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AUDIT OF
U.S.A.I.D./NEPAL'S IMPLEMENTATION OF
A.I.D.'S PAYMENT VERIFICATION POLICY
IMPLEMENTATION GUIDANCE

AUDIT REPORT NO. 5-367-87-3
MAY 26, 1937

May 26, 1987

MEMORANDUM FOR U.S.A.I.D./Nepal, Director, David Wilson

FROM: Richard E. Derrick, RIG/A/Singapore

SUBJECT: Audit of U.S.A.I.D./Nepal's Implementation of A.I.D.'s Payment Verification Policy Implementation Guidance (Audit Report No. 5-367-87-3)

This report presents the results of audit of U.S.A.I.D./Nepal's Implementation of A.I.D.'s Payment Verification Policy Implementation Guidance. The audit objective was to evaluate U.S.A.I.D./Nepal's compliance with the Guidance.

The audit concluded that U.S.A.I.D./Nepal did not fully comply with several important areas included in A.I.D.'s Payment Verification Policy Implementation Guidance.

U.S.A.I.D./Nepal did comply with some actions directed by the Guidance. For example, U.S.A.I.D./Nepal generally complied with the requirement to prepare annual reports identifying the mission's methods of project implementation and financing procedures.

The audit disclosed four specific problem areas. First, annual assessments were not made. Second, cash advances to the Government of Nepal were not justified. Third, financial management of project funds was not adequate. Fourth, project papers did not adequately provide for audit coverage.

We are recommending that U.S.A.I.D./Nepal take actions to ensure that the required assessments are made, cash advances to the Government of Nepal are justified and controls over advances are improved. Also, U.S.A.I.D./Nepal should evaluate the need for and provide necessary funding for audit coverage of projects.

Your comments to the draft report were considered in finalizing this report. The comments are discussed in appropriate sections of the report and your full response is attached as Appendix 1 to the report. You disagreed with the first three findings and recommendations concerning annual assessments and justification and controls over advances. You generally concurred with the fourth finding, but did not concur with the related recommendation. Based on your comments the four recommendations in this report are considered unresolved.

Please provide us within 30 days any additional information related to actions planned or taken to implement the recommendations.

EXECUTIVE SUMMARY

The purpose of A.I.D.'s Payment Verification Policy Implementation Guidance was to ensure that A.I.D. missions gave high priority to choosing the most effective and efficient methods for project implementation and financing. Another purpose was to improve the missions' monitoring of projects once they were underway. The Guidance was issued by the A.I.D. Assistant to the Administrator for Management on December 30, 1983. U.S.A.I.D./Nepal had 11 active projects with total obligations and accrued expenditures of $95.5 and $70.8 million, respectively, as of September 30, 1986.

The Office of the Regional Inspector General for Audit/Singapore made a compliance audit of U.S.A.I.D./Nepal's implementation of A.I.D.'s Payment Verification Policy Implementation Guidance. The audit was done during the period November 24, 1986 through January 15, 1987. The audit objective was to evaluate U.S.A.I.D./Nepal compliance with the Guidance.

U.S.A.I.D./Nepal did not fully comply with several important areas included in A.I.D.'s Payment Verification Policy Implementation Guidance.

U.S.A.I.D./Nepal did comply with some actions directed by the Guidance. For example, U.S.A.I.D./Nepal generally complied with the requirement to prepare annual reports identifying the mission's methods of project implementation and financing procedures.

The audit disclosed four specific problem areas. First, annual assessments were not made. Second, cash advances to the Government of Nepal were not justified. Third, financial management of project funds was not adequate. Fourth, project papers did not adequately provide for audit coverage.

A.I.D. policy guidance required A.I.D. missions to perform annual assessments of the host governments' and the missions' voucher approval and examination procedures and report thereon. U.S.A.I.D./Nepal did not perform the required annual assessments and misleading information was reported to A.I.D./Washington. These problems resulted primarily because U.S.A.I.D./Nepal was not fully aware of what was required. The failure to make the required assessments and report accurate information inhibited both U.S.A.I.D./Nepal's and the Agency's ability to fully identify the extent of and correct U.S.A.I.D./Nepal and the

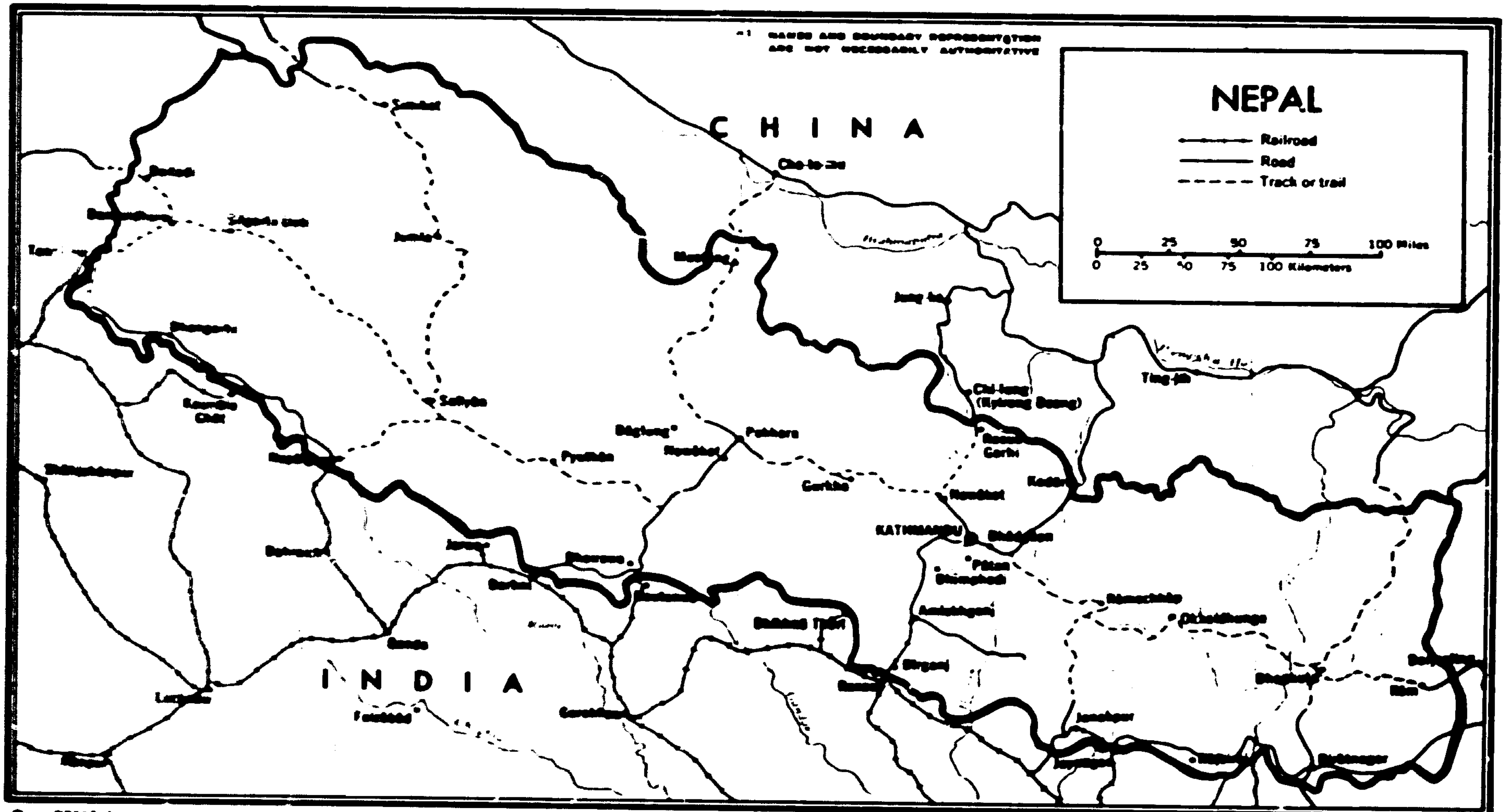
Government of Nepal financial management and related internal control weaknesses. These weaknesses were identified in consultant reports and U.S.A.I.D./Nepal post payment reviews which identified substantial payments by U.S.A.I.D./Nepal for questionable and unauthorized costs claimed by the Government of Nepal. U.S.A.I.D./Nepal had not yet recovered payments of more than $286,560 for unallowable taxes claimed by the Government of Nepal. This report recommends that U.S.A.I.D./Nepal make the required assessments and recover from the Government of Nepal the payments for unallowable taxes. U.S.A.I.D./Nepal did not agree to make the assessments but did agree to recover the payments for unallowable taxes.

A.I.D. policy guidance issued in December 1983 stated that it was A.I.D. and U.S. Government cash management policies to minimize the use of cash advances for project implementation. The policies stipulated two requirements for authorizing the use of cash advances. One was that the use of advances should be justified based on the recipient's need for an advance. The second was that the recipient organization should have adequate financial management and related internal controls for controlling and accounting for U.S. Government funds. U.S.A.I.D./Nepal provided sizable cash advances to the Government of Nepal without satisfying either requirement. The use of cash advances to the Government of Nepal during the three-year period ended December 31, 1986 resulted in either unnecessary or inefficient use of U.S. Government funds of about $1.4 million. This condition occurred because U.S.A.I.D./Nepal was not fully aware of the A.I.D. and U.S. Government policies to restrict or limit the use of cash advances to host governments. This report recommends that U.S.A.I.D./Nepal justify the need for cash advances to the Government of Nepal. U.S.A.I.D./Nepal disagreed with the finding and recommendation.

A.I.D. policy emphasized a need for improved accounting over project funds. U.S.A.I.D./Nepal practices for advancing funds to the Government of Nepal for project implementation purposes did not adhere to acceptable financial management standards. This occurred because U.S.A.I.D./Nepal did not have adequate policies and procedures to limit cash advances to the Government's immediate disbursement needs or for a proper accounting of the outstanding advances. Therefore, U.S.A.I.D./Nepal project funds amounting to over $37 million were more vulnerable to waste and abuse. This report recommends that U.S.A.I.D./Nepal establish adequate policies and procedures for providing and accounting for authorized cash advances made to the Government of Nepal. U.S.A.I.D./Nepal did not concur.

A.I.D. policy required that project papers include an evaluation of the need for audit coverage along with a description of the audit and the allocation of funds for such coverage. Six project papers approved by U.S.A.I.D./Nepal for initial funding subsequent to the policy's effective date did not provide for adequate audit coverage. The failure occurred because responsible U.S.A.I.D./Nepal officials were not fully aware of the specific requirements or simply forgot to ensure compliance. The lack of adequate audit coverage may prevent early detection of project accounting and financial problems. This report recommends that U.S.A.I.D./Nepal take actions to ensure that evaluations are made of the need for and necessary funding is provided for audit coverage of projects. U.S.A.I.D./Nepal generally concurred with the finding but not the recommendation.

Office of the Inspector General



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AUDIT OF
U.S.A.I.D./NEPAL'S IMPLEMENTATION
OF A.I.D.'S PAYMENT VERIFICATION
POLICY IMPLEMENTATION GUIDANCE

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AUDIT OF
U.S.A.I.D./NEPAL'S IMPLEMENTATION OF
A.I.D.'S PAYMENT VERIFICATION POLICY
IMPLEMENTATION GUIDANCE

PART I - INTRODUCTION

A. Background

The purpose of A.I.D.'s Payment Verification Policy Implementation Guidance was to ensure that A.I.D. missions gave high priority to choosing the most effective and efficient methods for project implementation and financing. Another purpose was to improve the missions' monitoring of projects once they were underway.

In April 1982, the A.I.D. Administrator named a task force to review the Agency's payment process. This action responded to the results of A.I.D. Inspector General audits. The work of this task force was to coincide with action on Office of Management and Budget Circular A-123 which required all federal agencies to undertake a self assessment of internal control vulnerability. The task force effort resulted in 16 policy statements which were approved by the Administrator in May 1983. The implementing guidance was issued by the Assistant to the Administrator for Management on December 30, 1983.

Each mission was responsible for implementation of the Guidance. They were responsible for ensuring that comprehensive general assessments were performed annually on the methods of project implementation and financing. The controllers were specifically responsible for annual assessments of mission and host government voucher examination and approval procedures. Annual reports on the assessments were to be sent to the A.I.D. Office of Financial Management and the cognizant A.I.D. regional bureau in Washington, D.C.

