



CAYMAN ISLANDS

**REPORT OF
THE AUDITOR GENERAL**

on the

**Financial Statements of the
Government of the Cayman Islands
for the year ended 31 December 1995**

Cayman Islands Audit Office, 23 August 1996

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REPORT OF THE AUDITOR GENERAL FOR THE YEAR ENDED 31 DECEMBER 1995

Introduction

In accordance with the provisions of Section 42 (1)(b) of the Public Finance and Audit Law, 1985, this Report is submitted to the Presiding Officer of the Legislative Assembly of the Cayman Islands. This report concerns my examination and certification of the Financial Statements of the Government of the Cayman Islands for the year ended 31st December 1995, and other such matters which relate to the performance of my duties and the exercise of my powers under the Public Finance and Audit Law, 1985. The Report has been agreed with the appropriate Government authorities to be a fair summary of all relevant facts concerned with the various issues raised. This Report, together with the Financial Statements of the Government, will now be considered by the Public Accounts Committee of the Legislative Assembly in accordance with Standing Orders (Revised). After the deliberations of the Public Accounts Committee, this Report, the certified Financial Statements and the Report of the Public Accounts Committee shall then be laid before the Legislative Assembly and submitted to the Secretary of State in accordance with Section 42 (2) of the Public Finance and Audit Law, 1985.

PART I

Financial Statements of the Cayman Islands Government for the Year Ended 31 December 1995

1.1 The Government's Financial Statements comprising:

- the Statement of Receipts and Payments
- the Surplus and Deficit Account
- the Statement of Movement of the General Reserve
- the Statement of Assets and Liabilities
- the Statement of Public Debt; and
- the accompanying Notes and Appendices

were transmitted to me duly signed and approved by the Accountant General on 22 August 1996. I completed my audit and certified the financial statements and accompanying notes and appendices on 23 August 1996. The certified financial statements were then transmitted to the Presiding Officer of the Legislative Assembly of the Cayman Islands, together with this Report in respect of my examination of the financial statements and on other matters relating to my duties and the exercise of my statutory powers in accordance with the requirements of Section 42 (1)(b) of the Public Finance and Audit Law, 1985.

Audit Opinion

1.2 As more fully described in paragraphs 1.20 to 1.22, I have qualified my audit opinion on the 1995 annual financial statements because I consider the accounting policy for overseas medical advances is inappropriate. Overseas medical expenditure is not being brought to account at the date of payment but is classified as a recoverable advance and is shown as an asset in the annual Statement of Assets and Liabilities. Amounts accumulated in the advance account are brought to account periodically, usually accompanied by conversion of individual debts to long term loans. The effect of this accounting policy, which has been followed for many years, is to defer recognition of expenditure to future periods. I drew attention to this situation in both my 1993 and 1994 Reports and warned that the annual financial statements were being distorted by late and inconsistent accounting treatment. I did not qualify my audit opinion in either 1993 or 1994 because the amounts involved were within accepted materiality levels. As at 31 December 1995 accumulated overseas medical expenses charged to advances stood at \$7,721,834. In my opinion at least

\$4,005,188 relating to 177 completed cases should have been classified as expenditure between 1993 and 1995. In my opinion the accumulated deficit is understated and assets are overstated by this amount. Further, it is my opinion that most of these medical advances will prove to be irrecoverable. I emphasise that this qualification arises from disagreement with a long standing accounting policy. It is not a criticism of Government's policy in providing overseas medical services to citizens of the Cayman Islands.

1.3 I also disagree with the accounting treatment for three land purchase transactions whereby expenditure of \$603,439 paid in 1995 has been deferred to 1996. In my opinion, 1995 expenditure is further understated by this amount. Details are provided in paragraphs 1.12 and 1.13.

1.4 With the exception of the accounting policy issues disclosed in paragraphs 1.2 to 1.3, and excess expenditure of \$102,022 reported at paragraph 1.5, in my opinion the financial statements properly present the receipts and payments of the Cayman Islands Government for the year ended 31 December 1995.

Excess Expenditure

1.5 For fiscal 1995 only one small excess and unauthorised expenditure was recorded by the Prison Department on Head 07.

	\$
<i>Estimated:</i>	3,588,221
<i>Actual:</i>	3,690,243
<i>Excess:</i>	102,022

Explanation

The excess expenditure occurred mainly under the personal emoluments sub-head (\$176,829) offset by savings in supplies and materials and utilities. The Department reports three main reasons for the overspend.

- Additional overtime was needed for the supervision of Cuban refugees by off-duty prison officers. The prison submitted requests for supplementary funds in May and June 1995 totalling \$124,675. The requests were reduced to \$55,000 in the expectation that Cubans would have left the island by June 1995. In any event the request was denied by Finance Committee.
- Four Prison Officers posts were approved and filled during 1995 at a cost of \$64,416 but insufficient funds were included in the budget to cover these posts.

- Due to heavy workload in the maintenance shop an additional maintenance assistant was hired. In January 1995 a supplementary request was made for \$24,414 to cover the cost of the wages for this post but budgetary cover was provided for only six months.

The Prison Department is not linked to the Treasury's general ledger system because of computer equipment failures. Unlike other government departments, the prison cannot obtain accurate and timely financial information.

Financial Highlights for Fiscal 1995

1.6 It will be seen from **Figure 1.1** that Government recorded a net deficit of \$5,598,272 on the Receipts and Payments Account for 1995, of which \$2,457,676 was covered by the accumulated surplus from previous years. This is \$2,888,542 above the original budget deficit of \$2,709,730 presented to the Legislative Assembly in November 1994. Summary highlights of 1995 financial performance include:

- The budget deficit was 3.2% of recurrent revenue. Although the budget deficit was more than originally planned, the variance of \$2.888 million was only 1.6% of total revenue. By most standards this is a satisfactory performance outcome.
- Total budget expenditure of \$177.977 million was increased by \$20.865 million of supplementary approvals (\$8.465 million recurrent and \$12.400 million capital), of which \$961,474 was funded through blocking of approved budgets. No additional revenue enhancement measures were introduced to fund supplementary expenditure.
- With the exception of Prison Department, all Heads of expenditure remained within final approved estimates. Despite the magnitude of supplementary approvals, recurrent and capital expenditure was \$579,000 (0.36%) less than the original budget.
- Excluding approximately \$4.678 million additional revenue received from the Water Authority to refinance a Caribbean Development Bank loan, recurrent revenue was \$2.145 million (1.25%) below budget. The variance can be attributed to two or three key transactions.
- Local loan proceeds were \$1.772 million compared to \$3.313 million budgeted. The \$1.541 million shortfall is attributable to a change in project financing mix and to delays in commencing two projects.

Figure 1.1: Budget Estimate and Out-turn for the Year Ended 31st December 1995

	Original Estimate 1995 \$m	Final Approved Estimate 1995 \$m	Actual 1995 \$m	Actual 1994 \$m
RECURRENT REVENUE				
Local	<u>171.954</u>	<u>171.954</u>	<u>174.487</u>	<u>152.108</u>
RECURRENT EXPENDITURE				
Statutory	15.267	15.267	19.726	12.001
Recurrent	<u>139.419</u>	<u>147.884</u>	<u>138.430</u>	<u>126.162</u>
<i>Sub-total</i>	154.686	163.151	158.156	138.163
Capital	<u>23.291</u>	<u>35.691</u>	<u>23.701</u>	<u>18.157</u>
TOTAL EXPENDITURE	<u>177.977</u>	<u>198.842</u>	<u>181.857</u>	<u>156.320</u>
SURPLUS / (DEFICIT)	(6.023)	(26.888)	(7.370)	(4.212)
FINANCED BY				
Local Loan	<u>3.313</u>	<u>3.313</u>	<u>1.772</u>	<u>4.719</u>
ABOVE LINE CASH FLOW	<u>(2.710)</u>	<u>(23.575)</u>	<u>(5.598)</u>	<u>0.507</u>
Cash Movements Below the Line				
(Increase)/ Decrease in Imprests			(0.116)	(0.001)
Increase / (Decrease) in Deposits			(1.254)	1.396
(Increase) / Decrease in Advances			(2.526)	(2.531)
BELOW LINE CASH FLOW			<u>(3.896)</u>	<u>(1.136)</u>
NET CASH FLOW FOR YEAR			(9.494)	(0.629)
TRANSFER FROM /(TO) RESERVES			-	(0.445)
CASH BALANCES				
Beginning of Year			<u>3.360</u>	<u>4.434</u>
End of Year			<u>(6.134)</u>	<u>3.360</u>
TOTAL ASSETS & LIABILITIES			16.744	15.721

- Government's net cash position deteriorated by almost \$9.5 million during the year. At 31 December 1995 Government's local bank accounts were overdrawn by \$6.134 million net. I have commented further on Government's cash position later in this report.
- The true net cash outflow position is understated because Deposit Accounts have been inflated by \$513,395 drawn down from loan funds but unspent at the year end.
- The General Reserve balance at year end was \$4.386 million held in local fixed deposits and United States Government securities. There were no transfers between general revenue and general reserves during 1995.

Financial Management Issues

1.7 There are three issues affecting Government's financial position which I would like to comment on. These are:

- The year end cash position
- Budget management
- Prepayments.

The Year End Cash Position

1.8 Cash balances vary considerably during the course of a year and are at their lowest level each December. Surplus cash is invested on fixed deposit. Treasury's goal is to optimise investment interest and Government earned \$742,000 from this source in 1995. Overall, Government's cash position deteriorated by about \$9.5 million during 1995. At year end 1995, Government's main bank account was overdrawn by \$7.480 million, compared to an authorised overdraft limit of \$4.5 million. Positive bank balances held locally and overseas amounted to \$1.346 million. The overdraft limit position recorded at the bank was breached only late in December 1995, when the balance exceeded the authorised overdraft limit by a maximum \$77,000 for a few days. The more favourable position at bank is attributable to unpresented cheques, which amounted to about \$6.4 million as at 31 December 1995. In my opinion, the year end overdraft is probably the single most important feature of Government's financial position and presents our biggest financial challenge for the immediate future. Closely related to the cash position is the General Reserve, which was only \$4.4 million at the end of 1995. I welcome

the Financial Secretary's announcement that reserves policy will be examined during the forthcoming revision of the Public Finance and Audit Law.

Budget Management

1.9 Traditionally senior finance officials use anticipated underspends to finance supplementary expenditures. In principle this practice is both sound and allowable by law. Certain supplementary expenditures were approved late in the financial year on the basis of a balanced budget. However, low cash balances have the practical effect of restricting Government's financial flexibility. With limited room for manoeuvre, Government's ability to project accurately annual expenditure and revenues assumes critical importance. This is a fairly complex exercise. Expenditure and revenue do not flow evenly through the financial year. A large portion of recurrent revenues are collected during the first three months of the year. There is a well documented tendency for capital expenditure to accelerate during the second half of the financial year. For example, 47% of capital spending has occurred in the last three months of the 1993-95 financial years. There are also systems deficiencies. Although the Budget and Management Unit (BMU) is responsible for compiling budgets and authorising release of funds, it relies upon the Treasury to project expenditure and revenue out-turns. The Treasury accounting system cannot provide projections of budget out-turn. Treasury uses a separate system to project the annual budget out-turn which operates on the principle of trend analysis over a 4 - 5 year cycle. This basic system has limitations and intervention is needed to interpret and adjust crude results.

1.10 Capital expenditure is more unpredictable and is difficult to track and forecast with Treasury's trend analysis. Public Works Department (PWD) also provides periodic forecasts of capital spending. PWD has no proper forecasting tools at all and its projections can only be regarded as informed "guesstimates". The Department would like to enhance its Public Works Support System (PWSS) but this task has not been prioritised by the Computer Steering Committee. Budget projections prepared by Treasury and PWD are presented to Executive Council to assist top level decision making. By convention, the Audit Office does not have access to policy documents and did not audit any of the forecast out-turns prepared for 1995. However we have been made aware that Government was presented with a wide range of budget outcomes for 1995 capital projects.

1.11 Several initiatives are in hand to improve cash and budget management. Government is planning a new financial and personnel system (IFHRIS) which will provide better financial management information. IFHRIS offers an opportunity to overhaul budgeting and forecasting. A key element of the new system should be the involvement of Controlling Officers and financial managers in preparing regular out-turn projections for all areas of expenditure and revenue under their control. The Portfolio of Finance and Development modified the warrant release system in 1996 to provide better information for

finance managers. Departments are now required to apply for quarterly releases of recurrent funds. The BMU has created a large spreadsheet to record all quarterly releases for recurrent expenditure. This should help in projecting budget out-turn. Controlling Officers now prepare estimated monthly cash flow profiles for all capital projects. This could also provide some useful budget management information.

Prepayments

1.12 An amount of \$1,510,287 has been included in Advance Accounts in respect of departmental prepayments. This amount represents cheques drawn in 1995 and, in the main, paid over to suppliers. Under generally accepted cash accounting principles, the date of payment governs the year of account. The payments in question were excluded from 1995 expenditure because goods and services had not been received by the year end. I reviewed these adjustments very carefully. I have concluded that the adjustments are acceptable, with the exception of three land purchase transactions totalling \$603,439 which I consider should be classified as 1995 expenditure.

1.13 A total of \$1,080,473 relates to various land purchases, which Government instructed should proceed in 1995. Standard practice of Lands and Surveys Department is to request cheques in advance because vendors expect payment once land transfer documents have been signed. The payment procedures have since been amended following audit recommendation. The Treasury subsequently removed from 1995 expenditure to an advance account all property transactions which were not registered until 1996. In my opinion the year of account is determined by the date when liability for payment had matured, which is effectively the date on which land transfer documents are signed. The Lands and Survey Department concurs with this view. The three disputed transactions comprise:

- A compulsory land acquisition of \$397,814 (US\$475,000) which was concluded on 22 December 1995. The cheque was drawn in 1995 but was not released to the vendor until 3 January 1996. The land transfer document was received by the Registrar shortly thereafter.
- Two payments totalling \$205,625 relate to instalments payable to vendors for land acquired in 1994 for the national sports and recreation centre. In accordance with contracts entered into in June 1994, the payments in question became due and payable on the anniversary of the purchase agreements subject to Government obtaining detailed planning permission. This was obtained during 1995. There were lengthy delays in completing the land transfer documentation due to legal complications. Nonetheless, the purchase transactions were completed well before 31 December 1995. In my opinion there is no justification for deferring these payments to 1996.

1.14 Payments totalling \$1,095,513 were initially treated as prepayments and were removed to an

advance account. Following audit review a total of \$665,699 was reinstated as 1995 expenditure. Most of this relates to expenditure incurred by the Department of Tourism for advertising and promotion. These payments must always be paid to the agency before the advertisement is published. Some of the expenditure rightly disallowed for 1995 relates to the purchase of computer equipment. Advance payments were made to local suppliers by several departments in order to spend 1995 budget allocations before the end of the year. The equipment was not delivered until 1996. As of 30 June 1996 some 1995 equipment purchases had still not been installed. Other advance payments removed from the 1995 accounts involve overseas purchases. In some cases vendors demand payment in full before shipping orders. Other vendors will ship goods without prepayment but expect prompt settlement. In one case examined, a payment of \$160,000 was made for goods ordered which were in transit at year end.

1.15 Attention has been focused on prepayments because of certain irregularities detected by the Financial Secretary during 1995. The irregularities stem from an advance payment of \$100,000 made in late 1994 as a deposit for furniture to be delivered at a later date. The furniture supply had not been tendered. There was no reasonable justification for the deposit, which appears to have been little more than a device to spend the approved budget allocation. Following intervention by the Financial Secretary, the supplier has agreed to return the advance, less \$1,500 for legal expenses. The refund was received in June 1996 and the furniture supply has since been tendered. Government's financial loss is limited to \$1,500 plus loss of 18 months interest. Two other irregularities involving the same department were detected subsequently. These involve further advances for landscaping (\$26,250) and construction (\$28,975). As the 1994 accounts are indelible, it was not possible to reverse these transactions in 1995. A Board of Enquiry convened by the Financial Secretary has reported on this matter.

Summary

1.16 We see three main issues which need to be addressed.

- Based on current information, Government's cash position may be tight at year end 1996. Action should be taken to ensure that the authorised overdraft limit of \$4.5 million is not exceeded without our bankers' prior approval. It may be desirable to increase the overdraft limit to cater for minor budget variances which can occur with even the best planning and management.
- Investment is needed in new systems and procedures to improve financial management and forecasting.
- Controlling Officers must be held accountable for non compliance with financial regulations regarding advance payments.

Public Debt

1.17 Public Debt consists of Government's direct borrowing plus self-financing loans raised by Government on behalf of Statutory Authorities. New loans drawn down in 1995 amounted \$1,200,000. **Figure 1.2** shows that total public debt decreased by 15.7% in 1995. The decrease is attributable to early repayment of the Water Authority's loan with the Caribbean Development Bank (\$5,050,873 at 31 December 1994), which was refinanced locally supported by Government guarantee, plus scheduled repayment of loan capital. Excluding the early repayment of the Water Authority's CDB loan, debt service costs were 6.3% of 1995 recurrent revenues - a rate consistent with that in 1994. Debt service costs continue at a moderate level in comparison with regional and international standards.

Figure 1.2: Public Debt

	1995	1994
	\$	\$
Public Debt		
Totals per Statement of Public Debt	33,241,188	37,024,723
Totals per Self-Financing Loans	<u>18,320,862</u>	<u>24,136,831</u>
	<u>51,562,050</u>	<u>61,161,554</u>
Debt Service Costs		
Principal and Interest repayments	15,302,435	8,680,579
Debt Service costs as a % of Recurrent Revenue	8.8% *	5.7%
* 6.3% excluding loan refinancing		

1.18 In addition to the loans shown in the Statement of Public Debt, Government has bought lands at a cost of \$2,742,880 under vendor financing agreements. Cumulative repayments amount to \$1,474,764, leaving a balance of \$1,268,116 owed at 31 December 1995.

