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AUDIT OF
PRIVATE SECTOR SUPPORT PROGRAM AND
P.L. 480 LOCAL CURRENCY GENERATIONS
USAID/EL SALVADOR

AUDIT REPORT NO. 1-519-85-13
SEPTEMBER 26, 1985

AGENCY FOR INTERNATIONAL DEVELOPMENT

OFFICE OF THE REGIONAL INSPECTOR GENERAL
AMERICAN EMBASSY
TEGUCIGALPA - HONDURAS

September 26, 1985

MEMORANDUM

TO : Mr. Robin Gomez, Director, USAID/El Salvador

Coinage N. Gothard

FROM : RIG/A/T, Coinage N. Gothard, Jr.

Subject : Audit Report No. 1-519-85-13, "Audit of Private Sector Support Program and P.L. 480 Local Currency Generations, USAID/El Salvador"

Attached for your information and use are five copies of the subject audit.

The purpose of the audit of the private sector support program was to determine: (a) progress towards achieving program objectives, (b) Government of El Salvador (GOES) compliance with conditions of the ESF grant agreement and memorandums of understanding, and (c) weaknesses in USAID/El Salvador and GOES management that might impede the efficient and effective implementation of the program. We also reviewed USAID/El Salvador and GOES controls over the use of P.L. 480 local currency generations which the USAID has monitored under the private sector support program.

The program has made significant progress in helping to stabilize the Salvadoran economy. The decline in the real Gross Domestic Product which started in 1979 was arrested in 1983 and a positive growth rate of 1.5 percent was achieved in 1984.

Except as noted below, GOES compliance with provisions of the program agreements has been satisfactory. The GOES did not comply with eleven provisions. However, they were unable to comply with some of the provisions because of unrealistic assumptions or insufficient resources. Other provisions were complied with or were being corrected prior to the publication of this report.

At the beginning of our audit, we noted that USAID/El Salvador's management of the program was fragmented and that a centralized monitoring procedure had not been established to adequately document and verify GOES compliance with the various provisions in the program agreements. We believe that these internal control weaknesses led to the submission of incomplete information to AID/Washington to satisfy a congressional reporting requirement dealing with the degree of GOES compliance with ESF and P.L. 480 local currency provisions. Prior to the issuance of this report, USAID/El Salvador had corrected these reporting and management inadequancies.

USAID/El Salvador and GOES needed to improve the attribution of import transactions to AID disbursements. Our tests detected that USAID/El Salvador accepted a significant number of ineligible import transactions for attribution. USAID/El Salvador and the GOES corrected these problems prior to the publication of this report.

We confirmed that the Central Bank needed to further improve the management of its Department of International Prices to more effectively identify overpricing of imports and underpricing of exports in order to help deter capital flight. Since USAID/El Salvador had corrected or was taking adequate corrective action in these areas through its Contractor, Arthur Young and Co., our recommendations were closed upon publication of this report.

We found certain control problems in the use of the ESF and P.L. 480 local currencies. These problems were corrected prior to the publication of this report. Except as noted above, internal controls over the ESF and P.L. 480 local currencies were satisfactory. Over the life of the program USAID/El Salvador has made numerous improvements in these controls.

All eleven recommendations contained in this report are closed upon publication because of corrective actions taken by USAID/El Salvador.

EXECUTIVE SUMMARY

The Office of the Regional Inspector General for Audit in Tegucigalpa, Honduras made an audit of the Private Sector Support Program in El Salvador. The objectives of our audit were to determine (a) progress towards achieving program objectives, (b) Government of El Salvador (GOES) compliance with conditions of the grant agreement and memorandums of understanding, and (c) weaknesses in USAID/El Salvador and GOES management that might impede the efficient and effective implementation of the program. We also reviewed USAID and GOES controls over the use of P.L. 480 local currency generations which have been monitored by the USAID under the Private Sector Support Program. This was our third audit of the program covering activities from January 1, 1983 through December 31, 1984.

Because of a sharp decline in the Salvadoran economy caused by the civil war, AID and the GOES agreed, in December 1980, to implement a Private Sector Support Program to be financed with Economic Support Funds (ESF). The objectives of the program were to ameliorate El Salvador's balance-of-payments crisis, to strengthen the private sector by providing foreign exchange resources for the importation of essential commodities, and to help restore economic stability. By December 31, 1984 AID had obligated $429.9 million under this program of which $399.9 million had been disbursed to the GOES. AID's Private Sector Support Program has been successful in helping to stabilize the Salvadoran economy. The decline in real economic growth which started in 1979 was arrested in 1983. In 1984 an estimated positive growth rate of 1.5 percent was achieved.

USAID/El Salvador has placed certain conditions on its assistance provided under the Private Sector Support Program in order to improve the performance of the economy, to obtain GOES compliance with requirements of other AID programs, and to require the Central Bank to establish and improve the operation of a system to verify the prices of imports and exports in order to deter capital flight through the overpricing of imports and underpricing of exports.

U.S. dollar funds under this program were made available to the GOES as cash transfers. In turn, the GOES was to make available an equivalent amount of foreign exchange within 12 months of the date of each disbursement in order to permit raw materials, intermediate goods, spare parts, agricultural inputs and capital goods to be imported from the United States by the private sector. To monitor compliance with this and other provisions, the GOES agreed to prepare reports on its attribution of eligible import transactions to AID financing. Another condition of the program was that the GOES would make available local currency in amounts at least equivalent to the dollar funds disbursed for purposes mutually agreeable to both governments.

At the beginning of our audit, we noted that USAID/El Salvador's management of the program was fragmented and that a centralized monitoring procedure had not been established to adequately document and verify compliance by the GOES with the various provisions in the program agreements. Prior to the issuance of this report, USAID/El Salvador had corrected these inadequacies.

Many ineligible import transactions were attributed to AID disbursements made in 1982 because of inadequate selection procedures. The Central Bank is now improving its procedures in order to avoid past attribution deficiencies.

Our review confirmed the findings of USAID/El Salvador and Arthur Young and Co. that further improvements were needed in the price-checking system established by the Central Bank to prevent the overpricing of imports and the underpricing of exports, and so to help deter capital flight. USAID/El Salvador has been in the process of assisting the GOES Central Bank to correct these deficiencies for some time now through a contract with Arthur Young and Co. The USAID advised us that they do not believe that capital flight through over/under invoicing is currently a problem as evidenced by Central Bank balance of payment data and corroborated by other observations (e.g., return of wealthy citizens) which indicated disminution or elimination of capital flight starting in 1983.

The ESF grant agreement and Memoranda of Understanding (MOU) were also used as tools to help monitor the use of local currency funds generated from the sale of P.L. 480 commodities under separate P.L. 480 agreements and MOUs. The ESF MOUs incorporate the P.L. 480 MOUs by reference. Since 1980, P.L. 480 agreements and MOUs led to the shipment of commodities worth $152 million.

Our review disclosed a few deficiencies in the management of P.L. 480 and ESF local currencies. Specifically, the GOES' sales agents (banks) had not promptly deposited the proceeds from the sale of P.L. 480 commodities into GOES special accounts and they had retained interest earned on credit sales; the Central Election Council had used some ESF counterpart funds for ineligible purposes; and ESF and P.L. 480 local currency bank accounts had not been reconciled.

Another aspect of our review dealt with GOES compliance with the terms and conditions of its agreements with AID. When Congress passed the FY 1985 AID Continuing Resolution, it placed a requirement on the Agency to make periodic reports on GOES compliance with the local currency provisions of the program agreement. We compared the report that USAID/El Salvador made to AID/Washington in November 1984 with the results of our audit and found that, whereas the Mission had reported only one area of non-compliance, in our opinion, at that time, the GOES had not fully complied in five areas. In April 1985, USAID/El Salvador added mention of those five areas in its report to AID/W on GOES compliance with the FY85 program. In our opinion, this addendum to its most recent report accurately reflected the degree of non-compliance with the local currency provisions of the 1984 Memorandum of Understanding. In most cases, the GOES had been unable to comply because of unrealistic assumptions or insufficient resources.

In addition, we found six areas not subject to the statutory reporting requirement in which the GOES had not achieved compliance. Prior to the issuance of the report, USAID/El Salvador obtained GOES compliance with five of those provisions and had started action to obtain compliance with another.

Overall, GOES internal controls were found to be adequate except as noted above. Since the inception of the program in 1980, USAID/El Salvador and the GOES have made many improvements in internal controls and others are in the process of being implemented.

We held an Exit Conference with USAID/El Salvador on May 2 and 3, 1985 to obtain their comments on our audit findings. Our draft report was submitted to the USAID on June 21, 1985 and they provided written comments to the draft report on August 23, 1985. Prior to the publication of this report, we considered all comments made by USAID/El Salvador. Their written comments to our draft report are included as Appendix 1.

In general, USAID/El Salvador agreed with our audit report. We made numerous changes in the report based on their comments. Where we did not agree with their comments, we have included their comments as well as ours in the appropriate section of the report.

All eleven recommendations included in this report are closed upon publication because of corrective actions taken by USAID/El Salvador on our audit findings and draft report; also, three of the recommendations were closed because USAID/El Salvador had identified the problems and was taking adequate corrective action.

Office of the Inspector General

AUDIT OF
PRIVATE SECTOR SUPPORT PROGRAM
AND P.L. 480 LOCAL CURRENCY GENERATIONS
USAID/EL SALVADOR

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AUDIT OF
PRIVATE SECTOR SUPPORT PROGRAM
USAID/EL SALVADOR
PART I - INTRODUCTION

A. Background

Beginning in 1979, El Salvador experienced a sharp decline in economic activity because of political instability caused by kidnappings, factory take-overs, bombings, and terrorism. This led to a deterioration of the country's domestic resources and foreign exchange position. By the end of 1980, the Gross Domestic Product had dropped by 10.5 percent and net international reserves by $304 million to a negative balance of $69.9 million.

In response to this situation, AID and the GOES agreed, in December 1980, to implement a Private Sector Support Program to be financed with Economic Support Funds (ESF). The objectives of the program were to ameliorate El Salvador's balance-of-payments crisis; to strengthen the private sector by providing foreign exchange resources for the importation of essential commodities, and to help restore economic stability.

By December 31, 1984 AID had obligated $429.9 million under this program of which $399.9 million had been disbursed to the GOES. The program was both grant and loan financed. The grant portion of the program included the original grant plus ten ammendments for a total of $405 million. The loan portion consisted of one loan for $24.9 million.

The status of these cash transfers as of December 31, 1984 was, (in millions of U.S. dollars):

	Obligated		Disbursed	
Private Sector Support I	Date	Amount	Date	Amount
Grant (519-0267)				
Original Grant	12/17/80	$20.0	12/19/80	$20.0
Amendment No. 2	03/26/82	20.0		
Amendment No. 3	06/15/82	5.0	07/01/82	25.0
Amendment No. 4	09/22/82	75.0	09/28/82	75.0
Amendment No. 5	12/17/82	39.6	02/09/83	19.6
			03/29/83	20.0
Amendment No. 6	05/11/83	42.4	05/13/83	25.0
			05/31/83	17.4
Amendment No. 7	07/29/83	38.0	10/18/83	20.0
			12/02/83	18.0
Amendment No. 8	01/23/84	25.0	03/29/84	25.0
Amendment No. 9	06/15/84	75.0	08/03/84	50.0
			11/10/84	25.0
Amendment No. 10	12/15/84	65.0	12/31/84	35.0
Total Grants		$405.0		$375.0
Private Sector Support II				
Loan (519-K-030)	07/21/81	$24.9	07/31/81	$24.9
Grand Total		$429.9		$399.9

One provision for the use of the dollar funds was that the GOES make available within 12 months from the date of each disbursement an equivalent amount of foreign exchange to import from the United States raw materials, intermediate goods, spare parts, agricultural inputs and capital goods for the private sector. To monitor compliance with this provision, the USAID required the GOES to report on the import transactions attributed to AID financing.

