

UNITED STATES GOVERNMENT

# Memorandum

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**TO :** Mr. Russel E. Aulik, RIG/A

**DATE:** AUG 20 1982

**FROM :** Mary C. Kilgour, <sup>MK</sup> Acting Director, USAID/Philippines

**SUBJECT:** Economic Support Fund Audit  
Elementary School Construction (492-0342)  
Project Design (492-0343)  
Report No. 2-492-82-12, July 14, 1982

The Mission has prepared and attached its response to the subject audit. We have attached a copy of the Rural Energy authorization with the authorization cable and accordingly request the closing of all six recommendations.

We are also distributing a copy of this response to all recipients of the subject audit and request that this response be affixed to the audit report. The Mission believes that a substantial portion of the audit is based on an incomplete understanding of the GOP fiscal system which results in confusion and several erroneous conclusions. As a result, the success of the project and the constructive findings of the audit are overshadowed.

In addition, this report is substantially different from previous drafts and the Mission was not provided an opportunity to offer comments. This response represents our comments.

**Enclosures:**

1. Mission response
2. copy of Rural Energy authorization  
and authorization cable (for RIG/A only)

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USAID Response to  
Audit Report No. 2-492-82-12, July 14, 1982  
Economic Support Fund - Philippines  
Elementary School Construction (492-0342)  
Project Design (492-0343)

This AID Mission welcomes the audit process as quite useful to its project implementation responsibilities. Indeed, in the case of the subject audit, the auditors identified a problem which assisted the Mission in realizing the need for further clarification of its procedures. Unfortunately, the confusion shown by the subject Report and the focus of attention on a relatively minor detail resulted in conclusions that were so erroneous as to overshadow the constructive result of the audit and success of the Project.

As stated on page one of the Report, the purpose of the audit was to determine whether or not:

- (1) ESF-funded projects were being implemented in accordance with sound financial management principles and regulations;
- (2) these funds were being used in an efficient and economical manner;  
and
- (3) the project activities were achieving objectives.

These are laudable objectives with which the USAID Mission has no objection. However, the Report gives an overall distorted picture because it appears to reject the context in which the assistance was provided, the dual purpose of the Project, the effort of the Mission to utilize regular GOP procedures rather than create redundant inefficient procedures, and the effort of the GOP to implement the project in accordance with its own sound financial management principles and regulations.

The focus of our concern with the Report is not on its recommendations which can be easily addressed, but on the erroneous conclusions resulting from a seeming failure to fully ascertain the facts relevant to the issues raised. Because these erroneous conclusions are stated prior to the recommendations, we are obliged to address both so that readers of the audit report will not be left with a false impression of the Mission's project management abilities.

The Principal Point of Concern

As noted above, the principal point of concern is not with the recommendations, but with the apparent failure of the auditors to fully ascertain the facts relevant to the issues raised in the audit. This then led to certain erroneous conclusions as to the management of the Project, particularly regarding the GOP budget/disbursement procedures. Accordingly, this response will not follow the sequence of the audit report, but will first address the section titled, "USAID and GOP Financing Procedures Were Not Clear."

Unfortunately, the auditors appear to have stopped the field work before they had the time to learn and understand the GOP budget/disbursement procedures. Perhaps, with a better understanding of this system, much of the uncertainty expressed in the Report would have been eliminated. In subsequent paragraphs, we will attempt to summarize the operations of the GOP fiscal system and clarify the specific areas of confusion.

At the same time, though, the Mission recognizes that the project documentation describing how this project would interface with the GOP fiscal system was itself not clear. It was this audit which resulted in the Mission developing revised procedures for implementing other ESF projects and obtaining AID/W approval of those revisions in May, 1982. Those revised procedures were set forth in a memo cleared by the Asia Bureau, GC and FM which was attached to the ESF Rural Energy Project and sent to the Administrator. His authorization, in August 1982, of that Project was with full knowledge of the revised ESF procedures. The constructive element of this audit is that the ESF project documentation is now much more specific on how this project relates to the GOP fiscal system.

