

GAO

Report to the Chairman, Committee on  
the Budget, House of Representatives

September 2000

INTERNATIONAL  
MONETARY FUND

Status of Efforts to  
Strengthen Safeguards  
Over Lending



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## Abbreviations

IMF      International Monetary Fund

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

National Security and  
International Affairs Division

B-285775

September 1, 2000

The Honorable John R. Kasich  
Chairman, Committee on the Budget  
House of Representatives

Dear Mr. Chairman:

The International Monetary Fund is a cooperative, intergovernmental, monetary, and financial institution whose financial resources are provided by its member countries.<sup>1</sup> The Fund provides financing to member countries that are experiencing or are about to experience balance-of-payments problems, that is, when they have difficulty obtaining the foreign currency needed to meet their external financial obligations. The Fund lends to member countries by providing them with foreign currencies to augment their international reserves.<sup>2</sup> Funds are generally provided in installments that are linked to the borrower's observance of specific economic and financial performance criteria. The Fund's Articles of Agreement require borrowers to provide information the Fund needs to determine whether its borrowers meet these economic and financial performance criteria. The articles also require the Fund to adopt policies that will establish adequate safeguards for the temporary use of its resources. To date, the vast majority of the Fund's borrowers have repaid their obligations.<sup>3</sup>

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<sup>1</sup> The Fund pays interest to its members for its use of their contributions.

<sup>2</sup> With the exception of some financing for low-income countries, the Fund does not loan funds to a country, per se. Rather, the country "purchases" the currency it needs from the Fund with an equivalent amount of its own currency and then later "repurchases" its own currency according to the terms applicable to the Fund's financing policy. Purchases are usually made pursuant to "arrangements" that set out the understandings between the Fund and the borrowing member country. For the purposes of this report, we will use the terms "borrower" to refer to the country receiving Fund financial assistance. We use the terms "disbursement" and "loan" to refer to "purchases" and "repay" to refer to "repurchase."

<sup>3</sup> As of January 2000, 7 of the Fund's 93 active borrowers were in arrears for more than 6 months. These arrears, totaling \$1.5 billion, represent about 2 percent of the Fund's total outstanding credit.

Over the last 2 years, the Fund has called for several investigations by independent international accounting firms to determine whether allegations were true that certain borrowers had misappropriated Fund resources and/or had misreported<sup>4</sup> information to the Fund. The accounting firms reported that they found no evidence that Fund resources were misappropriated; however, the investigations, which were made publicly available by the Fund, confirmed that certain borrowers had misreported information to the Fund. In doing so, they obtained Fund resources they may not have been entitled to. The Fund and the countries involved have undertaken a number of corrective steps (see apps. I and II for descriptions of two of these incidents and the corrective steps undertaken).

In response to these events, beginning in October 1999, the Fund undertook in-depth studies of its procedures and controls to identify ways to strengthen safeguards on the use of its funds and its procedures for assessing the integrity of the financial information reported to the Fund by its members. For both of these areas, a series of reviews completed in February 2000, identified a need for the Fund to improve its procedures and controls. In response to your concerns about whether the Fund's policies provide reasonable assurances that financial resources provided to member countries are adequately safeguarded, we are providing a status report on the Fund's progress in strengthening its policies and procedures relating to (1) the appropriate use of Fund resources by borrowers and (2) the accuracy of economic and financial information reported by borrowers, and upon which the Fund makes lending decisions.

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<sup>4</sup> "Misreporting" is defined by the Fund to denote inaccurate information provided intentionally or unintentionally to the Fund by a member country in breach of the Fund's rules for mandatory information, in particular to ascertain compliance with the agreed conditionality for disbursement of Fund resources.

To address these issues, we interviewed Fund officials responsible for financial management and compliance matters and reviewed and analyzed information contained in a series of studies on these topics completed by the Fund in February 2000.<sup>5</sup> We did not assess the quality or completeness of these studies; however, we noted that an external panel of international experts reviewed one of the studies for the Fund and endorsed its recommendations. We also interviewed officials from the Department of the Treasury, which has the lead role within the executive branch regarding U.S. policy toward the Fund.

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## Results in Brief

The International Monetary Fund's long-standing method for safeguarding its resources against misuse by borrowers has primarily been to monitor borrowers' compliance with specific, agreed-upon loan conditions, and Fund management believes that this means of assurance has generally been adequate. However, according to a study conducted by Fund staff, the Fund's financial resources have been vulnerable to borrower misuse because the Fund had not typically assessed the control procedures exercised by its borrowers' monetary authorities over their resources. Without such assessments, the Fund did not have reasonable assurance that the borrowers' systems of internal controls, accounting, reporting, and auditing were adequate to ensure the integrity of the borrowers' financial operations. Although internal controls can be circumvented, an assessment as to the adequacy of these controls could lead to improved financial reporting and detection of the misuse of resources. The Fund has introduced additional measures for safeguarding its resources. Beginning with loans approved after June 30, 2000, the Fund's policy now is to assess the control environment of borrowing countries' central banks, particularly their internal controls and accounting and reporting systems, to evaluate the integrity of their operations. According to Fund management, the Fund will withhold loan disbursements until borrowers have corrected any critical deficiencies discovered in the course of these assessments. Fund management also intends to assist borrowers in building their capacity to manage funds to help prevent the misuse of international reserves, including those obtained from the Fund. This process of assessing the control environment and building management capacity is still in the

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<sup>5</sup> Although these studies are classified and not publicly available, the Fund has published some information contained in them in the "Report of the Acting Managing Director to the International Monetary and Financial Committee on Strengthening Safeguards on the Use of Fund Resources and Misreporting of Information," dated April 10, 2000.

experimental phase, and, according to Fund management, it will take time and resources to implement. Fund management officials said they cannot estimate the overall magnitude of this effort until more progress has been made in implementing it. In addition to these assessments, as of July 1, 2000, the Fund implemented a policy of requiring all borrowers to publish financial statements of their central banks, audited by independent external auditors in accordance with internationally accepted standards.

