

# U4 Expert Answer



## Corruption, auditing and carbon emission reduction schemes

### Query

**Please provide an overview of available instruments and relevant experience for conducting integrity audits in relation to carbon emission reduction schemes. What are the key questions to be addressed in such integrity audits?**

### Purpose

We would like to provide support to the Indonesian Supreme Audit Institution (BPK) to equip them with the relevant skills to conduct integrity audits in relation to carbon emission reduction schemes.

### Content

1. Corruption risks in carbon emission reduction schemes
2. Instruments for conducting integrity audits in carbon emission reduction schemes
3. Case study of Indonesia's Reforestation Fund
4. References

### Caveat

At the request of the enquirer, this expert answer primarily focuses on the challenges associated with programmes for Reducing Emissions from Deforestation and Forest Degradation (REDD).

### Summary

There is a broad consensus that the success of climate mitigation strategies will in part depend on addressing

governance challenges in the contexts in which these strategies are to play out. There are major corruption risks associated with carbon emissions reduction schemes such as REDD. First, REDD takes place in a corruption-prone sector. In many developing countries, the forestry sector faces corruption risks in the form of state looting, elite capture, theft and fraud. By facilitating illegal logging, deforestation and forest degradation, corrupt practices can critically undermine the success of climate mitigation schemes. In addition, specific governance challenges may be associated with emerging forest development practices and carbon trading schemes. These include inappropriate validation and verification, misappropriation of carbon rights, double counting and fraudulent trade of carbon credits.

Carbon emission reduction schemes are also associated with a planned large influx of funds (albeit staggered and performance-based) into countries that currently have limited absorption capacities and weak management systems. As a consequence, national governments hosting REDD programmes need to have effective auditing systems in place to ensure sound financial management and effective enforcement of financial regulation. Beyond addressing issues of financial management, Supreme Audit Institutions (SAIs) are assuming a growing role in the emerging

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field of environmental governance and integrity. While they generally do not directly address issues of corruption and financial integrity, environmental audits can reduce opportunities for corruption by promoting transparent and accountable programme management and strengthening the oversight mechanisms and monitoring processes of environment-related projects, including carbon emission reduction schemes.

## 1 Corruption risks in carbon emission reduction schemes

The first streams of the USD 30 billion in fast-start climate change financing agreed in Copenhagen in December 2009 are beginning to trickle through to recipient developing countries. Yet no fully coordinated mechanism is in place to monitor these money flows and address the major governance and accountability risks associated with carbon emission reduction schemes.

As institutions in charge of promoting sound financial management, the effective use of public funds and robust internal control mechanisms, Supreme Audit Institutions (SAIs) have an important role to play in addressing these accountability risks. A key challenge for SAIs will be to identify areas that are particularly vulnerable to corruption in climate financing and to monitor these risks in the activities of public agencies involved in the administration of carbon emission reduction schemes.

### Background on carbon emission reduction schemes: REDD programmes

#### *What is REDD and REDD +?*

Scientists estimate that forest loss accounts for approximately 17% of global carbon emissions, suggesting that emissions from deforestation release more carbon into the atmosphere than the transport sector (Bond and al, 2009). In view of this, there is a growing consensus that mitigation of dangerous levels of global warming may partly be achieved through the protection of forests in an international regime.

The initiative for Reducing Emissions from Deforestation and Forest Degradation (REDD) has been developed to address this challenge. It consists of

a set of steps designed to directly link market/financial incentives to the reduction of carbon emissions from deforestation and forest degradation. In other words, REDD intends to compensate forest owners – governments, companies or communities – if they can prove that they have reduced carbon emissions either by preserving existing forests or scaling-up more sustainable and controlled forest activity. More recently, REDD + gives greater prominence to activities relating to conservation, sustainable management and enhancement of carbon stocks in existing forests. While REDD's primary objective is to reduce carbon emissions, it is expected that it will deliver "co-benefits" in terms of biodiversity conservation and poverty alleviation by generating substantial new revenue flows for developing countries.

#### *Key issues associated with REDD implementation*

While, conceptually, REDD seems relatively straight forward, major envisaged implementation challenges have been raised in relation to the initiative (Angelsen, A., 2008 and Peskett, L., Bockhaus, M., 2009). The key issues include:

**Interplay of global, national and sub-national architecture:** The first prerequisite for REDD implementation is to establish a global architecture to manage and track disbursements as well as national and sub-national structures and institutions to monitor REDD programmes and funds.