1.19 The \$1.2 million loan drawn down in December 1995 was used mainly for medical facilities projects (\$628,064) and for building work at the Community College (\$513,395). The draw down for Community College work was unspent at the year end and was placed in a Deposit Account. A similar funding situation arose in 1994 and I was given assurances that this would not recur. In my opinion the draw down was not necessary as the Community College capital project did not begin until late 1995. Part of this project may be financed from the College's surplus funds. During 1996 the Loan (Capital Projects) Law, 1993 was amended to allow funds to be spent on other capital projects.

Advance Accounts - Overseas Medical Expenses

Accounting Issues

1.20 Certain payments for overseas medical treatment are charged to an advance account at the time of issue. These payments are not classified as expenditure in the Statement of Receipts and Payments, but as assets in the Statement of Assets and Liabilities. Expenditure incurred is brought to account at infrequent intervals. This accounting policy has several implications for Government finances.

- The practical effect is to defer expenditure from the year in which payment is made to a future period.
- Funds required for overseas medical expenses are not factored into Government's annual cash budget. As a result year end cash balances are less than forecast.
- As advance accounts are not reviewed regularly, irrecoverable advances continue to be classified as recoverable assets. This has the effect of overstating assets and understating expenditure in Government's annual financial statements.

Section 20 of the Public Finance and Audit Law, 1985 requires the Financial Secretary to issue an advances warrant before an advance payment can be made from public moneys. This procedure is not followed, resulting in a minor technical breach of the law. Of greater significance, the Legislative Assembly is not invited to approve an annual financial allocation for overseas medical treatment for non civil servants. This appears to conflict with section 4 of the Public Finance and Audit Law, 1985. Legislative approval for overseas medical expenses tends to be sought infrequently, usually when approval of Finance Committee is required for write off or conversion to long term loans.

1.21 This accounting policy has been questioned by my predecessors on a number of occasions during the past 10 years. In 1991 my predecessor concluded that the accounting treatment was improper. In his opinion, the use of advance accounts disguised the extent of overseas medical expenditure and avoided Parliamentary scrutiny and approval. I agree with his remarks. Following recommendations by the Public Accounts Committee, the 1991 Government Minute agreed that overseas medical advances should be reviewed at least annually. Completed cases would be transferred to a loan basis and budgetary provision would be included in the annual estimates to cover these expenses. As a first step an amount of \$6.3 million was removed from advance accounts and was brought to account in December 1992. Regrettably, Government has since failed to honour its commitment and no further action has been

taken to implement an appropriate accounting policy. Once again, overseas medical expenses have been permitted to accumulate in the advance account.

<i>Balance as at</i>	\$	
December 1992	407,617	Analysis of the advance account as of 30 June 1996 indicates 465 active accounts, of which 99 accounts totalling \$522,749 relate to excess room charges owed by Civil Servants. The remaining 366 accounts (\$8,315,942) relate to overseas treatment for non entitled patients.
December 1993	2,497,537	
December 1994	5,021,887	
December 1995	7,721,834	
June 1996	8,838,691	

1.22 In both my 1993 and 1994 Reports I advised Government that recurrent expenditure is being distorted due to the present accounting treatment for overseas medical advances. In view of the magnitude of advances outstanding as at 31st December 1995, I have been obliged to qualify my audit opinion on Government's financial statements. For the financial years 1993 to 1995, in my opinion, expenditure has been understated by at least \$4,005,188 in respect of 177 completed overseas medical advance cases. The accumulated deficit on the Surplus and Deficit Account is likewise understated by this amount. I recommend that the use of the Advance Account should be discontinued and that all overseas medical payments should be charged to an approved Head at the time of issue.

Control and Management Issues

1.23 There are two categories of patients - exempt and non-entitled. Civil servants form a sub-category of entitled patients and pay only the difference between local room rates and overseas room rates. Other expenses for exempt patients are charged to expenditure at the time of payment. All expenses paid on behalf of non-entitled patients are charged to an advance account. Non-entitled patients do not normally provide any security for repayment. Internal Audit Unit (IAU) carried out a comprehensive audit of the overseas medical system. The audit comprised examination of 100 patients with balances exceeding \$10,000. Records were examined to ensure that established standards and procedures were complied with as regards referral, financial assessment, letters of guarantee, promissory notes, payments, billings and collections. An overview of cases audited is provided at **Figure 1.3**.

1.24 The audit study revealed that procedures are deficient in many key areas. In particular, we highlight that no effective action was being taken to monitor repayment or to initiate debt recovery for all delinquent cases prior to August 1996. Specific issues are highlighted below.

Figure 1.3: Audit Summary

	Referrals	Promissory Notes	Financial Assessments	Repayments
Advances & Indigents	61	54	61	3
Civil Servants	39	N/A	N/A	18
Exceptions	0	13	51*	67 **
Examined	100	41	56	88***

* 9 patients were not assessed for various reasons. 5 patients files are in Cayman Brac. 37 forms were incomplete.

** 21 Patients made at least one payment. 46 Patients has not made any payments of which 21 are Civil Servants.

*** This figure excludes 7 indigents (exempt) and 5 Cayman Brac patients.

Source: Draft Internal Audit Report dated April 1996. The Health Services Department has not yet agreed all the observations and conclusions made by the IAU.

- **Organisational Issues**

Several departments are involved in overseas medical: Treasury, Health Services, the Ministry of Health, Drug Abuse Prevention and Rehabilitation and Social Services. Responsibilities have changed in recent times. The Health Services Department took over the accounts payable and accounting functions in March 1994. With effect from August 1995 responsibility for authorisation of overseas medical treatment was also transferred to the Health Services Department from the Ministry of Health, Drug Abuse Prevention and Rehabilitation. It is acknowledged that the issues in the following paragraphs have developed over a number of years and should not be blamed on any individual or department. However there appears to be a distinct lack of co-ordination and co-operation between departments. The Health Services Department maintains that responsibility for receivables management and debt collection rests with the Treasury and/or the Hon Financial Secretary. The Portfolio of Finance and Development does not agree with this assertion. The Health Services Department has not been adequately resourced to administer overseas medical expenses and recovery of advances. Four posts have been identified as essential but only one (payables) has been authorised and filled.

- **Financial and Other Records**

The Health Services Department receivables system does not differentiate between advances and loans, whereas Treasury classifies advances as assets in the Statement of Assets and Liabilities. Loans recoverable are not classified as assets by Treasury and only appear in a subsidiary accounting statement. Separate receivables sub-systems are maintained by Treasury and the Health Services Department. These have never been reconciled. It appears that there was a difference of about \$1.4 million between the two systems at 31 December 1995 (Treasury

\$14,235,391; and Health Services \$12,848,161). We noted that patient loan or advance repayments are logged to the Treasury system first. Despite attempts to improve the reporting of cash received by Treasury to Health Services, there are still many errors in this process. There are no controls in place to ensure that all receipts are processed by the Health Services system. As a result, Health Services records sometimes omit payments made by patients. This is compounded by delays of up to three months before payments are recorded on individual Treasury accounts. This has resulted in demands for payment issued in error. The problem may worsen and may undermine confidence in Government's financial records.

- **Financial Assessments**

Financial assessments for all advance patients are administered by a Medical Social Worker (MSW). IAU found that there were no assessments in 39% of the cases sampled. All the remaining transactions tested were partially incomplete. None of the financial or other information provided to the MSW is ever verified. The Health Services Department has commented that this is not the work of the MSW. This gap in procedures may influence amounts subsequently recovered from patients and/or sureties.

- **Promissory Notes**

Promissory notes are agreements for repayment to the Health Services signed by an advance patient and usually two sureties. IAU's sample revealed that 24% of required promissory notes were not available for review. This finding is still subject to confirmation by Health Services. The Legal Department has now reviewed promissory note arrangements.

- **Status of Advances**

Generally, patients are not required to provide security before proceeding for treatment overseas. In a few cases, some of which date back to 1984, patients have agreed to permit Government to take a charge over their property. However in these instances Government's interest in the property has not been registered with the Lands and Survey Department. The Ministry of Health has commented that it has been waiting for the Financial Secretary to authorise the waiver of stamp duty before registering charges. Legal Department advised us that the security should be registered. For all intents and purposes the loans and advances are unsecured. This obviously lessens recovery prospects.

- **Billings and Collections**

Repayment of the outstanding balance advanced should begin three months after initial treatment. A monthly repayment plan is approved by the MSW based on the patient's circumstances. Patients are now sent bi-monthly billing statements. The overseas accounts

officer has completed computerisation of the overseas medical process. Effective August 1996, monthly invoices and statements will be issued to patients. Delinquent accounts will be sent automatic reminder letters and defaulters will now be referred to the Debt Collection Unit for legal action.

- **Advance Patients**

IAU analysis revealed that only 3 of the 54 advance patients examined are making regular monthly payments. A further 21 patients paid the required deposit and at least one monthly payment. In all 30 patients have made no financial contribution, including nine cases where financial assessments had not been completed and a repayment plan was not established. My office established that over \$1 million is owed in respect of 22 deceased persons. Repayment history in these cases varies considerably.

- **Civil Servants**

Of the 39 civil servants sampled, 11 were found to have paid their bill in full. Of the remaining 28 who owed an aggregate \$129,713, only seven were making payments. Salary deductions have not been established in any of remaining 21 cases, some of who have either left the service or are deceased. None of these persons appear to be making any payment toward reducing their indebtedness. Medical treatment may be continuing in some of these cases. IAU's findings arose from a 40% sample, which suggests that the total delinquency position on civil servants' accounts will be significant. It is not clear whether this situation has arisen solely from control weaknesses or whether other factors are involved. I was told that Health Services management had referred a list of 40 civil servants to Treasury in July 1995 to recover outstanding advances through salary deductions. This does not seem to have been actioned.

Overseas Medical Loan Accounts

1.25 Periodically overseas medical advances are converted to interest-free loan accounts. As at 31st December 1995 a total of \$6,513,557 was owed, repayable over three to 15 years. Only \$104,636 (1.4% of total loans made) was collected in 1995. The Audit Office conducted a review of all accounts with outstanding balances greater than \$50,000. The objective of this exercise was to establish whether patients are complying with their agreed repayment plan. We examined 32 accounts where patients owed a total of \$3,551,833 as at October 1995. Our audit showed that a total of only \$214,191 (5.7%) had been recovered against these accounts since 1992.

- Seven persons owing \$826,411 are deceased.

- A total of \$138,564 was paid on two accounts by insurance companies, leaving a balance of \$8,051 owed on one account only.
- Of the remaining 23 accounts, only one was being serviced on a regular basis. Irregular repayments totalling \$13,318 had been made on another four accounts. No repayments at all had been made on any of the other accounts.

I am very concerned about the lack of attention given to this important area of Government finance. As a subsidiary issue, the Department is unable to report the magnitude of loan arrears, thereby obscuring public disclosure and accountability.

[Postscript: The number and value of future overseas medical advances should be greatly reduced if Government's proposed compulsory health insurance scheme becomes law later this year. According to media reports the premium will cover overseas treatment. The balance of unrecovered advances will still have to be brought to account as recurrent expenditure.]

Deposit Accounts - Immigration Security Deposits

1.26 Immigration deposits are collected from employers of every work permit holder and their dependants. Deposits are intended to cover the cost of repatriation at the end of an employee's service in the Cayman Islands and are repayable to the employer following the employee's final departure from the Islands. The amount of the deposit depends on the employee's nationality and ranges from \$150 to \$2,000. Although deposits are lodged in Government's bank account, they do not form part of general revenue and are recorded as a liability in the annual Statement of Assets and Liabilities. The Immigration Department is responsible for collecting and authorising refund of deposits, whilst the Treasury Department is responsible for the management of the deposit account and funds collected.

1.27 From time to time immigration deposits have been transferred to general revenue. The authority cited for this transaction is section 23(4) of the Public Finance and Audit Law, 1985, which permits deposits unclaimed for five years to be treated as moneys received for the purposes of the Government. Amounts of \$1,210,362 and \$1,000,000 were transferred to General Revenue in 1991 and 1995 respectively. The underlying principle applied for the 1991 transfer was all deposits collected before 1987 that is five years prior to the transfer date. In my opinion this interpretation and accounting action was inappropriate. An employer may claim refund of the deposit only after repatriation occurs. It therefore follows that the five year waiting period before Government can transfer unclaimed deposits should also commence at this time. The opinion of the Hon Attorney General has been sought to clarify the legal position.

1.28 As far as my office could ascertain, the deposit account has not been reconciled since the early 1980s. The Audit Office therefore carried out an exercise to try to establish Government's financial liability for refundable immigration deposits as at 31 December 1995. Limitations to the immigration database prevented us from establishing the dollar value of deposits held. The only other feasible approach was to undertake a computer head count of work permit holders and their dependants. One month and six month permit holders were excluded, as these categories do not require a deposit. We also excluded from the head count permit holders from whom Immigration Department do not require a deposit. The results of the head count were as follows:

Position as at 31 December 1995

Permit Holders	8,036
Dependants of Permit Holders	1,328
Estimated Security Deposit Liability	\$4,595,100
Deposit Account Before Appropriation	\$5,748,057
Deposit Account After Appropriation	\$4,748,057

1.29 From discussions with Immigration Department officials and from our own enquiries, it became clear that the immigration database was incomplete and could not be relied upon to provide an accurate estimate of security deposit liability for the following reasons.

- The present immigration database was introduced in August 1993. Some three year work permits issued in 1993 were not recorded on the system at the date of audit.
- The computer head count reported only 1,328 dependants of work permit holders. We strongly suspect that dependants' information is incomplete and has not been recorded systematically in the database. We carried out a limited test to establish whether all dependants were properly recorded in the system. Out of six cases selected, three which were shown as having no dependants actually had 10 dependants for which deposits of \$7,800 had been paid. Although the sample size is far too small to extrapolate over the entire population, it provides strong evidence that the liability is understated. We did not conduct an extended audit of dependent numbers based on a statistical sample sufficient at an acceptable confidence level as this would have been too time consuming.
- Security deposits are also collected from some overseas students resident on the Islands and temporary residents awaiting permanent residence approval. These transactions are not recorded on the work permit database.

- There is a time lag in processing refunds, typically of up to one month. As at 31st December 1995 the deposit account included amounts for work permit holders who had left the island during the month of December and were thus not included in the computer head count.
- Immigration Department does not check if security deposits are reclaimed once the permit holder has departed the Islands permanently.

1.30 I reported my findings to the Financial Secretary in February 1996. I concluded that the provisions of section 23(4) of the Public Finance and Audit Law, 1985, were interpreted too literally in 1991 when \$1.2 million was transferred to General Revenue. Government should have waited for five years after persons had departed the Islands before contemplating any appropriation. No review was carried out to establish whether any of the designated persons had actually left the Islands and whether the relevant security deposit had been refunded. In respect of the transfer proposed for fiscal 1995, I recommended that it would not be prudent to appropriate any unclaimed deposits to General Revenue unless the transfer was supported with a schedule of permit holders who have departed the Islands. Confirmation should be obtained from Immigration Department that no refund of security deposit had been requested or paid to these persons. The Financial Secretary is of the opinion that the amount calculated as Government's refund liability as at 31st December 1995 (\$4,595,100) is not materially understated and has authorised the transfer of \$1,000,000 to general revenue. Based on my audit, and from information and explanations provided by the Immigration Department, I remain of the opinion that it is highly probable the refund liability is understated by a material amount. As a result of systems and management deficiencies, I have been unable to quantify the extent of the potential understatement and the impact, if any, on the Statement of Assets and Liabilities, the Statement of Receipts and Payments and the Statement of Surplus and Deficit.

1.31 I have made three main recommendations to the Financial Secretary about the control and management of these deposits.

- There is urgent need for regular reconciliation of the deposit account. So far as I can establish, this has never been accomplished despite numerous audit recommendations reaching back to 1982. Reconciliation could be relatively simple if a dollar value for each security deposit held was retained in the immigration database.
- Since these deposits are not funds which can be used by Government in the normal course of events, immigration deposits should be held in a separate bank account and should not be mixed with general revenues. Government would continue to receive interest on the deposits. I am also of the opinion that the Statement of Assets and Liabilities should disclose the

restriction on the use of the cash balances to comply with recognised accounting practice.

- Responsibility for financial management of the deposit account should be transferred from Treasury Department to Immigration Department.

1.32 Both the Financial Secretary and the Chief Immigration Officer agree that Government has a moral and ethical obligation to refund the immigration security deposit once an employee has been repatriated to the country of origin. The Financial Secretary has assured me that if any financial deficiency is identified after reconciliation of the deposit account, the liability will be made good from general revenue. All deposit refund liabilities will continue to be met in full.

Arrears of Revenue

1.33 Under the cash basis of accounting, revenue is only recognised once it is received. The scope of my audit of the Statement of Arrears of Revenue was restricted to an overall review of the information submitted by Controlling Officers to Treasury. Generally, I concluded that the 1995 Statement is more accurate and reliable than those presented in previous years. Revenue arrears at 31 December 1995 are reported at \$18,359,308 (1994: \$12,494,145), excluding between \$3 - \$4.5 million of pre-1992 medical fees. The increase of \$5,865,163 is mainly attributable to three situations.

- Head 65-010: Arrears of Hospital Fees increased by \$1,927,173 from \$3,880,140 in 1994 to \$5,807,313 in 1995. The established trend seems to be that only 50% of recorded hospital revenues are collected each year, including arrears. Although cash collections actually dropped by \$337,000 in 1995, Health Services officials have commented that revenue has improved in 1996.
- Head 65-004: Arrears of Company Fees increased by \$1,789,395 from \$2,294,959 in 1994 to \$4,084,354 in 1995. The increase is attributable to a change in the basis of reporting. Prior to 1995, General Registry and Shipping reported arrears for the current year only. In 1995 the department changed to the cumulative basis of reporting.
- Head 71-301: Government considers that the Civil Aviation Authority owes \$1,717,590 for its contribution to General Revenue for 1994 and 1995. The Authority disputes this position. I have commented on this long running saga elsewhere in this report. I was not able to finalise the Authority's 1994 accounts as a result of this issue, which had still not been resolved as at 31 July 1996.