In regard to the questions concerning the GOP fiscal system, we will first attempt to summarize its operations in the following paragraphs and then relate those operations to the management of the Project.

The Philippine Government uses a budgetary control system. Under this system, separate budgets are prepared by the national government, the local government units, and government corporations. These budgets are consolidated by the Office of Budget and Management (OBM) (formerly Ministry of Budget) into a national resource budget. From OBM the budget goes to the President and then to the Batasang Pambansa (Congress) where it is enacted into a General Appropriations Act (GAA). The GAA includes line item appropriations for each major activity of each ministry or other organization receiving appropriations. In addition, it includes a special category called the Foreign-Assisted Projects Support Fund (FAPSF). This lump sum appropriation account is used to fund foreign-assisted projects which start too late to be included in line item budgets of the individual ministry or agency. The advice of allotment for ESF School Construction Project was released against the FAPSF appropriation account.

The GAA is executed through the allotment, release, and disbursement of funds for each of the approved budget appropriations (or in the case of the FAPSF, for each approved foreign-assisted activity included in the FAPSF). At the start of the year, each national government agency submits to the OBM its Work and Financial Plan (WFP) for the ensuing year within the context of its approved budget as set forth in the GAA. On the basis of the WFP, the OBM releases the Advice of Allotment (AA) and the Cash Disbursement Ceiling (CDC) to the agency/ministry i.e. allottee. The AA serves as the annual authority of the agency to incur obligations or commitments to carry out a program or a project within the approved budget. The CDC, on the other hand, specifies the maximum amount of funds that may be withdrawn from the Treasury for a given quarter to liquidate the obligations or commitments.

The funds to finance the GAA come from revenues, borrowings and other such sources. These funds, which comprise the government's General Fund, are deposited in the National Treasury of the Philippines and are made available to the ministries or agencies for expenditures through the appropriations/allotment/CDC process. The General Fund is made up of many individual accounts including several "special accounts", one of which is the Special Account for the school construction project. Expenditures are made either by treasury warrants or by treasury checks. A check is issued for expenditures of ₱100,000 or less and a warrant is prepared for expenditures in excess of ₱100,000. Whereas treasury warrants are drawn directly against the National Treasury, checks are drawn against an intermediary government bank where the National Treasury maintains an account known as the Treasury Checking Account of Agencies (TCAA). The National Treasury controls and regulates the disbursement of government funds through the TCAA which is a centralized check disbursement system that consolidates all cash balances of ministries and agencies. All checks issued by ministries or agencies are drawn against this account. There are only three authorized government banks where the TCAA may be maintained, namely: the Philippine National Bank, the Philippine Veterans Bank, and the Land Bank of the Philippines.

All disbursements of funds by the different units of a ministry are covered by a General Voucher (GV). The GV is prepared by the requisitioning department with a certification by the department head on the voucher that payment is necessary and correct. The budget unit validates the amount of the GV against the amount of the previously recorded obligation. The GV is then approved for payment by an authorized official before review by the Commission on Audit (COA) Resident Auditor, if the disbursement is subject to preaudit.

Disbursements subject to preaudit by COA include:

1. The first payment of recurring expenditures in excess of ₱2,000 per month.
2. Payment of all consumable items exceeding ₱20,000, and all expenditures exceeding ₱40,000.
3. All refunds.
4. The final payment of salaries, wages and benefits to officers and employees.
5. Payments of back pay claims and cash advances.

After preaudit, the check or treasury warrant is prepared on the basis of the approved GV and recorded.

The allottee submits a daily report to the Bureau of the Treasury (BT) for TCAA checks and a monthly report for treasury warrants. The BT sends to the allottee a Statement of Account Current detailing all payments and/or charges made to the ministry's accounts during the month. The statement is used in reconciling the reciprocal accounts of the ministry/agency and the BT.