Another condition of the dollar disbursements was that the GOES would make available local currency in an amount at least equivalent to the dollar funds disbursed to be used for purposes as agreed to by the two governments.

The ESF local currency made available in 1980 and 1981 ($44.9 million) was tied to specific project uses. Starting in 1982 and continuing through 1983, the ESF local currency made available ($220 million) was not tied to specific project uses. Instead the Ministry of Finance agreed to include in its regular budget by specific budget line items an equivalent amount of funds for priority programs as negotiated with AID. (colones, the local currency of El Salvador, have been converted to dollars at the rate of 2.5 colones per dollar throughout the report).

In 1984, part of the local currency ($10 million) was made available to the Ministry of Planning for specific project uses. The balance ($90 million) was made available to the Ministry of Finance to finance specific budget line items in priority areas as was done in 1982 and 1983. In 1984 the Ministry of Finance was not required to attribute funds to its budget as was done in 1982 and 1983. Instead the local currency generations were to be deposited into a special acount to be expended on specific budget line items.

The USAID has also used the ESF grant agreements to help budget and control the use of local currency sales proceeds generated under separate PL 480 agreements.

Through 1984, those agreements totalled $152,001,000:

Year	Title	Amount ($000)
1980	I	$ 2,880
1981	I	24,500
1982	I	19,900
1983	I	39,000
1983	II 1/	16,721
1984	I	49,000
Total		$152,001

1/ Section 206

The Ministry of Planning manages the P.L. 480 local currency generations. These funds have been budgeted for specific uses based on action plans submitted by other government agencies and approved by the Ministry of Planning. The USAID advised us that they concur in the approval of some plans. These plans have been used in AID priority areas to finance (1) GOES counterpart for AID and other donor projects and (2) separate GOES programs.

Starting in 1983, the Ministry of Planning was given greater control over the use of these funds to expedite their use. In April 1983, the National Assembly passed legislation creating the Technical Secretariat for External Financing (SETEFE), with a special checking account and authority to budget and order disbursement of funds from external sources to all agencies specifically listed in the legislation. Those agencies include all the organizations receiving P.L. 480-generated funds.

The USAID has also placed conditions upon assistance provided under the private sector support program in order to: (1) obtain changes in GOES policies and so to improve the performance of the economy (2) increase the supply of credit available to the private sector (3) obtain GOES compliance with requirements of other AID programs (4) encourage GOES negotiation of a new agreement with the International Monetary Fund, and (5) require the Central Bank to establish and improve the operation of a price-checking unit to detect and control improper pricing practices that could contribute to capital flight.

B. Audit Objectives and Scope

This is our third audit of the private sector support program. It covered the period from January 1, 1983 through December 31, 1984.

The first audit of the program (Report No. 1-519-82-5 dated January 20, 1982) questioned whether the GOES should use AID funds to guarantee lines of credit since the procedures did not provide immediate balance-of-payments impact. It also questioned whether local currency funds should be tied to specific projects since project monitoring had overburdened the small USAID/El Salvador staff. Moreover, the report pointed out the need for the GOES to implement a planned price-checking system for import transactions, and to improve the management of two local currency funds established under the program. The report made five recommendations. All recommendations have now been closed.

The second audit of the program (Report No. 1-519-83-8 dated April 20, 1983) disclosed that the program had appeared to slow the decline in real economic growth. It also disclosed that improvements were needed in the price-checking unit, GOES reporting procedures and definition of the credit expansion targets. That report contained two recommendations which have been closed.

This review was made at the request of the AID Deputy Administrator.

The purpose of the current audit was to determine: (a) progress towards achieving program objectives, (b) GOES compliance with conditions of the grant agreement and memorandums of understanding, and (c) weaknesses in USAID and GOES management that might impede the efficient and effective implementation of the program. We also reviewed USAID and GOES controls over the use of P.L. 480 local currency generations which have been monitored by the USAID under the private sector support program.

The audit was performed in accordance with U.S. Government auditing standards. Accordingly, it included a review of the records of the USAID, the GOES, certain importers, as well as interviews with officials from those organizations. We randomly sampled 79 import transactions attributed to AID financing by the GOES and approved by the USAID to verify that the transactions complied with established criteria. We obtained confirmatory evidence by reviewing transaction files at the Central Bank, visiting Salvadoran importers, and corresponding with U.S. exporters.

AUDIT OF
PRIVATE SECTOR SUPPORT PROGRAM
USAID/EL SALVADOR

PART II - RESULTS OF AUDIT

The purpose of the audit of the private sector support program was to determine: (a) progress towards achieving program objectives, (b) GOES compliance with conditions of the ESF grant agreement and Memorandums of Understanding, and (c) weaknesses in USAID/El Salvador and GOES management that might impede the efficient and effective implementation of the program. We also reviewed USAID/El Salvador and GOES controls over the use of P.L. 480 local currency generations which the USAID has monitored under the private sector support program.

The program has made significant progress in helping to stabilize the Salvadoran economy. The decline in the real Gross Domestic Product which started in 1979 was arrested in 1983 and a positive growth rate of 1.5 percent was achieved in 1984 (see page 56).

Except as noted below, GOES compliance with provisions of the program agreements has been satisfactory. The GOES did not comply with eleven provisions. However, they were unable to comply with some of the provisions because of unrealistic assumptions or insufficient resources. Other provisions were complied with or were being corrected prior to the publication of this report (see page 54).

At the beginning of our audit, we noted that USAID/El Salvador's management of the program was fragmented and that a centralized monitoring procedure had not been established to adequately document and verify GOES compliance with the various provisions in the program agreements. We believe that these internal control weaknesses led to the submission of incomplete information to AID/Washington to satisfy a congressional reporting requirement dealing with the degree of GOES compliance with ESF and P.L. 480 local currency provisions (see page 54). Prior to the issuance of this report, USAID/El Salvador had corrected these reporting and management inadequacies.

USAID/El Salvador and GOES needed to improve their attribution of import transactions to AID disbursements. Our tests detected that USAID/El Salvador accepted a significant number of ineligible import transactions for attribution. USAID/El Salvador and the GOES corrected these problems prior to the publication of this report (see page 7).

We confirmed that the Central Bank needed to further improve the management of its Department of International Prices to more effectively identify overpricing of imports and underpricing of exports in order to help deter capital flight. Since USAID/El Salvador had corrected or was taking adequate corrective action on these problems through its contractor, Arthur Young and Co., our recommendations were closed upon the publication of the report (see page 43).

We found a few control problems over the use of the ESF and P.L. 480 local currencies (see page 33). These problems were corrected prior to the publication of this report. Except as noted above, internal controls over the ESF and P.L. 480 local currencies were satisfactory. Over the life of the program USAID/El Salvador has made numerous improvements in these controls.

All eleven recommendations contained in this report are closed upon publication because of corrective actions taken by USAID/El Salvador. However, in the not-too-distant future, we plan to follow-up on some of these closed audit recommendations.

A. Deficiencies in Past Attribution of Dollar Transfers

The deficiencies described in this section of the report were generally known to USAID/El Salvador. Moreover the Mission and its contractor, Arthur Young and Co., have been at work for some time to devise an automated system that would effectively correct the deficiencies described in this report for future cash transfer programs. However, the terms and conditions of past ESF transfer agreements/covenants between AID and the GOES have not been fully complied with to date and corrective actions recommended in this report are needed to achieve that compliance.

1. Past Attribution Deficiencies

The USAID has accepted many ineligible import transactions for final attribution against $100 million transferred to the GOES in 1982 under Amendments 2, 3 and 4 to the Grant Agreement. The Central Bank, with USAID support and assistance, is now improving its procedures for selecting transactions for attribution in order to avoid past deficiencies. The Grant Agreement and AID Implementation Letters set forth the specific criteria to qualify import transactions for attribution against U.S. dollars disbursed to the GOES. These criteria were source, origin, import period, merchandise categories, type of industry, FOB value, documentation and certification by the Superintendent of Banks.

The attribution process is the mechanism by which AID is assured that its assistance is accurately linked to the purchase of imports meeting specified criteria. The grant agreement as amended provided that, over a period of 12 months from the date of each dollar disbursement, the GOES would make available to the private sector an equal amount of foreign exchange for the importation of raw materials, intermediate goods, spare parts, agricultural inputs and capital goods from the United States. The eligible private sub-sectors were manufacturing, agribusiness, commerce, transportation and energy. In addition, program implementation letters specified that FOB values should be used for attribution, commodities should be of U.S. source and origin, files should be maintained at the Central Bank to support each transaction, and only completed transactions (goods imported into El Salvador) should be accepted for final attribution. The implementation letters also provided that the Central Bank should report eligible transactions to the USAID for approval and that those transactions should be certified by the Superintendent of Banks.

As of December 31, 1984, $375 million had been disbursed under the grant since the inception of the program in 1980. The Central Bank had submitted $241.9 million worth of transactions for attribution to the grant of which the USAID had approved $115.5 million and was reviewing $126.4 million.

Our findings are based mainly on a randomly selected sample of 79 transactions out of 5116 transactions attributed to $75 million disbursed to the GOES in 1982 under Amendment No. 4 of the Grant Agreement. The results of our sample and a description of the procedures used are shown in Exhibit 1 of this report. The sampling technique we used produced results that can only be used to project the number of transactions not complying with established criteria.

It cannot be used to project dollar values. Certain findings are also based on reviews done by the USAID/Controller and the Superintendent of Banks of El Salvador prior to our audit.

Below we summarize the individual attribution deficiencies found during our audit (these deficiencies are discussed in more detail starting on page 15 of this report).

	Page No.	Description
I.	$25 million disbursed under Amendments 2 and 3	
	10	The GOES still needs to submit $3,433,122 in ineligible transactions (because of USAID disallowances) to fully attribute the $25 million disbursed under Amendments 2 and 3
II	$75 million disbursed under Amendment No. 4	
	10	The GOES still needs to submit $1,609,789 in eligible transactions (because of USAID disallowances) to fully attribute the $75 million disbursed under Amendment No. 4.
	15	An estimated 37.9 percent of the transactions accepted by the USAID were not eligible for attribution because they did not comply with one or more of the grant criteria for import period, type of commodity, industrial subsector, U.S. source, U.S. origin and financing by the GOES (see Exhibit 1).
	25	An estimated 19 percent of the transactions were not accepted at the required FOB value (see Exhibit 1).
	12	Documentation required to support an estimated 83.5 percent of accepted transactions could not be found in Central Bank files (see Exhibit 1).
	23	$4,465,239 in transactions were accepted for attribution twice (the USAID had already disallowed $4,419,297 of these duplicate transactions).
	27	$39,452,621 in transactions were not certified by the Superintendent of Banks.