**Overall allocation criteria:** Clear principles and criteria need to be established for the basis on which benefits and financial incentives will be fairly allocated and distributed across countries.

**Scope and scale:** There are many issues involved in defining the scope of REDD programmes, including the relative emphasis on deforestation and degradation versus carbon stock enhancement, the types of activities to be accounted for, and forest definitions. There is also a need to determine the required level of accounting and crediting to be recognised in international agreements.

**Setting reference levels for existing emissions to track progress:** Reductions in emissions are likely to be difficult to measure in countries where existing data is poor. Major efforts are required to set accurate reference levels for REDD host countries.

**Monitoring, reporting and verification (MRV)** of forest cover, emissions and emissions reductions are of central importance to the initiative and there is a need to identify appropriate mechanisms and technical solutions to obtain accurate carbon values of project sites and establish a baseline. However, MRV faces major information, technological and methodological challenges, such as the lack of agreed upon forest definitions, inconsistency between types of measurement and monitoring methods, dispersed and incomparable information, and a lack of historical and project-scale information (Barr, C., 2010).

**Additionality:** Additionality - reductions in emissions that would not have taken place without additional support - is important when reductions in emissions are supported to help offset emissions taking place elsewhere. If additionality is not assured then no carbon offset is taking place. Experience with the Clean Development Mechanism (CDM) indicates that, in practice, additionality is difficult to prove and monitor. Several studies have confirmed that many projects under consideration should not be awarded additionally status, as they would have been carried out anyway and therefore will not yield *additional* emissions. (Loris, N., 2009). The challenge is magnified for REDD since additionality here means that the status quo would not have persisted without intervention generating a double counterfactual to prove and monitor.

**Dealing with carbon leakage:** REDD mechanisms need to ensure that deforestation is not simply moving to other forest areas.

**Permanence:** There is a possibility that deforestation and forest degradation may occur after the project site verification has taken place. The REDD mechanism thus needs to ensure that forest conservation achieved in a project area is permanent.

**Distribution of the benefits:** Benefits from REDD should be distributed in an equitable manner and reach forest communities. The risk of undue capture of funds and benefits by national governments or local elites need to be minimised.

**Participation of indigenous people and local communities:** Specific types of safeguards and appropriate benefit sharing mechanisms need to be included to ensure participation of forest dependent communities and the respect of their human rights.

**Building implementation capacities and sound governance structures:** REDD will require significant levels of funding for MRV, capacity building, policy reform, governance activities in countries with weak governance.

## Links to corruption and governance

For national institutions aiming to ensure accountability of REDD, the first challenge consists in identifying corruption risks in the forestry sector, as well as the governance challenges associated with emerging forest development and carbon trading schemes. As REDD is still in its preparation phase, few practical lessons can be drawn from experience and research in this area is still in its infancy. However, a number of corruption risks can be anticipated based on experience in the forest sector and more generally in forested developing countries.

### *The link between corruption, deforestation and forest degradation*

Corruption is widespread in most countries that are expected to benefit from REDD. Indonesia, for example, ranks 111 out of 180 countries in the 2009 TI Corruption Perceptions Index (CPI). Where it is not well-managed, and where general governance is weak, the forest sector may be associated with state looting, elite capture, theft and fraud. While there is considerable lack of knowledge about the actual extent of deforestation and forest degradation that can be directly or indirectly attributed to corruption, several studies have confirmed links between the quality of governance and the rate of deforestation in the world's main timber producing countries (Layden, M., 2009). Corruption in the forestry sector can undermine the profitability and sustainability of forest resources, as well as attempts to strengthen monitoring and law enforcement in the sector. It may also contribute to a weakening of broader governance systems.

Corruption can affect the forest sector at different levels (Tacconi L., and al, 2009 and Bulkan, J. and Palmer, J., 2008):

**Regulatory capture:** Loggers close to political elites can influence and manipulate decision-making processes to ensure that laws and policies are designed in accordance with vested interests. The state can also allow the available technical regulations for improving forest management to be ignored or to be

used selectively against loggers who lack political influence.

**Biased design and implementation of land-use plans:** Corruption can distort the land allocation process that classifies forests for various purposes. It can also weaken the enforcement of environmental regulations.

**Improper allocation of timber concessions and harvesting licences and forest conversions permits:** In Liberia, a 2004 review of existing timber concessions established that only 47 of the 70 timber operators identified by the review committee were able to produce agreements and permits granting them permission to operate. In many instances concessions had been granted through political patronage and favouritism (Global Witness, 2005).