1.34 Controlling Officers should report arrears of revenue on a cumulative basis. However several departments seem to have misunderstood the basis of reporting and reported arrears for the current year only. The reporting basis was also inconsistent in previous years. The Audit Office has discussed the correct reporting basis with departments which have significant amounts of arrears. These departments have taken appropriate action to report on the cumulative basis for 1995. We recommend that Treasury reminds all departments of the correct reporting basis for 1996.

1.35 We noted that some arrears of company fees (Head 65-004) are deleted by the department when a company is struck off. We remind all departments that authority for write off is vested with the Financial Secretary. Revenue written off should be disclosed in the annual Statement of Write-Offs, Waivers and Losses.

Tourist Accommodation Tax Arrears

1.36 Included in the Statement of Arrears of Revenue as at 31 December 1995 is \$1,013,785 in respect of estimated amounts owed for tourist accommodation tax by 30 properties. Two properties are responsible for \$917,111 (90%) of the arrears. The former Ramada Treasure Island Resort owes \$586,726, which was disclosed in my 1992 annual report. There is no prospect of recovering this debt which should now be written off. The other major debtor is a local management company which has accumulated debts of \$330,385 over a nine year period and has now transferred its business interests to another company. My main concern in this case is that debt recovery action taken by Government has been generally ineffective. **Figure 1.4** summaries significant recovery action taken. Until late 1994 this has been limited to irregular demands for payment, supplemented by occasional reminders to the company. Previous promises to clear accumulated debts were never honoured and agreement could not be reached on an acceptable payment plan to recover tax arrears.

1.37 Debt recovery was reactivated in late 1994 by the Treasury Department after substantial work had been carried out by both the Treasury and Legal Departments to determine the actual amount owing and the most practical course of action. Since the company has no valuable assets, Legal Department commented that there would not have been much point in taking action which would have forced the company into liquidation. Further tax arrears of \$54,710 accumulated during 1995. In early 1996 the debtor company submitted a plan to clear accumulated liabilities by regular monthly payments. The payment plan was supported by the company's bankers and would have liquidated the debt over five years. Government agreed with the proposal in June 1996. However, by July 1996 the company's bankers indicated that they were not prepared to proceed with the repayment plan because the company's

Figure 1.4: Main Debt Recovery Action

Date	Action Taken
July 1991	Letter from Treasury urging payment.
March 1992	Meeting scheduled for 9 March. Cancelled.
October 1993	Letter from Treasury demanding payment of \$411,300.
November 1993	Meeting with Accountant General to set up repayment plan.
May 1994	Meeting with Accountant General and company bankers.
November 1994	Letter from Accountant General on outstanding debts.
February 1996	Demand for payment of US\$154,118 within 14 days.
April 1996	Company proposes to clear tax arrears over a five-year period.
June 1996	Agreement in principle with company and bankers for repayment of tax.
July 1996	Bankers decide not to proceed with payment plan.

trading position had deteriorated. The company also owes the Government \$27,289 for hotel reservation fees as at 31 December 1995.

1.38 Three issues need to be considered.

- **The Legal Position**

Failure to pay tourist accommodation tax to Government was a criminal offence under section 8 of the original Tourism Accommodation (Taxation) Law. This provision was repealed by the Tourist Accommodation (Taxation) (Amendment) Law, 1994, which came into effect on 1 June 1995. Section 10 of the new Law provides for a fine of up to \$50,000 and to imprisonment for two years for "fraudulent evasion" of tax and other specified offences. However, no provision has been made for a penalty to be imposed for simple non payment of tourist accommodation tax.

The Legal Department does not know why section 8 was repealed but has advised that under the Law proprietors are liable for the payment of the tax. The present Law does not appear to protect fully Government's interests, especially in cases where a proprietor has appropriated and used tax revenues for personal purposes. The Legal Department agrees that legislation should be enacted to reinstate a provision along the lines of the repealed section.

- **Involvement of Banks**

Taxes collected on behalf of Government are not physically segregated from a company's general funds. Once Government taxes are deposited with other revenues, the company's bankers are

able to control the release of taxes to Government. A company may be willing to pay over Government tax but is physically prevented from doing so because its bankers are not prepared to release the funds. This has been a recurring feature of the case in question, much to the frustration of Government officials. Banks are usually secured creditors whereas Government is an unsecured creditor. This issue needs to be addressed properly because Government has lost well over \$1 million in tourist accommodation tax revenues from insolvent companies. Ideally Government taxes should be preferred in a liquidation. Following examination by the Public Accounts Committee in 1993, Government agreed to initiate a study of the law during 1994. I am not aware whether the study was ever carried out. An alternative solution might be a voluntary code of practice for banks.

- **Licensing**

In 1993 the Public Accounts Committee recommended that this company's operating licence should be restricted if an acceptable payment plan for tax arrears was not put in place. With effect from August 1995, the debtor company ceased trading and transferred its business interests to another company. The new company was granted various operating licences by the Immigration Department (trade and business licence), the Department of Tourism (hotel licence) and the Registrar of Companies (formation of new company). These Departments have confirmed that they were unaware of the debts owed to Government. In any case there appears to be no provisions in any of the relevant laws to allow departments to withhold a licence for non payment of taxes.

Write-Offs, Waivers and Losses

Customs Import Duty

1.39 Write-Offs, Waivers and Losses incurred by government departments are disclosed in Note 11 of the financial statements. Two main issues arise on the waiver of import duty:

- Scope, justification and accountability for import duty waivers.
- Management and control by the Customs Department.

1.40 Research by the Internal Audit Unit (IAU) indicates that many commercial entities are benefiting from import duty concessions and waivers as at 31 December 1995. Concessions are spread over several business sectors including gas, fuels, chemicals, bakery, telecommunications, utilities, liquor, brewing

and hotels. No time limits for concessions were stipulated in some of the cases. We noted that some concessions were granted under the Tariff Law, 1934 for pioneer industries and had been in force for at least 30 years. In another well known example, import duty concessions have been authorised for a total of 50 years. Other exemptions are project related and are granted by Executive Council under the Customs Law. The justification for continuing with specific import duty concessions for prolonged periods does not seem to have been reviewed. The conditions under which some of these entities received concessions many years ago may not now be applicable. It appears questionable to the Audit Office whether there is continuing justification for all these concessions. On the other hand some entities have binding agreements with Government or Government agencies. It would be extremely difficult, if not impossible, to cancel or suspend these concessions. The Customs Department has never been in a position to determine accurately the annual value of duty concessions. The Audit Office is not able to provide even a rough estimate. The annual amounts waived are substantial in relation to total import duty collected.

1.41 Control and management of import duty concessions is the responsibility of Customs Department. We are aware of two cases where the terms of duty concessions are alleged to have been exceeded by importers. The amounts of duty owed are \$243,000 and \$25,807. In both cases the Legal Department has advised that the importations were not covered by the exemptions granted by Government. The disputes came to light in July 1995 and January 1995. Both cases are currently the subject of internal discussions and negotiations between the Customs Department and importers. In view of this I am unable to provide case details at this time. However my office will continue to keep a watching brief on these matters and I will report further if necessary. It is not appropriate to allocate specific blame for these cases to any individual or department. Part of the problem is interpretation of the instrument under which the duty waiver was approved and communications between the various parties involved. I am satisfied that appropriate action is being taken to pursue recovery of these amounts.

1.42 There are also practical difficulties for Customs Department. The numerous duty waivers and concessions have never been consolidated into formal staff guidance notes. Customs officers are aware of the existence of duty concessions and waivers in general, but they do not have access to the precise terms and conditions of individual waivers. Officers rightly tend to concentrate on assessing dutiable transactions rather than scanning the fine print of waivers to check compliance.

1.43 Importation of building materials at duty free or reduced rates presents special problems. There is some risk that materials imported may not be used on the approved project. Normally, quantity surveyors (QS) lists are used to support materials imported on concessionary terms. This type of control does not appear to be effective. The Collector of Customs does not have sufficient officers to implement

the level of control needed to provide adequate assurance that the concessions are not being abused. Control weaknesses noted on one recent duty waiver case include:

- By the time construction had reached the fourth floor, only the QS list of materials for the building foundation had been submitted to Customs Department. Customs officers were therefore unable to check compliance with QS lists as importations were being cleared.
- Auditors noted that QS listings were being submitted to Finance Department but were apparently not forwarded to Customs prior to release of imports. Only estimated quantities of items to be imported were provided by the various sub-contractors. The Customs Department was unable to confirm whether all imports were actually used for the project. No cumulative records of materials imported are kept.

1.44 The situations described above arose as a result of weak or inadequate internal controls. Better controls are needed to prevent recurrence. Duty waivers on construction materials are of special importance in view of the concessions granted on the current project for the construction of George Town hospital. Controls could be improved by:

- Ensuring that all parties are clear on the scope of each duty concession.
- Changing the method by which construction materials are exempted. Alternatives include payment of duty in full with subsequent claims for refunds certified by an independent QS; or a licence system which records cumulative importations.

1.45 The Audit Office continues to monitor developments in two cases of suspected evasion of duty. An amount of \$646,886 is reported to be involved in the larger case, which was first brought to attention in January 1992. I reported on this issue in 1993. The other case, which first surfaced in 1993, involves a restoration penalty of \$72,507, although the actual amount of duty evaded was much less.

PART II

Departmental Audits

Social Services Department

Cayman Islands Marine Institute

Background

2.1 For some years the community has been concerned about increasing juvenile crime and how best to deal with the problem. Social Services Department held firm views that the problem should be solved at home rather than through expensive overseas referrals. Following exploratory visits to three overseas facilities, Government entered into a five year agreement with Associated Marine Institutes (AMI)¹ effective January 1994 to provide a juvenile rehabilitation programme in Cayman Islands using premises at the Bonaventure Boys Home. AMI is contracted to operate a 6 bed residential unit and 25 day places for children aged 13 to 17 years. Recently the programme has also provided up to 10 extended evening places. Referrals are made by school principals, social workers and the youth court only as a final resort after other rehabilitation attempts have failed. Graduation from the programme is determined by the student achieving certain individual targets and being fully rehabilitated into a school or place of employment. The programme has operated at or above 90% capacity since May 1995 and above full capacity since January 1996. Services are provided through Cayman Islands Marine Institute (CIMI), incorporated as a local not for profit company in early 1994. CIMI is managed by a mainly local Board of Trustees. The Cayman Islands Government is not represented on the Board.

2.2 The project was considered by the Public Sector Investment Committee (PSIC) in June 1993. Both PSIC and Executive Council recommended that details of expected costs compared with current costs with expected reductions in dysfunctional behaviours be examined. PSIC was told that CIMI would replace the three existing programmes, Bonaventure House, the Alternative Education Unit and the Approved Schools programme, saving an estimated net \$126,000 per annum on operational costs. It was intended that the programme would proceed to Phase II PSIC appraisal, but this was never completed. None of these programmes was actually discontinued. Bonaventure House still exists on a

¹ Associated Marine Institutes is a not for profit organization based in the United States which operates over 40 affiliate marine institutions. AMI institutions focus on the marine environment as a motivational tool to redirect youth to become contributing and productive citizens. Institutions provide education facilities and a marine oriented youth development programme. Cayman Islands is AMI's first venture outside mainland USA.

smaller scale providing full time residential services for boys. The Alternative Education Programme, operated by Education Department, provides services for children under 13 with emotional or behavioural problems; for high school students on short term suspension; and for other students with other unique handicapping conditions. The department also needs access to approved schools abroad. Students are sent to these institutions as ordered by the courts because suitable local resources are still not available. We concluded that many of the broad policy assumptions submitted to PSIC were not realistic. Longer term programme effectiveness will be measured by a series of performance indicators developed by the Social Services Department and AMI. The indicators comprise:

- A target of 70% successful terminations, measured by favourable graduation from the programme.
- Each student will improve his/her educational performance by an average of two grade level increases.
- Prior to termination, students will be placed in an appropriate placement such as school (60%) or in work (40%). Yearly placement checks will be made over three years to document continued placements at school or work.
- The rate of recidivism will not exceed 25%. This will be calculated from review of criminal records.

2.3 The Social Services Department believes that an 18 month period of operation is too short to evaluate programme performance. It has suggested that evaluation should take place after two to three years operation. The Audit Office welcomes this positive initiative by the Department.

2.4 Financial and Stores Regulations mandates compulsory tendering for supply of goods and services exceeding \$100,000. The department indicated that of three programmes visited in United States, only AMI was prepared to consider offering their programme overseas. Services provided by AMI/CIMI were therefore not tendered. In this type of situation, effective budget review is vital to ensure that services represent good value for money. The CIMI programme has cost just over \$1.9 million to operate in its first two years, including start-up costs for salaries and equipment (refer [Figure 2.1](#)). The approved budget for 1996 has been increased by 17% from \$790,000 to \$926,030. Our preliminary enquiries indicated that CIMI's performance against budget had not been monitored.

Figure 2.1: Programme Costs 1994 & 1995

	\$
Capital	190,363
Programme start-up	125,627
1994 Operating Expenses	786,750
1995 Operating Expenses	786,750
Miscellaneous	<u>18,145</u>
Total	1,907,635

2.5 The Audit Office carried out an inspection audit in order to determine whether contract services were being provided in accordance with contract and with due regard to economy and efficiency. AMI and CIMI have co-operated fully and have permitted access to their financial records. However we were unable to complete parts of the examination because most of the financial records and supporting documentation is kept in Tampa. We plan to visit AMI's head office later this year to complete the audit work. Four main issues emerged during our audit:

- AMI indirect expenses.
- Manpower levels provided by AMI.
- Accumulated cash balances; and
- Educational issues.

AMI Indirect Expenses

2.6 AMI collects funds, co-ordinates operations and maintain records for CIMI. For providing these and other services, AMI retains 20% of all recurrent revenues prior to distributing such funds to CIMI. We calculated that AMI overheads for the first two years of the programme amounted to \$341,000, including \$25,000 of the start-up budget. Senior civil servants did not seem to be aware of this arrangement at the start of our audit. AMI management has assured us that the 20% overhead arrangement is standard for all their affiliate institutions.

2.7 Our audit revealed that AMI had deducted a further \$92,000 from CIMI's net monthly payments between January 1994 and June 1995. CIMI management informed us that services are usually provided by AMI and other affiliated institutes to CIMI, for which payment is due. As these transactions originate in Tampa, we were unable to establish what services had been provided. We also established that about \$13,000 of foreign exchange losses are incurred each year through the method of transferring funds from

Government to CIMI through AMI. This could be avoided by paying AMI's 20% indirect cost direct to AMI in United States currency and paying CIMI in local currency.

Manpower Levels

2.8 The agreement between CIMI and government requires CIMI to provide the necessary staff to perform services in accordance with recognised professional standards. Government is obligated to pay for these services in accordance with the agreed budget. Since the contract does not specifically require budgeted staff numbers to be provided by AMI, we were not sure whether Government's financial position had been properly safeguarded. Our audit revealed that only two thirds of manpower budgeted and paid for had actually been provided by AMI (refer Figure 2.2). Whilst staffing problems could reasonably have been expected during the start up phase of the programme, we were concerned that this situation has continued for well over two years. We were told that staff had been loaned to CIMI from AMI and affiliate institutes free of charge to compensate for manpower shortages. During the first two years of operations approximately 22 man months were provided under these arrangements. CIMI is responsible for meeting the cost of travel, meals and lodging for these persons. We were unable to determine the total cost of loaned personnel, but concluded it would be considerable.

Figure 2.2: CIMI Manpower 1994 - 1996

<i>Period</i>	<i>Man-months</i>			<i>Expenditure</i>		<i>Variance</i>
	Budget Months	Actual Months	Percent Supplied	Budget CIS	Actual CIS	CIS
Feb - June 1994	71.4	53.2	74.5	217,817	71,692	146,125
July 94 - June 95	257.6	172.2	66.8	248,232	251,510	(3,278)
July 95 - March 96	<u>235.2</u>	<u>148.9</u>	63.3	<u>249,813</u>	<u>238,294</u>	<u>11,519</u>
Totals	<u>564.2</u>	<u>374.3</u>	<u>66.3</u>	<u>715,862</u>	<u>561,496</u>	<u>154,366</u>

Accumulated Cash Balances

2.9 CIMI receives payment of the agreed budget by equal monthly instalments, less amounts deducted by AMI. For its first six months of operations CIMI received \$218,000 for salaries expenses but spent only \$72,000. This has enabled CIMI to accumulate substantial cash balances.

	<i>Total Assets</i>	<i>Cash Balances</i>
	\$	\$
Year to June 1994	293,882	223,290
Year to June 1995	274,908	200,186

We understand that cash balances have been reduced during 1996. There seems to be no specific obligation for AMI to refund any excess funds retained. Prior to our audit, the Department of Social Services was not aware of CIMI's financial position and the accumulated cash balances. I do not consider it appropriate for a Government funded institution to have accumulated so much cash in such a short period. A sensible amount of working capital is required but this should be no more than one months expenditure. I consider that Government should try to recover surplus funds paid to AMI/CIMI or to adjust future budgets accordingly. The Department wants CIMI to use surplus cash to construct the proposed girls' unit. AMI/CIMI appear willing to channel the surplus into the programme area but not into a building which would be owned by Government in the long run.

2.10 The approved budget for 1996 includes \$73,899 for seven months operating expenses for a proposed girls unit, including AMI's 20% overhead. Planning approval for the girls' facility was granted in May 1996. It is doubtful whether the unit will be in existence much before the end of 1996 or early 1997. In my opinion it is inappropriate to provide funds so far in advance of need, especially in light of the cash surplus which CIMI has already accumulated through AMI's failure to provide the agreed manpower levels. Neither Social Services Department nor the Ministry of Community Development was aware of CIMI's cash surplus when 1996 budget was under discussion. In my opinion these funds should be recovered.

Educational Issues

2.11 The programme outcome approved by the Cayman Islands Government indicates that 60% of students were expected to be reintegrated into the school system, with the remainder absorbed into the workplace. Initially individuals were expected to complete the programme within a nine to 12 month period. Students are remaining on the programme for longer periods than planned. To date only five students have graduated from the programme. All parties agree that there is a problem reintegrating students back into the state school system. The high school is reluctant to accept CIMI students. To date only one student has been reintegrated. One other was refused entry. CIMI and the high school have recently agreed to leave most of the referred students at school and to arrange participation in the CIMI programme between 3 pm and 9 pm. CIMI has only limited educational facilities. Most of the school curriculum cannot be taught at CIMI due to the need for laboratories, specialist rooms and the

school based assessment component of subjects. Extended length of stay in the CIMI programme may have considerable financial impact on the programme when demand for new places cannot be satisfied.