To correct these past attribution deficiencies, we believe the USAID and the Central Bank should review all transactions accepted for attribution to AID disbursements under Amendment 4 to the Grant Agreement and disallow any ineligible transactions. In the event that the Central Bank is unable to provide enough substitute transactions to fully attribute AID disbursements under Amendments 2, 3 and 4, then the USAID will have to determine what remedies are available to correct the problem.

Recommendation No. 1

We recommend that USAID/El Salvador:

(a) determine the eligibility of all transactions accepted for final attribution to the AID disbursement under Amendment No. 4 to the Grant Agreement and disallow any ineligible transactions.

(b) in the event that the Central Bank is unable to provide enough substitute transactions to fully attribute AID disbursements under Amendments 2, 3 and 4 of the Grant Agreement, then the USAID in consultation with appropriate legal counsel, should determine what remedies are available to correct the problem.

Action Taken by USAID/El Salvador to Close Recommendation No. 1

This recommendation is closed upon publication of this report because of actions taken by USAID/El Salvador on our audit findings and draft audit report. The USAID contracted Arthur Young and Co. to review and determine the eligibility of transactions on file at the Central Bank in order to fully attribute Amendments 2, 3, and 4 to the Grant Agreement. The Arthur Young and Co. report dated August 15, 1985 contained a listing of 3302 transactions for $100,012,589 which were deemed eligible for attribution to Amendments 2, 3, and 4. In addition, they found 190 eligible transactions for $3.3 million in excess of attribution needs.

Arthur Young and Co. used some eligibility criteria that were different than those used by the AID auditors. On June 5, 1985 (after we finished our review but before Arthur Young and Co. started theirs) USAID/El Salvador issued Implementation letter No. 32 to change some of the eligibility criteria retroactive to Amendment 3. By issuing this letter, USAID/El Salvador has, in effect, "changed the rules of the game" by eliminating the United States origin requirement and accepting CIF instead of FOB values for imported commodities retroactively. This action increased the number and value (cost of goods plus insurance and freight) of transactions available for attribution. As a matter of principle, we find it difficult to condone this device for the same reason we would object to granting a retroactive waiver of AID's source/origin requirements for commodities financed directly by AID. At the same time, however, we realize that the matters under discussion in this section are historical in nature and that no useful purpose would be served in bringing this deficiency to the attention of the GOES at this time. Moreover, the Mission and the GOES have taken steps to preclude that shortfalls of this nature recur in future cash transfer programs. Consequently, while we have closed our audit recommendation, we have added this deficiency to our list of areas of non-compliance (see page 54).

2. AID Disbursements under Amendments 2, 3, and 4 to the Grant Agreement Were Not Fully Attributed to Import Transactions

AID disbursements of $100 million under Amendments 2, 3 and 4 to the Grant Agreement were not fully attributed to import transactions as of December 31, 1984. Implementation Letter No. 22 provided that the attribution process should be completed 18 months after the date of each AID disbursement. This was not done because the USAID disallowed some transactions and the Central Bank has not submitted substitute transactions as requested. The USAID should ensure substitute transactions are submitted in a timely manner so that eligible import transactions can be fully attributed to AID disbursements.

Recommendation No. 2

We recommend that USAID/El Salvador obtain from the Central Bank $5,042,911 in eligible import transactions in order to complete its attribution to AID disbursements under Amendments 2, 3 and 4 of the Grant Agreement.

Action Taken by USAID/El Salvador to Close Recommendation No. 2

This recommendation is closed upon publication of this report because of corrective actions taken by USAID/El Salvador on our audit findings and draft audit report. The USAID contracted Arthur Young and Co. to review and determine the eligibility of transactions on file at the Central Bank in order to fully attribute Amendments 2, 3, and 4 to the Grant Agreement. The Arthur Young and Co. report dated August 15, 1985 contained a listing of 3302 transactions for $100,012,589 which were deemed eligible for attribution to Amendments 2, 3, and 4. In addition, they found 190 eligible transactions for $3.3 million in excess of attribution needs.

Discussion

An additional $5,042,911 in eligible import transactions are needed to fully attribute AID disbursements under Amendments 2, 3 and 4 of the Grant Agreement as of December 31, 1984. The status of cash tranfers and related attributions as of December 31, 1984 were:

Amendment	Date of A.I.D. Disburse-ments	Due Date for Sub-mission of Transactions	Amount of A.I.D. Disburse-ments	Amount of Attributions Approved	Amount of Attributions Lacking
2 & 3	07/01/82	01/01/84	$ 25,000,000	$21,566,878	$3,433,122
4	09/28/82	03/28/84	75,000,000	73,390,211	1,609,789
			$100,000,000	$94,957,089	$5,042,911 2/

2/ The value of transactions previously disallowed ($5,380,135) had exceeded the value of transactions needed to fully attribute AID disbursements ($5,042,911) because prior approvals before disallowances exceeded the amount disbursed.

The Grant Agreement and Implementation Letters required the Central Bank to present transactions to the USAID for final attribution not later than 18 months after the date of each disbursement. These attribution deadlines were initially met by the Central Bank. However, disbursements under Amendments 2, 3 and 4 have not been fully attributed because the USAID disallowed $5,380,135 in transactions per Implementation Letter No. 24, dated April 19, 1984. Implementation Letter No. 24 also gave the Central Bank 60 days to submit substitute transactions. Implementation Letter No. 25 extended this deadline to October 19, 1984. However, the Central Bank had not submitted substitute transactions as of December 31, 1984 because it had overlooked the matter and the USAID had not followed up to ensure compliance.

3. Required Documents Supporting Many Import Transactions Approved by USAID/El Salvador Could Not Be Found in Central Bank Files

At the time of our review USAID/El Salvador had accepted $115.5 million in import transactions from the Government of El Salvador (GOES) for final attribution to grant disbursements. Our review showed that documentation necessary to support many of the transactions was not available in Central Bank files. However, this does not mean that the documentation was not available at the time of attribution. AID implementation letters specified the documentation required to support each transaction for final attribution. Because Central Bank filing and documentation procedures were not adequate, our sample of 79 transactions attributed to the $75 million AID disbursement under Amendment No. 4 disclosed that 83.5 percent of the 5116 transactions probably were not supported by all of the required documentation in Central Bank files (of the transactions we sampled, the Central Bank did not have files for 36.7 percent of the transactions and the documentation was not complete for 46.8 percent).

Recommendation No. 3

We recommend that USAID/El Salvador obtain evidence from the Central Bank that :

a) the required documentation exists to support the final attribution of AID's $75 million disbursement under Amendment No. 4 to the grant agreement.

b) written filing procedures have been established to maintain the required documentation for each transaction.

Action Taken by USAID/El Salvador to Close Recommendation No. 3

This recommendation is considered closed upon publication of this report because of corrective actions taken by USAID/El Salvador on our audit findings and draft audit report. The Arthur Young & Co.'s eligibility review of transaction files in the Central Bank (first mentioned on page 9 of this report) also included a review to determine the eligibility of the documentation. The Arthur Young and Co. report dated August 15, 1985 contained a listing of 2287 transactions for $75,003,825 deemed eligible for attribution to Amendment No. 4.

Arthur Young and Co. used documentation criteria that were different than those used by the AID auditors. On June 5, 1985 (after we finished our review but before Arthur Young and Co. started theirs) USAID/El Salvador issued Implementation letter No. 32 to reduce the number of documents required to support a transaction retroactive to Amendment 3, dated June 15, 1982.

On August 13, 1985 the Central Bank established written procedures for the filing and documentation of import transactions attributed to AID financing.

Discussion

Implementation Letter No. 5 dated June 26, 1982 required the Central Bank to maintain a separate file for each import transaction. The files were to contain the following documentation in order to make the transactions eligible for final attribution:

1. Letter of Credit Transactions

   Application for Foreign Exchange "Form 15"
   Letter of Credit
   Commercial Invoice
   Bill of Lading or Airweigh Bill
   Import Certificate

2. Supplier Credit Transactions

   Same as above except evidence of payment by the Central Bank to supplier instead of a letter of credit.

We randomly sampled 79 transactions from the universe of 5116 transactions approved for attribution under Amendment No. 4 to the Grant Agreement. We found tha 83.5 percent 3/ of the sampled transactions were not supported in Central Bank files as required (see Exhibit 1). The Central Bank did not have files for 29 transactions (36.7 percent). Of the 50 files found, 13 were for letter-of-credit transactions. Those files contained the required documentation. The remaining 37 files found were for supplier credit transactions (46.8 percent of the sample). The latter did not contain the following required documents:

Name of Document	No. of Transactions	Percent
Commercial Invoice	1	2.7
Bill of Lading	7	18.9
Import Certificate	28	75.7
Evidence of Payment	37	100.0

During our visits to the 79 importers, we found most of the documentation that was missing from Central Bank files. Detailed information on the results of our sample is presented in Exhibit 1 to this report.

3/ Since we conducted an attribute sample, it can only be used to project the number of transactions not complying with criteria. It can not be used to project dollar values. To illustrate, 65.8 percent of the transactions in the sample were supplier credit transactions but they represented only 30.4 percent of the value of all transactions in the sample.

The files maintained by the Central Bank did not contain the required documentation because of inadequate filing procedures. Also the USAID accepted incomplete transactions for attribution for which the documentation was not yet available.

Central Bank filing procedures for transactions submitted to the USAID for attribution in 1984 under Amendments 5, 6 and 7 of the grant agreement now appear adequate. We sampled 15 of these transactions and found that the files contained all of the required documentation except evidence of payment for supplier credit transactions. However, we discovered that the Central Bank does not have written filing procedures. We suggest that such procedures be established in writing to avoid any future problems.

The USAID commented that it believed past documentation requirements had been unrealistic and that they plan to reduce the requirements to the minimum necessary to provide adequate information to ascertain that transactions have been completed and paid and meet all eligibility requirements.

4. Many Import Transactions Approved by USAID/El Salvador Did Not Qualify for Attribution

USAID/El Salvador had accepted $115.5 million in transactions for final attribution to grant disbursements to the Government of El Salvador (GOES). However, our review of the last $75 million accepted by the USAID disclosed that many import transactions, even though they were supported by the required documentation, failed to qualify for attribution. The grant agreement and AID implementation letters set forth specific criteria for import transactions to qualify for attribution, such as source, origin, date of importation, merchandise categories and type of industry.

Both Central Bank procedures for reviewing import transactions and USAID/El Salvador procedures for reviewing and approving attributions were inadequate or in some cases non-existent. Our review of approved transactions demonstrated that some transactions were: (1) for ineligible commodities and industries, (2) approved twice, (3) applicable to ineligible import periods. (4) not accepted at the required FOB values, (5) incomplete, 4/ or (6) of ineligible source and/or origin.

The weaknesses in the procedures used by the Central Bank to select transactions for attribution are addressed later in this report. However, procedures have now changed and conditions at the Central Bank are different than those described in this finding.

Recommendation No. 4

We recommend that USAID/El Salvador:

a) obtain evidence from the Central Bank attesting to the fact that it has reviewed the transactions approved for AID's disbursement of $75 million under Amendment No. 4 to the grant agreement so as to ensure that the transactions were: (1) for eligible commodities and industrial subsectors, (2) financed by the Central Bank, (3) applied to the eligible import period, (4) accepted at FOB values, (5) not duplicate, and (6) in compliance with AID source and origin requirements. (Any transactions that do not meet these criteria should be disallowed by the USAID and eligible transactions should be substituted for them.)

b) define the criteria for eligible commodities and industrial subsectors and obtain from the Central Bank evidence that it has implemented procedures to use those

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4/ These transactions were accepted by the USAID for final attribution but should only have been accepted on a preliminary basis.

definitions to record the commodity and industrial subsector classification on a source document such as the Import Permit Application "Form 10".

c) approve only completed transactions for attribution.

d) clearly define criteria for classifying transactions by eligible import periods.

e) obtain evidence from the Central Bank that it has instituted a procedure to obtain evidence of payment from commercial banks for supplier credit transactions.

f) disallow two transactions for a total of $45,941.78 approved twice per Implementation Letter No. 19 and obtain eligible substitutes.

