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Report to Congressional Committees

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WORLD BANK

Management Controls Stronger, but Challenges in Fighting Corruption Remain

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Contents

Abbreviations

COSO	Committee of Sponsoring Organizations of the Treadway Commission

United States General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

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The Honorable Mitch McConnell
Chairman
The Honorable Patrick Leahy
Ranking Minority Member
Subcommittee on Foreign Operations
Committee on Appropriations
United States Senate

The Honorable Sonny Callahan
Chairman
The Honorable Nancy Pelosi
Ranking Minority Member
Subcommittee on Foreign Operations, Export Financing
and Related Programs
Committee on Appropriations
House of Representatives

The World Bank[1] lends billions of dollars each year to help countries alleviate poverty and promote economic and social progress. The Bank provides loans that support specific projects as well as loans that support broader economic and social reform. In addition to making loans, the Bank provides advice and technical assistance to borrowing countries. The World Bank currently manages a portfolio of approximately 1,500 projects valued at about $121 billion.[2]

The Bank operates in a difficult and challenging environment in countries where transparency (openness) and accountability are often lacking, and corruption—broadly defined as the abuse of public office for private gain—

[1]The "World Bank" and "Bank" refer to the World Bank Group of institutions. The World Bank Group is made up of the original "World Bank"—the International Bank for Reconstruction and Development—as well as the International Development Association, the International Finance Corporation, the Multilateral Investment Guarantee Agency, and the International Center for the Settlement of Investment Disputes. Our review focused on the lending operations of the International Bank for Reconstruction and Development and the International Development Association.

[2]Project lending totaled about $13.6 billion, about 47 percent, of the Bank's total lending commitments for fiscal year 1999.

sometimes flourishes. The Bank must satisfy its dual mandate of providing development assistance in these environments and exercising its fiduciary responsibility, including ensuring that corruption is minimized in the projects it finances.

In 1996, the President of the Bank elevated the discussion of corruption by identifying it as a significant deterrent to development and made a pledge to address it more directly with its borrowers. Following the President's announcement, the World Bank adopted an anticorruption strategy in 1997 and introduced an anticorruption action plan in January 1999.[3] (See app. I for a chronology of Bank anticorruption efforts and app. II for a detailed description of this plan.)

One of the Bank's major goals was to create an operating system that would help ensure that funds are used as intended and spent in accordance with good management practices. The Bank's anticorruption strategy is aimed at improving its systems of management controls, particularly in the areas of procurement and financial management, and ensuring that it is consistent with the standards of effective management control. These standards were defined by the Committee of Sponsoring Organizations of the Treadway Commission and were adopted by the Bank in 1995.[4]

The Congress has directed GAO to review the Bank's progress in strengthening measures to prevent corruption.[5] In conducting our work, our objective was to determine whether the outcomes from the Bank's management initiatives would collectively provide reasonable assurances that project funds are spent as intended. To do this, we focused on examining the progress the Bank has made in meeting the five standards

[3]The action plan was the result of a number of initiatives flowing from various units within the Bank. Several items, such as a major financial management improvement initiative, were already underway at the time the action plan was announced. The relative significance of steps in the action plan varies as does their ease of implementation. (See app. II.)

[4]The National Commission on Fraudulent Financial Reporting, known as the "Treadway Commission," was created in 1985 by the joint sponsorship of the American Institute of Certified Public Accountants, the American Accounting Association, the Institute of Internal Auditors, the Institute of Management Accountants, and the Financial Executives Institute.

[5]Public Law 105-277, 112 Stat. 2681-167 (Oct. 21, 1998). The Congress also mandated that we review the Bank's personnel procedures, especially regarding the protection of individuals who have alleged that mismanagement, fraud, and abuse of Bank funds have occurred. For our assessment of Bank personnel practices, see *World Bank: Status of Grievance Process Reform* (GAO/NSIAD-99-66, May 13, 1999).

for effective management control. These standards deal with (1) organizational structures, managerial capacity, and systems necessary to establish a sound management control environment; (2) risk assessment; (3) policies and procedures for ensuring that management directives are carried out; (4) monitoring progress in achieving desired outcomes; and (5) dissemination and communication of information.

We did not make a complete assessment of the Bank's management control system but focused on Bank efforts to improve controls that the Bank had identified as weak. We limited our scope to reviewing Bank controls over project lending, which cover about one-half of the Bank's operations. To gain a first-hand view of how these controls are implemented in the field, we also visited four countries that are large Bank borrowers. As agreed with the Bank, we did not name these countries in this report or identify the Bank-financed projects we reviewed.[6] Appendix VI contains a more detailed description of our scope and methodology.

Results in Brief

In its efforts to address corruption concerns, the Bank has undertaken an ambitious and systematic effort to identify and correct key weaknesses in its system of management controls. The Bank has made significant progress in meeting each of the five standards of an effective management control system. However, challenges remain and further action will be required before the Bank can provide reasonable assurance that project funds are spent according to the Bank's guidelines. Surmounting some of these challenges—particularly in building borrower managerial capacity for implementing Bank projects—will be onerous and will require a long-term effort because problems of corruption and weak management are often endemic to the economic development environment in which the Bank operates.

Summarized below is the status of the Bank efforts in meeting each of the five standards of an effective management control system.

- *Organizational structure, managerial capacity, and systems.* We focused on Bank efforts to improve internal oversight mechanisms, project management, and public institutions in borrowing countries. The Bank

[6] We reviewed 12 randomly selected projects for 12 different countries approved between November 1, 1998, and July 1, 1999, and a judgmental sample of 6 ongoing projects approved prior to November 1998.

has added new oversight committees and staff to better monitor Bank operations and borrower procurement and financial management practices. For example, the Bank has established a new fraud and corruption hotline and hired about 90 new procurement and financial management specialists. However, many of the public agencies in borrowing countries charged with implementing Bank-financed projects are managerially weak and lack skilled and experienced staff. A series of recent Bank studies show that borrowers often have difficulty complying with Bank procurement rules. Significant institutional capacity building will be necessary to ensure that borrowers can carry out their management control responsibilities effectively.

- *Risk assessment.* The Bank has focused more attention on better assessing the risks associated with corruption and weak managerial capacity of its borrowers. However, the risks identified are not always raised to the attention of senior decisionmakers and fully addressed in risk mitigation plans. Moreover, the Bank does not have a system for allocating its anticorruption assistance among borrower countries based on risk.
- *Policies and procedures for ensuring management directives are carried out.* The Bank has strengthened controls by devoting more attention and resources to supervising its projects more closely. This has included, for example, hiring or training local Bank staff or contracting with consultants to review borrower procurement actions more closely. However, the Bank and some borrowers do not always comply with Bank procedures on project auditing and Bank supervision of borrowers' procurement and financial management practices.
- *Monitoring.* The Bank has introduced some new tools for monitoring and evaluating the implementation of Bank projects. However, these tools do not provide enough information for Bank management to measure the extent to which some key management control problems are being resolved. For example, Bank studies on the quality of Bank supervision do not fully address key performance problems reported by external and internal auditors.
- *Information and communication.* The Bank has significantly improved its dissemination and communication of information on its anticorruption efforts, both within the Bank and in borrowing countries. However, some borrower governments and nongovernmental organizations are still not aware of the Bank's hotline and other mechanisms for reporting fraud and corruption.

The Bank is aware of many of these challenges and continues to take actions to address them but does not publicly report progress in implementing these management control improvements. This report contains recommendations to improve the Bank's internal oversight mechanisms and risk assessment process, and to assure that the Bank monitors and reports on progress in correcting weaknesses in project management. We also recommend that the Department of the Treasury annually report to the Congress on the results of efforts to strengthen the Bank's management control system.

In commenting on this report, the Bank noted that it holds itself to a high control standard and that it had already identified many of the weaknesses we cited through its own self-evaluations and has remedial actions underway. Treasury and the Bank agreed with our findings and recommendations and said that a more aggressive approach is needed in strengthening the Bank's management control systems over project lending and building borrowers' institutional capacity to fight corruption.

Background

Concerns about corruption have intensified in recent years as there is a growing realization among international financial donors, including the World Bank, that corruption may undermine development by deterring investment and growth and exacerbating poverty. Although no Bank-wide estimates of the magnitude of this problem have been developed, levels of corruption vary from country to country. World Bank staff estimated that in one large borrowing country, about 20 to 30 percent of all development funds, totaling several billion dollars each year, had been systematically diverted.

The Bank requires borrowers to establish and maintain effective management controls over project funds and to implement projects. For example, borrowing agencies are required to produce a variety of financial and progress reports and to arrange for regular, independent project audits. For its part, the Bank exercises oversight of project implementation through a variety of control activities, including review of financial statements and audit reports, prior review of many procurement actions, and review of the eligibility of many project expenditures.

The Bank and borrowers use the following process to develop and implement projects. (App. V describes the Bank's management control activities in more detail.)

- *Project identification and preparation.* Project development begins when Bank staff and borrowers identify a project idea. During the

subsequent preparation phase, borrowers bear the primary responsibility for examining all aspects of the proposed project and for preparing a project plan for Bank consideration.
- *Project appraisal and negotiation.* After preparation is complete, Bank staff appraise sponsor proposals (including the arrangements for procurement and financial management). Bank staff negotiate with project sponsors the terms and conditions under which the Bank will commit funds to the project and, finally, prepare a project appraisal document. This document is supposed to contain all of the information the Bank management and the Executive Board need to decide whether or not Bank financing should be provided.
- *Board approval.* The Bank's Executive Board decides whether to approve each proposed project and, in doing so, exercises oversight over the implementation of Bank policies and procedures—including those that govern procurement and financial management.
- *Project implementation.* The responsibility for project implementation rests with the borrowers, who must conform to Bank policies and procedures and other conditions outlined in the loan agreement. The Bank monitors and supervises project implementation, including project procurement and financial management, on a continuing basis until project completion and disburses funds contingent upon the borrower providing required documentation. Projects are subject to an annual independent audit arranged by the borrowers. These audits are to include an assessment of the adequacy of the accounting and internal control systems.

The 181 member countries of the World Bank govern it through an Executive Board—the Bank's primary oversight and decision-making body. Twenty-four Executive Directors from Bank member countries comprise the Executive Board. This Board considers and decides on overall policy issues that guide the Bank's general operations and approves specific project proposals presented by the President of the Bank. The United States is the largest contributing member to the World Bank and thus holds the greatest number of voting shares (16.5 percent) on the Bank's Executive Board (voting shares are allocated on the basis of member contributions). Other members holding the largest number of voting shares are Japan (7.9 percent), Germany (4.5 percent), France, and the United Kingdom (4.3 percent each).[7] The Secretary of the Treasury, who

[7]These voting shares apply to projects financed through the Bank's market-based lending.

represents the United States as a governor of the World Bank, has the lead role within the executive branch regarding U.S. policy toward the Bank.

In line with the best practices of major financial institutions in the United States, the Bank in 1995 adopted the management control standards of the Committee of Sponsoring Organizations of the Treadway Commission (COSO). This control framework, known as the "Internal Control – Integrated Framework," establishes a common definition of management controls for all Bank units and provides a standard to assess improvements in these controls. We refer to the components of this framework as the "COSO standards" in this report. (See app. III for a more complete discussion of these standards).