Public Works Department

Fuel Sales and Stocks

2.12 Public Works Department has been responsible for the purchase and issue of fuels for government vehicles for over 20 years. Fuel purchases and sales are processed through an advance account, which is classified as an asset in the Government's annual financial statements. User departments are invoiced on a monthly basis. Reimbursements are made through an internal transfer arrangement. In theory, departments should ensure that all fuel issues are brought to account in the year of issue. The year end balance on the advance account should represent the physical quantity of fuel held. An examination of this advance account revealed that year end balances had increased significantly over the past four years:

	\$
1992	30,820
1993	48,572
1994	81,068
1995	98,513

2.13 Our review of this account revealed weak control and accounting practices both on the part of PWD and user departments. Our scope of audit did not include substantive examination of departmental fuel usage records. Accordingly we make no representation as to whether all fuels have been used for authorised official purposes.

- Charges totalling \$79,404 for fuel billed to various departments during 1995 remained unpaid at year end. Of this amount, revenue transactions to the value of \$6,622 had been submitted to Treasury but had not been processed during 1995. Public Works Department believes that certain departments deliberately delay the preparation of transfer vouchers if they do not have sufficient funds available in their budgets.
- In one case we noted that a department which owed over \$20,000 at year end 1995 had obtained Finance Committee approval in December 1995 to use \$33,000 of supposed "savings" from its fuel budget for the purchase of additional computer equipment. PWD also cites departmental forgetfulness and ineffective follow up as reasons why revenue recovery is so much in arrears.

PWD has assured me that it will be much more vigilant in future. A revised invoice format has been introduced and revenue recovery will be strictly monitored on a monthly basis. PWD is also considering to refuse fuel issues to delinquent departments.

- Discrepancies in fuel stock figures reported in the annual accounts can be traced back as far as 1982. Maximum capacity of the existing tanks is 6,000 gallons, valued at approximately \$10,570. Physical stock of petrol and diesel at 31 December 1995 was estimated by auditors at \$7,475. Audit staff calculated a reconciling difference of approximately \$14,000. Public Works Department attributes the shortage to evaporation over a period of many years and calculates that the difference equates to less than one half of one per cent of total throughput. This is within tolerable limits. It is likely the imbalance will have to be written off as an unreconciled accounting difference.
- Public Works records have not been reconciled with the Treasury's General Ledger for at least 20 years. The department has acknowledged that reconciliation should be carried out more frequently and blames staff shortages and constraints. The new refuelling facility (refer paragraph 2.14 below) will be equipped with a modern fuels accounting and management system which should enable better control and reconciliation without additional manpower or other costs.
- The Audit Office has recommended changes to the existing billing procedures in order to enable speedier revenue collection from departmental users. Public Works Department supports our recommendations.

2.14 The present government fuel facility has been operational for over 30 years. It has become a hazard because the tanks are above ground, and are old and leaking. A new full-service fuels facility is being constructed on government property, which will provide round the clock access to Government vehicles. Management of the new facility will become the responsibility of the Department of Vehicle and Equipment Services. My office was informed that the new facility should minimise the possibility of misuse of fuel by government employees when using private gas stations. Following a competitive tendering exercise, the refuelling facility and all equipment will be provided on loan to government by Texaco Caribbean Inc. It is understood that the supplier will invest approximately \$400,000 in this facility.

2.15 Prior to the new refuelling facility, competitive bids were not sought for supply of fuels. For many years Public Works Department purchased fuel products at special Government rates, slightly below normal retail prices. Under a new 15 year supply contract with Texaco, fuels will be supplied to

Government at dealer net prices. I asked Public Works Department why Government had not previously obtained the standard dealer discount offered by Texaco and Esso. Following my enquiries, the department held discussions with Texaco with a view to securing a price rebate retrospective to January 1995. Texaco has now told the department that no rebate can be justified. Offers to provide a Government fuelling facility and rebated fuel prices were submitted by both Texaco and Esso in August 1993. Although Government will save over \$150,000 per annum through improved supply terms, I am concerned that it has taken over two and a half years to conclude the formal contract with Texaco for a refuelling facility. The delay has meant additional fuel costs for Government as a whole. It is disappointing that Texaco has not seen fit to allow a retrospective price rebate.

Department of Tourism

2.16 The Department of Tourism comprises five regional offices and five resident representatives in North America and one regional office in the United Kingdom, plus representation in Canada, Germany, Italy, Japan and Spain. The Department employs approximately 55 persons in regional offices and 15 persons in Grand Cayman. The Department has been going through a period of change since early 1995. The objectives are to return strategic control to its Grand Cayman head office and to develop adequate management systems in both Grand Cayman and the regional offices. A new Director of Tourism was appointed in 1995 and additional specialist support staff have been engaged. One innovative development has been joint Government - private sector promotions. Examples include US\$99,000 for a watersports promotion; US\$15,000 from the Sister Islands Tourism Association; US\$41,000 towards the annual Rates and Facts brochure; and co-operation from overseas wholesalers and airlines.

2.17 The Department's five-year Tourism Management Policy has been developed to ensure that the Cayman Islands will continue to be a high-quality, upscale product. The key points of the plan include:

- Quality must be the prime characteristic of the Islands' tourism.
- Tourism must offer value.
- Environmental resources and cultures must be protected and enhanced.
- Moderate growth is needed.
- There should be less reliance on the US market.
- A unified tourism identity and strategy is required for all three Islands.
- The tourism product should be diversified.

2.18 Government's tourism budget has increased by 58% over the last five years, compared with a 41% increase for other recurrent expenditures. Almost \$58 million (90%) of the past five years budgets has been spent on advertising, collateral and overseas operations. **Figure 2.3** provides an analysis of expenditure for the period 1991-1995.

Figure 2.3: Department of Tourism Expenditure 1991 -1995

<i>Year</i>	<i>Personal Emoluments</i> \$	<i>Overseas Operations</i> \$	<i>Advertising, Collateral & Photography</i> \$	<i>Others</i> \$	<i>Total</i> \$
1991	373,463	4,264,996	5,853,978	702,533	11,194,970
1992	395,108	4,563,850	6,473,278	742,656	12,174,892
1993	439,199	4,484,954	6,941,492	920,067	12,785,712
1994	516,415	5,049,592	7,331,244	1,085,849	13,983,100
1995	542,339	5,797,428	7,715,582	1,107,403	15,162,752

Source: Audited financial statements 1991 – 95.

In conducting our audits, we recognised that the Department operates in a hybrid private / public sector mode. Our examination concentrated on general financial control issues and contract management, in particular the contracts with our North American advertising agency, O'Leary, Clarke & Partners, (formerly Kaprelian O'Leary Inc) and our public relations agency, Aaron D. Cushman and Associates Inc. We also carried out a value for money audit of the Cayman Islands Reservation System (CIRS) which is based in the department's Miami administrative office. Audit findings and suggestions for improvements have been communicated to the Department of Tourism. I am pleased to report that the Department has taken corrective action to address many of the weaknesses identified.

General Issues

2.19 A number of general management issues were identified.

- Only limited financial information is provided to legislators because the main expenditure categories (advertising, collateral and overseas operations) are disclosed as one line entries in

both the annual budget and accounts.

- The Department was not able to produce several long term supplier contracts involving very large recurring expenditures. These contracts are supposed to be lodged in Treasury but could not be located. In at least two cases a copy had to be requested from the supplier. In another instance only a simple letter of appointment could be located. Officials were not aware of the terms and conditions of these contracts.
- The Department has not developed a management information system and is unable to determine the actual cost of specific programmes or projects.
- The Department does not measure reliably the effectiveness of its advertising campaigns in qualitative and quantitative terms. Work has recently commenced in this area.
- Performance targets are not set for any of the regional offices. Outputs are not quantified.

Advertising Agency for North America

2.20 The initial contract was established in 1985 and was revised in 1988. The agency is engaged to provide all usual services provided by a general advertising agency, including the placing of magazine and television advertising. The agency is compensated through a guaranteed minimum commission of 15% of the value of all advertising and collateral orders placed. Industry practice dictates that magazine advertising must be prepaid, typically up to two months before publication. The Department makes payments to the agency based on internal invoices. Specific control weaknesses identified include:

- The Department does not receive original third party invoices from media houses, television stations and other service providers. Generally we were able to locate adequate accounting documentation in support of the agency's invoices during our inspection of the agency's records. Our limited testing revealed one case where US\$17,588 was paid to the agency for an invoice which had also been paid by the Department direct. A credit note has since been issued to correct this error.
- The Department does not verify that Government actually receives advertising services paid for. No checks are carried out to verify that spot television advertisements are actually aired.
- The agency normally requires advance payments for work relating to collateral & photography.

A total of CI\$1,222,403 was paid for collateral and photography during 1995 of which \$1,035,752 (85%) was classified as advance payments. We saw no evidence of any controls in place to monitor clearance and appropriate accounting discharge for these advances. The Department did not know the number and value of advances outstanding as at 31 December 1995. Our audit work and discussions with the agency revealed that 12 advances totalling US\$440,961 were outstanding as at the year end.

- The agency has acquired a number of assets for marketing purposes over the past 11 years but the Department has no independent records of these. The Department is now addressing its world-wide partners to determine inventory held on its behalf.

2.21 One major project carried out during 1995/96 by the agency was the production of a new sales film. The existing film has been used for the past six years. Production of the film commenced in June 1995 and was completed in May 1996. The cost of producing the eight and a half minute film was US\$596,979. Of this, the agency received a total of US\$116,993 (for creative development and supervision - US\$41,036; and commission - US\$75,957). Other major expense components include location shoot (US\$300,591), editing (US\$69,822) and music rights and production (US\$47,800). We found it difficult to determine whether this project represented good value for money. We were particularly concerned that the final project cost was almost double the original budget.

- Neither the Department nor the agency was able to provide us with an accurate and complete cost of production. We saw no evidence that the Department had reviewed actual production costs against budget. The final cost was determined only after intensive and time consuming audit analysis of monthly accounts and discussions with the agency.
- The original approved project budget was US\$303,930. The final cost of production exceeded the original budget by 96%. Final costs also exceeded the final approved budget by US\$58,209 (10.8%). Three supplementary budgets were approved by the Department: US\$14,665 in August 1995; US\$2,010 in November 1995; and US\$218,345 in April 1996.
- We learned that the April 1996 supplementary budget of US\$218,345 relates to a second film shoot authorised by the Department. The initial film footage was viewed by regional offices. The general consensus was that additional promotional material relevant to particular markets was needed. This included emphasis on George Town as a business centre and footage for Cayman Brac and Little Cayman. It was not clear why all required film footage was not identified at the concept development stage and included in the original shoot, nor why input

from regional offices was not sought earlier. We were unclear whether concept development was the responsibility of the agency or the Department.

- The Department indicated that much of the filmed material not used in the sales film has been archived. To date four television commercials have been produced from the material at no extra cost.

Public Relations Agency

2.22 The consultant was hired through competitive tendering procedures to provide comprehensive public relations and related support services in North America. Services are provided for a fixed monthly fee, presently US\$27,500 per month, plus defined production costs and out of pocket expenses. A total of \$386,176 was paid to the contractor during 1995 for professional services (\$276,399) and production costs (\$109,777). Two minor points arose during our audit. Professional fees were increased in 1995 by 10% from US\$25,000 to US\$27,500 per month. We were unable to locate any written approval from the Department for this increase. The Director has confirmed that the increase was for additional services provided by the contractor's regional offices and had been approved verbally by the Department. Audit checks revealed that US\$4,900 had been paid to the contractor for creation and maintenance of a Cayman Islands home page on the Internet for the months of November and December 1995. The services were not provided until 1996. The Department has received credit for the overcharge. The Department is presently tendering for the provision of public relations services.

Cayman Islands Reservation System

2.23 The Cayman Islands Reservation System (CIRS) was established in 1984 to assist smaller hotels and condominiums who could not afford the scale of advertising necessary to attract overseas visitors. CIRS operates a toll-free booking system for individuals and travel agents on behalf of about 80 hotels and condominiums in the Cayman Islands. The service is also a first point of contact for prospective visitors and the travel trade who want information about Cayman Islands. CIRS charges commission of 3% on confirmed room sales. A discount is available to properties which generate sales over US\$20,000. Commission rates have not been reviewed since inception of the programme. During 1995 CIRS achieved bookings of \$2.276 million, representing less than 2% of national room sales. Our analyses indicated that almost three quarters of sales were concentrated in 19 properties. Small apartments and lodgings generated less than 1% of bookings. Generally, the larger hotels operate proprietary reservation systems and tend not to make much use of CIRS. In 1991 Government's Management Service Unit carried out an examination of CIRS. The unit questioned the need for the service and recommended that a separate study be carried out on the viability of CIRS. It also recommended that replacement personnel should not be recruited until the

study was completed. At the date of our audit we established that the review had never been carried out. CIRS operations were continuing as before, fully manned, and DoT was considering investing up to US\$650,000 on information technology.

2.24 Our audit covered issues of economy, efficiency and effectiveness, as well as an examination of revenue collection. We addressed the following issues:

- cost of operating the service
- service and performance
- information technology
- revenue collection

Operating Costs

2.25 Costs are included within the budgets of overseas offices and are not readily identifiable. Neither Grand Cayman headquarters nor the Miami administration office were aware of the costs of the service, though both assumed the service was operating at a loss. We calculated total direct costs and identifiable overheads for fiscal 1995 at \$342,822. Annual revenues invoiced were \$67,142, indicating that only 20% of costs are recovered. The 1995 operating loss was over \$275,000. This is expensive and costly by any standard. CIRS has seven full time employees and almost 60% of expenses are payroll related. Computer services absorb a further 15%. Revenues collected over the past ten years totalled \$621,484, fluctuating between \$35,000 and \$75,000 per annum. The business does not exhibit any signs of growth: 1991 and 1992 were poor years, with revenues of only \$35,000 and \$49,000 respectively. We estimate that CIRS has consumed over \$2.5 million net of public revenues since its creation.

2.26 We were told that 10% commission is the industry minimum, with 20% the norm for wholesalers. CIRS management explained that most bookings are made by travel agents (estimated 70% trade and 30% private) who also charge properties a 10% commission. Travel agent commission was blamed for limiting CIRS options for higher commissions. We are not aware of any study done on the possibility of increasing revenue and virtually no management information on booking volumes was available. Even after allowing for a 10% trade discount, we calculated that revenue could be increased by over 300% if a standard commission of 20% was levied. Based on current business levels, this commission structure would recover 85% of costs. We also saw opportunities for cost reduction, mainly in the area of computer services. The department is preparing a needs analysis to determine the level and span of services which the private sector will buy into and the best way to provide these services. Cost of operating the CIRS service will be included in the needs analysis. With limited additional promotion and improved service levels, we concluded that CIRS could be transformed from a cost centre to a profit centre.

Information Technology Issues

2.27 Reservation software has been leased since 1984 from a Miami based company at a cost of US\$6,500 per month, recently reduced to US\$5,000 per month for reasons of poor service. The Audit Office calculates that almost US\$1 million will have been paid to the lessor by the end of fiscal 1996. As the contract had not been lodged with Treasury Department, we requested DoT to provide us with a copy for audit purposes. Personnel in both Grand Cayman headquarters and Miami were unable to locate the contract and had to request a copy from the service provider. We concluded that the contract does not adequately protect the interests of the Department. No minimum levels of service are specified and the contract does not address ownership of data processed by the service provider.

2.28 A 1995 study by Government Computer Services described the CIRS system as "woefully inadequate" Amongst some of the shortcomings identified were:

- The system is very slow, poorly designed and has no user manual.
- The software was written over 10 years ago for hardware which is now obsolete. The service provider's personnel do not seem to have any knowledge of programming or data communications for this outdated system.
- Printers are regularly inoperative and CIRS business activity is disrupted.
- Only confirmed reservations are retained on the system. As most enquiries do not result in a confirmed reservation, a manual record has to be kept of every transaction. CIRS does not retain any processed data, which is held by the service provider. The Audit Office was unable to establish whether this arrangement posed a commercial risk to Cayman Islands through unauthorised use of Cayman's data by others.
- The system can only show properties held as inventory. Properties offered "on request" are not listed when CIRS personnel respond to a customer enquiry.
- The system is not user friendly. Descriptive information is very limited and the CIRS supervisor cannot enter or amend any information on the system. All changes have to be processed by the service provider. The system cannot print labels for brochure mailings.

2.29 The Department's Miami office is very dissatisfied with system performance, particularly the lack of flexibility and the continual business interruptions caused by system non availability. CIRS does not

keep any record of downtime. The Department is actively addressing these problems and the Central Tenders Committee has given approval for selective tendering for a replacement system. One system under consideration by the Department was estimated to cost over US\$650,000, plus recurring annual costs of over US\$30,000. Cayman Airways Limited has recently opened a tours reservation service which teams approximately 40 island properties and other services with CAL flights. Audit personnel were very impressed with CAL's reservation system, its service levels and the volume of business generated. Total CAL system costs were reported to be under US\$50,000 for hardware and software, which is owned outright. This service operates from the room adjacent to CIRS in Miami. CIRS management are aware of the service, and of the competition posed by CAL's entry to the reservations market. We have passed information about CAL's database to the Department of Tourism for evaluation. The Department believes that continuity of service is an important factor in the package tours business. Commercial operators can, and do, discontinue services. At destination level a different approach is necessary to ensure the service is available and cost effective.

Service and Performance

2.30 CIRS is available 9-7 EST Monday to Friday , a total of only 50 hours per week. Call volume is busiest between 3 pm and 7 pm. The service does not operate at all during weekends, a popular time for vacation reservation. By contrast, CAL's system operates for 78 hours per week, including 9 hours on Saturday and Sunday. Traditionally CIRS has been advertised to the trade only, though private clients can be referred via an information line. There is no electronic linkage with client properties. Delays can occur when reservation enquiries are received for properties offered on request. Despite these limitations, CIRS management considers that clients are satisfied with the service levels. The Audit Office has recommended that DoT should survey its customers to assess the quality of service provided and to establish whether CIRS is really needed. DoT has agreed to progress our questionnaire at a convenient time.