The Fund had traditionally relied primarily on a relationship of trust with its members as a basis for assuring the integrity and accuracy of the information it needs, such as the amount of the country's international reserves, to effectively design and monitor programs and make lending decisions. Nonetheless, the Fund has established a number of measures to help prevent, detect, and address borrower misreporting of key information, whether unintentional or intentional. For example, according to Fund management, it checks, to the extent possible, the validity of the information reported by borrowers; also, in 1984, the Fund's Board of Executive Directors established guidelines for applying sanctions against borrowers that receive loan funds based on misreported information. Despite these measures, the internal Fund study concluded in February 2000 that the Fund faced limitations in its ability to obtain assurances as to the accuracy of information that borrowers reported. In several instances, borrowers reported inaccurate information to the Fund and received loan funds to which they may not have been entitled. According to the Fund study, the Fund remained vulnerable to borrowers receiving loan funds based on misreported information. To address these concerns, the Fund has taken several steps. In March 2000, for example, Fund management adopted a new policy of publicizing the identities of countries that obtain Fund resources based on inaccurate reporting. In July 2000, the Fund's Board of Executive Directors revised and strengthened its guidelines for addressing cases of borrower misreporting, and it may levy sanctions in more types of misreporting cases. According to Fund officials, the Fund's management has also begun to strengthen its internal operating practices for monitoring borrowers' compliance with loan conditions and reporting requirements, but it has not yet completed and reported on its plans in this area. Since some of the Fund's initiatives are still in the developmental or implementation stages, the extent to which these actions will be effective in correcting the weaknesses identified in the Fund studies is as yet unknown.

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## Background

International reserves are critical for a country's economic well-being. Holding these reserves helps ensure that a country can meet its international financial obligations, such as for imports of goods and services or repayment of foreign debt. International reserves also support the value of a country's local currency and, thus, its purchasing power in international markets.<sup>6</sup> In times of economic distress, when a country risks depleting its international reserves, it may obtain financial assistance from the International Monetary Fund (IMF) in the foreign currency it needs.

Because IMF funds are provided for balance-of-payments support and are not earmarked for any specific expenditures, it is difficult to track or control how borrowers use IMF funds. Unlike project funds from other lenders, such as the World Bank, IMF funds are typically added to and commingled with a country's international reserves for general use by the country and are usually under the control of the central bank. Given the fungible nature of money, tracking the specific use of IMF funds is virtually impossible.

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## Measures for Protecting Its Resources From Misuse

The primary means by which the IMF assures itself that its resources are safeguarded and that funds are repaid is by establishing specific agreed-upon conditions and performance criteria for its loans. Often borrowers must meet certain preconditions<sup>7</sup> before the IMF's Board of Executive Directors will approve a loan arrangement or disbursement.<sup>8</sup> After the loan arrangement has been approved, borrowers must usually adhere to a host of agreed-upon conditions before IMF funds are released. These conditions may include general commitments to cooperate with the IMF staff in formulating and implementing economic policies and meeting specific, quantitative targets for macroeconomic variables as well as more qualitative measures involving explicit structural reform policies. Meeting

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<sup>6</sup> International reserves give people confidence to hold a local currency, thus supporting its value, because these reserves represent the ability of the government to readily convert local currency to major currencies.

<sup>7</sup> These preconditions, called "prior actions," are policy measures that the IMF management views as key to the effectiveness of the assistance program to a country. They may include such things as reforming the operations of the country's foreign exchange market or lowering its level of foreign debt arrearages.

<sup>8</sup> The Board of Executive Directors consists of 24 members, including a U.S. Executive Director.

quantitative performance criteria usually entails staying within prescribed minimum and maximum levels for various macroeconomic variables, such as international reserves, domestic credit extended by the central bank, budget expenditures and revenue, and external debt. Meeting qualitative performance criteria usually involves implementing agreed-upon policy changes, such as reforming procedures for conducting fiscal and monetary transactions or operating the banking system. IMF funds are usually disbursed in installments, with each installment contingent upon compliance with such agreed-upon quantitative and qualitative performance criteria. If a country fails to meet performance criteria, disbursements cease, unless the Board of Executive Directors issues a waiver.

IMF staff monitors loan arrangements to ensure that borrowers meet the agreed-upon conditions and performance criteria. It assesses each borrower's compliance with performance criteria, typically on a quarterly basis, and, based upon these assessments, the Board of Executive Directors makes decisions about whether to release additional portions of the loan.<sup>9</sup> The staff relies primarily on information provided by the borrowers in conducting this monitoring.

The IMF also has several other measures that it believes contribute to safeguarding its resources. For example, the IMF management has encouraged member countries to voluntarily adopt internationally accepted codes and standards of operation with regard to monetary, fiscal, and financial policy-making; banking supervision; the dissemination of economic and financial data; and the management of international reserves. In addition, the IMF supports the proper management of borrowing country resources, including IMF funds, through its good governance initiatives, which involve policy advice, loan conditionality, and technical assistance in areas such as improving public sector accountability. Furthermore, IMF loan arrangements with borrower countries often contain provisions that the IMF can use to withhold financial assistance from members engaged in poor governance or corruption that can be shown to have a macroeconomic impact. According to the IMF, it has withheld loan disbursements and new resource commitments in such cases.

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<sup>9</sup> For more information on this process, see *International Monetary Fund: Approach Used to Establish and Monitor Conditions for Financial Assistance* (GAO/GGD/NSIAD-99-168, June 22, 1999).

Despite these measures for protecting its resources from misuse, a February 2000 internal IMF study indicated that the IMF's existing procedures did not provide all necessary assurance that its borrowers' management controls were sufficient to prevent the borrower's misuse of international reserves, including IMF funds.<sup>10</sup> The study noted that the IMF did not conduct assessments of the control environment of its borrowers' monetary authorities (typically central banks), including their systems of internal controls, accounting and reporting, as commercial lenders usually do with respect to their private borrowers. The IMF's traditional assessments of countries' fiscal, monetary, financial, and banking operations did not typically address the capacity of central banks<sup>11</sup> to manage funds borrowed through the IMF.