The Treadway Commission identified the following five standards that constitute the criteria against which a management control system is to be evaluated. All five standards must be met for controls to be judged effective in any particular area of an organization's operations, thus providing reasonable assurance that funds are spent as intended.[8]

1. *Control environment* – An organization should establish a positive control environment, that is, one with a structure, discipline, and climate conducive to sound management controls. Factors that significantly affect the control environment include the integrity and ethical values of management and staff, the competence of personnel, the way the agency is organized, the manner in which management assigns authority and responsibility, and the attention and direction provided by oversight groups.

2. *Risk assessment* – An organization should properly identify, analyze, and manage the possible risks involved in meeting organizational objectives.

3. *Control activities* – An organization should establish control activities consisting of policies, procedures, techniques, and mechanisms that ensure that management directives are being carried out to meet

[8]It is recognized that no matter how well designed and implemented, management controls cannot provide absolute assurance that program funds will be used as intended. For example, human mistakes, judgment errors, and acts of collusion to circumvent controls can limit their effectiveness.

organization objectives. They include approvals, authorizations, verifications, and reviews of operating performance.

4. *Monitoring* – An organization should continually monitor and evaluate all aspects of internal control to assess the quality of performance over time. Serious management control deficiencies should be reported to higher levels, including top management and the Board of Directors.

5. *Information and communication* – An organization should identify, capture, and communicate information in a form and time frame that enable people to carry out their responsibilities.

In 1999, Bank management used these standards in assessing the effectiveness of internal controls over financial reporting but has not used these standards to determine the adequacy of management controls over the Bank's project lending operations. The Bank concluded that management controls over financial reporting at the International Bank for Reconstruction and Development and the International Development Association funds met COSO standards. The Bank's external auditor concurred with this statement.[9]

Control Environment Has Improved at the Bank but Is Weak Among Borrowers

According to COSO standards, establishing an effective management control environment requires well-managed and properly structured organizations with qualified personnel in place to implement proper management controls and address corruption. We assessed the control environment in terms of the Bank's internal oversight mechanisms, project management, and Bank efforts to improve public institutions in borrowing member countries.

While the Bank has made significant progress in strengthening its control environment by creating new oversight structures and increasing staff with expertise in financial management and procurement, many borrowers still have weak structures and limited managerial capacity, according to Bank records and officials. Consequently, the Bank has increasingly targeted its anticorruption efforts on building borrowers' institutional capacity to fight corruption.

[9]On July 21, 1999, the Bank reported that its external auditor, Deloitte Touche Tohmatsu, agreed with this conclusion.

Bank Internal Oversight Mechanisms Have Been Strengthened but Need Further Improvements

Internal oversight is key for preventing, detecting, and addressing corruption. Although the Bank has long had an internal audit function and a system of management controls, the Bank recognized that its internal oversight mechanisms were weak, according to several officials we spoke to. These officials indicated that the Bank lacked a central focal point for reporting and reviewing allegations of wrongdoing and sufficient expertise to investigate allegations of wrongdoing. In addition, while the Bank expected its staff to exhibit strong ethical behavior, the Bank did not have a strong ethics awareness program. The Bank's external auditor reported in 1998 that the Bank's internal audit department—a key management oversight unit—had a fairly restricted scope of audit coverage and played a limited role within the Bank. For example, about 78 percent of the 206 internal audit reports conducted from fiscal years 1995 through 1997 were focused on administrative compliance issues, such as country mission office procedures, rather than on determining whether project funds were being used as intended.

While the Bank has made progress in strengthening internal oversight units, it still faces challenges in ensuring that all fraud and corruption allegations are centrally reported and effectively addressed.

Progress

In 1998, the Bank established a 24-hour worldwide fraud and corruption hotline, created a new Oversight Committee on Fraud and Corruption for reviewing and monitoring allegations, formed an Investigations Unit comprised of professional fraud investigators, hired new investigative staff, and established a high-level Sanctions Committee to review results of investigations and to make recommendations to the World Bank President on whether certain contractors or individuals should be declared ineligible for Bank-financed contracts. In addition, the Bank strengthened its ethics outreach program and increased staff expertise to investigate allegations of employee misconduct. As of March 2000, the hotline had received 156 calls since its inception in October 1998. Ninety allegations resulting from these calls were referred for investigation to the Oversight Committee on Fraud and Corruption.[10] Of the 90 allegations, 47 were investigated and found to have been either unsubstantiated or did not involve Bank funds. Two other allegations have been fully investigated and closed while 41 are still being investigated.

[10]Sixty-six calls did not result in an investigation.

In addition, the Bank's internal auditor had increased the proportion of operational audits targeting management controls, procurement, and financial management issues (in relation to administrative compliance audits) in fiscal years 1998-99 to 28 percent versus 22 percent in fiscal years 1995-97. The internal audit department's annual workplan calls for about the same level of coverage of operational audits in fiscal year 2000.

Challenges

The Bank's initiatives to detect, prevent, and investigate fraud and corruption are positive steps; however, the Bank recognizes that further steps are needed to build on the progress made to date.

- First, not all fraud and corruption allegations have been centrally reported to the Oversight Committee on Fraud and Corruption. During our June 1999 visit to one country where the Bank identified corruption to be a serious issue, we found that over 30 allegations of wrongdoing that were reported locally to Bank officials had not been reported to the committee. However, according to Bank officials, the country mission was dealing with these allegations locally and forwarded them to the Oversight Committee on Fraud and Corruption after our visit and followed up appropriately. In November 1999, the Bank issued additional guidelines to help ensure that all field office allegations are reported centrally; however, more time will be needed to assess whether this new guidance is being fully implemented.
- Second, the new oversight units responsible for reviewing, monitoring, and investigating allegations—the Oversight Committee on Fraud and Corruption and the Investigations Unit—are not organizationally independent of the Bank's line management (see app. IV). The Oversight Committee on Fraud and Corruption reports directly to one of the Bank's managing directors. The Investigations Unit also reports to the Oversight Committee on Fraud and Corruption's secretariat. The independence of the investigative function could be affected by the fact that a managing director controls the budget of the Oversight Committee on Fraud and Corruption and Investigations Unit and also makes the final decision on whether an investigation is pursued, including those that may involve employees that report to this director. A January 2000 study by a Bank consultant confirmed our observation noting that the Investigation Unit did not have the necessary stature or independence. This study recommended that this unit report directly to the Bank President and be given the authority to independently investigative all matters involving fraudulent and corrupt practices.
- In addition, one member of the Oversight Committee on Fraud and Corruption also serves on the Sanctions Committee. Thus, a person who

helps decide what investigations should be undertaken also decides what sanctions should be imposed if improprieties are found. Bank managers we interviewed said that this arrangement might create a perception that impairment to independence may exist, regardless of whether it actually affects how investigative duties are carried out. In October 1999, the Bank contracted with a consultant to examine these organizational issues in more detail and propose alternatives to the present organizational arrangement.

- Third, we noted that the Bank's investigation function is fragmented between two units—the Investigations Unit and the Office of Professional Ethics. Each unit currently has its own investigative guidelines; case management system; a hotline and helpline, respectively; and investigative staff. According to Bank officials, this fragmentation has resulted in some confusion over the appropriate duties and responsibilities of these structures and some gaps in investigative coverage, hampering Bank efforts to promptly identify and investigate all allegations of potential wrongdoing. To resolve these problems, the heads of these units plan to work together toward standardizing the procedures and building internal capacity to operate a joint hotline and conduct investigations. In December 1999, the Bank hired another consultant to examine the operations of the Investigations Unit.

Bank Is Improving its Project Management Capabilities, but Some Borrowers Lack Experience and Skilled Staff

A strong control environment within the Bank and borrowing country institutions is critical for effectively implementing the Bank's system of project management controls. For many years, the Bank has had policies and procedures in place aimed at ensuring that project financial management and procurement are sound and that funds are used as intended. Responsibility for ensuring compliance with these policies and procedures is shared by the borrowers, which execute the projects, and the Bank, which supervises the borrower through a variety of approvals and reviews of borrowers' actions.

In recent years, the Bank has recognized that the control environment for its projects had deficiencies. Bank reports and studies issued in 1997 and 1998 indicated that in many cases, both the Bank and its borrowers had insufficient managerial capacity to ensure effective safeguards against the misuse of project funds.[11] In particular, the Bank identified deficiencies in financial accounting, reporting, and auditing in many projects. Furthermore, the Bank did not devote adequate attention to reviewing the borrowers' procurement actions. An underlying cause of this problem was that the Bank did not have an adequate number of skilled staff to ensure that borrowers were complying with financial management and procurement policies and procedures, which were designed to minimize opportunities for corruption.

The Bank has made progress in strengthening its project management capabilities but still faces major challenges in building this capacity among borrower agencies responsible for implementing Bank-financed projects.

Progress

The Bank has undertaken initiatives to enhance the control environment for Bank projects, both within the Bank and among borrowers. In fiscal year 1998, the Bank launched a major effort to hire and train more Bank staff qualified to deal with the financial management and procurement aspects of project management. As a result, the Bank increased the number of qualified financial management staff by about 159 percent (from 34 in fiscal year 1998 to 88 in fiscal year 1999) and the number of qualified procurement specialists by about 78 percent (from 46 in 1997 to 82 in 1999).[12] A financial management specialist and a procurement specialist are now to be assigned to every Bank project, both new and ongoing. Furthermore, the Bank has assigned many of these new staff members to its country missions,[13] where they can be more closely involved in implementing projects and strengthening management controls.

In addition, the Bank has undertaken initiatives to build the financial management and procurement capacity of those agencies in borrowing

[11]For example, see *The World Bank Procurement Function – Adjusting to Emerging Needs* (Washington D.C.: World Bank, Apr. 1998), and *Loan Administration Change Initiative (LACI) – Implementation Strategy Paper* (Washington D.C.: World Bank, June 29, 1998).

[12]Figures for financial management specialists and procurement specialists are as of August 1999 and June 1999, respectively.

[13]The Bank had 87 country missions as of the end of fiscal year 1999.

countries that are responsible for implementing projects. One major initiative introduced in July 1998 is aimed at ensuring that all new projects meet minimum requirements for financial management, including having adequate staffing, internal controls, and auditing arrangements.

Similarly, the Bank has focused on improving borrowers' compliance with Bank procurement rules. These efforts involve assessing implementing agencies' capacity to manage new projects and devising action plans to remedy any significant gaps either before the project begins or during the course of the project.

Challenges

Despite these initiatives, the Bank recognizes that it still faces a major challenge in ensuring strong financial management and procurement capacity among its borrowers as the institutional capacity-building required may be difficult and time consuming to achieve, according to senior Bank officials we interviewed. Also, the Bank's new initiatives to build greater financial management and procurement capacity, which began for new projects appraised in July 1998 (financial management) and November 1998 (procurement) only apply to about 208, or 14 percent, of the Bank's 1,500 projects. Bank studies indicate that management weaknesses persist in ongoing projects. For example, the results of a series of recently completed procurement audits show a lack of understanding of and noncompliance with Bank procurement rules among many (17 of 25) borrowers subject to these audits.

