Regional Inspector General for Audit
Singapore

AUDIT OF USAID/PHILIPPINES' ASSISTANCE FOR POLICY REFORM

Audit Report No. 5-492-95-020
September 22, 1995

USAID

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

September 22, 1995

MEMORANDUM

TO: Kenneth G. Schofield, Mission Director, USAID/Philippines

FROM: Richard C. Thabet, RIG/A/Singapore Richard C. Thabet

SUBJECT: Audit Report of USAID/Philippines Assistance for Policy Reform

Enclosed are three copies of the subject audit report. Our audit work showed that:

- Although USAID/Philippines ensured that the Philippines Government met the conditions precedent and special covenants prior to the release of funds, the Mission released funds for one program without meeting the intent of conditioning the assistance.

- The policy reforms generally resulted in the expected benefits materializing, except one program met with less success.

- We were unable to determine whether the funds provided for policy reforms were used for agreed upon purposes because the Mission did not track the withdrawal of the funds to their final acceptable uses.

This report contains one recommendation that when implemented will provide USAID/Philippines with better assurance that the funds provided for policy reforms were used for agreed upon purposes. Recommendation No. 1 is unresolved. The recommendation can be resolved if the Mission provides a plan of action to reestablish their procedures for its financial reviews, including the validation of debt service payments against loan statements from lenders. Please provide us information within 30 days indicating any actions planned or taken to implement the open recommendation.

Thank you for the cooperation that was extended to the audit team during the audit.

Attachments: a/s

EXECUTIVE SUMMARY

The Office of the Regional Inspector General for Audit, Singapore audited USAID/Philippines' assistance for policy reforms to determine if (1) the Mission ensured that the conditions precedent and special covenants were met prior to the release of funds, (2) the policy reforms resulted in the expected benefits, and (3) the funds provided for policy reform changes were used for agreed upon purposes (page 1 and Appendix I).

Although USAID/Philippines ensured that the Philippine Government met the conditions precedent and special covenants prior to the release of funds, the Mission did not meet the intent of conditioning the assistance for one program (page 4). The policy reforms generally resulted in the expected benefits, except for one program (page 9). Finally, we were unable to determine whether the funds provided for policy reform changes were used for agreed upon purposes (page 16).

This report contains one recommendation to USAID/Philippines:

- review statements from lenders to obtain reasonable assurance that the Government used USAID funds to pay agreed upon debt payments (page 17).

In responding to a draft of this report, USAID/Philippines officials did not agree with the third finding and recommendation. We carefully considered their comments in preparing this final report. Appendix II contains the complete text of the Mission's comments.

Office of the Inspector General

Office of the Inspector General
September 22, 1995

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INTRODUCTION

Audit Objectives

The Office of the Regional Inspector General for Audit, Singapore audited USAID/Philippines' assistance for policy reforms to answer the following audit objectives:

- **Did USAID/Philippines ensure that the Government of the Philippines met the conditions precedent and special covenants prior to the release of funds?**

- **Did policy reforms result in the expected benefits?**

- **Were the funds provided for policy reform changes used for agreed upon purposes?**

Appendix I contains a complete discussion of the scope and methodology for this audit.

Background

A variety of circumstances affecting U.S. national interests have required providing cash transfers. USAID categorized these circumstances into the following four general purposes:

- U.S. political commitments to Israel and Egypt resulting from the Camp David Accord;

- Security-related commitments with base-rights countries;

- Economic stabilization for those countries where the U.S. has major security or political interests and which are experiencing serious balance of payments or domestic budgetary problems; and

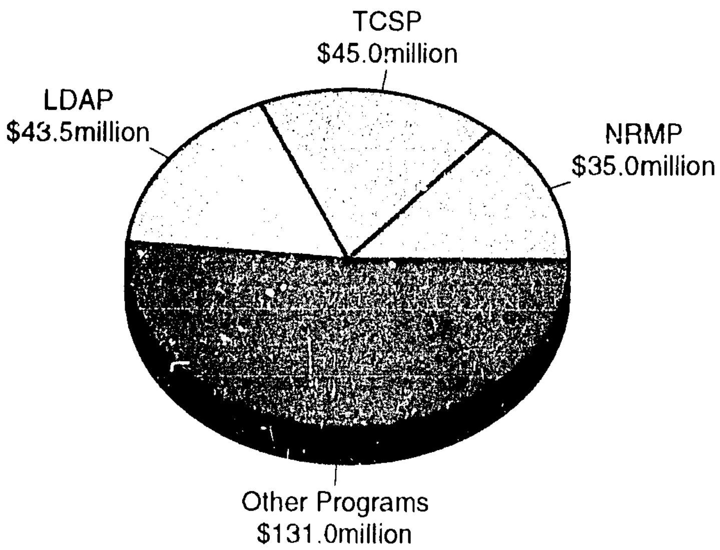
- Economic policy reforms for those countries where the U.S. has security or political interests and which are in need of structural adjustment reforms to achieve economic growth.

In providing cash transfers, the USAID strategy has been to link this bilateral assistance to economic stabilization and policy reform whenever possible. Accordingly, USAID usually attached conditions to this assistance in the way of conditions precedent or special covenants to the grants. These conditions varied depending on U.S. interests in the country and what was judged appropriate or negotiable, but they often required that the host government furnish evidence of its progress in implementing specified policy reforms or economic stabilization measures. If the conditions precedent for the policy reforms were not met, USAID would not make the cash transfer payments. Thus, this conditionality or leverage would better ensure that the expected benefits of USAID's assistance would materialize.