Action Taken by USAID/El Salvador to Close Recommendation No. 4

All parts of this recommendation, (a) through (f), are closed upon the publication of this report because of corrective actions taken by USAID/El Salvador on our audit findings and the draft audit report.

Part (a) - The Arthur Young & Co. review of transactions on file at the Central Bank determined the eligibility of enough transactions to support the $75 million disbursed under Amendment No. 4 to the Grant Agreement (see page 9).

Arthur Young & Co. used some eligibility criteria that were different than those used by the AID auditors. On June 5, 1985 (after we finished our review but before Arthur Young and Co. started theirs) USAID/El Salvador issued Implementation letter No. 32 to change some of the eligibility criteria retroactive to Amendment 3. The U.S. origin requirement was eliminated and transactions were allowed to be attributed at CIF value. This increased the number and value of transactions available for attribution.

Part (b) - The implementation of the computerized selection system which will use the Tariff Codes (NAUCA) and Industrial Use Codes (CIIU) to select eligible transactions by commodity and private sub-sectors should help to correct this problem.

Part (c) - On June 5, 1985 the USAID issued Implementation Letter No. 32 requiring evidence that the transaction has been completed prior to attribution.

Part (d) - On June 5, 1985 the USAID issued Implementation Letter No. 32 to clearly define the criteria for classifying transactions by eligible import period. The letter stated that the date which determines whether a particular transaction may be attributed to a particular Amendment, will be the date on which the Form 15 application was approved, or the date of the Import Certificate.

Part (e) - On June 5, 1985, the USAID issued Implementation Letter No. 32 which replaced the attribution criteria set forth in early letters retroactive to Amendment No. 3. The new implementation letter did not specify any evidence of payment requirements except to state:

> As noted in AID's letter of December 14, 1983 to BCR President Benitez, the issuance of Form 15 is to be construed as an irrevocable commitment on the part of the BCR to make available to the importer the amount of dollars indicated on the form.

According to Implementation Letter No. 32, Form 15 is one of the documents required in order to attribute a transaction to grant disbursements.

Part (f) - On June 6, 1985, the USAID issued Implementation Letter No. 33 to disallow two transactions for a total of $45,941.78. Eligible substitutes were obtained as part of the Arthur Young & Co. review (see Part (a) above).

Criteria and Procedures to Identify Eligible Commodities and Industrial Subsectors were Lacking

Some ineligible imports were attributed to AID financing because the criteria used for identifying eligible commodities and industrial subsectors were too general and procedures for selecting transactions were not adequate. As a result, our sample of 79 of the 5116 transactions attributed to the $75 million AID disbursement under Amendment No. 4 disclosed that probably eight percent of all the transactions did not apply to the eligible commodities or industrial subsectors to benefit by the program (see Exhibit 1).

Due to El Salvador's civil strife, essential commodities necessary to maintain commerce and enhance economic growth have become scarce. To alleviate this condition, the USG has provided financial assistance for the importation of necessary goods. These imports should be of a nature which will keep factories and farms operating and consumers supplied with essential goods. Basic items should be emphasized, such as raw materials, intermediate and capital goods for the private sector. Conversely, recreational and other luxury imports should be minimized.

Criteria established by the USAID to identify eligible imports for commodities and industries were broad and not definitive in nature. The commodity criteria included: raw material, intermediate goods, agricultural inputs, capital goods and spare parts of the Salvadoran private sector. The private sub-sector industries were manufacturing, agro-industrial, commerce, transportation and energy. These criteria are very general in nature and have not been refined for the employees selecting transactions for attribution to AID financing. This has led to varying interpretations as to the eligibility of commodities and industries. In addition, the prime document for approving the import transaction "Form 10" did not have spaces for recording all types of commodity and industrial subsector categories under this program. The current "Form 10" has been modified to include the use of the Uniform International Industrial Code.

Using statistical sampling techniques, we identified 6 (8 percent) of 79 AID financed transactions which we considered ineligible.

	Commodity	Usage	Reason Ineligible
1)	Spare parts for radio transmitter equipment. (Sample No. 11).	To repair equipment for a radio station.	Spare parts were imported by a radio station which was not one of the allowable industrial subsectors.
2)	Prescription contact lenses (Sample No. 34).	Retail Sales.	Contact lenses were a finished product which was not one of the allowable commodity categories.
3)	Circuit Brakers, Fuses, Tubes and Photo Cells. (Sample No. 39).	To repair cinema equipment.	Spare parts were imported by a public sector institution (Circuito de Teatro Nacional) which was not one of the allowable industrial subsectors.
4)	Spare parts for radio transmitter equipment (Sample No. 44).	To repair equipment for a radio station.	Spare parts were imported by a radio station which was not one of the allowable industrial subsectors.
5)	Pharmaceutical/Ophthalmic Products (Sample No. 74).	Wholesale/Retail Sales	These pharmaceuticals are considered a finished product which was not one of the allowable commodity categories.
6)	Medicines (Sample No. 79).	Wholesale/Retail Sales	Medicines were a finished product which was not one of the allowable commodity categories.

In order to maintain the integrity of the Economic Support Fund, better controls should be established to identify the commodities and industries that would be eligible for attribution to AID financing. We consequently believe that the commodity and industrial subsector criteria should be refined and that those refinements should be used to classify the transaction of a source document such as the Import Permit Application "Form 10".

USAID/El Salvador Comments

Transactions No. 11 and 44 were rejected by the auditors because they considered a commercial radio station to be outside the eligible subsectors. In our opinion, privately owned radio stations are part of the commercial sector in a free enterprise economy and are thus eligible under the criteria. Moreover, replacement parts of electronic equipment are commodities reasonably included in the program.

Office of Inspector General Response

We do not agree that a radio station is part of the commercial subsector. Webster's New Collegiate Dictionary defines commerce as "the exchange or buying and selling of commodities on a large scale involving transportation from place to place".

Since a radio station is not involved in the buying and selling of commodities, we did not classify it as part of the commerce or commercial subsector. This illustrates the need to define the private subsector categories to minimize differences of opinion as to what types of businesses fall into the different private subsectors.

USAID/El Salvador Comments

The USAID believes that the existing categories and sectors are an appropriate level of definition to permit accomplishment of project objectives.... Moreover, the new computer selection process of the Central Bank will assist in assuring that transactions selected fall within the established categories. The system uses the International Tariff Code (NAUCA) and Industrial Use Code (CIIU) to assist in identifying eligible transactions. Physical review of some of the documentation will still be required to assure eligibility. The NAUCA code has been used in the BCR since 1980; the CIIU code since 1984.

Office of Inspector General Response

We believe the existing commodities and sub-sector categories are adequate. However, as illustrated above, these categories need to be better defined to minimize differences in interpretation. The NAUCA and CIIU codes were not used by the employees of the Central Bank to classify the transactions we sampled. We agree that the action being taken to computerize the selection process using the NAUCA and CIIU codes to classify transactions will help to correct the problem (see page 18).

USAID/El Salvador Comments

While the mission agrees to some refinement in the procedure for the application of appropriate NAUCA and CIIU codes to assist in determining product eligibility, it maintains that a flexible interpretation is required and final decisions must be based on a direct review of the documents involved.

Office of Inspector General Response

We agree with the USAID comments above except we do not believe that a flexible interpretation is required. Differences of opinion on how to classify commodities and private subsectors should be minimized to avoid adverse publicity.

Incomplete Transactions Accepted for Final Attribution

Incomplete transactions were accepted for final attribution because the USAID had not applied established criteria in approving transactions. As a result there is no assurance that all grant disbursements have been used as intended.

The USAID accepted two types of transactions for final attribution. One type was financed by a letter of credit. Under this procedure, the importer's commercial bank applies for foreign exchange at the Central Bank to finance the proposed transaction. After the Central Bank approves the importer's Application for Foreign Exchange "Form 15", the importer's commercial bank opens a letter of credit through a U.S. bank payable to the U.S. exporter (supplier). The U.S. exporter is generally paid by the U.S. bank under the letter of credit after the goods are shipped.

The other type of transaction was financed by supplier credit. Under this procedure, the goods are sold by the U.S. supplier (exporter) to the Salvadoran importer on credit. After the goods are shipped to El Salvador and cleared through customs, the importer's commercial bank applies for foreign exchange at the Central Bank. After the Central Bank approves the Application for Foreign Exchange "Form 15", the Central Bank disburses dollars to the commercial bank and the U.S. supplier is paid.

Only completed transactions were to be accepted for final attribution. Implementation Letter No. 5 defines a completed transaction as one where the goods have arrived in El Salvador and have been cleared through customs. In the case of supplier credit transactions, the USAID also required the Central Bank to present evidence of payment prior to final attribution.

Implementation Letter No. 19 stated that the cumulative value of transactions approved for final attribution under Amendment No. 4 of the grant agreement was $75,942,946. As shown below, this amount included $37,039,014 of incomplete transactions (those that should have received preliminary AID approval only). The acceptance of incomplete (preliminary) transactions for final attribution is contrary to the established criteria.

Letter of Credit Transactions		
Annex D	$12,072,285	
Annex E	3,817,064	$15,889,349
Supplier Credit Transactions		
Annex G	$17,323,849	
Annex H	3,825,816	$21,149,665
TOTAL		$37,039,014

The letter of credit transactions were accepted based only on the approval of the Application for Foreign Exchange "Form 15" before the goods had arrived in El Salvador and cleared customs. The risk of accepting incomplete transactions for final attribution lies in the possibility that the importer may never use the approved foreign exchange allocation to import the goods. Our sample of 79 transactions attributed to Amendment No. 4 (5116 transactions) disclosed that this probably happened in 2.5 percent of the transactions (see Exhibit 1).

The supplier credit transactions were accepted for final attribution by the USAID before the Central Bank had presented evidence that the transaction had been paid, even though such evidence was required by Implementation Letter No. 22. Our sample of transactions under Amendment No. 4 confirmed that no evidence of payment existed in any of the supplier credit files which we reviewed at the Central Bank. To obtain such evidence the Central Bank should establish a procedure to obtain this information from the commercial banks. The inherent hazard in accepting supplier credit transactions prior to obtaining evidence of payment is that the U.S. supplier may never be paid. Our sample of 79 transactions under Amendment No. 4 disclosed that this probably happened in 2.5 percent of the transactions (see Exhibit 1).

To correct these problems, we believe that: (1) the USAID should only approve completed transactions for attribution; (2) the USAID and the Central Bank should review the $37,039,014 of incomplete transactions accepted for final attribution and disallow any transactions that do not comply with established criteria; and (3) the Central Bank should establish a procedure to obtain evidence of payment from the commercial banks for supplier credit transactions.