To enable the OBM and the COA to monitor the expenditures and evaluate the performance of the ministries/agencies, they are required to submit various reports including: Financial Report of Operations, Physical Report of Operations, Quarterly Report of Cash Disbursements and Unpaid Obligations, and the Trial Balance. The OBM and the COA, in turn prepare allotment and the expenditure reports which are submitted to the President and other appropriate government authorities. The COA, then, prepares an Annual Financial Report of the Government and submits it to the President and the National Assembly not later than the last day of September of each year.

With this overview of the GOP fiscal system, we can now clarify the several specific areas of confusion raised on page 6 of the Report.

1. "It is not clear whether the Ministry of Budget issued allotments required to implement this ESF project on the basis of the Special Account - General Fund (Development Project Fund) established under the Project Agreement or whether allotments were issued against the Foreign Assisted Projects Support Fund."

Mission Comment: As noted earlier, the Foreign-Assisted Projects Support Fund (FAPSF) is a lump-sum appropriation account within the GAA, maintained and controlled by OBM. Under the GOP system, there must be an appropriation account that OBM can cite as the authority for issuing such AAs and CDC's. It can not charge any other type of account. In this instance, allotments were issued (and properly so) against the FAPSF. A copy of the notices of allotment is available for review.

On the other hand, the Special Account is a part of the National Treasury's General Fund. It is not a part of the system which authorizes the expenditures of funds, but comes under the other half of the coin -- the system that provides the resources to cover the expenditure of funds. The General Fund is the source of money used to cover the checks issued in the implementation of the school project. The General Fund can not be the authority to issue the AAs and CDCs (nor can any of its special accounts).

2. "It is not clear whether the Special Account was intended as a "cash account" for making expenditures or whether it was intended only as a budgetary account."

Mission Comment: The Special Account is a part of the General Fund of the National Treasury and as such it is clearly a cash account.

3. "It is not clear as to how the USAID intended a FAR project when no FAR agreement was executed."

Mission Comment: Whether or not this is an output (FAR) type of project does not relate to the GOP financial procedures and should have no bearing on the uncertainty expressed in the section of which this statement is a

part. With or without a FAR agreement, the same GOP statutorily imposed procedures would be followed.

4. "It is not clear how the General Fund of the GOP--the source of funds--could finance the ESF schools project local currency expenses when the amount of supplementary appropriation pesos (equivalent of US \$18 million) provided by the US \$18 million advance were taken back out of the General Fund and put into a long-term (5 year), interest-bearing (16%) money investment and have never been made available to pay ESF project expenses."

Mission Comment: In this instance, the auditors' confusion is more understandable since, conceptually, the idea of segregating the peso equivalent of project dollars in the Special Account was a good one. Unfortunately, in actual practice, it has not worked on a timely basis, and has proven not to be a useful project management tool. Accordingly, the Mission recommended changing its point of monitoring focus to the AA and CDC process, and, in August 1982, obtained AID/W concurrence to do so.

The Special Account for the ESF Elementary School Construction Project has been assigned a fund code 153 to differentiate it from all other General Fund accounts. All checks issued against commitments incurred under the school project funds have a series of number codes including the fund code. This is where the system becomes a little confusing.

School construction has taken place in ten of the twelve regions of the Philippines. It would not be possible to accurately allocate the Special Account funds to all the government bank branches in the 10 regions where checks are cashed. Accordingly, all disbursements using the 153 code are initially paid with funds from the TCAA. In theory the allottee is required to prepare daily reports of checks issued and forward these reports to the Bureau of the Treasury. These reports should ultimately be the basis for a release of funds, equal to the total amount of checks issued, from the Special Account to an un earmarked account of the General Fund.

