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Regional Inspector General for Audit
Singapore

AUDIT OF USAID/PHILIPPINES' MANAGEMENT OF HOST COUNTRY-OWNED LOCAL CURRENCY

Audit Report No. 5-492-94-005
February 25, 1994

INSPECTOR GENERAL

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

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INTERNATIONAL
DEVELOPMENT

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MEMORANDUM

TO: Thomas W. Stukel Jr., Mission Director, USAID/Philippines

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

SUBJECT: Audit of USAID/Philippines' Management of Host Country-Owned Local Currency (Audit Report No. 5-492-94-005)

Enclosed are five copies of the subject audit report. Our audit work and the written representations made by your office confirmed that controls over host country-owned local currency were adequate in many areas. For example, USAID policies and procedures were followed in: (1) assessing the accountability environment of the Philippine Government; (2) designing the grant agreement and amendments; (3) depositing local currency into a special account and quickly releasing these funds; and (4) ensuring that the impact of the local currency program will be evaluated. However, the Mission should strengthen its controls over the deposit of funds into interest-bearing accounts, ensure that it receives reports showing uses of local currency, and obtain reasonable assurance that local currency is used for intended purposes.

Your comments to the draft report were very responsive. These comments are summarized after each finding and presented in their entirety in Appendix II. Based on your comments and supporting documentation, Recommendation Nos. 1 and 2.1 are closed. The remaining recommendations are resolved and can be closed when planned actions are completed.

Please provide us information within 30 days documenting actions taken to implement the open recommendations. I sincerely appreciate the cooperation and courtesies extended to my staff during the audit.

Attachments: a/s

EXECUTIVE SUMMARY

BACKGROUND

In June 1991, USAID issued Policy Determination No. 18 and supplemental guidance to provide better accountability and oversight over host country-owned local currency for non-project assistance. This policy superseded previous USAID policy and guidance and described controls over the generation, management, and programming of host country-owned local currency. Accountability standards for non-project assistance were provided in USAID's Supplemental Guidance on Programming and Managing Host Country-Owned Local Currency.

USAID/Philippines had one program agreement with a host country-owned local currency component that fell under the new policy and guidance. That program, the Natural Resources Management Program, had $20 million of obligations and expenditures subject to the new policy as of June 30, 1993. This $20 million generated an equivalent amount of host country-owned local currency: 533 million pesos (pages 1-2).

The Office of the Regional Inspector General for Audit/Singapore conducted an audit to determine whether, in accordance with USAID policy and supplemental guidance[1], USAID/Philippines (1) assessed the accountability environment in the host country, (2) designed the grant agreements and amendments, (3) ensured that local currency generations were deposited and quickly disbursed, (4) ensured that local currencies were used for intended purposes, and (5) ensured that the impact of the local currency programs will be evaluated (pages 2-3).

[1]The policy and supplemental guidance we refer to in all audit objectives are *Policy Determination No. 18* and the *Supplemental Guidance on Programming and Managing Host Country-Owned Local Currency*, which were issued by USAID in June 1991.

FINDINGS

With regard to the first objective, we found that USAID/Philippines did assess the accountability environment of the Philippine Government in 1991. However, we suggested that the Mission determine if it should reassess the environment due to a change in the Philippine administration in June 1992 (pages 4-6).

Concerning the second objective, we found that the Mission did design the grant agreement and amendments according to USAID policy and supplemental guidance (page 7).

For the third objective, we found that the Mission did ensure that the local currency was deposited into a special account and quickly disbursed, as required by the policy and guidance. However, the Mission thought that the local currency was not deposited into an interest-bearing account, as *favored* by the policy and supplemental guidance, but found out—in November 1993—that the Philippine Government did earn interest (about 5.2 million pesos or about $197,000) on its deposit. We recommend that the Mission either ensure that the Philippine Government deposit local currency into an interest-bearing account or document its justification for not requiring the Government to do so (pages 8-11).

Regarding the fourth audit objective, we found that USAID/Philippines has not ensured that local currencies were used for intended purposes as required by policy and guidance. This occurred because the Philippine Government did not understand reporting requirements under the agreement and has not provided the Mission with required reports showing its use of the local currency generated from the second tranche of funds. The funds were designated for general sector support which made specific identification difficult. Also, the Philippine Government intended to account for the funds by attribution. We recommend that the Mission clarify the reporting requirements to the Philippine Government. We also recommend that the Mission schedule appropriate financial monitoring and audit coverage for funds under the second and subsequent tranches to ensure that the attribution was done as agreed-upon (pages 12-18).

Finally, for the fifth objective, we found that USAID/Philippines did ensure that the impact of the local currency program will be evaluated according to the policy and supplemental guidance (pages 19-20).