The USAID stated they are planning to authorize preliminary attribution of incomplete letter of credit transactions in order to control at an early stage the source and value of transactions to ensure compliance with program requirements. We believe this procedure is not efficient because it has created many of the attribution problems discussed in this finding. A complex accounting system would be needed to track each transaction from its preliminary to final attribution stage in order to avoid duplication of transactions.

Also, under current procedures, the USAID, the Central Bank and the Superintendent of Banks would have to review each transaction twice (first for preliminary attribution and again for final attribution). To avoid this duplication of effort, the USAID should establish a realistic attribution period. If this is done, transactions would only have to be submitted once for final attribution, thus eliminating the need for preliminary attribution.

Transactions Attributed to Ineligible Import Periods

Many import transactions have been attributed to ineligible import periods because eligibility criteria were only vaguely defined and not applied by the USAID and the Central Bank in segregating transactions by eligible import periods. As a result, the Central Bank may not have made available an amount of foreign exchange equal to each disbursement within the eligible import periods.

The amended grant agreement provided that over a period of 12 months from the date of each disbursement under the grant agreement, the GOES would make available an equal amount of foreign exchange for the importation of goods from the United States.

The criteria for determining the eligible import period of a transaction has never been clearly defined. The USAID told us that if the commodities arrived in El Salvador (date of import certificate) or the Application for Foreign Exchange "Form 15" was approved during the 12-month period following each disbursement, then the transaction would be eligible for attribution to that period.

Implementation Letter No. 5, dated June 26, 1982, made reference to one of these criteria. It stated that the foreign exchange made available under Amendments 2 and 3 of the grant was to be used for payment due on eligible goods that arrived in El Salvador after the date of Amendment No. 2. Also, Implementation Letter No. 24 stated, when requesting substitute transactions for disallowed ones, that the substitute transactions were to be completed prior to the end of the eligible import period. Implementation Letter No. 5, dated June 26, 1982, defined a completed transaction as one in which the goods had arrived in El Salvador and been cleared through customs.

We found two examples where transactions were attributed to ineligible import periods.

First, we found that 27.8 percent of the 79 sampled transactions approved under Amendment No. 4 did not fall within the eligible import period. We classified the transactions as ineligible if the goods had not arrived or the Application for Foreign Exchange had not been approved during the eligible import period (see Exhibit 1).

Second, the USAID carried over attributions approved in excess of requirements from one disbursement to another even though they were not eligible for carryover. This happened when the USAID approved attributions for disbursements under Amendments 2 and 3 to the Grant Agreement. The cumulative value of transactions approved for final attribution under Amendments 2 and 3 was $26,508,384. The USAID attributed $20,605,721 to the original disbursement of $20 million made on December 19, 1980. However, the USAID carried over $605,721 of the excess attributions from the original disbursement and included it in the $26,508,384.41. The eligible import period under the amended Grant Agreement for Amendments 2 and 3 was from July 1, 1982 to June 30, 1983.

We question if any of the transactions from the original disbursements could be applied to Amendments 2 and 3 since the last of the transactions from the original disbursement were approved as completed by the USAID on October 1, 1981 or almost one year before the start of the eligible import period under Amendments 2 and 3. We could not verify this because we could not find in USAID or Central Bank files a listing of the transactions approved for the original disbursements. The Superintendent of Banks had not certified any of these transactions. In calculating the attributions still lacking under Amendments 2 and 3 on page 10 of this report, we have disallowed the ineligible carryover of $605,721.

To correct these problems, we believe that (1) the USAID should issue an Implementation Letter to clearly define criteria for classifying transactions by eligible import periods; (2) the USAID should not carryover attributions approved in excess of requirements from one disbursement to another if the attributions do not meet the eligibility requirements of the carryover import period; (3) the USAID and the Central Bank should analyze the transactions attributed to the AID disbursement under Amendment No. 4 to ensure that they fall within the eligible import period and disallow any ineligible transactions; and (4) obtain eligible substitute transactions for any disallowed, as suggested above.

Transactions Attributed Twice

The Central Bank has submitted some transactions to the USAID for attribution twice because the Central Bank had not established procedures to identify duplicate transactions. Some of these duplicate transactions were approved by the USAID. As a result, grant disbursements were not fully supported by eligible transactions.

USAID/Controller reviews disclosed the following:

- In January 1984, the Controller found that the USAID had approved 42 transactions for a total of $4,419,297 twice - first under Implementation Letter No. 10 dated March 18, 1983 and later under Implementation Letter No. 14 dated June 2, 1983. The USAID disallowed the duplicate transactions under Implementation Letter No. 24 dated April 19, 1984.

- The Controller found in June 1984 that the USAID had approved two transactions for a total of $45,941.78 twice. They were both listed in Annex A to Implementation Letter No. 19. The USAID had not taken action to disallow these duplicate transactions as of December 31, 1984.

Transaction No.	Amount
216/83	$ 2,000.00
1241/82	43,941.78
	$45,941.78

- In February 1984, the Superintendent of Banks advised the USAID that the Central Bank had resubmitted 226 transactions for a total of $7,739,847.63 that had been previously certified. The Controller reviewed some of these transactions in June 1984 and found that the Central Bank submitted 66 transactions twice for a total of $1,221,404. The transactions were first submitted and approved by the USAID in Annexes D and E of Implementation Letter No. 19 dated October 19, 1983. They were resubmitted by the Central Bank in February 1984 but were not approved because the USAID Controller identified the duplication. The Central Bank submitted duplicate transaction to the USAID mainly because they had not established procedures for identifying duplicate transactions. This generally occurred when the Central Bank submitted incomplete (preliminary) transactions to the USAID for approval and resubmitted these transactions again after completion.

To correct this problem, we believe the USAID should disallow the two transactions for a total of $45,941.78 approved twice in Implementation Letter No. 19.

Transactions Attributed to Ineligible Source and Origin

Some import transactions have been attributed to ineligible source and origin because the Central Bank had not adequately applied eligibility criteria in selecting transactions for attribution. As a result, there is no assurance that all AID grant disbursements have been used as intended.

The Grant Agreement provided that imports should be from the United States for use by the private sector. Implementation Letter No. 22, dated March 21, 1984, established an additional requirement that the origin of imported goods to be attributed to Amendment No. 4 should be from the United States. The USAID plans to eliminate the U.S. origin requirement for transactions to be attributed to AID disbursements retroactive to Amendment No. 3.

Our sample of the 79 transactions attributed to the AID disbursement of \$75 million under Amendment No. 4 disclosed that some transactions did not meet these requirements. We found that 2.5 percent of the sampled transactions were not of U.S. source and 2.5 percent were not of U.S. origin (see Exhibit 1).

Selective reviews done by the USAID/Controller's Office also confirmed that the source and origin requirements were not fully met. The transactions identified to be ineligible as a result of the Controller's review were disallowed under Implementation Letter No. 24.

We believe that the USAID and the Central Bank should review the transactions approved under Amendment No. 4 of the Grant Agreement to ensure compliance with these requirements and disallow any ineligible transactions.

USAID/El Salvador Comments

USAID/El Salvador maintains that based on a GC opinion dated April 16, 1984 and the language of the Authorization for the project, origin is not a criteria in determining eligibility. While operating on this assumption for some time, on June 5, 1985 in Implementation Letter No. 32 the Mission formally clarified this position retroactive to Amendment No. 3.

Office of Inspector General Response

Our review of the eligibility of transactions was based on the source and origin criteria in effect when we did the review. These were the same criteria used by the USAID/El Salvador Controller's Office and the Superintendent of Banks in their reviews. Implementation Letter No. 32, which retroactively eliminated the U.S. origin requirement, was issued after we completed our review.

Transactions Were Not Accepted at FOB Values

Some transactions were not accepted for attribution at FOB 5/ values as required by AID Implementation Letters. This happened mainly because the USAID accepted transactions at CIF 6/ values for attribution before they were completed and FOB values were known. As a result, the amounts attributed to AID financing were overstated.

Our sample of 79 transactions attributed to the AID disbursement of \$75 million under Amendment No. 4 disclosed that 19 percent of the sampled transactions were not attributed at FOB values. This occurred mainly because the USAID accepted incomplete transactions (those that should have only been approved on a preliminary basis) for final attribution in Annexes D and E of Implementation Letter no. 19. To avoid this problem the USAID should only

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5/ FOB = Cost of goods at port of export.
6/ CIF = Cost of goods at port of import, which includes insurance and freight.

approve completed transactions where FOB values are known or, if not known, estimate the FOB value using the procedure established in Implementation Letter No. 22.

USAID/Controller reviews also disclosed that transactions were not accepted at FOB values.

We believe the Central Bank should review the transactions attributed to the $75 million disbursement under Amendment No. 4 and adjust the amounts erroneously attributed at CIF values to FOB values; also the USAID should only accept completed transactions for attribution where FOB values are known or estimate the FOB values using established procedures.

USAID/El Salvador Comments

USAID/El Salvador disagrees with attribution of only FOB values. The full value of U.S. Dollars made available, including insurance and freight, should be used in calculating the value of eligible transactions.

Office of Inspector General Comments

Our eligibility review as well as those made by the Controller's Office of USAID/El Salvador and the Superintendent of Banks has based on the FOB requirements in effect when the reviews were made. On June 5, 1985, after we completed our review, the USAID issued Implementation Letter No. 32 to retroactively authorize the use of CIF values.

5. Transactions Were Not Adequately Certified by the Superintendent of Banks

Because of a lack of proper controls, the USAID accepted many transactions for final attribution which either were not certified by the Superintendent of Banks or were certified but not based on a review of all the eligibility criteria. AID implementation letters set forth the responsibilities of the Superintendent of Banks and the eligibility criteria.

Many transactions were approved but not certified by the Superintendent because the USAID accepted incomplete (preliminary) transactions and the Superintendent only certified completed transactions. The certifications of the Superintendent did not cover a review of all the eligibility criteria because the responsibilities of the Superintendent were not clearly defined in AID implementation letters. As a result of these certification deficiencies, controls to ensure proper eligibility were not established and the USAID cannot be assured that the transactions accepted for attribution are eligible under the terms of the program.

Recommendation No. 5

We recommend that USAID/El Salvador:

a) obtain the certification of the Superintendent of Banks for uncertified transactions attributed to the AID disbursement under Amendment No. 4 and disallow any transactions that cannot be certified.

b) issue a revised implementation letter to clearly define the certification responsibilities of the Superintendent of Banks to ensure the Superintendent certifies transactions against all eligibility criteria (this can be done by including a list of the eligibility criteria in the Superintendent's statement of responsibility).

Action Taken by USAID/El Salvador to Close Recommendation No. 5

Both parts of this recommendation are closed upon the publication of this report because of corrective actions taken by USAID/El Salvador on our audit findings and draft audit report.

Part (a) - The Arthur Young & Co. report on its review of import transactions to support the AID disbursement under Amendment 4 of the Grant Agreement contained a certification as to the eligibility of the transactions. USAID/El Salvador believes, and we agree, that under these circumstances a certification by the Superintendent of Banks would be superfluous.

Part (b) - On June 5, 1985 USAID/El Salvador issued Implementation Letter No. 32 which clarified the eligibility criteria and procedures to be used by the Superintendent of Banks in certifying transactions.

Background

Implementation Letter No. 5 dated June 26, 1982, provided that the Superintendent of Banks submit a certified report of completed import transactions to the USAID. A completed transaction was defined as one where the merchandise has arrived in El Salvador and been cleared through customs. The certification was to contain an explanation of those transactions for which there was a discrepancy between the amount of foreign exchange and the quantity or type of goods received in the country, as shown in the various transaction documents such as the application for Foreign Exchange, the Letter of Credit or customs documentation.