Unfortunately, the system has not functioned promptly and as the auditors correctly report, transfers have not been made from the Special Account. However, this has not had a negative impact on the implementation of the project. In effect the project has been funded through TCAA and the implementing ministries have not been concerned whether the funds came from the Special Account or the TCAA. Since this system has worked so well, the Mission now considers the Special Account a supernumerary account.

FYI: The GOP is well aware that its inability to promptly reflect disbursements against the various accounts within the General Fund is a serious weakness in its efforts to implement effective cash management procedures. The problem has been the focus of GOP/IMF/IBRD discussions and may result in the installation of a computerized system. End FYI.

Erroneous Conclusions Resulting from the Confusion over the GOP Fiscal System

As noted earlier, the section regarding the GOP fiscal system seems to be the critical point of misunderstanding which led to mistaken conclusions in other sections -- which is why it was addressed first. Now, using the clarifications presented in the preceding pages, this portion of our response will address other specific sections of the audit report which appear to be based on a lack of understanding of the fiscal system described above.

"The \$18 Million Schools Construction Project was not Implemented as Authorized And ESF Funds Were Not Closely Controlled"

As was done during the process of the audit, the Mission acknowledges that the project documentation was confusing, ambiguous and conflicting in presenting the true purpose and nature of the project. We acknowledge that the audit played an important role in pointing out the need for the Mission to review its ESF implementation procedures. This does not mean, however, that the project funds used to implement this project were not closely controlled.

The Mission believes that the controls built into the GOP fiscal system as described in the preceding pages, the reports received by the Mission from the Secretariat and the frequent and thorough field trips by Mission staff, did in fact provide adequate implementation controls.

The auditors were also concerned in this section that the Special Account was never subjected to joint controls and in June 1981 substantially all funds in the account were transferred to a certificate of deposit. Hopefully it is clear at this point that the Special Account was not required for implementation of this project; and in fact was a redundancy. For AID's purposes, it is adequate to know that the peso equivalent of our project dollars is included in the GOP fiscal system as an appropriated item and that funds are available in the General Fund for implementation. Beyond this, i.e. the establishment of a Special Account - General Fund, AID gains no additional security or benefit. The Mission proposed, and AID/W has accepted, the elimination of the use of the Special Account in all future projects.

"ESF Project Funds Not Fully Used as Intended - GOP Equivalent Pesos Used to Earn Interest"

The interest issue has been resolved by the GC as mentioned in the audit. Money is fungible and GOP pesos were, in fact, allotted and used for the construction of elementary schools -- as intended by the Project. The delay in reconciliation with the Special Account has been addressed above and, in USAID's view, is not a significant issue.

"Schools Constructed Could Not be Linked to ESF Financing by AID"

In this section the auditors conclude that since the funds used to implement this project initially came from the General Fund and not specifically from the Special Account, the schools were funded out of the regular GOP budget for the school construction program and not additional to the regular GOP budget. As we have stated previously, all checks issued for the implementation of this project have a fund code number 153. This code is used only for this ESF Elementary School Construction Project. Ultimately all checks issued with this code will be charged against the Special Account and the funds in the Special Account will be transferred to the General Fund. Thus, the additionality issue is raised on the basis of a lack of understanding the GOP fiscal system.

In fact, the following table shows the regular elementary classrooms constructed or being constructed within the regular budget of the Ministry of Public Works and Highways (MPWH).

MPWH Regular Elementary Classroom Construction  
(Amounts in P000s)  
Source of Data: MPWH Reports

	1978	1979	1980	1981	1982
Additions/Replacement-Cost	72,300	302,544	254,177	329,324	428,294
Additions/Replacement-(Number)	(850)	(11,354)	(9,769)	(12,283)	(14,265)

Furthermore, we have compared a test sample of the listing of schools constructed under the ESF project to the MPWH regular school construction program listing for 1981 and confirmed that there is no duplication.