**Illegal logging:** Corruption is a major facilitator of illegal logging. Bribery can be used by logging operators to harvest timber without a permit, to transport illegally-logged timber, to improperly obtain logging permits that are not recognised by the forestry regulatory framework, or to prevent concessions from being effectively monitored.

### *Governance and corruption challenges for carbon emission reduction schemes*

There is broad consensus that the success of climate change mitigation schemes will in part depend on effectively addressing governance and integrity issues. Funds will be channelled to countries with fragile governance structures, weak institutions, poor legal frameworks and/or enforcement records. In many cases, they are affected by widespread corruption and patronage between political and business elites and the logging industry (Global Witness, 2009). Corruption risks could potentially increase as unscrupulous actors realise they could benefit from the substantial revenue flows from climate change mitigation schemes.

In addition to the governance environment of countries which may benefit from carbon reduction schemes, weak forest carbon accounting may also lead to opportunities for fraud and corruption which could undermine the potential of such schemes to effectively reduce carbon emissions. These risks are associated with a lack of required capacity in many countries to measure and monitor changes in forest carbon emissions and carbon stocks (Herold, M., 2009). An

article in the forthcoming 2010 Global Corruption Report on Climate Change identifies a series of corruption risks associated with weak MRV processes, based on cases that have occurred in countries undergoing the “REDD+ readiness” process or in projects under the Clean Development Mechanism (CDM) (Barr, C., Forthcoming). These include:

- **Inappropriate validation:** Bribery, corruption or conflicts of interest can influence validators’ decisions with regard to projects that qualify for REDD+ financial incentives. At this stage of the process, fraud can also take the form of project sponsors presenting inaccurate or misleading data.
- **Overestimation of carbon benefits:** There may be strong incentives for various stakeholders to overestimate the amount of carbon emissions reduced/ carbon stocks enhanced. MRV agencies may also be subject to political pressure from state elites that would like to maximize the potential of emission reduction schemes to generate revenues.
- **Verification of fictitious projects:** MRV governance weaknesses could result in verification of projects that never took place or in corrupt developers seeking REDD payments for forest areas that are not endangered.
- **Double-counting and fraudulent trade of carbon credits:** There have been instances of commercial fraud in carbon credit trading on global carbon markets, including practices such as selling fictitious credits for nonexistent or illegitimate projects, or with the same credits sold to multiple buyers. Such practices are made possible by poorly regulated carbon markets and the intangible and complex nature of carbon credits.
- **Misappropriation of carbon rights:** In some countries corrupt carbon brokers and project developers may be taking advantage of opaque negotiation processes to take over local landowners’ carbon rights in a fraudulent manner, in some cases with the complicity of government officials.

## 2 Instruments for conducting integrity audits in carbon emission reduction schemes

Integrity audits of revenue flows generated by climate financing do not differ in nature from the audits of other public resources flowing through the national budget. Regular investigative auditing techniques can be applied by SAIs to identify opportunities for corruption.

But beyond financial management, carbon reduction schemes raise broader issues of environmental governance and integrity, which have become an emerging area for auditing activities. Within this framework, SAIs are assuming a growing role in the field of environmental auditing. While not directly addressing issues of corruption and financial integrity, these types of audits have the potential to reduce opportunities of corruption by promoting transparent and accountable programme management and strengthening oversight mechanisms and monitoring processes of environmental projects.

### Auditing tools to fight corruption

#### *The role of Supreme Audit Institutions in fighting corruption*

With substantial new revenue associated with carbon emission reduction schemes, sound financial management and financial good governance are required to ensure that REDD funds are well managed. SAIs have a key role to play in this regard as part of their regular financial oversight functions. For example, in its capacity as the sole state auditor, BPK, the Indonesian Supreme Audit Institution, is likely to play a central role in designing and implementing a monitoring, reporting and verification process for REDD+ financing mechanisms in Indonesia.

SAIs are not *per se* specialised anti-corruption agencies, and are not explicitly responsible for detecting and investigating corrupt activities. According to the Lima declaration of guidelines on auditing precepts<sup>1</sup>, SAIs are national-level watchdog agencies

that have the broad mandate to oversee the management of public finances with the view to promoting (INTOSAI, 1998):

- proper and effective use of public funds;
- development of sound financial management;
- proper execution of administrative activities;
- communication and information to public authorities and the general public.