On March 21, 1984 Implementation Letter No. 22 changed the certification procedures to also require the Superintendent of Banks to certify the report of transactions submitted by the Central Bank to the USAID by affixing his seal to each page of the Central Bank report.

Transactions Not Certified by Superintendent of Banks

Many transactions were approved for final attribution by the USAID without the required certification of the Superintendent of Banks. This happened mainly because the USAID accepted incomplete (preliminary) transactions for attribution and the Superintendent of Banks only certified completed transactions. As a result, some of the transactions attributed were ineligible and the amounts attributed to others were not correct.

The Superintendent of Banks had certified $35,547,679 of transactions approved by the USAID for final attribution to the $75 million disbursed under Amendment No. 4, leaving $39,452,321 of transactions uncertified. This happened because the Central Bank submitted many incomplete (preliminary) transactions to the USAID for approval and did not ask the Superintendent to certify the transactions.

To correct this problem, we believe the USAID should obtain the certification of the Superintendent of Banks for uncertified transactions attributed to the AID disbursement under Amendment No. 4 and disallow any transactions that cannot be certified.

Certifications by Superintendent of Banks Do Not Cover All Eligibility Criteria

The certification by the Superintendent of Banks of transactions submitted for attribution did not cover all of AID's eligibility criteria because the responsibilities of the Superintendent were not clearly defined in AID implementation letters. Consequently, the USAID cannot be assured that the certified transactions are eligible for attribution under the terms of the program.

We believe that the certification responsibilities of the Superintendent as defined in AID implementation letters is too general to ensure AID that transactions are eligible in accordance with established criteria. We have compared the established eligibility criteria with those included in the Superintendent's certification reviews. This comparison showed that the Superintendent has not included in his reviews the eligibility of transactions by import period. As a result, we found that 27.8 percent of our sample of transactions attributed to the $75 million disbursement under Amendment No. 4 did not fall within the eligible import period (see Exhibit 1).

The Superintendent also made some errors in other areas because:

- he lacked time and personnel to do the certifications;

- some of the eligibility criteria were too general;

- many documents in Central Bank files were copies thus creating the possibility of duplicate certifications;

- the Central Bank had not promptly sent copies of AID Implementation Letters to the Superintendent. For example, the USAID had issued 28 Implementation Letters as of February 13, 1985 but the Superintendent had received only 22.

The certification of the Superintendent of Banks did not cover all of AID's eligibility criteria because the responsibilities of the Superintendent had not been clearly defined in AID Implementation Letters. Consequently, the USAID cannot be assured that the certified transactions are eligible for attribution under the terms of the program.

To correct this problem we believe the USAID should issue a revised Implementation Letter to clearly define the certification responsibilities of the Superintendent of Banks to ensure that the transactions are reviewed against all established criteria. This can be corrected by including a list of the eligibility criteria in the statement of the Superintendent's certification responsibilities.

The USAID said they are considering eliminating this certification requirement for future disbursements once a computerized system has been established for selecting transactions for attribution (see page 30 of this report).

6. Procedures for Selecting Transactions for Attribution Were Not Adequate

Many ineligible transactions were selected for attribution to AID disbursements in 1982 and 1983 because, as noted previously, Central Bank selection procedures were not adequate. The AID grant agreement and implementation letters set forth criteria for determining the eligibility of transactions. The Central Bank modified its selection procedures in late 1983 to input information on import transactions in its computer files. Changing from a manual to a computerized selection system should greatly reduce the number of ineligible transactions selected for attribution. However, a computerized process for selecting transactions for attribution had not yet been established.

Recommendation No. 6

We recommend that USAID/El Salvador verify that the Central Bank has installed a computerized selection system for attribution of import transactions to AID financing.

Action Taken by USAID/El Salvador on Audit Recommendation

Recommendation No. 6 is to be considered resolved on the publication of this report because Arthur Young & Co. under a contract with USAID/El Salvador are providing technical assistance to the Central Bank to develop, among other things, a computerized selection system by August 1985. We plan to perform a follow-up review in the not-too-distant future to verify that this system is operating effectively.

Discussion

Current Central Bank procedures for selecting transactions for attribution are as follows:

- The Department of Exterior selects the letter of credit transactions for attribution and the Department of Exchange Control selects the supplier credit transactions.

- These two departments submit a report of selected transactions to the Data Processing Department.

- The Data Processing Department inputs the data into an AID data base file and prints a listing of the transactions reported

We believe that the current role of the Data Processing Department is too limited to ensure the accurate selection of eligible transactions. Currently the process of selecting transactions is not computerized. The Data Processing Department simply transcribes transactions selected by other departments. However, the Data Processing Department has designed and incorporated into the AID data base most of the elements (fields) that would be needed to establish a computerized selection system. In addition the Data Processing Department could access the Central Bank's main data base for all import transactions to supplement needed information not included in the AID data base. Therefore, the change from a manual to a mechanized selection system could be made without having to make a big investment in time and resources.

The AID data base now being used has most of the fields needed for a mechanized selection system. However, there is no data in some of the fields. The status of these fields is as follows:

Criterion	Field Exists	Field is Used
Source	Yes	Yes
Origin	No	No
Date of Arrival	Yes	Yes
FOB Value	Yes	Yes
Date of Payment	Yes	Yes
Type of Industry	No	No
Type of Commodity (raw material, agriculture, etc.) 7/	Yes	Yes
NAUCA Code 8/	Yes	Yes
Type of Payment, (total, partial or last)	Yes	No
Transaction Certified	Yes	No
Transaction Reported to USAID for Attribution	Yes	No
Data of "Form 15" Approval 9/	No	No

To develop a computerized selection system the Data Processing Department must determine:

- what information is needed;
- what source documents can be used for obtaining information needed;
- changes necessary in source documents;
- how files should be modified so they can contain required information;

7/ Will be modified to make more specific.

8/ Nomenclatura Arancelaria Uniforme Centroamericana (Uniform Central American Tariff Code).

9/ Field for letter-of-credit transactions exists but not for supplier credit transactions.

software needed to: (i) capture information, (ii) determine which transactions meet attribution criteria (eligible import period, source, etc.), (iii) eliminate the selection of duplicate transactions, and (iv) carry out any other required processing.

In 1984 the Central Bank submitted $126.4 million in import transactions to the USAID for attribution using the selection procedures described in this finding. To verify the eligibility of the transactions selected, the USAID contracted with Peat, Marwick and Mitchell. To assist the contractor in the analysis of the transactions, the Central Bank computer was used to identify and eliminate duplicate transactions.

B. P.L. 480 and ESF Local Currencies

1. Interest Earned and Sales Proceeds Retained from the Sale of P.L. 480 Title I and II Commodities

The banks that sell P.L. 480 Title I commodities on behalf of the GOES were allowed to retain interest earned on credit sales and to accumulate and use sales proceeds at zero interest cost. This is contrary to sound business practices since it prevents SETEFE 10/ from earning interest on these funds. This situation arose because these matters were not adequately covered in the sales agreements between the GOES and the banks. We also found that the Institute of Food Regulation (IRA) had retained proceeds from the sale of Title II commodities and that the Agricultural Development Bank had authorized credit sales exceeding 180 days. Both actions were contrary to their sales agreements with the GOES. As a result, the banks and IRA have made unearned profits, and the interest earned on credit sales had not been programmed and controlled. Also, the local currency projects financed by the sales proceeds could be delayed due to a shortage of funds in the special accounts.

Recommendation No. 7

We recommend that USAID/El Salvador:

a) obtain evidence from the GOES that its sales agreements with the Agricultural Development Bank and the Mortgage Bank have been modified to require the deposit into the special account within a specified number of days after generation of: (1) sales proceeds and (2) any interest earned on credit sales (less a reasonable administrative fee).

b) ensure that SETEFE obtains from the Mortgage Bank the $9.4 million sales proceeds retained since September 1984.

c) obtain evidence that SETEFE has established a procedure to verify that the Agricultural Development Bank, the Mortgage Bank and the Institute of Food Regulation deposit their sales proceeds and interest earned into the special accounts when required by their sales agreements and comply with the credit provisions of their agreements.

10/ SETEFE, the Technical Secretariat for External Financing, was established in 1983 to manage funds received from foreign donors.

Actions Taken by USAID on Audit Recommendations

All parts of this recommendation are closed upon publication of this report because of corrective actions taken by USAID/El Salvador and the Government of El Salvador.

Part (a) - The Government of El Salvador signed new sales agreements with the banks in August 1985 that will allow SETEFE to charge 7 percent interest on sales proceeds held by the banks. In addition to the above, SETEFE can deposit the sales proceeds and interest earnings received from the banks into interest-bearing commercial accounts until such funds are needed for program purposes. While this procedure is not exactly what we recommended, it satisfies the intent of our recommendation to provide more income to SETEFE for program purposes and eliminate the unearned profits for the banks.

Part (b) - SETEFE obtained $9.1 million of the sales proceeds retained from the Mortgage Bank in April 1985.

Part (c) - In a letter dated July 24, 1985, SETEFE informed USAID/El Salvador that they have set-up a special unit to monitor bank compliance with its sales agreements.

Background

The GOES entered into sales agreements with the Agricultural Development Bank and the Mortgage Bank (GOES owned banks) to sell P.L. 480 Title I commodities. These agreements provide that the sales proceeds be deposited into a special account whenever requested by SETEFE. The sales proceeds are jointly programmed by SETEFE and the USAID for development activities such as separate GOES projects and as counterpart for AID and other donor projects. The sales agreements provide that the P.L. 480 Title I commodities can be sold by the banks on credit for up to 180 days. They also provide that banks should charge the market rate of interest on credit sales. The agreements in effect allow the banks to retain all interest earned on credit sales since they are silent as to which institutions are entitled to keep the interest earned.

The GOES has also signed a sales agreement with the Institute of Food Regulation (IRA) to sell P.L. 480 Title II (Section 206) commodities. This agreement as well as the P.L. 480 Title II Memorandum of Understanding requires IRA to deposit the sales proceeds monthly in a special account maintained for this purpose by SETEFE.

Interest Earned on Credit Sales Retained by Agricultural Development Bank

The interest earned by the Agricultural Development Bank on credit sales of P.L. 480 Title I commodities had been retained by the bank because the sales agreement is silent concerning the disposition of interest earnings. This is contrary to sound business practices since the bank had made unearned profits and the interest earned had not been programmed and controlled as are the proceeds from the sale of commodities.

We found that for the year ending December 31, 1984, the Agricultural Development Bank earned the equivalent of $506,000 in interest on credit sales of P.L. 480 commodities. The USAID was aware that the bank had retained the interest but considered it a means to capitalize the bank. It is our opinion that if the USAID and SETEFE believe that the bank needs this money, then it should be deposited into the special account (less a reasonable administration fee) and disbursed to the bank through the established budgetary and control system.

We also found that, although the Mortgage Bank had not made any credit sales using P.L. 480 commodities, its sales agreement is also silent on the disposition of interest earned. We thus believe that this agreement should also be modified to provide for the deposit of interest earned into the special account to avoid potential unearned profits and provide additional resources to finance GOES development activities.