In monitoring cash transfer assistance for policy reforms, USAID missions, such as USAID/Philippines, have had primary responsibility for ensuring that the conditions attached to the grants are met, that the host country deposits the cash transfer payments into a separate account, and that the host country then uses these payments for agreed upon purposes.

As of September 30, 1994, USAID/Philippines was responsible for administering seven bilateral activities with policy reform (cash transfer) components. The cash transfer components for these activities accounted for obligations of $289.4 million, commitments of $274.4 million, and expenditures of $254.5 million. We reviewed three of the activities in detail: the Local Development Assistance Program; the Targeted Child Survival Program; and the Natural Resources Management Program. The Mission expended $43.5 million, $45.0 million and $35.0 million, respectively, for cash transfers associated with the three activities. The following chart illustrates the percentage of total policy reform cash transfer expenditures represented by these three activities.

USAID/Philippines' Expenditures for Policy Reform



Total Expenditures equal $254.5 million

LDAP: Local Development Assistance Program
TCSP: Targeted Child Support Program
NRMP: Natural Resources Management Program

REPORT OF AUDIT FINDINGS

Did USAID/Philippines Ensure that the Government of the Philippines Met the Conditions Precedent and Special Covenants Prior to the Release of Funds?

Although USAID/Philippines ensured that the Philippine Government (Government) met the conditions precedent and special covenants prior to the release of funds, the Mission released funds for one program without meeting the intent of conditioning the assistance.

To ensure that the Government met the conditions precedent prior to the release of funds, USAID/Philippines applied the procedures of USAID Handbook 3 for project assistance in reviewing and approving the evidence submitted by the Government that it had met the conditions precedent. The Mission gathered information from various sources and met with Government officials to monitor the Government's efforts in meeting the conditions precedent. The Mission recorded its monitoring information in periodic reports on program implementation reviews. A review committee then made determinations on whether the conditions precedent had been met and recommended that the Mission Director release the funds. The Director then issued a Program Implementation Letter notifying the Government that the conditions precedent were met and that the cash transfer was approved.

Through these procedures, USAID/Philippines properly confirmed that the Government met the conditions precedent to disbursement before the Mission released $123.5 million in cash transfer funds for the Local Development Assistance, the Targeted Child Survival, and the Natural Resources Management Programs.

For the Local Development Assistance Program, USAID/Philippines followed the above process in properly reviewing and approving evidence submitted by the Government to demonstrate that it had taken the actions required by the conditions precedent before the Mission made the cash transfer payments. The Government submitted adequate evidence demonstrating that it had taken these actions. For example, one condition precedent called for an increase in internal revenue allotments to local governments of at least 100 percent by the end of the Program. The Government submitted adequate evidence that it had increased the allotments to local government units from 4.2 billion pesos ($168 million) in 1989 to 18.1 billion pesos ($724 million) in 1992. Thus, it exceeded the end of program target of 8.4 billion pesos ($336 million) by more than 200 percent.

Another condition precedent required the Government to designate an additional six provinces as pilot provinces for decentralization. The Government submitted adequate evidence that it had designated eight additional provinces for the pilot program, thus exceeding the target by two provinces. An important action which accelerated the decentralization process was the Government's implementation in 1991 of a Local Government Code. This code provided a legal basis for the transfer of responsibilities, authorities, and powers from national to local governments. Decentralization reforms were well underway at all local government levels in all regions of the country. Officials of the local government in Puerto Princesa confirmed that the Program's conditions precedent were met. Furthermore, these officials were very supportive of the Local Government Code and the Local Development Assistance Program.

For the Targeted Child Survival Program, USAID/Philippines followed the requirements of USAID Handbook 3 in properly reviewing and approving evidence submitted by the Government for the Program. Before releasing any of the cash transfer payments made under this Program, the Mission first confirmed that the Government met the conditions precedent. The evidence reviewed included documents submitted by the Government and contractor assessment reports on the Government's compliance with the conditions precedent. For example, the Government submitted evidence to the Mission demonstrating that it had met the 10 conditions precedent under the Program for the fourth cash transfer payment. A Mission Review Committee evaluated the documentation and found it to be adequate.

The Government met all 10 of the Program's 33 conditions precedent selected for verification at the provincial level. For example, one condition precedent called for increased budget appropriations for child survival services in priority provinces and cities. Although this performance indicator did not specify any target increase, the budget for child survival services increased dramatically. The Government's budget for child survival services increased from 2.3 billion pesos ($92 million) in 1989 to 3.7 billion pesos ($148 million) in 1992. The regional and provincial budget allocations for child survival also increased significantly from 1989 to 1992. Furthermore, the Government met or exceeded eight of the nine end of program targets for service delivery. One target of immunizing 80 percent of pregnant women against tetanus by 1993 was not fully met; only 73 percent was achieved.

Another condition precedent called for integrated provincial health plans that include input from provincial representatives of other Government agencies. Provincial health officials in Cagayan, Isabela, and Palawan confirmed that the planning process for provincial health included input from a wide variety of interested parties including representatives from consumer groups, and the public and private sectors.

For the Natural Resources Management Program, USAID/Philippines followed the requirements of USAID Handbook 3 in reviewing and approving evidence submitted by the Government and contractor assessment reports that it had met the conditions precedent. For example, the Government submitted evidence demonstrating that it had met the seven conditions precedent to the second cash transfer payment. The Mission Review Committee evaluated the evidence and found it to be adequate.

When USAID/Philippines determined that the Government did not meet the conditions precedent to the third cash transfer payment for the Natural Resources Management Program, it reprogrammed the remaining $39 million. As discussed below, however, the Mission's reprogramming of the remaining funds into another program negated the effectiveness of conditioning the assistance on policy reform.