The A.I.D. Inspector General issued an audit report on December 12, 1983 on the management of cash advances by six A.I.D. overseas missions, including U.S.A.I.D./Nepal (Audit Report No. 0-000-84-15). The report noted that U.S.A.I.D./Nepal was providing excessive advances to the Government of Nepal because the mission did not adequately estimate the cash flow needed to fund projects. The excessive advances resulted in the U.S. Government incurring unnecessary interest costs and losing an additional $817,000 due to the devaluation of the local currency against the dollar.

U.S.A.I.D./Nepal had 11 active projects with total obligations and accrued expenditures of $95.5 million and $70.8 million, respectively, as of September 30, 1986.

B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Singapore made a compliance audit of U.S.A.I.D./Nepal's implementation of A.I.D.'s Payment Verification Policy Implementation Guidance . The audit was done during the period November 24, 1986 through January 15, 1987.

The audit objective was to evaluate U.S.A.I.D./Nepal's compliance with the Guidance. Audit work included a review of files and records and interviews with responsible U.S.A.I.D./Nepal and other A.I.D. officials. The work also included a review of A.I.D. regulations and directives. Internal control practices were tested as they related to the Guidance. U.S.A.I.D./Nepal comments to our draft report were received in April 1987. Their comments have been incorporated in the report as appropriate and the full text of the comments are included as Appendix 1. The audit was made in accordance with generally accepted government auditing standards.

**AUDIT OF
U.S.A.I.D./NEPAL'S IMPLEMENTATION OF
A.I.D.'S PAYMENT VERIFICATION POLICY
IMPLEMENTATION GUIDANCE**

PART II - RESULTS OF AUDIT

U.S.A.I.D./Nepal did not fully comply with several important areas included in A.I.D.'s Payment Verification Policy Implementation Guidance.

U.S.A.I.D./Nepal did comply with some actions directed by the Guidance. For example, U.S.A.I.D./Nepal generally complied with the requirement to prepare annual reports identifying the mission's methods of project implementation and financing procedures.

The audit disclosed four specific problem areas. First, annual assessments were not made. Second, cash advances to the Government of Nepal were not justified. Third, financial management of project funds was not adequate. Fourth, project papers did not adequately provide for audit coverage.

We are recommending that U.S.A.I.D./Nepal take actions to ensure that the required assessments are made, cash advances to the Government of Nepal are justified and controls over advances are improved. Also, U.S.A.I.D./Nepal should evaluate the need for and provide necessary funding for audit coverage of projects.

Annual assessments were to include a realistic evaluation and appraisal of the (1) methods of project implementation and financing, (2) mission's voucher examination and approval procedures, (3) host country's monitoring and invoice examination procedures, and (4) host country agencies' contracting, procurement and payment verification capability.

U.S.A.I.D./Nepal generally complied with the requirement for annual assessments of the mission's methods of project implementation and financing procedures. U.S.A.I.D./Nepal submitted the assessment results in its annual reports which provided a detailed payment process matrix for active and planned projects and programs. U.S.A.I.D./Nepal did not fully implement the requirements for the other three assessments.

The most significant omission was U.S.A.I.D./Nepal's failure to make annual assessments and accurately report on the Government of Nepal's monitoring and invoice examination procedures and the related mission voucher examination and approval procedures as required under Policy Statement Numbers 8 and 9 of the Guidance. For the three-years ended December 31, 1986, U.S.A.I.D./Nepal approved payments to the Government amounting to about $13.9 million.

The annual assessments called for under the above two policy statements were designed to formalize a process which already should have been in place. The assessments were to involve a randomly selected sample of vouchers large enough to provide reasonable assurance that the voucher approval and examination processes in place were adequately represented by the assessments. One of the objectives of the assessments was to highlight areas of relatively high vulnerability and to project solutions or changes in procedures which would result in decreased vulnerability.

There was no evidence at U.S.A.I.D./Nepal to show that any of the required annual assessments were made of the Government of Nepal's and the mission's voucher examination and approval procedures. U.S.A.I.D./Nepal officials said one assessment was made for calendar year 1983 -- an assessment of the mission's voucher examination procedures. According to U.S.A.I.D./Nepal officials, a sample of selected vouchers was reviewed as required by the Guidance. However, no documentation was retained to identify the scope or results of this assessment. U.S.A.I.D./Nepal did not make subsequent annual assessments of the mission's voucher procedures. U.S.A.I.D./Nepal also did not make any annual assessments of the Government of Nepal's monitoring and voucher examination procedures as required by the Guidance.

In the initial annual report submitted on March 22, 1984 for calendar year 1983, U.S.A.I.D./Nepal reported that it "believed" the Government of Nepal basically had adequate voucher approval procedures; but, it also noted that the procedures were not always uniformally applied to A.I.D.-financed projects. The report stated that U.S.A.I.D./Nepal relied primarily on the Government's internal control procedures in processing the claims by the Government of Nepal. The report concluded that although U.S.A.I.D./Nepal's internal control of these reimbursements appeared to be only fair, U.S.A.I.D./Nepal believed that the periodic post-payment review of these reimbursements by the mission financial analysts ensured adequate internal control of these reimbursements to preclude waste and abuse of U.S. Government funds.

The annual update reports submitted by U.S.A.I.D./Nepal on March 14, 1985 and January 31, 1986 did not provide new assessments of U.S.A.I.D./Nepal and Government of Nepal voucher examination procedures. The updates merely stated that the initial "general assessment" remained valid.

The fiscal year 1986 assessment report submitted in November 1986 by U.S.A.I.D./Nepal to the A.I.D. Office of Financial Management in Washington, D.C. was misleading in numerous instances. Examples are noted below.

-- The report incorrectly stated that the assessment of U.S.A.I.D./Nepal's voucher approval and examination procedures was based on a sample of vouchers large enough to provide reasonable assurance on the allowability of claims. Actually, no sample was taken and there was no formal assessment.

-- The report stated that the Government of Nepal's monitoring and voucher review process was adequate to ensure the propriety of claims submitted to U.S.A.I.D./Nepal. There was no evidence to support this statement. In fact, no formal assessment was made.

-- The report stated that U.S.A.I.D./Nepal was including in project papers the required evaluation of audit coverage and, if necessary, budgeting project funds to provide necessary audit coverage. However, U.S.A.I.D./Nepal did not comply with this requirement.

According to the mission controller, annual assessments of Government of Nepal's payment verification procedures were not made because the mission's financial analysts periodically performed limited financial reviews at selected Nepalese Government agencies. Concerning the lack of annual assessments of the mission voucher examination and approval procedures, the controller contended that the assessment made for 1983 would suffice because there was no major change in the procedures since the initial assessment was made for 1983.

Regarding the fiscal year 1986 assessment report, a temporary U.S.A.I.D./Nepal official responsible for preparing the report stated the report was prepared primarily based on discussions with U.S.A.I.D./Nepal financial analysts and project officers. He relied on the personal knowledge and experience of these officials. No formal assessments were performed of U.S.A.I.D./Nepal's or the Government of Nepal's voucher examination procedures. This official said it was not possible to make the required assessments and to complete the annual report on time due to the shortage of financial staff and his impending departure from Nepal for assignment elsewhere. U.S.A.I.D./Nepal believed the requirement for formal assessments was discontinued under the new policy guidelines issued in September 1986.

The failure to make the required assessments and report accurate information inhibited both U.S.A.I.D./Nepal's and the Agency's ability to fully identify the extent of and correct U.S.A.I.D./Nepal and Government of Nepal financial management and related internal control weaknesses. These weaknesses were identified in U.S.A.I.D./Nepal post-payment reviews of Government of Nepal claimed costs. For example, 15 of these review reports issued by the U.S.A.I.D./Nepal controller during the three-year period ended December 31, 1986 identified over $900,000 of questionable costs. Substantial amounts of these costs were questioned because the Government routinely spent funds in excess of approved activities or budget line items. As of December 31, 1986, U.S.A.I.D./Nepal had recovered or was in the process of recovering about $135,000. The remaining questionable costs were retroactively approved by U.S.A.I.D./Nepal project officers or had not yet been resolved.

Several reports identified that U.S.A.I.D./Nepal paid unallowable contract taxes claimed by the Government of Nepal. In October 1983, U.S.A.I.D./Nepal notified the Government of Nepal that Standard Provision No. B.4 of U.S.A.I.D./Nepal project agreements with the Government appeared to provide exemption from payment of the Nepal contract tax. In February 1985, U.S.A.I.D./Nepal notified the Government that such taxes were exempt under U.S.A.I.D./Nepal-financed projects. U.S.A.I.D./Nepal identified that from October 1, 1981 through December 1, 1984 the unallowed tax payments amounted to about 4.2

million Nepalese Rupees -- or about $286,560 at the average monthly exchange rate during that period of about 14.5 Rupees to $1. The exact amount of unwarranted tax payments to the Government after December 1, 1984 was not known.

U.S.A.I.D./Nepal's dialogue with the Government to resolve the problem of the contract taxes was instrumental in the change of a Government law effective October 2, 1986 which specifically exempts the collection of contract taxes from foreign-aid funded projects. This law should help resolve the problem of unwarranted tax payments. However, the Government of Nepal had still not refunded or agreed to refund the more than $286,560 in taxes already paid by U.S.A.I.D./Nepal.

Two reports prepared by U.S.A.I.D./Nepal consultants in 1986 also identified serious weaknesses in the Government of Nepal financial management procedures and practices. For example, the financial reports submitted by the Government of Nepal to foreign-aid donors were often inaccurate and greatly delayed. Another weakness was the inability of the project accountants to follow the Government's financial rules and regulations. The reports stated that these weaknesses adversely affected satisfactory implementation of two large A.I.D.-funded projects.

In conclusion, U.S.A.I.D./Nepal has not fully complied with the requirements of the A.I.D. Payment Verification Policy Implementation Guidance. U.S.A.I.D./Nepal should ensure the required annual assessments are made. They need to prepare and submit to A.I.D./Washington a revised payment verification policy report for fiscal year 1986. They should also determine the amount of payments to the Government of Nepal for unallowable taxes and recover this amount.

Management Comments

U.S.A.I.D/Nepal disagreed with this finding and recommendation. Regarding the annual assessments, they objected to the report statement that there was no evidence at U.S.A.I.D./Nepal to show that any of the required annual assessments were made of the Government of Nepal's and the mission's voucher examination and approval procedures. The mission added that the assessments were included in the annual reports. The mission noted that the A.I.D. policy guidance required only minimal effort for the annual updates of the host government's and mission's voucher approval and examination procedures, and that the mission performed the assessments in accordance with this guidance. U.S.A.I.D./Nepal believed the 1983 guidance did not intend that the mission perform new assessments each year.

U.S.A.I.D./Nepal believed that the 1986 guidance precluded the need for annual assessments of the Government of Nepal's and the mission's voucher approval and examination procedures. They acknowledged that no separate sample of vouchers was taken to respond to the questionnaire concerning the mission's voucher approval process. The mission believed its normal voucher review process and its post payment financial reviews were adequate to provide reasonable assurance that A.I.D. funds were expended in accordance with the terms of the agreements. Also, the mission did not see a need to prepare a new report for fiscal year 1986 because they believed it is doubtful that A.I.D./Washington's understanding or use of the information would have been materially affected.

U.S.A.I.D./Nepal disagreed with the report that misleading information was reported to A.I.D./Washington and that this inhibited both U.S.A.I.D./Nepal's and the Agency's ability to identify and correct U.S.A.I.D./Nepal's and the Government of Nepal's financial management and related internal control weaknesses.

U.S.A.I.D./Nepal did not believe that a discussion and recommencation pertaining to unallowable taxes should be combined with the issue of annual assessments. The mission did not believe the two issues were related. However, they are updating the amount of taxes paid by U.S.A.I.D. up to the enactment of the 1986 legislation. Thereafter, they will submit a claim to the Government of Nepal for that amount.

Office of Inspector General Comments

U.S.A.I.D./Nepal disagreed with the finding and, therefore, Recommendation No. 1 is unresolved.