To better assess the risks in IMF loan programs and to help borrowers strengthen their management controls, the IMF's Board of Executive Directors approved a plan in March 2000 for IMF staff to assess the management controls of borrowing countries' central banks. According to the IMF, these assessments would evaluate whether the control, accounting, reporting, and auditing systems within borrowing countries' central banks are adequate to control and monitor the IMF funds entrusted to them. The assessments are to determine whether borrowing countries are complying with a series of desirable practices, rules, and regulations regarding internal control procedures, financial reporting, and audit mechanisms. The objective of this approach is for both the country authorities and the IMF to be reasonably assured that the systems put in place to manage international reserves are adequate to ensure the proper use of IMF funds. Assessments would also address the accountability and transparency (openness) of government policies that affect central bank operations.

These assessments are being conducted, on an experimental basis, for all countries with new loan programs approved after June 30, 2000, and will be conducted in one or two stages. In the first stage, borrowers will be asked to provide information and documents relating to the internal control and external auditing procedures of their central banks, as well as legislation and other information concerning the operations of the central banks. If IMF management, based on the staff's review of the documents, judges a

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<sup>10</sup> See footnote 6.

<sup>11</sup> The central bank of a country is usually the fiscal agent for IMF loans.

borrower's management controls to be adequate, it will regard the assessment as complete. If not, a second stage will follow, including an on-site assessment. IMF staff will head up the on-site assessment teams, which will include experts from central banks, multilateral agencies, such as the World Bank, and private accounting firms. The assessment teams will then propose actions to address any identified weaknesses in internal procedures, including any internal control deficiencies. According to the IMF's Treasurer, if critical vulnerabilities are found in a central bank's control environment, the IMF will require the borrower to undertake immediate improvements to address them before any loan funds are disbursed. This assessment process became operational as of July 1, 2000, and first stage assessments have been initiated for 33 countries as of August 2000.

Assessments will be more limited for ongoing programs approved before June 30, 2000: Borrowers will be required to publish the financial statements of their central banks, independently audited in accordance with internationally accepted standards, and to provide the IMF with the audit report and management letter. This audit documentation will be required for all future loan programs as well.

According to the IMF, these assessments will be beneficial because they will

- enhance the overall implementation of control, accounting, and reporting procedures at central banks and raise awareness of internationally recognized standards and best practices;
- provide the IMF with a more comprehensive knowledge of its members' practices and activities and the opportunity to make practical recommendations for improvements, based on identified best practices; and
- reduce the potential for misuse and misreporting of international reserves by borrowers.

The IMF intends these assessments to be comparable to procedures followed in private capital markets, where commercial lenders to private borrowers follow the universal principle that, in addition to measured risk-taking, they have a fiduciary duty to protect shareholders' capital. This duty calls for various safeguard mechanisms to ensure that borrowers have adequate financial management and internal control systems capable of

reliably recording and reporting all financial transactions. The proposal for conducting the assessments was endorsed by an international panel of experts from the public and private sectors, convened by the IMF, who are familiar with the relevant management, control, and other issues relating to central bank and treasury operations.

The IMF's Board of Executive Directors approved the assessment program in April 2000, but achieving tangible and sustained results from the program may take many years. Conducting these assessments will be a major new undertaking for the IMF, according to IMF management officials, requiring additional resources, including specialized staff. IMF officials said that the necessary resources have been allocated to conduct the assessments that will be required during the first year of this initiative. However, conducting these assessments in all borrower countries and implementing all of the necessary reforms may be a long-term effort. IMF management officials told us that the IMF is committed to the long-term implementation of this effort and that resources will be made available for conducting the assessments and providing member countries with technical assistance to implement reforms.

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## Procedures for Helping to Prevent Borrowers From Misreporting Key Information

As has been the practice for many years, the IMF depends primarily on borrowers to provide accurate economic and financial data to them. Even so, the IMF established several procedures and controls for validating borrower financial and economic information and addressing cases of misreporting. However, an internal IMF study completed in February 2000 found that these procedures and controls were limited in their ability to deter and redress cases of misreporting of key economic and financial information by borrowers.<sup>12</sup> In over a dozen cases, borrowers have obtained IMF funds that they may not have been entitled to by misreporting such information to the IMF. Beginning in April 2000, the IMF undertook a number of initiatives to improve its systems for preventing, detecting, and addressing cases of misreporting. However, some of these initiatives are still in developmental or implementation stages; consequently, the extent to which these actions will be effective in correcting the weaknesses identified in the IMF studies is as yet unknown.

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<sup>12</sup> See footnote 6.

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## IMF Relies Primarily on Borrowers to Provide Accurate Information

The IMF, as a cooperative institution, has relied primarily on a relationship of trust with its members as a basis for assuring the integrity and accuracy of the information it needs to effectively exercise surveillance, design and monitor programs, and make lending decisions. IMF members provide various types of information to IMF, as follows.

- *Reporting on Preconditions:* Before the IMF makes a loan, it may request borrowing countries to provide certain information demonstrating that the borrower has met certain preconditions to qualify for IMF assistance.
- *Mandatory Reporting Under Loan Arrangements:* Once a loan arrangement with a borrowing country has been approved, the country is required to report data relating to the quantitative and qualitative performance criteria. The nature and frequency of reporting required of a borrower are normally detailed in a technical memorandum of understanding between the IMF staff and the borrower. Typically, certain critical data, such as the net amount of international reserves, must be reported on a more frequent basis—usually weekly or daily. The IMF also requires borrowers to report other financial and economic data not directly related to specific performance criteria. Such information, such as fiscal data, is essential for monitoring the borrower's economic performance and policies that may have a direct bearing on the structure of IMF assistance programs and lending decisions.
- *Other Mandatory Reporting of Essential Information:* The IMF's Articles of Agreement also obligate members to provide information that the IMF needs to carry out its duties. As a minimum, the articles specifically list certain categories of required information, such as international reserve levels and balance-of-payments data. In addition to this information, the articles allow the Board of Executive Directors to require other specific information from members for the purpose of any IMF activity.
- *Voluntary Reporting:* In addition to the mandatory reporting, borrower countries are encouraged to adopt a data collection system, called the Special Data Dissemination Standard, to report on various aspects of their economic and financial condition. The IMF suggests that such a system include information, which would be publicly accessible through an IMF website, on the amount and composition of international reserves, other foreign exchange assets held by the central bank and the government, short-term foreign liabilities, and related activities that

affect the usability of reserves. As of March 2000, 47 of the IMF's 182 member countries had adopted this voluntary standard.

