of KAISA enterprises would generate income for low-income farm families.

USAID/Philippines agreed that it did not adequately document its decision to waive the condition precedent which required that a technical assistance contract be signed before disbursement of funds. Nevertheless, the Mission believed waiving that condition precedent was not germane to the failing KAISA mill operations. USAID/Philippines stated that the scope of work for the technical assistance contract was not intended to include a review of the feasibility studies. Rather, that assistance was intended to assist in the operations of the mills.

In conclusion, the project feasibility studies for KAISA Enterprise Development which were submitted for AID approval after the construction had started were inadequate. In addition, the USAID/Philippines signed a cost reimbursement contract for the construction of KAISA rice mills without first requiring FSDC to obtain technical assistance contract as required in the Project Agreement. Because of the inadequate feasibility studies and the lack of timely technical assistance, project-funded rice mill operations, costing about $450,000, were failing and might be liquidated. We believe a primary cause for these conditions was ineffective monitorship by USAID/Philippines. Had the Mission effectively reviewed the feasibility studies and had the technical assistance team been available to assist the FSDC in project implementation, the AID funds provided for the KAISA rice mills probably would have been put to better use.

Institutional Development Training - The institutional development component in the Small Farmer Systems II Project was controlled by a cost reimbursement agreement which specified the types and length of training courses reimbursable under the project, as well as the direct costs eligible for reimbursement. FSDC training records showed many courses which were taught in less time than established standards, yet AID paid a "standard cost" and not direct cost for each course. Thus, part of the $1 million AID paid to FSDC for training probably should not have been paid.

In August 1982, USAID/Philippines approved the institutional development component training plan. This plan listed various training courses which FSDC planned to teach under the Small Farmer Systems II Project. The plan also stated the expected duration of each training course and the course objective and methodology.

In January 1983, USAID/Philippines and FSDC signed a Cost Reimbursement Agreement for the project institutional development activities. The Mission agreed to reimburse 100 percent of the eligible FSDC incurred direct training costs for activities specified in Annex I of the agreement. Reimbursement by AID for direct training costs was limited to the cost of renting training sites, supplies, board and lodging, transportation of trainees and guest speakers, gasoline for such transportation, honoraria paid to guest speakers, and to other costs that may be agreed to in writing.

There were two basic problems with the implementation of the agreement: (1) the courses actually taught differed substantially in duration from the time specified in the training plan, and (2) the costs charged to USAID/Philippines for these courses were based on standard costs, not actual direct costs, as required by the Project Agreement. For example:

-- One course called the "Integrated Services Association (ISA) Officer's Training" was supposed to require three days (or 24 hours) to teach. Yet during the second quarter of 1984, the time reported for teaching this course varied from three hours to 36 hours, and the average time spent teaching the course was about eight hours. However, USAID/Philippines paid a standard cost based on 24 hours to teach the course. FSDC training records also showed that a total of 484 hours were spent teaching all ISA officer training courses for this quarter. Yet the FSDC claim to the Mission was based on the standard cost of a three-day course. Based on the standard course time and assuming eight teaching hours each day, USAID/Philippines paid for 1344 hours to teach this course, or 860 hours more than it should have paid.

-- In a another case, a course called "Financial Management Training" was supposed to be a three-day course. The training records showed that the length of the course varied from four to 40 hours, with the average course taking only 9.6 hours. A total of 42 classes were taught during the second quarter of 1984. Training records also showed that a total of 404 hours were spent teaching the course. However, the Mission payment to FSDC was based on the standard three-day course, or 1008 hours. In addition, the FSDC claim to USAID/Philippines stated that 77 courses were taught rather than the 44 reported by the FSDC area offices. As a result, AID paid for 35 courses more than were actually taught.

USAID/Philippines' controls and monitoring were not in place to ensure the quantity of training was delivered as planned. For example, the standard costs for courses were developed by FSDC about 1981. However, the Mission records indicate these standard costs were not reviewed by Mission officials prior to AID's payments for the training.

USAID/Philippines paid over $1 million for course listings on a standard cost basis through June 30, 1984. About that time, FSDC requested an advance payment for a number of training activities. Since some of the data supporting the request appeared questionable USAID/Philippines decided to stop funding the training until FSDC could adequately support the training costs already reimbursed by AID. To date, FSDC has not been able to support these costs.