In our view, U.S.A.I.D.'s failure to adequately recognize the requirements for the assessments under Policy Statements 8 and 9 is a major reason for our disagreement. For example, U.S.A.I.D.'s comments show that they confused the requirements for the general assessment under Policy Statements 1-5 with the requirements for the specific assessments under Policy Statements 8 and 9. As a point of clarification, the audit report was revised to show that the policy guidance intended that the annual assessments should formalize a process already in place. The guidance further stated that the assessments were to involve a randomly selected sample of vouchers large enough to provide reasonable assurance that the voucher approval and examination processes in place were adequately represented by the assessments.

We recognize that U.S.A.I.D./Nepal submitted its annual reports each year. But, the submission of the annual reports in itself is not evidence to support that the required assessments under Policy Statements 8 and 9 were made. At the time of our audit, there was no supporting documentation in the mission files which would enable the auditors to review and ascertain that the assessments were actually made.

Discussions between the A.I.D. Office of Financial Management and the Office of Inspector General confirmed statements in our draft report that the 1986 guidance modified the reporting requirements but did not waive the basic requirements for conducting annual assessments under Policy Statements 8 and 9.

Although U.S.A.I.D./Nepal disagreed with our conclusion that misleading information was reported to A.I.D./Washington, audit results showed that such information was reported. In our opinion, U.S.A.I.D./Nepal should have reported to A.I.D./Washington on U.S.A.I.D.'s and the Government of Nepal's financial management and related internal control weaknesses identified in financial reviews performed by U.S.A.I.D. and consultants. Failure to report these problems inhibited the Agency's ability to correct these weaknesses in a timely manner.

The issue of contract taxes is an example where adequate reporting to A.I.D./Washington may have prompted more timely action. We believe adequate financial management practices by the Government of Nepal and the mission could have precluded A.I.D. payment of these taxes. If the payment of these taxes were reported to A.I.D./Washington in each of the annual submissions, A.I.D./Washington could have directed U.S.A.I.D/Nepal to stop payment in 1984 and to recover past payments.

We recognize that U.S.A.I.D. is taking action to recover the unallowable taxes. However, we still believe a recommendation to recover this amount is warranted because of the significant amount ($286,500 plus) involved and the long delay in taking the recovery action.

2. Cash Advances to the Government of Nepal Should Be Justified.

A.I.D. policy guidance issued in December 1983 stated that it was A.I.D. and U.S. Government cash management policies to minimize the use of cash advances for project implementation. The policies stipulated two requirements for authorizing the use of cash advances. One was that the use of advances should be justified based on the recipient's need for an advance. The second was that the recipient organization should have adequate financial management and related internal controls for controlling and accounting for U.S. Government funds. U.S.A.I.D./Nepal provided sizable cash advances to the Government of Nepal without satisfying either requirement. The use of cash advances to the Government of Nepal during the three-year period ended December 31, 1986 resulted in either unnecessary or inefficient use of U.S. Government funds of about $1.4 million. This condition occurred because U.S.A.I.D./Nepal was not fully aware of the A.I.D. and U.S. Government policies to restrict or limit the use of cash advances to host governments.

Recommendation No. 2

We recommend that U.S.A.I.D./Nepal:

a. justify the need for cash advances to the Government of Nepal, and

b. ensure that the Government of Nepal organizations requiring cash advances have adequate financial management and related internal controls for controlling and accounting for U.S. Government funds.

Discussion

A.I.D.'s Payment Verification Policy Implementation Guidance issued on December 30, 1983 stipulated that it was A.I.D. and the U.S. Government cash management policies to minimize the use of cash advances for project implementation and defer payments until all costs were incurred or goods and services delivered. These policies were more fully described in A.I.D. Handbook 1, Supplement B, Chapter 15; A.I.D. Handbook 13, Section 1.B.3; U.S. Treasury Financial Requirements Manual 6-8000; and A.I.D. Controller's Guidebook, Chapter 16. The policies stipulated two requirements for justifying cash advances. First, cash advances to organizations for project implementation were to be justified based on a need of the recipient. Second, recipient organizations were to have adequate financial management and related internal controls for controlling and accounting for U.S. Government funds. The internal controls were to assure that cash advances would be kept to the minimum levels necessary to meet immediate disbursement needs of the recipient. The policies restricted advances to a maximum 90-day requirement.

U.S.A.I.D./Nepal records showed an average daily outstanding advance balance of $2.3 million for the three-year period ended December 31, 1986.

U.S.A.I.D./Nepal provided these advances to the Government without adequately satisfying the two requirements for authorizing cash advances. U.S.A.I.D./Nepal probably was not able to adequately justify the need for cash advances for project implementation purposes or show that the Government of Nepal had acceptable financial management and related controls to qualify for advances. These two issues are discussed below.

U.S.A.I.D./Nepal included a justification for advances in its first report required under the A.I.D. Payment Verification Policy Implementation Guidance. Subsequent annual reports required under the Guidance did not discuss the practices of providing cash advances to the Government of Nepal.

The first report was sent to the A.I.D. Office of Financial Management and the A.I.D. Bureau for Asia and Near East on March 22, 1984. In their report U.S.A.I.D./Nepal justified advances to the Government of Nepal principally because Nepal was one of the poorest countries in the world and as such, did not have sufficient capital to conduct major financial undertakings such as development projects. An appendix to the report included eight additional reasons to justify advances in general and other reasons to justify advances in excess of the 90-day maximum authorized by the U.S. Treasury.

Nepal is one of the poorest countries in the world. However, in our view, this in itself does not justify providing the Government of Nepal cash advances for project implementation purposes. The 1984 report did not provide (1) an analysis of advance requirements for individual projects or (2) other support that the Government of Nepal needed cash advances for project implementation. The eight additional reasons cited by U.S.A.I.D./Nepal did not adequately justify the need for cash advances as discussed in Exhibit 1. Examples of these reasons which were not supported by evidence or were not actually practiced included the following:

-- The Mission's 1984 report stated that the system for providing advances eliminated delays in providing funds to the A.I.D.-funded projects. U.S.A.I.D./Nepal officials said there was no support for this statement and acknowledged that this was still a serious problem in project implementation.

-- The report stated that U.S.A.I.D./Nepal established a financial monitoring document to track the flow of A.I.D. funds as they proceeded through the Government of Nepal financial system to project activities. This document was not used and U.S.A.I.D./Nepal did not know how long the Government held A.I.D. funds before the funds were spent for project activities.

-- The report stated that the risk involved in this small advance had big payoffs in terms of the institutional development objective of the program. The average daily balance of outstanding advances in both 1983 and 1984 was almost $3.1 million. U.S.A.I.D./Nepal officials said there was no support concerning the "big payoffs"

Also, the March 22, 1984 report stated that an A.I.D./Washington audit team reviewed the system in 1983 and concluded that there was no practical way that advances to the Government could be for less than a 240-day requirement. U.S.A.I.D./Nepal officials said that this statement was based on discussions with the auditors but there was no report or other document to substantiate the statement. Notwithstanding, the A.I.D. Inspector General in Audit Report No. 0-000-84-15; dated December 12, 1983 ("Management of Cash Advances by A.I.D. Overseas Missions Needs Improvement") reported that U.S.A.I.D./Nepal's practices for advancing funds to the Government of Nepal were inadequate and resulted in excessive advances of $4 million. As a result, the U.S. Government incurred unnecessary interest costs and lost an additional $817,000 in 1981 and 1982 due to the devaluation of the local currency against the dollar.

In addition to the lack of evidence to support the need for cash advances, U.S.A.I.D./Nepal's procedures for funding projects indicated that U.S.A.I.D./Nepal could fund at least some activities or projects on a reimbursable basis. The procedures provide for U.S.A.I.D./Nepal and the Government of Nepal to fund local currency costs based on a specific percentage of each activity's costs as the costs were incurred.

For example, the agreement for a family planning and rural health project required the Government to pay 80 percent

($1.5 million) of general operating expenses and 43 percent ($715,000) of health workers costs incurred during the year ended July 15, 1986. More than $1 million of the Government's share -- which was 70 percent of the total planned expenditures of about $1.5 million during the first four-month period -- was to be made available at the beginning of the year. This initial funding by the Government would have covered more than an 83-day cash requirement based on the total planned expenditure for the first period. The same amount if replenished periodically would have covered a 108-day requirement and the entire 120-day requirement for the second and third four-month periods, respectively. Therefore, U.S.A.I.D./Nepal's $592,000 advance to the Government was not needed for these activities during the year if the Government was reimbursed every 30 or 60 days.

The need for U.S.A.I.D./Nepal advances to the Government is further questioned because U.S.A.I.D./Nepal's records showed that at least for certain periods U.S.A.I.D./Nepal funded the Government of Nepal on a reimbursement basis. For example, as of July 15, 1985, U.S.A.I.D./Nepal records showed that the outstanding advance to the Government was about $1.2 million. The Government subsequently submitted claims for about $2.9 million for expenditures incurred prior to that time. Thus, the Government spent about $1.7 million of its own funds which were eventually reimbursed by U.S.A.I.D./Nepal. The audit found similar cases for other periods.

U.S.A.I.D./Nepal also did not ensure that the Government of Nepal's organizations responsible for controlling and accounting for project funds had the required financial management and related internal controls to qualify for cash advances. Available documentation and discussions with U.S.A.I.D./Nepal officials raised serious doubts whether the organizations did have acceptable practices and controls. Examples of weaknesses and required practices or controls are noted below:

> The Government's Ministry of Finance which was responsible for distributing the advances routinely holds the funds for more than a month and in some cases several months before releasing them to organizations responsible for implementing projects. Advance recipients should have procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and the disbursement by the recipient.

-- Financial reviews performed by U.S.A.I.D./Nepal financial analysts and consultants showed that Government of Nepal organizations receiving advances did not have adequate financial management and related internal controls to properly account for funds and to determine the allowability of costs. Advance recipients should have acceptable financial management and related internal controls in these two areas.

-- The Government of Nepal in some cases took more than a year after specific advances were made to report on the status or expenditure of the funds. Advance recipients should provide current (monthly or quarterly) and complete reporting on the status of outstanding advances.

-- The questionable costs identified in U.S.A.I.D./Nepal post-payment reviews which were performed after Government of Nepal audits showed these audits did not adequately protect U.S. Government interests. U.S. Government advance recipients should provide for sufficiently independent audits (usually annually) to ascertain the effectiveness of the financial management systems and related internal controls. The audits should test the fiscal integrity of financial transactions, as well as compliance with the terms and conditions of the project agreements. U.S.A.I.D./Nepal did not ensure that such audits were performed in accordance with generally accepted auditing standards as required by the project agreements.

Based on the average daily outstanding advance balance shown on U.S.A.I.D./Nepal records of about $2.3 million for the three years ended December 31, 1986, unnecessary interest costs to the U.S. Government during that period were about $562,000. U.S.A.I.D./Nepal also noted on its records that an additional $883,000 was lost during the three-year period due to the devaluation of the local currencies against the dollar. Thus, based on available documentation at U.S.A.I.D./Nepal, the use of cash advances to the Government of Nepal during the three-year period ended December 31, 1986 resulted in either unnecessary or inefficient use of U.S. funds amounting to about $1.4 million.

U.S.A.I.D./Nepal contended that it is normal A.I.D. policy to provide cash advances to host governments for project implementation purposes. A responsible U.S.A.I.D./Nepal official commented in his written response to an early draft of this finding that U.S.A.I.D./Nepal was not aware of any A.I.D. or U.S. Government policies to restrict or limit the use of cash advances to host governments for project implementation purposes.

In conclusion, a substantial amount of U.S. Government funds was inefficiently used because of U.S.A.I.D./Nepal's practice of providing cash advances to the Government of Nepal. U.S.A.I.D./Nepal needs to justify the use of cash advances to the Government of Nepal for project implementation purposes. They also need to assure recipient organizations have adequate financial management and related internal controls to control and account for U.S. Government funds.

Management Comments

U.S.A.I.D/Nepal disagreed with this finding. They did not believe that cash advances to host governments must be justified based on the recipient's need for the advance and the recipient's ability to control and account for U.S. funds. Instead they stated, "In view of the fact that it is A.I.D. policy (as stated in A.I.D. Handbook 19, page 1B-17) that host government institutions are 'normally funded on an advance of funds basis', advances to the host country government do not require special justification".