Through its monitoring efforts, the IMF's staff attempts to check the validity of this reported information to the extent possible, according to IMF management officials. IMF staff sometimes indirectly cross-check information received from the borrowers against information from third-party sources and may assess the validity of the reported information in the light of common sense and economic principles. However, much of this information is generated by member government sources, and the IMF does not have the resources to independently validate it on a routine basis. When there is particular cause for concern about the accuracy of international reserves data and the reliability of controls on the use of reserves, the IMF has required independent investigations or audits of the financial records of the central bank and, in a few cases, other entities, such as bank subsidiaries, or public accounts. For example, in 1999, in response to allegations of misreporting of Russia's international reserves, the IMF required an independent audit of financial transactions between the Russian Central Bank and its offshore subsidiaries. (See app. I for a description of the results of this audit.)

In 1984, the IMF's Board of Executive Directors established guidelines for addressing instances in which borrowers have provided erroneous or false information on program performance criteria or other conditions (whether intentional or not). These misreporting guidelines and other IMF rules require IMF management to investigate all potential cases of misreporting and to submit a report to the Board (along with recommendations) in every case where misreporting has occurred. The IMF can address cases of misreporting in a variety of ways. Under the misreporting guidelines, the IMF can call on the borrower to repay, usually within 30 days, funds obtained from the IMF based on misreported information concerning performance criteria or other conditions specified by the IMF Board in approving the loan disbursement. (See table 1 for a summary of cases of borrower misreporting of information to IMF.) In addition, under the IMF's Articles of Agreement, the IMF may impose other sanctions on borrowers for misreporting information required by the Board of Executive Directors or explicitly required under the articles. These sanctions may include denial of access to additional funds, declaration of temporary ineligibility to receive funds, suspension of voting rights in the IMF, and expulsion from membership in the IMF. In addition, in the recent cases of misreporting by Russia, the IMF called on Russia to voluntarily hold IMF funds in a special account to be used only for repayment of Russia's other IMF loans. In some

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cases, the IMF may call on borrowers to correct the information and take steps, such as implementing new data collection and reporting systems, to ensure more accurate reporting in the future.

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### IMF Borrowers Have Received IMF Funds Based on Inaccurately Reported Information

According to the February 2000 IMF study on borrower misreporting and other IMF documents, 17 cases have been brought to the attention of the Board of Executive Directors since 1984 in which the Board had approved loans or disbursed funds based on inaccurate information provided by the borrower (see table 1 for a summary of these cases). However, it is not reasonably possible to judge the seriousness and pervasiveness of misreporting based on these 17 cases. The study pointed out that the IMF's Board has approved hundreds of loans during this period in which misreporting was not raised as an issue. However, it is not possible to determine whether there were other cases of misreporting that were not uncovered by IMF staff.

Table 1: Cases of Borrower Misreporting of Information to IMF Brought to the Board of Executive Directors Since 1984

| Case            | Years   | Type of information misreported   | Loan funds received by the borrower on the basis of inaccurate information (stated in millions of year 2000 U.S. dollars <sup>a</sup> ) | Early repayment of loan funds requested by IMF due to inaccurate reporting by borrower |
|-----------------|---------|---|---|--|
| 1               | 1985    | External credit and loan guarantees   | \$13.7  | No   |
| 2               | 1985    | Credit to the government  | 78.5  | No   |
| 3               | 1986    | External debt   | 20.0  | No   |
| 4               | 1988    | External arrears  | 3.6   | No   |
| 5               | 1988-89 | Monetary and balance-of-payment statistics, domestic, and external debt           | 267.4   | Yes  |
| 6               | 1990    | Net international reserves  | 274.7   | No   |
| 7               | 1995    | External arrears  | 334.1   | No   |
| 8               | 1995    | Loan preconditions  | <sup>b</sup>  | <sup>c</sup>   |
| 9               | 1995-96 | Loan precondition and operation of foreign exchange market                        | <sup>b</sup>  | <sup>c</sup>   |
| 10              | 1996    | International reserves, domestic assets, credit to government, and budget deficit | 2,734.5   | No   |
| 11              | 1996    | Loan precondition   | <sup>b</sup>  | <sup>c</sup>   |
| 12              | 1996-97 | Key transactions  | <sup>b</sup>  | <sup>c</sup>   |
| 13              | 1996-97 | National income and fiscal data   | <sup>b</sup>  | <sup>c,d</sup>   |
| 14              | 1996-98 | International reserves  | <sup>b</sup>  | <sup>c</sup>   |
| 15 <sup>e</sup> | 1998    | Fiscal data   | 26.6  | Yes  |
| 16              | 1999    | Budget deficit  | 52.7  | No   |
| 17              | 1999    | Loan guarantees   | 30.6  | No   |
| <b>Total</b>    |         |   | <b>\$3,836.4</b>  |  |

<sup>a</sup>The IMF originally reported these amounts in special drawing rights (the IMF's standard unit of account). We converted these amounts to dollars using a GAO-constructed special drawing rights price deflator and the average annual exchange rate. We used a U.S. implicit price deflator to express the figures in year 2000 dollars.

<sup>b</sup>The IMF did not state the amount of funds disbursed in these cases in its February 2000 report to the Board of Executive Directors on misreporting, which we used as the source for this table. That report, and thus this table, identifies only those funds disbursed based on misreported data relating to performance criteria.

<sup>c</sup>Requirement of early repayment of the loan was not available as a sanction for misreporting in these cases under the IMF's misreporting guidelines.

<sup>d</sup>In this case, the borrower voluntarily repaid a portion of the loan early.

<sup>e</sup>This case of misreporting was disclosed by the IMF after the February 2000 study on misreporting was completed.

Source: GAO analysis of IMF data.

