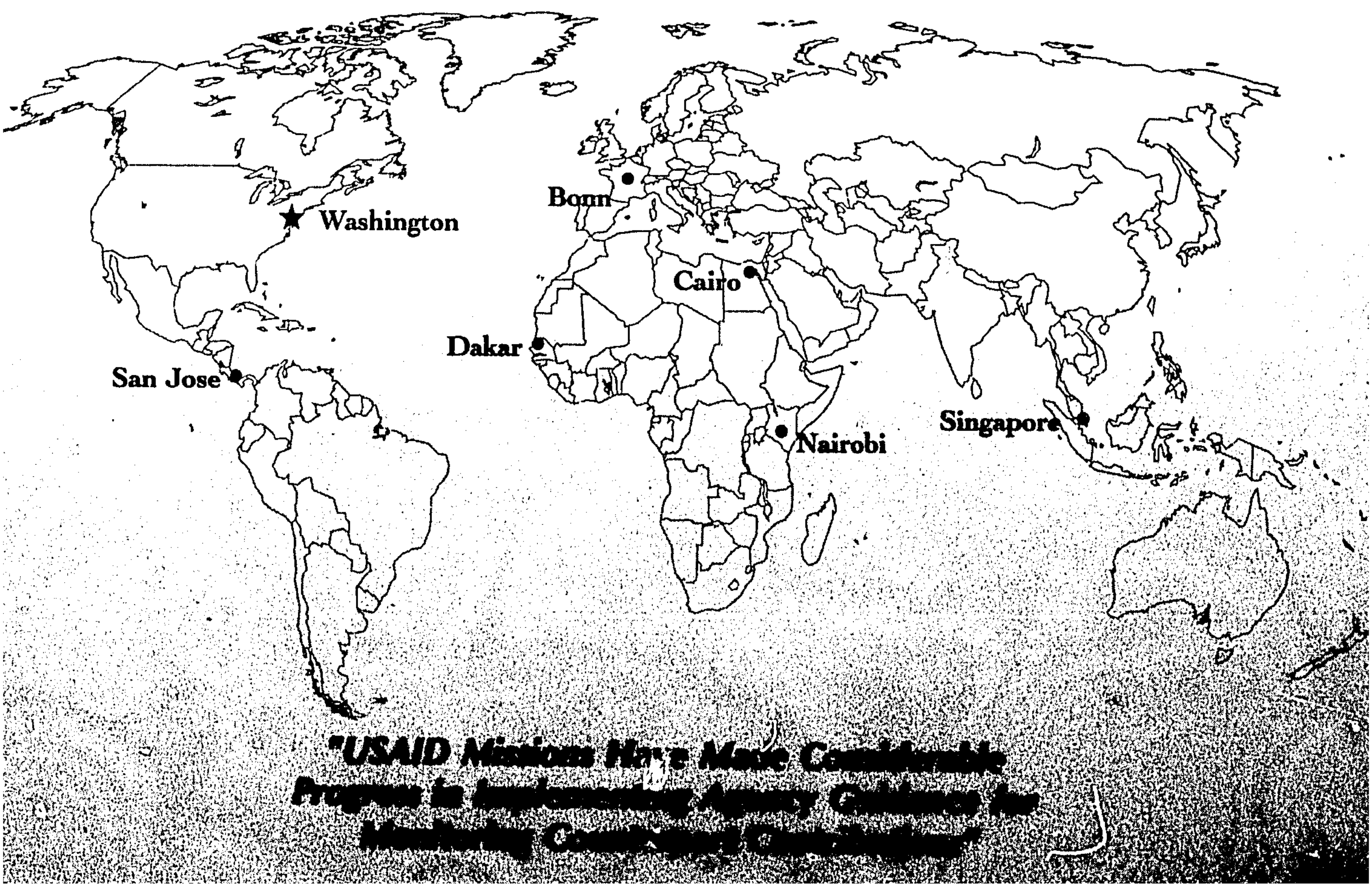
Assistant Inspector General for Audit

WORLDWIDE AUDIT OF USAID CONTROLS OVER COST SHARING AND MATCHING CONTRIBUTIONS BY HOST COUNTRIES

Report No. 5-000-95-006
March 29, 1995



INSPECTOR GENERAL

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

USAID
U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

*Assistant
Inspector General
for Audit*

March 29, 1995

MEMORANDUM

TO: AA/PPC, Colin I. Bradford

FROM: AIG/A, James B. Durnil

SUBJECT: Audit Report on Worldwide Controls Over Cost Sharing and Matching Contributions by Host Countries

This capping report summarizes the results of our audits of USAID's Control Over Cost Sharing and Matching Contributions. The audits conducted at six USAID missions concluded that considerable progress has been made in the missions' implementation of the Agency's 1991 Guidance on the subject. However, we also found that mission personnel had conflicting interpretations as to what the actual requirements for identifying in-kind contributions and applying exchange rates were. Because the language included in Handbook 1, Part VII, Section 2.41 is somewhat ambiguous, the Agency's policy is subject to different interpretations.