Notwithstanding U.S.A.I.D./Nepal's position that advances to host governments do not have to be justified, they stated that the eight major reasons it provided in its March 22, 1984 payment verification submission to A.I.D./Washington adequately justified the use of advances. The mission also believed the Government of Nepal had adequate financial management and related internal controls.

U.S.A.I.D./Nepal stated that the factual issues concerning the Government of Nepal's ability to fund some activities on a reimbursable basis may be debated. They also commented that the advances have done what they were designed to do; i.e., facilitate project implementation by making funds available to Government of Nepal projects based on the immediate disbursing needs of the project.

U.S.A.I.D./Nepal objected to (1) the conclusion that the advances resulted in a waste of about $1.4 million, and (2) the reference to the 1983 Inspector General audit report. The bulk of U.S.A.I.D.'s comments focused on further explaining their advance system.

Office of Inspector General Comments

U.S.A.I.D./Nepal's comments were not responsive to the finding and recommendation. Therefore, the recommendation is unresolved and will be retained.

U.S.A.I.D./Nepal's position that advances do not have to be justified is incorrect. After receiving the draft report, the mission requested and we provided them additional justification for the two requirements. Thereafter, discussions between the Office of Financial Management and the Office of the Inspector General confirmed that A.I.D. and U.S. Government cash management policies prescribe that cash advances should be based on need and the advance recipients should have adequate financial management and related internal controls.

The eight reasons cited by U.S.A.I.D. to justify advances are not good reasons. None of the reasons address whether the Government of Nepal had the capability to pre-finance project activities and whether they could provide the funding in a timely manner for project implementation. Most of the reasons could be applicable under a cost reimbursable method of funding as discussed in Exhibit 1. Furthermore, as discussed in the audit report, some of the reasons given were misleading or incorrect.

U.S.A.I.D./Nepal comments did not provide any evidence that the Government of Nepal had acceptable financial management and related internal controls. We believe that the report shows the Government does not have acceptable controls.

The audit provided specific examples that the Government of Nepal does have the financial resources to pre-finance some project activities for which advances have been approved. The mission did not provide any support that advances facilitated project implementation. As discussed in this report, the advances did not preclude Government of Nepal delays in providing funds to A.I.D.-funded projects which resulted in serious project implementation problems.

Office of Inspector General audit reports as a normal practice generally address past audits of the same subject matter and attribute dollar savings or inefficient use of A.I.D. monies to specific audit findings. Furthermore, U.S.A.I.D./Nepal referred to the past audit in their March 1984 submission justifying the use of advances.

3. U.S.A.I.D./Nepal Needs to Improve Financial Management of Project Funds.

A.I.D. policy emphasized a need for improved accounting over project funds. U.S.A.I.D./Nepal practices for advancing funds to the Government of Nepal for project implementation purposes did not adhere to acceptable financial management standards. This occurred because U.S.A.I.D./Nepal did not have adequate policies and procedures to limit cash advances to the Government's immediate disbursement needs or for a proper accounting of the outstanding advances. Therefore, U.S.A.I.D./Nepal project funds amounting to over $37 million were more vulnerable to waste and abuse.

Recommendation No. 3

We recommend that U.S.A.I.D./Nepal establish policies and procedures for providing and accounting for authorized cash advances made to the Government of Nepal. The policies and procedures should:

(a) limit cash advances to the immediate disbursement needs for project implementation and for not more than the maximum 90-day requirement authorized by the U.S. Treasury,

(b) ensure that current and reliable data are used to determine the amount of advances,

(c) require the Government of Nepal to submit timely written requests for funds along with an analysis of the advance requirements and status of outstanding advances, and

(d) require the Government of Nepal to report when funds are provided to the project activities.

Discussion

A.I.D.'s Payment Verification Policy Implementation Guidance issued in December 1983 was aimed at reducing A.I.D. vulnerability for waste and abuse of U.S. Government funds. Improved accounting over project funding, including minimizing the use of cash advances for project implementation purposes, was a means identified to reduce vulnerability.

Acceptable financial management standards are prescribed in U.S. Treasury Financial Requirements Manual 6-8000; A.I.D. Handbook 13, Section 1.B.3; and A.I.D. Handbook 1, Supplement B, Chapter 15. Based on these standards, the

U.S.A.I.D. Controller's Guidebook, Chapter 16, provides specific guidance to A.I.D. missions on the use of U.S. Government funds in international programs. Missions are responsible for monitoring cash management practices to ensure compliance with the prescribed policies and procedures. The Guidebook stipulates that:

-- U.S. dollars will be retained in the account of the U.S. Treasury as long as possible to minimize interest costs to the U.S. Government;

-- the U.S. Government will not permit the withdrawal of dollars from the account of the U.S. Treasury prior to the need for the dollars as determined by the actual immediate funding requirements of the recipient organization to carry out the project;

-- no U.S. dollars should be exchanged for foreign currencies prior to the time the foreign currency is needed for immediate funding requirements; and

-- exceptions to the U.S. Treasury policies and guidelines will be made only on the basis of a determination that such exceptions would be advantageous to the U.S. Government.

U.S.A.I.D./Nepal provided cash advances to the Government of Nepal under a working capital system. Under this system, U.S.A.I.D./Nepal released the funds to the Government of Nepal's Ministry of Finance which then distributed the funds through other Government organizations to user organizations. The advances were commingled with the Government's funds and were to cover local currency costs.

During the period January 1, 1984 through December 31, 1986, advances under the system were provided for six projects. The total average daily balance of the outstanding advances according to U.S.A.I.D./Nepal financial records for these projects during the three-year period was about $2.3 million. The total amount of funds to be disbursed through this working capital system over the life of these projects was $37.2 million.

Finding Number 2 of this report identifies that U.S.A.I.D./Nepal needed to (1) justify the need for providing advances to the Government of Nepal and (2) assure that the Government had adequate financial management and related internal controls for controlling and accounting for U.S. Government funds. In addition, U.S.A.I.D./Nepal practices for advancing funds under the working capital system did not adhere to acceptable A.I.D. or U.S.

Government financial management standards. Three basic problem areas are discussed below.

<u>Maximum Advances Allowed by the U.S. Treasury</u> - The established U.S.A.I.D./Nepal policy allowed for advances to cover a 240-day period -- as opposed to the maximum 90-day requirement authorized by the U.S. Treasury. The 240 days was designed to cover the Government of Nepal's cash requirement for 120 days and allowing an additional 120 days for processing the claims. U.S.A.I.D./Nepal authorized the additional requirement because the Government of Nepal was slow in reporting expenditures and the Government's financial system was designed to provide funding to project activities on a 120-day basis. These were not adequate reasons for exceeding the 90-day maximum authorized by the U.S. Treasury.

<u>Practices for Providing Advances</u> - U.S.A.I.D./Nepal did not have adequate procedures for limiting advances to the Government. A fixed formula was used to calculate the amount of advances for an eight-month period (240 days) in the Nepalese fiscal year. The advances were to cover four months of past and four months of future expenditures.

The use of the formula resulted in excessive advances for some periods and shortages for other periods. For example, advances of almost $2.9 million were provided to the Government between November 16, 1984 and March 15, 1985 to cover expenditures through March 15, 1985. These advances were about $1 million more than was needed to cover expenditures through the end of the period. For the subsequent four-month period, no advance was provided and the Government had to spend more than $1.7 million of its own funds before being reimbursed by U.S.A.I.D./Nepal.

The problem in calculating accurate advance requirements was mainly due to the use of old rather than current data to determine past expenditures and unreliable estimates for future expenditures. Two examples of each case follow:

- Past expenditures under a resource conservation project were <u>estimated</u> at $408,172 compared to actual expenditures claimed of $163,320 for the four-month period ended March 15, 1986. Thus, the excess advance was $244,852.

- Past expenditures under a rural area development project were <u>estimated</u> at $639,074 compared to actual expenditures claimed of $340,354 for the same four-month period ended March 15, 1986. Thus, the excess advance was $298,720.

-- Under the same rural area development project, projected expenditures were estimated at $591,286 compared to actual expenditures claimed of only $153,727 for the four-month period ended November 15, 1985. Thus, the excess advance was $437,559. For the four-month period ended July 15, 1986, projected expenditures under the same project were estimated at $262,871 compared to actual expenditures claimed of about $1.1 million. Thus, in this case, the advance was about $800,000 short.

U.S.A.I.D./Nepal did not use current data for past expenditures in calculating advance requirements because the Government did not report on expenditures in most cases for several months after the funds were advanced and spent. Therefore, when U.S.A.I.D./Nepal made the advance, they did not have timely information to determine the amount of the current advance which remained outstanding. The problem of unreliable estimates of future expenditures occurred in part to inflated expenditure projections.

Another problem in U.S.A.I.D./Nepal's policies and practices for providing advances was that the Government was not required to provide a written request for funds along with an analysis of the advance requirements including the status of outstanding advances. Advances were usually provided based on a verbal statement by Government of Nepal officials that additional funds were needed for disbursement to project activities.

Monitoring Cash Advances - U.S.A.I.D./Nepal did not monitor cash advances to ensure that the advances were spent in a timely manner for approved project activities. As stated earlier, U.S.A.I.D./Nepal provided the cash advances to the Government of Nepal's Ministry of Finance which released the funds through other Government organizations to user activities for project purposes. Except for one project, U.S.A.I.D./Nepal did not know when the Ministry of Finance actually released the funds to the other Government organizations. Available documentation for the one project showed that the Ministry of Finance released most funds more than a month after U.S.A.I.D./Nepal made the advances. For example, on November 15, 1985, U.S.A.I.D./Nepal advanced almost $1.3 million equivalent of local currency to the Ministry of Finance. One month later the Ministry had only released to the intermediary Government organizations the local currency equivalent of $400,000. The funds were not fully released by the Ministry until March 1986. U.S.A.I.D./Nepal did not know when the funds were actually received by the project activities.

Conclusion

Inadequate financial management practices by U.S.A.I.D./Nepal to determine appropriate amounts of advances and to monitor expenditures had and will continue to make U.S.A.I.D./Nepal project funds more vulnerable to waste and abuse.

U.S.A.I.D./Nepal needs to establish adequate policies and procedures for providing and accounting for authorized cash advances made to the Government of Nepal. The policies and procedures should be consistent with A.I.D. and U.S. Department of Treasury financial management standards and specifically address the authorized advance amounts, methods for determining advance requirements, and U.S.A.I.D. monitorship.

Management Comments

U.S.A.I.D./Nepal disagreed with the finding and recommendation. The mission believed it had adequate financial management procedures for advancing funds to the Government of Nepal. They reiterated that advances exceeding the 90-day limitation were justified in its March 22, 1984 payment verification submission to A.I.D./Washington. The mission maintained that this justification remains fully adequate.

They also objected to other report conclusions referring to (1) unwarranted vulnerability to waste and abuse of $37 million in U.S. Government funds, (2) inadequate U.S.A.I.D. accounting of outstanding advances, and (3) inaccurate advance estimates.

Office of Inspector General Comments

U.S A.I.D./Nepal comments were not responsive to the finding and recommendation. Therefore, this recommendation is unresolved.

We believe U.S.A.I.D./Nepal's 240 day advance to the Government of Nepal is well in excess of the 90 day maximum requirement prescribed by U.S. Treasury. In discussions with the Office of the Inspector General, the A.I.D. Office of Financial Management stated that exceptions to the 90 day requirement should be justified to the A.I.D./Washington Controller who will request appropriate Office of Management and Budget and U.S. Treasury review and clearance. However, the Office of Financial Management had no record that U.S.A.I.D./Nepal requested an exception.

Additional U.S.A.I.D./Nepal comments concerning waste and abuse of $37 million, inadequate accounting for advances, and inaccurate advance estimates were considered and clarifications and revisions to this report were made where deemed appropriate.

4. U.S.A.I.D./Nepal Needs to Provide for Audit Coverage in Project Papers.

A.I.D. policy required that project papers include an evaluation of the need for audit coverage along with a description of the audit and the allocation of funds for such coverage. Six project papers approved by U.S.A.I.D./Nepal for initial funding subsequent to the policy's effective date did not provide for adequate audit coverage. The failure occurred because responsible U.S.A.I.D./Nepal officials were not fully aware of the specific requirements or simply forgot to ensure compliance. The lack of adequate audit coverage may prevent early detection of project accounting and financial problems.