As table 1 shows, according to IMF records, borrowers have received over \$3.8 billion in IMF loans<sup>13</sup> on the basis of misreported data.<sup>14</sup> This does not necessarily mean that the borrowers would not have received the funds had they reported the required information accurately. If the discrepancy were minor or temporary in nature, or if appropriate policy measures could be agreed with the authorities, a waiver may have been granted, permitting the country to receive the funds despite the breach of a performance criterion.

Reasons for misreported data in these 17 cases varied widely, according to the IMF study. An unspecified number were attributable to weaknesses in the borrowing country's internal reporting systems and poor coordination among government agencies within the borrowing country.<sup>15</sup> These cases included misreporting of external debt levels, budget deficits, and international reserves. Other cases were attributable to borrowers' inexperience and lack of familiarity with IMF procedures. The IMF study indicates that an unidentified number of misreporting cases were inadvertent, while some appeared to be intentional. Some cases were revealed by borrowing country authorities themselves, some by individuals and organizations within the country, and some by IMF staff during monitoring. According to the study, some cases might have been detected earlier if the IMF staff had monitored available information more closely.

The IMF study on misreporting noted that the IMF has not ensured that borrowers have adequate systems in place for preparing and verifying key financial and economic data. There have been instances in which misreporting has been the result of weaknesses in the administrative systems, reporting arrangements, and control structures in member countries, according to the IMF.

The study also found that in some instances, IMF staff procedures for validating information reported by borrowers did not appear to be effective in uncovering cases on misreporting. The study identified the following limitations in these procedures.

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<sup>13</sup> Loan funds provided to Russia represent over 70 percent of this total.

<sup>14</sup> This total includes only funds disbursed based on inaccurate information relating to performance criteria, not on information on preconditions or other essential information.

<sup>15</sup> The IMF study on misreporting did not enumerate each type of misreporting case.

- Although loan arrangements contain specific conditions that are verifiable and monitorable, in some instances, the loan documents did not clearly define how IMF staff would monitor borrower compliance with specific loan conditions. Therefore, the data reporting requirements may not have been clearly specified when the Board of Executive Directors approved a loan arrangement.
- Information about known weaknesses and anomalies in reported information was not always shared among IMF staff and with the Board of Executive Directors; such information would have indicated the areas in which IMF staff should have more carefully scrutinized borrower actions and financial and economic conditions.
- The IMF staff did not always use third-party information effectively or widely enough to cross-check reported information. In particular, IMF staff had not always obtained information available within a borrowing country that could have confirmed or contradicted information provided by government authorities. The IMF staff had not always used resident representatives—IMF officials posted in member countries—effectively for this purpose.

According to the IMF study on misreporting, the IMF had not consistently imposed sanctions on borrowers for misreporting. The IMF has requested early repayments in 2 out of 11 cases where such a remedy was available under IMF guidelines (see table 1).<sup>16</sup> Instead, the IMF has usually called on the borrower to take corrective action to improve the accuracy of reported information. According to the IMF's Treasurer, the IMF did not request early repayment of the loans in many of these cases because the misreporting was judged to be small and/or did not alter the IMF's view of the member's performance under a loan arrangement. Also, the IMF had not applied sanctions available under the provisions in its Articles of Agreement in cases of misreporting because these sanctions were considered to be disproportionately severe, according to the IMF's Treasurer.

According to the IMF study on misreporting, the IMF's ability to ensure accurate reporting may have been hampered in the past by limitations in its

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<sup>16</sup> As noted in table 1, in one additional case a borrower voluntarily repaid loan funds that had been obtained on the basis of misreported information.

own policies and procedures for addressing cases of misreporting, as follows:

- IMF management did not consider sanctions provided for in the misreporting guidelines applicable in all cases in which borrowers provided inaccurate information to the IMF. In particular, these sanctions were not considered applicable in cases where the Board of Executive Directors approved loan arrangements or disbursements based on incorrect information from the borrowers indicating that they had fulfilled the loan's preconditions. In such cases, the IMF determined that the sanctions did not apply because the preconditions were not identified in the loan arrangement or other Board decisions as specific conditions or criteria for receiving IMF funds.
- Sanctions for misreporting key information under the IMF's Articles of Agreement were not available in some cases. The articles do not specifically require reporting of certain types of critical information such as fiscal and financial information. Thus, unless this information was specifically required under a loan arrangement, the sanctions provided for in the Articles of Agreement did not apply if this information was misreported.
- IMF guidelines had provided that, in order to require early loan repayment or impose certain other sanctions against borrowers for misreporting, evidence of the misreporting must have been discovered within a 2-year limitation period. Recent cases of misreporting indicate that 2 years may not be sufficient time to discover misreporting (see app. I for one such example of misreporting). The 2-year limitation period does not apply to sanctions for misreporting provided for in the Articles of Agreement.
- The IMF did not have a general policy on publicizing cases of misreporting. The threat of adverse publicity in these cases could have acted as a deterrent to misreporting.
- The IMF had not established basic ground rules for investigating cases of misreporting to ensure that all cases were handled consistently. In most cases, investigations had been conducted entirely by IMF staff, but in some cases, other procedures were followed, including the use of outside consultants engaged by the IMF or by the borrowing country authorities.

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## Efforts to Improve the Fund's Ability to Prevent Misreporting

The IMF has begun to address most of the limitations identified in its February 2000 study on misreporting and strengthen its policies and procedures for preventing misreporting, as follows.

