
Chapter 6 Auditing Public Debt Service Activities

This chapter helps SAIs to identify the elements of debt service activities in PDM, recognise their importance and relate the topic with the relevant audit types, criteria, sources of evidences and sample questions and findings.

6.1 What Are Public Debt Service Activities?

Public debt service activities are any financial operations related to repayment of the principal and payment of interest, commission, commitment fees, service charges and other fees and, possibly, late interest payments. Debt service can take the form of cash payments, the creation of an arrear, a rescheduling of principal payments, a partial or complete prepayment of principal, debt forgiveness or a debt swap.

The debt service or payment process requires active participation of several entities, namely, the DMOs, the creditors, ministry of finance (budget and treasury units), and the central bank, as the fiscal agent responsible for the country's foreign exchange reserves and monetary policy.

In the context of public finance management, the implementation of an IFMIS allows the automation of the debt service payment procedure. This modern concept minimises risks and facilitates the production of accurate debt service schedules, the generation of the payment orders, the execution of the debt-related budget and the transfer of servicing funds without delays.

Debt reorganisation or restructuring usually involves relief for the debtor from the original terms and conditions of debt obligations. Debt reorganisation or restructuring can take the form of debt rescheduling, debt forgiveness and debt conversions.

Paying on time the correct amounts specified in public debt agreements is the main objective of debt service activities. It is important for debt managers to adopt sound practices in debt servicing because countries that always pay on time are likely to have higher credit status and lower borrowing costs.

A critical component of an effective debt service operation is a secure, up-to-date and complete debt database. This tool is essential to make risk analyses, such as the detection of large servicing payments in the near future, irrespective of the original maturity of the debt instruments.

A complete, up-to-date debt database is necessary to produce accurate debt-service schedules. Prudent debt managers would produce conservative estimates of feasible future borrowing, and incorporate into their future debt schedules the country's macroeconomic conditions, the country's balance of payments prospects, and the government's fiscal position.

Integration between the debt information systems and the other components of public administration (accountancy, treasury and budget) is important to execute debt service operations automatically.

6.2 Auditing Debt Service Activities in Public Debt Management

The focus of the audit of debt service activities would be to examine whether the payments were made on time in the correct amounts and whether the related transactions were recorded accurately and completely.

For efficient debt service activities, the debt managers should adopt sound practices and a secure, up-to-date and complete debt database, if possible, integrated with the other

components of public administration. In assessing the effectiveness, efficiency and economy of debt service activities, SAIs can use flowcharts that visually represent the exchange of important documents and communications in debt operations, as shown in *Figure 8*. SAIs could also focus on the adequacy of cash projections' process to the extent considered in the fiscal budget formulation and on exchange of information between different stakeholders.

Figure 8. Flowchart Debt Servicing Activity

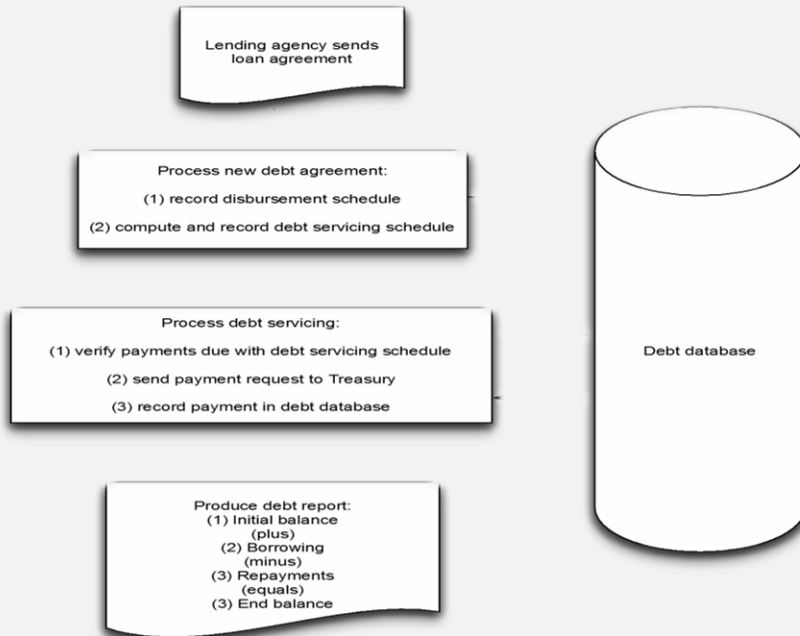
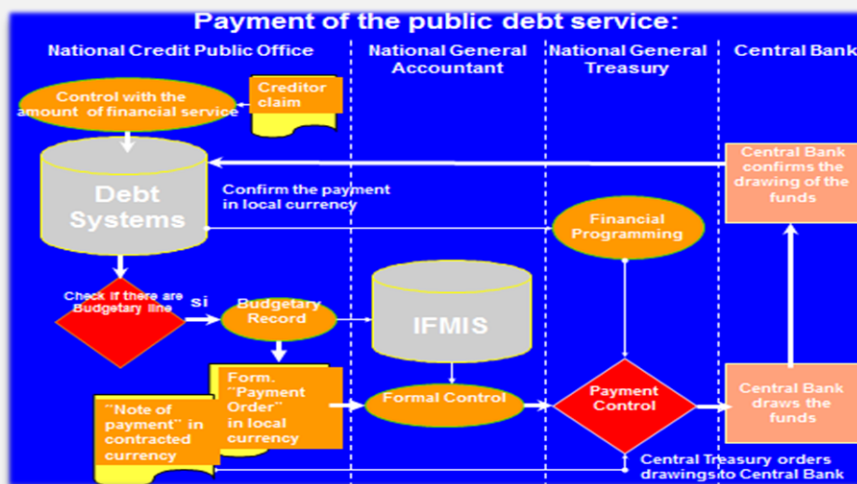