As a result, the role of SAIs in addressing corruption is mainly focused on deterrence and prevention through promoting public sector transparency and accountability within a broader climate of good governance (Evans, A., 2009). As auditing activities primarily concentrate on documentary/physical evidence, they are not always in a position to investigate actual events of corruption which usually do not leave any documented evidence. However, SAIs may be in a position to identify red flags and *opportunities for corruption* in the course of their work, especially when they uncover irregularities such as falsified statements and claims, purchasing for personal use, illegal bidding practices, tax evasion, malpractice in the liquidation of public companies, overbilling or non delivery of goods and services, etc.

In recent years, some SAIs have taken a more active role in addressing corruption and have sought to proactively identify and monitor areas of their work that are particularly vulnerable to corruption risks as part of the audit planning process. Further approaches undertaken by SAIs to strengthen their role in anti-corruption have included forging effective relationships with other national institutions, involving the public in auditing processes and widely publicising the recommendations of audit reports.

#### *Fraud and corruption detection processes while conducting regular audits*

The Asian Organisation of Supreme Audit Institutions (ASOSAI) has developed guidelines for dealing with fraud and corruption in accordance with INTOSAI standards. These have been prepared with a view to guide auditors in detecting fraud and corruption as part of their normal audit functions (ASOSAI, 2003). The audit process entails three major phases - including

independence, powers, scope and relationship with the executive and legislative branches.

<sup>1</sup> The Lima declaration was adopted in 1977 by the International Organisation of Supreme Audit Institutions and sets out international standards for SAIs, such as

planning, execution and reporting - in which a corruption focus can be integrated.

At the planning stage, for example, the auditor should proactively identify high risk areas within the entity on which the audit should be focused, based on an initial risk assessment on an entity-wide basis. Commonly perceived high-risk areas include: contracts of service/procurement, inventory management, sanctions/clearances, programme management, revenue receipts, cash management, general expenditure and other areas which interface with the public. Auditors should then identify red flags for each of the specific high risk areas. Further examination may be needed to determine whether the identified fraud and corruption risks exist, considering the evidence obtained during the audit process.

At the execution level, auditors must perform auditing procedures in response to the identified fraud and corruption risks. This can involve changing the nature, timing or extent of the auditing procedures to obtain more reliable corroborative evidence of fraud and corruption opportunities identified in the risk assessment. Auditors should document all above activities and their results for supporting their conclusions and for future reference, including discussions among audit team members, procedures performed to obtain information, fraud and corruption risks identified, etc.

### *Corruption audits*

There is also a possibility to conduct specific corruption audits. The objective of such audits is to assess the opportunities of corruption in an organisation and evaluate the efficacy of the existing control environment in preventing it (Khan, M. A., 2006).

In order to focus the audit on detecting opportunities for corruption, the auditors should build into the audit programme five general principles (transparency, good governance, economic efficiency, and effectiveness) and apply these issues to common functions such as general administration, procurement and human resource management of the audited organisation/department. In addition, specific issues relating to the technical operation of the audited agency should also be included, accompanied by a review of specific laws and rules relating to the technical work of the agency.

The nature of corruption audits may require auditors to adopt innovative auditing techniques, look at other data beyond internal records and collect information from outside sources, using tools such as surveys of clients, employees or the general public.

### *Participatory audits*

A promising approach for auditors to detect fraud and corruption is the emerging concept of participatory auditing (Khan, M. A., 2006). The objective of such audits is to identify opportunities for corruption along the public service delivery chain by asking the end users or clients of the audited agency. While participatory techniques still have to be fully developed, public service users can be involved in the audit process via the use of tools such as user satisfaction surveys, citizens report cards, town-hall meetings etc, to assess the quality of public service delivery.

### *Performance audits*

Conducting periodic performance audits of all projects may have a deterrence function and help minimise corruption risks. Performance audits can help detect corruption by highlighting areas of inefficiency, lack of economic efficiency, lack of effectiveness and failure to achieve results and impact (Khan, M. A., 2006). While inefficiency and ineffectiveness may be attributed to other factors and are not conclusive proof of corruption, performance audits can raise red flags, point to issues where corruption is likely to have occurred and trigger further, more thorough, investigations.