MISSION RESPONSE

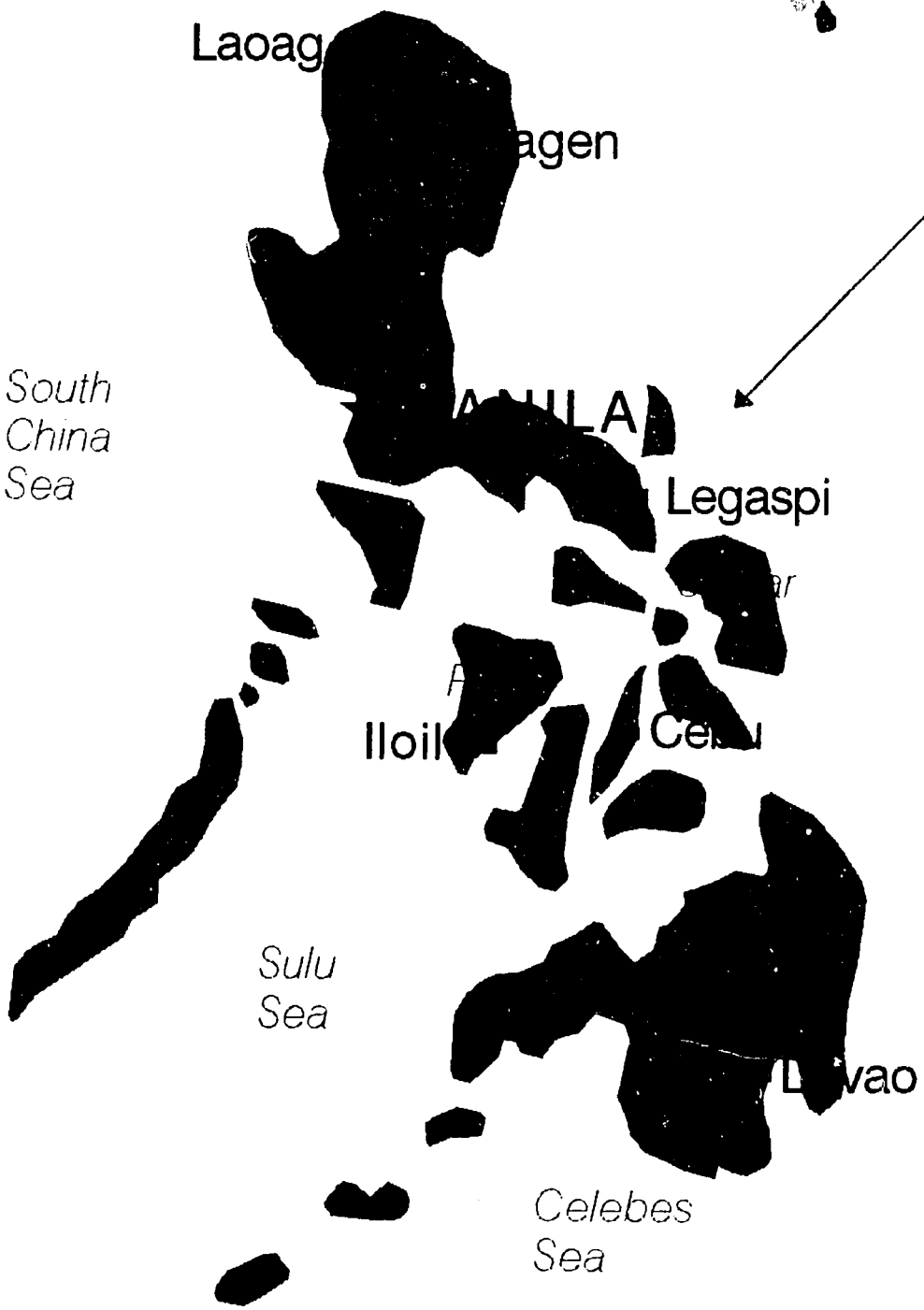
In their response to the draft report, USAID/Philippines' officials concurred with the three recommendations. The Mission's comments are summarized after each finding and presented in their entirety as Appendix II. Based on USAID/Philippines' actions, audit recommendation nos. 1 and 2.1 are closed while audit recommendation nos. 2.2 and 3 are resolved and can be closed when agreed-to actions are completed.

Office of the Inspector General

Office of the Inspector General
February 25, 1994

Philippines

Area: 116,000 sq mi
Population: 58 million



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INTRODUCTION

Background

Host country-owned local currency has been long recognized as an area of vulnerability in the USAID economic assistance program. The USAID Inspector General and the General Accounting Office have reported on problems with USAID's oversight and accountability of local currency, including management of special local currency accounts and ensuring that local currency is used for agreed-upon purposes. As a result, USAID issued detailed guidance to address the weaknesses in oversight and accountability.

In June 1991, USAID revised its policy on host country-owned local currency by issuing Policy Determination No. 18 (PD-18). This policy superseded both Policy Determination No. 5 of 1983 and its supplemental guidance of 1987. PD-18 describes controls over the generation, management, and programming of host country-owned local currency. Most importantly, it prescribes accountability standards for non-project assistance as explained in *USAID's Supplemental Guidance on Programming and Managing Host Country-Owned Local Currency* (Supplemental Guidance) of June 1991.

We examined USAID/Philippines' portfolio of non-project assistance and found that the criteria for this audit only applied to the Natural Resources Management Program (Resources Program).

The Philippine Government (Government) and USAID/Philippines signed an agreement for the Resources Program in September 1990. The estimated cost of the program was $125 million and included a local currency element of $75 million. When the agreement was signed, USAID/Philippines obligated $15 million for local currency generation.

Another $20 million was obligated for local currency generation under the Resources Program by the Mission in July 1991. It was later disbursed in December 1991. During that same month, the Government deposited its local currency equivalent of 533 million pesos into a special peso account to comply with the agreement. The funds in this account were transferred to the Government's General Fund in March 1992. No more

funds were obligated or expended under the local currency component through June 1993.

Since PD-18 applies only to local currency generated from obligations made after June 1991, it only affects local currency generated from the $20 million obligated in July 1991 and all future obligations.

Audit Objectives

The Office of the Regional Inspector General for Audit/Singapore audited USAID/Philippines' controls over host country-owned local currency. This audit was conducted as part of a worldwide audit of host country-owned local currency led by RIG/A/Nairobi. The results of our audit will be included in the capping report issued by that office. Our field work was conducted from June 28 to August 27, 1993 to answer the following audit objectives. Did USAID/Philippines:

- Assess the accountability environment in the host country as required by USAID policy and supplemental guidance?
- Design the grant agreements and amendments in accordance with USAID policy and supplemental guidance?
- Ensure that local currency generations were deposited and quickly disbursed as required by USAID policy and supplemental guidance?
- Ensure that local currencies were programmed and used for intended purposes as required by USAID policy and supplemental guidance?
- Ensure that the impact of the local currency programs will be evaluated in accordance with USAID policy and supplemental guidance?

In answering these audit objectives, we tested whether USAID/Philippines (1) followed applicable internal control procedures in PD-18 and the Supplemental Guidance and (2) complied with certain provisions of laws and regulations. Our tests were sufficient to provide reasonable—but not absolute—assurance of detecting abuse or illegal acts that could significantly affect the audit objectives. When we found problems, we

determined their cause and effect, and made recommendations for corrective action.

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

REPORT OF AUDIT FINDINGS

Did USAID/Philippines assess the accountability environment in the host country as required by USAID policy and supplemental guidance[2]?

USAID/Philippines assessed the accountability environment of the Philippine Government (Government) in 1991 as required by USAID policy and supplemental guidance. Based on their assessment, USAID/Philippines concluded that (1) the Government's financial reporting system was adequate to meet the requirements of general purpose reporting, (2) the internal controls for effectively using and reporting on USAID-funded activities were adequate, and (3) the implementing agencies responsible for managing the special account had adequate financial management capabilities. However, another assessment of the accountability environment may be needed due to a change in the Government in 1992.