USAID/Philippines Should not Negate the
Effectiveness of Conditioning Assistance

USAID/Philippines determined that the Government would not meet the conditions precedent to the third cash transfer payment for one program and cancelled the remaining two cash transfer payments of $39 million. However, the Mission then reprogrammed these funds into another program to assist the Government in implementing the policy changes that had already been enacted but not implemented. The Mission reprogrammed the funds intended for debt relief into a grant to fund a project of the same Government agency that failed to implement the reforms. The Mission, in effect, rewarded this agency for its failures. In doing so, the Mission defeated the purpose of having conditionality with the assistance.

USAID Handbook 1 says that conditionality refers to conditioning the provision of resources to a recipient on the policies which a donor expects the recipient to follow. The use of such resources, in turn, must be in furtherance of the donor's objectives in providing the resources. Thus, conditionality is a device to promote the use of the resources in conformity with the purpose of the program providing them. Also, Handbook 1 says that for conditionality to be implemented effectively creditable consequences must be established if the conditions are not met.

In view of Handbook 1 policy, USAID/Philippines' decision to reprogram the remaining $39 million was inconsistent with USAID's desire of establishing creditable consequences if the conditions are not met. The authorizing officer for the program considered the conditions precedent essential for program success. The Mission's reprogramming of the funds into another program managed by the same Government agency did not meet intent of establishing the conditions precedent, and undermined the Program's original objective and the creditability of the conditionality.

A 1992 Program monitoring and assessment report noted the potential effects of not following through with the policy actions planned for the remaining conditions precedent to the two cash transfers which were canceled. The report said that, while positive changes in the forest sector had occurred since the initiation of the Program, it was important that the momentum of all pre-determined activities under the policy actions be sustained. Delays in meeting the policy performance indicators would affect the Program's implementation timetable as well as negate earlier accomplishments.

According to the authorizing document for the Program, one of its primary purposes was to promote the economically and ecologically sustainable management of the Philippines' natural resources, with special attention to tropical forests and biodiversity. This purpose was critical because the country's forests have been an economically and ecologically valuable resource that has been disappearing rapidly. For example, the targeted forest area covered 30 percent of the country in 1969. Twenty years later, this coverage had fallen to less than 15 percent, with most of the remaining forest area logged over. Much of the logged over area was in badly degraded condition. To preserve the remaining targeted forest areas, one of the critical objectives of the Program was to ban logging in these areas. To meet this Program objective, the conditions precedent for one policy action required the implementation and maintenance of a logging ban in certain targeted forests.

USAID/Philippines, however, canceled these conditions precedent and, thus, the logging ban was no longer required. Therefore, the Mission had less assurance that the program would meet the objective of preserving the targeted forests. While the Government took some steps to stop illegal logging, it was largely unsuccessful. For example, the Government estimated that about 50 percent of the local wood used in the Philippines still came from illegal logging.

The Project Officer disagreed and said that illegal logging did not relate directly to the protection of the targeted forest areas. He said that most illegal logging occurred in other forest areas that were logged-over some years ago. He said that most of the targeted forest areas were in high elevations and on steep terrain which usually had no roads. This made them harder to reach. In contrast, the other forest areas already had roads and were found in more gentle terrain, aside from being relatively closer to markets. The issue of illegal logging taking place in targeted forest areas is addressed later in this report.

The principal aim of the Program was to assist the Government to achieve sustainable development through policy reforms aimed at protecting the forests. To sustain the country's industries for forest products and the environmental services that forests provide, one of the critical changes necessary was for the Government to implement policies leading to the protection and management of forests. The fundamental measure required to protect the forests was to prohibit logging in the targeted forest areas. That implied first a political decision and then effective programs to bring those forests under protection. The Government did not implement the enacted policy reform addressing this problem—the banning of logging in the targeted forests.

We are not making a recommendation because USAID/Philippines' decision to reprogram the funds back into the program was reviewed and approved by the Regional Legal Advisor and the Assistant Administrator for the Asia/Near East Bureau. Furthermore, the funds were reprogrammed to support the Mission's reengineering effort that is combining all environmental activities under one strategic objective.

Management Comments and Our Evaluation

USAID/Philippines did not comment on this finding in its response to the draft report. However, Mission officials had earlier provided additional information to clarify certain facts and to provide better perspective for this finding which were carefully considered in the draft report.

Did Policy Reforms Result in the Expected Benefits?

The policy reforms generally resulted in the expected benefits, but one program met with less success.

The Targeted Child Survival Program met or exceeded eight of nine of the targets for service delivery. A midterm evaluation of the Program concluded that the Government's performance in implementing the policy reforms was remarkable. The reforms almost immediately resulted in improvements in the Government's performance in service delivery.

For example, the Government established an effective planning process. This process required cities and provinces to identify the services needed for child survival and then to rank them according to priority. The Government then increased budget appropriations to address the programs for child survival. In determining the budgets, the Government gave priority to high-risk and undeserved cities and provinces.

The program successfully promoted the awareness of immunization and motivated mothers to fully immunize their children. The program promoted this awareness through advertising on television and radio as well as in magazines and newspapers. The promotion also included educational information given to mothers when they came to clinics for service. To further encourage participation in the program, the health centers created a festive mood on the immunization day. The campaign focused on measles vaccine, using the vaccine as a "hook" to bring mothers and children to health centers for free immunizations (measles and five other vaccines). The health centers also provided the mothers with a full range of services and information for maternal and child health. As a result, the Program successfully increased the percentage of fully immunized infants from 65 percent in 1988 to 90 percent in 1992 (Department of Health statistics), well beyond the target of 85 percent by 1993.