Revenue Collection

2.31 Control weaknesses were noted in revenue processing. Billings generated by CIRS Miami are passed to Treasury Department, who convert the billing into local currency. The invoice is then input into Treasury's Revenue Control System. We were unable to determine the completeness of the revenues billed because no controls have been established in Treasury to ensure that all billing reports have been received and processed. As an alternative audit procedure, we attempted to reconcile Treasury billings with Miami sales figures for the period 1991 -1995. Our reconciliation revealed that commissions recorded by the Miami office for this period were \$204,571 more than those actually billed by the Treasury Department. This variance appears attributable to Miami's failure to take into account cancellations when calculating monthly sales figures. In view of the absence of controls and the variance revealed, we make no representations as to the completeness or accuracy of billings.

2.32 Although most properties settle bills promptly, revenue arrears as at 31 December 1995 amounted to \$40,230, of which 76% were aged 12 months or more. Most of the arrears are owed by one management company. Treasury is actively pursuing other debts owed by this management company (see paragraphs 1.36 to 1.37) but has apparently not addressed the issue of CIRS arrears. In February 1996 I recommended to Treasury that the CIRS service should be terminated where accounts are more than three months overdue.

2.33 Our audit findings and suggestions for improvements have been communicated to the Department of Tourism. I am pleased to report that corrective action has either already been implemented or will soon be carried out.

Overseas Telephone Costs

2.34 Between 1991 and 1995 Government's telephone operating costs rose by nearly 40% from \$794,000 to \$1,102,000, excluding equipment purchases. As tariffs have not increased during this period, cost increases are attributable to demand factors. Increased staff numbers explain some of the increase. Another reason may be demands for new services such as faxes, and particularly cellular phones which are expensive. Some Departments now have access to the Internet. A further reason could be staff misuse and lack of vigilance and concern by managers. The Audit Office estimates that per capita costs have risen by a quarter over the period in question, from \$408 to \$510 per annum. Most of the telephone budget is managed by the Portfolio of Finance and Development, but a few departments are responsible for their own budgets. The Audit Office felt that central control might be a contributory factor to cost increases. Managers who are not responsible or accountable for their own telephone budgets have little or no incentive to economise on use. Following our audit, the Portfolio of Finance and Development said it was working towards transferring telephone budgets to Controlling Officers. We caution that unless Controlling Officers are tasked to exercise proper management and control of telephone costs, decentralisation may bring added risks of waste and misuse.

2.35 Installation of telephone lines and equipment is authorised by the Portfolio of Finance and Development. The exact number of telephone lines assigned to Government is not known. An equipment survey is being carried out to determine the number of lines, their locations and the types of equipment in use. We doubt whether much money is being wasted as a result of unused facilities, though we noted that the Health Services Department had paid \$496 in rental charges on three lines which were not in use.

2.36 The Audit Office carried out an examination of 1995 telephone bills for four departments:

Education, Health Services, Police and Tourism (Cayman offices only). We concentrated on international calls, but restricted the scope of our examination to private calls and cash recoveries. Accordingly, we make no representations as to whether all overseas business calls were actually for official Government business. About one third of the total telephone budget is spent on overseas calls. Controlling Officers are required to certify which overseas calls are official and are supposed to recover the cost of private calls from the officers concerned. Recovery arrangements operate on an honour system.

2.37 With the exception of the Police Department, the results of our examination indicated that better control was needed. Weaknesses noted by auditors included:

- International calls should be logged as either official or private so that relevant expenses can be reimbursed by civil servants. We found that call logging varied. For example, Health Services Department was able to produce comprehensive records for almost all overseas calls routed through the main hospital switchboard, though there were no records for one telephone used mainly for overseas referrals. Education Department had no records for four of their five international lines. In Tourism Department there were no auditable records for any of the 22 lines with international access facilities. Tourism officials acknowledged that there were many unidentified overseas calls.
- Overseas calls were not always identified as either official or private. There is a strong probability that many calls in this category are unrecovered private calls. Amounts not identified as private or official were:

Tourism	\$1,444 over four months
Health Services	\$525 over nine months
- Recoveries for personal international calls were minimal compared to total calls, official and personal, at the Tourism and Education Departments.

	<i>Total Calls</i>	<i>Amounts Recovered</i>	%
	\$	\$	
Tourism	39,035	279	0.7
Education	14,525	Nil	0

- Cash collected was not always remitted to Finance on a timely basis. One department examined did not return bills for the whole of 1995. In another department bills were outstanding for over

three months. We were told that many overseas calls could not be identified on these bills and therefore they were not returned to the Portfolio of Finance and Development.

Following our audit the Portfolio of Finance and Development introduced new procedures to tighten controls and to improve management. These include recovery of private calls direct from salary. The Department of Tourism has introduced a computerised log to record all overseas calls. Unidentified calls for 1995 are being investigated and all personal calls will be recovered. I regret to report that the Education Department has not responded to my report which was issued in February 1996.

2.38 During 1992/93 an internal audit revealed that Government had been overcharged by Cable and Wireless for numerous international calls which were never connected. In 1993 the telephone company admitted that these “one minute calls” had been raised incorrectly as a result of telephone exchange problems. The company refunded Government \$7,638 covering the period April 1992 to March 1993. The company also requested that Government make further claims for reimbursements on a monthly basis. However, at the date of audit, my officers noted that no further claims have been made by Government. The results of our audit indicated that “one minute call” errors seem to be continuing. We estimate that at least \$20,000 may have been overpaid to Cable and Wireless during the last three years as a result of this oversight. The Budget and Management Unit agreed that Departments had been negligent in not detecting and reporting these. Due to current workload and staff complement, the BMU is not in a position to carry out a comprehensive check at this time. The Financial Secretary has instructed users to keep accurate records and to submit a monthly claim for unconnected international calls.

Legal Fees

2.39 In August 1993 Executive Council directed all statutory authorities, state owned enterprises and certain grant-aided bodies to pay a fixed annual fee for the provision of legal services by the Government Legal Department. This should have provided \$148,000 of annual revenue. However at the date of audit only \$75,000 had been recovered from the organisations concerned, leaving a balance of \$221,000 recoverable and owing to Government for the 1994 and 1995 financial years as shown in **Figure 2.4**.

2.40 Only the Port Authority, the Turtle Farm, and the Community College (1994 only) have paid their contributions. The Accountant General has indicated that the responsibility for collection of fees for services provided by any government department lies with that department. It appeared that no department or individual in Government had been assigned specific responsibility for managing the

Figure 2.4: Legal Fees Outstanding at 31 December 1995

	1994	1995
	\$	\$
Cayman Airways	55,000	55,000
Port Authority	Nil	Nil
Civil Aviation Authority	25,000	25,000
Water Authority	25,000	25,000
Cayman Turtle Farm Ltd.	Nil	Nil
Community College	Nil	5,000
AIDB/HDC	2,500	2,500
Cayman National Cultural Foundation	250	250
Museum	250	250
Total	108,000	113,000

collection of these revenues. Certain debtors claimed not to be aware of their financial obligations, whilst others were waiting to be billed before paying. Prior to 1995 the amounts owing were not disclosed in the annual Arrears of Revenue Statement.

2.41 I issued an audit report on the status of these fees in March 1996. During May and again in June 1996 the Solicitor General requested confirmation of the outstanding amounts from the Accountant General so that reminders could be sent to the relevant bodies. At the date of preparing this report, no response to the audit findings has been received and requests for payment had still not been issued. The Audit Office has encouraged those Statutory Authorities audited by us to pay outstanding fees. This has met with some success. Recent audited financial statements of three of these Authorities include accruals for legal fees.

Finance and Development

<i>Advertising</i>	<i>Budget</i>	<i>Expenditure</i>
<i>1994</i>	<i>500,000</i>	<i>378,708</i>
<i>1995</i>	<i>500,000</i>	<i>617,090</i>
<i>June 1996</i>	<i>1,004,000</i>	<i>844,794</i>

2.42 In order to maintain and develop Cayman Islands' position in the financial services industry, and in light of increased competition from other offshore jurisdictions, Government allocates significant

budget resources to advertising and promotion. We examined two initiatives implemented in 1994/95 which featured cost sharing between Government and the private sector:

- publication of a high quality financial services handbook
- conferences in three major financial centres

Financial Services Handbook

2.43 As the cost of the handbook was anticipated to be less than \$100,000, a Departmental Tendering Committee was established to control the bidding process. Total cost of preparing and printing 20,000 copies of the handbook was \$116,454. I am satisfied that payments made were in accordance with the contractual agreement. Revenue totalling \$81,574 was collected from sale of a directory listing within the handbook and the handbook itself. Participants paid \$500 for a single directory listing and an additional \$250 for further entries. The handbook itself was sold at various prices ranging between \$3 and \$15. We concluded that revenue controls were not adequate. We computed the revenue expected from the number of directory listings in the handbook and compared this to revenue actually collected. There appears to be a shortfall in the region of \$14,000. The Portfolio has investigated this discrepancy and has collected and/or accounted for an additional \$10,500, with the balance awaiting confirmation of payment by the companies concerned. Revenue collected covers 80% of project costs and I consider the net cost to Government (\$24,380) represents good value. The Portfolio has commented that revenue failed to cover the cost of the publication because there were fewer listings than expected.

International Conferences

2.44 In September 1994 Government contracted with an American business consulting company to organise and promote financial conferences in New York, London and Hong Kong to be held in February 1995. The contract amount was US\$162,500, plus US\$114,000 budgeted for hotel and marketing expenses. Normally competitive tenders are required for a contract of this size. In this instance tendering procedures were not followed. We were told that the company awarded the contract was the only entity able to organise the conferences at the dates required by Government. Total project expenditure amounted to US\$205,561 (CI\$172,163). The costs of travel and accommodation for Cayman's representatives are not included in these figures. I am satisfied that payments made were in accordance with the contractual agreement. Approximately 30% of costs were covered by conference fees (US\$60,051) collected from 374 participants.

PART III

Audits of Statutory Authorities and Other Public Bodies

3.1 With the exception of the Civil Aviation Authority, the financial statements of all Statutory Bodies have been audited generally in accordance with time limits prescribed by law. In my last Report I disclosed that preparation of the Civil Aviation Authority's 1994 accounts had been delayed pending the appointment of a financial controller. CAA's draft financial statements were received in October 1995 and audit field work was completed by November. However it has not been possible to finalise the audit because of a disagreement between Government and the Authority. This concerns the Authority's budget contributions to Government for 1994 and 1995 and Government's commitment to the CAA for a 1992 grant for the National Weather Service. Also unresolved at the date of preparing this report were other material issues which affect my audit opinion. I have been in regular communication with both the Financial Secretary and the Permanent Secretary, Ministry of Tourism, Aviation and Commerce, but I have not been able to expedite clearance of these financial statements. Work has not started on the 1995 audit. I find this situation disappointing for two reasons:

- Lengthy delays reduce the value of financial statements and weaken accountability.
- The Public Accounts Committee's appreciation of a separate audit report about the Authority's revenue (see paragraphs 3.12 to 3.23) would have been enhanced by reference to the financial statements.

3.2 For fiscal 1995 the Audit Office undertook the audit of six Statutory Authorities: the Agriculture and Industrial Development Board; the Community College; the Cayman Islands Currency Fund; the Housing Development Corporation; the Public Service Pensions Fund; and the Water Authority. Private sector auditors were engaged by the Auditor General to carry out the audits of the Civil Aviation Authority and the Port Authority.

3.3 Since presentation of the last Annual Report the undernoted financial statements have been certified:

3.3.1 The Agricultural and Industrial Development Board: Audit of the 1995 financial statements was completed in July 1996. We are reviewing the presentation of the financial statements prior to issuing the audit opinion. I have no report to make on this account.

3.3.2 The Community College of the Cayman Islands: The College's financial statements for the year ended 31 December 1995 were certified on 5 August 1996. I have no report to make on this account.

3.3.3 The Cayman Islands Currency Fund: Financial statements for the year ended 31 December 1995 were certified on 18 June 1996. I have no report to make on this account.

3.3.4 The Housing Development Corporation: Financial statements for the year ended 30 June 1995 were certified on 31 May 1996. I have prepared a report on the disposal of the Corporation's mortgage portfolio at paragraphs 3.5 to 3.11.

3.3.5 The Port Authority: Financial statements for the year ended 31 December 1995 were certified on 19 June 1996. I have no report to make on this account.

3.3.6 The Public Service Pensions Fund: Financial statements for the year ended 31 December 1995 were certified on 20 August 1996. As disclosed in paragraphs 3.24 and 3.25 below, I have been obliged to render a qualified audit opinion on these financial statements as a result of ineligible pension contributions collected from Group Employees.

3.3.7 The Water Authority: The Financial Statements for the year ended 31 December 1995 were certified on 8 July 1996. I have no report to make on this account. Part IV of this Report deals with my special audit of the Spotts - Pease Bay water distribution project.

3.3.8 Financial Statements of Non Government Organisations: Accounts certified in the previous 12 months include:

- The Commonwealth Parliamentary Association (Cayman Islands Branch): accounts for the year ended 31 December 1995;
- Cayman Islands / UK Overseas Students Fees (Refund) Statement: statement for academic year 1995/96.

3.3.9 Traditionally the annual financial statement audits of Statutory Authorities have been carried out free of charge. With effect from 1996 I intend to charge an audit fee for this work as provided for in section 44(2) of the Public Finance and Audit Law, 1985. My reasons for this are twofold. Statutory Authorities already include the value of services provided by other government departments in their financial statements. There seems no reason to provide free audit services. Second, certain authorities are

not preparing properly for the annual audit. As a result my office has to provide considerable accounting advice and assistance.

Contributions from Statutory Authorities

3.4 Contributions received from Statutory Authorities were below budget. The shortfall from the Currency Fund was covered in my 1994 Report.

Authority	Subhead	Budget	Collected
		\$	\$
Currency Fund	71-101	1,600,000	393,726
Port Authority	71-201	200,000	200,000
Civil Aviation Authority	71-301	2,608,795	2,000,000
Water Authority	71-401	Nil	Nil

Housing Development Corporation

Sale of the Loan Portfolio

3.5 On 30 June 1996 the Housing Development Corporation concluded the sale of its mortgage portfolio to Cayman National Bank for \$1,994,593. The consideration represents a 10% discount of \$221,621 on the book value of the loan portfolio. The Audit Office reviewed the divestiture with two broad objectives in mind:

- to assess whether the sale process was properly planned and managed; and
- to evaluate whether the sale proceeds were fair and reasonable.

Background

3.6 The Corporation was created under the Housing Development Law, 1981 to provide finance for the construction and acquisition of homes for middle to low income Caymanians. At that time only limited bank finance was available for house purchase. Between 1984 and 1990 the Corporation managed to raise a little over \$3 million through two issues of debentures. Government contributed a further \$400,000 of capital between 1992 and 1993 and has paid for most of the Corporation's operating costs in the shape of staff and

office accommodation. In 1995 Government's subsidy was worth \$167,453 (1994: \$147,298). Throughout its 15 year history the Corporation made 121 loans totalling \$5.3 million before Government directed the suspension of lending in December 1993.

3.7 Since its establishment the Corporation has always found difficulty in raising enough funds to meet client demand for mortgages. Funds also have to be set aside to repay the 20 year debentures due in 2004 and 2009. The Board established a sinking fund for this purpose in 1988. Whilst the Corporation has always reported an operating surplus, by 1995 almost all of this was being transferred to the sinking fund. By the year 2000 sinking fund requirements would have risen to over \$210,000 per annum. Since the Corporation has only minimal accumulated surplus, this would have involved some contribution from capital. Prudent financial management also dictates that the Corporation cannot use money accumulated in the sinking fund to grant new mortgages. Thus, through no fault of its own, the Corporation was faced with a double dilemma: the gradual erosion of its capital base and the inability to meet demand for mortgage finance.

3.8 In 1993 Government introduced the Guaranteed Home Mortgage Scheme in partnership with several local banks. Under this scheme Government became the guarantor rather than the provider of mortgage finance. With the new initiative in place, Government concluded that the Corporation should be directed to sell its mortgage portfolio. In February 1995 Government directed the Corporation that: (i) the sale should be for cash only, by way of private offering; (ii) the sale should be restricted to financial institutions licensed to carry on the business of mortgage financing; (iii) debenture holders must be repaid out of the sale proceeds; and (iv) the sale should be completed within six months.

Sale Process

3.9 The Corporation established a sub committee to plan and oversee the sale process. The sub committee decided to release information in phases, culminating in a sealed bid procedure. Details of the sale were presented to the financial sector in July at the Radisson Resort. Phase I: Invitations to participate in the sale, together with basic information about the portfolio, were sent to 135 financial institutions. Phase II: Five institutions responded positively. Additional financial information was released to these parties. Phase III: Only Cayman National Bank proceeded to the due diligence exercise and was granted access to the Corporation's records. The sole sealed bid was submitted on 1 November. At that stage the process had taken about two months longer than directed. Although only one bid was received, the Audit Office considers that public interest was properly served by the open and transparent sale process. The phased release of information served two purposes. First, the Corporation was able to maintain confidentiality up to the due diligence process. Second, the phasing and sealed bid procedure may have created some competitive tension between prospective bidders. Overall we concluded that the sale process was well thought out and executed.

We think the additional time taken was reasonable and did not diminish the value of the offer received from Cayman National Bank.