In sum, we believe that the USAID should obtain evidence from the GOES that the sales agreements with the Agricultural Development Bank and the Mortgage Bank have been modified to provide for the deposit of interest earned on credit sales (less a reasonable administrative fee) into the SETEFE special account.

Sales Proceeds Not Promptly Deposited in Special Account by Mortgage Bank and Agricultural Development Bank

The Mortgage Bank and Agricultural Development Bank have not promptly deposited proceeds from the sale of P.L. 480 Title I commodities into the special account because the agreements between the GOES and the banks require that funds be deposited only when requested by SETEFE. This is contrary to sound business practices since the retention of sales proceeds prevents SETEFE from earning interest on these funds. As a result, the Mortgage Bank can use these funds to finance its operations and realize unearned profits. Also, delays in the deposit of sales proceeds to the special account could delay the implementation of project activities financed with P.L. 480 monies.

We found that between September and December 1984, the Mortgage Bank had accumulated and retained about $9.4 million in proceeds from the sale of P.L. 480 commodities. The Mortgage Bank did not promptly deposit the proceeds in the special account because SETEFE did not request any deposits as provided by the sales agreement between the GOES and the bank; also, the agreement does not require that the proceeds be deposited after generation. Consequently, the bank had free use of this money.

We also found the Agricultural Development Bank had retained $7,207,956 in sales proceeds for three months in 1984 (September 1 through November 21, 1984).

We believe the sales agreements between the GOES and the Agricultural Development Bank and the Mortgage Bank should be modified to require the deposit of proceeds into the special account within a specified number of days after the proceeds are generated. We also believe that the USAID should ask SETEFE to obtain from the Mortgage Bank the ¢9.4 million of sales proceeds retained since September 1984.

Sales Proceeds Retained by Institute of Food Regulation

According to a SETEFE financed external audit, the Institute of Food Regulation (IRA) retained $772,795 of proceeds generated from the sale of P.L. 480 Title II (Section 206) commodities from August 9 to November 22, 1984. This was contrary to the IRA agreement with the GOES and the GOES/AID P.L. 480 Title II Memorandum of Understanding which provided that IRA should deposit these proceeds into the special account on a monthly basis. Consequently, IRA was able to use these funds to finance its operations and realize unearned profits. Also the delays in the deposit of the funds to the special account could delay the implementation of projects financed with the Title II monies. During 1984 there was a shortage of funds in the Title II account and it was thus necessary for SETEFE to use Title I monies to finance Title II activities. To ensure that IRA, the Mortgage Bank and the Agricultural Development Bank deposit sales proceeds when required by their agreements, SETEFE should establish a procedure to verify compliance with the agreements.

Agricultural Development Bank Authorized Credit Sales for More than 180 Days

On December 6, 1984, the Agricultural Development Bank extended four overdue loans made to a private Salvadoran company, Sello de Oro, S.A., for an additional 120 days. The amount extended totalled $1,126,171. This was contrary to its sales agreement with the GOES which authorizes credit for up to 180 days only. The granting of credit for more than 180 days delays the deposit of sales proceeds into the special account and in our opinion should not be condoned unless previously authorized by SETEFE.

USAID/El Salvador Comments

The USAID objected to our recommendation because a legal opinion from the Regional Legal Advisor that stated that interest earned on credit sales is not part of the P.L. 480 proceeds and is not subject to AID control.

Office of Inspector General Response

Our recommendation is not based on a legal opinion but on sound business practice. In addition, AID Policy Determination No. 5, dated February 22, 1983, as quoted below, supports our position that the host government should earn interest on idle funds:

> Mission should consider depositing the sales proceeds into an interest bearing commercial bank account established to help finance development activities not agreed upon during negotiations or not yet ready for implementation; both the principal and the interest can later be used for funding such activities.

2. The Central Election Council Did Not Observe AID Restrictions on The Use of ESF Funds

The Central Elections Council received 10.4 million colones ($4.16 million) in ESF local currency funds and used at least the equivalent of $295,818 for expenses ineligible under the terms of the 1984 Memorandum of Understanding. Operating personnel we talked to at the Central Election Council and the Ministry of Finance were not aware of restrictions on the use of ESF funds. Although USAID/El Salvador contends that senior GOES personnel were aware of the restrictions, controls were not effectively established to prevent the use of ESF funds for ineligible expenses.

Recommendation No. 8

We recommend that USAID/El Salvador require the GOES to:

a) review all expenditures incurred by the Central Election Council and attribute to ESF funds only expenses allowable under the terms of the 1984 Memorandum of Understanding.

b) return to the Ministry of Finance special account any ESF funds not attributed to allowable expenses and reprogram these funds.

Actions Taken by USAID/El Salvador to Close Recommendation No. 8

This recommendation is closed upon publication of this report because USAID/El Salvador took corrective action on our audit findings and draft audit report. On July 27, 1985, the Government of El Salvador revised its first report of ineligible expenses dated April 23, 1985 which we analyzed during our audit (see Exhibit 2). The revised GOES report showed that ineligible expenses increased to $1,277,922 (C.3,194,805) from $494,158 (C.1,235,396.51) shown in its first report.

As shown below, the GOES determined that $696,702 (C.1,741,755.97) of the C.10.4 million of ESF funds were not used for eligible expenses. The Government of El Salvador asked USAID/El Salvador for authority to jointly reprogram this money and the USAID agreed.

		(Millions of Colones)	
	Total	AID	GOES
Contributions	11,853	10,400	1,453
Less Ineligible Expenses	3,195	1,742	1,453
Eligible Expenses	8,658	8,658	---

The GOES list of ineligible expenses of C.3,194,805.49 was slightly more than the figure shown in our draft report of C.2,941,960.91 because the Government of El Salvador considered all salary expenses as ineligible whereas we considered as ineligible only the salary expenses of council personnel who, in our opinion, could influence the outcome of the election. However, we are willing to accept the criteria used by the GOES to determine the ineligibility of salary expenses.

Background

In calendar year 1984, the GOES budgeted 13,008,585 colones ($5,203,434) for the Central Election Council to finance the Salvadoran election program. Of the 13,008,585 colones budgeted for the program, 10.4 million colones ($4.16 million) was to be financed with ESF local currency under the terms of the 1984 Memorandum of Understanding. The remaining 2,608,585 colones ($1,043,434) was to be financed by the GOES from its own resources.

The 1984 Memorandum of Understanding contained the following restrictions regarding the use of the ESF funds (10.4 million colones) allocated to the Central Election Council, unless AID otherwise agreed in writing.

> Eligible. Funds were to be used only for financing certain expenses. They are (i) office and administrative supplies, (ii) ballot boxes and stands, (iii) design, printing and distribution of ballot forms and other legal documents (iv) general transportation in support of elections, and (v) short-term contracts in direct support of the election program in general or of the Salvadoran Elections Project in particular.
>
> Ineligible. Funds were specifically not to be used for financing (i) salaries, per diem or training of election officials (poll watchers, local poll administration teams, etc.), (ii) the cost of the political debt 11/, and (iii) publicity related to the elections.

The USAID/El Salvador Program Officer told us that salary costs of election officials would be ineligible only if the officials were in a position to influence the outcome of the election. Even though this rule was not specifically stated in the 1984 Memorandum of Understanding, we nevertheless accepted it in determining the eligibility of expenses. According to current procedures, the Ministry of Finance ultimately determines how the expenses incurred by the Central Election Countil will be financed. As such, even if the Council specifically states on its vouchers that certain expenses are to be financed with ESF funds, the Ministry of Finance presumably has the final determination as to whether GOES or ESF funds will be used.

11/ Debt incurred by political parties participating in the elections.

Discussion

Our review of a report prepared by the Ministry of Finance on April 23, 1985 regarding the expenses of the Central Election Council showed that at least $295,818 in ESF funds were used to finance ineligible expenses. This amount could be higher because the expenditure report included 1,147,706 colones ($459,082) in unliquidated obligations for which expense details were not available. Of the 13 million colones in expenses or obligations incurred by the Central Election Council as of April 23, 1985, we found that 3,348,131 colones were for expenses ineligible under the terms of the 1984 Memorandum of Understanding (see below). Since the ineligible expenses of 3,348,131 colones exceeded the GOES contribution to the Central Elections Council of 2,608,585 colones, the excess of 739,546 colones or $295,818 will have to be charged to ESF funds unless the GOES increases its contribution to the project by the same amount.

Comparison of Ineligible Expenses Identified by AID Auditors and GOES

	Per AID Auditors	Per GOES Report 04/23/85
Total Budget	C.13,008,585	C.13,008,585
Less: ESF Local Currency Funds	10,400,000	10,400,000
GOES Funds Available for Ineligible Expenses	C. 2,608,585	C. 2,608,585
Less: Total Ineligible Expenses as of 12/31/84 (Exhibit 2)	C. 2,941,961	C. 1,235,397
Ineligible Unliquidated Obligations	406,170	406,170
GOES Funds Available for Ineligible Expenses	-	967,018
	C. 3,348,131	C. 2,608,585
ESF Funds used to Finance Ineligible Expenses	C. 739,546	C. ---
Dollar Equivalent	$ 295,818	$ ---

As can be seen above, the GOES report of expenses dated April 23, 1985 only contained 1,641,567 colones of ineligible expenses compared to 3,348,131 colones found by our auditors. Exhibit 2 shows the differences between the findings of our auditors and the GOES. Our auditors found ineligible expenses for salaries, publicity, per diem, entertainment, food, and alcoholic beverages. The GOES only found ineligible expenses for salaries and publicity. Our auditors and GOES agreed on the amount spent for publicity but the GOES reported a much lower amount for ineligible salaries. The GOES only reported 48,420 colones of ineligible expenses for salaries of poll watchers. However, our auditors found 331,850 colones of ineligible payments to poll watchers. In addition, we included the salaries of the management officials of the Central Election Council as ineligible since management was in a position to influence the outcome of the election (see Exhibit 2).

Our auditors did not include in their list of ineligible salaries 586,017 colones advanced to the "Juntas Departamentales" for the salaries of local poll administration teams since these advances had not been liquidated. Once these advances are liquidated and the expenses are recorded in the accounting records, the amount of ineligible expenses for salaries would have to be increased.

Our auditors also reported per diem expenses as ineligible because they were explicitly disallowed in the Memorandum of Understanding. We also classified expenses for entertainment, food and alcoholic beverages as ineligible. The Memorandum of Understanding did not explicitly allow or disallow these expenses.

Personnel at the Central Election Council and Ministry of Finance who were interviewed by our auditors were unaware of the restrictions on the use of ESF counterpart funds and consequently had not established the necessary internal control procedures. USAID/El Salvador personnel contended that senior GOES personnel were aware of the restrictions when the Memorandum of Understanding was negotiated and signed.

USAID/El Salvador personnel also contended that the Ministry of Finance had established budgetary controls to ensure that ineligible expenses would not be charged to ESF funds. These controls would require the funding of ineligible expenses with GOES funds. However, our review of the budget and conversations with budget officials of the Ministry of Finance showed that controls were not established to identify ineligible expenses.

Failure to establish these controls, such as in this case, can result in misuse of funds. To ensure that the funds were used as intended, we believe the GOES should review all expenses incurred and only attribute eligible expenses to ESF funds. Any remaining ESF funds not attributed to eligible expenses should be returned to the special account of the Ministry of Finance and reprogrammed as agreed to by the GOES and USAID/El Salvador.