Our review of 12 randomly selected projects approved by the Bank since November 1998 identified 5 projects in which the borrowers' implementing agencies had little or no experience managing development projects, according to Bank records and staff. Thus, their ability to effectively manage the financial and procurement aspects of project implementation and safeguard against corruption appeared limited. Six of the projects we reviewed did not meet the Bank's minimal financial management requirements at the time that the Board approved the projects. Furthermore, for 3 of the 12 projects, the Bank determined that the borrowers' implementing agencies had particularly weak capacity for carrying out procurement in accordance with Bank rules. For four projects, the implementing agencies were not yet functioning and did not have key staff or operating procedures in place. Bank officials told us that it is common practice for borrowers to delay fully establishing project-implementing organizations until after projects are approved by the Board. These officials indicated that most management deficiencies would be corrected, as a legal condition of the loan, before any Bank funds are actually disbursed. However, even with required corrective actions, the ability of these agencies to exercise proper financial management and procurement functions is unproven, given the agencies' lack of experience.

In addition, the Bank remains concerned that project auditors lack institutional independence. Project auditing is a critical element of the Bank's management control system; the Bank uses audits, arranged for by the borrower, to help ensure that project funds are used as intended. The Bank is required to approve the selection of the auditors. However, Bank guidance on auditor selection acknowledges that it is often not possible to ensure the independence of auditors, particularly government auditors that are used for auditing Bank-financed projects in many countries. The Bank guidance states that government auditors are frequently not professionally qualified accountants—many are political appointees, and some are public service administrators. Furthermore, the Bank has been concerned that government auditing institutions sometimes are understaffed, underfinanced, and subject to political pressure.

Until the Bank has assurance that its borrowers' institutions are properly organized, staffed, and experienced in financial management and procurement, the overall control environment for its projects will continue to be weak. Although the Bank has strengthened its capacity to supervise projects, it recognizes that this cannot fully compensate for the weaknesses of its borrowers, given the shared responsibility in implementing management controls. Hence, Bank assurances that funds will be managed appropriately depend on the success of ongoing and future capacity-building efforts.

Bank Faces Long-term Challenges in Improving Public Institutions in Borrower Countries

The Bank has recognized that the key to helping countries fight corruption is to help them create a sound control environment at the country level. Many borrowers lack well-functioning public management systems; accountable organizations; and a strong legal framework to prevent, detect, and redress corruption. The Bank has supported a wide variety of initiatives to strengthen public institutions in its borrowers but faces significant challenges in ensuring that these efforts will be successful over the long run.

Progress

The Bank has introduced new programs to help borrowers establish strong management controls on a countrywide basis. The Bank has helped launch over 350 anticorruption activities in 95 countries. For example, it has conducted detailed surveys to help diagnose the magnitude and nature of corruption in 13 countries, and a major governance pilot program is currently working with teams in 7 African countries to develop and implement targeted anticorruption action plans. The Bank has also provided numerous institutional development grants to borrowers to enhance their ability to deal with corruption. For example, in one country we visited, the Bank awarded a grant to a newly created National Office of Public Ethics. The Bank has also supported capacity-building in the accounting and auditing professions, which are viewed as a critical area of reform for many large borrower countries. A country we visited received two grants to provide procurement and financial management training for agencies that implement projects and for auditing institutions.

Challenges

The Bank faces a difficult and long-term challenge in trying to help borrower countries create effective and well-managed institutions. According to the Bank's Annual Review of Development Effectiveness in 1998, only 40 percent of Bank-supported projects have had substantial impact on institutional development. In addition, the Bank's achievements in institutional building in the financial sector were deemed likely to be sustainable in just 50 percent of countries for a variety of reasons, including "fragile institutional environments," and low capacity to absorb foreign aid.[14] A 1998 evaluation of the World Bank Institute's (the World Bank's research and training institute) efforts to help curb corruption in two African countries questioned the sustainability of these efforts for several reasons, including the lack of needed reforms in public procurement and lack of support and involvement of civil society. Bank officials are optimistic about the prospects for greater impact in its more recent institution-building efforts, because they said these efforts are based on some new approaches. Nonetheless, given the challenging nature of this work, major improvements in borrowing country institutions should not be expected for some time.

[14] *1998 Annual Review of Development Effectiveness* (Washington, D.C.: World Bank, 1999).

Bank's Risk Assessment Process Is More Detailed, but Some Weaknesses Persist

According to COSO standards, an effective management control system requires risk assessments to properly identify, analyze, and manage the possible risks to meeting project objectives. Recently, the Bank has focused attention on better assessing the risks associated with corruption and the weak management capacity of its borrowers. However, our review revealed that weaknesses persist in the Bank's risk assessment process at the project level and country level. As a result, the Bank has approved some projects with limited assurance that all risks and borrower weaknesses have been addressed and that the Bank's supervision of the project will minimize the potential misuse of project funds.

Project Risks and Mitigation Plans Not Always Identified for Decisionmakers

The Bank assesses project risks primarily during the project appraisal and approval process. When evaluating a project, the Bank staff prepares a project appraisal document. According to Bank guidance, this document should include all the information that Bank management and the Board need to decide whether or not Bank financing should be provided, including an assessment of critical project risks. This guidance requires that the appraisal identify each critical risk, note the severity of the risk (ranging from negligible to high), and indicate any measures to be taken to minimize the risk. These risks may include economic, political, and social factors that could hinder the implementation of the project and prevent it from meeting its development objectives.

A series of Bank studies from 1994 to 1998 showed that Bank staff had often not adequately assessed all risks in projects reaching approval stages with Bank management and the Executive Board of Directors. In particular, Bank staff did not always explicitly state the risks posed by the inadequate management capacity of many borrowers' institutions or incorporate appropriate strategies to mitigate these risks. Although the Bank has made progress in ensuring that project risks are better identified and assessed during project design, the Bank faces additional challenges in ensuring that the results of these risk assessments are clearly communicated to the Board of Directors—the key decisionmakers charged with approving Bank project loans.

Progress

The Bank has established new requirements in 1998 to ensure that staff more systematically address risks in the design of new projects. Bank project managers and procurement and financial management specialists are required to analyze the risks to successful project implementation, including administrative, institutional, and financial risks. New project appraisal documents must include an action plan for reducing the risks through capacity-building activities and for mitigating the risks through appropriate levels of Bank supervision. In assessing procurement risks for each project, a Bank procurement specialist is required to rate the level of risk (ranging from low to high) and devise an appropriate supervision plan. This supervision plan is to include the monetary amount (threshold value) above which Bank pre-approval would be required for procurements; it is also to indicate to what extent the Bank will audit procurements to ensure that the borrower has followed Bank rules.

Challenges

Despite improvements in project design requirements, a July 1999 Bank study of new projects approved in 1998 showed that project appraisal documents continued to be unduly optimistic—Bank staff often understated or did not disclose known project risks relating to borrowers' implementation capacity to Bank management and the Board of Directors.[15]

Our review of 12 projects approved after November 1998 confirmed that the Bank's senior decisionmakers still have not adequately assessed the risks posed by potential corruption and weak managerial capacity of borrowers. We found that Bank staff had generally conducted the required assessments of financial management and procurement capacity for the new projects we reviewed. However, in nine cases, Bank staff did not clearly present the results of these assessments in the project appraisal document when seeking project approval from Bank management and the Board of Directors, as required by Bank guidelines. The Bank staff did not indicate the level of procurement risk for seven projects and did not indicate whether the project met the Bank's minimum financial management requirements for seven projects. Consequently, the Board may not have had sufficient information to assess the borrowers' capacity when approving these projects.

Furthermore, we believe that Bank staff did not adequately identify the risks that potential corruption poses to projects when seeking management and Board approval. Only 4 of the 12 projects we reviewed identified corruption or undue political interference as a critical project risk (even as a low or negligible one), even though Bank reports had indicated that

[15] *Quality at Entry in Calendar Year 1998: A Quality Assurance Group Assessment* (Washington D.C.: World Bank, July 1999).

corruption is a problem in all of the countries included in our project sample.

In addition, in the new projects we reviewed, the Bank often did not identify what steps the Bank will take to manage identified risks and weaknesses. In six of eight projects in which Bank staff had flagged weak management capacity, corruption, or political interference as a critical risk, the project appraisal documents did not describe what specific supervisory actions the Bank planned to take to mitigate the risks. For most projects with these types of risks, the Bank proposed providing additional technical assistance for the borrower agencies (sometimes funded by the projects) or requiring additional borrower actions to address the risks. Given the recognized weaknesses in borrower institutions and the difficulty borrowers have had in building capacity, technical assistance and borrower actions alone may not be sufficient to ensure that project risks can be mitigated.

Furthermore, the project appraisal documents provided to the Board and Bank management did not consistently and comprehensively address how the Bank staff proposed to supervise the projects in order to compensate for specific borrower management weaknesses. Senior Bank officials told us that they have recognized the need for better planning of supervision activities and are devising new requirements for this function. The Bank plans to introduce these new requirements by June 2000.

Country Assistance Strategies Do Not Always Address Corruption Risks

The Bank also assesses risks at the overall country level when making decisions about country assistance and lending levels. In 1992, the Bank introduced a country assistance strategy process as a key tool in examining, among other things, the performance of Bank projects and the policy reform record in countries that receive Bank assistance. The Board considers the results of this analysis, including the risks posed by corruption, poor governance, and an adverse public policy environment, when approving loans and establishing lending levels for each country. In addition, the Bank's process for allocating the Bank's concessional (below market interest rate) loans among borrowers includes consideration of country governance issues, which includes corruption issues.

The Bank acknowledges that historically, like other international financial institutions, it has not adequately addressed the risks associated with corruption and poor governance when making decisions on providing country assistance. According to several Bank officials we spoke to as well as the Bank's anticorruption literature, the Bank had for years been reluctant to address corruption risks openly and directly with borrowers.[16]

The Bank has made progress in addressing the nature and extent of corruption and related risks in some but not all country lending strategies.

Progress

In 1998, the Bank introduced new rules requiring country assistance strategies to explicitly address the state of governance and corruption in the country and its impact on Bank programs so that these issues could be considered in the Board's lending decisions. In the same year, the Bank also introduced new procedures for enhancing the usefulness of key inputs into these country assistance strategies. For example, Bank staff are now required to complete, with borrower assistance, comprehensive risk assessments of countries' national financial management and procurement systems to better identify major risks and weaknesses in institutions, government policies, and legal frameworks.

Challenges

Only about one-fourth of the 31 fiscal year 1999 country assistance strategies that we reviewed included a discussion of corruption-related risks or the role that progress on corruption-related issues would likely have on the Bank's lending decisions. However, Bank officials told us that the treatment of these issues in the country assistance strategies has improved over time. In December 1999, the Bank completed a review of the treatment of corruption and governance issues in Bank country assistance strategies. While the study noted an improvement in the discussion of these issues from fiscal year 1998 to 1999, less than 40 percent of the assistance strategies were rated as satisfactory or better in explicitly assessing corruption risks to Bank projects and proposing remedial measures, if pertinent. This study also found that few assistance strategies included performance benchmarks or lending triggers related to governance conditions or corruption risks. The Bank expects more improvement in the discussion of these issues over time as more country strategies are subject to the new requirements.