Proceeds of Sale

3.10 Commercial mortgage finance tends to be provided at variable rates of interest. In contrast, all mortgages made by the Corporation have been at fixed interest rates of between 9% and 11%. At the time of sale, bank mortgage interest rates were quoted to be between 11% and 12%. As the weighted average interest rate of the 69 loans in the portfolio offered for sale was only 9.98%, the sub-committee recognised that prospective bidders would expect to purchase the portfolio at a discount to book value. Fixed rate mortgages also pose uncertainty to lenders because interest rates cannot be predicted over the longer term. Other factors which the sub-committee thought would influence an offer included the delinquency position (24 out of 69 accounts), loan servicing costs (average loan outstanding \$36,000) and borrowers' socio-economic groupings. At an early stage the sub-committee agreed to limit any discount to \$100,000 (approximately 4% of the portfolio). However the sub-committee recognised that it would be very difficult to find a buyer at this price, partly for the reasons outlined above, and partly because expected increases in United States interest rates would lead to higher mortgage rates in Cayman Islands.

3.11 Prior to commencement of the sale process, the Audit Office's calculations suggested a buyer might expect a discount of between 4.8% and 10.3%, based on 11% and 12% required rates of return, which were indicative of mortgage rates then prevailing. Following receipt of Cayman National's offer which indicated a 10% discount, the Corporation secured Government's approval to attempt to negotiate better terms. However the negotiations yielded no improvement. Although Government was always at liberty to reject the offer, this would have been a false economy. As explained in paragraph 3.7, the Corporation is barely able to generate sufficient funds to meet the annual transfer to the sinking fund. This position would have deteriorated, as the annual contribution increased and the Corporation's surplus decreased. In summary, the Corporation would have been forced to repay part of its debentures either through Government equity or by an annual Government subvention. Taking account of all the factors outlined above, we concluded that:

- Cayman National's offer was priced to market conditions and offered good value.
- The \$221,621 discount on disposal was within the range we expected.
- The disposal at a discount was the correct strategic decision which fitted with new policy initiatives. It will probably save Government money in the long run.
- About \$1.3 million will be left after repayment of the debentures.

Civil Aviation Authority

Revenue Study

3.12 The main activities of the Civil Aviation Authority comprise general management and control of airports, air traffic, navigation, aircraft certification and licensing of air crews. In late 1995 the Audit Office conducted a study to review the Authority's main revenue sources, which comprise rents, aircraft landing and parking fees and passenger departure taxes. We also examined cash management and debt collection activities.

Rental Income

3.13 The Authority generates around \$750,000 per annum from rental income. The scope of our study excluded rentals charged to Government departments as this is presently the subject of protracted policy deliberations. The commercial property portfolio comprises approximately 20,000 sq ft of retail, restaurant and office space. Rents of duty free shops and airline counters are \$25 sq ft. These rates have remained unchanged since 1984. Facilities maintenance at Owen Roberts main terminal is borne by the Authority. It was intended that these costs would be recovered from the Authority's tenants through periodic rate reviews. To date this has not taken place. Office rents are \$15 and \$17 sq ft. The rationale for the higher rate (\$17 sq ft) is that office space at the front of Owen Roberts has greater visibility to the public, and thus ought to attract a higher charge.

3.14 Our enquiries suggested that rents of duty free shops and airline counters are broadly comparable with existing market prices at purpose-built shopping malls and other retail complexes. We considered that premium rates could be justified, particularly for duty free liquor shops, because Owen Roberts offers a unique sales opportunity. The range of current market prices for office space in George Town averages \$25 - \$30 sq ft. If all the Authority's available office space (6,878 sq ft) was rented at \$25 sq ft, annual income would increase by \$62,550.

3.15 The Authority also leases 189,414 sq ft of land at \$0.50 sq ft, which seems low. We did not find any evidence that rents were being reviewed periodically. The present rate may be increased to \$5.00 sq ft when current lease agreements expire. Whilst the Audit Office does not have specialist knowledge of the local property rental market, we felt that rental income had probably not been maximised. The Authority has indicated that property rents and advertising rates are being reviewed and any adjustments will be effected in 1997. Specialist advice could be obtained from Lands and Survey Department. There may also be merits in offering duty free concessions by public tender.

Departure Tax

3.16 Departure tax is a major revenue source for the Authority. The Audit Office attempted analytical review of departure tax revenues against immigration departure records. We were unable to obtain any independent assurances from this procedure because Caymanians do not need to complete immigration departure declarations.

3.17 Our evaluation indicated that there were no effective internal controls to ensure completeness and accuracy of revenue collection. All persons aged 12 years or older are liable to pay departure tax, which is collected by airlines on behalf of the Authority. Returns of departure tax to the Authority are supported by the reporting airline's manifest of departing passengers. However only one airline was providing passengers' dates of birth in manifests. This prevents the Authority from carrying out independent checks to confirm that tax has been collected for all persons liable. Audit tests established several instances where persons aged 12 years and over were classified as exempt. Management has tightened procedures with effect from June 1996. Documentary evidence is now required for all passengers exempt from departure tax. The onus remains on the Authority to implement appropriate internal checks on these documents. We also noted that there was no consistency in the frequency of departure tax collections from airlines. Tax was being collected on a fortnightly basis from one airline, whilst all other airlines accounted for this monthly. Management has since introduced daily tax collection effective June 1996.

Delegation of Revenue Collection Functions

3.18 A private sector company was authorised to collect landing and parking fees for private aircraft on behalf of the Authority during the period January 1994 and April 1995. These arrangements have since been terminated. The Audit Office ascertained that there is no specific legal authority for this arrangement, which exposed the Authority to some element of financial risk. Departure tax collected from persons leaving the Islands in March and April 1995 on private aircraft had also not been paid over to the Authority, apparently because the Authority failed to issue an invoice. We noted that the collection agent is seeking to negotiate a waiver of debts owed to the Authority. This should not include revenue collected on behalf of the Authority. Management agrees with this position.

3.19 Aviation Week activities in June 1994 and 1995 were examined to check that the Authority had accounted for all associated revenue activities. Management informed us that certain revenues had also been collected by the private sector company. In response to an audit enquiry, management produced a copy invoice for \$5,421 purporting to show that the Authority had billed the agent for fees collected.

When my auditors checked with the accounting department, it was evident that the invoice had not been processed and issued. Management has confirmed that the Authority has now recovered all revenue in respect of Aviation Week. We concluded that appropriate controls had not been instituted to manage agency collection of statutory revenue.

Aircraft Landing and Parking Fees

3.20 Aircraft using the Authority's general areas are charged landing and parking fees. Major airlines operating regular scheduled flights and charter companies are billed landing fees by means of monthly invoices which are generated from computerised air traffic records. Our audit indicated that this system is operating satisfactorily and should ensure the completeness of landing and parking fees from major operators. The computerised billing system for landing and parking fees has now been extended to accommodate the collection of fees from private aircraft.

3.21 Aircraft landings during peak periods are subject to the undernoted premium charges:

16:00 - 21:00 GMT; 25% on normal landing fees
00:00 - 12:00 GMT; 50% on normal landing fees

Our audit of one month's landings indicated that premium charges were not always levied for private aircraft. We recommended that management should monitor the charges made for landing fees to ensure that premium rates are levied during peak hours.

Treasury Management

3.22 This has also been a weak area. We estimated that at least \$57,000 in interest income was lost between January 1994 and September 1995 because the Authority kept most of its cash balances in non interest bearing accounts. Management has confirmed that arrangements are now in place to maximise interest income.

Debt Collection

3.23 A credit period of one month is given to the Authority's customers. At 30 September 1995 \$2,378,119 was owed to the Authority, 99% of which was at least 60 days old. Of this \$1.4 million owed by a single debtor was recovered in full by the end of 1995. It was evident from the age of the Authority's debtor balances that there has been no persistent debt recovery. The consequences of untimely debt collection are loss of interest income and the risk that debts may become uncollectible.

The Authority has confirmed that more time and effort will be allocated to debt collection and management.

Public Service Pensions Fund

3.24 Once again I have issued a qualified audit opinion on this account. Pension contributions totalling \$139,728 (employers' \$69,864 and employees' \$69,864) have been collected and credited to the Fund during 1995, in respect of some, but not all, weekly paid Caymanian Group Employees with seven or more years service. Legal Department has advised me that there is no basis for the collection of these contributions. I am pleased to report that this matter has now been satisfactorily addressed in The Pensions (Amendment) Law, 1996 which requires contributions to be collected from all Group Employees.

3.25 Revenue for 1995 was \$4,022,711. At December 1995 the Fund's assets amounted to \$16,735,273, all of which is held in short term fixed deposits. The most recent actuarial valuation of the civil service pension liability was carried out as of 1 January, 1993. The valuation is based on factors which may no longer be applicable. I recommend that a current valuation should be undertaken as of December 1996. It may be useful to determine separately the unfunded past service liability for reckonable service prior to 1 January 1990.

PART IV

The Spotts - Pease Bay Water Distribution Project

Background

Description of the Project

4.1 In February 1987 the Water Authority commenced construction of a piped water distribution system. The original works for the George Town Water Supply project (GTWS) consisted of a one million gallon reservoir, approximately 15,000 metres of large (6 - 12 inch) and 6,000 meters of small diameter water main, fixtures and appurtenances. As the complete project area had not been finalised at the time of tender, the South Church Street and Walkers Road areas were priced on a provisional basis. This involved a further 4,800 metres of large diameter and 4,500 metres of small diameter pipes. The contract required all works (including provisional items) to be completed within 330 days from the award of the contract - that is by May 1988. In response to consumer demand, the scope of the original project was extended progressively in three distinct phases and a separate system was provided for Cayman Brac. The complete distribution system for Grand Cayman comprises three reservoirs of 2.8 million gallons capacity, a pumping station plus approximately 69 km of large diameter and 143 km of small diameter water main, serving approximately 5,100 consumers. The entire project was completed in May 1994 at a cost of \$18 million.

4.2 The project was designed and supervised by the Authority's own engineers. Separate contracts were let for civil engineering works and for materials supply. This type of arrangement is apparently quite common within the Caribbean region. As the initial project funding was through a Caribbean Development Bank (CDB) loan, the Authority was obliged to follow CDB's procurement procedure. This required the project to be tendered in all CDB Member States, including Canada, France and the United Kingdom. The materials supply contract was let in February 1987 to Propax Industrial Exports Ltd (Propax) of the United Kingdom. The civil engineering works were awarded to Petroservicios Ltda of Columbia in June 1987. American suppliers were ineligible because the USA was not a CDB Member State. There is no doubt that this restriction led to increased materials costs, as European sourcing involves substantially higher freight costs. As the scope of the project increased, supplementary funding was arranged from a variety of sources, including loans from a number of property owners in the South Sound area.

4.3 A project profile is provided at **Figure 4.1**.

Figure 4.1: Project Profile

	Original Contracts Let	P21 George Town (1)	P24 George Town- Spotts	P25 Cayman Brac	P26 Spotts- Pease Bay	Total
Budget Costs	\$	\$	\$	\$	\$	\$
Civil Engineering	2,598,975	3,717,617	1,808,078	298,647	4,543,034	10,367,376
Propax Materials	853,577	1,433,558	592,164	298,504	1,818,604	4,142,830
Other Materials	-	-	358,206	127,647	369,782	855,635
Total Contracts	3,452,552	5,151,175	2,758,448	724,798	6,731,420	15,365,841
Other Costs (2)						2,610,962
						\$17,976,803
Water Main Installed	Metres	Metres	Metres	Metres	Metres	Metres
Large Diameter Pipe	15,253	30,812	12,316	1,930	24,161	69,219
Small Diameter Pipe	18,320	51,981	22,714	4,529	64,108	143,332

(1) The scope of the original P21 contract was extended.
(2) Other costs comprise project management/engineering services, bank charges, and miscellaneous items.

Scope of Audit

4.4 The original scope of audit was intended to be restricted to the Spotts - Pease Bay segment of the distribution project, which was constructed between December 1991 and May 1994. However by 1989 both the materials and civil engineering contracts had evolved into single source supply arrangements with Propax and Petroservicios. The pricing structures of both contracts had been increased and altered considerably. Accordingly the Audit Office found it necessary to review both contracts from their inception in 1987. Several issues were identified from our preliminary review.

Materials Supply Contract

- Tendering and supplier selection
- Price increases and overall value for money
- The justification for using a UK based single source supplier for materials
- Status of Propax Industrial Exports Ltd.

Civil Engineering Contract

- The use of Variation Orders for changes to the scope of the tendered works;
- Increases in unit rates awarded to the contractor;
- Payment of "method and time related charges" to the contractor
- Project management.

Project Performance

Subsidiary Issues

- The potential for conflict of interest between project personnel and the contractor
- Non payment of Customs Duties by the contractor; and
- Cash overpayment to the contractor.

During the course of our examination of the civil engineering contract it became apparent that there existed a difference of opinion between the Audit Office and the Water Authority on various contractual matters. The Audit Office therefore obtained the services of a firm of professional consulting engineers to advise on these technical issues.

Materials Supply Arrangements

Tendering and Supplier Selection

4.5 The original GTWS Phase I tender documents offered options to bid for all or part of the seven portions of plant and material. Tenderers were given three pipe options to quote: ductile iron, uPVC and a combination of DI and uPVC. The tenders for DI and DI/uPVC options were found to be prohibitively expensive in view of the high freight costs. All bidders were reportedly pre-qualified in accordance with CDB procedures. Tender documents were issued to 38 bidders, of which 22 submitted completed tenders. Only four tenderers bid for supply of all plant and materials.

4.6 All tenders were evaluated by the Authority in terms of price, delivery and compliance with specifications. According to the Authority’s evaluation report, the four bids for the supply of all plant and material were best in terms of price and delivery. The evaluation of these bids is summarised at **Figure 4.2**.

Figure 4.2: Evaluation of Materials Supply Bids

Total Procurement	Tender Sum	Evaluated Cost
	\$	\$
Tender 1	860,967	865,967
Tender 2	865,301	925,746
Tender 3	932,108	932,108
Tender 4	990,000	not evaluated

The tender evaluation report did not recommend either of the two lowest bids for various reasons, principally delivery factors and did not explicitly recommend the acceptance of any particular tender. Three suggestions were made to the Public Tenders Committee (PTC), including the option to let the contract to various individual tenderers. The main reasons for non acceptance of the lowest tender are summarised below.

Delivery

- Only Tender 3 was prepared to guarantee delivery of the materials within 110 days from execution of the contract. Tender 1 quoted delivery of 110 to 120 days from date of receipt of final drawings. The PTC was advised that non delivery within a 110 day period would expose the Authority to substantial financial damages, with a penalty of \$1,200 per day quoted. The Authority had contracted to purchase at least 150,000 US gallons of desalinated water per day from a third party effective February 1988. Had the reservoir not been completed on time, the Authority would have suffered a penalty of \$1,575 per day. As the civil engineering contract did not commence until August 1987, it would appear that there was sufficient time for the extended delivery period quoted by the low bidder.

Alleged Non Compliance with Specification

- The Authority indicated that the meter boxes, pumps and electric motors proposed by the low tenderer did not meet specifications in minor ways. The Authority also complained that the tenderer's nominated supplier of manhole covers and frames had proven to be unreliable in an earlier contract.

The precise circumstances surrounding the award of this contract are unclear and certain key documents cannot be found. The Audit Office was unable to locate the relevant minutes of the PTC, despite intensive searches by several departments of Government. A recommendation was apparently made by the PTC to Executive Council, but this document also cannot be located. However inquiries with the Clerk to Executive Council established that the award of the materials procurement contract was apparently not referred to Council.

4.7 Water Authority management held negotiations with Tenderer 3 (Propax Industrial Exports Ltd). The tender sum was reduced in several ways, primarily a discount of \$58,700 for improved shipping rates plus certain reductions and variations to items and quantities tendered. A contract was executed with the company in late February 1987 in the amount of \$853,577.

4.8 The Audit Office reviewed contract performance. We noted a number of inconsistencies and questionable assessments in the evaluation tender exercise.

Delivery

- In the event Propax delivered only 85% of materials within the 110 day period specified. Materials delivery was not completed until late November 1987. Time critical materials (the reservoir panels) were received by the deadline and the Authority was able to take delivery of water on schedule and without incurring any penalty. The materials procurement contract provided for liquidated damages up to 5% of the contract value for late delivery. The Authority did not impose any penalty for late delivery as it incurred no damages or extra costs. This appears reasonable.

Alleged Non Compliance with Specifications

- The Audit Office was surprised to note the adverse comments about the low bidder's supplier of manhole covers and frames. Further examination of tender documentation revealed that the three low bidders had proposed identical products from the same supplier. The Authority's objection to Tenderer 1's supplier is therefore invalid. The other technical objections to products offered appear to be minor and capable of resolution. They do not appear to be sufficiently serious to warrant rejection of the tender.
- It was also noted that lockable meter boxes were specified in the tender documents, whereas non-locking boxes were quoted and supplied by Propax. Lockable boxes were quoted by Propax at an additional cost of \$7,612. The low bidder complied with the tender specification. This variation should have been reflected in the evaluated bid prices but was not.

4.9 In October 1987 the three lowest tenderers were asked to quote for a further 8,300 meters of pipe and associated fixtures for an extension to GTWS. This tender exercise did not involve the PTC and was administered in-house by the Authority. A sealed bid procedure was not followed, and tenders were submitted by fax or mail. Quotations were to be received by 22 October, 1987. This second contract was also awarded to Propax as the low bidder.

	Tender	The Audit Office was surprised to note that the Propax bid was faxed late on 23 October, a full day after bids should have closed. Normally late bids should not be considered. We were unable to obtain any explanation for this anomaly.
	\$	
Propax	164,054	
Tender 2	164,768	
Tender 3	192,654	

Price Increases

4.10 With effect from July 1988, Propax became the Authority's single source supplier. This arrangement continued without interruption until mid 1994 and included the materials required for the water extension to Red Bay - Spotts and the Cayman Brac and Spotts - Pease Bay projects. The total amount paid to Propax is in excess of \$4.1 million, as disclosed at **Figure 4.3**. Only 20% of the materials ordered were covered by recognised tender procedures.

Figure 4.3: Materials Supply Summary

Project	Pipe Length Metres	Tender Amount \$	Amount Paid \$
P21 George Town (1)	82,793	853,577	1,433,558
P24 George Town Extension	35,030	No tender	592,164
P25 Cayman Brac	6,459	No tender	298,504
P26 Spotts -Pease Bay	88,269	No tender	1,818,604
	<u>212,551</u>		<u>4,142,830</u>

(1) The scope of P21 was extended after the original contracts were let.