The Government also successfully implemented a program to control and treat diarrhea in children. This program focused on informing and motivating mothers to provide oral fluids to their children with diarrhea. The target was to increase the use of oral rehydration therapy[1] from 25

1 Oral Rehydration Therapy is used to prevent death from dehydrating diarrhea in young children. This method of treatment encourages continuous feeding and fluid replacement with a solution containing oral rehydration salts rather than treating the children with antidiarrheal, antibiotics or intravenous fluids.

percent in 1991 to 60 percent in 1993. Again, the Government used a strategy aimed at changing the behavior of mothers. The first step was to explain to mothers what dehydration was and why it was dangerous. Next, the program informed mothers about the advantages of oral rehydration therapy and encouraged its use. As a result mothers began using this therapy more frequently—its use increased from 25 percent in 1991 to 63 percent in 1993 (Department of Health statistics), thus exceeding the target of 60 percent.

The Government achieved the above results through the implementation of policy reforms that, among other things, allowed it to adopt and execute a strategy of promoting smaller family size, complete immunizations, breastfeeding, and early illness and disease prevention.

For the Local Development Assistance Program, the policy reforms resulted in increased resources and authority for the local government units. The purpose of this program was to support the Government's decentralization reform, most notably increased autonomy for local government units that includes the transfer of power, responsibility and resources from the national Government to local governments. As a result of the Program, the local government units embraced the idea of decentralization and fully supported its implementation nationwide.

An unexpected benefit arose when the Government passed an Act titled the "Local Government Code of 1991". The Code provided for the granting of broader powers, authority, responsibilities and resources to local government units. The passing of the Code reinforced the Government's support for the Program and helped motivate the local government units to implement the program's objectives.

One of the Program's policy objectives that the Government successfully implemented was to increase the levels of discretionary resources from national sources to local governments. An implementing action called for under this objective was to increase the allotment of national Government funds to the local governments. The Program's target was to increase the amount of funds transferred to local governments by at least 100 percent.

For the years 1989 to 1991, the Government transferred to local governments 4.2 billion pesos ($168 million), 6 billion pesos ($240 million), and 8.5 billion pesos ($340 million), respectively. Thus, the Government exceeded the target and did so three years ahead of schedule.

These funds allowed the local governments to improve the delivery of basic social services. For example, the City of Puerto Princesa established a system of satellite clinics in outlying communities to provide health services for rural people. The City also improved its infrastructure, encouraged private sector investment and addressed broader issues, such as environmental protection. Puerto Princesa also launched a campaign to educate its people on the importance of the environment and the need to keep the city clean. As a result, the City was voted the cleanest city in the Philippines during 1994.

Another successful policy reform under this Program was to give greater administrative authority to local governments. Before the implementation of this policy, city governments had to obtain approval from the President's office to buy even the smallest items, like office equipment. However, the policy reforms substantially shortened the procurement process when the Government delegated procurement authority to provincial and city governments. This delegation dramatically shortened the time required by local governments to buy things.

The above illustrates some of the benefits that the Government achieved through the implementation of policy reforms under the Program. For the Natural Resources Management Program, however, the Government had less success. This issue is discussed below.

The Natural Resources Management Program Did Not Fully Achieve the Expected Benefits

Contrary to good management practices, USAID/Philippines could not objectively measure the progress of the Natural Resources Management Program. A major cause of this problem was the Program's design which did not have good performance indicators that were objectively verifiable and targeted. The Program's design also focused on enacting the policy reforms but not on implementing them. As a result, the Government substantially delayed implementation of the policy reforms funded through USAID's cash transfer assistance.

Good management practices dictate that, when cash transfers are conditioned on host country policy reforms, these reforms should be specifically defined in the program's approval document and then carried over to the nonproject agreement. Specific criteria should also be developed in the approval document for assessing host country progress in achieving the reforms and measuring the impact of the reforms.

USAID, however, has not provided sufficient guidance on the need for providing a specific statement of the policy reforms and the criteria for assessing the progress and impact of the reforms in program approval documents. This need for guidance was brought to USAID's attention in a June 1988 General Accounting Office audit report.[2] The report disclosed that USAID had mixed success in using cash transfers to encourage economic policy reforms. The report concluded that:

> *"Although the difficulties in achieving and measuring reform progress and impact are clear, we believe that USAID could improve the prospects for successful policy reform efforts by establishing sufficient criteria to guide its policy reform efforts...we recommend that the USAID "Administrator require that each internal USAID program document justifying cash transfer programs seeking policy reforms:*
>
> - *clearly state the specific economic policy reforms the cash transfer is intended to encourage,*
> - *specify the anticipated timeframes or milestones for achieving these reforms, and*
> - *state the anticipated impacts of the reforms on economic development."*

USAID responded to the General Accounting Office that it would try to ensure that program authorization documents contain the information and that subsequent documents assess progress in relation to these criteria.

USAID/Philippines designed the Natural Resources Management Program, however, without developing good performance indicators that were objectively verifiable and targeted. The Program's design also focused on enacting the policy reforms but did not give details on implementing them. As a result, this Program was not fully successful and had to be redesigned.

We selected three of the Program's eight policy actions for verification at the provincial level. Two of the three policy actions reviewed were not implemented far enough to yield results, and the expected benefits for the remaining policy action were not achieved.

The implementation of one policy reform to establish Community Forestry Programs was behind schedule because the targeted communities were not ready to execute their management plans.

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2 Report Number GAO/NSIAD-88-182, "Foreign Aid: Improving the Impact and Control of Economic Support Funds".