## **Audit activities with an environmental perspective**

### *Experience with environmental auditing*

As governments invest greater resources in the field of environment and sustainable development, SAIs are assuming an important role in the emerging field of environmental auditing. In recognition of the need to develop SAI expertise and promote knowledge-sharing in this relatively new field of auditing, INTOSAI has established a Working Group on Environmental Auditing (WGEA) to assist SAIs in understanding key issues related to environmental auditing, develop guidelines and methodologies and exchange information and expertise. The WGEA identified 2000 environmental audits conducted by SAIs over the past decade, covering the full range of audit types –

financial, compliance and performance (INTOSAI-WGEA, 2007).

Financial audits can assess whether a government's financial statement reflects its environmental costs and liabilities. Compliance audits assess compliance with national and international environmental laws, treaties and policies. Performance audits assess whether a government meets its environmental objectives, is effective in producing environmental results, and operates efficiently and economically. Comprehensive audits combine two or more of these three types of audits.

Environmental audit findings typically highlight some of the following areas of concerns:

- Gaps and weaknesses in terms of implementation, legislation and allocation of resources;
- Financial management weaknesses, including improper funding of governmental programmes, poor administrative protocols, and beneficiaries receiving funds without following the proper process;
- Audits have also found that funds were not used efficiently or economically to ensure the best result for the environment;
- Concerns and recommendations with regard to the reliability of data and the lack of detailed information are frequently raised as well.

A few SAIs - such as those in the Netherlands, Canada and Australia - have begun auditing a broad range of activities on climate change. For example, in Canada, the Office of the Auditor General reviewed the overall federal approach to addressing climate change. The Australian National Audit Office looked at the efficiency and effectiveness of the government's program to reduce greenhouse gas emissions in the trucking industry.

### *INTOSAI auditing standards and guidelines*

To support SAI environmental auditing activities, the WGEA has produced various studies and guidelines

related to environmental auditing, which are accessible on the WGEA website<sup>2</sup>, including:

**Draft: Auditing forests: guidance for Supreme Audit Institutions (2010):** These guidelines have been developed to help governments strengthen their internal controls for forest management and improve their assessment and mitigation of forest related risks.

**Draft: Auditing government response to climate change (2010):** This document provides guidance on auditing government management of climate change, whether through mitigation or adaptation audits. For mitigation audits, it recommends a four step audit planning process, including 1) identifying green house gas (GHG) emissions; 2) mapping government response in mitigating climate change in terms of commitments, targets, responsible public bodies, policy instruments , 3) choosing audit topics and priorities (achievement of targets, efficiency and economy risks assessments and analysis); and 4) designing the audit.

- **Draft Environmental accounting: current status and options for SAIs (2010).** Based on current international efforts to develop environmental accounting standards, this report reviews the available options for how SAIs can use environmental accounts in their audit work or be otherwise involved in their country's environmental accounting efforts.
- **Guidance on conducting audits of activities with an environmental perspective (2001):** The purpose of this guide is to provide SAIs with a basis for understanding the nature of environmental auditing as it has so far developed in the governmental sphere.
- **The audit of international environmental accords (2001):** The aim of this booklet is to outline the approaches by which audits of international environmental accords might be carried out, whether they are conducted as compliance audits or as performance audits.

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<sup>2</sup> <http://www.environmental-auditing.org/Home/WGEAPublications/StudiesGuidelines/tabid/128/Default.aspx>

### *The Gold Standard*

The Gold Standard Foundation is a non-profit organisation which registers projects that reduce greenhouse gas emissions and certifies their carbon credits for sale on both compliance and voluntary offset markets. The Gold Standard quality benchmark was originally developed by a group of NGOs present at the 7<sup>th</sup> Session of the UNFCCC Conference of the Parties (COP) in 2001, when rules of procedure for the Clean Development Mechanism (CDM) were being decided. These NGOs pushed for the establishment of a rigorous methodology that would:

- make it possible for project developers to adhere to the agreed CDM criteria for carbon offset projects;
- ensure that project implementation led to real and verifiable emissions reductions and made a measurable contribution to sustainable development.

While not primarily concerned with corruption, this foundation has developed methods and tools that enable project developers to meet the Gold Standard's rigorous requirements in a transparent manner. It has trained auditors that are charged with overseeing registration, certification and oversight processes and a Technical Advisory Committee that can provide guidance.