USAID's *Supplemental Guidance on Programming and Managing Host Country-Owned Local Currency* (Supplemental Guidance) prescribed the new accountability standards for managing host country-owned local currency adopted in Policy Determination No. 18 (PD-18). These standards require a mission to assess the general accountability environment in the host country to identify the methods of implementation and financing which are suitable in the host country environment. As part of a general assessment, the Supplemental Guidance required missions to examine (1) general financial management capabilities of the host government, (2) quality of accounting and financial management personnel within the host government, (3) systems in place to allocate and expend funds, (4) external economic factors that might influence the use of local currency, and (5) its experience with ensuring accountability for USAID resources and local currency in that country.

[2]The policy and supplemental guidance we refer to in all audit objectives are *Policy Determination No. 18* and the *Supplemental Guidance on Programming and Managing Host Country-Owned Local Currency*, which were issued by USAID in June 1991.

Although USAID/Philippines assessed the Government's accountability environment in 1991 in compliance with PD-18 and the Supplemental Guidance, the Mission did not address external economic factors that might have influenced the use of local currency. We could not determine if this omission affected the quality of the assessment.

In addition, the Mission issued its own accountability guidelines for local currency in June 1992. These guidelines outlined three alternatives to be considered for providing accountability over local currency.

- The first alternative was to follow the Supplemental Guidance and determine that the funds were deposited to the General Fund of the host country. Appropriately, the Mission decided that this alternative was inadequate.

- The second alternative was to require disbursement data. The Mission determined that this alternative was too costly.

- The third alternative was to accept Government reporting. The Mission chose this alternative and decided to supplement it with limited financial monitoring and non-Federal audits.

A Reassessment Suggested by the <u>Guidance was not Carried out</u>

In June 1992, a new president took office in the Philippines. We could not determine if this change in government affected the accountability environment in the Philippines. However, section 2.1 of the Supplemental Guidance states that missions will be required to perform a general assessment of the host country's financial management "*... at least once every five years or more frequently if circumstances in the host country change substantially (such as with the advent of a new administration).*" Hence, we suggested that the Mission determine if another assessment is warranted. If no assessment is needed, the Mission should document its decision.

The Mission indicated that a reassessment is not warranted at this time because: (1) there are no significant changes in the Government's accountability environment brought about by the change in administration and (2) the Mission does not plan to release the third and fourth tranches of funds but will reprogram those funds for a new project

that does not require local currency generation. The Mission stated that while the change in administration did cause changes in administrative duties and responsibilities of personnel, the Government's overall financial management and policies did not change.

Based on the response by USAID/Philippines, we feel the question of a reassessment has been adequately addressed and no further action is needed.

Did USAID/Philippines design the grant agreements and amendments in accordance with USAID policy and supplemental guidance?

USAID/Philippines designed the grant agreement and amendments for the Resources Program in accordance with USAID policy and supplemental guidance.

USAID policy and supplemental guidance prescribe that the Mission:

- specify how local currency is to be generated,
- require local currency to be deposited into a special account for joint programming by USAID and the host government,
- specify planned uses of dollars in the bilateral assistance agreement,
- require local currency generations to support the economic development objectives in section 575(a) of the 1991 Appropriations Act,
- set up accountability guidelines, and
- provide for monitoring implementation of local currency-financed activities, regular reports, and audits.

In the grant agreement, the Mission specified an acceptable method of generating local currency, included a provision for a special account[3], and addressed legal issues contained in PD-18's Appendix A. A local currency program, with four approved options, to support development objectives defined in section 575(a) of the 1991 Appropriations Act was also included. The agreement also covered the accountability requirements specified in PD-18, and included provisions for monitoring local currency-financed activities, regular reports, and audits.

[3]The purpose of a local currency special account is to ensure that funds generated under a grant agreement are segregated from other funds. Thus, accountability for these funds will be ensured through disbursement from the special account.

Did USAID/Philippines ensure that local currency generations were deposited and quickly disbursed as required by USAID policy and supplemental guidance?

USAID/Philippines did ensure that local currency was deposited into a special account and quickly disbursed as required by USAID policy and supplemental guidance. However, the funds were not initially deposited into an interest-bearing account.

USAID policy and supplemental guidance direct the Mission to:

- require that local currencies be placed into a special account,
- specify (with the host government) in the agreement when local currency deposits should be made and the amounts of local currency to be deposited,
- require that jointly programmed local currency should be disbursed as quickly as is consistent with sound programming and prevailing economic conditions in the recipient country, and
- favor placing local currency into an interest-bearing account because disbursement delays do occur.

The second tranche of funds ($20 million or 533 million pesos) under the Resources Program was deposited into the special account at the Central Bank of the Philippines on December 27, 1991, in accordance with the program agreement. The program agreement adequately defined the foreign currency exchange rate to be used and detailed when the deposit would be made. The local currency funds were generated and deposited on the same day (December 27, 1991) that the second tranche of funds was released to the Government. Later, the funds were quickly transferred from the special account to the Government's General Fund for the Resources Program. However, the funds were not initially deposited into an interest-bearing account.

Mission did not Follow USAID Policy on Interest-bearing Accounts

USAID/Philippines did not ensure that the Government deposited the local currency funds into an interest-bearing account nor did it document a decision as to why funds were not deposited into such an account. PD-18 and the Supplemental Guidance state that USAID policy ***favors*** the deposit of local currency funds into such an account. The funds were not deposited into an interest-bearing account because the grant agreement did not specify that the special account should be interest-bearing. Mission officials stated that the Government had cited International Monetary Fund considerations as the reason the funds were not deposited into an interest-bearing account. In November 1993—20 months after the funds were expended—the Government notified the Mission that the funds earned interest during most of its term in the special account[4]. As a result, the Mission did not know that about 5.2 million pesos (about $197,000) of interest was earned on local currency generated from USAID funds.