The objective of this policy reform was to increase community participation in forestry management. To accomplish this objective, the Government contracted with 50 non-government organizations to provide assistance and training to 50 communities with Community Forestry Programs. By the end of the contract, each community was expected to develop a plan to manage the sustainability of the forests for income generation to the community.

Notwithstanding community enthusiasm for the program, the expected benefits for this policy reform have not fully materialized. The authorizing document for the program assumed that 20 management plans would be ready and inspected before the third cash transfer payment was made. However, as of September 30, 1994, not one of the 17 community management plans was completed. By March 1995, the three communities we visited only had draft management plans. All three communities indicated that they needed more financial management training to enable them to implement their management plans effectively. In April 1995, USAID/Philippines awarded a contract for technical assistance under the redesigned Program to address this need.

The Project Officer said that one of the reasons for the slow implementation was that the original Program focused on enacting the policy reforms rather than on implementing them. The Program approval document lacked objectively verifiable indicators to measure progress in policy reform implementation. He added that, under the newly redesigned Program, USAID/Philippines would concentrate on implementing the policy reforms that were enacted.

To comply with another policy reform, the Government issued an administrative order in May 1991 to prohibit logging in targeted forest areas. One of the major objectives of the Program was to stop illegal logging in the targeted forest areas. While the Government enacted the policy, it did not successfully implement it—various parties as well as media reports revealed that illegal logging continued to be common in the Philippines.

USAID staff, contractors, and community leaders were of the opinion that illegal logging was still very active in the Philippines. The Under Secretary of the Department of Environment and Natural Resources estimated in one newspaper article that 50 percent of the local wood supply came from illegal logging operations. Community leaders at the three communities we visited also indicated that illegal logging activities were taking place in the forests surrounding their communities. Two of the three communities said that they had confronted the illegal loggers who were local politicians and

Government officials. One community said that, in February 1995, Government officials confiscated a warehouse full of illegal logs from a local mayor.

The Project Officer contended that illegal logging did not directly relate to the protection of the targeted forests areas. The Project Officer said that the Program's approach was to work with the Department of Environment and Natural Resources to develop and implement policies that would provide the basis for transferring the management of forest land to communities. Under this process, the communities would assume management authority over these lands, thus enabling them to extract forest products on a sustainable basis. One of the most important issues in protecting the forests was the prevention of slash-and-burn farming and illegal logging. According to the Project Officer, studies showed that, whenever forests were transferred to communities, there was a marked decrease in slash-and-burn farming and illegal logging. Therefore, the Project Officer believed that USAID/Philippines was addressing issues of illegal logging and protection of the targeted forest areas through the direct involvement of communities in the protection and management of forest resources.

While we agree that some progress was undoubtedly made, much remained to be done to meet the Program's goal of preserving forest resources. For example, to supplement the May 1991 administrative order, the Government issued additional guidance in November 1991 on implementing the logging ban. The new guideline called for the identification, aerial survey, mapping and, then, demarcation of the targeted forest areas. The non-demarcation of the targeted forest areas clearly contributed to the problem of illegal logging. The identification, aerial survey, and mapping tasks were completed in early 1992. While the guideline said that demarcation should have been started immediately after the aerial survey, none of the forests had been marked yet. The Project Officer attributed this to the Government's lack of resources and the magnitude of the effort.

In summary, the Natural Resources Management Program was less successful than the other two programs reviewed because it lacked good performance indicators and the USAID/Philippines focused on enacting the policy changes rather than on implementing them. We are not making a recommendation, however, for several reasons.

Under the Program's new direction, USAID/Philippines has established plans to focus on implementing the policies that were enacted. The Mission has redesigned the Natural Resources Management Program to help ensure that it will be consistent with the Mission's new Program Performance

Information for Strategic Management system objectives. According to Mission officials, the various projects, programs or activities are now part of results packages designed to support the achievement of strategic objectives rather than activity level outputs. Both the Mission and the Agency have been striving to address the need for better planning through the new Program Performance Information for Strategic Management system and the Agency-wide effort to reengineer for results.

If in the future USAID/Philippines has another cash transfer-based policy reform activity, the Mission needs to design the activity in such a way that progress and impact can be measured as precisely as possible. The Mission's difficulties in measuring the progress of its activities were identified in a recent USAID Office of Inspector General audit,[3] and those problems will be resolved through the recommendation closure process.

Management Comments and Our Evaluation

USAID/Philippines did not comment on this finding in its response to the draft report. However, Mission officials had earlier provided additional information to clarify certain facts and to provide better perspective for this finding which were carefully considered in the draft report.

3 Audit of USAID/Philippines' Monitoring, Reporting and Evaluation Systems - Audit Report Number 5-492-95-011, dated June 15, 1995

Were the Funds Provided for Policy Reform Changes Used for Agreed Upon Purposes?

USAID/Philippines needed to obtain better assurance that the Government consistently uses the funds provided for policy reform changes for agreed upon purposes.

USAID/Philippines established managerial controls that helped to ensure that the Government used the funds for the agreed purposes, namely external debt repayment. In accordance with statutory requirements and USAID policies and procedures, the Mission ensured that the Government established separate bank accounts to receive the dollar cash transfer payments. Furthermore, the Mission reviewed:

- the Government's spending plans to verify that it would use the funds for the agreed purposes;
- bank statements to verify that the Government deposited the funds into the separate accounts in the amounts specified in the program agreements; and
- accounting records, memoranda, cables, and telex messages from the Government's Treasury and Central Bank in support of the cash transfer transactions.