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[16]For example, see *Helping Countries Combat Corruption: The Role of the World Bank (Washington, D.C.: World Bank, Sept. 1997).*

Bank's Process to Prioritize Anticorruption Programs

One of the first steps in establishing a major anticorruption program in a country is conducting an assessment of that country's procurement and financial management systems. However, the Bank has not prioritized, based on corruption risk, which countries should undergo these assessments. In its action plan, the Bank indicated that it would target assessments at countries where corruption risks were greatest. Bank officials confirmed that they did not use a systematic approach or establish priorities for conducting these assessments. Instead, the assessments were generally scheduled based on the interest of the borrowers or the existing knowledge level of Bank staff. As of November 1999, of 143 borrowers, the Bank had completed financial management risk assessments for 57 countries and country procurement risk assessments for 16 countries. Figure 1 shows that few assessments (two procurement assessments and seven financial management assessments) were completed for the Bank's top 10 fiscal year 1999 borrowers. These borrowers collectively received 62 percent of Bank financing in that year.

Figure 1: Anticorruption Risk Assessments Among the World Bank's 10 Largest Borrowers

Largest borrowers based on FY 1999 total lending [a]	Country	FY 1999 total lending (billions of dollars)	Country assistance strategy	Country procurement assessment review completed [b]	Country financial accountability assessment or country profile of financial accountability completed [b]
1	Argentina	$3.2	1998 [c]	No	Yes
2	Indonesia	2.7	1999 [c]	Yes	Yes
3	China	2.1	1998 [c]	No	Yes
4	Korea	2.0	None	No	Yes
5	Russia	1.9	1999	Yes	No
6	Brazil	1.7	1998 [c]	No [d]	No [d]
7	Thailand	1.3	1998	No	Yes
8	India	1.0	1999 [c]	No [d]	Yes
9	Bangladesh	1.0	1999 [c]	No [d]	Yes
10	Mexico	0.9	1999	No	No

Legend

FY = fiscal year

[a]Total lending includes investment and adjustment loans.

[b]Completed between 1997 and August 1999.

[c]Progress report.

[d]Review is either planned or underway but was not completed as of August 1999.

Source: World Bank data.

A senior Bank official told us that the Bank hopes to target future anticorruption efforts, including the Bank's country financial management and procurement risk assessments, to higher risk borrowers and that the Bank is currently developing some comprehensive "good governance" indicators to better guide its efforts.[17] A Bank official indicated that it may take several years to develop these new indicators.

In addition to not targeting risk assessments to higher risk borrowers, the Bank has not scheduled the completion of its country level assessments of procurement and financial management risks to coincide with the approval of the Bank's country assistance strategies. Our review of fiscal year 1999 country assistance strategies did not reveal any cases in which the Bank included a discussion of the risks to development posed by weak financial management and procurement practices in the borrowing countries.

Since the types and level of Bank financing appear to have been set through the country lending process without a full consideration of these important risk management tools, the Bank may have missed an important opportunity to better target its anticorruption risk assessments and leverage its efforts to minimize opportunities for corruption in Bank-financed projects. A senior Bank official told us that the proper sequencing of these events is more likely to occur in the future as the Bank gains more experience.

[17]For example, the World Bank Institute has developed six clusters of governance indicators for over 150 countries. The six clusters are (1) voice and accountability, (2) political instability and violence, (3) government effectiveness, (4) regulatory burden, (5) rule of law, and (6) graft.

Increased Emphasis Placed on Control Activities, but Project Auditing and Supervision Remain Weak

According to COSO standards, effective control activities should be undertaken to ensure that management's directives are carried out. The Bank has established various control activities to ensure that borrowers follow Bank rules when implementing Bank-financed projects. The borrowing nation monitors implementation of projects and reports progress and financial status periodically. Independent audits arranged by the borrower are a key component of the Bank's control activities. For every project, the Bank requires the borrower to arrange for an independent auditing firm or institution to conduct an annual financial audit. Audits must include reviews of project financial reporting and testing of internal controls for the project.

To supplement borrower monitoring and project audits, Bank staff conduct various types of procurement and financial management supervision of projects to ensure borrowers' compliance with Bank rules. These activities include, among other things, reviewing project financial accounting, reporting, and auditing arrangements; reviewing bid awards and contracts; reviewing project expenditures; and visiting project sites. In some cases, Bank approvals of certain borrower actions are specifically required under the loan agreements. For example, for major procurements, representing about one-third of the value of total Bank-financed procurement contracts, Bank staff must pre-approve contract awards to ensure that they are fair and verify that contract expenditures are eligible under the loan agreement before Bank funds are disbursed. However, for the remaining procurements, Bank staff are only required to conduct spot-checks to ensure that Bank rules were followed.

In the past several years, the Bank's internal auditor has identified significant weaknesses in some control activities. For example, recent Bank reports have revealed that many Bank-approved auditors produced audit reports that were late and of poor quality, with limited identification of problems. In addition, Bank studies for 1996 through 1998 noted that the Bank had not practiced appropriate financial management supervision and ensured that borrowers complied with the Bank's basic financial accounting, reporting, and auditing requirements. For example, in a September 1998 report on the quality of Bank supervision, Bank reviewers found that financial management supervision, while improving, was less than satisfactory in over 30 percent of the projects reviewed. In addition, other Bank studies indicated that the Bank often failed to conduct required spot-checks of borrowers' compliance with procurement and expenditure eligibility requirements . As a result, a large and growing percentage of the contracts financed by the Bank were awarded without any Bank review.

The Bank has made progress in strengthening project auditing and supervision, but it is not yet clear whether its efforts have been successful.

Progress

The Bank has devoted increased resources and attention to financial management and procurement supervision. In the financial management area, the Bank has increased awareness among staff about the importance of ensuring adequate financial management arrangements and reporting in its projects. It has also upgraded its financial management policies and procedures, established a framework for ensuring proper financial management, and provided additional staff and training for this purpose.

In the procurement area, the Bank has taken a variety of steps to better supervise borrowers' procurement activities and ensure that contracts were awarded in compliance with Bank guidelines. This has included hiring or training local Bank staff or contracting with local consultants to review borrowers' procurement actions. In addition to improving routine procurement supervision, the Bank has undertaken a number of special procurement audits to help oversee the use of project funds. In fiscal years 1998 and 1999, the Bank conducted or contracted for intensive procurement reviews of 54 of its approximately 1,500 projects. Since 1996, the Bank identified cases in 26 projects in 16 countries in which the borrower did not comply with the Bank's procurement rules. Thus, the Bank refused to finance contracts valued at at least $114 million. In addition, the Bank has debarred 44 firms and 9 individuals, prohibiting them from conducting future business with the Bank.[18]

[18]The information on Bank "misprocurements," that is, expenditures that have not been procured in accordance with Bank procurement rules and related loan agreements, covers the period from January 1996 to November 1999. Data on bank misprocurements occurring before this date are not available, as they were not centrally tracked. Debarment data are through March 24, 2000.

For some new projects, the Bank has also introduced innovative approaches to project design and implementation intended to provide more effective controls over the use of project funds. For example, in several new projects we reviewed, community-based monitoring programs are being devised that incorporated input from local citizen and user groups. The Bank believes that since these groups have a vested interest in the outcome of the projects, they will put pressure on responsible officials to ensure the proper use of project funds. In one country we visited, the Bank allocated project funds to hire local consultants to facilitate community involvement in project design and implementation, including monitoring of project expenditures. Project implementers posted detailed information in local villages on the schedule and cost of small infrastructure works financed by the project. Eight of the 12 new projects[19] we reviewed specifically included some aspect of increased transparency or community involvement in the project design to help prevent the misuse of funds.

Challenges

Although there are signs of improvement in the quality of supervision, the Bank is still having difficulties in correcting some of the shortcomings that the Bank's internal units and external auditors have highlighted. For example, according to a 1999 Bank study on procurement reform in two of the Bank's six geographical regions, one of these regions had not conducted the required level of procurement supervision, even though both regions had engaged in significant hiring of new specialized staff and training of existing staff members to strengthen this function. Bank officials indicated that this region is taking corrective measures to ensure that the required level of procurement supervision is completed.

The Bank is also experiencing difficulty in meeting financial management supervision requirements. A 1999 Bank study found that the percentage of projects for which Bank staff meet basic financial management supervision requirements increased from about 70 percent in 1998 to about 80 percent in 1999.[20] However, Bank officials who conducted this study noted that Bank performance in this area was still deficient, considering that the requirements "should have been easily attainable." Bank officials are optimistic that performance of these basic requirements will improve further as the Bank continues to build its financial management capacity.

[19]Approved since November 1, 1998.

[20]*Supervision Quality in Fiscal Year 1999: A Quality Assurance Group Assessment* (Washington, D.C.: World Bank, Oct. 7, 1999).

However, the Bank is also establishing additional requirements that will make financial management supervision more challenging in the future.

We found little evidence that improved financial management supervision has resulted in any increase in the quality of project auditing. The previously cited 1999 Bank study of financial management supervision indicated that Bank staff were generally more diligent about reviewing project audit reports. However, according to Bank managers we spoke to, supervision of project auditors is not considered the responsibility of Bank staff, and Bank staff conduct little quality control of audit work.

Bank Conducts Extensive Monitoring, but Progress in Addressing Control Weaknesses Not Measured

According to COSO standards, an effective management control system requires monitoring of the controls to assess their quality over time and to ensure that problems are promptly resolved. Although the Bank has established an extensive array of mechanisms to monitor project management, it does not clearly measure progress the Bank is making in correcting management control weaknesses. Without a monitoring system that focuses on key areas of weakness, the Bank's management and Board of Directors cannot be certain that the initiatives in the Bank's anticorruption action plan are appropriate or sufficient to safeguard loan funds.

The Bank has a variety of systems to monitor and evaluate the quality of its management processes and controls. At the individual project level, Bank staff regularly (at least semiannually) submit a project status report, which includes the staff's assessment of the progress of project implementation and the status of procurement and financial management, among other issues. These reports are compiled and analyzed annually to provide Bank management and the Board with a detailed report on overall portfolio performance. In addition to this reporting, various Bank units conduct evaluations of Bank project management. The Bank's internal auditor has conducted occasional audits of various aspects of Bank supervision of Bank projects. The Bank's quality assurance unit has taken a systematic evaluation approach, conducting annual studies to evaluate the quality of new project designs and Bank supervision activities. Finally, the Bank's external auditor assesses annually the adequacy of the Bank's management controls over financial reporting.

The Bank has made progress in using new tools for monitoring and evaluating the implementation of Bank projects. However, it faces challenges in ensuring that it corrects acknowledged weaknesses in management control activities.

Progress

The Bank has improved its monitoring mechanisms by assigning responsibility for tracking Bank-wide compliance with quality standards for project supervision to a central operations group. This unit draws upon various monitoring mechanisms in place and has established some new ones. To assess progress on procurement reforms, the unit has sponsored new studies of two regions in 1999, with similar studies to follow in the future. To assess progress in financial management reform, the unit focuses on the quality assurance group's annual review of supervision quality. In addition, in 1999, the unit solicited status reports on project supervision from the regional procurement and financial management advisors in each of the Bank's six regions and compiled annual status reports for Bank management.

Challenges

Bank monitoring efforts do not fully assess the impact of Bank efforts to improve the strength of its management controls over project lending. In particular, the Bank's monitoring efforts do not focus on key deficiencies in management controls highlighted by Bank studies in the past few years. Consequently, we were unable to determine the extent to which the Bank has corrected these deficiencies. In particular, we were unable to determine whether the quality of project audits has improved or whether Bank staff have conducted required reviews of project procurement, financial reporting, and expenditure eligibility.

