

Defragmentation: What Can Donors Do?

What can development partners do to deal with donor-induced fragmentation?

This is a follow-up note to the ISE Development Practice Note on the consequences of donor-induced fragmentation, which argued that the way development partners have managed their ODA spending and development programs has resulted in what ISE termed “donor-induced fragmentation” of government accountability systems. The paper presented three levels of disintegration: i) budgets and resource allocation systems; ii) accounting and classification systems; and iii) systems for scrutiny, oversight and accountability. It also maintained that these three levels result in significantly reduced accountability, which increases fiduciary and development risks¹. This outcome is in direct conflict with the one of the main reasons development agencies often cite for needing to bypass country systems in the first place – to avoid exposures to fiduciary and reputation risks.

We received some feedback on the original note asking what can development actors do to help solve this, and in particular, what the World Bank and bilateral actors can do. The purpose of this note is to present options on what these actors can practically do to lead the way to improve the status quo by making changes in systems, processes, standards, and / or behaviors. The note is structured around the three levels of fragmentation categorized in the original ISE note: budgeting, accounting, and scrutiny, and concludes with future directions.

The intended target audience for this note is primarily aid effectiveness, public finance, and governance experts in development agencies. The secondary audience is other development professionals, aid and public finance officials in aid-heavy countries, and interested stakeholders in aid-heavy countries. The idea being that if these audiences can help solve this issue, we will collectively see improved value for money in development

References:

1. Fiduciary risk here means essentially the short-term risk of misappropriation, mismanagement and corruption. Development risk here means the longer-term risk of not achieving development objectives such as poverty reduction, economic growth and institutional strengthening.

About ISE's Development Practice Notes

ISE Development Practice Notes present new ideas and good and / or innovative practices in the field of development. Different sectors and themes are covered, including fiscal performance, health and education sectors and social protection. DPNs are produced by ISE staff, associates, consultants and fellows. ISE DPNs are widely distributed and are also available on the ISE Website at <http://effectivestates.org/publication-category/dpn/>

- **What Determines Public Finance Quality?**
- **Team-Based Performance Management**
- **Who Cares About Development Risk?**
- **Consequences of Donor- Induced Fragmentation**
- **Medium-term Focus for Long-term Problem Solving**
- **Revocable Debt Relief**
- **Absorptive Capacity**

investments, more efficient systems, and enable developing country governments to take the driver's seat in managing their own national programming and policy priorities.

BUDGET FRAGMENTATION

Budget fragmentation can take many forms. Three key areas were identified in ISE's original Note on this topic as the drivers of budget fragmentation: i) Separation of operating and development budget, which contributes to a misallocation of resources and fragments accountability systems; ii) projects and multi-donor trust funds using different classification and accounting systems – making it difficult to consolidate and compare budgets and accounts; and iii) bypassing a single budget process – making it difficult to allocate all resources efficiently – to areas that have the biggest impact.

Reducing budget fragmentation helps to deliver resources to the highest priority areas or those with the greatest social and economic impact (also known as allocative efficiency). Countries can best do this through a consolidated and comprehensive approach to budgeting. At its simplest, governments need to have a single budget process to allocate it properly. Fragmenting this resource allocation – making resource allocation decisions outside the primary single budget process – breaches this core public finance principle for good budgeting. The single budget process ensures that: i) only the fiscal policies with biggest impact or the most important get approved – approving a project outside the budget process means that projects with lower priority might get approved because they were not considered alongside all the other options, nor within the context of the budget deficit targets²; and ii) aggregate fiscal balance targets – and therefore fiscal sustainability – are achieved and properly protected. A single budget process is arguably a pre-condition for achieving fiscal discipline. The key result here is that not

too many projects be approved outside of the single annual budget process. Otherwise, it significantly increases the risk that the government might be spending much more than it should over time, compromising fiscal stability and creating the conditions for aid-dependency.

We believe that development actors can reduce budget fragmentation directly by focusing on four areas:

- **Supporting reform programs** that prioritize budget defragmentation;
- **Protecting the integrity of the single budget** process of recipient governments;
- **Adopting best practice policy-based budgeting methodologies** for donor projects and multi-donor trust funds; and
- **Following best practice Public Investment Management methodologies** for donor projects and multi-donor trust funds.