Figure 9 shows how the above functions could be distributed between various departments.

Figure 9. Distribution of Functions for Debt Service Payments



6.2.1 Compliance audit of debt service activities

An SAI can conduct a compliance audit of, amongst others, whether instalments are made as per amortisation schedules and agreements, the information on the schedule agrees with the underlying contracts and debt service activities are in line with established policies and procedures.

The following could be common audit objectives:

- To ascertain whether the public debt database is complete and accurate so as to provide reliable financial information for debt service;
- To ascertain if the DeM system was integrated with other components of public administration consistent with sound international practices;
- To determine whether the debt service process, budget and schedules were adhered to as required under relevant laws, rules and agreements; and
- To determine whether repayments were made to the creditor as per the loan agreement.

6.2.2 Performance audit of debt service activities

Performance audit should focus on the efficiency, effectiveness and economy of carrying out the debt service activities. SAIs can examine the accuracy of the debt service forecasts included in the fiscal budget and its impact on the cost of debt servicing; the cash management activities and related holding costs of cash; whether the established procedures related to debt service activities are in line with best practice; and whether the knowledge management between key stakeholders promotes efficient, effective and economical debt servicing.

The following are possible objectives for a performance audit of debt service activities:

- To ascertain the accuracy of government cash flow forecasts and its impact on cost of debt servicing;
- To determine the rationality of fixation of repayment schedule vis-à-vis the timing of inflow of main sources of government revenue;
- To determine the adequacy and effectiveness of coordination and consultation between relevant agencies relative to debt service activities;
- To ascertain the existing cash-flow forecasting and projection capacity with respect to management of the government's consolidated account, central government account and foreign currency accounts;
- To determine whether all relevant information on loans under debt reorganisation have been validated and updated in the Public Debt Management Information System; and
- To examine whether the debt information provided by the DMO for debt restructuring was complete and appropriate.

6.3 Representative Audit Questions on Public Debt Service Activities

Audit objective: To ascertain whether the public debt database is complete and accurate so as to provide reliable financial information for debt servicing

- 1) Is all debt information relevant to debt servicing as shown in the loan agreement accurately captured in the DeM system?
- 2) Are the dates in the schedule of public debt in the DeM system in agreement with the scheduled dates in loan agreements?
- 3) Are interest projections updated in the system according to the latest disbursement information?
- 4) Do DeM staff reconcile any discrepancies between the public debt schedule and the public country debt data available in websites of the World Bank, the IMF and other creditors?

Audit objective: To determine whether the debt service process, budget and schedules were adhered to as required under relevant laws, regulations and agreements

- 1) Is there a register of all correspondence received at the DMO regarding scheduled payments?
- 2) Are all billing statements received prior to the due date?
- 3) Is a payment made in the absence of a billing statement?
- 4) Are billing statements checked against the DMO's debt schedule? If so, how many discrepancies were detected?
- 5) Have all payments in waiting been cleared within an appropriate time period?
- 6) Are debt service payments made in accordance with procedures?
- 7) Are any debt service payments made that were not in the budget?
- 8) At the budget department, is there a document that records actual expenditures related to debt service? Differences in actual expenditures should be reconciled?
- 9) Are there differences between interest amounts as budgeted and interest amounts effectively paid by the DMO? If so, have these differences been reconciled?
- 10) Are billing statements reconciled against the actual debt service payments made? How many discrepancies were detected?
- 11) Are there differences between the payment orders registered in the MoF or the treasury and the payments made (debit advices) by the fiscal agents (central bank or agent banks)?
- 12) Do the DMO staff identify the reasons for under- or over-payments reported by the creditors?