- IMF management plans to revise and improve procedures for gathering and using information on borrowers' economic situations, according to IMF officials. Changes to these procedures are intended to intensify existing efforts to cross-check, question, and refine information initially received from the borrowers.
- In July 2000, the Board of Executive Directors revised and strengthened the IMF's guidelines for addressing misreporting. The IMF's procedures have been broadened so that the guidelines will now be applied to cases of misreporting of information relating to preconditions and other essential information that borrowers are required to provide. The Board has also lengthened the limitation period for imposing penalties from 2 years to 4 years. These and other modifications to the guidelines give the IMF greater flexibility and scope to impose penalties on borrowers in cases of misreporting.
- According to IMF management officials, in October 2000, the Board is scheduled to discuss possible expansion of the list of information that members are required to provide under the IMF's Articles of Agreement to include more extensive data reporting requirements, including reporting of fiscal and financial information. Such modifications could give the IMF greater authority to impose sanctions against misreporting of these types of data. In October 2000, the Board also plans to consider procedures to deal with potential cases of misreporting related to the assistance it provides under the Highly Indebted Poor Countries Initiative.<sup>17</sup>
- In March 2000, the Board of Executive Directors adopted a policy to publicize each case of misreporting, suitable to the seriousness of the misreporting, after the Board has fully reviewed the case and issued its conclusions. In fact, the IMF has publicized two misreporting cases in April and May 2000 under this new policy, issuing press releases clearly

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<sup>17</sup> The goal of the Highly Indebted Poor Countries Initiative is to bring heavily indebted countries' debt loads to a level where they can make debt payments on time and without rescheduling. Resources to reduce the level of debt are provided by the IMF, the World Bank, and other multilateral and bilateral creditors.

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identifying the borrowers (Pakistan and Ukraine), details about the misreporting incidents, and information about the remedial steps that the IMF and the borrowers have taken.<sup>18</sup>

The IMF has not yet taken explicit steps to address a few of the limitations described in the IMF study on misreporting. We could not determine how the IMF will address the need for clearer monitoring plans for its loan programs, as described in the study. However, according to the IMF Treasurer, IMF staff are making greater efforts to ensure that data required for monitoring of borrower compliance with loan conditions are defined more clearly. Also, while the IMF has not adopted any new ground rules for investigating potential cases of misreporting or criteria for sharing information about known weaknesses and anomalies in reported information among IMF staff or with the Board of Executive Directors, the Fund's management is considering whether or not new ground rules are warranted.

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## Agency Comments

We received written comments from the Department of the Treasury, the agency that represents the United States at the IMF, as well as from the IMF. Treasury and the Fund's management have agreed with the information presented and their comments are reprinted as appendixes III and IV. In addition to their overall comments, the Treasury and the IMF provided technical comments, which we incorporated in the report as appropriate.

Treasury commented that the report provides, overall, an informative and useful treatment of an extremely important issue that is central to the integrity of the IMF. While the Treasury points out that IMF's strengthened safeguards cannot be absolutely failsafe, they constitute a meaningful effort in the area of protecting IMF resources and deterring misreporting. Treasury stated that one of its highest priorities is to ensure that the IMF's strengthened system of safeguards is vigorously and forcefully implemented, continuing an effort that the U.S., through the Treasury, has been working to promote for a considerable period of time. Treasury noted that, in addition to the new safeguards and misreporting framework, it is essential that the IMF do a better job in using the existing instruments at its disposal, particularly with respect to monitoring and cross-checking data

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<sup>18</sup> The Fund had also publicized two earlier cases of misreporting—by Russia, in August 1999, and by Jordan, in October 1999.

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provided by countries, and applying the existing guidelines on misreporting of data.

The IMF reemphasized the importance placed by its management and Board of Executive Directors on assuring that IMF resources are used for their intended purpose and the member countries' economic programs being supported by these resources are based on accurate information. The IMF stated that the Board of Executive Directors and management satisfy themselves as far as is reasonably possible that borrowing member countries comply with their obligations to use IMF resources as intended and to supply accurate information to the IMF. The IMF also stated that in the vast majority of cases it has had—and continues to have—an excellent experience with the trust-based relationship central to its interaction with individual members. The IMF noted that significantly strengthened policies are now in effect, in particular, safeguards assessments of member countries' central banks and the stronger misreporting guidelines.

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## Scope and Methodology

To identify the IMF's progress in strengthening its policies and procedures relating to (1) the appropriate use of Fund resources by borrowers and (2) the accuracy of economic and financial information reported by borrowers, we reviewed documents, prepared in 1999 and 2000, relating to these subjects provided by the IMF and the U.S. Department of the Treasury. In particular, we reviewed and analyzed a series of internal IMF studies, issued in February 2000, that specifically addressed the issues of borrower misuse of international reserves and borrower misreporting. These studies described the IMF's existing policies and procedures to prevent misuse of funds and misreporting by borrowers, identified weaknesses in these policies and procedures, described cases of borrower misreporting and potential misuse of funds, and outlined recommendations for improvement. We also interviewed cognizant Treasury officials, the IMF's Treasurer, and officials in the IMF's Policy Development and Review Department to identify the status and nature of current IMF efforts to improve its management controls.

We conducted our work in Washington, D.C., from April through July 2000 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Honorable Lawrence H. Summers, the Secretary of the Treasury; Horst Köhler, Managing Director of the IMF; and interested congressional committees. Copies will be made available to other interested parties upon request.

Please contact me on (202) 512-4128 if you or your staff have any questions about this report. Other contacts and key contributors to this report are listed in appendix V.

Sincerely yours,

A handwritten signature in cursive script that reads "Harold J. Johnson".

Harold J. Johnson, Associate Director  
International Relations and Trade Issues

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# The International Monetary Fund's Response to Recent Cases of Misreporting by Russia

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In 1999, the International Monetary Fund (IMF) became aware of allegations that the Central Bank of Russia had used offshore subsidiaries during 1994-96 to allocate its international reserves for inappropriate purposes. Based on these allegations, the IMF required the Central Bank of Russia to undergo an investigation of its financial transactions with subsidiaries. The investigation was conducted by an independent, international accounting firm, which issued four reports on the investigation between July and December 1999. The primary investigation report, published in August 1999, revealed that Russia had engaged in transactions that resulted in misreporting of required information to the IMF. In particular, Russia had repeatedly misstated total international reserves from 1995 through 1998 by improperly counting as international reserves funds that the Central Bank of Russia was using to guarantee loans and Russian government securities purchases. In addition, Russia had understated net domestic assets, net credit to the government, and the budget deficit. Funds were made available to Russia during 1996 that would not have been made available on the basis of a correct reporting of international reserve data.

The following specific examples of misreporting by Russian authorities were uncovered in the audit.