A. Supporting reform programs that prioritize budget defragmentation.

It's not new that donors should help governments to strengthen their fiduciary systems. However, to take on the problems of budget fragmentation means ensuring reform programs take on some intractable problem areas. These include: i) consolidation of donor projects in government budget and financial statements³; ii) government budget preparation systems to fully include donor projects so that decision makers have the full picture; and iii) ensuring aid financed projects comply with international best practices such as policy based and medium-term budgeting, and public investment management. Such reforms would ideally form mutually agreed conditionalities on the provision and acceptance of aid.

References:

2. "Bad" projects – or projects with low returns on investments - are much easier to get through systems that are designed to exclude bad projects, if they don't get go through those systems in the first place. These bad projects could get approved, for example, through undue influence.
3. Consolidation here means aggregating financial accounts in way that ensures consistency and accuracy. When done well there is no double counting or omissions and there is clear picture of financial and economic stocks and flows, including revenue, expenditures and balance sheet items.

Donors should use international government finance classification standards in their projects to facilitate consolidation. In the presence of separate development and operating budgets⁴, the most important reform is for donor projects to use the same classification system for operating and development budgets, and ideally to the same reported classification level as the accounting system. The classification system used should be compliant with standards such as Government Finance Statistics (GFS), including the Classification of the Functions of Government (COFOG). In addition, reform efforts would need to establish consolidation and elimination rules (that allow the systemic aggregation of revenue, expenditure and financing items in to the consolidated budget. Such rules would also cover consolidation and elimination rules for aggregating sub-national and public corporations accounts in to high levels of government fiscal aggregates including the general government and public sector levels.

There are other priority reforms. These include firstly, the establishment of national public sector standards for classification (e.g. GFS), accounting (e.g. IPSAS), reporting (e.g. GFS and IPSAS) and internal (e.g. ISPIA) and external auditing (e.g. ISSAI and ISA), that are compliant with respective international standards and with any differences to mandatory provisions fully explained and with complete position statements on all non-mandatory standards. Secondly, adoption of best practice planning and reporting of multi-year aid financed projects including national standards for economic evaluations and fiscal impact analysis (multi-year budgeting – see Section C, and public investment management – see Section D). Thirdly, key controls rules put in place such as Treasury Single Account rules for donor projects, “special appropriation⁵”, “carryover” and revenue and financing controls rules for all aid financed projects.

References:

4. Separate development budgets almost exclusively use a different classification system to the operating budget, reporting only at a higher level than that of the corresponding operating budget, which generally report at a min level of salaries, goods and services and capital.
5. These special appropriations are for aid financed projects, where the grant or loan agreement forms the appropriation or the authority to spend. Such agreements do not need to be re-appropriated as an annual appropriation (opening up opportunities for mismanagement and corruption).
6. Meaning that aid which at a minimum is channelled through the recipient country's public sector.
7. The most common fiscal year in the world today is the calendar year, of which 69% (157 countries) of countries use, including Euro countries and a general mix. The next most popular fiscal year at 15% (34 countries) is that used by the UK (1 April - 31 March) and many commonwealth countries. The third most popular at 9% (21 countries) is the start at mid-year version (1 July - 30 June), which is used by a general mix of countries, with Australia being the richest in GDP per-capita terms. The World Bank follows this cycle also for their own corporate activities. The least most popular (excluding unique fiscal years) is that adopted by the US (1 October - 30 September) at 5% (12 countries).

B. Protecting the integrity of the single budget process of recipient governments.

Donors need to ensure resource allocation decisions occur within the context of a country's fiscal year and budget preparation cycle. This can be done in different ways.

First, is to provide the right data on time. This means ensuring that donor approved estimates (of their own aid budgets)⁶ at the ministry and project levels are provided in time for inclusion for Cabinet considerations of the whole budget. This should be done on the basis of a country's fiscal year and with updates provided in time for publication of the final approved budget. A budget call circular could be one way of achieving this. Donors should not wait to be asked to provide this information to recipient governments. They should do this routinely as a matter of good practice to support defragmentation. Best practice would be to ensure that the Cabinet also considers donor project performance yearly and considers whether non-donor financed activities are in accordance with allocative efficiency prerequisites.