This report makes a three-part recommendation for the office of Policy and Program Coordination to clarify the Agency's existing policy. Based upon your comments to our draft report, all parts of the recommendation are considered resolved and will be closed upon our confirmation that your proposed actions have been fully implemented. Your comments were fully considered in finalizing this report and are included as Appendix II.

I appreciate the cooperation and courtesies extended to the audit staff.

Assistant Inspector General for Audit

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"USAID Missions Have Made Considerable Progress in Implementing Agency Guidance for Monitoring Counterpart Contributions"

EXECUTIVE SUMMARY

This is a report on USAID missions' controls over cost sharing and matching contributions by host countries. This report represents a summary of findings which were previously reported to missions in Botswana, Guatemala, Honduras, Indonesia, Morocco, and Sri Lanka. The audits generally identified mission-specific problems and were limited to covering only part of USAID's controls, namely the cable guidance issued in 1991. This report addresses one finding which requires Agency-wide attention.

The audit objective was to determine whether missions followed USAID's 1991 cable guidance for monitoring counterpart contributions to USAID-financed programs, projects and activities.

The audit found that missions had generally followed the guidance provided in the 1991 cable, to the extent possible. However, we did identify one area requiring Agency-wide attention. USAID needs to more clearly define its policy on: (1) how missions value in-kind contributions, (2) how missions use exchange rates when computing host country contributions, and (3) whether missions should include USAID-financed resources as the host country's "in-kind" contribution.

Office of the Inspector General

Office of the Inspector General
March 29, 1995

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INTRODUCTION

Audit Objectives

The Office of the Inspector General for Audit audited USAID controls over cost sharing and matching contributions by host countries to answer the following audit objective:

- **Did missions follow USAID's 1991 cable guidance for monitoring counterpart contributions to USAID-financed programs, projects and activities?**

Appendix I contains a complete discussion of the scope and methodology for these audits.

Background

Congress wanted to ensure that countries receiving U.S. foreign assistance were financially committed to the successful outcome of the development activities paid for by this assistance. As a consequence, it enacted Section 110 of the Foreign Assistance Act of 1961, as amended, which requires foreign governments to make contributions of at least 25 percent towards the cost of foreign aid programs to ensure that these host governments have a vested interest in the success of USAID-financed activities.

Contributions by foreign governments are made either in the form of cash or "in-kind" contributions. In-kind contributions generally consist of resources such as office space, land, vehicles, or staff salaries—all of which should be necessary for the successful implementation of the program or project.

The audit covered 87 projects in the 6 countries of Botswana, Guatemala, Honduras, Indonesia, Morocco and Sri Lanka, with total USAID funding of $1.70 billion and planned host country contributions of $1.24 billion. Total USAID obligations and expenditures for the projects to March 1993 were

$1.24 billion and $856 million respectively. Host country contributions reported for the 87 projects were $898 million, but only $65 million of the contributions were verified by USAID.

REPORT OF AUDIT FINDINGS

Did missions follow USAID's 1991 cable guidance for Monitoring Counterpart Contributions to USAID-financed Programs, Projects and Activities?

USAID missions have made considerable progress in implementing the Agency's 1991 cable guidance for monitoring counterpart contributions to USAID-financed programs, projects, and activities. The missions generally adhered to USAID Handbook 3, Chapter 2, Appendix 2G for the project agreements that were signed after the issuance of the 1991 guidance by calculating the level of host country contributions based upon the total cost of the projects; identifying the project operating and/or capital costs to be provided by the host governments; and excluding contributions by other donors in the calculation of host country contributions as a percentage of total project costs. Missions generally followed the guidance to ensure that systems are in place to obtain information on host country contributions and that such information is recorded in the official record/files of the mission.