The Bank does not systematically monitor the quality of project audits. Although the Bank has a system for tracking compliance with auditing requirements, according to Bank officials this system generates unreliable data that cannot be used to reach firm conclusions because Bank staff have not consistently entered these data accurately or on time. The Bank's planned implementation of a new management information system may improve the reliability of these data in the future. Based on our review of the Bank's other periodic monitoring activities, none includes a systematic assessment of audit quality. For example, the Bank's annual study of financial management supervision addresses whether Bank management received and reviewed the required audit reports but not the quality of the audit. Thus, the Bank has not determined the extent to which the reliability of project audits as a management control activity has improved.

In addition, the Bank conducts limited monitoring of the extent to which Bank staff carry out required supervision at the project level, the regional level, or the Bank-wide level. At the project level, Bank staff are not required to report on compliance with key procurement and financial management supervision requirements in their mandatory project status reports. For example, these reports do not indicate to what extent Bank staff conducted required spot-checks of completed procurement actions and project expenditures reports to ensure that the borrower complied with Bank rules. Regional-level monitoring and reporting on supervision performance have also been incomplete. The annual regional reports on procurement and financial management supervision do not provide an analysis of the extent to which each region conducted the required level of supervision. As a result, Bank management cannot use these reporting systems to compile Bank-wide data for assessing whether Bank staff are meeting supervision quality standards.

At the Bank-wide level, the Bank does some monitoring and evaluation of project supervision in the annual review of supervision quality, prepared by the Bank's Quality Assurance Group. However, this review gives an incomplete picture of the quality of Bank supervision because it includes only certain supervisory activities and does not encompass some important Bank supervisory functions where performance has persistently been weak. For example, the review of procurement supervision does not address the Bank's performance in conducting required spot-checks of contract awards made by borrowers.[21] Similarly, the review of financial management supervision does not address the Bank's performance in spot-checking the eligibility of project expenditures. As a result, the supervision quality scores generated by this study mask performance problems reported by external and internal auditors.

The Bank also lacks meaningful performance indicators that could be used to monitor the impact of its institutional development efforts in strengthening management controls in borrowing countries. Only 2 of the 31 country assistance strategies we reviewed established measurable indicators for improving the anticorruption environment. Also, an evaluation of the Bank's anticorruption efforts in two African countries prepared by a World Bank consultant in 1998 indicated that the Bank's performance indicators could not be used to measure the effectiveness of the Bank's interventions and approaches. Bank officials told us that

[21]According to Bank procurement staff, the assessment addresses the Bank's performance in conducting prior review of proposed contract awards but not ex-post reviews of contracts awarded without the Bank's prior approval.

developing indicators to assess progress being made in this area is very difficult, but efforts are underway.

Information and Communication Have Increased, but Challenges Exist in Borrower Countries

COSO standards emphasize the need for information to be communicated in a form and time frame that enable people to carry out their responsibilities. Bank management recognized the need to increase the level and quality of its communications on anticorruption initiatives with its own staff and among borrowers and has launched a major effort to improve communications through a variety of outreach programs. This outreach effort has been conducted through the internet, special publications, Bank-sponsored conferences, workshops, training sessions, and other means.

Despite progress in improving information and communications, the Bank still faces challenges in raising awareness within borrowing countries.

Progress

The Bank has strengthened communication with and coordination on anticorruption issues among international donors, nongovernmental organizations, former government officials, academicians, business leaders, and other organizations. The Bank has also worked in tandem with the Organization for Economic Cooperation and Development, an economic forum of major industrialized countries, to promote global initiatives, such as the International Anti-bribery Convention.

Challenges

During our country visits, we found that some borrowing country staff and members of civil society charged with monitoring Bank projects were not fully aware of the Bank's efforts to establish new mechanisms for countering fraud and corruption in Bank-financed projects. For example, we visited several locations during our field visits where civil organizations involved in monitoring Bank-financed projects were not aware of the hotline or other mechanisms for reporting allegations of fraud and corruption. As a result, allegations of fraud and corruption in Bank projects could potentially go unreported to the Bank's Oversight Committee on Fraud and Corruption or be handled locally without the committee's knowledge. Senior Bank officials confirmed that additional efforts need to be made to increase awareness of the anticorruption activities and resources within borrower countries, particularly project implementing agencies and beneficiaries.

Although the Bank's external auditor does assess the adequacy of some management controls, the scope of the assessment is limited to controls relating to the Bank's financial statement reporting. The scope of the external auditor's annual assessment does not currently extend to controls over project lending. The Bank is planning to extend the scope of its future COSO reviews to include an examination of the efficiency and effectiveness of its operations, which will include its lending operations.

Conclusions

The Bank lends billions of dollars to developing countries each year in a difficult and challenging environment. Over the past several years, the Bank has made a vigorous attempt to strengthen its management controls and build borrower capacity to better manage Bank-financed projects to reduce opportunities for fraud and corruption on its projects. This effort has entailed making major improvements in the Bank's internal oversight structure, project management, and institutional development strategies. However, these controls, although improving, are not yet strong enough to provide reasonable assurances that project funds are spent according to the Bank's guidelines. Significant weaknesses still exist in each of the key components of the Bank's management control system. Efforts are underway to address many of these weaknesses in (1) internal oversight mechanisms, (2) assessing risks in individual projects and in overall country assistance strategies, (3) allocating anticorruption assistance among borrowers based on risk, (4) monitoring and reporting progress in correcting management control deficiencies, and (5) disseminating information on anticorruption activities within borrowing countries. Additional steps would enable the Bank to further limit opportunities for fraud and corruption and safeguard project funds. Continual management attention would also help sustain the current improvement efforts and ensure these remaining weaknesses are fully addressed. Nevertheless, questions will remain about the adequacy of the steps taken to strengthen these controls unless the World Bank publishes periodic public progress reports.

Recommendations

To help ensure that the World Bank achieves its goal of obtaining reasonable assurance that project funds are spent as intended and that corruption risks are mitigated in Bank-financed projects, we recommend that the Secretary of the Treasury instruct the U.S. Executive Director of the World Bank to work with other Executive Board members to encourage the Bank to

(1) integrate investigative functions into a single unit and establish organizational independence of the unit to better address allegations of wrongdoing;

(2) include more complete information in project appraisal documents and country assistance strategies on the risks related to corruption and any procurement and financial management weaknesses of borrowers, as well as planned supervisory actions to mitigate the identified risks;

(3) target procurement and financial management assessments at countries where corruption risks are greatest;

(4) monitor and report on progress in strengthening management controls and correcting past project management control weaknesses, including results of efforts to strengthen project auditing and supervision; and

(5) develop a plan to raise awareness of the Bank's anticorruption program among project implementing agencies and beneficiaries.

Furthermore, to ensure that Bank's anticorruption initiatives have the desired impact, we recommend that the Secretary of the Treasury monitor Bank progress in meeting each of the five components of an effective management control system and annually report to the Congress evidence of progress.

Agency Comments and Our Response

We received written comments from the Department of the Treasury, the agency that represents the United States at the World Bank, as well as from the World Bank. These comments are reprinted in appendixes VII and VIII. In addition to their overall comments, the Treasury and the Bank provided technical comments, which we incorporated in the report as appropriate.

Treasury agreed with our findings and recommendations and characterized the report as a fair and constructive assessment of a difficult and challenging subject that provides helpful guidance to assess process and policy improvements at the Bank. Treasury said that the Bank should increase its up-front investment in project control systems, particularly those related to procurement, financial management, and audit. Moreover, Treasury also said that the Bank should be more aggressive in building borrowers' capacity to fight corruption, in providing more project planning and reviews prior to contract award, and in performing more assignments of borrowers' public sector management control mechanisms to provide greater assurance that project money is well spent.

The World Bank said our report provides valuable input into its ongoing anticorruption efforts. The Bank noted that it has made significant progress, given that it is about one year into implementation of its anticorruption action plan and that fighting corruption will require a long-term effort. The Bank also indicated that it is taking action on the issues and recommendations outlined in our report, including steps to (1) strengthen the independence of the Bank's investigative functions, (2) report risks more explicitly in project documents, (3) allocate anticorruption assistance on the basis of risk, (4) improve monitoring tools, and (5) introduce greater public reporting on its anticorruption initiatives.

The Bank agreed that there are still areas requiring improvement in its management control system but believes that, for the most part, it has reasonable assurance that project funds are spent as intended. As our report points out, it is generally recognized that all five of the Committee of Sponsoring Organizations of the Treadway Commission standards must be met for controls to be judged effective in any particular area of an organization's operations, thus providing reasonable assurance that funds are spent as intended. We believe the Bank is not in a position at the time to gauge the extent to which this is the case due to the weaknesses in its current system of controls described in our report.

We are providing copies of this report to the Honorable Lawrence Summers, the Secretary of the Treasury; James Wolfensohn, the President of the World Bank; and interested congressional committees. Copies will be made available to other interested parties upon request.

This report was prepared under the direction of Benjamin Nelson, Director, International Relations and Trade Issues, who may reached on (202) 512-4128 if you have any questions about this report. Other contacts and key contributors are listed in appendix IX.

Henry L. Hinton, Jr.
Assistant Comptroller General

Chronology of Major World Bank Efforts to Strengthen Management Control System

Since 1995, the Bank has undertaken a series of steps to strengthen its management control system. Figure 2 outlines major milestones in this effort.

Figure 2: Milestones in the World Bank's Efforts to Strengthen its Management Control System, 1995-2000

Year	Milestones
1995	World Bank adopts internationally accepted standards of effective management control
1996	•**October**: Bank President addresses the "cancer of corruption" at World Bank/International Monetary Fund annual meetings
1997	•**February**: "Strategic Compact" introduced, which includes mandate and resources to hire additional financial management and procurement specialists, strengthen Bank's fiduciary functions, provide anticorruption assistance to interested borrowers, launch an ethics outreach program, and undertake selective procurement audits
	•**September**: Anticorruption strategy adopted, entitled "Helping Countries Combat Corruption - the Role of the World Bank"
1998	•**June**: Directive introduced requiring more rigorous assessments of countries' procurement systems
	•**July**: Directives aimed at improving project financial management take effect for new projects
	•**October**: 24-hour worldwide anticorruption hotline introduced
	•**November**: Directives aimed at improving project procurement take effect for new projects
1999	•**January**: Anticorruption action plan announced to staff
	•**December**: Revised code of ethics introduced
2000	•**January**: Task force formed to review risk management system

Source: World Bank.

Implementation Status of the World Bank's Anticorruption Action Plan

In 1997, the World Bank adopted an anticorruption strategy as outlined in a report titled "Helping Countries Combat Corruption: The Role of the World Bank." To implement its strategy, the Bank subsequently put together an Anticorruption Action Plan. This plan outlines a series of anticorruption activities for the Bank to undertake aimed at (1) strengthening internal oversight mechanisms within the Bank, (2) improving the Bank's project management processes, (3) strengthening public institutions in borrower countries, and (4) supporting international efforts to reduce corruption. Table 1 shows the implementation status of the Bank's anticorruption plan as of December 1999.