Second, donor aid management systems can be set to cover and report on the two most common fiscal years adopted around the world⁷ – the calendar year (1 January - 31 December) and the start at mid-year version (1 July - 30 June). 80% of all countries in the world have either of these as fiscal years, with 69% following calendar year, so it makes sense to adopt calendar year as default. Ideally, these timelines should be set at donor headquarters and integrated into management reporting systems. An interim solution is that additional systems could be operated at the country level until donor headquarter systems become operational.

Thirdly, project and trust fund review timetables be set based on the budget cycle. Donor reviews of projects are often not aligned with the recipient government's budget

cycle. Results often do not feed into the budget preparation process. Poor performing projects often stay operational and on budget, even if the funds are not being spent, while project managers try to fix implementation capacities, allowing valuable resources to lie idle. It is rare that project supervision teams recommend that funds should be reallocated to a completely different purpose (i.e. a different project), as most project team supervision leaders appear keen to keep funds in their sector and/or under their control.

Ensuring the integrity of a single budget process helps make a government more accountable, not less. In aid-heavy environments, having separate resource allocation bodies that separate donor projects from government projects hurts donors and governments. For donors, it leads to separation of donors from government's other and core businesses. For recipient governments, it causes the whole budget process to be weakened. For certain aid-heavy governments, it can be quite attractive to keep things separate for reasons other than efficiency and effectiveness. Moreover, by fragmenting budget processes, it can actually make it easier for corrupt governments to be much more corrupt. A single budget process breaks down key barriers to transparent budgeting – like clear and complete reporting on the budget as a whole – breaking down accountability pathways for citizens to understand what is actually going on with their government.

C. Adopting best practice policy based budgeting methodologies for donor projects and multi-donor trust funds.

Donor projects and trust funds almost never use policy-based budgeting techniques or any of the key features. The creation of rolling forward estimates of existing commitments up to grant/loan closure dates does not often occur with donor projects or trust funds. Standard methodologies for fiscal space creation and filling are almost never used. And linking resources to output and outcome targets set against specific budget components are just as rare. Project level linkages to “results targets” and “log

frames” are routine, but these are set in project management paradigms not budgeting and fiscal accountability paradigms. Distinctions between outputs, intermediate outcomes and outcomes are routinely muddled making it difficult to hold people, and teams accountable. This is the case especially if projects focus on intermediate outcomes and outcomes over outputs. Implementers have complete control over outputs, where there is far less control over outcomes. For example, it is commonplace in PFM reform projects to see changes in PEFA performance indicators (intermediate outcome) in results frameworks, but these are adopted with no clear plan on what actually needs to be done – to be outputted – to achieve the target scores.

Donor projects are multi-year, so budgeting systems should be multi-year. Almost all aid projects are time-bound over a number of years. The authority to spend aid money is said to lapse after a period of time. World Bank grant agreements, for example, expire after a few years – unspent balances at the end of the period need to be handed back. Most aid-heavy country budgets do not reveal how much money of an aid financed project is left to be spent and how much time is left to spend it⁸. This is the most basic system to deal with multi-year projects – often referred to as the obligation system. It is not best or common practice, though it was included in draft International Public Sector Accounting Standards (IPSAS) standard on “disclosure by recipients of external assistance”. Good practice requires estimates of how much aid revenues will flow and expenditures will be made per fiscal year until the end of the grant or loan agreement. Good practice for the number of forward years past the current budget year is in our view three years, as this covers the terms of almost all donor projects. This allows almost complete coverage of all medium-term donor funding agreements in the budget. Donors sometime report on forward year plans, but usually not in a way or at the right time that allows the information to be incorporated in a Government's medium-term budget, if it has one.

References:

8. Though this information is generally collected in donor databases, which are almost never used for budgeting purposes.

Disbursement reporting by donors in a multi-year setting is very weak – they generally look backwards, not forwards. Donors do use disbursement rates that look backwards, where disbursements as a percentage of the total grant/loan proceeds is reported, but they almost never report on disbursements rate improvements required to complete the project on time with zero balance. This indicator reveals how slow a project is going. The usual disbursement rate indicator is very misleading in multi-year grant/loan agreement settings. A 20% disbursement rate says very little until you combine it with time information. If \$1 million has been disbursed over four years from a \$5 million grant, which lapses after five years, then the average annual disbursement rate is 5% and the required improvement in disbursement performance is 16 times the current rate⁹. Disbursement rate indicators that look forward such as this one make it very clear very quickly if a project is going slow and can be used to predict if the project will be extended, or preferably, be a leading indicator that there is fiscal space emerging in current aid allocations. Donor project extensions are commonplace – not because they successful, but because the projects have significant levels of unspent funds, indicating poor management of multi-year funds.