Erroneous Conclusion of the Purpose and Nature of the Assistance

The third major point this response will address is the erroneous conclusion as to the purpose and nature of the assistance. This Mission believes that it is very important for all, including the auditors, who are involved with this ESF program to understand its dual aspects. Thus, the misunderstanding expressed in the section beginning at the bottom of page 12 is also very troublesome. Fortunately, recommendations 1 and 2 specifically provide the opportunity to resolve this concern which is discussed in more detail later in the response to the recommendations. However, the Mission would like to note that this matter is also relevant to the last section of the narrative entitled:

"The US \$18 Million Advance Has Been Costly to the U.S. Treasury  
And Has Not Been Liquidated in Over 18 Months."

The funds provided under the ESF appropriation are for two purposes which have

been repeatedly pointed out to the auditors. One is to provide an agreed upon amount of economic support in accordance with the authorities of Chapter 4 of Part II of the Foreign Assistance Act. The other is to do this to the maximum extent practicable in a developmentally oriented way, in this case by "improving community access to basic elementary education throughout the Philippines." Any assistance program, in any amount, can be viewed as "costly" if one does not consider the reason for the assistance and the context in which it is given. The eighteen million dollars was transferred to the GOP in exchange for the GOP appropriating and using its own pesos to build the schools. This transfer was made under a system approved by the AID Administrator. The system was approved in the overall context of the ESF program and the military bases negotiations which led up to the ESF program. However, the auditors gave this context little weight.

Instead they focused on a regulation developed for dealing with advances to non-governmental contractors and ignored the provision related to "advances to governments" (State cable 273219 dated Oct. 19, 1977 at page 5) which is the more relevant one in the context of programs such as this one. The auditors seem to be confused as to the purpose and context of this program which, again, led to an erroneous conclusion that the objectives of the Project were not being met. The Mission can only repeat that this Project has met both of its objectives and has done so extremely well.

#### Recommendation Response

With all of this prolonged background, this response finally comes to the Audit recommendations. These recommendations are quite reasonable and easily answered. The Mission requests that each be closed.

#### Recommendation No. 1.

"USAID/Philippines coordinate with the AA/Asia to (a) reach a determination as to whether or not ESF projects under the remaining ESF commitments of about US\$180 million should be financed as non-project or program assistance through cash transfers of ESF dollars or as discrete development projects, and, (b) ensure that project documentation clearly reflects that determination."

Last May, the USAID Mission sent its RLA to AID/Washington to seek a determination as to how to treat the Philippine ESF Projects. On May 29, 1982, the AA/ASIA designate and the Acting AA/ASIA determined that the USAID Mission should continue to develop specific Projects but should incorporate into those projects a clearer statement of the dollar transfer mechanism relative to local cost components of the Projects which would support the GOP's use of its own appropriated pesos for local costs. This transfer is to be accounted for as a disbursement at the time of releasing the dollars. Further, the AA/ASIA designate and Acting AA/ASIA

agreed that the Special Account would be eliminated in favor of relying on the GOP's appropriation/allotment process. This decision was transmitted to the AID Administrator in an attachment to the action memorandum recommending authorization of the ESF Rural Energy Project, which was authorized by the Administrator on August 16, 1982. A copy of the attachment will be furnished to RIG/A/M as soon as it is available in the Mission. The Rural Energy Project, the Regional Development Fund Project, and the Markets Project -- all approved by the Asia Bureau this summer and authorized (or to be authorized within a few days) by the AID Administrator have had considerable discussion regarding the nature of the assistance and the disbursement mechanism approved by the Asia Bureau. All Project Papers for these Projects are available for review at any time.

Recommendation No. 2.

"USAID/Philippines coordinate with the AA/Asia and the AID Controller to (a) reach a determination as to whether remaining ESF projects should be financed through up-front dollar advances or periodic reimbursements for equivalent, valid project local currency expenses, and (b) ensure that project documentation includes clear and specific procedures to implement that determination."