Table 1: The Status of the Action Plan, as of December 1999

	World Bank Action	Status of implementation
1	Strategy setting and dissemination • Update strategy. Develop messages for annual meetings, and briefing materials.	Completed
	• Present to the Board a public sector strategy paper and governance update.	Completed
2	Executive Directors' briefing • Brief the Board on the implementation of the Bank's anticorruption action plan.	Completed
3	Anticorruption web sites • Establish web sites to share country experiences.	Completed
	• Expand internal and external web sites.	Underway
4	Anticorruption workshop and conference • Conduct workshop on lessons learned from the Bank's experience with corruption.	Completed
	• Conduct conference on analytical developments, i.e., lessons learned from a sector standpoint.	Underway
5	Major reports on corruption • Submit outline for possible *World Development Report* on institutions, including corruption.	Completed
	• Prepare Europe and Central Asia Region anticorruption report.	Underway
6	Rules for reporting and handling fraud and corruption allegations • Present proposal to senior management to clarify rules for reporting and handling internal and external fraud and corruption allegations.	Completed
7	Workshop on procurement practices • Conduct workshop with experts to generate ideas on useful modern procurement practices.	Completed
8	Staff survey • Survey staff on Bank culture, ethics, and their willingness to report corruption.	Completed
9	Security plan • Prepare action plan to increase security for staff.	Completed
10	Annual meetings • Hold seminar on corruption at the October 1998 annual meetings.	Completed

Continued

	World Bank Action	Status of implementation
11	Hotline Launch hotline for reporting internal fraud and corruption.	Completed
12	Staff training • Hold orientation for all regional staff, including resident mission staff. • Provide specialist training.	Substantially completed
13	Accountability within regional departments • Designate within each of the regions clear accountability and resources for anticorruption efforts.	Substantially completed
14	Project design support • Establish a focal point within the Operational Core Services Network for links between project design and corruption.	Completed
	• Assist operational staff, through best practice dissemination and advice, in project design features that can help to reduce corruption in Bank projects.	Underway
15	Publication of series of anticorruption notes • Publish notes to provide guidance on corruption diagnosis and public sector reform approaches.	Underway
16	Procurement capacity building and risk analysis • Complete scheduled country procurement assessment reviews in high-risk countries. • Procurement Board to help teams implement new procedures for project capacity/risk analysis and evaluate experience.	Underway
17	Financial management • Implement the Loan Administration Change Initiative to ensure that all World Bank projects appraised after June 1998 meet minimum requirements for financial management. • Increase the use of country financial accountability assessments, focusing on higher risk and priority countries.	Underway
18	Implement financial management and procurement reforms • Assess and report on the first year's experience with the implementation of financial management and procurement reforms. (completed) • Adapt implementation of the reforms in light of the findings.	Underway
19	Require the systematic use of country risk assessments • Issue guidelines for best practices and sequencing of the country procurement assessment reviews and the country financial accountability assessments.	Underway
20	Country requests for assistance • Undertake anticorruption programs in countries requesting assistance (e.g., corruption studies, surveys and workshops, policy and institutional reform).	Underway
	• Implement institutional reforms in countries that have a clear commitment and request assistance.	Underway
21	Institutional reviews • Undertake 4-5 pilot institutional reviews, including diagnostic work on governance and public sector performance, which will provide input in formulating country strategies and designing projects.	Underway
22	Research, training, and dissemination of best practices • Undertake surveys and workshops, conduct training programs, and publish research reports.	Underway
23	Special topics • Investigate the boundaries of Bank involvement in the area of political finance and corruption.	Planned
24	Country assistance strategy • Explicitly address governance and corruption in every country assistance strategy.	Underway

Continued from Previous Page

	World Bank Action	Status of implementation
25	High-risk countries • Focus on countries with high indicators of corruption.	Underway
26	Anticorruption and lending • Finalize Bank policy note on anticorruption and lending, including adjustment lending, in high-risk countries.	Underway
27	Governance • Refine, evaluate, and disseminate internally existing governance indicators. • Prepare principles or code of good governance.	Underway
28	International Development Association funding • Assist in defining governance criteria for the Twelfth Replenishment of the International Development Association (IDA-12).	Underway
29	Sector strategy papers • Require that anticorruption concerns are systematically addressed in key sector strategy papers.	Underway
30	Multilateral development banks and bilateral donors • Share information and coordinate efforts with multilateral development banks and bilateral donors.	Underway
31	Nongovernmental organizations • Continue collaboration with nongovernmental organizations on anticorruption.	Underway
32	Organization for Economic Cooperation and Development • Continue participation in the Working Group on Bribery. • Assist Organization for Economic Cooperation and Development efforts to promote the antibribery convention in non-Organization for Economic Cooperation and Development countries.	Underway
33	Professional bodies and associations • Enhance working relationships with international professional organizations such as the International Organization of Supreme Audit Institutions.	Underway
34	Crime and money laundering • Continue participation in international conferences and other efforts to address international crime.	Underway
35	Projects and program evaluation • Assess how corruption risks have been addressed in selected Bank projects and programs.	Underway
35	Ethics program • Develop modern ethics management program, including updating the Code of Professional Ethics, providing integrity awareness training for staff, and investigating and addressing allegations of staff misconduct.	Underway
37	COSO and internal controls • Review adequacy of internal controls. • Audit major risk areas of the Bank. • Continue control self-assessments in Bank units. • Report status of internal controls to the Audit Committee. • Managing directors and vice presidents to annually submit a letter of representation on the adequacy of internal controls in their respective areas.	Underway

Continued from Previous Page

Legend

COSO = Committee of Sponsoring Organizations of the Treadway Commission

Note: This table provides the status of the World Bank's implementation of its anticorruption action plan, which was presented to the Board in November 1998 and updated in July and December 1999.

Source: World Bank.

The Committee of Sponsoring Organizations of the Treadway Commission's Management Control Framework

In 1995, the World Bank adopted the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework to establish a common definition of management controls for all Bank units and a standard against which unit managers and auditors can assess and measure progress in improving management controls. GAO and other professional bodies use this framework, referred to as the "Internal Controls–Integrated Framework," as a standard in evaluating management controls. (See GAO's Nov. 1999 standards that update and replace the previous standards first issued in 1983).[1]

The COSO framework emphasizes accountability and ownership of controls at all levels. Under this model, the effectiveness of a management control system is measured by its capacity to provide reasonable assurance to the Executive Board of Directors and management regarding the achievement of their objectives in the following three categories:

- effectiveness and efficiency of operations,
- reliability of financial reporting, and
- compliance with applicable laws and regulations.

Management Control Components

Under COSO, management control is defined as consisting of five interrelated components that form the criteria for effective control. The five components are used as the criteria to evaluate the strengths and weaknesses of the controls and to identify what actions can be taken to improve controls. All five components must be present and effective in order for management to have the reasonable assurance needed. These components include the following:

Control environment. An organization should establish a positive control environment, that is, one with a structure, discipline, and climate conducive to sound management controls. Factors that significantly affect the control environment include the integrity and ethical values of management and staff, the competence of personnel, the way the agency is organized, the manner in which management assigns authority and responsibility, and the attention and direction provided by oversight groups.

[1] *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1, Nov. 1999).

Risk assessment. An organization should properly identify, analyze, and manage the possible risks involved in meeting organizational objectives.

Control activities. An organization should establish control activities consisting of policies, procedures, techniques, and mechanisms that ensure that management directives are being carried out to meet organization objectives. They include approvals, authorizations, verifications, and reviews of operating performance.

Monitoring. An organization should continually monitor and evaluate all aspects of management control to assess the quality of performance over time. Serious management control deficiencies should be reported to higher levels, including top management and the Board of Directors.

Information and communication. An organization should identify, capture, and communicate information in a form and time frame that enable people to carry out their responsibilities.

World Bank Implementation Schedule

In 1995, the Bank established a 5-year timeline to ensure that, by the end of fiscal year 2000, management will be able to express assurance that adequate controls are in place, not only for financial reporting purposes, but also for efficiency and effectiveness of operations. The Office of Controller made a commitment to

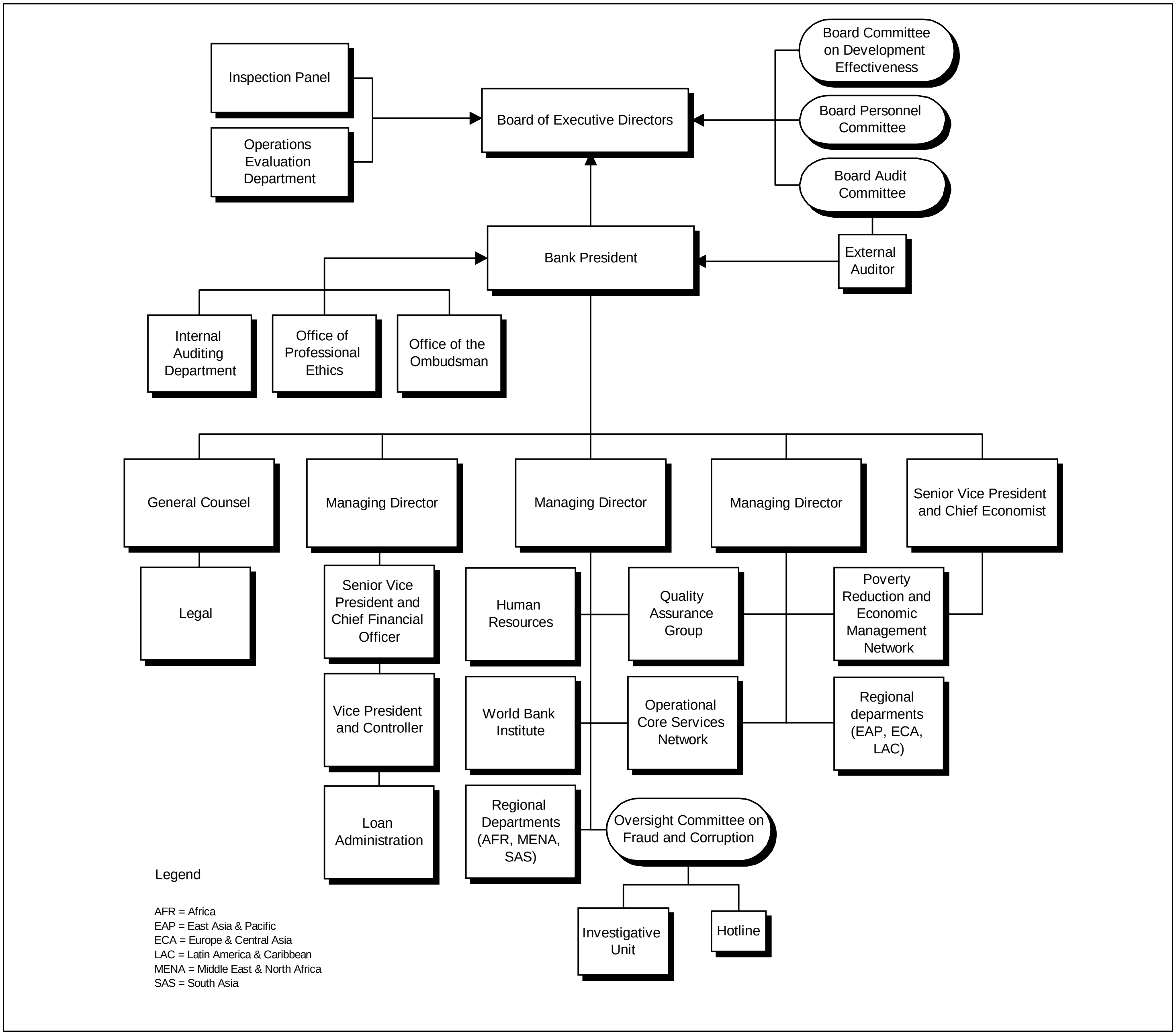
- meet the COSO standards for control effectiveness across the Bank's major operational areas by the end of fiscal year 1996;
- extend the COSO standards for prudential controls to nonfinance organizational units in the Bank in fiscal year 1997;
- assert that both the International Bank for Reconstruction and Development and the International Development Association have maintained effective controls over financial reporting as of June 30, 1997, and obtain the external auditor's agreement;
- expand the application of the COSO framework during fiscal years 1998 and 1999, so that issues of organizational efficiency and effectiveness are brought to light; and
- become an institution in which Bank management and staff will have the ability and process in place to analyze the effectiveness of internal controls for their areas of responsibility.