D. Following best practice Public Investment Management methodologies for donor projects and multi-donor trust funds.

Best practice here is well documented in PEFA 2016. For donor projects and multi-donor trust funds this means that they need to **follow national guidelines** on: i) **economic evaluations**, including established methods for cost-benefit analysis (CBA), and cost-effectiveness analysis (CEA); ii) **full fiscal impact analysis** (covering project lifecycles and future and ongoing recurrent cost requirements); iii) **standardized criteria for project prioritization** and selection; and iv) **project implementation monitoring** covering costs, progress against contractual milestones, project plan deviations; and earmarked funding balances (such as uncommitted balances against a multi-year lapsing grant).

References:

9. $16 = 80/5$: 80% of the grant has to spent in 1 year to complete on time with zero balance / 5% was that average annual disbursement rate

10. Coordination comments are the impartial advice from all ministries with an interest in the policy or project. It is usually provided to a cabinet within budget preparation context. They should form part of a final budget submission or project proposal.

National prioritization systems and other rules need to be supported. The prioritization of all the projects proposed in single budget cycle year needs to be conducted by a single central authority, rather than split between various authorities (see also section C on protecting the integrity of the single budget process). Donors or Governments do not necessarily have to comply with prioritization outcomes, though they do need to explain the reasons for deviation. A crucial element of the prioritization process that should be included in national guidelines is that economic evaluations and costings should be independently verified as accurate, with costings to represent the minimum cost to meet the proposed policy and project objectives. Timelines for provision of costings prior to consideration by central authority would be included in such guidelines, along with requirement for coordination comment¹⁰ from other stakeholders. This means, for example, that a donor should not be validating the costings and evaluations produced by the donor.

ACCOUNTING, CLASSIFICATION, AND CONTROL FRAGMENTATION

At the donor headquarter level, policies, procedures and systems need to be developed to support defragmentation efforts. Adopting international standards for the classification, accounting, and reporting of government revenue, expenditure, assets, and liabilities would be a very good start.

Donors need to supplement donor classification systems with government finance classification systems for explaining planned aid-financed expenditures and actual aid-related spending, not just commitments and disbursements. Donors do not use international standards for classifying budget expenditures of aid financed projects by recipient governments, nor do they report on actual spending in the same way. If donors reported plans and actual results in GFS, not only would it make it very simple to consolidate donor-related aid operations in both budget and financial statements, it would also make it clear what aid money is actually buying.

Donors still do not use the standard GFS economic classification system for reporting on aid flow commitments, aid flow disbursements, expenditure budgets and actual spending. Nor do they use the international standards for classification of the functions of government (similar to sectoral classifications). Generally, donors report and manage at the activity level (e.g. teacher training) or aid purpose level (similar to sectoral classification). Consequently, these donor reports do not report on budgets and costs of actual inputs like remuneration of personnel, allowances, travel, utilities, stationary, vehicles, computers and buildings. Budgeting for inputs is the most basic of budgeting concepts and crucial to managing corruption. In our view, budgeting against activities and outputs should only be in addition to decent input budgets, not replace them. Such an approach is highly opaque and increases fiduciary and development risks.

Donors' annual reporting is too opaque on inputs, outputs, and government function. The World Bank's Annual Report, for example, does not explain what aid resources have been spent on things like salaries and remunerations, travel, utilities, cars, computers and buildings, nor how much of its money has gone or will go to different functions of government in a country¹¹, let alone what part of the country the money went and was spent in. This does not constitute transparent annual reporting. By not following the international standard for classifying budgets and accounts by function means that it becomes very difficult to know how much is being spent on, and the composition of spending in, specific sectors over time and point in time. This also makes it difficult to make useful international comparisons. Mapping rules (or bridging tables) from existing donor classifications (such as those set by the World Bank and the OECD-DAC CRS) to international government finance classification standards is an interim solution. This, however, has many disadvantages, not least that there are major differences between disbursements and expenditures. Disbursements generally only means money has been transferred

somewhere; it does not necessarily mean that the money has actually been spent on something. This is an example of differences in timing as well as classification.