> **Recommendation No. 1: We recommend that USAID/Philippines require and ensure that all host country-owned local currency be deposited in interest-bearing accounts *or* document its justification for not requiring the Government to deposit funds into an interest-bearing account as favored by USAID policy.**

Section 5.6 of PD-18 and section 5.2 of the Supplemental Guidance ***favor*** local currency being placed into interest-bearing accounts in deposit-taking institutions, with any interest considered as principal. This method is preferred if such accounts are permitted under host government laws and regulations and do not undermine internationally-supported stabilization agreements and sound monetary policy. Furthermore, the Supplemental Guidance states that:

> *"A written determination not to follow A.I.D.'s preference for interest-bearing accounts may be made by the Mission*

[4]Interest was earned on deposits from January 1, 1992 through March 31, 1992. The local currency was deposited into the special account on December 27, 1991 and transferred to the Government's General Fund on March 31, 1992. Presumably, no interest was earned on the funds from December 27-31, 1991.

Director. Copies of each determination shall be retained by the Mission."

The local currency was deposited into a special account with the Central Bank of the Philippines in December 1991 and transferred from that account to the Government's General Fund for the Resources Program in March 1992. Mission officials stated that the Government cited International Monetary Fund considerations as the reason for not using an interest-bearing account. The special account was not an interest-bearing account because that requirement was not put in the grant agreement. Mission officials stated that the Government cited International Monetary Fund considerations as the reason for not using an interest-bearing account. The Mission should have, but did not, document its decision to not require interest on these funds. However, in November 1993, the Mission received a credit advice from the Government showing that interest was earned on the local currency generation for most of its time in the special account. We observed that the 5.2 million pesos was credited directly to the Government's demand deposit account without passing through the special account. As a result, interest totaling about 5.2 million pesos—about $197,000—was earned on local currency generated with USAID funds, without prior knowledge of the Mission. The Management Response (Appendix II, page 4) also reveals that the Mission learned, after the fact, that the interest earned was credited to a Bureau of Treasury (BTr) regular account. We also consider this undesirable since such deposits may no longer be directly available to the Department of Environment and Natural Resources (DENR) for program purposes. This contravenes both USAID policy and supplemental guidance which require interest to be programmed as if it were principal—i.e. to be used for program purposes.

We noted that in April 1992, the Mission implemented a policy that required the Government to transfer local currency funds from the special account into the General Fund of the Government within two days of making the deposit. Even with this policy, the Mission should still document any decision to not require the Government to use an interest-bearing account as favored by USAID policy.

Management Comments and Our Evaluation

The Mission stated that it did not specify in the grant agreement that the special account be interest-bearing since the funds were to be transferred immediately to the Government's General Fund. Neither the Mission nor the Government intended to let the local currency stay in the special account for such a long period of time. A misunderstanding about

implementation procedures caused the three-month delay in the transfer of funds from the special account to the Government's General Fund.

The Mission also stated that it was not aware that the special account may or may not earn interest based on the Government's Monetary Board decision. On May 28, 1992, the Philippine Central Bank complied with Monetary Board Resolution No. 184 and credited the BTr's regular account with interest on all its regular and special accounts from January 1 through March 31, 1992. The Mission estimated that interest earnings on Resources Program funds totaled about 5.2 million pesos. Since the Mission does not plan to release additional program funds under the Resources Program, it does not see the need to require the Government to deposit local currency in interest-bearing accounts or to document any justification for not requiring such accounts. The Mission stated that, if it implements new programs with local currency generations, it will adhere to USAID policy on interest-bearing accounts contained in PD-18 and the supplemental guidance. The Mission therefore requested closure of Recommendation No. 1.

Based on the Mission's response, we are closing Recommendation No. 1. However, we noted that the interest earned on funds in the Resources Program special account was not deposited into that account and may not be included in the accounting required for funds which is discussed in the next section. USAID/Philippines should ensure that all local currency--including interest—under the Resources Program is accounted for and reported on as required by the agreement.

Did USAID/Philippines ensure that local currencies were programmed and used for intended purposes as required by USAID policy and supplemental guidance?

USAID/Philippines did not ensure that local currencies were programmed and used for intended purposes as required by USAID policy and supplemental guidance. The Mission did not receive the required reports showing the uses of the local currency nor did it have reasonable assurance that the currency was used for intended purposes.

USAID/Philippines Has Not Received Reports Showing the Uses of Local Currency

As discussed below, the Government has not provided the Mission with the required reports showing its use of local currency for the second tranche of funds. USAID policy and supplemental guidance require the Mission to ensure that the local currency was expended for intended purposes. That assurance would be provided through Government-issued reports required in the Program Assistance Approval Document (PAAD) and the Program Agreement. However, the Controller stated that the Mission had not received the required reports since the Government's Commission On Audit (COA) and Department of Budget and Management (DBM) did not provide this information. Officials from COA and DBM in turn, stated that the recipient agency, DENR, did not provide them with the necessary information to certify and audit for transmittal to the Mission. We found that the host country officials responsible for providing these reports did not clearly understand their reporting responsibilities under the program agreement. As a result, the Mission could not determine how the local currency was used as required by USAID policy and supplemental guidance.

Recommendation No. 2: We recommend that USAID/Philippines:

2.1 clarify the reporting requirements of the program agreement with cognizant organizations of the Government regarding the timing and content of the reports; and

2.2 withhold the release of funds under future tranches until acceptable reports are received.

PD-18 stated that local currency must be programmed to support economic development objectives as defined in legislation. The Supplemental Guidance also contains similar requirements. Missions may program local currency to support one or more of four options. One option is supporting particular sectors of a government's budget. The grant agreement for the Resources Program stated that the local currency would be used to support the Government's Department of Environment and Natural Resources (DENR).

USAID/Philippines programmed all local currency generations under the second tranche for general sector support. However, USAID/Philippines determined that local currency generations transferred to the General Fund cannot be traced to any ultimate use because, once transferred, these funds are accounted for by attribution.

USAID/Philippines has provided assistance to the Government through various programming vehicles requiring local currency since the mid-1980's. Accounting for local currency was through attribution to line items in the Government's budget. Attribution has consistently been required at 125 per cent of the local currency generated in each program. Under the second tranche of the Resources Program, 533 million pesos was generated. The Mission required that the Government attribute 666 million pesos (125 per cent of the 533 million pesos generated)[5] in its budget for the Resources Program. Mission officials said that requiring attribution of 125 per cent of the local currency generated would provide additional assurance that if there were some unallowable costs (e.g. military or police activities), at least 533 million pesos would have been spent on allowable costs. In addition, the June 1992 guidance called for financial monitoring and non-Federal audits to ensure the reliability of the host country's reports.