- 13) Are there any prepayments of debt service? Has the debt service schedule been modified to incorporate prepayments?
- 14) Are there any scheduled payments that were not acted upon?
- 15) Are all payments in arrears acted upon? Has a payment previously in arrears already been made?
- 16) What is the status or classification of amounts in waiting that will not be paid or are in arrears? Are there any write-offs or rescheduled debt?

Audit objective: To ascertain the accuracy of government cash flow forecasts and its impact on cost of debt servicing

- 1) What offices are involved in cash flow forecasting?
- 2) Which office prepares the cash flow forecast and what is the frequency of preparation?
- 3) What is the information considered in the cash flow forecast and from where are they sourced?
- 4) Is a cash flow forecast and meeting conducted prior to auctions of government securities?
- 5) Is there an analysis of the deviation of the actual cash flow from the projected cash flow and its effect on the level of borrowings and related costs?

Audit objective: To determine whether all relevant information on loans under debt reorganisation have been validated and updated in the PDMIS

- 1) Are the new debt agreements confirmed with the creditors?
- 2) Is each rescheduled loan clearly identified as a rescheduling, for example, with an extension name such as 'Paris Club1', 'Paris Club2', 'HIPC'?
- 3) Are the data elements in each loan tranche modified in accordance with the debt rescheduling agreement?
- 4) Do the DeM staff certify that the loan amortisation tables incorporate the terms of each debt rescheduling agreement?
- 5) Is the new interest rate correct so that debt managers can obtain the correct amount of interest to be rescheduled?
- 6) Are the negotiated terms in Paris Club documents incorporated in the PDMIS?

6.4 Audit Criteria for Debt Service Activities

The main DeMPA principles that can be used to establish criteria during the audit of debt service activities are included in DPI-11 and DPI-12.

As indicated, debt service includes the procedures and activities that relate to payment of the principal and interest components of debt, taking into account possible debt reorganisation or

restructuring. The principles establish a guideline on how to organise the debt service activities.

DPI-12 covers debt administration and data security, including availability and quality of documented procedures for the processing of debt-related payments. The recommended practice requires that all payment notifications be checked with internal records before payments are made, payment instructions be subject to a minimum two-person authorisation process and all payments be made by the due date.

Another principle, DPI-6 on coordination with fiscal policy, does not deal directly with debt service activities but affects the government's ability to service the debt effectively. It emphasises the importance of reliable and timely forecasts of the central government's debt servicing.

Unlike DeMPA, the UNCTAD Principles do not cover debt servicing activities, but they include two recommendations on debt restructuring—one on the responsibility of the lenders and one on the responsibility of the sovereign borrowers.

On the responsibility of the lenders, the principles state, 'In circumstances where a sovereign is manifestly unable to service its debts, all lenders have a duty to behave in good faith and with cooperative spirit to reach a consensual rearrangement of those obligations. Creditors should seek a speedy and orderly resolution to the problem.'

On the responsibility of the sovereign borrowers, the principles state, 'If a restructuring of sovereign debt obligations becomes unavoidable, it should be undertaken promptly, efficiently and fairly.'

6.5 Sources of Evidence in Auditing Debt Service Activities for Public Debt Management

The SAI should obtain sufficient evidence to determine if the DMOs have complete and reliable information on debts due. An example would be an updated debt amortisation schedule for all loans and debt securities.

The SAI may use the following sources to collect evidence or understand the debt service activities:

- 1) Procedures manual for processing of debt-related payments and receivables, for debt data recording and validation and for storage of agreements and debt administration records;
- 2) Documents on the physical storage of original, signed copies of loan and derivative agreements in a secure location, of the scanning and maintenance of such agreements in electronic form in a secure location, or of both;
- 3) Documents on validation procedures against payment notifications;
- 4) Evidence of an independent confirmation of all data with external creditors and major domestic investors; and
- 5) Evidence of a two-person authorisation process.

6.6 Illustrations of Audit Findings on Debt Service Activities

The findings identified by the SAIs can be classified into three main categories, related to: (1) debt service projections and payment orders; (2) unpaid obligations from state or local governments; and (3) poor cash management.

1) Debt service projections and payment orders

The SAIs found that lack of good records and update of the necessary variables are causing discrepancies between the payment schedule and the payment order. In another case, debt repayments were not included in the fiscal budget, resulting in a shortage of cash and short-term borrowing to cover long-term debt.

2) Unpaid obligations from state or local governments

The SAIs observed that incorrect recording and monitoring of the general government liabilities are causing problems (arrears) due to non-payment of the local governments' obligations. The provisions of the law for the specific country require the state government to deduct the interest payments from the grants to the local governments resulting from the debt the state has been increasing over the years.

3) Poor cash management

The SAIs noted that the non-existence of a sinking fund to finance debt payments when they become due resulted in borrowing to finance debt payments. The sinking fund was supposed to finance the current debt from the revenue and taxes collected during the period and exposed the country to default risks.