The best and most accurate solution is to budget and account at the correct classification levels in the first place. This would mean donor headquarter systems would need to be strengthened, though interim solutions could be covered by separate country level systems.

Donors could set high disclosure standards for their accounting and reporting standards. While debate on cash versus accrual accounting, and if and how a developing country should transition to accrual accounting are important issues, what is more important is that if donors do adopt international government finance classification standards, they must also be very clear on the accounting and reporting standards used. In particular, donors need to disclose where accounting and reporting standards both comply and diverge from mandatory and non-mandatory international standards and guidance. Simple statements of "compliance" or "based on" should not be accepted without such disclosures on divergence.

On the issue of cash versus accrual, there are two important points to make on coverage and comparability for accountability. Firstly, most countries use a form of cash accounting. While 75% of OECD countries now adopt a form of accrual accounting¹², 83% of 109 countries assessed for accounting approaches followed cash or modified cash for budgets or end-of-year financial statements. Secondly, comparability of budgets and accounts is crucial in delivering deep accountability as it enables lay-citizens to scrutinize government promises with performance on actual results. The easier it is for citizens to do this the easier it is to keep the government accountable for its performance against its promises. A clear read between budget statements and end-of-year financial statements is absolutely crucial for this to be achieved. A clear read means it must include the use of same table formats in budget papers as the financial

References:

11. Currently, The World Bank Annual Report and Financial Statements report using the World Bank's own unique sector classification system and a "global practices" classification, which is an organisational classification system. Both can be considered a quasi-government functional but are not consistent with GFS-COFOG complicating consolidation for developing countries.
12. See 2017 OECD report on Accrual Accounting Practices at: <http://html5.dcatalog.com/?docid=69f45ab3-469b-474b-84bf-a72b00f63fb5#page=1> In 2013, 59% of OECD countries had adopted accruals (see 2014 PWC report at <http://www.pwc.com/gx/en/psrc/publications/assets/pwc-global-ipsas-survey-government-accounting-and-reporting-pdf.pdf>).

statements. With this in mind, it infers that whatever the accounting standards adopted, budget statements should follow the same standard, including the reporting formats.

IPSAS 24 on Presentation of Budget Information in Financial Statements delivers a reasonable work around

to the situation when budgets are prepared on a different accounting and/or classification basis to IPSAS. This is set to allow for differences in legal requirements for budgets being different to legal requirements for reporting final outcomes. Ideally, budgets should always be prepared on the same basis as the audited financial statements to deliver proper comparability, deeper accountability and stronger confidence in government reporting.

The weaknesses with the standard are that: i) it does not require the “easy read” criteria such as same table formats and ii) the reconciliation requirements of accrual information in accounting systems for cash based budget appropriations can be difficult to do and to audit for accuracy. Still, the standard is good enough. The problem, however, is that many countries do not comply with this standard nor deliver the level of comparability to make it very easy for citizens to scrutinize performance against promises by examination of budgets and audited financial statements. It is quite common in low and middle-income countries to have budget statements and the end-of-year financial statements using different classification, accounting, or reporting standards.

Donors can help get an IPSAS standard for disclosure of external assistance by aid recipients. The draft but stalled IPSAS Disclosure Requirements for Recipients of External Assistance (2006) provides reasonable guidance on what aid recipients should be publishing in their financial statements. One of the major problems with the draft standard, and hence its lack of progress, is that the information requirements are too onerous given the level of information recipients have on external assistance¹³.

References:

13. See project status report on Cash Basis IPSAS- Disclosure by Recipients of External Assistance at IPSAS <https://www.ipsasb.org/projects/cash-basis-ipsas-disclosure-recipients-external-assistance>

14. See Cash Basis IPSAS Issued January 2003 Updated 2006: Financial Reporting Under the Cash Basis of Accounting:

In the meantime, the pursuit of compliance with IPSAS Cash Standard¹⁴ under the area of payments by third parties would still deliver significant progress in defragmenting systems by improving consolidation, increasing transparency and strengthening accountability. The existing standard already requires that the classification system of donor controlled projects to be the same as governments and specifically cover economic and function classifications, neither of which are currently routine for donors.