USAID/Philippines stated that it has established procedures to ensure that vouchers are not accepted for processing that are based on standard costs. Claims for reimbursement of training costs must include sufficient supporting documentation to justify such costs. In addition, the use of standard costs for training activities has been specifically precluded in recent project agreements signed.

In conclusion, reimbursement claims for training costs were based on FSDC developed standard costs that were not reviewed by Mission officials. The standard costs claimed did not have any relationship to actual costs incurred. Consequently, AID may have been overcharged for part of the $1 million it paid for project training activities.

Commodities - AID regulations require project officers to monitor and ensure AID-financed commodities are used efficiently and effectively and for project purposes. However, USAID/Philippines did not monitor commodity usage in accordance with AID requirements. As a result, Mission officials did not know the extent to which AID-financed project commodities, valued at $369,000, were being used for project purposes.

Handbook 15 states that USAID/Philippines is responsible for the review of project progress reports to verify that commodities financed by AID are being effectively used in the project. AID project assistance agreements specify that the grantee must ensure that the commodities financed under such agreements be effectively used for the purpose for which the assistance was made available.

Under the commodities component of this project, vehicles totaling $369,000 were purchased. The vehicle procurement consisted of eight audio-visual vans ($146,000) and eight utility trucks ($223,000). In addition, under the KAISA Enterprise component, rice mills ($128,000) and miscellaneous items ($59,000), such as scales, moisture meters, driers, etc. were procured for six project sites.

The project officer did not have available the information required to monitor commodity usage. For example, a listing of project commodities, including serial numbers and locations, is essential for proper monitoring and end-use checks. However, the project officer did not have a listing of the vehicles or other commodities and their locations.

During our audit, we found vehicles not being used in accordance with project purposes. The purpose for purchasing eight large utility trucks was to enable the KAISAs to move produce and equipment from the ISAs to the KAISAS and on to regional marketing and distribution centers. These vehicles were assigned to FSDC supply and equipment warehouses. While the trucks benefitted the FSDC operations, they were not used for the specific project purpose of marketing project produce and moving equipment.

During our audit we also found an audio-visual van valued at $18,275 had not been used for over six months. The reasons given were that 1) the FSDC area office it was assigned to only had enough training materials to support one van, and 2) there were no funds for the driver and gasoline for the van. Had an effective commodity monitoring procedure been in place, this problem may have been detected and corrected earlier.

The Mission disagreed that it lacked formal project procedures for monitoring the receipt, distribution and end-use of project commodities. Such procedures are included in AID Handbooks 3 and 15 and project officers are expected to follow them. USAID/Philippines stated that it monitored the use of 16 project vehicles during field trips to their locators. FSDC's original allocation plan showed that the eight large utility trucks would be assigned primarily to the six pilot enterprises. However, a subsequent review of that plan vis-a-vis program requirements showed that the trucks would be better utilized if they were allocated to FSDC's central and area offices. Moreover, the Mission stated that the placement of the trucks at the area offices facilitated the transport of crops and farm produce from a greater number of KAISAs to the market places than could have been done otherwise. Therefore, this arrangement made it possible for the trucks to service more of the program's requirements than would have been achieved had they been allocated to the six pilot KAISAs. USAID/Philippines acknowledges that it could have done a better job in documenting its monitoring of project commodities.

In conclusion, the Mission had no formal project procedures for monitoring the receipt, distribution and end-use of project commodities. As a result, the Mission did not know if project resources were being effectively and efficiently used.

Project Results - Both AID regulations and the Project Agreement require a system for monitoring project results. While sufficient data were available to accurately measure project results, important project data were not being collected, recorded or analyzed by the project officer. This occurred because the monitoring system used emphasized implementation tracking rather than the tracking of project accomplishments. As a result, neither the project officer nor USAID/Philippines management knew the extent to which project goals and objectives were being achieved.

Each project is required to have a system for measuring project results made up of (1) project objectives and goals stated clearly in measurable terms, quantifiable and with periodic milestones; (2) information on actual progress in the same measurable, quantifiable terms as stated in objectives and goals and the same time period; and (3) reports which compare each objective and goal against progress made during project implementation.