The Program Assistance Approval Document required the Government to provide quarterly certified disbursement reports by the succeeding quarter and annual audited reports of disbursements by September 30 of the following year. The program agreement required the grantee to furnish **"quarterly reports on disbursement of pesos made against eligible budget categories, certified by a responsible officer of the Grantee to the effect that accounts reported therein have not been reported against any other assistance, and appropriate reports from the Commission on Audit."** The special peso account implementation plan

[5]The revised amount to be attributed should be about 673.0 million pesos based on the additional interest of 5.2 million pesos earned.

also stated that DBM shall prepare and submit to USAID, through the Department of Finance, unaudited quarterly disbursement reports.

As of August 27, 1993, the Government had not provided the Mission with the required certified quarterly or annual audited reports for the second tranche of funds (533 million pesos or $20 million—plus interest). Therefore, the Mission does not have assurance that the local currency was expended for its intended purpose. The Mission has not determined the extent of audit and review work to be performed in order to provide adequate accountability in accordance with the guidance either. The Controller stated that this was due to the slowness of COA and DBM in providing information. These organizations in turn pointed to DENR for its failure to provide the necessary information for them to certify and audit the information for transmittal to the Mission.

An unofficial partial report of attributed disbursements under the second tranche of funds was provided to the Mission. The report was not complete because it contained information for only 11 of 14 regions and 407.1 million pesos of about 673.0 million pesos (including interest) to be attributed under the Resources Program.

Partial Report of Attributed Disbursements by DENR Under the Second Tranche

DENR ORGANIZATION	*PESOS (millions)*	*DOLLARS (millions)*
FOREST MANAGEMENT SERVICES	213.8	8.0
GENERAL ADMINISTRATIVE SERVICES	134.2	5.0
ECOLOGIC RESEARCH AND DEVELOPMENT SERVICES	20.6	0.8
ENVIRONMENTAL MANAGEMENT SERVICES	19.8	0.8
PROTECTED AREAS AND WILDLIFE DEVELOPMENT SERVICES	10.5	0.4
FIELD NETWORK SURVEY	8.2	0.3
TOTAL	*407.1*	*15.3*

As noted in the chart above, funds were attributed to the Protected Areas and Wildlife Development Services. The Philippine Eagle Center in Davao City received funds from that service. This Center safeguards eagles, bats, deer, crocodiles and other wildlife. The Center has bred the Philippine Eagle—an endangered species—in captivity. The following photograph shows part of the Philippine Eagle Center.

Located in Davao City, the Philippine Eagle Center is funded by the Protected Areas and Wildlife Development Services—an organization that received funds from the Resources Program.

We found that Government officials did not understand the type of information to be reported to the Mission, when it was to be reported, and by whom it was to be reported. Even though the program agreement spelled out requirements for the quarterly certified reports and annual audited reports, the DBM officials responsible gave no explanation as to why they did not provide the reports. The information necessary for the reports appeared readily available to them.

The only documentation available showing the Mission's effort to gain the host country's compliance was in an internal memorandum in June 1993. The Mission explained that the only leverage they have over the host country is to withhold future tranches until reports are received. We believe that the Mission should have been more assertive in attempting to receive the required reports from the Government. We also feel that full compliance with these requirements is absolutely necessary prior to the release of the next tranche of funds. As a result, we have recommended that the Mission receive all required reports in acceptable form and content before releasing the third tranche of funds.

Management Comments and Our Evaluation

The Mission stated that, in September 1993, its officials met with COA, DBM, and DENR representatives to discuss issues and resolve problems relating to the delayed reports. In order to expedite report submission, DENR mobilized its finance staff to assist in preparing the required reports. These reports have been submitted to DBM for certification. Based on this action, the Mission requested closure of audit recommendation no. 2.1.

Based on the Mission's actions—and the planned reprogramming of the third and fourth tranches—we are closing audit recommendation no. 2.1 upon issuance of this audit report.

The Mission also stated that DBM is currently reviewing the required reports. Therefore, audit recommendation no. 2.2 is resolved and can be closed when we receive a copy of the DBM-certified report.

Mission Does Not Have Reasonable Assurance That Local Currencies Were Used For Intended Purposes

The Supplemental Guidance and Mission guidance require the use of financial monitoring or non-Federal audits to ensure the quality of disbursement reports submitted by the Government. As of this audit, the Mission had not determined the nature, extent, or timing of these efforts to ensure accountability for the second tranche of funds under the Resources Program. Mission officials explained that they were waiting to receive the reports from the Government before determining the type and scope of additional financial monitoring or auditing to be performed. Thus, the Mission did not have reasonable assurance that the funds were used for its intended purposes.

> **Recommendation No. 3: We recommend that USAID/Philippines schedule appropriate financial monitoring and audit coverage of the disbursements attributed to the second and all subsequent tranches of funds to ensure that attribution of the funds was in accordance with Mission guidance on attribution and the program agreement.**

Section 5.1.C of the Supplemental Guidance states that missions should ensure that special accounts are audited periodically. During the Program Assistance Approval Document stage, the Mission and the host government should discuss auditing requirements for the special account.

The program agreement should define audit responsibilities, frequency, and funding. Furthermore, program agreements must reserve audit rights in the U.S. and state that USAID's audit rights will not be subordinated or infringed upon by arrangements for audits by the host government or outside auditors.

In June 1992, USAID/Philippines issued internal guidance which recognized that local currency transferred to the Government's General Fund could not be traced to an ultimate expenditure as they are accounted for by attribution. In order to reduce the risk of the local currency being misused, the Mission required the host country to spend at least 125 per cent of the local currency generated for activities provided for in the agreement. In addition, the Mission determined that financial monitoring or non-Federal audits should be used. The nature, timing, and extent of this activity, however, were not defined in the guidance.

The Mission has not received the reports required for the second tranche of funds. Mission officials stated that they were concerned with the poor reporting of the Government and would take steps to correct the reporting. Those steps were to send Mission financial analysts to the Government units and pressuring the Government to fulfill the reporting requirements before releasing the third tranche of funds.

We recognize that financial monitoring and audit activities are more difficult without the required reports from the Government. Therefore, we emphasize the need to make the receipt of the reports a Mission priority as well as the importance of subsequent monitoring and review. A significant 18 months have passed since the expenditures have occurred. About $40 million of future tranches face the same risks.