4.11 We found no evidence of competitive price quotations being sought for any of the single source purchases. No formal contract arrangements were put in place for project P24, 25 and 26 procurement and the Authority's financial interests were not properly protected. Main orders were placed by fax, with supplementary orders added in at a later stage. Prices of several supplementary orders were increased, apparently as a result of increased producer prices or shipping inefficiencies. The Audit Office has charted the main price movements for large and small diameter pipe at **Figure 4.4**. Between February 1987 and August 1991 the prices for large diameter pipes (4, 6, 8 and 12 inch) increased by 112%, 95%, 75% and 53% respectively. Pipe prices were held firm for Phase II of the Spotts - Pease Bay project which commenced in July 1992. An average increase of 9% was applied for Phase III of the project effective January 1993.

4.12 The Audit Office arranged for Crown Agents to carry out a pricing test in June 1994. This exercise established that Propax's 1993 pipe prices were between 29% and 59% higher than CIF prices quoted by the Crown Agents. In view of this situation, the Audit Office communicated informally its concerns about both the method and high cost of materials procurement to the Authority's Chairman. In mid 1994 the present management changed procurement practices. It is now the Authority's firm policy to seek competitive quotations in compliance with Government Financial and Stores Regulations.

Figure 4.4

Materials Supply Contracts - Propax Industrial Exports Ltd

Cost Per Metre - Expressed in Pounds Sterling

uPVC pipes with flexible joints: 5.8m - 5.6 m effective lengths

Size	Materials Supplied by Propax						Comparative Prices		
	P21 Original	P21 Extension	P21 Extension	P26 Phase I	P26 Phase II	P26 Phase III	Direct Purchase Quote	Crown Agents Test	Water Authority Tender
	Feb-87 (1)	Oct-87	Jul-88	Aug-91	Jul-92	Jan-93	Jun-91	Jun-94	Aug-95
300 mm	17.46	N/R	N/R	26.52	26.52	28.67	24.16	22.21	18.01
250 mm	-	-	-	-	-	20.85	-	-	12.75
200 mm	8.04	8.69	9.30	14.04	14.04	15.48	12.92	10.48	-
150 mm	5.45	5.77	6.49	10.64	10.64	11.50	9.22	7.22	4.83
100 mm	2.51	2.75	2.70	5.32	5.32	N/R	4.96	3.30	2.23

(1) Excludes special discount negotiated

(2) Table does not reflect cost and supply fluctuations for uPVC pipe in period 1987-95.

4.13 Audit review established that pipes purchased in 1993 via Propax single source arrangements were on average 74% more expensive than materials purchased through a competitive bid process in 1995 for pipes made to a similar specification. The results of this small procurement exercise (3,350 metres of pipe) are also summarised at **Figure 4.4**. Taking into account increases in producer prices, quantity discounts and shipping economies of scale, the Audit Office concluded that up to 50% of the cost of pipes for the Spotts-Pease Bay extension could have been saved through competitive procurement in the United States.

Justification for Single Source Supply

4.14 The Audit Office questioned management why the single source purchasing arrangements were permitted to continue for almost six years, apparently in contravention of Financial and Stores Regulations. Management pointed out that a compulsory tendering policy did not apply to Statutory Authorities between 1990 and 1993. Propax had proved to be a reliable and knowledgeable supplier. Single source procurement was viewed as a necessary expedient in view of inadequate staffing at professional engineer level. The Authority was also precluded from purchasing pipes in the United States because it was following a British standards specification (BS 3505 Part C: 1986). Pipes to this specification were not available from suppliers or manufacturers in the USA.

4.15 These explanations are worth further analysis:

CDB Restrictions on Procurement

- It is agreed that CDB restrictions prevented procurement in the United States initially. However as a direct consequence of the Authority's single source procurement policy, the CDB refused to consider financing the Spotts - Pease Bay extension. This decision was known fully 12 months before the civil engineering works commenced and resulted in a requirement for locally-provided commercial financing. This situation provided an opportunity for lower materials costs through sourcing in the USA.

Specifications

- Investigations by the Audit Office revealed that the specification BS 3505 Part C (nominal bore imperial size) has largely been replaced by metric uPVC pipe made to ISO dimensional specifications for the UK water industry. There are only two known manufacturers world-wide who presently manufacture to BS 3505C. Metric pipe to UK water industry standards is available at a discount of approximately 17.5% to the BS 3505 standard. Management has commented that a change to metric pipes would have caused a number of technical and operational problems and was not appropriate. During 1995 the Authority changed specification and purchased a quantity of pipes to a recognised North American specification (ASTM SDR26). Management has commented that these materials are suitable in all respects and are compatible dimensionally with BS 3505C. In the opinion of the Audit Office, the lifting of financing restrictions in 1989/90 should have prompted management to review procurement practices. The feasibility of changing materials specification to achieve better value for money in the Spotts - Pease Bay project should have been evaluated prior to continuing with the existing supply arrangements.

Direct Purchase from Manufacturer

- The only evidence of price review located by the Audit Office was a quotation received in 1991 from a British uPVC pipe manufacturer. Although this was between 7% and 15.4% lower than comparative prices quoted by Propax, the Authority took no steps to modify the supply arrangements to direct purchase from the manufacturer. This action alone could have saved at least \$100,000 on the Spotts - Pease Bay project.

Transparency and Accountability

- Under Government procurement regulations, all acquisitions of goods and services in excess of \$10,000 must be obtained by contract after public tender. Not only should all eligible suppliers have an equal opportunity to bid, but the award of public contracts must be seen by the community to be fair and equitable. Management has a duty to ensure that goods are sourced by the most economical means commensurate with quality to obtain maximum value for public money. It is accepted that both financial and non financial benefits may arise through long term relationships with a supplier. In these circumstances, management is under a clear obligation to ensure, through market testing, that optimum value for money is received in single source procurements. There is no evidence that the Authority's Board was ever invited to endorse a single source procurement policy. Indeed there is no Board discussion of materials procurement between 1988 and 1994, during which time Propax received over \$3 million of additional orders.

Materials procurement does not appear to have been referred to the Central Tenders Committee at the time the Spotts - Pease Bay project was under review. As the materials component represented around 40% of total civil engineering costs, we consider this to be a highly significant departure from established procedures.

Status of Propax Industrial Exports Ltd

4.16 At an early stage of the audit, it was observed that a cheque for \$795,131 for materials supplied by Propax was actually made payable to an unknown third party, Mr E Mayar. There was no documentation on file supporting this diversion of contractor funds. This was considered to be a material breach of internal control. Management could not explain who Mr Mayar was nor why the payment was made to him. Propax was contacted and advised that the Authority's payment against Phase I materials for the Spotts - Pease Bay extension was extensively delayed due to the Authority's difficulties in confirming available financing. In order to honour suppliers' terms, Propax was forced to borrow from a business associate at short notice. It was a condition of this loan that overdue payments with interest would be payable directly to Mr Mayar. The Audit Office was unable to independently

validate these explanations. Although there was no financial loss to the Authority, the diversion of legitimate payments to an unknown third party constituted a material breach of internal control and placed the Authority at considerable risk.

4.17 Further enquiries by the Audit Office on the status of Propax revealed several anomalies and apparent irregularities.

Pre Qualification of Propax

- Under CDB procedures, all tenderers for the materials supply contract had to be prequalified. The Authority prequalified Propax on 6 August 1986 but none of the prequalification documentation could be provided for audit. The relevant files had been stored in the basement of the Tower Building. During 1992 it was found that some old files had been damaged due to water leakage. Management collected all salvageable project files and stored them in the project manager's office. The Audit Office made further attempts to obtain prequalification documentation from the CDB, but without success. In view of subsequent disclosures, audit review of prequalification documentation is of high importance.

Trading Status

- Enquiries with the UK Registrar of Companies revealed that Propax Industrial Exports Ltd was registered in April 1985 with £100 paid up share capital. According to statutory returns filed, the directors continue to report that Propax has never traded and is a dormant company within the definition of the UK Companies Act ordinance. This is clearly false. The company continues to show £100 in paid up share capital as its sole asset in its returns filed with the UK Registrar.

Civil Engineering Contract

4.18 Additions and changes to the scope of works were administered through a series of 33 Variation Orders. Some of these were of a technical nature. Some were to change existing or to create new unit rates for items not foreseen in the original tender. Such variations are normal and expected in any large civil engineering contract. However 16 of the Variation Orders were issued to allow extensions to the original distribution system. The initial contract period of 330 days was extended to include:

- a. additional works in the George Town and South Sound areas (P 21)
- b. the South Sound - Prospect - Spotts area (P 24)
- c. a separate project on Cayman Brac (P 25)
- d. the Spotts to Pease Bay project (P 26).

The civil engineering works were eventually completed in May 1994, some seven years after award of the original contract. The value of work carried out by the contractor increased from the tender sum of \$2.6 million to \$10.367 million. Although the GTWS Phase I tender was cited as the nominal authority, for all practical purposes the extension projects were administered, incorrectly, as four separate and distinct contracts with separate certification and payment procedures. **Figure 4.1** summarises the total costs of the civil engineering contract.

Price Increases

4.19 The civil engineering contract was based on the Conditions of Contract for Works of Civil Engineering Construction issued by the Federation Internationale des Ingeneurs-Conseils (FIDIC). Clause 70 of the contract expressly prohibits price increases due to variations in the cost of labour, plant and materials and requires the contract be carried out on a fixed unit price basis. A fixed price contract was selected because the works were to be completed in 330 days and it was not considered necessary to include a mechanism for price increases. Clause 52(3) of the contract deals with price increases which may become due once the value of completed works exceeds 115% of the original contract sum. During the period of the original contract (330 days) no price adjustments were made and thus the requirements of clause 70 were complied with. Once the value of completed work reached 115% (effective 1 January 1989), the requirements of clause 70 were ignored and the Engineer awarded annual rate increases to the Contractor. For 1989, 1990 and 1991 rate increases were calculated separately for each group of similar items of work. Average rate increases in this period appear broadly comparable with the Cayman Islands consumer price index (CPI). For 1992 through to 1994 rate increases were applied across the board, based on the CPI. The rate increases allowed were as follows:

1989	11.6%	average (covers May 1987 to December 1988)
1990	3.4%	average
1991	6.4%	average
1992	39.0%	time and method related overhead charges incorporated in every individual unit rate (see paragraphs 4.26 - 4.28).
1992	6.6%	(CPI)
1993	1.4%	(CPI)
1994	3.5%	(CPI).

Price increases awarded to the contractor between 1989 and 1994 total \$1,427,581, including increases for time and method related charges. Details are provided at **Figure 4.5**.

Figure 4.5 Contract Price Increases

	Unit Rates 1987 Prices \$	Price Increases \$	Percent Increase %	Total Cost \$
P21	3,619,986	97,631	2.7	3,717,617
P24	1,561,184	246,894	15.8	1,808,078
P25	248,357	50,290	20.2	298,647
P26	3,510,268	1,032,766	29.4	4,543,034
Total	8,939,795	1,427,581		10,367,376

4.20 During the course of the audit, the Authority's engineers advised that price increases had been awarded properly under the provisions of clause 52(3) of the contract. Management also commented that, in their opinion, fixed unit rates could no longer be justified due to the various extensions to the original project. The Audit Office disputed this interpretation in view of the requirements of clause 70. Furthermore, clause 52(3) provides for adjustments to be made to the contract price upon the certified completion of the whole works and not on an interim basis during the course of construction. The works executed under the contract were not completed, as a whole, until May 1994. The Audit Office therefore obtained the services of a firm of professional consulting engineers to advise on contract interpretation. The consultants concurred with the auditors' findings and concluded that clause 52(3) had been applied incorrectly. The consultants noted that when the Engineer applied clause 52(3) he did so by using calculations and information which appear to relate solely to increases in the cost of labour, plant and materials, which were expressly prohibited under section 70. Cost increases may be considered under section 52(3), but it is also intended that this clause deals with efficiencies and economies of scale, which may benefit both the Employer and Contractor because of increases in the value of work. In this case only inflationary costs were reviewed and for this reason the price increases were not in agreement with either clause 52(3) or clause 70.

4.21 The consultant has commented that the longer a contract period is extended the more onerous becomes the requirements of a fixed unit rate contract. However, the provisions of clause 70 cannot be ignored. If the Engineer believes that the contract provisions have become too onerous, he should recommend to the Employer that the remaining works be tendered in order to obtain the current market price. The consultants confirmed that retendering should have been applied to projects P24 (George Town - South Sound - Spotts); P25 (Cayman Brac); and, most decidedly, to P26 (Spotts - Pease Bay). The Audit Office was also informed that many administrations impose an upper limit on the extent of contract variations (say, 120% of contract value).

Justification for Awarding Additional Work to Petroservicios

4.22 In summary, the contract was altered from fixed price to variable price in order to cope with substantial changes to the scope of works. It is not clear at what point variations cease to be legitimate variations to the original contract and become a change in scope for which new unit rates should be developed or a fresh contract negotiated. The independent consultant concluded that new contracts were appropriate in the following circumstances:

- The works on Cayman Brac, since conditions on Cayman Brac are clearly different to those existing on Grand Cayman.
- The whole of the P24 project area was relatively less densely populated compared to that which would have been experienced in the downtown and industrial area of the original GTWS area. This would have the effect of improving the Contractor's production rate and general ease of operations.
- The Spotts - Pease Bay project included works along the main road and in subdivisions. Whilst construction would have been relatively slow through Bodden Town because of the narrow right of way, limited available detours and private property boundaries, overall the volume of traffic was significantly less than in George Town. In many of the subdivisions within the P26 project area traffic was, and remains, virtually non-existent. The Contractor was effectively working in a greenfield situation. Staff of the Authority have argued that site conditions in the P26 project area during 1992-94 were comparable to those experienced in George Town between 1987 and 1989. The independent consultant does not agree with these views. He concluded that the P26 project was carried out in conditions so different to the original contract that a fresh contract should have been considered.

4.23 The original project was intended as the first part of a four phase scheme, implying that management and/or the Board intended to proceed with a multi-year programme. By the latter part of 1990 it was evident that the Authority, or at least the Director, intended to proceed with the Spotts - Pease Bay phase by awarding an extension to the existing Contractor without a public tender. The justification for this course of action appears to have been twofold. First it was claimed that existing contract prices were unlikely to be bettered by any other contractor invited to bid. Second, a public tender would involve a time delay which would likely negate the current favourable prices negotiated with the existing contractor and might make the project prohibitively expensive. Staff of the Authority suggested to auditors and the consultant that the decision to award the Spotts - Pease Bay extension to Petroservicios was made for several reasons:

- The Authority was very satisfied with the quality of work performed by Petroservicios, who had come to be regarded as an arm of the Authority and were co-operative and flexible.
- Between January 1990 and 1993, the Authority did not consider that it was bound by Government's Financial and Stores Regulations which mandate compulsory competitive tendering.
- There would be little interest from other contractors on the island.
- The contractor's existing unit prices were competitive. Retendering would have increased costs substantially.
- There was insufficient time to tender.

4.24 The independent consultant provided the following comments in relation to this issue:

- It cannot be assumed that prices would have increased between 1987 and 1991. Supply and demand factors should be taken into account. There is always a risk that tender prices will be higher than expected. However, if several "arms length" bids are received, the Employer can be sure that the lowest tender will reflect prevailing market prices. The wider public interest is served by an open and competitive process.
- There is reliable evidence that two or three local contractors would have shown keen interest had the works been tendered publicly. One reputable local contractor made strong representations to the Board and management following the announcement that the Spotts - Pease Bay project was to be awarded to Petroservicios without a public tender.
- The general economic conditions in Cayman Islands during 1991 were somewhat depressed. As local contractors had little other work on hand, the weak business environment may have caused them to be very competitive and to submit keen prices. Additionally, the prospect of local competition would have created competitive tension. The possibility that the existing contractor might have lowered his prices, or held firm at existing 1990 or 1991 rates, in order to win the Spotts - Pease Bay project appears to have been ignored by the Authority. Had unit rates been held fixed for the duration of the project at existing prices, the Authority would have achieved considerable cost savings, as follows:

Saving at 1990 unit rates:	\$554,068
Saving at 1991 unit rates:	\$315,016

The independent consultant also noted that the CDB had declined to consider funding project P26 unless competitive tendering procedures were followed.

- The Authority's staff have advanced arguments that sufficient time was not available for a full tender exercise. The Authority's staff estimate that it would have taken up to seven months to complete the design, prequalify bidders, issue tender documents and award a contract for project P26. Normally this should have been sufficient time. However, at that time, total project personnel comprised only one project manager and one resident engineer. Management told me that these personnel were fully occupied with the P24 and P25 projects and with two disputes on the sewerage project. They were therefore not available to collect design data, complete detailed designs and prepare tender documents while administering the existing P24 and P25 projects. Had the P26 been put out to tender, the project could not have commenced before mid 1992, with the probable result that the project would have been delayed or even abandoned. The decision to proceed with the P26 project was known by the fall of 1990 and the contract extension was not awarded to Petroservicios until August 1991. However the detailed design for P26 was not completed until late 1991, several months after the issue of the Variation Order to the Contractor. The Audit Office concluded that the Authority's development projects had not been properly resourced. In the opinion of the Audit Office, it is a matter of concern when large public contracts are let on the basis of expediency, rather than in compliance with the principles of competitive public tendering.
- One of the main cost advantages of continuing with Petroservicios advanced by management was the cost of rock cutting. The original P21 project included only 25m³ of rock on the bill of quantities. As the work progressed site conditions changed and substantially more rock was encountered. In total almost 6,000 m³ of continuous rock was excavated on the P21 and P24 projects. New rate for rock cutting was therefore negotiated and a rate of \$13.73 m³ was agreed. This was subsequently increased to \$23.75 m³ through the annual price increase mechanism and incorporation of overheads. The independent consultant concluded that these price increases were appropriate in the circumstances. In a comparison between the current Petroservicios prices and the second lowest unit rate tendered in 1987 for rock excavation, the Authority assumed the current (1991) rock cutting rate for a new bidder would be \$90 m³. The estimated quantities of rock for the P21 and P26 projects are crucial to this assessment. It is not likely that a tender rate for 25,000 m³ of rock excavation will be similar to that quoted for 25 m³. If the original 1987 tender rate was not valid for Petroservicios (it was increased from \$1.60 to \$23.75 m³) then similar assumptions are equally not valid for other bidders. If the comparisons are invalid, the arguments used to support the continued use of Petroservicios are also invalid. It is simply not correct to assume that a contractor would bid \$90 m³ in 1991. This flawed comparison

reinforces the benefit of tendering the P26 project. In the opinion of the Audit Office, it is not proven that retendering would have increased unit rates.