USAID/Manila has coordinated with AA/ASIA and the AID Controller a determination that the Mission will make periodic dollar transfers, which shall be treated as disbursements not advances, in support of the GOP using its own appropriated funds to carry out mutually agreed-upon project activities. This system is the one approved at the May 29, 1982 meeting and is the one sent to the Administrator with the Rural Energy Development Project Authorization. Project documentation, as noted earlier, reflects that determination.

Recommendation No. 3

"If the determination reached under Recommendation No. 1 results in providing remaining ESF assistance on a discrete development project basis, USAID/Philippines coordinate with the AA/Asia to ensure that all Project Agreements with the Host Government include provisions that (a) require, prior to release of ESF monies, that controls over project funds be set up which are adequate to enable accomplishment of the objectives of the ESF funds granted and to preclude diversion or loss of funds provided to non-project ventures, and (b) clearly spell out disbursement procedures for both ESF dollars and local currencies, including the basis for, methodology, and timeframe of liquidation of any funds advanced."

The determination reached on May 29, 1982 confirmed the original plan to provide the remaining ESF assistance on a discrete development project basis. Accordingly, all new Project Agreements have revised language approved by AID/Washington which sets forth the procedures for the expenditure of project funds, both U.S. dollars and Philippine pesos, adequate to the needs of the project. To our knowledge, there is no evidence whatsoever of any diversion or loss of funds to non-project ventures. We have carefully reviewed the GOP's own control system and find it completely adequate in this regard. The new Agreements on disbursements are available for review at any time.

Recommendation No. 4

"USAID require that all advances made to the Secretariat for travel purposes be refunded immediately if a trip does not take place and within 90 days of completion of travel, if it does take place."

Following receipt of an earlier draft of this audit, the USAID Controller's Office worked with the Secretariat to institute a better liquidation procedure. At this time, no advances made for travel remain unliquidated for more than 90 days. No additional advances have been made for travel which did not take place.

Recommendation No. 5

"The USAID/Philippines request the Ministry of Human Settlements to review the acceptance procedures to ensure that principals are not being requested to give approval prematurely."

At this point, the recommendation is essentially moot since virtually all schools constructed under the program are complete and accepted. We believe that the acceptance procedures did provide reasonable assurance that all work performed in connection with school construction was satisfactory and deficiencies were corrected.

As has been noted in earlier responses to the draft audit, USAID monitored construction of the elementary schools closely, including visits to more than half of the three-room units and several visits to each of the larger schools. To assure ourselves that deficiencies noted and called to the attention of the Ministry of Public Works, as well as the contractors were corrected, the USAID engineers have conducted follow-up visits to a number of schools and continue to do so.

Recommendation No. 6

"USAID/Philippines request the GOP to provide assurances that at a minimum arrangements be made for transportation of completed furniture to schools and some type of new or used furniture be supplied."

We also believe this recommendation is moot, since substantially all of the schools are complete and furnished. While delays were disappointing, we understand that PTAs and other local organizations made temporary arrangements to furnish new schools when project funded furnishings were not yet delivered. We are unaware of a single completed school being unused due to a lack of furniture. Further, we continue to believe that the experience of manufacturing the furniture afforded the often small trade and vocational schools under the project was also a benefit.

Finally, it should be noted that USAID approved the reprogramming of savings in the construction component of the project for 27 additional schools. However, savings in the furnishings component were sufficient to furnish only nine of them. MEC has assured the Secretariat that local PTAs would provide adequate furnishings for the remaining eighteen schools rather than see them go unused.

In conclusion, this has been a successful Project, resulting in almost 900 new, well-built typhoon resistant schools in the Philippines. The schools were built quickly and efficiently, and the experience gained from this Project is of immense value in designing and implementing future ESF projects. The audit was helpful in one aspect but its overall effect has been counter-productive. The Mission believes that issuance of this audit report on the basis of an incomplete understanding by the auditors of the GOP fiscal system was unfortunate.