Although these managerial controls ensured that the Government deposited the cash transfer funds into a separate account and planned to use the funds for the agreed purposes, USAID/Philippines needed to have better assurance that the Government used the funds as planned for those purposes. This issue is discussed below.

USAID/Philippines Needs to Better Ensure that Payments Are Applied to Specified Loans

Contrary to USAID policy, USAID/Philippines did not sufficiently track cash transfer funds to ensure that the Government used them for the agreed purposes. Although the Mission had planned to better track the use of those funds, it did not implement its plans. As a result, the Mission did not have reasonable assurance that the $254.5 million in cash transfer funds were used for agreed upon purposes.

<u>Recommendation No. 1</u>: We recommend that USAID/Philippines obtain and review loan statements from lenders to ensure that the Philippine Government uses cash transfer funds to pay agreed upon debt payments.

USAID policy guidance on cash transfer assistance provides that appropriate procedures for specifying and tracking the uses of the dollars released will vary depending upon the nature of the assistance, the recipient's foreign exchange and import regimes, the integrity of its accounting systems, the political environment, and other factors. To help ensure that cash transfer funds are used as intended, USAID Handbook 1 policy, says that:

> "Financial records shall be suitable, at a minimum, to document the withdrawal and disposition of dollar funds from the separate account and their tracking to final acceptable uses. For example, this may include central bank and commercial bank documents demonstrating that USAID funds were transferred from a host country central bank-controlled account to an account identified for external debt repayment, and that debt service payments actually were made with the transferred dollars."

USAID/Philippines' system tracked the deposit and withdrawal of the dollar funds in the separate account as required by USAID policy. To track the deposit and withdrawal of the funds, the Mission reviewed:

- bank statements from the Philippine National Bank in New York for the special accounts showing all deposits and withdrawals of the cash transfer fund; and

- payment authorization letters from the Philippines Bureau of Treasury showing payee instructions, specific account where cash transfer funds were to be deposited, the loan payment amount, and due dates; and outgoing telexes from the Central Bank of the Philippines to the Philippine National Bank of New York with instructions on how to disburse the funds.

Contrary to USAID policy, however, USAID/Philippines did not track the withdrawal of the funds to their final acceptable uses to ensure that the Government actually made the debt service payments with the transferred dollars. The Mission neither reviewed loan statements nor obtained confirmations from the lending institutions to verify that the Government used the funds to liquidate the specified loans. The Mission's review procedures stopped short of tracking the funds to their end use.

USAID/Philippines had identified this need for external confirmation. In reviewing cash transfer transactions under the Targeted Child Survival Program, the Mission concluded that the Central Bank's financial records were complete except for confirmation documents from lending institutions. The Mission's review reported that the Government had encountered difficulties in obtaining the confirmations. As a result, the Mission and the Government agreed that the Mission would be responsible for obtaining the confirmations.

For unclear reasons, however, USAID/Philippines did not implement its plans for obtaining the confirmations, as neither the Government nor the Mission obtained the confirmations. An official from the Controller's office believed that it was not a usual practice for lending institutions to make confirmations on loan payments received. However, while it is unusual for a lending institution to make direct confirmations to USAID at USAID's request, lending institutions often do make the confirmations when the requests come from the borrower (the host government)[4].

The official said that the USAID/Philippines had intended to use alternate procedures to verify that the funds were used properly. The Mission planned to verify the payments through reviews of loan status statements from lenders, actual transactions from the dollar accounts, and Philippine Government audit reports. However, the Mission had not reviewed loan status statements from lenders nor received the audit reports regularly.

As a result, USAID/Philippines' fund tracking system did not provide reasonable assurance that the funds were used for agreed upon purposes. As the Philippines has had a history of corruption and political instability, the Mission should enforce strict monitoring procedures on the tracking of cash transfer funds to their intended final uses.

USAID/Philippines should not rely solely on documents internally generated by the Government, but should obtain confirmation from external sources. Confirmation will provide the Mission with better assurance that the $254.5 million in cash transfer funds were used as intended. Without

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4 As of the date of this report, one of three lending institutions had provided us confirmation at the Government's request. This institution was the International Bank for Reconstruction and Development which confirmed loan payments of $45.7 million.

using direct confirmation from lending institutions, the loan statements provided to the Government by the lending institutions represented the only external and independent documents that the Mission could use to corroborate Government maintained documents.

Management Comments and Our Evaluation

USAID/Philippines did not concur with the finding and recommendation. The Mission believed that the recommendation is moot and should be dropped from the report because procedures used in 1992 included validating debt service payments against loan statements from lenders (e.g., Summary Statement of Amounts Due from International Bank for Reconstruction and Development). By tracing the withdrawals recorded in the Philippines National Bank Statement of Account to the Schedule of Debt Service Payment and the payment documents maintained by the Central Bank including loan statements, the Mission believed it could obtain reasonable assurance that the funds were used for the intended purpose.

Recommendation No. 1 is unresolved. We agree that the procedures outlined by the Mission would, if implemented, provide reasonable assurance that the funds were used as intended. However, the procedures used in 1992 were no longer in place. The recommendation can be resolved if the Mission provides a plan of action to reestablish these procedures for its financial reviews, including the validation of debt service payments against loan statements from lenders.

SCOPE AND METHODOLOGY

Scope

Except as discussed in the following paragraph, we audited USAID/Philippines' assistance for policy reforms in accordance with generally accepted government auditing standards. We made the audit at the offices of USAID/Philippines, the Central Bank of the Philippines, and the Philippines Bureau of Treasury in Manila. We also visited 14 sites in the provinces of Cagayan, Ifugao, Isabela, and Puerto Princesa where USAID funded activities for policy reform were located. The audit was made from January 3 through April 5, 1995.