Management Comments and Our Evaluation

The Mission stated that under the Recipient Contracted Audit program, it had identified commitments for which audit responsibility lies with COA, the Government's Supreme Audit Institution. The second tranche was among the transaction in the list of commitments subject to COA's audit. The action was identified in the Mission's Audit Management Plan submitted to RIG/A/Singapore in June 1993.

Based on the Mission's response, audit recommendation 3 is resolved and can be closed when the Mission forwards the result of COA's audit to us.

Did USAID/Philippines ensure that the impact of the local currency programs will be evaluated in accordance with USAID policy and supplemental guidance?

USAID/Philippines ensured that the impact of the local currency program will be evaluated in accordance with USAID policy and supplemental guidance.

Section 7.1 of the Supplemental Guidance states that the Mission and the host country are expected to develop verifiable performance indicators to guide their programming of local currency by measuring the program's tangible results.

The Resources Program is a policy-based sector assistance program undertaken by DENR and USAID. The purpose of the Resources Program is to (a) promote the economically and ecologically sustainable management of the Philippines' natural resources, with special attention to tropical forests and biodiversity; and (b) increase economic efficiency in the forest products industry. The Resources Program focused on eight policy areas—land tenure, forest charges, entry into and exit from the forest products industry, privatization of Government holdings, old growth forest protection, residual forest management, technology development and transfer, and community-based forest management. Performance indicators for the eight policy areas were established as required by USAID policy and supplemental guidance, and conditions for those indicators were required to be met before any of the four tranches of funds were released. The conditions were met for the first two tranches before they were released. Conditions for the third tranche were not met. Therefore the third tranche was not released when due (the end of 1992) and has not yet been released as of the date of this report.

USAID/Philippines required a mid-term and final evaluation in the agreement. The mid-term evaluation has been completed and a report was issued in September 1992. The evaluation team found sufficient progress in most policy areas and, when necessary, recommended corrective action. Some of these recommended actions included:

> clarifying the basis for new forest fees, revising accounting systems to trace costs and revenues, and testing a system to impose fees on standing timber for the forest charges policy;

- eliminating the privatization of Government holdings policy because the underlying assumption was unsubstantiated; and

- suggesting a better indicator—hectares of residual forest under approved management plans—rather than a simple increase of 100 million pesos for forest management activities under the residual forest management policy.

The local currency component represents $75 million in the program agreement. The performance indicators were written with conditions that needed to be met prior to the release of each of the four tranches. The grant agreement also provided for both a mid-term and a final evaluation. Thus, based on the inclusion of performance indicators and the requirement for evaluations, we concluded that the Mission has ensured that the impact of the local currency component will be evaluated according to USAID policy and supplemental guidance.

SCOPE AND METHODOLOGY

Scope

We audited USAID/Philippines' Management of Host Country-Owned Local Currency in accordance with generally accepted government auditing standards. We conducted the audit from June 28 to August 27, 1993 and did our field work in the offices of USAID/Philippines and the Philippine Government (Government) in Manila, and at field sites in Davao City and Los Baños. We obtained a representation letter from Mission management confirming information which we considered essential for answering our audit objectives and for assessing internal controls and compliance. These written representations have been included as part of the Mission's comments in Appendix II.

In answering the audit objectives, we tested whether USAID/Philippines implemented and followed internal controls prescribed by USAID's *Policy Determination No. 18* (PD-18) and its *Supplemental Guidance on Programming and Managing Host Country-Owned Local Currency* (Supplemental Guidance). Our audit tests were designed to provide reasonable assurance in answering the audit objectives. In instances where problems were found, we identified the cause and made recommendations to correct the problems. The audit did not assess the adequacy of the design of the system of internal controls as it was assumed that they were adequately designed. We did assess the implementation of the internal controls related to host country-owned local currency by answering the five audit objectives. We also reviewed USAID/Philippines internal controls assessment for controls related to the audit objectives and found that no internal control weaknesses had been identified or reported.

The universe consisted of only the Natural Resources Management Program. Between July 1, 1991 (the effective date of PD-18 and the Supplemental Guidance) and June 30, 1993, the Mission obligated and

expended $20 million that resulted in the generation of host country-owned local currency of 533 million pesos.

Methodology

The methodology for each audit objective is discussed below. The methodology also included steps to assess the internal controls and the compliance related to each audit objective.

Audit Objective One

The first audit objective was to determine if the Mission assessed the accountability environment in the host country as required by USAID policy and supplemental guidance. In order to accomplish this objective, we reviewed the Mission's assessment of the host government's accountability environment and its June 1992 guidance on local currency to determine compliance with PD-18 and the Supplemental Guidance. We discussed the assessment and guidance with Office of Financial Management staff.

Audit Objective Two

The second audit objective was to determine if the Mission designed the grant agreements and amendments in accordance with USAID policy and supplemental guidance. To accomplish this objective, we reviewed the program agreement and all amendments in order to determine if the pertinent requirements of PD-18 and the Supplemental Guidance were met.

Audit Objective Three

The purpose of this objective was to determine if USAID/Philippines ensured that local currency generations were deposited and quickly disbursed as required by USAID policy and supplemental guidance. To accomplish the objective, we assessed whether local currency generations covered by PD-18 and the Supplemental Guidance were deposited and quickly disbursed in accordance with this guidance. This was accomplished by examining the program agreement and bank statements. In addition, we also discussed aspects of this objective with the Mission's Office of Financial Management staff and RIG/A/Nairobi.

Audit Objective Four

The purpose of this objective was to determine if USAID/Philippines ensured that local currencies were used for intended purposes as required by USAID policy and supplemental guidance. To complete this objective, we reviewed USAID's and the Mission's guidance on local currency and discussed how it was being implemented on the Resources Program with the Mission's Office of Financial Management staff and Government officials. We also visited Department of Environment and Natural Resources activities whose expenses are to be attributed to the second tranche of funds. These visits were in Manila, Davao City, and Los Baños. During these visits we determined the roles of the Philippine Government's Commission on Audit, Department of Budget and Management, and Department of Environment and Natural Resources in ensuring accountability for funds under the second tranche. We also determined why expenditure reports for second tranche funds were slow in being submitted to USAID.