### *The Climate Community & Biodiversity Alliance (CCBA) standards*

The CCBA is an international partnership of research institutes and NGOs that promote integrated solutions to land management. Within this framework, the CCBA has developed voluntary standards to help design land activities that simultaneously minimise climate change, protect biodiversity and promote sustainable development (CCBA, 2008). While not directly looking at issues of financial integrity, CCBA standards constitute a good place to start, as they promote a broader concept of environmental integrity throughout the entire process of designing and implementing land based projects to reduce GHG emissions and generate positive impacts for local communities and environment. They argue for a systematic, independent and documented process of evaluation of the project design (validation process) and the project's delivery of net climate, community and biodiversity benefits

(verification process) against each of the CCBA criteria. (CCBA, 2010).

CCBA standards identify land based carbon mitigation projects that are designed to deliver robust and credible GHG reductions and deliver net benefits to the local community and environment. These standards comprise 14 required criteria and three optional "gold level" criteria looking at issues such as original condition in the project area, baseline projections, management capacity and best practices, legal status and property rights, net positive climate impact, offsite climate impact (leakages), climate impact monitoring, net positive community impact, offsite stakeholder impacts, etc. A third party evaluator assesses projects using a set of indicators to determine if a project satisfies each of these criteria. Gold status is awarded to projects that satisfy one of the optional criteria by providing exceptional social and environmental benefits.

### *Forest Stewardship Council (FSC) audits*

The FSC is an international multi-stakeholder organisation that promotes responsible management of forests through independent certification and labelling of forest products. FSC certification standards comprise 10 principles and 56 associated criteria that promote well-managed forests in accordance with environmentally and socially responsible guidelines as elaborated in the FSC's Principles and Criteria (FSC, 2002). FSC principles include compliance with applicable laws and international treaties, recognition and respect of indigenous people's rights, equitable use and sharing of benefits derived from the forest, appropriate monitoring and assessment of activities to assess the conditions of the forest, management activities and their social and environmental impact.

### *UNDP's Minimum Social and Environmental Standards and Risk Assessment Tool*

To guide programme design, the UN-REDD Programme has developed a draft "do no harm" approach to minimum social and environmental standards and an accompanying risk assessment tool. The tool addresses minimum social and environmental standards in terms of governance, stakeholder livelihoods and policy coherence. The primary objective of the tool is to identify risks of non-compliance, build

stakeholder confidence and improve transparency and sustainability of program activities.

The first good governance criteria of the self assessment tool relates to anti-corruption with a view to ensuring that the program is not involved or complicit in corruption. It assesses country, sector and program level corruption risks by looking at issues such as the legal framework, the anti-corruption controls in place, the existence of a transparent carbon, land or other resource related dispute resolution mechanism as well as an effective complaint mechanism. The second good governance related criteria looks at transparency and accountability to ensure that program administration and activities, as well as allocation and distribution of funds and benefits at all levels of government are carried out in an accountable and transparent manner.

### 3 Case study of Indonesia's Reforestation Fund

While Indonesia has the world's third largest area of tropical forest, as well as extensive carbon-rich peatlands, it is also the world largest emitter of CO<sub>2</sub> from deforestation and forest land use change. Like many tropical forest countries, Indonesia also has a long track record of corruption and fraud in the forestry sector. A recent study published by the Center for International Forestry Research (CIFOR) examines Indonesia's experience with the country's multi-billion dollar Reforestation Fund (*Dana Reboisasi*, DR) over the past 20 years and highlights important lessons for financial governance relevant to the implementation of REDD+. The following sections summarize key findings from the CIFOR study, entitled *Financial Governance and Indonesia's Reforestation Fund during the Soeharto and Post-Soeharto Periods, 1989-2009: A Political Economic Analysis of Lessons for REDD+* (Barr, C. et al., 2010).<sup>3</sup>

#### The Suharto regime

Established in 1989, the DR was financed by a volume-based levy paid by timber concessionaires and quickly

became the single largest source of government revenues from Indonesia's commercial forestry sector. During the Suharto regime, the Ministry of Forestry in charge of managing the funds allocated more than a billion USD from the DR in cash grants and discount loans to commercial plantation companies with the view to promoting the development of industrial plantations. The use of DR subsidies for commercial forestry development resulted in the creation of perverse incentives for unsustainable forest management, as it encouraged the removal of natural forest cover for developing new commercial plantations. In addition, large proportions of DR funds were lost to fraud, corruption or diverted from their intended use, as uncovered by a third party financial audit conducted in 1999 that documented losses of 5,2 USD billion over a five years period. Forms of fraud, corruption and unethical practices included:

- The distribution of a significant proportion of the DR funds and forest conversion licences to politically favoured projects or companies close to the political elite or;
- Fraudulent practice by recipients of DR subsidies, inflating their investment costs and/or overstating the areas planted to secure larger DR subsidies;
- Systematic financial mismanagement of the funds;
- Routine diversion of the funds for use that were not consistent with the DR mandate;
- DR funds wasted on poorly managed projects, with DR subsidy recipients routinely failing to meet their targets;
- Significant proportion of DR loan recipients failed to repay their debts, representing a significant loss of state's assets.