New accounting, classification, and reporting standards for donors would help aid recipients enormously.

A voluntary standard like that of IPSAS 24, but targeting what donors should be doing, would help aid recipient countries defragment their systems. The standard would make it clear how donors should report on actual use of aid resources by recipients. As noted above, the OECD-DAC CRS system is woefully inappropriate for this purpose. It is a donor classification system, not a government finance classification system. The new standard would draw on GFS and IPSAS standards to make it clear how donors, including multilateral institutions, should be reporting on the aid and resultant expenditure flows to recipient governments. Compliance with such a standard would help deliver the information that would make it easy for aid recipient countries to comply with the existing IPSAS standard on third party payments, as well the draft standard on disclosure of external assistance.

Internal control systems should also be harmonized with best practices and international standards. Recent internal reviews of multi-donor projects found many instances of poor internal control practices that contributed to fragmentation and increases in fiduciary risks. These practices were set up by the supervising donors. A dozen of the key control weaknesses identified are presented here:

1. **A stand-alone Excel-based financial management system** was used with limited audit trail for transactions. No other accounting system components were used

including commitment and procurement, payroll, electronic payments, check cutting, e-procurement, supply verification, other contract management functions, and reporting (web and report writers). Ad-hoc systems outside normal reconciliation and auditing systems were used for electronic payments;

2. **Different Chart of Accounts** were adopted with different classifications for economic, administrative, and program, and no classification system was adopted for function or location.
3. **Commercial bank accounts** were used outside the direct Treasury Single Account (TSA) with different arrangements (including poor disclosure systems) for exchange of foreign currencies. Proper sub-accounts under a direct TSA were not established nor planned to be established;
4. **Financial controls were not in place, weak, or different**, including around processes and monitoring, such as **bank reconciliation, arrears tracking** (outstanding payments on invoices received for services rendered – not one age-based arrears report was ever produced because the systems did not capture the information to produce one), and **suspense account clearance** (e.g. clearing petty cash holding accounts once the use of petty cash and type of expenditure made is confirmed);
5. **An obligation-based system of approval and spending control was used** as opposed to the governments annual lapsing cash-based system of control, and clear special appropriation rules for multi-year aid operations were not specified or adopted;
6. **Simple or extensive commitment controls were not used** – for example, purchase order requisition systems were not adopted.
7. **Separation of duties** rules in budget execution process was rudimentary allowing collusion within small teams.
8. **Establishment control systems** were not used for the management of national consultants, with no report ever produced on the number and cost of consultants being produced.

9. **Other standard budget and planning processes were not used**, with trust fund budget and planning effectively set through the ad-hoc procurement plan revision process and approval processes and an annual reporting process that was different to the budget cycle;

10. **Standard in-year financial performance reports were not used**;

11. **The donor's remuneration framework controls were used** as a guide for selection of consultants – in the absence of a Government remuneration framework for consultant services (which was subsequently established);

12. **The donor's rules on procurement were simply added as an addendum to the country's procurement law** for the donor finance projects.

The donor claimed that this was sufficient for the donor to report that it was using country systems for procurement.

Donors should avoid these bad practices as a matter of policy for both their government and donor executed aid project operations. What this means in practice is that donor should do something different:

1. **Use a good quality accounting system – either the Government's accounting system, a quality accounting system in-country for all donor projects;** or a donor headquarters managed system that is usable in-country;
2. **Use the same Chart of Accounts** or a classification system that is consistent with the GFS.
3. **Use sub-accounts under the recipient Government's own Treasury Single Account (TSA)** and have clear systems for the exchange of foreign currencies;
4. **Ensure routine reporting of bank reconciliation, arrears tracking (by age) suspense account clearance** – ideally in a way that can be consolidated at the administrative unit level;
5. **Ensure special appropriation regulations** are supported in recipient countries that make it clear how to budget, account and report on aid operations – including being consistent with IPSAS third party payer standards;

6. **Adopt commitment controls** including purchase order requisition systems;
7. **Strengthen separation of duties rules** in budget execution process, including to cover wider scope of personnel;
8. **Develop and use establishment control systems** for management and reporting of national and international consultancies;
9. **Ensure budgets drive procurement plans**, not the other way around;
10. **Ensure accounting system produces at least the same standard in-year financial performance reports** as the government;
11. **Support adoption of a donor-government agreed remuneration framework** based on principles of parity, efficiency and effectiveness);
12. **Do not add the donor's own procurement rules to the country's procurement law and claim that the donor is then using country systems.** Instead, help fix laws to meet international standards, and be clear when the donor is satisfied with the law that it can then allow procurement to follow the national law.