Audit Objective Five

The purpose of this objective was to determine if the Mission ensured that the impact of the local currency programs will be evaluated in accordance with USAID policy and supplemental guidance. In order to do this, we obtained and reviewed the Program Assistance Approval Document (PAAD) and the mid-term program evaluation. We reviewed them for compliance with the guidance's requirement that verifiable performance indicators be established in the PAAD and assessed in the program evaluations. We also reviewed the program agreement to determine if any further evaluations were required.

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

USAID / Philippines
APO AP 96440

Fax No.: 632-521-5241
Tel. No.: 632-521-7116

MEMORANDUM

TO : Mr. Richard C. Thabet
RIG/A/Singapore

DATE: JAN 20 1994

FROM : Richard A. Johnson
Acting Director, USAID/Philippines

SUBJECT : Draft Audit Report
Audit of USAID/Philippines' Management of
Host Country-Owned Local Currency

REFERENCE : Thabet/Stukel memo dated December 16, 1993

As requested in referenced memorandum received on December 21, 1994, enclosed is Mission response to the findings and recommendations specified in the draft audit report. Also enclosed is a Representation Letter covering the subject audit.

We hope that our response will be fully considered in finalizing the audit report, and that these, together with the Representation Letter, are appended to the final report.

Attachments: As stated.

cc: IG/A/PPO, AID/W
ASIA/FPM/C, AID/W

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

USAID / Philippines
APO AP 96440

Fax No.: 632-521-5241
Tel. No.: 632-521-7116

MISSION RESPONSE ON
AUDIT OF USAID/PHILIPPINES' MANAGEMENT OF
HOST COUNTRY OWNED LOCAL CURRENCY

First Objective: Did USAID/Philippines assess the accountability environment in the host country as required by USAID policy and supplemental guidance?

Findings:
USAID/Philippines did assess the accountability environment of the Philippine Government in 1991. However, RIG suggests that the Mission determine if it should reassess the accountability environment due to a change in the Philippine administration in June 1992.

Mission Response:
We believe that a re-assessment is not warranted at this time for two reasons: (1) there are no significant changes in the GOP's accountability environment brought about by the change in administration; and (2) the Mission has no plans of releasing the 3rd and 4th tranche but instead will reprogram those funds for a new project that will not require local currency generation.

With the change in administration, reorganization was effected in various government agencies (such as the Department of Environment and Natural Resources, Department of Budget and Management, Department of Finance, National Economic and Development Authority). This brought about changes in the administrative duties and responsibilities of personnel; however, the GOP's overall financial management policies and systems remain the same.

The notably peaceful and democratic change in leadership without apparent internal strife signalled the restoration of political stability in the country. We believe that strong leadership and political will are contributory factors to strengthening the accountability environment.

Second Objective: Did USAID/Philippines design the grant agreements and amendments in accordance with USAID policy and supplemental guidance?

Findings:
The Mission did design the grant agreement and amendments according to USAID policy and supplemental guidance. However, the Mission did not require the Government to deposit the local currency into an interest-bearing account.

Mission response is provided under the third objective.

Third Audit Objective: Did USAID/Philippines ensure that local currency generations were deposited and quickly disbursed as required by USAID policy and supplemental guidance?

Findings:

The Mission did ensure that the local currency was deposited into a special account and quickly disbursed. However, the Mission did not ensure that the local currency was deposited into an interest-bearing account as favored by USAID policy nor did it document a decision as to why funds were not deposited into such an account. The Mission thought that the local currency was not deposited into an interest-bearing account but later found that the Philippine Government earned interest on its local currency deposit.

Mission Response:

The Mission did not specify in the grant agreement that the special account be interest bearing since the local currency funds generated from the tranch releases were to be immediately transferred to the Government's general fund. It was never the intent of the Mission and the GOP to let the local currency sit in the special account for a long period.

Furthermore, for the GOP to pay itself interest serves no purpose and, in fact, is counterproductive to fiscal management because it gives a false impression of additional revenue when actually this constitutes only a transfer of funds from one pocket to the other. If the peso account was necessarily in an independent commercial account, interest would be an issue but this is not the case.

It must also be noted that the special account to which the second tranche local currency was deposited, was the same special account used for the first tranche generation. Section 5.1 of the Supplemental Guidance states that "... one special account can be used on a non-fiscal year basis".

The first tranche local currency was immediately transferred to the general fund. However, a misunderstanding about the implementation procedures caused the three-month delay in the transfer of the second tranche local currency. The Bureau of Treasury did not effect the transfer as it was awaiting formal notification from USAID. USAID notification, however, was not a requirement in the implementation plan.

Based on the bank statements and previous discussions with the GOP, Mission believed that the special account was non-interest bearing. Copies of monthly bank statements of the peso special account showed that there were no credit entries representing interest earned for the period. The credit advice dated December 27, 1991 for P533,000,000 had the same balance as of the date of transfer to the general fund on March 31, 1992.

Mission was not made aware, however, that the special demand deposit account was one which may or may not earn interest depending on the GOP Monetary Board's decision. Only at the time of the audit was the Mission informed by the Bureau of Treasury (BTr) of the nature of the special account and the corresponding interest it had earned. In compliance with Monetary Board Resolution No. 184, the Central Bank, on May 28, 1992, credited the BTr's regular account for approximately P287 million representing interest on all its regular and special deposit accounts from January 1 to March 31, 1992. Interest earnings attributable to the NRMP local currency is approximately P5.243 million.

Recommendation No.1: **We recommend that USAID/Philippines:**

1.1 **require and ensure that all host country owned local currency be deposited in interest-bearing accounts or**

1.2 **document its justification for not requiring the government to deposit funds into an interest-bearing account as favored by USAID policy.**

Mission Response:

Inasmuch as the Mission does not plan on further releases of program funds under NRMP, we do not see the need to require the GOP to deposit local currency in interest bearing accounts or to document justification for not requiring the government to deposit the funds into such an account. In the future, if and when USAID/Philippines implement new programs with local currency generations, Mission will ensure that USAID policy on interest bearing accounts, as contained in PD 18 and supplemental guidance, is strictly enforced.

We, therefore, request that Recommendation No. 1 be considered CLOSED upon report issuance.

Fourth Audit Objective: Did USAID/Philippines ensure that local currencies were reprogrammed and used for intended purposes as required by USAID policy and supplemental guidance?