- In 1996, the Central Bank of Russia deliberately falsified its records and reported a sale of Russian government securities to its subsidiary, the Financial Management Company, which did not occur, and reported the proceeds of the sale as international reserves. As a result, Russian authorities overstated net international reserves and understated net credit to the government and net domestic assets by \$1.2 billion.
- In 1995 and 1996, the Financial Management Company used funds that it had received from the Central Bank of Russia to guarantee the purchase of Russian government securities even though the Central Bank of Russia had reported these funds to the IMF as international reserves. Thus, in addition to overstating net international reserves, Russian authorities understated net domestic assets as well as net credit extended to the government.
- In 1996, the Central Bank of Russia deposited \$300 million with another subsidiary, Eurobank, to guarantee credits it extended to Russian commercial banks. In reporting to the IMF, the Central Bank of Russia misclassified these loans as liquid international reserves, even though they could not be immediately converted to foreign currency. Thus, the

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**Appendix I**  
**The International Monetary Fund's Response**  
**to Recent Cases of Misreporting by Russia**

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central bank overstated the total amount of its international reserves.

- In 1997 and 1998, the Central Bank of Russia extended as much as \$223 million in credit to another subsidiary, the Ost-West Handelsbank. However, the central bank continued to report these funds as liquid international reserves, even though they could not be immediately converted to foreign currency. Thus, the central bank again overstated its total amount of international reserves to the IMF.

In 1996, Russia received about \$2.7 billion<sup>1</sup> on the basis of information that has been subsequently deemed to be incorrect. The penalties provided by the IMF's guidelines on misreporting did not apply in these cases because the 2-year limitation period on imposing penalties had already expired by the time the IMF had become aware of the misreporting. However, the IMF determined that the misreporting violated mandatory reporting requirements established in the IMF's Articles of Agreement, for which there is no established limitation period. Under a \$4.5-billion loan program that the IMF Board of Executive Directors approved in July 1999, Russia agreed to hold all new IMF funds in an account at the IMF that may be used only to repay Russian debt to the IMF. This procedure would apply to any new IMF program negotiated in 2000. The IMF and Russia agreed on a number of other remedial actions, including the creation of internal barriers at the central bank between operations with its foreign subsidiaries and its reserves management, redefinition of international reserves to exclude deposits with foreign subsidiaries, an IMF assessment of Russian reporting procedures, and a further investigation of the operations of the Central Bank of Russia with other subsidiaries.

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<sup>1</sup> This amount is stated in year 2000 dollars. The IMF originally reported the amount as 1.9 billion special drawing rights (the IMF's standard unit of account). We converted special drawing rights to dollars using a GAO-constructed special drawing rights price deflator based on the average annual exchange rate. We used a U.S. implicit price deflator to express the figure in year 2000 dollars.

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# The International Monetary Fund's Response to Recent Cases of Misreporting by Ukraine

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Various allegations have been made about the use of Ukraine's international reserves held by the National Bank of Ukraine, the country's central bank, in 1996-98, prior to approval of Ukraine's most recent IMF arrangement in 1998. The IMF learned in 1998 about some central bank transactions that gave the impression that Ukraine's international reserves were larger than was actually the case. At that time, the IMF required Ukraine to correct its reporting of these reserves and institute quarterly audits by a reputable international accounting firm. Based on new allegations this year, the IMF also required that the National Bank of Ukraine undergo a series of transactional investigations by an independent, international accounting firm. The results of the first two investigations (covering July 1997 through January 1998) indicate that Ukraine had engaged in transactions leading to an overstatement of its international reserves. For example, in 1997, the National Bank of Ukraine deposited some of its international reserves with a foreign bank, which then lent the funds to a commercial bank in Ukraine, which redeposited the funds with the National Bank of Ukraine. This "round tripping" resulted in the same international reserves being counted twice. IMF management will not know the full extent of the overstatement until ongoing investigations have been completed. By giving a misleading impression of the size of Ukraine's international reserves, Ukraine appeared to meet the performance criteria for its loan program and obtained IMF funds that it might not otherwise have received.

As of August 2000, the IMF was completing its review of the situation to determine what sanctions should be levied against Ukraine for its provision of inaccurate reserve information. Remedial action, which the IMF's Board of Executive Directors will consider shortly, could include early repayment of IMF disbursements that Ukraine received on the basis of inaccurate information it reported to the IMF. According to the IMF, at its request, the National Bank of Ukraine has taken a number of corrective steps, including depositing all of its liquid reserves in top-rated international banks, discontinuing all transactions that had rendered international reserves liquid, and improving international reserves management practices. Further, the IMF would expect the Ukrainian authorities to leave possible future disbursements to the Ukraine in an account in the IMF that may only be used to repay Ukrainian obligations to the IMF.

# Comments From the Department of the Treasury



ASSISTANT SECRETARY

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

August 15, 2000

Mr. Harold J. Johnson  
Associate Director, International Relations and Trade Issues  
General Accounting Office  
Washington, DC 20548

Dear Mr. Johnson:

Thank you for your letter regarding the draft report, "International Monetary Fund: Status of Efforts to Strengthen Safeguards Over Lending," (GAO code 711487). Our view is that the draft report provides, overall, an informative and useful treatment of an extremely important issue that is central to the integrity of the International Monetary Fund (IMF). In addition to the technical comments that Treasury staff have already transmitted, I would like to emphasize a few points regarding efforts by both the IMF and U.S. authorities to safeguard IMF resources and prevent misreporting of information to the IMF.

The IMF has traditionally relied on its program conditionality to ensure that its resources were safeguarded and that the Fund was repaid. While the Fund carefully monitors compliance with the terms and conditions of its lending, it has necessarily relied to a certain degree on a relationship of trust with its members. This system has by and large worked well, and cases of arrears have been confined to a handful of countries. But in recent years, especially given the growing complexity of financial transactions and prominent cases in which public resources were misused, it has become clear that a more rigorous system of central bank controls and procedures is needed to better safeguard public resources, including those lent by the IMF to borrowing countries.