Although the missions did not completely follow the guidance in a few instances, alternative procedures had been implemented, thereby negating or significantly reducing any bad effect. For example, all six missions included in our review did not fully follow USAID's requirements to (1) review the adequacy of the host country contributions during project implementation reviews, and/or (2) test the reliability of the contribution reports during site visits and evaluations. Yet, although this was not done, most missions developed alternative procedures to ensure the adequacy of contributions and project officers occasionally reviewed the contributions. Also, several missions were verifying contributions during the normal course of conducting controller's office financial reviews.

While missions were generally following USAID's 1991 cable guidance for monitoring counterpart contributions to USAID-financed programs, projects, and activities, we did note one area of concern which warrants

USAID headquarters attention. Missions were not following the requirements of Handbook 1, Part VII, Section 2.41 for computing the value of in-kind contributions and rate of exchange to be used in calculating host country contributions.

Missions' Project Agreements Did Not Specify
<u>How Host Country Contributions Are Determined</u>

Missions did not define the basis for valuing the host governments' contribution and did not use historical exchange rates when computing actual contributions. This occurred because USAID policy and procedures in this area are not very clear. As a result, missions' valuation of $833 million of the $898 million in reported contributions in their records and reports may not have been sufficiently accurate to answer Congressional concerns set forth in section 110 of the Foreign Assistance Act of 1961—Are Host Governments financially committed to the successful outcome of development activities paid for by the United States?

> **<u>Recommendation No. 1</u>: We recommend that the Bureau for Policy and Program Coordination amend its policy on monitoring counterpart contributions to ensure it:**
>
> **1.1 requires missions to identify "in-kind" contributions and define the basis for valuing those contributions at project inception;**
>
> **1.2 requires missions to define the exchange rate to be used in converting local currency into dollars; and**
>
> **1.3 addresses the issue of whether prior USAID project resources or other donor country resources should be included as part of the host government's "in-kind" contribution.**

USAID Handbook 3, Appendix 2G, discusses the general requirements for recipient country contributions to USAID development activities. To properly value host governments' real resources, they must first be identified. Section D.2.a of Appendix 2G stipulates:

"The assurances should list and state the value of the items which the [host] government will contribute to the project being assisted by USAID. The assurance would be cited in the Project Paper..."

The Agency guidance for the exchange rate to be used in converting host country contributions is found in Handbook 1, Part VII, Section 2.41:

"The value of the...contribution provided by a host country... should generally be obtained by first pricing the host country's real resource contribution in local currency. This figure then is converted into dollars at the HR (highest exchange rate) current at the time of the project agreement...

Thus at the signing of an assistance agreement, the host government's real resource contribution is to be expressed both in terms of absolute dollars and a percentage of the total project."

Furthermore, USAID's 1991 Cable Guidance reminded missions of these requirements:

"Missions should follow guidelines in referenced Handbook [3] and Handbook 1 Part VII 2.41 for computing the value of in-kind contributions and rate of exchange to be used in calculating the HG contributions."

Handbook 1, Part VII, Section 2.42 requires the host country to contribute at least 25 percent to the project costs regardless of devaluation, inflation or other similar financial or economic event, unless authorized by waiver in the case of the relatively least developed countries.

Despite the Handbook 3 requirement to list and disclose the value of the host government contribution to USAID-financed projects and the 1991 cable reminder to follow Handbook 3, none of the six missions specifically identified the types of in-kind contributions or the value of these contributions at the project inception.

For example, between April 1991 to March 1993, USAID/Morocco signed eight new project agreements, four of which required host country contributions. None of the new project agreements defined the basis for valuing the Moroccan contributions or the exchange rates to be used throughout the life of the projects.

At USAID/Indonesia, none of the 21 projects reviewed specifically identified the host government's resource contribution or the corresponding values of the in-kind contributions in the agreements and amendments. Furthermore, only 3 of the 21 projects differentiated between cash and in-kind contributions. Although these three agreements disclosed the dollar amounts of in-kind contributions, the specific type and value of these resources were not identified—only a lump sum was assigned to real property, man-hours to be charged, and volunteer work. In addition to not defining the specific inputs and the basis for valuing the non-cash contributions, the agreements did not specify the exchange rate that should be used to convert the local currency to U.S. dollars.

At USAID/Sri Lanka, none of the 13 projects selected identified and valued the real resources of the host government. Also, USAID/Botswana did not adequately define the basis for valuing the host country's contributions in five project agreements reviewed. Similar problems were found for the other two missions.