In order to meet these goals, the Office of Controller adopted the Control Self-Assessment methodology for assessing controls based on the COSO framework. This approach uses the staff from various Bank units to

- review the business unit's objectives, key processes supporting the stated objectives, associated risks, and mitigating controls; under normal circumstances, testing of key controls and documentation of testing is required;
- hold workshops to (1) analyze obstacles and strengths that affect the organization's ability to achieve key business objectives and (2) decide upon an approach to address issues arising from the process;
- identify reportable conditions requiring control enhancements together with the results of the control self-assessment workshop in the business unit's action plan; and
- obtain representation letters from all the Bank's senior managers acknowledging their responsibility for effective controls and confirming that they have maintained an effective system of management control.

The control self-assessment methodology was initiated during fiscal year 1996. Bank management has issued a series of reports to the Audit Committee of the Executive Board on the Bank's progress made in implementing the COSO management control framework. The Internal Audit Division also issued annual reports in 1998 and 1999 providing independent observations and findings on internal controls in the Bank based on prior audits and the control self-assessment workshops. In 1999, the Bank concluded that it met the COSO criteria for effective internal control over financial reporting for the International Bank for Reconstruction and Development and the International Development Association. The Bank's external auditor examined management's assertion and concluded that it was fairly stated, in all material respects. Bank management has not made an assertion regarding the adequacy of internal controls over operations.

World Bank Management Control Structure



Source: World Bank.

Management Controls in the World Bank's Project Lending

The Bank and borrowers share responsibility for establishing and maintaining effective management controls. The borrower is responsible for execution of project procurement and financial management in accordance with Bank policies and procedures, as agreed with the Bank. The Bank is responsible for monitoring and supervising procurement and financial management on a continuing basis until project completion. The major management controls that Bank projects are subject to are outlined as follows.

Procurement

Project procurement capacity assessment: Prior to project approval, the Bank independently assesses the adequacy of the procurement arrangements and plans, focusing on the institutional capacity to carry out these arrangements and assess risks involved. Based on this assessment, the Bank and the borrower develop an action plan to address any deficiencies.

Contract award and management: During project implementation, the borrower is responsible for ensuring that contracts for goods and works are awarded and managed in accordance with the policies and procedures agreed to with the Bank. For each contract, the borrower is required to document the procurement process, including analyzing bids, and to make this documentation, as well as the contract and other relevant information, available to the Bank.

Prior procurement reviews: For procurement contracts above a specified monetary threshold, the Bank reviews the procurement documents before the contract award is made to ensure that the borrower follows Bank procurement guidelines. The prior review thresholds vary by project, depending on the implementing agency and type of contract awarded.

Ex-post procurement reviews: Contracts not subject to prior review are subject to ex-post review by the Bank on a sample basis to ensure that they were awarded in compliance with Bank procurement guidelines. Minimum sample size varies by project and generally ranges from 5 percent to 20 percent of contracts, depending on the implementing agency.

Financial Management

Project financial management assessment: Prior to project approval, the Bank independently assesses the adequacy of the financial management arrangements, including accounting, financial reporting, and auditing systems, to ensure that they can provide accurate and timely information on project resources and expenditures. The assessment focuses on the borrower's institutional capacity to carry out these arrangements and analyze the risks involved. Based on this assessment, the Bank and the borrower develop an action plan to address any deficiencies.

Financial accounting, reporting, and auditing : During project implementation, the borrower is responsible for maintaining a financial management system, including records and accounts, and for preparing financial statements in a format acceptable to Bank adequate to reflect the operations, resources, and expenditures related to the project. The borrower must have the financial statements for each year audited by independent auditors acceptable to the Bank.

Annual audited financial statements must be submitted to the Bank by an agreed date and include (a) an assessment of the adequacy of accounting and internal controls systems to monitor expenditures and other financial transactions and ensure safe custody of project- financed assets; (b) a determination as to whether the borrower and project implementing entities have maintained adequate documentation on all relevant transactions; and (c) verification that expenditures submitted to the Bank are eligible for financing, and identification of any ineligible expenditures.

Prior approval of auditor: Bank staff are required to approve the auditor based on a review of the auditor's independence, qualifications, experience, and terms of reference and inform the borrower whether the auditor is acceptable.

Review and follow-up of audit reports: Bank staff ensure that audits are submitted on time, that their scope and quality are acceptable, and that any deficiencies identified in the project's accounting and internal controls, or in the reliability of financial statements, are corrected by the implementing agency.

Prior review of project expenditures: For major contracts above a specified monetary threshold, the Bank reviews the borrowers' withdrawal applications before disbursing loan funds to ensure expenditures are authorized, eligible, and adequately documented.

Ex-post review of project expenditures: Expenditures for contracts not subject to prior review by the Bank are subject to ex-post review by Bank staff to ensure that they were authorized, eligible, and adequately documented. The sample size for such reviews is not clearly specified in Bank guidelines.

Objectives, Scope, and Methodology

To determine whether the Bank's management control system provides reasonable assurances that project funds are spent as intended, we assessed each of the following components of that system: the control environment, risk assessment, control activities, monitoring, and information and communication. For each of the five components, we (1) identified acknowledged management control weaknesses, (2) assessed the Bank's progress in addressing those weaknesses or otherwise strengthening management controls, and (3) identified remaining challenges in assuring the improvement measures are consistent with COSO management control standards.

To identify acknowledged management control weaknesses, we reviewed numerous internal Bank reports and special studies prepared by the Controller's Office, the Internal Audit Department, the Operations Evaluation Department, the Quality Assurance Group, and other Bank units and consultants. We also interviewed a variety of senior Bank officials throughout the Bank for additional background, details, and clarification of these issues.

To identify the progress made by the Bank in strengthening management controls, we reviewed the Bank's 1997 anticorruption strategy and related initiatives aimed at strengthening internal oversight units, improving project management, and strengthening public institutions in borrower countries to reduce opportunities for corruption. We interviewed and obtained documentation about these initiatives from numerous World Bank officials in Washington and in four countries. We also met with representatives of the Board of Executive Directors Audit Committee, the U.S. Department of the Treasury, and other multilateral institutions, such as the International Monetary Fund, the Asian Development Bank, the United Nations Development Program, and nongovernmental organizations.

To identify remaining challenges, we evaluated how key management control units were implementing the World Bank's initiatives. With regard to internal oversight issues, we reviewed the operations of the Office of Professional Ethics, Oversight Committee on Fraud and Corruption, Investigative Unit, and the Internal Audit Department, and other Bank units. We reviewed their mandates, composition, reporting authority, policies and procedures, and a random sample of reports and cases relating to allegations of fraud and corruption in Bank projects. With regard to project management, we reviewed the operations of key units involved in project implementation, including the Operational Core Services Network, the Controller's Office, and all six regional offices. We reviewed

12 randomly selected projects for 12 different countries approved between November 1, 1998, and July 1, 1999, and a judgmental sample of 6 ongoing projects approved prior to November 1998. As part of these file reviews, we reviewed project documents, interviewed some Bank and borrower project staff, and conducted several site visits. We also reviewed a variety of internal Bank reports and studies on project management and supervision conducted by the Internal Audit Department, the Operations Evaluation Department, and the Quality Assurance Group, and other Bank units and interviewed officials involved in preparing these reports and studies. With regard to strengthening public institutions in borrower countries, we examined a random sample of 30 country assistance strategies and related documents approved since June 1, 1998, to determine how corruption and good governance issues were addressed.

We did our work from January 1999 through December 1999 in accordance with generally accepted government auditing standards.

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

March 23, 2000

Mr. Benjamin F. Nelson
Director
International Relations and Trade Issues
U.S. General Accounting Office
Washington, DC 20548

Dear Mr. Nelson:

Thank you for the opportunity to comment on the General Accounting Office's draft report on World Bank financial management controls. The report (World Bank Management Controls Stronger, but Challenges in Fighting Corruption Remain; GAO/NSIAD-00-73) covers a difficult and challenging subject and, we believe, does so fairly and constructively. Its analysis and recommendations track broadly with our own thinking, and provide very helpful guidance for process and policy improvement in the future.

Establishing and maintaining effective internal controls are as essential for the World Bank as they are for any large financial organization, and perhaps more so given the uniquely challenging nature of its work and the particular risks it faces. We have carefully considered GAO's specific recommendations against this background. In our view they constitute an appropriate set of steps that should be incorporated into a specific action program for the Bank going forward.

- The various elements of the Bank's investigative function should be combined into a single unit, which should be organizationally independent within the Bank.

- Project appraisal documents and country assistance strategies should include a more complete assessment of risks related to corruption, as well as borrowers' procurement and financial management weaknesses.

- The effectiveness of the Bank's direct anti-corruption assistance could be increased by allocating it more systematically on the basis of assessed risk.

- Improvements should be made in the Bank's monitoring and reporting on progress in strengthening management controls, including project auditing and supervision.

- An action program is needed to increase the profile and understanding of the Bank's anticorruption agenda among borrowers, implementing agencies, and beneficiaries.

Each of these issues has been the focus of intensified scrutiny and analysis in recent years, both within and outside of the Bank. As a result, there already exists a substantial foundation for a Bank-wide action program, as well as a high degree of consensus among the Bank's largest shareholders about an effective way forward. Specifically we would note the following:

- With our strong support the G-7 Ministers called upon the World Bank to perform an authoritative review of its procedures and controls and to identify ways to strengthen financial safeguards. We have followed-up on this initiative with specific proposals for safeguard improvements that are now under active discussion in G-7 fora. Our expectation is that this effort will produce a solid G7 consensus around improvements that will track closely with the GAO's recommendations.

- The IDA-12 replenishment agreement, which governs the Bank's new concessional operations during the 1999-2001 period, contains specific recommendations to integrate financial and procurement management and risk assessment considerations much more systematically into the Bank's lending programs. Specifically, the IDA Deputies agreed that Country Financial Accountability Assessments (CFAAs) and Country Procurement Assessment Reports (CPARs) should be prepared for individual borrowers, and then integrated into the Country Assistance Strategies (CASs) that provide the key multi-year framework for Bank operations. CFAAs and CPARs are specifically designed to identify weaknesses in borrower country fiduciary processes, identified by the GAO report as one of the most serious challenges in the Bank's current control system. Under IDA-12, CASs are to be published as a matter of routine; to date, in fact, 100 percent of IDA CASs have been published.

- The IDA-12 replenishment also incorporates major steps forward on the broader issue of Bank engagement in borrower country governance issues. A substantially improved system of performance indicators, for which we pressed strongly, now incorporates an assessment of corruption and governance issues into IDA lending allocations.