FRAGMENTATION IN SCRUTINY THROUGH AUDITING

Donors could make much better use of country auditing systems for their own interests. This need not fragment an aid recipient's auditing system either. External and internal audit principles often get confused, yet are distinct. External audits of donor projects/operations rarely get published. External auditing of a project is often done in isolation and at separate times, opening gaps in coverage and capacities to detect various forms of fraud such as double counting expenditures in different projects. Internal audit functions are often done in non-conformity to international standards for internal auditing.

Donors can help themselves and country systems by:

- **Separating external audit and internal audits** – and being clear on the principles that differentiate them, with external auditing focusing on confirming the reliability of financial statements produced, and internal audit focusing on being an early warning systems for management focusing on a continuous improvement of business processes;
- **Ensure internal audits of donor projects comply with international standards for internal auditing.** Simple provisions like adopting an internal audit charter, approval of annual internal audit plans, and audit committee membership rules would make a big difference.
- **Adopt the single external audit principle** and support consolidated auditing by the single auditor. Allow and promote cross project and cross fund audit coverage.
- **Publish all external audits on reliability of financial statements** produced for project/projects and multi-donor trust fund operations.

A standard for auditing of external assistance provided to and received by recipient governments would be helpful.

Currently, auditing against current cash IPSAS on third party payers is possible, though it is not required if the country had not adopted IPSAS. SSAI 5520 does provides guidance and good practice for SAIs on the audit of disaster-related aid, but there is no similar provision for how best to audit different types of donor projects and trust funds. It is treated just like any other accounting entity, rather a special case that causes massive fragmentation problems if not managed well. Further work can be pursued with INTOSAI on exploring options for a new International Standards for Supreme Audit Institutions (ISSA) on auditing of external assistance provided to and received by recipient governments.

FUTURE DIRECTIONS

The Paris Declaration and the Accra Agenda for Action have outlined a helpful and almost universally accepted agenda for donors. The declaration and the agenda cover many areas including statements about first option use of country fiduciary and procurement systems, registering aid in recipient government budgets, making aid flows more predictable and supporting, coordinating and harmonising systems across donors, and the need to support public financial management reform programs.

What is somewhat unclear is the criteria and conditions that would actually trigger the first use of country fiduciary and procurement systems and the extent of that use in terms of proportion of aid going through the different systems (properly). This has been well debated and the current donor consensus is that since donor preferences (i.e. political and legislative conditions at home and in recipient countries) are so diverse, it is not yet possible to set any general guidance on what conditions should trigger greater use of country systems and budget support type aid arrangements. Consequently, different donors have quite different conditions for different types of budget support at various levels of detail. Nevertheless, we believe that there is still more work that could be done to see if donors could harmonize their systems further in this area. In particular,

much work is needed in the area of delivering credible conditionality in support of using governing systems to improve governing systems. This is a big and important area where we feel that donors and governments could improve, including by focusing on mutual accountability and in particular, performance against promises.

What appears to be most unclear, is what donors could be doing to reverse the fragmentation. Or in other words, what donors can do to help countries overcome the current problems of country systems, given this was in part created by donors behaviour over the last century. The ISE Development Practice Note on Donor-Induced Fragmentation explained these problems in key areas of budget fragmentation, accounting and classification fragmentation, and fragmentation of systems for scrutiny through audit. This note presents several concrete options of how donors could make their work more transparent, more cost-effective, and more accountable. It would also assist country recipients to develop robust fiduciary systems. It is recognized that many of the options presented are indeed difficult and would go against practices and systems that have been in place for decades. That said, if donors are serious about aid effectiveness and getting a much bigger bang from the aid buck, a serious effort to deal with the problems of aid-related fragmentation is needed.