#### The post-Suharto era

Progress has been made in the post-Suharto era to improve state management and governance of forest assets. In particular, the DR has been integrated into the State Treasury under the control of the Ministry of Finance to ensure that the fund would be administered in a more accountable and less politicised manner. The Supreme Audit Board (BPK) has been strengthened as the sole external auditor, and 29 audits related to the DR were conducted between 2004 and 2008. All of them have been published on the internet. The creation of an independent Corruption Eradication Commission (KPK) and Corruption Court has also resulted in the

<sup>3</sup> For a detailed discussion of the issues summarized in this section, readers are encouraged to consult the full CIFOR report, available at: <http://www.cifor.cgiar.org/Knowledge/Publications/Detail?pid=2886>

prosecution of a few high profile DR-related corruption cases.

In spite of these efforts, Indonesia continues to face major challenges of perverse incentives and weak financial management and revenue administration by government institutions. Poor record keeping and financial reporting makes it difficult to assess the extent to which DR funds are being used for their intended purpose. A BPK audit of the Ministry of Forestry's management of government owned accounts (for 2006 and 2007) highlighted numerous weaknesses in internal financial controls and widespread irregularities in its account management practices.

There are also indications that the misuse of DR funds has become more decentralised, as Indonesia's provincial and district governments have gained greater authority to administer forestry revenues. There have been widespread reports of local officials misappropriating DR funds to finance fictitious rehabilitation projects, under-spending DR funds or diverting them for unauthorised purposes. In some regions, the costs of DR projects have been "marked up" to illicitly inflate their budgets. Large amounts of DR funds have also allegedly been placed in time deposit or investment accounts rather than being allocated to reforestation projects. Recent government audits also indicate that both national and regional governments lack the capacity to spend the resources allocated for reforestation and rehabilitation projects and regularly fail to meet their spending targets, in some cases by more than 50%.

Since 2007, the Ministry of Finance has transferred DR funds earmarked for the national government to a new financial intermediary, the Forest Development Funding Agency Public Service Unit (BLU-BPPH). The BLU-BPPH has been granted a high level of financial flexibility and there are concerns about how the funds will be administered as BLU-BPPH practices may diverge from regular public finance standards.

The persisting prevalence of corruption in the post Suharto period suggests that, in the absence of effective mechanisms for oversight and accountability, the influx of substantial REDD funds could put additional stress on already weak and fragile institutions. This underscores the critical need for improving budgeting, accounting, internal financial controls and reporting processes.

## Areas of support for REDD in Indonesia

Given the large sums of money involved, strong systems for financial management and governance must be established to ensure the successful and sustainable implementation of REDD in Indonesia. Capacity building in the area of financial management will therefore be of critical importance during the REDD+ "readiness" process. This will include staff training and professional development, enhancement of organisational structures and strengthened capacity in budgeting, financial accounting, fiscal management and other aspects of revenue administration. The CIFOR study concludes with a set of recommendations to pre-empt potential corruption within the framework of REDD + payment schemes, including:

- Strengthening financial management and revenue administration, as well as increasing transparency and accountability of government agencies administering forest and carbon fiscal resources;
- Strengthening the capacity of the Corruption Eradication Commission, the Corruption Court as well as Indonesia's Financial Intelligence Unit (PPATK) which oversees the implementation of anti-money laundering laws;
- Strengthening the capacity of the Supreme Audit Board (BPK) as the sole external auditor for the Government of Indonesia ;
- Establishing effective systems for financial monitoring, reporting and verification (MRV), including regular third party audits of the accounts through which REDD+ funds are administered;
- Establishing strong coordination between agencies administering REDD + payments, those overseeing the DR and those responsible for land allocation, forest use and industrial licensing;
- Revising policies to remove misaligned and perverse incentives;
- Imposing solid due diligence and accountability on the beneficiaries of both REDD+ and DR funds.

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