Findings:

USAID/Philippines did not ensure that local currencies were programmed and used for intended purposes as required by USAID policy and supplemental guidance. The Mission did not receive the required reports showing the uses of the local currency or have reasonable assurance that the currency was used for intended purposes.

Recommendation No.2: We recommend that USAID/Philippines:

2.1 clarify the reporting requirements of the program agreement with cognizant organizations of the Government regarding the timing and content of the reports; and

2.2 receive, in an acceptable form and content, all required reports on expenditures under the second tranche before releasing any future tranches of funds.

Response to Recommendation 2.1:

USAID/Philippines has clarified the reporting requirements of the program agreement with the Department of Environment and Natural Resources (DENR) after the NRMP grant agreement was signed. Disbursement reports for the first tranche local currency were correctly and timely submitted to USAID through the Department of Finance of the Philippines (DOF). However, due to GOP reorganization in 1992 and the resulting unfamiliarity of newly assigned staff, DENR was delayed in complying with the reporting requirements for the second tranche.

On September 9, 1993, a meeting was held among representatives of COA, DBM, DENR and USAID to discuss issues and resolve problems behind the delay in the submission of required reports to USAID. It was agreed in that meeting that a workshop will be conducted to inform the new staff of DENR regional offices of the report formats, deadlines and budget line items to be reported on. However, due to the planned reprogramming of the 3rd and 4th tranche, DENR-NRMP Project Management Office (PMO) decided to call off the workshop as it was deemed unneccesary.

DENR-NRMP/PMO, to expedite report submission, mobilized their PMO finance staff to assist the regional offices in the preparation of the required Report of Disbursements. The required reports were subsequently submitted to the Department of Budget and Management (DBM) for certification.

Mission, therefore, requests CLOSURE of Recommendation No. 2.1 based on the above actions.

Mission, therefore, requests CLOSURE of Recommendation No. 2.1 based on the above actions.

Response to Recommendation 2.2:

The Department of Finance has informed us that the required reports of disbursements for the second tranche are now under review by the DBM. We will furnish you a copy of the report as soon as we obtain them.

Recommendation No. 3: We recommend that USAID/Philippines schedule appropriate financial monitoring and audit coverage of the disbursements attributed to the second and all subsequent tranches of funds to ensure that attribution of the funds was in accordance with mission policy on attribution and the program agreement.

Mission Response:

In June, 1993, USAID/Philippines submitted to RIG/A its FY 1994 Audit Management Plan (AMP). In line with the Recipient Contracted Audit program, Mission identified commitments for which the audit responsibility rest on COA, the GOP's Supreme Audit Institution. The $20 million commitment for NRMP's second tranche release is among the transactions included in the list of commitments subject to COA audit. For your reference, a copy of Attachment 3 of the AMP is attached.

Mission will further discuss with COA the audit scope for the disbursements attributed to the NRMP second tranche release. It should be noted that all government disbursements are post audited by COA. Therefore, the report submitted by the GOP is virtually an audited report; it only lacks COA certification.

Based on the above action, Mission requests that Recommendation No. 3 be RESOLVED upon report issuance.

Fifth Objective: Did USAID/Philippines ensure that the impact of the local currency programs will be evaluated in accordance with USAID policy and supplemental guidance?

Findings:

USAID/Philippines ensured that the impact of the local currency program will be evaluated in accordance with USAID policy and supplemental guidance.

Mission has no comments.

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

USAID / Philippines
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REPRESENTATION LETTER

AUDIT OF USAID/PHILIPPINES MANAGEMENT OF
HOST-COUNTRY OWNED LOCAL CURRENCY

JAN 20 1994

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

Dear Mr. Thabet:

You have asked that USAID/Philippines provide a Representation Letter in connection with your audit of USAID/Philippines Management of Host-Country Owned Local Currency. Your staff has informed us that the audit covered the local currency generated under the Natural Resources Management Program. This program was the only agreement covered by Policy Determination No. 18 and the supplemental guidance on Programming and Managing Host-Country Owned Local Currency. The audit was intended to answer the following objectives:

Did USAID/Philippines:

- Assess the accountability environment in the host country as required by USAID policy and supplemental guidance?
- Design the grant agreements and amendments in accordance with USAID policy and supplemental guidance?
- Ensure that local currency generations were deposited and quickly disbursed as required by USAID policy and supplemental guidance?
- Ensure that local currencies were programmed and used for intended purposes as required by USAID policy and supplemental guidance?
- Ensure that the impact of the local currency programs will be evaluated in accordance with USAID policy and supplemental guidance?

I have asked the offices concerned with the audit, particularly the Office of Natural Resources, Agriculture & Decentalization

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. I have also asked them to make representations to me about the activities audited and the audit itself. They have made these representations and indicated they are aware that USAID/Philippines management is relying on their representations and knowledge and the representations and knowledge of their staffs are the basis for the representations of this letter.

Among other techniques, we rely extensively on the audit reports of contracted private independent audit firms and A.I.D.'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.

Based upon this reliance on audit, 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 various offices and staff involved, I confirm, as a layman and not as a lawyer, the following representations with respect to the audit of the Mission's management of host-country owned local currency:

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 agreement 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 records related to the activities audited.

3. To the best of my knowledge and belief, to the extent available within the Mission, Mission records relating to the activities audited are accurate and complete and give a fair representation as to the status of the activities audited.

4. To the best of my knowledge and belief, as a layman and not as a lawyer, USAID/Philippines is not aware of any known material instances 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 material irregularities related to the management of host-country owned local currency which we consider substantive, involving Mission employees with internal control responsibilities for the matter under audit or other organizations responsible for management of the host-country owned local currency. For the 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 known instance (other than what has been included in the draft audit report or reported by the Mission during the course of the audit) in which, in the Mission's judgment, there has been a material noncompliance by the Mission with A.I.D. policies and procedures or violation of U.S. law or regulation, which would substantially impact upon the matter under audit.

7. To the best of my knowledge and belief, as a layman and not as a lawyer, USAID/Philippines is not aware of any known instance (other than what has been included in the draft audit report or reported by the Mission during the course of the audit) in which, in the Mission's judgment, there has been a material noncompliance by the Misison with the terms of the project agreement relating to the activities audited, which would substantially impact upon the matter under audit.

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

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

Sincerely,

Richard A. Johnson
Acting Director

APPENDIX III

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