- These steps track well with the Bank's own Corruption Strategy, under which it committed to take corruption explicitly into account in country risk analysis, lending decisions, and portfolio supervision if it affects project or country performance and if the government's commitment to deal with corruption is in question.

- Largely as a result of the initiative the Bank has taken on the corruption issue, borrowing countries are increasingly requesting the Bank's assistance to fight corruption. Specific work ranges from diagnostic efforts to identify problem sources, to technical assistance, to lending for public sector management reforms.

These are welcome and important steps forward. They reflect strong US advocacy over a period of years, the clear and public commitment of the Bank's President, and a growing appreciation of the urgency of the issue among the Bank's shareholders more broadly. They also track well with the priorities identified in the GAO report. Nevertheless, it is also clear that there is scope for further improvements, and we agree with GAO's assessment that these be pursued as a matter of priority. In particular, we would identify the following as areas worthy of special attention going forward.

- We believe the Bank should increase its internal, up-front investments in project control systems, including in procurement, financial management, and audit. There is a need for more aggressive Bank support for capacity building for borrowers, more up-front project planning, more up-front reviews prior to contract award, and more detailed diagnostic work on borrowers' public sector management control mechanisms.

- A working group comprising the MDB Chiefs of Procurement has been developing a master standard bidding document for procurement of goods. We have been strongly supporting this effort to move the World Bank and regional development banks to uniform MDB procurement rules of the highest standard and to require the use of best-practice MDB standard bidding documents. The result will be increased transparency and efficiency gains for borrowers and bidders; perhaps more importantly, the effort should produce an improved model for wider use by donors and in national procurement systems.

- The Bank's administrative budget must provide sufficient resources for the additional work needed to deliver these improvements.

The Treasury Department is committed to strong and effective internal controls in all of the multilateral financial institutions, as well as more focused Bank assistance to strengthen borrowers' fiduciary controls and public sector management. This report is a substantial contribution to that objective, and one whose key components we will be pursuing directly with Bank management.

Separately, we greatly appreciate the open and constructive working relationship that we have had with GAO over the years, and that characterized our engagement on this latest report. This report is one more in a long series of GAO reports on the IFIs, done over a period of many years, that have been enormously useful to us as a major shareholder, and to the institutions in providing helpful and objective analysis.

Sincerely,

William E. Schuerch

William E. Schuerch
Deputy Assistant Secretary
International Development, Debt &
Environment Policy

Comments From the World Bank

Note: GAO comments supplementing those in the report text appears at the end of this appendix.

The World Bank
Washington, D.C. 20433
U.S.A.

JAMES D. WOLFENSOHN
President

March 16, 2000

Mr. Benjamin F. Nelson
Director
International Relations and Trade Issues
U.S. General Accounting Office
441 G Street N.W.
Washington, D.C. 20548

Dear Mr. Nelson,

I welcome the opportunity to comment on GAO's draft report entitled "World Bank: Management Controls Stronger, but Challenges in Fighting Corruption Remain." I have made the fight against what I have termed the "cancer of corruption" one of my top priorities in my time as President of the Bank, and I consider this report to be a valuable input into our ongoing efforts. I am very encouraged that two of your key findings are that the "Bank has undertaken an ambitious and systematic effort to identify and correct key weaknesses in its system of management controls" and that "significant progress has been achieved." These supportive findings will enable the Bank to move forward with even more confidence that we are headed in the right direction.

It is just over two years since our Board approved our Anti-Corruption Strategy, and we are just over one year into implementation of our Anti-Corruption Action Plan. In that short time, the attention given to governance issues inside and outside the Bank has increased dramatically, our dialogue with our client countries on these issues is notably more open, and more than 350 specific anti-corruption programs and initiatives have been undertaken in 95 borrower countries. This is a substantial achievement – and we are proud that the Bank has been able to play the leading role within the development community in this area.

What follows are some comments on contextual and control issues discussed in the report.

Mr. Benjamin F. Nelson -2- March 16, 2000

Contextual Issues

See comment 1.

Because the report limits its scope to the Bank's internal controls over investment lending, the broad dimension of our overall governance and anticorruption work are not fully described. It would have been useful to point out that the Bank also does a vast amount of work through the policy dialogue, lending for adjustment and public sector reform, and advisory services. Indeed, many Bank stakeholders would argue that these constitute the most important dimensions of the Bank's anticorruption efforts. In addition, a top institutional priority of the Bank is to work in partnership with other international financial institutions to develop credible and efficient fiduciary systems in the Bank's borrower countries as a key component of the whole development strategy.

See comment 2.

Equally, the report could have made it clearer that it is the very nature of the Bank's role as a development institution to work in poor countries that have weak controls and capacities. While noting that "problems of corruption and weak management are often endemic to the economic development environment in which the Bank operates," there tends to be a blurring in the report between the Bank's internal controls and those of our borrowers.

See comment 3.

We welcome the fact that the report holds the Bank to the high control standard we have set for ourselves. One indication of this is that the report and its recommendations are grounded in the criticisms noted in our own self-evaluations and reflect remedial actions already underway. At the same time, we still believe that it would have been useful to compare the Bank's efforts with other international financial organizations, many of which are taking a cue from the Bank's leadership in this area.

Control Issues

We appreciate that the GAO notes the many steps that the Bank has taken to strengthen its internal control activities, including those covering financial management, procurement and supervision. The Bank's active projects have benefited the most from improvements in the control environment, from 27% considered at risk of not meeting development objectives to only 19% in FY99. At the same time, the report also points to the remaining challenges in implementation of the changes that have been introduced over the last two years to strengthen these controls. We agree that more work needs to be done. Accordingly, we have stepped up our efforts through:

- **Strengthening our internal oversight:** last September, the Bank engaged a distinguished former U.S. Attorney General – Mr. Richard Thornburgh – to review the structure of our internal Oversight Committee on Fraud and Corruption and advise us on ways to improve it. We are in the process now of addressing the issues raised in Mr. Thornburgh's report and thereby make the Oversight Committee on Fraud and Corruption an even more effective tool. GAO's observations will be a further useful input to this process.

Mr. Benjamin F. Nelson -3- March 16, 2000

- **Strengthening our borrowers' capacity:** we have made this a priority through increased lending (the number of projects with public expenditure reform components increased from 9% in FY97 to 28% in FY99 and the proportion of adjustment loans with anti-corruption or fiscal transparency components increased from 8% in FY98 to 43% in FY00 to date); enhanced country-level advisory services (including pilot diagnostics led by the Operations Evaluation Department); and the inclusion of "good and clean governance" as one of the central pillars of the Comprehensive Development Framework.

- **Strengthening our risk assessments:** we are sharpening our discussions of risks in Country Assistance Strategies – which are now required to cover governance issues – and are making our discussion of project risks more explicit in Board documents. It should be noted, of course, that IDA lending levels have been influenced by governance criteria for some time.

- **Strengthening monitoring tools:** in addition to the steps already taken under our Strategic Compact – which are noted in the report – we are moving ahead to further improve staff skills and reporting mechanisms in the key control areas of financial management, procurement and supervision; we are refocusing the Internal Auditing Department's work more on operational compliance issues; and we are working with our borrowers to improve the quality of project audits.

- **Strengthening awareness of our anticorruption initiatives:** at GAO's suggestion, we have taken steps to make our anticorruption Hotline better known and more accessible. In addition, we have established an external web site on corruption issues (including a listing of debarred firms and consultants), strengthened our training programs to address more explicitly corruption issues (especially through the World Bank Institute), and built up substantially our Professional Ethics Office.

GAO's Recommendations and the Bank's Response

Let me turn briefly to the report's specific recommendations – and I note that they are very much in line with reforms which the Bank already has had underway through its reform program since 1997:

- We are examining ways to strengthen the independence of our investigative functions especially in light of the GAO and the Thornburgh reports' recommendations.

- We are making the reporting of risks more explicit in project documents and Country Assistance Strategies – and are adjusting supervision intensity to be commensurate with risks.

- We are taking steps to better allocate our anticorruption assistance on the basis of risk using existing processes, in particular through monitoring closely the requirement that every CAS discuss governance issues.

Mr. Benjamin F. Nelson -4- March 16, 2000

- We are taking measures to improve our monitoring tools – and it should be noted that our most recent status reports to the Board (March 2000) on financial management and procurement have an explicit focus on strengthening project auditing and supervision.

- We are putting together an even more focused and cohesive communication program on our anticorruption efforts – and again GAO's suggestions here are useful.

In addition, and in line with the report's recommendation, we are taking the initiative to introduce regular progress reports on our anticorruption activities and to make those reports public. This was a constructive suggestion from GAO and, in fact, we are preparing a report that will chart the progress we have made since our anticorruption strategy was publicly introduced in 1997. It is also worth noting that we already have a public web site which contains an extensive array of information on the anticorruption activities of the Bank, and that I and my colleagues take every public speaking opportunity to speak to the issue of the Bank's efforts and progress on its anticorruption initiatives.

Conclusion

To conclude, we appreciate that the report makes many valid and useful points about the Bank's system of internal controls. At the same time, we believe that the substantial progress which the Bank has made in strengthening its controls – given the difficult environment in which we work – allows us reasonable assurance that project funds for the most part are used as intended.

Tackling corruption is difficult and complex, and the Bank is required to focus its efforts in countries where controls are weak – something that we should not shy away from. On the contrary, we must be even more aggressive in our capacity building efforts – and that is the essence of our anticorruption strategy. We have to be prepared for a long, hard struggle – and we have to work together. Fighting the cancer of corruption is a challenge not just for the Bank, but for the entire development community.

Sincerely yours,

Jim Wolfensohn

James D. Wolfensohn

The following are GAO's comments on the World Bank's letter dated March 16, 2000.

GAO Comments

1. We agree that an important dimension of the Bank's anticorruption effort is provided through policy dialogue, lending for adjustment and public sector reform, and advisory services as many borrowers lack well-functioning public management systems, accountable organizations, and a strong legal framework to prevent, detect, and redress corruption. Our report noted that the Bank has helped launch over 350 anticorruption activities in 95 countries, including a variety of initiatives designed to help borrowers strengthen public institutions and establish strong management controls on a countrywide basis.

2. We agree that the Bank's role as a development institution is to work in countries that may have weak controls and capacity. However, we disagree that there is a blurring in the report between the Bank's internal controls and those of the borrowers. The report focuses on the Bank's system of controls to ensure project funds are used as intended, including its systems for project supervision, monitoring, and auditing. The report also recognizes that the responsibility for ensuring compliance with the Bank's policies and procedures is shared by the Bank's borrowers, which execute the projects, and the Bank, which supervises the projects through a variety of approvals and reviews of borrower actions. (See app. V for a description of the major management control activities.)

3. Our legislative mandate was to evaluate the control processes and anticorruption programs at the World Bank; thus, we did not analyze the anticorruption programs of other international financial organizations to see whether these organizations have reasonable assurances that project funds are being used as intended.

GAO Contacts and Staff Acknowledgments

GAO Contacts

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Acknowledgments

In addition to those named above, Mark B. Dowling, Barney L. Gomez, Luisa Joy G. Labez, Rona H. Mendelsohn, Zina D. Merritt, James B. Michels, Gertrude O. Moreland, and Lawrence L. Suda also made key contributions to this report.

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