Recommendation No. 4

We recommend that U.S.A.I.D./Nepal:

a. issue a mission order requiring that project papers include an evaluation of the need for and description of planned audit coverage together with an allocation of necessary project funds for audit coverage; and

b. evaluate the need, establish a plan, and provide appropriate funding for audit coverage for the six projects approved after January 1, 1984.

Discussion

Effective January 1, 1984, A.I.D.'s Payment Verification Policy Implementation Guidance required that each project paper include an evaluation of the need for audit coverage along with a description of planned contract and project audit coverage by the host government, A.I.D., and/or independent public accountants. Project funds were to be budgeted for independent audits unless adequate audit coverage by the host government or A.I.D. was reasonably assured or when audits by third parties were not warranted.

None of the project papers for the six projects approved for initial funding by U.S.A.I.D./Nepal since January 1, 1984 included an adequate evaluation of the need or plan for audit coverage. All six projects papers merely stated that audits may be performed by the A.I.D. Inspector General and the U.S.A.I.D./Nepal financial management staff may conduct limited financial reviews during the life of the project. Only three of the six project papers included some funding for such audits during project implementation. The total estimated A.I.D. funding for the six projects was $32.4 million.

The two project officers who prepared four of the six project papers said they were not fully aware of the specific requirements for addressing audit coverage in the project papers. The project officers for the remaining two projects did not prepare the project papers and were not aware that the papers did not adequately address audit coverage.

The U.S.A.I.D./Nepal controller stated that he assumed that the A.I.D. Inspector General and the U.S. Defense Contract Audit Agency would perform most of the required audits. He added that no request was made to these offices to determine whether or not the necessary audit coverage could be provided. The controller attributed the problem to the lack of Agency-wide guidance and procedures for evaluating the need and estimating the cost for the required coverage.

The lack of adequate contract and project audit coverage could preclude U.S.A.I.D./Nepal's early identification of accounting and financial problems in their projects. U.S.A.I.D./Nepal's annual assessments required under the Office of Management and Budget Circular A-123 have recognized the importance of audits. The annual assessments for the two years ended October 15, 1985 noted that inadequate financial compliance audit coverage was a major internal control weakness.

In conclusion, U.S.A.I.D./Nepal should place more emphasis on including an evaluation of the need for adequate audit coverage in each project paper prior to approving new projects. U.S.A.I.D./Nepal should also evaluate and provide funding as appropriate for audit coverage for the six projects approved after the Payment Verification Policy Implementation Guidance was issued.

Management Comments

U.S.A.I.D./Nepal generally concurred with the finding but not the recommendation. The mission believed it was somewhat unreasonable and impractical for the mission to implement the actions recommended. The mission did not believe the A.I.D. policy guidelines were adequate for evaluating the need and providing appropriate funding for audit coverage.

Office of Inspector General Comments

This recommendation remains unresolved. If the mission does not believe it can comply with the A.I.D. policy due to inadequate implementation guidance, the mission should request additional guidance from A.I.D./Washington.

B. Compliance and Internal Controls

Compliance - The major compliance exceptions noted were as follows:

- U.S.A.I.D./Nepal did not make the annual assessments required by A.I.D.'s Payment Verification Policy Implementation Guidance (Finding 1)

- U.S.A.I.D./Nepal did not comply with A.I.D. and U.S. Government policies in providing cash advances to the Government of Nepal (Findings 2 and 3)

-- U.S.A.I.D./Nepal did not include in project papers an evaluation of the need for audit coverage and an allocation of necessary funding for such coverage required by A.I.D.'s Payment Verification Policy Implementation Guidance (Finding 4).

Other than the conditions cited, tested items were generally in compliance with applicable laws and regulations, and nothing came to our attention that caused us to believe that untested items were not in compliance.

Internal Controls - There were three internal control exceptions.

- U.S.A.I.D./Nepal and Government of Nepal voucher approval processes did not prevent questionable payments to the Government of Nepal (Finding 1).

- U.S.A.I.D./Nepal practices were not effective to ensure proper justification and adequate control for cash advances to the Government of Nepal (Findings 2 and 3).

- U.S.A.I.D./Nepal practices were not effective to ensure that project papers adequately provided for audit coverage (Finding 4).

Other than the weaknesses cited, internal controls were found to be generally adequate in all material respects.

C. Other Pertinent Matters

A.I.D. Handbook 3, Chapter 8 and Supplement B, required missions to conduct assessments of the host countries contracting and procurement capability during the planning stage of all A.I.D.-financed projects. These assessments were to determine the most effective means of project implementation; i.e., A.I.D.-direct contracting versus host-country contracting. The Payment Verification Policy Implementation Guidance issued on December 30, 1983 encouraged use of the host country contracting, but required assessments only where host country contracting was proposed as a means of project implementation. Notwithstanding these differences, U.S.A.I.D./Nepal did not perform any assessments of Government of Nepal contracting capabilities.

The project papers for two of the six projects approved after January 1, 1984 proposed the use of host country contracting for commodities. U.S.A.I.D./Nepal subsequently decided to change the implementation plan by assigning the commodity procurement responsibility to a U.S. technical assistance contractor. U.S.A.I.D./Nepal did not, however, notify the A.I.D. Office of Financial Management of the change as required by the Guidance.

As of December 31, 1986, there were only two small active host country contracts being used in the implementation of U.S.A.I.D./Nepal funded projects. U.S.A.I.D./Nepal had established an informal policy that host country contracting would not be used for project implementation. This decision was based on the opinions of the U.S.A.I.D./Nepal's staff -- not formal assessments -- that it would be easier implementing projects if procurements were not done by the Government of Nepal.

AUDIT OF
U.S.A.I.D./NEPAL'S IMPLEMENTATION OF
A.I.D.'S PAYMENT VERIFICATION POLICY
IMPLEMENTATION GUIDANCE

PART III - EXHIBITS AND APPENDICES

Eight Reasons U.S.A.I.D/Nepal Used to Justify Cash Advances to the Government of Nepal Under a Working Capital System

This exhibit identifies the eight reasons U.S.A.I.D./Nepal used in its March 22, 1984 payment verification submission to justify cash advances to the Government of Nepal under a Working Capital System. The mission's comments dated April 13, 1987 to our draft of this report stated that these eight reasons were generally valid to justify the use of advances to fund project activities.

In our opinion, none of the eight reasons address whether the Government of Nepal had the capability to pre-finance project activities and whether they could provide the funding in a timely manner for project implementation. The eight reasons (verbatim) used by U.S.A.I.D./Nepal and the Office of the Inspector General response as to why we do not believe the reasons adequately show that advances are needed to avoid seriously interrupting or impeding project implementations are discussed below.

U.S.A.I.D./Nepal stated that the Working Capital System has been able to:

A. Separate planning from expenditure functions.

The simple process of having a phase for budget planning separate from implementation represents a significant step forward in budgeting procedures in Nepal. Up until 1960 there was no budget as it is known today. Expenditures were decided on in an ad hoc fashion until the creation of the Rastraya Panchayat as the organ for budget review and approval. Even in the recent past, since 1960, when the up-stream planning and costing out was insufficiently conducted, the Approved Budget had little legitimacy as a plan of action. Consequently, items in the budget were called into question by the central authorities and were finally never implemented at all. By breaking up the process into a specific time for each function-planning, approving and implementing, without allowing any overlap between the functions -- the example set by those projects under the Working Capital System has already greatly enhanced GON financial administration of projects.

B. Provide feedback for more realistic planning.

The significance of the Financial Monitoring document which is issued throughout the MOF, line ministries and implementation units should not be underestimated in the Nepalese context. It is one of the few occasions that GON officials have available a document which compares the planned figures with actual figures. Because officers can see the gap between planned and actual figures over time and modify future planning estimates, this document is beginning to have very positive effects on the ability to plan activities both in GON and in the Mission.

C. Piggy-back on GON own verifications procedures

Under the Working Capital System, U.S.A.I.D. agrees to advance to the GON Ministry of Finance, a certain percentage of what has been approved in the GON Budget. Since there is no way that the Mission could possibly monitor all the individual activities included in its major project activities, the Mission piggy backs on the GON Accounting System. This approach is backed by two strengths which, by tradition and design, are inherent to this system. First, by tradition, the audit system in Nepal held responsible any GON official who defaulted not only with his own person, but also with that of his heirs up to the seventh generation. Today, even though penalties are less terrifying, they still command absolute respect. Secondly, by design, under the GON System new budget releases cannot be made until previous budget releases are accounted for.

D. Help Institutionalize the Mission Program

By piggy-backing on GON financial procedures, a big advantage of the Working Capital System is that no matter if U.S.A.I.D. or the GON funds the project activity the procedures are the same. This provides a procedure whereby the GON may eventually increase its financial participation while U.S.A.I.D. can reduce its support. Thus the System creates a financial "umbilical cord" relationship which can be progressively, and relatively painlessly, severed.

E. Reduce Financial Vulnerability for the Mission

At the first timester of the life of the project activity, the Mission advances the GON a sum equivalent to what is approved for that trimester. This procedure, as well as allowing the Mission to work closely and constructively with the MOF, reduces the amount of financial vulnerability the Mission is exposed to. It does this because after the initial advance is out, the Mission has the opportunity to review and approve all the payment vouchers before making new advances. If any of the vouchers are disallowed or are not accompanied by ample information, the sum can be simply substracted from the funds advanced.

F. Allow the Mission to Work in Concert with GON on the level where the problems are in the field.

The rationale traditionally offered for not advancing funds is that once the host country has been advanced funds it would be very difficult to account for them. In order to maintain control over how funds are spent, the host country should spend its own money and request reimbursement from the donor. This approach may be useful as a negotiating ploy with the top ministerial levels. But in Nepal it is not at the top levels where the disbursement problems were, but in the field. By showing sufficient confidence in the MOF to advance only the amount of one trimester of one year and to replenish it during the total life of the project, the Mission has been able to work side by side on all levels of project implementation proposing changes and new procedures. The ADB and IBRD, who require the GON to play the role of financier for their projects, have not been able to maneuver in this manner. The Mission is confident that the risk involved in this small advance has already had big payoffs in terms of the institutional development objectives of our program.

G. Help Stream Line the Expenditure Process

Another breakthrough that the Mission has helped to bring about is the establishment of the District Treasuries. Previously, funds were passed down through a complicated system of bank accounts at every level of the hierachy. It was so time consuming that funds arrived with only three weeks remaining in the quarter (the Nepalese Fiscal Year was broken down on the quarter system at that time). Now the District Treasuries are responsible not only for disbursement but also for local revenue collection. They are notified directly to credit particular accounts with the approved amounts. This has all but eliminated the problem of delayed releases.

H. Simplify Accounting at the District Level Where the Least Skills are

In the Field Offices a simple double entry account is kept for the total amount of funds. Previously, two accounts were kept; one account of GON funds and a second account of USAID funds. This procedure allowed, in theory, the Mission to fund specific, precise budget items of the activity. In practice, it was impossible to account for the money at all. First, when expenditures occurred the tendency was to use the USAID funds in priority order. At the end of the year all USAID funds had been expended while GON funds were still in ample supply. If this had continued, GON would not have been able to live up to its financial participation obligation as stated in the Project Agreement. Second, when releases were made periodically there was no way of indicating what portion would be attributed to the GON account and to the USAID account. Third, keeping separate accounts at the local level overburdened the system at its weakest point because it is at the local level where personnel are the least well-trained. Now a simple double entry account of all money is maintained. As a general rule, expenditure vouchers are sent to the department level, where manpower is usually more capable, to be processed for submission to the Mission controller. A flat percentage rate or "reimbursement factor" is applied which the mission has agreed upon during the budgeting stage. When these reimbursement vouchers are received by the controller and approved, a credit is taken against the outstanding working capital advance.

Office of Inspector General Comments

This report shows that reasons B, F and G were not supported by evidence or were not actually practiced.

In our opinion, reasons A, C, D and H could be applicable under a cost-reimbursement method of funding. Therefore, these are not good reasons for providing cash advances. On the contrary, as stated in this report, A.I.D. and U.S. Government cash management policies are to minimize the use of cash advances for project implementation and defer payments until all costs were incurred or goods and services delivered.