USAID/Philippines/Philippines had not established such a system for monitoring the results of the Small Farmer Systems II Project. The only monitoring requirement the Mission had was for the quarterly Project Status Report. However, the Project Status Reports for this project did not provide sufficient detail nor analysis of many of the project indicators. Only a few project indicators were being reported in the quarterly Project Status Reports. These reports only showed accomplishments for three of the ten output indicators for the project. For example, the December 1984 project status report stated that FSDC had completed 116 irrigation projects. The report did not mention how many structures were planned or the likelihood of meeting the project goal for completed structures. In addition, the report neither stated an annual goal for irrigation structures completed nor compared construction progress against the goal.

USAID/Philippines' emphasis has been on implementation monitoring. For instance, the Mission kept track of irrigation systems completed but did not go beyond the numbers to determine if productivity was increasing, farm income was increasing, or any of the other stated project benefits were flowing to the targeted farmers. Monitoring for project results should include an analysis of data on project progress against goals and objectives and indicators determined to be relevant to those goals and objectives. Although FSDC had been collecting some data on project progress, USAID/Philippines had not made a detailed, periodic analysis of how this data measured against all project goals and objectives.

USAID/Philippines officials stated that in practice, Agency and Mission policy is to incorporate monitoring and evaluation systems into projects that become the responsibility of the GOP implementing agencies. The purpose of such systems is to collect information for making management decisions. While effective project/program management and accurate record keeping are complementary activities, the Mission places higher priority on effective management. In an environment of severe limitations on staff resources, this means that the Mission must adopt practices that provide them the management information needed -- though such practices may not leave them with a set of records that contain all of the details upon which management decisions are made.

USAID/Philippines officials also stated that quarterly monitoring and evaluation information is documented and discussed with senior Mission management at the Project Implementation Review (PIR) meetings. The forms used for the PIR meetings are designed to identify issues and the action decisions need to maintain implementation progress. While the most important issues come to the attention of senior management as they occur, the PIR system provides formal assurance that project issues reach senior management at least every quarter. A very important function of the PIR system is that it enables Mission management to identify potential issues or problems before they occur and take corrective action.

Finally, Mission officials told us that other important parts of the Agency's and Mission's monitoring and evaluation systems include reviewing annual project implementation plans, participating in "internal reviews" which involve an intensive effort over several days, and providing for in-depth project evaluations to be undertaken when very critical decisions have to be made such as whether to terminate, continue, expand, or substantially redirect a project.

In conclusion, AID Handbook 3 stipulates that systems should be developed for monitoring project results at the time the project is designed. This was not done for the Small Farmer Systems II Project. Consequently, because project results were not adequately monitored, and USAID/Philippines did not know the extent to which the Small Farmer Systems Project was meeting its goals and objectives.

Summary Comments

In summary, the Farm Systems Development Corporation was virtually insolvent due to the lack of GOP funding and poor internal management practices. Because of these conditions, FSDC may not be able to effectively implement or sustain project activities. USAID/Philippines has taken the required remedial actions to ensure additional AID resources are not invested in an organization that cannot effectively carry out AID-financed development activities. However, we believe many of the internal FSDC managerial deficiencies could have been avoided or corrected had USAID/Philippines more effectively monitored the operations of FSDC. Because of inadequate monitoring, many of the development activities financed by AID failed or will not be sustained, other activities financed by AID were of questionable development value, and much of the AID $23.9 million investment in FSDC will be of marginal developmental value, if any.

Management Comments

USAID/Philippines stated that their comments to the Records of Audit Findings have been adequately addressed in the report and they, therefore, have no further comments.

2. USAID/Philippines Should Recover Overpayments from the Farm Systems Development Corporation Resulting from Incorrect Voucher Certifications

The Mission signed a cost reimbursement agreement with Farm Systems Development Corporation (FSDC) for the construction of six rice mills in which the Mission agreed to reimburse eligible actual project costs, less certain items, such as working capital and land procurement costs. The Corporation claimed that the costs they submitted were actual when they were in fact estimates. As a result, USAID/Philippines made $13,895 overpayments for the rice mills.

Recommendation No. 3

We recommend that USAID/Philippines recover the $13,895 in overpayment made for the Federations of Integrated Services Associations Enterprise project component.

Discussion

On March 13, 1983, USAID/Philippines and FSDC signed a Cost Reimbursement Agreement for the construction of six KAISA Enterprise rice mills. The agreement stated that AID would reimburse the lesser of the two following formulas:

(a) 75 percent (total cost less KAISA cash/in kind contribution), or

(b) Total Cost less (KAISA cash/in kind contribution + land procurement cost + working capital)

On January 12, 1984, USAID/Philippines paid $381,868 for five of the rice mills. Another $79,461 was paid for the 6th mill on May 11, 1984. Out of the total reimbursement of $461,329, the Mission overpaid FSDC by $13,895.