Compounding the problem of not identifying and defining a basis for valuing "in-kind" contributions at project inception was the inconsistent treatment of exchange rate conversions. For example, USAID/Guatemala used the historical rate at the time of signing the agreement in 4 of 13 projects, and applied current rates for the other 9 projects. Similarly, USAID/Honduras used the historical rate for three of the six projects. USAID/Indonesia used the exchange rates prevailing at the time the host country contribution was reported, while USAID/Morocco used both the historical and the prevailing rate. USAID/Botswana either did not convert the contributions into dollars or used the prevailing rates when they did.

Finally, USAID/Sri Lanka, which was using both the historical and the prevailing rate, switched to the historical rate after seeking the advice of the Regional Legal Advisor. This advice was based on the concept that at the time of signing the agreements, neither the host government nor USAID assumes a risk of a devaluation of its own contribution. This basis is consistent with USAID policy, and with the general principles of law governing agreements. However, the ambiguity in Agency guidance led to inconsistent application of exchange rates, as shown below:

TYPES OF CONVERSION RATES EMPLOYED AT USAID MISSIONS

USAID Mission	Historical rate at the signing of the agreement	Prevailing rate at time of reporting, or at project amendments	Host government contributions were not converted
Botswana		*	*
Guatemala	*	*	
Honduras	*	*	
Indonesia		*	
Morocco	*	*	
Sri Lanka	*	*	

USAID officials in Botswana, Guatemala, and Indonesia expressed concern that applying the historical rate of exchange (at the time of signing the project agreement) could cause the host government to meet or exceed the originally planned contribution and still fall below the required 25 percent of total project costs in dollar terms.

For example, in a June 1993 final project evaluation the Government of Guatemala exceeded its planned contribution of Quetzal 25 million by contributing Quetzal 42 million (rate of exchange at the signing of the agreement was Quetzal 1 = $1). However, the evaluators noted that although the project had nearly ended, 355 of the planned 900 critical teaching positions had not been filled. This situation occurred because of the devaluation of the Quetzal to 2.7 Quetzals to the dollar. The devaluation led to higher salaries and, including the 355 make-up teachers, the final amount of counterpart contribution needed would have to be much more than the original Quetzal 42 million. Conversely, if the originally planned $25 million contribution had been adjusted upward as the local currency devalued, i.e., Quetzal 2.7 times $25 million equals Quetzal 67.5 million, the Quetzal 42 million contributed by the Government of Guatemala would have been far less than what was agreed to. USAID/Guatemala contends that the Government of Guatemala had implemented this project well when viewed in terms of the dollar amounts converted at the historical rate, but its performance in terms of actual versus planned inputs was much less than expected because of the devaluation.

Another example cited by USAID/Honduras concerned the counterpart contributions of the Forestry Development project. This project reported first quarter 1993 contributions of Lempiras 836,318, and this was reported in the Semi-Annual Report as $418,159 using an exchange rate of Lempiras 2 equals U.S.$1. If the March 1993 exchange rate was used where Lempiras 6 equals U.S.$1, the amount of reported contributions would have decreased to $139,386 or 33 percent of what was actually reported. Considering that $4.8 million in counterpart contributions remains to be provided to the Forestry Development project, the decision as to what exchange rate to use is essential.

The Agency's guideline is unclear because Handbook 1, Part VII, Section 2.41 could be interpreted in two ways. First, the exchange rate disclosed in the project agreement should be used throughout the life of the project to value the host country's contributions, thereby benefitting the host government in fixing its rate. Second, the dollar value of the real resource contribution should be obtained, regardless of exchange rate fluctuations—thereby benefitting the U.S. government (in a declining local economy) in fixing the dollar amount.

Furthermore, Sections 2.41 and 2.42 conflict in that section 2.41 is designed to insulate the host government from the effects of fluctuations in exchange rates. However, section 2.42 requires the host government to contribute at least 25 percent to project costs regardless of devaluations, inflation or similar financial or economic events.

In addition to the ambiguity in these sections, another reason offered by USAID officials was that it was difficult—if not impossible—to specifically determine the required government contributions at the inception of projects. Mission officials said that it was more practical to briefly describe the contributions and include the total required amounts. This brief description would thereby allow for flexibility in the types and values of in-kind contributions made over the life of the project. However, such flexibility allows the manipulation of the resources claimed as counterpart contributions, which may or may not be needed on the projects.