Reason E also does not justify the use of advances. The cost-reimbursement method of funding would provide less vulnerability than cash advances. In addition, reason E appears to indicate advances are made to cover a four-month period and vouchers are reviewed and approved before making new advances. As noted in Finding 3 of this report, advances are provided to cover an eight-month period. This report also notes that the Government was not required to provide a written request for funds along with an analysis of the advance requirements including the status of outstanding advances.

April 13, 1987 DMW

David M. Wilson, Director
USAID/Nepal

Draft Audit Report of USAID/Nepal's Implementation of AID's Payment Verification Policy Implementation Guidance.

Mr. Richard Derrick, RIG/A
American Embassy, Singapore

The following are USAID/N's comments keyed to the four specific problem areas, internal controls and other pertinent matters cited in the draft report:

1. Annual assessments were not made

The draft report has noted that "AID Policy Guidance required AID missions to perform annual assessments of the host government and Missions' voucher approval and examination procedures and report thereon" and that "USAID/Nepal did not perform the required annual assessments and inaccurate or misleading information was reported to AID/Washington". RIG/A further stated that "problems resulted because USAID/Nepal placed a low priority on performing the assessments".

USAID believes that the first statement is inaccurate and that the latter two statements are fundamentally inconsistent with the facts and thereby misleading to the reader. The AID policy guidance in question here is the Payment Verification Policy Implementation Guidance issued December 30, 1983 to all Mission Directors (Attachment I). The exact wording of this Policy guidance is that "the USAID should prepare a general assessment of methods of implementation and financing procedures used by the USAID".

USAID/Nepal complied fully with this guidance and submitted this Mission's comprehensive general assessment to AID/W March 22,1984 this assessment is Attachment II. The guidance did not state, nor do we believe intend, that the missions were to perform entirely new assessments from scratch each year. The intent of the guidance appears to be quite clear from the guidelines, which stated "the Mission should review and update this first assessment annually. The annual update will involve minimal effort except when missions undertake substantial changes in the way they do business" (underlining added). USAID/N prepared and submitted to AID/W annual updates of its 1984 assessment for 1985 and 1986 in accordance with these implementing guidelines. These up dates are found in attachment III.

We take strong exception to the draft audit report statement on p.9 that "there was no evidence at USAID/N to show that any of the required annual assessments were made of the Government of Nepal and the mission's voucher examination and approval procedures". This statement is not only inconsistent with the facts, but in our opinion is intentionally misleading. USAID/N included the required assessment of this Mission's voucher examination and approval procedures with the first comprehensive report (see Attachment II) submitted in 1984. That assessment also included a complex flow chart of the USAID/N vouchering process, as well as this Mission's assessment of the GON's monitoring and voucher examination procedures. USAID/N advised RIG/A of these facts in the Mission's written response to the audit findings, but for reasons not known to us, this response has been ignored in preparation of the draft report.

We also strongly object to the statement on p.10 that "USAID did not make subsequent annual assessments of the mission's voucher procedures and USAID/Nepal also did not make any annual assessments of the GON's monitoring and voucher examination procedures as required by the Guidance". This statement is false. As illustrated by Attachments II and III, USAID/N conducted the required assessment in 1984 and thereafter reviewed the assessments annually and updated the assessments.

It is the contention of this Mission that we have fundamentally complied with the intent of the policy guidance. In early 1984 USAID/N submitted the comprehensive general assessment to AID/W as called for by the policy guidance. We also submitted the required updates in 1985 and 1986. If there was an inconsistency between the Missions' submissions and the policy guidance, or if these reports were inadequate, AID/W PM should have, and presumably would have, pointed this out to the Mission at some point in the last three years. However, since USAID/N has received no corrective guidance from AID/W pertaining to any of those three submissions, we believe they were responsive and acceptable.

We very strongly disagree with the opinion expressed in the report on p-7 that "inaccurate or misleading information was reported to AID/W" and that "this inhibited both USAID/Nepal and the Agency's ability to identify and correct USAID/N and the GON financial Management and related internal control weaknesses". Where is the evidence to support this claim? The USAID/N financial review reports alluded to in support of these statements were not management audits nor were they consultants' conclusions or recommendations. In fact, those post payment reviews were simply financial compliance reviews; they were not assessments of GON financial management nor were they reviews of GON internal controls. We submit that USAID/N financial compliance review reports,some of which were 3 and 4 years old, are not appropriate documents on which to conclude that GON internal financial management and controls are inadequate.

With respect to the four points made on pp.11-12 of the draft report, regarding USAID/N's FY 1986 submission, it is important to note that Payment Verification Policy Implementation Guidance issued to all Mission Directors on September 29, 1986 (Attachment IV) effectively abrogated the requirement for annual updates of the comprehensive assessment. This new guidance states "we are modifying the reporting requirements under Policy Statements Nos.1 through 10 to the submission of a simple questionnaire in the form attached".

USAID/N believes that the modified reporting requirement applicable to 1986 therefore precluded the need for new assessments in connection with responses to Policy Statements 6-9 on the 1986 questionaire. Under the new guidance these fou questions are intended to be answered by a "yes" or" "no". USAID responded to Policy Statement questions 6, 8 and 9 of tha questionaire with "yes" answers. It is arguable that our response should have been further elaborated.

Regarding Policy Statement No.6, the RIG/A is referred to the Mission's earlier comments on the draft audit findings which are still valid, and to section 4 of this response.

Regarding Policy statement No.8, while no separate sample of vouchers was taken to respond to the questionaire, we believe the samples of vouchers reviewed by Mission financial analysts at the time of their reviews and the daily review of all payment vouchers processed by this USAID by the Controller/Certifying Officer constitutes a sufficiently large sample of vouchering activities to provide reasonable assurance on the allowability of claims.

Regarding policy statement No.9, there was no need to prepare a new assessment of the GON monitoring and voucher review process to respond to this question. The Mission, on a regularly scheduled basis, monitors the GON voucher process through financial reviews and improper claims by the GON are disallowed. We believe this process, coupled with intermittent audits, provides the Mission with reasonable assurance that USAID/N's funds are expended in accordance with the terms of grant agreements.

Even with such elaborations or qualifications of USAID responses to the questionnaire, it is doubtful that AID/W's understanding or use of the information would have been materially effected. As a result of a cable inquiry by AID/W, item (II) 3 of the 1986 questionaire pertaining to Host Country Contracts was revised and submitted to AID/W (Attachment V).

Based upon the above facts and discussion, USAID/N believes that recommendation No.1 parts a and b should be dropped from the final report.

With regard to part c of recommendation No.1, we do not believe that a discussion and recommendation pertaining to unallowable taxes should be combined with the issue of annual assessments. They are not logically related to each other. In fact, part c of the recommendation is superfluous because USAID/N had already recognized the problem of unallowable contract taxes and has had considerable negotiations on it underway with the GON, dating from 1984. As a result of these negotiations, the GON finally accepted the validity of the USAID position on contract tax exemption of AID projects and agreed to new language that has been put into all grant agreements signed in FY 1986. In addition, the GON enacted new legislation effective October 2, 1986, prohibiting assessment and collection of contract tax on all foreign aid projects.

Starting in 1985, USAID/N's Office of Financial Management has been collecting data to assertain the exact amount of contract tax collected between 1981 and 1984. Because the refunding of the contract tax collected by the GON from USAID/N assisted projects has been disputed by the GON, the Mission has not yet issued a formal claim for contract tax payments. However, the Mission is currently in the process of further updating the amount of contract tax collected from AID-assisted projects for the period 1985 to the enactment of the new legislation October 2, 1986. Upon completion of the collection and collation of the data pertaining to payment of contract tax which we currently estimate will take several more months, USAID will prepare and submit a formal claim to the GON for the amount determined to be due as a result of our review. Since the final USAID claim will cover the entire five-year period prior to enactment of the legislation by the GON, some further negotiation with the GON may be necessary to finalize the USAID/N claim.

2. Cash Advances to the Government of Nepal were not justified.

The draft audit report states on p-17 that "AID Policy Guidance issued in December 1983 stipulated that it was AID and U.S. Government cash management policies to minimize the use of cash advances for project implementation". USAID/N is unable to find such a statement in that policy guidance. The closest thing we could find to that statement was in the discussion section on bank letters of commitment on page 3 which stated "another reason is Agency and US cash management policies which aim to minimize advances and defer payments as long as possible, i.e. until all work is completed or goods and services delivered" That statement does not say that it is U.S.G. or AID policy to minimize use of cash advances for project implementation.

HB 19 page 1B-7 sets forth quite clearly AID Policy on use of cash advances as follows: "A. I.D. policy favors payment to A.I.D-financed recipients on the basis of goods delivered or services performed or to cover costs already incurred by the recipient. An exception to the policy is made for non-profit organizations and host country government institutions, which are normally funded on an advance of funds basis " (underlining added).

This is another example of the use of misstatements in the draft report which have the effect of significantly misleading the reader. The frequency of such examples give rise to questions about the overall intent of the drafter.

USAID/N was also unable to find the exact source of the "two prerequisites"for authorizing the use of cash advances to the host government in the guidance which the draft audit report states on p.17 that "the policies required". The report concludes that USAID/N provided sizeable cash advances to the Government of Nepal without satisfying either prerequisite i.e. "advances should be justified based on a specific need and the recipient organization should have adequate financial management and related internal controls for accounting for U.S.Government funds". Not only is this a misstatement of applicable policy, but the report goes on to falsely conclude that "the use of cash advances to the GON during the 3 year period ending December 31, 1986 resulted in a waste of U.S.Government funds of about $1.4 million", and that this all came about because "USAID/N was not fully aware of the AID and U.S. Government policies to restrict or limit the use of cash advances to host governments." This is sheer nonsense!

In view of the fact that it is AID Policy that host government institutions are "normally funded on an advance of funds basis", advances to the host country government do not require special justification. Nevertheless, in Nepal, there is a long history of justification for funding project implementation on an advance of funds basis.

Advances of funds are made to the GON for project implementation purposes through use of a Working Capital System (WCS) in order to coordinate budgeting, funding and releases on a trimesterly basis, which is the basis on which GON financial institutions budget and expend funds for development projects. A detailed description of the Working Capital System and a justification and explanation of why this system is the most practical approach in the Nepalese context was included as an attachment to the comprehensive general assessment submitted to AID/W March 22, 1984. That submission to AID/W also specifically included a justification for use of advances of funds to the GON in excess of the normal 90 day limitation established by the U.S.Treasury. Furthermore, USAID/N believes that the GON has adequate financial management and related internal controls for controlling and accounting for advances of U.S.Government funds. GON controls are assured by the fact that the HMG Comptroller General conducts monthly audits of all funds expended on both regular and development project receipts and expenditures. In addition, the GON Auditor General (an independent constitutional body) conducts a financial and management audit of all projects annually.

To the best of our knowledge in over 35 years of U.S. assistance to the GON, during which time project assistance has been facilitated through the continous use of advances of funds to the host government, there has been no single instance of less than a full accountability of all funds advanced.

The report speculates on p.19 that "USAID/N probably was not able to adequately justify the need for cash advances for project implementation purposes or show that the GON had acceptable financial management and related controls to qualify for advances".

This is not only speculation, but is false and misleading. The justification for cash advances contained in the WCS documents submitted to AID/W is adequate to the task.

We take exception to the auditor's contention that "USAID/N justified advances to the GON because Nepal was one of the poorest countries in the world and as such, did not have sufficient capital to conduct major financial undertakings such as development projects". Although the statement is true, and Nepal still is one of the least developed countries in the world, that was not the basis of the justification for the WCS of advances to the GON. The justification for use of the WCS was set forth in Section II of attachment B pertaining to USAID/N's WCS which was included as an attachment in the 1984 comprehensive general assessment (refer attachment II). The justification detailed eight major reasons for utilization of the WCS system of advances, not one of which was the fact that Nepal is one of the poorest countries in the world. Those reasons for utilizing the WCS are still generally valid. The Nepal experience with the WCS has been that the WCS has done what it was designed to do, i.e. facilitate project implementation by making funds available to our projects through the government based on projected immediate disbursing needs of the projects covered under the WCS.