FSDC submitted cost figures for reimbursement which were $13,895 higher than the actual costs incurred. When asked where they obtained the figures submitted for reimbursement, the FSDC Finance and Administration Director said they used the figures on the certificates of completion (which were estimates) rather than the actual figures because the actual costs were not available at the time, and FSDC needed the money quickly.

The following is a summary of the overpayments for each KAISA Enterprise reimbursed by the Mission.

KAISA	Costs Claimed	Actual	Difference
Antique	82,081	81,571	510
Laguna	80,551	77,194	3,357
South Cotobato	74,825	75,926	(1,101)
Misamis Occidental	79,461	76,014	3,447
Nueva Ecija	73,314	68,719	4,595
Isabela	$ 71,098	$ 68,011	$ 3,087
TOTAL	$461,330	$447,435	$13,895

The reason for this overpayment in the KAISA Enterprise component was that FSDC certified that the reported costs were correct, when in fact they were not.

In conclusion, FSDC incorrectly certified the costs of the Enterprise Development construction, and AID reimbursed FSDC based on incorrect certifications. We believe the overpayment should be reclaimed. In further dealings with FSDC, USAID/Philippines should test documentation on a sample basis before paying vouchers.

USAID/Philippines is taking remedial action to recover the overpayments made to the FSDC by offsetting the overpayments from current reimbursement claims. In addition, the Mission is testing the sufficiency of documentation submitted by FSDC in support of its claims for reimbursement.

Management Comments

USAID/Philippines stated agreement with this recommendation.

B. Compliance And Internal Control

Compliance

Audit tests made during our review showed that USAID/Philippines did not adequately document its waiver of a condition precedent which precluded the commitment of funds for Federations of Integrated Services Associations (KAISA) Enterprise Development before a technical assistance contract was signed. This compliance deficiency is discussed in detail in the body of the audit report. Nothing came to the auditors' attention as a result of specific procedures that caused them to believe untested items were not in compliance with applicable laws and regulations.

Internal Control

Overall, internal controls for this project were found to be appropriate and were operating in a satisfactory manner. We noted several instances of non-compliance with internal controls during our review: (1) Farm Systems Development Corporation disbursement certifications were incorrect thus leading to a $13,895 overpayment by AID; (2) there were insufficient controls over payment made by USAID/Philippines for institutional development training; and (3) there was no monitoring system to track commodity use or to measure project results. The internal control deficiencies are discussed in detail in the audit report. Nothing came to the auditors' attention as a result of specific procedures that caused them to believe untested items were not in compliance with applicable laws and regulations.

AUDIT OF
SMALL FARMER SYSTEMS II PROJECT
USAID/PHILIPPINES

PART III - EXHIBITS AND APPENDICES

V.

EXHIBIT 1

Small Farmer Systems II Project
Disbursements
As Of December 31, 1985

Project Element	Loan/ Grant	Original Budget	Amended Budget	Disbursed
Irrigation Systems Development	L	$2,399,000	$1,428,000	$ 347,643
Institutional Dev.	L	2,019,000	1,389,000	1,070,989
KAISA Enterprises	L	1,190,000	462,000	461,329
Upland Development	L	432,000	100,000	11,093
Commodities	L	350,000	369,000	369,296
Technical Assistance	L	710,000	852,000	567,417
			G	0
750,000	0			
Research/Development	G	160,000	160,000	8,987
Participant Training	G	250,000	250,000	176,147
Evaluation	G	90,000	90,000	18,318
Total		$7,600,000	$5,850,000	$3,031,219

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UNITED STATES GOVERNMENT

APPENDIX 1

Memorandum

TO : Mr. Leo L. LaMotte
RIG/A/M

DATE: 3 DEC 1986

FROM : Frederick W. Schieck
Mission Director

SUBJECT : Mission Comments on Draft Audit Report of the Small Farmers Systems II Project USAID/Philippines Project No. 492-0334

The Mission appreciates the opportunity to comment on the subject draft report. The draft report adequately includes the Mission's responses to the Records of Audit Findings covering this subject which were previously submitted. Accordingly, the Mission has no further comments to make on the draft report.

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APPENDIX 2

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