USAID/Sri Lanka officials opined that the inputs of real resources provided by the host government for the projects should be detailed at the project inception, and meet the minimum 25 percent counterpart contribution. Furthermore, the basis of valuing the planned contributions should also be determined. The actual contributions could later be verified. This basis is required to effectively monitor contributions during project implementation and to minimize future problems in assigning values to non-cash contributions. Although this requirement is included in Handbook 3,

Appendix 2G, the policy is not fully developed or specific. The Handbook requires the project paper to

> *"list and state the value of the items which the [host] government will contribute to the project being assisted by USAID"*

However, the Handbook does not specify how comprehensive the list should be or establish a basis for valuation. Also, the Handbook does not address whether resources from a previous USAID project or from other donor country resources should be counted as the host country's in-kind contribution.

Without specific Agency guidelines the missions are unable to determine whether the host country contributions are realistically valued, and in the absence of this, cannot satisfy Congressional concerns that host countries be financially committed to the successful outcome of these programs.

The audit reports of Sri Lanka and Morocco emphasized that the descriptions of real resources provided by the host government were not defined. These reports further disclosed that the basis of valuing the resources was not established at project inception. All six audit reports noted that missions did not follow Handbook 1, Part VII Section 2.41, for computing the value of the in-kind contributions and application of the rate of exchange used to calculate the host country contributions. The missions' valuation of the contributions in their records and reports may also not have been adequate enough to provide help in determining whether the host governments were making agreed upon contributions. As a result, from the six audits, $833 million of the reported host country contribution of $898 million as of March 31, 1993 were not verified by the respective missions.

In summary, USAID should ensure that all missions specifically identify the "in-kind" contributions at project inception and define the basis of valuing these "in-kind" contributions. Furthermore, the Agency should address whether previous USAID project resources or other donor country resources should be included as the host country's "in-kind" contribution. Finally, the Agency should clearly stipulate the intended exchange rate policy for the purposes of valuing the local currency contributions.

Management Comments and Our Evaluation

USAID's office of Program and Policy Coordination responded to the draft report. Management generally concurs with the report's findings and the three-part recommendation, and stated that the recommendation will be implemented upon completion of the Agency's reengineering efforts, scheduled for October 1, 1995. At that time, Handbooks 1-4 will be replaced by the Agency's reengineered concepts of program and project design and management. These concepts will include the necessary revisions to the Agency's policy on cost sharing and matching contributions by host countries.

Based upon the proposed action to be taken by management, all three parts of our recommendation are resolved and will be closed upon our confirmation that existing policy has been revised as appropriate. The official management comments are included as Appendix II.

SCOPE AND METHODOLOGY

Scope

The Office of Inspector General audited USAID's controls over host government cost sharing contributions in six countries: Botswana, Guatemala, Honduras, Indonesia, Morocco, and Sri Lanka[1]. The audit was made in accordance with generally accepted government auditing standards. Our audit tests were designed to provide reasonable assurance that the answers to the audit objectives were valid. The audit was confined to testing the Mission's implementation of four control requirements identified in the 1991 USAID procedures on host country contributions (Department of State cable 138349).

The audit was made from September 30, 1992 through August 26, 1993. Field work was done at the offices of the six USAID missions, host government offices, and 20 implementing organizations.

The six missions had 87 active projects during fiscal years 1992 and 1993, with USAID's totalling $1.7 billion, obligations of $1.24 billion, and expenditures of $856 million. Contributions reported by the host governments were $898 million, of which $65 million was verified.

Audit of USAID/Botswana's Controls Over the Botswana Government's Counterpart Contributions (Report No. 3-633-94-002, January 14, 1994)

Audit of USAID/Guatemala's Controls Over the Guatemalan Government's Counterpart Contributions (Report No. 1-520-94-002, January 31, 1994)

Audit of USAID/Honduras's Controls Over the Honduran Government's Counterpart Contributions (Report No. 1-522-94-005, March 22, 1994)

Audit of USAID/Indonesia's Controls Over the Indonesian Government's Cost Sharing Contributions (Report No. 5-497-93-013, August 16, 1993)

Audit of USAID/Morocco's Controls Over Host Country Contributions (Report No. 7-608-94-003, November 17, 1993)

Audit of USAID/Sri Lanka's Controls Over the Sri Lankan Government's Cost Sharing Contributions (Report No. 5-383-94-001, November 29, 1993)

In addition to the methodology described in the following section, USAID management provided written representations that we considered essential for confirming our conclusions on the audit objectives and for assessing internal controls and compliance.