The GAO's report importantly recognizes that the IMF has undertaken a serious and far-reaching initiative over the past year to strengthen further the system for safeguarding the use of Fund resources and for deterring the misreporting of data to the IMF. This Administration attaches high priority to protecting the integrity of the IMF's resources and to ensuring that taxpayer resources are well used. It is one of our highest priorities to ensure that this strengthened system is vigorously and forcefully implemented in the period ahead.

The Treasury Department, in close collaboration with Congress, has been working to promote these objectives for a considerable period of time. Treasury's report to Congress in April 1999 on safeguarding the use of IMF resources called attention to this important issue. The issue was subsequently highlighted by both the G-7 and the Interim Committee in September 1999 – leading the IMF to launch in November a review of its current system and to consider potential enhancements. The IMF convened a panel of eminent external experts to assist in this effort, and with the help of the panel developed proposals for a new framework for safeguard assessments and strengthened measures to deter and respond to cases of misreporting.

**Appendix III  
Comments From the Department of the  
Treasury**

The new safeguards framework adopted by the Executive Board and now being implemented requires, among other things, that all countries making use of IMF resources publish central bank financial statements that have been audited by independent external auditors in accordance with internationally accepted standards. It also establishes a process to identify critical vulnerabilities and provide for their remedy before further disbursements. IMF procedures for handling misreporting require an investigation of all cases of alleged misreporting within four years (expanded from two years), a report to the Executive Board on all cases of actual misreporting, corrective actions as appropriate for violations of commitments to the IMF, and publication of cases of misreporting after the Board has reviewed each case and issued its conclusions. In addition to the new safeguards and misreporting framework, it is essential that the IMF do a better job in using the existing instruments at its disposal, particularly with respect to monitoring and cross-checking data provided by countries, and applying the existing guidelines on misreporting of data.


These steps have already been brought to bear in the handling of concerns involving Russia, Ukraine, and Pakistan. With U.S. support, the IMF is implementing significant remedial measures including publicizing cases of misuse of resources and misreporting of information to help deter future violations.

At the same time, the report realistically recognizes that the nature of IMF financing – which is provided to central banks in the form of general support to address balance of payments difficulties – means that Fund resources are commingled with other central bank reserves and that it is difficult to track directly the end use of IMF resources after these have been deposited with the relevant central bank.

The U.S. has played and will continue to play a leading role to help ensure that the IMF strengthens its traditional work to protect its resources and deter misreporting. In particular, the U.S. will work to see that new safeguards are rigorously implemented and are developed to their full potential. While these new measures cannot be absolutely fail-safe, they constitute a meaningful effort in these areas, and reflect the experience that has been gained in order to better safeguard the use of public resources, including those of the IMF, in borrowing countries.

We look forward to seeing the final version of your report.

Sincerely,

  
Edwin M. Truman  
Assistant Secretary  
(International Affairs)

# Comments From the International Monetary Fund



FIRST DEPUTY  
MANAGING DIRECTOR

INTERNATIONAL MONETARY FUND  
WASHINGTON, D.C. 20431

CABLE ADDRESS  
INTERFUND

August 16, 2000

Mr. Harold J. Johnson  
Associate Director  
International Relations and Trade Issues  
United States General Accounting Office

Dear Mr. Johnson:

Thank you for seeking our comments on the August 2000 GAO draft report entitled "International Monetary Fund - Status of Efforts to Strengthen Safeguards Over Lending." We appreciate the care you have taken to portray the efforts of the IMF to strengthen the safeguards over the use of its resources by member countries. The IMF Executive Board and management accord high importance to the assurance that Fund resources disbursed to members are used for their intended purpose and to the assurance that member countries' economic programs being supported by these resources are based on accurate information provided to the IMF. As you are aware, it is the obligation of a borrowing member country to use the Fund's resources for the purposes agreed in the policy understandings approved by the Executive Board, and to supply accurate information to the IMF. The Executive Board and Fund management satisfy themselves as far as is reasonably possible that borrowing member countries comply with these obligations when using IMF resources, and take appropriate action when that is not the case.

As a cooperative institution, in the vast majority of cases the Fund has had—and continues to have—an excellent experience with the trust-based relationship that is at the core of its interaction with individual members. Therefore, the recent instances of a few member countries that provided incorrect information to the Fund in connection with IMF financial assistance, and the associated allegations of potential misuse of IMF resources, were of grave concern to the Executive Board, management, and staff.

After a review of the large array of procedures and practices long in place to safeguard Fund resources, the Executive Board recently took two additional decisions.

First, the Executive Board instituted procedures for safeguards assessments that are fully operational as of July 1, 2000. These procedures were endorsed by an internationally representative panel of experts from the private and public sectors; these experts will review experience with the safeguards assessments policies in 12-18 months. The safeguards

Appendix IV  
Comments From the International Monetary  
Fund

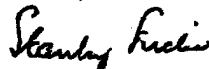
- 2 -

assessments apply to all central banks of countries using Fund resources; their purpose is to provide reasonable assurance to the IMF that a central bank's control, accounting, reporting and auditing systems in place to manage resources are adequate to protect the central bank's resources, including IMF disbursements. The Fund will require that critical vulnerabilities in central bank procedures identified through these safeguards assessments be remedied before additional Fund resources are disbursed. Additionally, the Fund will assist the central bank with technical assistance to improve its control capabilities on a permanent basis.

Second, the Executive Board in July 2000 adopted strengthened policies for dealing with incorrect information provided by member countries in connection with their use of Fund resources. These policies have taken immediate effect, as described in the GAO Report.

While the Fund continues to require the cooperation of its member governments to be effective, the Executive Board and management believe that significantly strengthened policies on these matters are now in effect.

Sincerely yours,



Stanley Fischer  
Acting Managing Director

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# GAO Contacts and Staff Acknowledgments

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## GAO Contacts

Harold Johnson (202) 512-4128  
Phyllis Anderson (202) 512-7364

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## Acknowledgments

In addition to those named above, Patricia Martin, James Michels, Rona Mendelsohn, Mary Moutsos, Samantha Roberts, and Mark Speight made key contributions to this report.

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