4.25 Management assert their after-the-fact enquiries about market rates support the continued use of Petroservicios. The independent consultant concluded that the decision to award the P26 extension to Petroservicios was based on a desire to continue what had become a comfortable working relationship. The Authority was very satisfied with the work performed by the Contractor and with the agreed unit rates. A full tender exercise would have imposed an additional workload on engineering personnel in late 1990 - early 1991 to the detriment of other activities. It was also suggested on several occasions to the Board, the Public Sector Investment Committee and to Government generally that Petroservicios would demobilise imminently if they were not awarded the P26 extension, involving the Authority in substantial remobilisation costs. The facts do not support this contention. The contractor was inactive for much of 1991 and carried out only tidy up and reinstatement work in George Town, plus the small Cayman Brac project. It would appear that the Contractor was off island for part of 1991 and had stored plant at the Authority's premises, apparently in anticipation of the award of P26.

Method and Time Related Charges

4.26 The tender documents allowed each bidder to insert prices against a number of general items (e.g. mobilisation, work permits, insurance, temporary works, etc) and also against so-called method charges which the Contractor was free to define as he wished (mainly site and office overheads). The price for recurring method and time related charges in the original contract was \$564,483, representing 39% of the aggregate unit rates. These charges were based on the original construction period of 330 days. When Variation Orders extending the contract period were issued to the Contractor, the cost of method and time related charges increased. Time extensions and the related increases in method and time related charges were based on the original pipe laying rate of 59 metres per day. During 1989 and 1990 the Engineer permitted, incorrectly, various increases to time and method related charges. With effect from 1991 the Engineer agreed to incorporate these charges into individual unit rates by increasing each individual item by 39%. Method and time related charges for project P26 totalled \$1,274,664. Of this amount some \$289,607 (23%) was assessed as attributable to price increases awarded by the Engineer between 1989 and 1994.

4.27 Superficially this appears to be a reasonable solution as it simplifies calculation of time and method related charges. However the Audit Office was not satisfied that this significant departure from the contract was appropriate in all the circumstances and that the price increases awarded between 1989 and 1994 were properly payable. The independent consultant advised that the time and method charges tendered will reflect the site conditions under which the works are to be performed. When the scope of

works and construction period are changed the relative importance of certain components of the time and method related charges may also change. Once a large extension to the works has been authorised it does not follow that time and method related charges should be automatically applied to on-going work.

In this case it would appear that time and method related charges should have been applied to the works done between 1988 and 1994 only after review and modification as to the items included, and the relative volume of items. Under this arrangement there is also a possibility that the contractor may be paid additional amounts in circumstances where productivity on the additional works is improved.

4.28 The Authority confirmed that the contractor took 14 months longer to complete the P21, P24 and P25 projects than was allowed. In view of this performance we were surprised to note that the Authority did not give a formal extension of time to the Contractor to complete P26. The Authority contends that the actual value for time and method related charges paid for project P26 represents 18.6 months, whereas the actual construction time taken was 29.5 months. The Authority has noted that the contractor could have been entitled to significantly more time and method related charges than was actually paid. The Audit Office drew several conclusions from this rather complex situation.

- The basis of calculating payments due under the contract was altered, apparently for convenience.
- Method and time related charges were increased generally in line with inflation, contrary to the contract.
- Method and time related charges for P26 were paid in the same proportion as for P21. Site conditions on the various projects clearly differ in a number of respects, including soil conditions and traffic conditions, both of which affect the contractor's rate of production.
- Project P26 took approximately 18 weeks longer to complete than was calculated in 1991, although no formal extension of time was ever granted to the contractor. It would appear that the change to a 39% on cost for method and time related charges worked to the benefit of the Authority.
- In total the project took almost seven years to complete. General time delays and idle periods worked to the detriment of the Authority in view of the annual price increases awarded to the contractor.

Overall, I am unable to form an opinion on whether fair value for money was achieved through the unauthorised changes in the calculation and payment of time and method related charges.

Project Performance

4.29 The Audit Office reviewed several performance indicators relevant to the Spotts - Pease Bay project. The civil engineering works appear to have been carried out to a high standard, with one minor exception. A one mile section of the main pipeline trench between Red Bay and Spotts was not constructed properly with the result that there have been several pipe fractures. The Authority intends to replace this section using in-house resources. The defect appears to be attributable to inadequate project supervision during mid 1989 as a result of insufficient engineering personnel, pressure of work and staff vacation.

4.30 Overall we found that project estimates were soundly based, with the exception that project management and incidental expenses were not included in the total project cost submission approved by Government. The civil engineering works and materials procurement were completed well under budget, mainly as a result of less continuous rock than expected - **Figure 4.6**.

Figure 4.6 Project Estimate and Cost

Civil Engineering & Materials	\$	Total Project Cost	\$
Approved Budget (1)	7,320,545	Approved Budget	7,320,545
Actual Cost (2)	6,358,286	Actual Cost	7,551,553
Less than Budget	962,259	More than Budget	231,008

(1) Approved budget figures exclude \$1,113,983 for the Lower Valley reservoir and pumping station included within the budget submission approved by Government. This work was deferred to a future period.

(2) Excludes project management and other expenses and \$373,138 in respect of Red Gate reservoir and pumping station

4.31 Excluding the reservoir and pumping station, the project took approximately four months longer to complete than was estimated in 1991 (912 days compared to 786 days). From a contractual point of view, no specific time extensions were included in the Variation Orders issued to the contractor. This is most unusual in a normal civil engineering contract and poses problems in calculating certain general items payable to the contractor. In practice, the incorporation of method and time related charges as a 39% on-cost to unit rates avoided the need to calculate general items separately.

4.32 By year end 1995 there were much fewer supply connections than originally estimated. **Figure 4.7** indicates that the number of active accounts at December 1995 was only 41% of the Authority's 1991 estimate. We calculate the capital cost per active account to be approximately \$7,600.

Figure 4.7 Spotts-Pease Bay Project - Consumers

	Approved Estimate Sept 1991	Active Accounts May 1994	Active Accounts Dec 1995	Active as a Percentage of Estimate
Phase 1*	1,300 *	307	530	40.8
Phase 2	600	256	258	43.0
Phase 3	600	283	254	42.3
Total	2,500	846	1,042	41.7
Note: *	Phase 1 includes 600 properties located in the P21 and P24 project areas included within the scope of P26.			

4.33 During 1995 the Authority made significant reductions to the direct cost of water produced, mainly through purchasing economies of scale. The Authority also benefited from a 6% rate increase to the water tariff. These factors considerably improved the financial performance of the project. Based on current profitability levels, we calculated the project pay back period to be approximately 31 years. However, present net profit before depreciation and finance costs covers only 25% of estimated annual debt service cost. We recognise that the number of consumers in the project area will increase as more properties are constructed and existing properties are connected to the system. This should improve project rate of return.

4.34 In the opinion of the Audit Office, the shortfall in the number of consumers has made the Spotts - Pease Bay project not viable financially. However, based on the Authority's (unaudited) budget forecast for the period 1995 -2001, we are satisfied that the Authority can generate sufficient funds from all operations to service its long term debt obligations. Water Authority management considers that the country received the best possible value for the money spent, given the external constraints which affected long term project planning.

Subsidiary Issues

Conflict of Interest

4.35 The Engineer appointed under the contract is expected to provide his services in a strictly fiduciary manner, one of trust. This is essential to the whole relationship between both the Employer and the Engineer and also to that between the Employer and Contractor. In performing his duties, the

Engineer is under an implied duty in common law and an express duty under the Code of Practice of FIDIC to act with complete independence of judgement in applying the terms of the contract with impartiality, honesty and integrity. The Engineer is entrusted during the construction period with administrative duties which may alter the time for completion of the works and vary the cost of such works. These duties include measuring and valuing of the executed works, fixing rates and prices of additional and varied work and deciding all matters which are within the Engineers' role under the Contract.

4.36 In carrying out his duties, the Engineer must do so with unfettered judgement. This is essential since, in performing these administrative duties, the Engineer is regarded as having dual role. On the one hand, he is considered as acting in the role of an agent of the Employer in ensuring that the work is executed by the Contractor in accordance with the provisions of the contract and that the Contractor is in possession of all the required documentation for such execution. On the other hand, the Engineer is regarded as a certifier or an adjudicator, as the case may be.

4.37 It was brought to the attention of the Audit Office that the Engineer had married the daughter of the major shareholder of Petroservicios during 1990. Our independent consultant advised that this relationship would place the Engineer in a position where his ability to perform his duties in an impartial manner might be called into question. In these circumstances the Engineer has a duty to make the situation known to the Employer as soon as possible and to take steps to separate himself from the position of influence in relation to the contract.

4.38 The potential for conflict of interest is especially relevant as regards Projects P24, P25 and P26. The conditions of contract for these works were modified significantly and thus altered the basis on which the original contract was tendered and awarded.

4.39 The extensions to the original contract were approved by the Board following recommendation by the Engineer. The main arguments advanced were that (a) it would take at least six months to tender for the additional works; and (b) that the Contractor's low rates would not be bettered. The Audit Office noted that the Engineer had decided to extend the scope of the works in favour of Petroservicios without public tender as early as mid 1990, fully 12 months before the formal award of the contract extension. Management maintain that there was insufficient time for a public tender exercise. Whether or not the unit rates negotiated with Petroservicios would have been bettered in an open tender competition is a matter of speculation.

4.40 The initial increase in unit rates was awarded to the Contractor in October 1989, retroactive to 1 January 1989. Thereafter rate increases were awarded on 1st January each year, 1990 through 1994.

With effect from 1992, rate increases were based upon the Cayman Islands Consumer Price Index (CPI). The Board was aware of these increases, which were awarded erroneously by the Engineer under the provisions of clause 52(3) of the conditions of contract. However neither the Board nor the Employer was consulted about the material alterations to the payment of time and method related charges.

4.41 The Audit Office could find no written evidence that the potential conflict of interest was ever disclosed formally to the Employer or the Board. The Authority has commented that the Board, senior management and key Government officials all knew of the marriage. In the opinion of the Authority there was no actual conflict of interest because the Engineer was not directly responsible for contract administration and did not personally negotiate the annual rate increases awarded to the contractor. The Audit Office agrees that the new works engineer had full responsibility for contract management with effect from July 1989. However by that time a precedent had been established for an annual rate increase. The Audit Office also concluded that the Engineer was responsible for all strategic decisions, including recommending the award of the P24, P25 and P26 projects to Petroservicios on a non competitive basis. In summary, considerable discretionary powers were assumed by the Engineer to negotiate with the Contractor. In the opinion of the Audit Office, these circumstances increased the conflict of interest.

Non Payment of Customs Duties

4.42 The tender conditions state that the contractor is liable for all costs of importing and re-exporting construction plant, including relevant customs duties as defined in the Customs Law (Second Revision). We noted that Petroservicios requested exemption from customs duties on certain items of construction plant, including two trenchers in August 1987. This application was refused by ExCo. A number of importations were released by Customs pending ExCo's decision. According to Customs records, the total amount of duty deferred was \$71,354. We could find no evidence that this revenue was ever recovered from Petroservicios and relevant Customs' records have now been destroyed. It is understood that certain items of plant, including two trenching machines were sold locally by Petroservicios on the conclusion of the Water Authority contracts. In February 1992, approval was granted under section 19 of the Customs Law for Petroservicios to import duty free another trenching machine for the Spotts to Pease Bay project. The plant remained on Grand Cayman for approximately 2 1/2 years and was re-exported on completion of the project.

4.43 It is the view of the Audit Office that the import duty concessions materially altered the conditions of the contract from duty paid to duty free. This may distort the tendering process and may lead to higher prices being bid by competing contractors. There is no evidence that the Water Authority benefited either directly or indirectly from Customs revenues foregone by Government.

PART V

Other Matters

Staffing

5.1 I am happy to report that, for the first time in many years, all audit posts were filled as of 1 July 1995. In common with other disciplines in the civil service, the Audit Office is facing longer term issues of retaining capable young Caymanians and providing them with a challenging and rewarding career. For the past two years my office has recommended a scheme of flexible grading for audit personnel, which rewards service and professional qualifications. There are now indications that the proposals will be supported by personnel. However I recognise that this scheme alone may not be sufficient, as the civil service cannot compete with the private sector in terms of either compensation or job opportunity. I expect to see a continuing exodus of accounting and finance personnel (amongst others) to the private sector after graduates have completed their bonding period. One member of staff has already resigned at the date of preparing this report.

Training

5.2 The Audit Office actively supports professional and technical training for all personnel. The Office participates in the regional training programme provided by the Caribbean Organisation of Supreme Audit Institutions (CAROSAI) with funding from the Inter American Development Bank. Government has also provided financial support for training and grants study leave to participants. During the 12 months to June 1996 approximately 280 man days were allotted to staff training. I am pleased to report that Mr Richard Roberts successfully completed his CPA examinations in May 1996.

Name	Post	Training Activity
K Jefferson	Audit Manager	2 week audit management and supervision workshop St. Vincent (1)
J Bodden	Senior Auditor	6 week financial and value for money auditing course, UK (2) Level 3, AAT, Community College (2)
R Roberts	Auditor	7 week CPA preparation course, USA (twice) (2) (3)
S Ramsay	Auditor	2 week performance auditing, Barbados (1) 2 week ACCA preparation course by private study (2)
S Edwards	Auditor	7 week CPA preparation course, USA (twice) (2) (3)
D Wesley	Assistant Auditor	Level 2 AAT, Community College (2)

Notes:

- (1) Sponsor: CAROSAI - Inter American Development Bank (IADB)
- (2) Sponsor: Cayman Islands Government
- (3) Sponsor: Officer

Information Technology in the Civil Service

5.3 I must register some concerns on Government's information technology (IT) policy, or rather the lack of an appropriate policy. There are several issues which I think need to be addressed.

- Government has not developed a comprehensive IT strategy.
- A Computer Steering Committee (CSC) was established some years ago but it is not clear what the Committee's function is. There does not seem to be any co-ordinated IT policy or direction. Neither the CSC nor Computer Services have been given terms of reference or clear objectives.
- There appears to be a reluctance to accept that considerable annual investment is needed to maintain and enhance IT services to an appropriate standard for efficient and effective governance. IT budgets taken to the Legislative Assembly for approval are unrealistic.
- The physical infrastructure is being stretched. Decisions are taken to introduce additional departmental systems without consultation or advice, and without considering technical and manpower support issues.
- The command and reporting structure of Computer Services Department does not appear to be appropriate for the scope of services demanded by user departments.

5.4 The lack of policy and planning may be best illustrated by reference to the 1995 computer equipment budget, Head 41 Subhead 101. Departmental bids were cut severely during the budget review stage. The total budget approved by the Legislative Assembly was \$537,080, of which 60% was allocated to Computer Services Department for essential items such as software licences and memory upgrades. Supplementary requests totalling \$683,035 were taken to Finance Committee, mainly in the second half of the year. Most of this relates to departmental purchases which were crammed into the last few weeks of the financial year. This situation tends to create a "spend it or lose it" situation for Controlling Officers. Neither Computer Services nor the CSC were consulted about this level of spending and were not positioned to provide the level of support needed. Some of the 1995 equipment purchases had still not been installed as of June 1996.

5.5 A similar budget situation appears to be developing in 1996. Once again departments were told that there were no funds for departmental IT. Only \$17,000 of the \$481,000 computer equipment budget was allocated to departments. By May 1996 supplementary departmental approvals ratified by Finance Committee totalled \$365,000 for 18 departments.

5.6 I regret to report that our own modest IT plans have been delayed over the past three years through lack of funding. This affects audit operations. Requests for funds were turned down in both 1993 and 1994. Our 1995 budget bid was cut on grounds of general policy but we managed to obtain funds for two PCs. Repeated requests to be linked to the PC network met with vague promises but no action, until late 1995. The continuing lack of adequate facilities hampers our effectiveness, general productivity and is a cause of staff frustration and demoralisation. For example, I was almost forced to cancel a CAROSAI - IDB funded computer workshop for regional Auditors General in 1994 because we were unable to provide basic PCs for instructors. I am glad to report that the private sector came to our rescue with the loan of equipment when pleas to Government to borrow equipment were ignored. On a practical level, we are obliged to use three different word processing packages and two spreadsheets because of outdated equipment and software. Our CAATs (computer assisted audit techniques) project was delayed for over two years due to lack of funds. I shall be requesting funds for equipment and software in 1996 but it is clear that the Audit Office does not come high on the list of priorities.

Computer-Assisted Auditing Techniques (CAATs)

5.7 CAATs are a standard audit tool for data extraction, analysis and statistical sampling. During 1995 the Audit Office purchased the Interactive Data Extraction and Analysis software package (IDEA 5). IDEA allows the auditor to examine, analyse, and report on sets of computer records from a variety of operating environments. With assistance from Computer Services, the Audit Office has successfully used IDEA software to determine sample size and to select non-payroll transactions for our annual audit of Government's financial statements. Other features of this software were used in the annual payroll audit. Complete implementation of this audit tool is dependent on further assistance from Computer Services. We anticipate future use on departmental systems and the planned Integrated Financial & Human Resources Information System (IFHRIS).

Acknowledgements

5.8 Once again I wish to record my deep appreciation to my colleagues in the Audit Office for their hard work and dedication. Several members of staff worked long hours in the evening and at weekends to complete the annual audits and the preparation of this report. As usual I am pleased to acknowledge the continuing co-operation and support of Controlling Officers and their staffs.

N K Esdaile
Auditor General

Grand Cayman
23 August 1996