Methodology

The underlying audit reports on which this report is based included four audit objectives. For the purpose of this capping report, we have consolidated the audit objectives into one overall objective. The overall audit objective was to determine whether missions followed USAID's 1991 cable guidance for monitoring counterpart contributions to USAID-financed Programs, Projects and Activities.

To accomplish the audit objective, we evaluated missions' controls with respect to the policies and procedures set forth in USAID's 1991 cable guidance on host country contributions.

To determine whether missions adhered to Handbook 3, Chapter 2, Appendix 2G, Handbook 1, Part VII, 2.41 for computing the value of in-kind contributions and rate of exchange used in calculating host country contributions, we examined 87 selected project agreements and determined compliance with the applicable Handbook provisions. We examined missions' most recent status reports, host government contribution reports, and financial reviews for the 87 projects to determine whether the host government and missions were using the above criteria in accounting for the actual contributions provided by the host government. We followed up on problems identified in the financial reviews to determine if corrective action had been taken. Finally, we reviewed the correspondence with legal council on the interpretation of the Handbook provisions related to exchange rate policy.

To determine whether missions reviewed host governments' contributions during project implementation reviews, and tested the reliability of reports by site visits and evaluations, we reviewed the 1991 and 1992 Project Implementation Review reports, the Controllers' Office summary of "Host Government Contribution" reports, the 87 host government contribution reports, and determined if they contained written statements by project officers verifying their reasonableness. We held discussions with the

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project officers of selected projects and reviewed any documentation provided. We also discussed the financial reports with the financial analysts. Based on our analysis and discussions, we visited selected Ministries and implementing agencies of the various host governments to verify that the agencies have auditable evidence in support of the amounts reported.

To determine whether missions included in their agreements or Project Implementation Letters, a requirement for host governments to report at least annually on its contribution, we reviewed the 87 selected project agreements, selected Project Implementation Letters (PILs), and correspondence identifying reporting requirements. We also determined whether the missions enforced these established reporting requirements by obtaining copies of all host government contribution reports on file and checked that the reports were submitted on time, and in the proper format as required by the reporting requirements. We discussed our findings with missions' officials.

To determine whether missions had established systems to obtain information on host government contributions, and to determine whether such information is recorded in the official records, we interviewed Mission Directors, Controllers, Financial Analysts, and Project Officers. This was done to gain an understanding of their roles and responsibilities for establishing and implementing the system for obtaining, recording and filing information on host government contributions. We obtained copies of Mission Orders and any other documentation identifying the system in place.

Finally, we incorporated the results of the above to determine overall whether the missions fully implemented the procedures established in the 1991 cable guidance on host government contributions.

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APPENDIX II

MAR 24 1995

MEMORANDUM

TO: AIG/A, James B. Durnil

FROM: AA/PPC, Colin I. Bradford, Jr. [initials]

SUBJECT: Draft Audit Report on Worldwide Controls Over Cost Sharing and Matching Contributions by Host Countries

Thank you for the opportunity to comment on the draft of the Audit on Controls Over Cost Sharing by Host Countries. I wish to advise you that the Bureau for Program and Policy Coordination, which is the part of USAID responsible for guidance on this matter, generally concurs in the Draft and its three-part recommendation.

We are pleased that you found that USAID has made considerable progress in making sure that host governments contributed their agreed share of our development projects in accordance with the Handbook Guidance. Although you noted some deviations from the procedures called for in the Handbook, you also noted that most missions developed alternate procedures, thereby negating or significantly reducing any bad effect.

The three-part recommendation that you propose will essentially extend and deepen the extant Handbook guidance. It would require (1) that missions identify "in-kind" contributions and define the local currency value thereof at the time of the project agreement; (2) that missions define the exchange rate to be used to convert this value into U.S. dollars; and (3) address the issue of whether prior USAID project or other donor resources should be included in the "in-kind" contribution.

As you know, USAID is undergoing a thorough reengineering of all aspects of its operations. As part of this process, the present Handbooks 1-4 will be replaced by reengineered concepts of program and project design and management. The target date for entry in to effect of the new system is October 1, 1995. The Recommendation, in its three parts, will be followed in this process.

I wish to thank you for the courtesies shown us by your staff in the conduct of this audit.

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