We were unable to obtain direct confirmation from two of three multilateral lending institutions sampled that the USAID funds had been received to make the specified loan payments. For eight of 10 cash transfer payments tested, the financial records of the Philippine Government indicated that the payments were sent to the multilateral lending institutions. However, we only received confirmation from one of three lending institutions on the accuracy of these records. For the remaining two sampled transactions, the Government could not provide needed documents to ascertain the disposition of the funds. Therefore, we were unable to determine whether the funds provided for policy reform changes were used for agreed upon purposes.

Our audit covered the seven programs with a policy reform component. These programs had policy reform component authorizations of $289.4 million, obligations of $289.4 million, and expenditures of $254.5 million as of September 30, 1994. We reviewed three programs in detail with total expenditures of $123.5 million. The programs reviewed were: the Local Development Assistance Program; the Targeted Child Survival Program; and the Natural Resources Management Program. USAID/Philippines obligated and expended $43.5, $45.0 and $35.0 million, respectively, for cash transfers under the three programs. We focused on these programs because they comprised 42.7 percent of the Mission's policy reform funds.

The programs selected also had policy reform activities which were observable and, thus, subject to field verification.

We did not attempt to verify the overall reliability of the computer-generated data in USAID/Philippines' Mission Accounting and Control System which we used to identify programs with a policy reform component and their related funding (i.e., obligations and expenditures). This lack of verification had no effect on our ability to answer the audit objectives.

In answering the audit objectives, we tested whether USAID/Philippines followed applicable internal controls and complied with certain legal requirements. Our audit tests were designed to provide reasonable assurance that the answers to the audit objectives are valid. In instances where problems were found, we expanded our work to identify the cause and effect of the problems and to make recommendations to correct them.

In addition to the methodology described in the following section for each audit objective, USAID/Philippines provided written representations which we considered essential for answering our audit objectives and for assessing internal controls and compliance.

Methodology

The procedures used to answer each audit objective were applied to the three programs selected for detailed review and discussed previously in the Scope section. The methodology for each audit objective is discussed below:

Audit Objective One

The first audit objective was to determine whether USAID/Philippines ensured that the Government of the Philippines met the conditions precedent and special covenants prior to the release of funds. To accomplish this objective, we assessed the Mission's internal control procedures for ensuring that conditions precedent were met before the release of USAID funds. We evaluated the Mission's procedures against the attributes in USAID Handbook 3 and USAID Delegation of Authority No. 652. Furthermore, we assessed the effect on program conditionality of the reprogramming of the Natural Resources Management Program against the attributes in USAID Handbook 1.

We discussed policy reforms and their objectives with responsible USAID/Philippines' officials, assessed how the Mission processed the documentary evidence submitted by the Government of the Philippines, and timed the release of USAID funds. The audit procedures were designed to determine whether selected Conditions Precedent were met before the release of funds. The Conditions Precedent tested were those that were important to program success and involved policy reform activities which were observable and thus subject to field verification.

Audit Objective Two

The second audit objective was to determine whether the policy reforms resulted in the expected benefits. To accomplish this objective, we assessed USAID/Philippines internal controls related to monitoring recipient inputs and accounting for the corresponding results against the requirements of USAID Handbook 3. Our assessment consisted of discussions with responsible Mission officials, contractors and host country counterpart officials, reviewing program status and monitoring reports, independent evaluation reports, and making on-site assessments of selected program activities.

The three programs selected for review had the largest policy reform components with activities that were observable. The Conditions Precedent selected for testing from each program were; (1) considered important to program success, and (2) involved policy reform activities that were observable and thus subject to field verification.

Audit Objective Three

The third objective was to determine if the funds provided by USAID/Philippines for policy reform changes were used for agreed upon purposes. To accomplish this objective, we assessed the Mission's internal controls procedures for ensuring that USAID funds were used for agreed upon purposes against the requirements in USAID Handbook 1 and the Fiscal Year 1987 Continuing Resolution. We also obtained documentary and testimonial evidence from Mission and Government officials, analyzed the reliability and sufficiency of that evidence, and concluded whether the Mission followed the applicable policies and procedures. To confirm that the funds were used for agreed upon purposes, we reviewed a representative sample of 10 disbursements from the three programs reviewed. The sample payments totaled $76.5 million or 61.9 percent of the cash transfer payments made under the three programs.

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

USAID/Philippines
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SEP 1 1 1995

MEMORANDUM

TO: Richard C. Thabet
RIG/A/Singapore

FROM: Gordon H. West, Acting Director
USAID/Philippines

SUBJECT: Draft Audit Report on USAID/Philippines' Assistance for Policy Reforms

REF: Your Memo on same subject dated 8/3/95

We reviewed subject report and noted that our comments on the discussion paper have been duly considered in the draft audit report. Please find below our further comments.

Recommendation No. 1 states that USAID/Philippines should "obtain and review loan statements from lenders to ensure that the Philippine Government uses cash transfer funds to pay agreed upon debt payments." The Mission believes that current procedures are adequate to ensure that program funds are used for agreed upon purposes.

Mission review procedures actually include validating debt service payments against loan statements from lenders (e.g., IBRD Summary Statement of Amounts Due) as evidenced in attached sample review report **(Attachment A)**. By tracing the withdrawals recorded in the PNB Statement of Account to the Schedule of Debt Service Payment and the payment documents maintained by the Central Bank (CB) including loan statements, we can obtain reasonable assurance that the funds were used for the intended purpose.