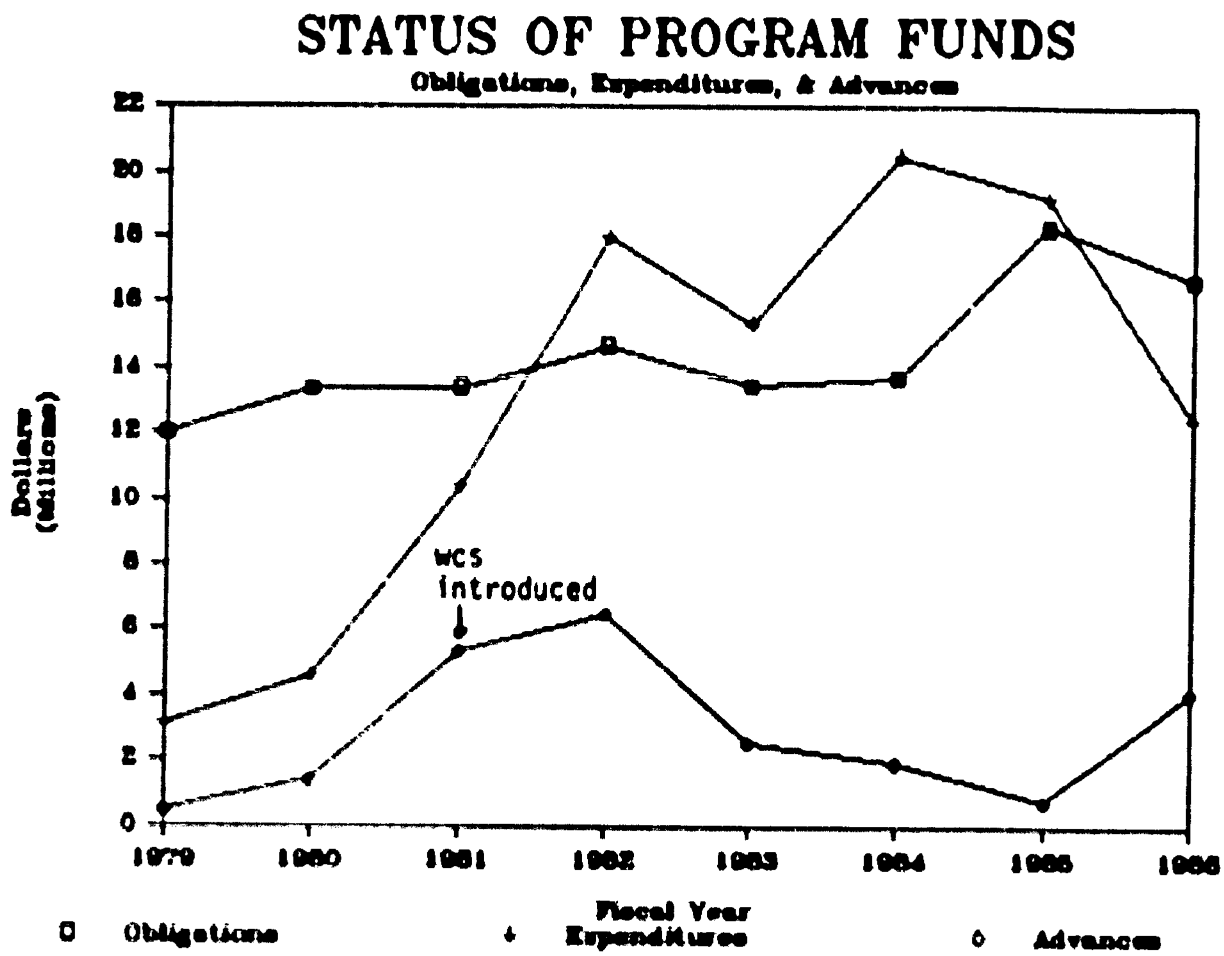
As a result of utilization of the WCS and close financial monitoring of project funding needs, USAID/N has, in fact, been able to achieve rather notable results since inception of the WCS-results that we attribute largely to use of the WCS of advances to the GON. While new obligations increased during 1981-1986 from approximately $13.4 million to as high as $18.3 million annually:

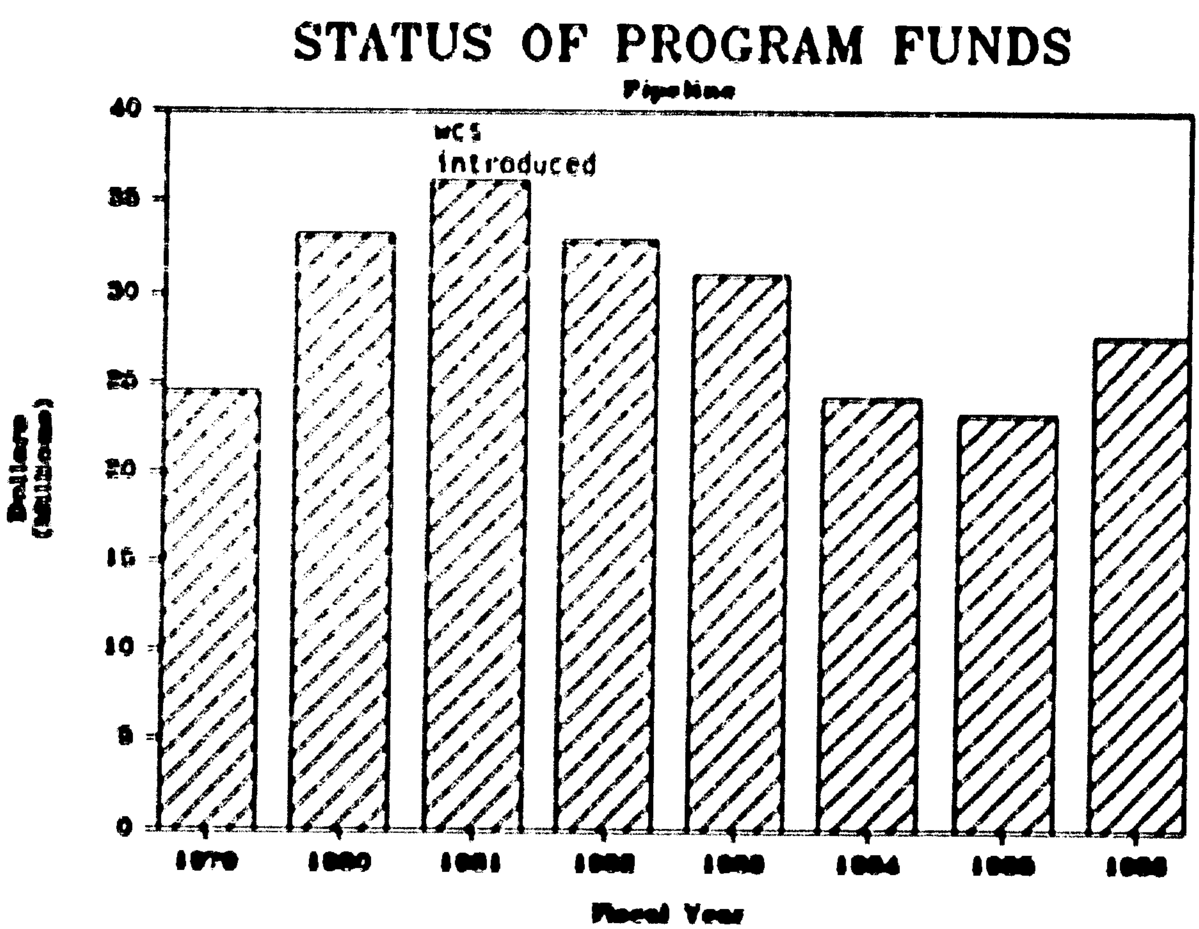
1. Expenditures increased from $10.4 million to as high as $20.5 million annually,
2. The pipeline actually decreased materially from $36.2 million to $23.3 at the end of that period, and
3. Outstanding advances to the GON actually declined materially from $5.3 million in 1981 and $6.4 million in FY 1982 to an average of approximately $2.3 million during the three-year period January 1, 1984-December 31,1986.

In terms of improving and facilitating effective project implementation and reducing outstanding advances, USAID/N believes the record of the WCS is commendable and clear from the facts. However, a reader would certainly not be able to glean that from the draft audit report.

The effects of the WCS on USAID/N's pipeline and level of outstanding advances are illustrated in figure 1.

FIGURE 1


STATUS OF PROGRAM FUNDS
Obligations, Expenditures, & Advances
Dollars (Millions)
0
2
4
6
8
10
12
14
16
18
20
22
WCS introduced
1979
1980
1981
1982
1983
1984
1985
1986
Fiscal Year
Obligations
Expenditures
Advances


STATUS OF PROGRAM FUNDS
Pipeline
Dollars (Millions)
0
5
10
15
20
25
30
35
40
WCS introduced
1979
1980
1981
1982
1983
1984
1985
1986
Fiscal Year

Although the WCS justification anticipated that most delays in release of funds to projects would be eliminated through use of the WCS, in actual practice, there are on occasion delayed releases by the GON for procedural reasons. Indeed, these reasons are often related to workings of the internal controls observed by the GON's Controller General in withholding disbursements until previous advances and audit recommendations are cleared.

USAID/N fails to understand the reference to and discussion of IG audit report no.0-000-84-15 dated December 12, 1983 on pp.2 and 21 of the draft. We object to the draft reports' language on those pages, which is not an accurate summation of that audit report as it pertained to Nepal. The drafter implies that the findings in that report are still valid; this is not so. The data on which the 1983 audit was based is 4-6 years old and is no longer applicable to advance policies and procedures in effect at this Mission at the present time. We believe any reference to the 1983 report in the present context is unwarranted and should not be included in the final report.

We do not know how the audit team arrived at the conclusion on p.22 that "USAID/N's general policy for funding projects indicated that USAID/N could fund at least some activities or projects on a reimbursable basis". We have no such "general policy". The factual issue may be debated. USAID/N policy has been and is currently to fund project implementation on an advance of funds basis and, we have agreed to do this with the GON. We have good reasons to believe that most or all of our projects require advances to assure effective implementation and that any change to a reimbursement process, in whole or part, would severely slow implementation and increase our pipeline level. We do not think the discussion on pp.22-23 is valid in view of the success of the WCS system in place at this Mission and the implications for our relationship with the GON and for our projects that a reversal of that system would entail. The "examples" included in this discussion were not included in the initial audit findings nor were they discussed with Mission financial management. Their significance and applicability to ongoing operation of the WCS system here is doubtful and they should be dropped from the report.

We would not modify such a good working relationship on the basis of delayed submissions of expenditure claims for a given trimester. It would be totally impractical to make such abrupt changes in the way we do business and still expect funds to flow from the GON on a relatively timely basis to our projects.

In determining the immediate disbursing requirements for any given trimester, if USAID analysis of the advances indicates that adjustments are required in subsequent periods, an adjustment is made. We fail to see what is wrong with this approach.

The major problem evidenced by the drafter's language on p.24 and throughout this draft report--a problem which has led to numerous incorrect interpretations and conclusions relating to recommendations 2 and 3--is a basic misunderstanding of just how the WCS really operates, i.e. how advances are made and accounted for by USAID/N. We feel obliged to reiterate this process again. Based on a program formula derived from experience and adjusted over time, USAID/N advances funds to the GON Ministry of Finance for project implementation. The Ministry of Finance (MOF) is solely responsible to USAID/N for the accountability of all funds advanced under the WCS. Once received by the MOF, the funds are commingled with other GON funds and do not retain a separate identity. The MOF advances GON funds to the various GON implementing agencies for project implementation. These agencies are responsible directly to the MOF for the accounting of all funds advanced by the MOF; they are not accountable to USAID for WC advances received from the MOF. The MOF is the <u>only</u> government entity responsible to USAID for the accountability of all WC advances to the GON.

I would also like to mention two additional very important elements: (1) implementing agency projects' immediate disbursement requirements--determined government-wide on a trimesterly basis--are the sole basis for determining the amount of funds advanced to the MOF; and (2) the funds advanced to the MOF for project implementation purposes are liquidated by applying agreed upon percentages of project expenditures incurred by the GON implementing agencies from the WC advances outstanding with the MOF.

There is currently only one advance recipient the MOF, under the WCS in effect at this mission. On a regular basis (trimesterly) the mission does have a current status of outstanding advances. However, where there are expenditures in remote locations of Nepal which have not been consolidated and the reimbursement claim prepared, those expenditures would not be reflected in our accounts.