On the issue of direct confirmation with lenders, the low response rate (1 out of 3) to the confirmation requests made during the audit, indicates the inefficiency of this procedure. In the 1992 USAID/Philippines Controller's Assessment, USAID/W also recommended (Action No. 19) that the Mission "consider obtaining payment confirmations from IFIs as a way to compensate for a lack of audited dollar account statements."

Mr. Richard C. Thabet

During the follow-up review done in May, 1994 on the status of required Mission actions, M/FM/PPC determined that the original recommendation should be dropped and that the "Audited Report on Debt Service Payments" would fully satisfy the monitoring requirements on the cash transfer program. M/FM/PPC recommended that the Mission follow up with the Central Bank on the 1992 and 1993 reports. (Shown in **Attachment B** are pertinent pages of the M/FM/PPC report.)

We received on June 8, 1995 the audited reports **(Attachment C)** which we find satisfactory. The audit was conducted by the Commission on Audit, the GOP's Supreme Audit Institution (SAI), in accordance with Philippine laws, rules and regulations and generally accepted auditing standards. The audit also conforms with the IG's Guidelines for Financial Audits Contracted by Foreign Recipients which states that USAID shall give preference to accepting audits of foreign governmental recipients performed by the host country's SAI.

Based on our latest follow up with the Department of Finance (DOF), the audit of 1994 transactions is still in progress. We will continue to follow up with the DOF on their submission of the 1994 report.

We believe that the above discussion renders Recommendation No. 1 moot. Additionally, positive changes in leadership and controls in government structures involved in funds and debt management have been implemented and appear to be working. An evidence of this is the fact that the GOP is up-to-date in its debt payments and is even capable of making payments prior to loan due dates; the July 19, 1994 Paris Club agreement has been terminated at the request of the GOP; government pronouncements have been made of a possible early exit from the IMF program.

At this time, there is no reason to believe that cash transfer funds intended for debt service payments will be diverted for other purposes. The level of risk has been greatly reduced.

We hope that the above comments will be fully considered in the final audit report and the recommendation dropped. The Management Representation Letter is enclosed for your appropriate action.

Attachments: As stated

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Mr. Richard C. Thabet
Regional Inspector General for Audit/Singapore
U.S. Agency for International Development
FPO AP 96534

Subject: Audit of USAID/Philippines' Assistance for Policy Reform

Dear Mr. Thabet:

You have asked that USAID/Philippines provide a Management Representation Letter in connection with your audit of the USAID/Philippines' Assistance for Policy Reform. Your staff informed us that the audit covered the activities of USAID/Philippines' cognizant offices as they relate to the policy reform programs and that it was intended to answer the following audit objectives:

- Did USAID/Philippines ensure that the Government of the Philippines met the conditions precedent and special covenants prior to the release of funds?

- Did policy reforms result in the expected benefits materializing?

- Were the funds provided for policy reform changes used for agreed upon purposes?

I have asked the offices concerned with the audit, particularly the Office of Population, Health and Nutrition, Office of Environment, Office of Governance and Participation, Office of Economic Development and the Office of Financial Management to make available to your staff all records in our possession for the purpose of the audit. They have assured me that all records in our possession have been made available.

In making the representations contained herein, we relied extensively on USAID's Office of the Inspector General as a primary element of internal control to determine compliance with applicable laws and regulations, and to ensure the accuracy of accounting and management information.

Mr. Richard C. Thabet

Based upon the representations made to me by my staff and their concurrence with the representations made herein, and in reliance on your office which has not informed me of any difficulty in obtaining records or information, or of any difficulty in obtaining the full cooperation of the offices and staff involved, I confirm, as a layman and not as a lawyer, the following representations with respect to the audit of USAID/Philippines' assistance for policy reform:

1. USAID/Philippines is responsible for: (a) the Mission's internal control system relating thereto; (b) the Mission's compliance with applicable U.S. laws, regulations, and the Project Agreements relating thereto; and (c) the fairness and accuracy of the Mission's accounting and management information relating thereto.

2. To the best of my knowledge and belief, USAID/Philippines has made available to RIG/A/S auditors all Mission record(s) relating to the audit objectives.

3. To the best of my knowledge and belief, Mission records relating to the audit objectives are accurate and complete and give a fair representation as to USAID/Philippines' policy reform activities.

4. To the best of my knowledge and belief, as a layman and not as a lawyer, USAID/Philippines is not aware of any instances which we consider material where financial or management information directly relating to this audit has not been properly and accurately recorded, other than the findings in the draft report.

5. To the best of my knowledge and belief, as a layman and not as a lawyer, USAID/Philippines has made available information regarding any known irregularities which we consider material related to USAID/Philippines' policy reform activities involving Mission employees with internal control responsibilities for the matter under audit. For purposes of this representation, "irregularities" means the intentional noncompliance with applicable laws or regulations and/or intentional misstatements, omissions or failure to disclose.

6. To the best of my knowledge and belief, as a layman and not as a lawyer, USAID/Philippines is not aware of any instance (other than what has been included in the draft audit report or reported by the Mission during the course of the audit) in

Mr. Richard C. Thabet

which, in the Mission's judgment, there has been a material noncompliance by the Mission with USAID policies and procedures or violation of U.S. law or regulation, which would substantially impact upon the matter under audit.

7. Following our review of your draft audit report and further consultation with my staff, and to the best of my knowledge and belief, there are no other facts as of the date of this letter (other than those expressed in our Management Comments to the draft report) which would materially alter the conclusions reached in the draft report.

I request that this Representation Letter be included as part of the official Mission comments on the draft report and that it be published as an Annex to the final report.

Sincerely,

Gordon H. West
Acting Director