It does happen, because of the nature of conditions and lack of

On p.25, the drafter states that USAID Nepal post payment reviews of GON audits show that these audits did not adequately protect U.S.Government interests. It should be noted again that USAID/N post payment reviews have <u>never</u> drawn the conclusion that the financial management systems and related internal controls in the GON are not adequate to properly account for funds advanced. Further, it is not the stated or implied intention of USAID project agreements that the GON is to be responsible for performing audits that provide adequate protection of <u>U.S Government</u> interests. That responsibility is the function of USAID financial reviews and U.S. Government audits. GON audits are conducted by two independent agencies and the audits are performed in accordance with generally accepted auditing standards in Nepal.

The draft statements on pp.25-26 to the effect that the U.S.Government incurred a "waste" approximating $1.4 million by way of unnecessary interest costs amounting to $562,000 and currency exchange losses amounting to $883,000 are patently absurd, and we strongly object to them. They are not based on fact, not justified and do not belong in this report.

USAID/N does not accept the erroneous conclusion that U.S. Government funds were wasted and that USAID/N needs to further justify the use of cash advances to the GON for project implementation purposes. Interest costs are normal costs attributable to conducting Mission business under current Agency Policy Guidance. This also applies to currency exchange losses incurred in the normal course of conducting business; AID does not speculate in the foreign exchange markets.

For all the reasons cited in this section of our response, USAID/N does not accept recommendation No.2 as valid. When it is normal Agency policy to conduct business in a certain manner,(i.e., through advances of funds made to host governments for project implementation) and, because USAID/N adhered to this policy and advanced funds to the GON on a well-justified basis of which AID/W was fully apprised, the recommendation set forth is not justified.

3. Financial Management of Project Funds was not adequate. We strongly disagree with the opinion on p.28 that "USAID practices for advancing funds to the GON for project implementation purposes did not adhere to acceptable financial management standards". Who is the authority on these acceptable standards? The most recent independent review of USAID/N standards by a qualified financial management officer of AID occurred as recently as September 1986, during the Mission Management Assessment. Dean Pratt, Controller of USAID Pakistan, throughly reviewed USAID FM operations and concluded "The financial management of USAID/Nepal is generally satisfactory. No serious Mission financial management deficiencies or problems have been identified during the assessment.." Controller Pratt's judgement was that the office was currently characterized by a "high level of concern for adherence to federal regulations."

We further do not agree that USAID/N did not have adequate policies and procedures to limit cash advances to the GON's immediate disbursement needs or a proper accounting of the outstanding advances. This audit conclusion is wrong on both counts. USAID/N does have practical policies and procedures in effect that are utilized to determine, with reasonable accuracy, the immediate disbursing needs of the GON for project implementation purposes. Apparently the audit report is questioning methodology here but doesn't specifically so state. This Missions' accounting for outstanding advances is fully in accordance with policies and procedures set forth in AID Handbooks and other regulations as discussed in section II above.

The draft report's contention that "inadequate financial management of project funds resulted in unwarranted vulnerability to waste and abuse of, or related to, about $37.2 million in U.S. Government funds" is patently false, unjustified, unjustifiable and sensationalistic. We object to it in the strongest possible terms and demand its excision from the report. We believe such an unsupported and unwarranted conclusion borders on abuse of the audit function. We are curious how it is possible to have $37.2 million subject to "waste and abuse" when USAID/N has outstanding WC advances to the GON which have averaged only some $2.3 million over a most recent 3-year period at any given time. Also, please refer to the GON record of accountability for advances noted in the previous section of this report.

Since USAID/N already has in place policies and procedures to provide and account for advances to the GON which are in conformance with AID regulations, with the possible exception of the 90-day requirement authorized by the Treasury, we do not accept the validity or practicability of any part of recommendation No.3.

Regarding advances exceeding the 90-day maximum authorized by the Treasury, USAID believes the justification previously provided to AID/W in the description of USAID/N's WCS on March 22, 1984, was and remains fully adequate in view of the circumstances affecting project implementation existing in Nepal. We have carefully structured our program implementation process utilizing the WCS to provide the capacity to fund and implement the program in a manner consistent with GON internal fiscal policies.

If the justification provided by the mission to AID/W for exceeding the 90 day limitation for advances was not acceptable to AID/W, we believe AID/W would have specifically advised the mission of this fact. However, since USAID/N received no corrective guidance from AID/W pertaining to the WCS, we presume that our justification for exceeding the treasury 90 day limitation for advances has been and remains fully acceptable.

USAID/N is in full compliance with the Handbook guidance described on pp.29-30 of the draft report. However, we take exception to the statement on p.30 that "one of the basis (sic) for this system (WCS) was to allow the GON to use the cash advances under one project to fund another that did not have available funds". This statement has no factual basis whatsoever. It may be theoretically possible for this to occur for brief periods under the WCS, but it was not "one of the basis (sic) for this system". The eight bases for the system were as repeatedly noted, clearly set forth in the March 22, 1984 submission to AID/W.

Regarding the procedures used by USAID/N for calculating advance requirements of the GON under the WCS, we would like to reiterate that the advances made to the GON are this Mission's best estimates based on empirical data from past experience. We do not use "unreliable estimates of past" expenditures. In fact, we use actual reported expenditures from the like trimester incurred one year earlier as one element in our calculation of estimated needs. Another element is the current year budgeted expenditures which we have, through experience, worked into a formula, subject to adjustment, that enables us to obtain a reasonable approximation, of GON working capital needs for each trimester. We do not claim the infallability of the estimated needs determined as a result of our analyses. Indeed, we have made adjustments several times in the past to successfully reduce outstanding advances. Activity fluctuations in a given trimester notwithstanding, a review of this Mission's advances for the past two years shows that advances outstanding on an annualized basis reasonably approximated total local currency expenditure claims received and processed. RIG/A was previously provided with the analyses of these annual requirements vs. advances.

We take exception to the statement on p.33 that "untimely reports resulted in inadequate USAID/N accounting of outstanding advances". This is simply not true. At any given time, USAID/N has accounting records fully adequate to correctly reflect the status of outstanding advances to the GON.

Furthermore, the last sentence on p.33 is also factually incorrect with regard to the WC calculation made in connection with each trimesterly advance. There is no evidence to support the misleading claim that USAID/N uses "inaccurate estimates intentionally made to compensate for the GON's slow release of project funds". Again, we believe the use of such language to be irresponsible.

We would like to reiterate that WCS advances are made to the GON on the basis of a negotiated agreement and understanding with the MOF, based on the operating policies and procedures utilized in financing GON implementing agencies. This understanding was most recently modified by letter dated 8/19/85, a copy of which was included in the Mission response to audit findings, to change the methodology of the calculation of the WC advances. These written understandings with the GON preclude the need for individual written requests for advances of funds on a trimesterly basis.

Regarding monitoring of cash advances (p.34), USAID/N continuously monitors AID advances to the GON for project implementation purposes. The fact that the GON has real difficulty in collection, consolidation and reporting of expenditure data from numerous widely scattered, remote and inaccessible field locations in Nepal is not new to USAID/N, though it may be to RIG/A. The Mission and the GON have been aware of these difficulties for many years. In fact, a principal impetus in the design of the WCS was an attempt to expedite flows of funds to AID-assisted projects <u>in spite of</u> the difficulties cited. The non-receipt of expenditure claims from the GON does not necessarily mean that GON funds were not expended in a timely manner. The problem is in large part a reporting time lag and not a disbursement time lag. This does not mean that there are not inherent delays in the beauracratic process of handling advances of funds by the GON. Some delays in this regard are unavoidable. A quote from the consultant's report done by Robert R. Nathan associates, Inc. May 28, 1980 on the Rapti Project seems appropriate here. The consultant stated in part "For money that flows to the HMG (GON) line ministries, the system of advances is recommended. No matter what disbursal arrangement USAID makes with HMG, HMG will still use advances internally. The ministry (MOF) will continue to advance quarterly (trimesterly) funds to departments, which in turn will advance them to the districts".

While the system of release of advances has been modified somewhat since that report was written, the internal GON delays in disbursing funds to projects through the various Departments and Agencies as well as the District Treasury Offices may remain for procedural reasons. Nevertheless, the local donor group (all of whom suffer from the same problem) is addressing the matter jointly with the MOF, and possible remedies are being discussed.

4. Project papers did not adequately provide for audit coverage.

In the absence of promised, specific Agency-wide implementation guidelines defining the criteria to be utilized in (1) evaluation of the need for audits, (2) defining adequacy of standards to gauge what types and scopes of audits would be required; and (3) criteria for estimating cost of various types of audits so that adequate funds could be provided for in the PPs, USAID has found it difficult to prepare adequate audit plans for recent project papers. However, USAID did provide specific funding for audit coverage is most of these PPs,and did make assumptions that at least some audit coverage would be available from the IG, as in the past. The issue here appears to be "adequacy" of audit coverage in the PP. During the audit team's visit, the mission agreed to try to improve this "adequacy" if the RIG and/or AID/W would provide an indication to the Mission of what constitutes "adequacy" in the evaluation of need for audit coverage and the budgetary provision for it in the PPs. Specific examples of PPs with "adequate" audit coverage were solicited from the audit team but no response was forthcoming. Members of the audit team were also requested to conduct a meeting with Mission staff to explain what constitutes "adequate" audit coverage,but declined to do so.

It seems somewhat unreasonable and impractical for this mission to take further significant actions with respect to the recommendation when in fact, neither the RIG/A nor AID/W, to date, has provided the specificity of "adequacy" for audit coverage by way of implementing guidelines. There are no current criteria available by which the Mission could effectively implement this recommendation. We have, nevertheless, discussed the issue in Mission staff meetings and assigned responsibility within the Mission for review of the adequacy of PP audit plans.

5. Compliance and Internal Controls.

In view of the detailed comments provided in sections of this response pertinent to recommendation nos.1,2 and 3, the compliance and internal control exceptions noted on pp.41-42 pertaining to those recommendations are, in the opinion of this Mission, unjustified and unwarranted conclusions based on the actual policies, procedures and practices existing in the Mission. USAID/N rejects outright four of the six exceptions noted. It will accept in part that its evaluation of audit needs and budgetary coverage for audits may not have been adequate, subject to some reasonable definition of adequacy from RIG or AID/W.

6. Other Pertinent Matters.

Since USAID/N relied on the judgment of project personnel directly involved in project implementation in assessing HCC capability, formal evaluations of HCC were not required. USAID/N determined by full consensus that it was not practical to broadly utilize HCCs as a mode of project implementation for projects in Nepal. This was the basis for USAID/N not performing expensive, unnecessary and time-consuming formal assessments of HCC capability, and in our view undertaking such a formal assessment would have constituted a waste of U.S.G. funds.

LIST OF REPORT RECOMMENDATIONS

Recommendation No. 1

We recommend that U.S.A.I.D./Nepal:

a. develop a plan of action to conduct the required assessments of the Government of Nepal's and the mission's voucher approval and examination procedures;

b. submit to A.I.D./Washington an accurate payment verification policy report for fiscal year 1986; and

c. recover the $286,560 paid to the Government of Nepal for unallowable tax payments, and

d. determine and recover the additional amount of unallowable taxes paid to the Government of Nepal after December 1, 1984.

Recommendation No. 2

We recommend that U.S.A.I.D./Nepal:

a. justify the need for cash advances to the Government of Nepal, and

b. ensure that the Government of Nepal organizations requiring cash advances have adequate financial management and related internal controls for controlling and accounting for U.S. Government funds.

Recommendation No. 3

We recommend that U.S.A.I.D./Nepal establish policies and procedures for providing and accounting for authorized cash advances made to the Government of Nepal. The policies and procedures should:

(a) limit cash advances to the immediate disbursement needs for project implementation and for not more than the maximum 90-day requirement authorized by the U.S. Treasury,

(b) ensure that current and reliable data are used to determine the amount of advances,

(c) require the Government of Nepal to submit timely written requests for funds along with an analysis of the advance requirements and status of outstanding advances, and

(d) require the Government of Nepal to report when funds are provided to the project activities.

Recommendation No. 4

We recommend that U.S.A.I.D./Nepal:

a. issue a mission order requiring that project papers include an evaluation of the need for and description of planned audit coverage together with an allocation of necessary project funds for audit coverage; and

b. evaluate the need, establish a plan, and provide appropriate funding for audit coverage for the six projects approved after January 1, 1984.

APPENDIX 3

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