USAID/El Salvador Comments

USAID/El Salvador disagrees with the comments and recommendations. The audit comments and recommendations were based on preliminary, incomplete GOES reports. At the time audit work was completed the GOES had not yet submitted to USAID a final report for attribution. The GOES final report was received by the Mission and only C.8.6 million were accepted as eligible. The difference, C.1.8 million is being jointly reprogrammed with the GOES.

Office of the Inspector General Response

USAID/El Salvador, in effect, implemented our recommendation. The GOES report of April 23, 1985, on which we based our audit finding, was called a final report by the GOES. This report was revised by the GOES on July 21, 1985 after we questioned the validity of the first GOES report in our draft audit report. The amount of total expenditures in both the first and revised GOES reports was the same (C.11,853,049). See Exhibit 2 for a comparative analysis of the IG draft report and the two GOES reports.

3. SETEFE Did Not Reconcile Its Bank Accounts to Books for ESF and P.L. 480 Local Currency Funds

SETEFE had not reconciled its bank accounts to its books for ESF and P.L. 480 local currency funds because a reconciliation procedure had not been established. Although a reconciliation procedure was not required, we believe it is sound business practice to help ensure the accuracy of SETEFE's accounting records and reports.

Recommendation No. 9

We recommend that USAID/El Salvador obtain from SETEFE evidence that it has undertaken to establish a procedure to reconcile its bank accounts on a monthly basis and submit these reports to USAID/El Salvador.

Actions Taken by USAID/El Salvador to Close Recommendation

This recommendation is closed upon publication of the report because of USAID/El Salvador corrective action. On March 22, 1985, the USAID obtained its first bank reconciliation from SETEFE. This reconciliation fully accounted for the differences between their book and bank balances. On July 2, 1985, SETEFE submitted additional bank reconciliations to the USAID through May 31, 1985. On July 12, 1985, SETEFE informed the USAID that bank reconciliations will be submitted to the USAID on a monthly basis and that they are opening the necessary bank accounts to segregate the funds provided by the different agreements.

Discussion

We found that SETEFE had not reconciled its bank accounts to its books for ESF and P.L. 480 local currencies because a reconciliation procedure had not been established. Reconciling bank accounts on a monthly basis is a sound business practice to help ensure the accuracy of records and reports. SETEFE had a book balance for its seven bank accounts of \$20,308,635.88 as of December 31, 1984. However, the bank balance for the seven accounts totalled \$24,880,167.55. The difference between the book and bank balances of \$4,571,531.67 needed to be accounted for to ensure the accuracy of SETEFE accounting records and financial reports to USAID/El Salvador. For example the SETEFE financial report to the USAID as of December 31, 1984 showed a bank balance for its seven accounts of \$19,587,130, which was not correct.

C. Verification of Import and Export Prices

The Central Bank established a price-checking system at the request of AID to prevent the overpricing of imports and the underpricing of exports in order to deter capital flight. Our first audit report of the Private Sector Support Progam, dated January 20, 1982, disclosed that the Central Bank had not implemented the planned price-checking system. Our second audit report, dated April 20, 1983, disclosed that the system had been established but that it was not operating effectively. We found that price-checking system did not: (1) independently select transactions for price verification, (2) review a sufficient number of import transactions, (3) maintain adequate files (4) prepare reports on price verifications or (5) have sufficient staff.

Since our last audit, the USAID took the following actions to improve the operations of the price-checking system.

- The price-checking unit was upgraded to a full department (Department of International Prices) and transferred to a more appropriate organizational location.

- The staffing of the Department of International Prices was increased from 3 to 8 professionals.

- Adequate reports on the results of price investigations were prepared and submitted to the USAID.

- The Department of International Prices established adequate files.

- The number of price verifications was increased.

- Arthur Young & Co. was awarded three different contracts to study the policy, procedures and controls of the Central Bank including the price-checking system.

Under its most recent AID contract Arthur Young & Co. is providing technical assistance and training to establish the price-checking system as an effective internal control mechanism for the approval of import and export transactions. Arthur Young & Co. is designing a mechanized system to correct most of the remaining procedural deficiencies in the price checking system. The contractor estimates that implementation of the mechanized system will begin in August 1985.

During our current audit we independently confirmed the validity of the findings of Arthur Young & Co. We also found that the Department of International Prices had not yet complied with USAID requirements to increase its staff and to use sampling procedures to select transactions for price verifications. However, prior to the completion of our audit, the USAID obtained Central Bank compliance with those requirements. In view of the corrective actions taken by USAID/El Salvador and those in process through the AID contract with Arthur Young & Co., our recommendations to improve the operations of the price-checking system with regard to import and export transactions are to be considered resolved with the issuance of this report. However, we plan to follow-up in the not-too-distant future to verify that the recommendations have been implemented via the mechanized system being designed by Arthur Young and Co.

USAID/El Salvador Comments

The USAID does not believe that capital flight through over/under invoicing is currently a problem as evidenced by Central Bank balance of payment data and corroborated by other observations (e.g., return of wealthy citizens) which have indicated the disminution or elimination of capital flight starting in 1983.

Office of Inspector General Response

Our review of the Central Bank data confirms the USAID statement. However, the Department of International Prices found that import transactions submitted to the Central Bank for approval in 1984 had been overpriced by $4.7 million.

1. Import Price Verification

The procedures used by the Department of International Prices to verify the prices of import transactions in order to deter capital flight can be improved. Specifically, (i) transactions to be reviewed were not independently selected, (ii) criteria for selecting transactions were too general, (iii) follow-ups by the Department of International Prices on price verification recommendations were not done, (iv) written policies to enforce sanctions against capital flight offenders were not established, (v) the agreed number of personnel were not hired, and (vi) information was not obtained from Salvadoran Customs on the results of its inspections of selected imports to determine if they coincided with the quantity and quality of the goods authorized for the transaction. As a result, the ability of the Department of International Prices to detect and control capital flight was hindered.

Recommendation No. 10

We recommend that USAID/El Salvador require the Department of International Prices of the Central Bank to:

a) exercise independence in accordance with Amendment No. 2 of the Memorandum of Understanding, dated July 24, 1984, by conducting statistically significant random samples of all approved import transactions.

b) establish procedures to ensure that all import transactions meeting the selection criteria established by the Department of International Prices are selected for price verification reviews.

c) revise criteria for selecting transactions for price investigation by using specific criteria such as tariff codes.

d) follow-up on price investigation recommendations.

e) establish a written policy to establish and enforce sanctions against capital flight offenders by adhering to Amendment No. 2 of the Memorandum of Understanding, dated July 24, 1984 (this recommendation is for the President of the Central Bank).

f) increase its staff to and maintain its level at ten professionals, as required by Amendment No. 2 of the Memorandum of Understanding, dated July 27, 1984.

g) obtain special reports from Customs on inspections of selected imports to verify that the value (quantity and quality) of goods imported coincide with the value authorized for the transaction.

Action Taken by USAID on Audit Recommendation

Recommendation No. 10 is to be closed on publication of this audit report because of actions taken or in process by USAID/El Salvador to implement the recommendation. While this audit was in process, the USAID took action to implement parts (a) and (f) of this recommendation. On February 18, 1985 the Department of International Prices established a procedure to verify the prices included in every 25th import permit application (part a). On February 1, 1985 the professional staff of the Department of International Prices was increased from 8 to 11 employees (Part f). The other parts of the recommendation should be corrected as soon as Arthur Young & Co., under its contract with USAID/El Salvador, completes its assistance to the Central Bank to implement a mechanized system for approving import and export transactions.

Background

Major concern had been expressed regarding the deliberate price manipulation of imported commodities for the purpose of diverting foreign exchange into private accounts outside of El Salvador. This practice, thought to be a major cause of capital flight, is both illegal and counterproductive to AID's overall objective of helping to restore El Salvador's economy.

One of the functions of the Department of International Prices is to deter capital flight through price verifications. The Department has made significant improvements to control price manipulation. Price investigation files have been created, monthly reports identifying the extent of capital flight averted have been prepared and personnel levels have been increased. Further improvements are also anticipated when mechanized procedures for import reviews are implemented.

For calendar year 1984, imports by El Salvador amounted to $1.1 billion. With the exception of Government-controlled imports estimated at $343.7 million, the majority of the remaining imports of $761.0 million should be verified in order to deter capital flight.

Arthur Young & Co. is providing technical assistance to the Department of International Prices to improve and mechanize its procedures. Most of the procedural weaknesses included in this finding should be corrected once the mechanized system is implemented.

Independence

To obtain maximum results, price verifications must be made with sufficient independence. One aspect of independence is the ability to freely select transactions. Our audit disclosed the independence of the Department of International Prices was impaired because another Central Bank unit (the Department of Exchange Control) selected transactions for verification. A 1983 Inspector General Report (No. 1-519-83-8) also cited insufficient independence as a problem area. Although some steps were taken to correct the problem, the corrective measures were not fully effective.

Since its inception, the Department of International Prices had never achieved full independence. Initially established in 1982 as a price-checking unit under the Office of the General Manager, its independence was limited because the Department of Exchange Control identified the transactions for it to verify. In January 1983, the price-checking unit was transferred to the Department of Exchange Control, but this did not improve its independence since another unit in the Department of Exchange Control continued to select the transactions to be verified. To correct this situation, the price-checking unit was made a full department in June 1983 under the Office of the President. Although this organizational change was made to ensure the independence of the Department of International Prices, procedures remained the same. The Department of Exchange Control still determined which and how many import transactions were to be verified.

Although the Department of Exchange Control selected transactions based on criteria established by the Department of International Prices, we found that the Department of International Prices had not established a procedure to verify that the transactions selected for price verification by the Department of Exchange Control met the established criteria. This procedure should be implemented to help the Department of International Prices achieve full independence.

Amendment No. 2 to the Memorandum of Understanding, dated July 27, 1984, asked the Central Bank to periodically conduct statistically significant random samples of all import transactions approved by the Central Bank to determine the reasonableness of prices. Our audit disclosed those reviews had not been made. Personnel at the Department of International Prices could not provide an adequate reason for not conducting the samples. These reviews would have provided a basis: (1) to verify the prices of import transactions not selected for price verification, and (2) to better define the selection criteria.

Selection Criteria

Guidelines established to select import transactions requiring price verification were too general in nature and, consequently, subject to interpretation. According to current procedures, 16 categories of commodities were identified as requiring verification by the Department of International Prices.

Products Requiring Verification

1. Solid Insecticides
2. Solid Herbicides
3. Liquid Herbicides
4. Solid Fungicides
5. Liquid Insecticides
6. Raw Materials/Pesticides
7. Vegetable/Seeds/Fruits
8. Pulverizers/Agricultural
9. De-creamers
10. Capital Goods/Agri-cultural
11. Vehicles
12. Industrial/Machinery
13. Equipment/Commerce
14. Capital Goods/Industry
15. Special Investigations
16. Fertilizers

Using statistical sampling techniques, we drew a random sample of 79 transactions and asked personnel at the Department of Exchange Control and the Department of International Prices which transactions should be selected for price investigation. Results showed the Department of International Prices selected 30 transactions (38%) not selected by the Department of Exchange Control. Since personnel at the Department of Exchange Control determine which transactions will be identified for price verification, the 30 transactions would not have been verified. Projecting the results of our sample, it is estimated that 1943 of 5116 import transactions approved for attribution during the period covered by our review probably would not be verified even though they met the criteria for verification as determined by the Department of International Prices.

To correct this problem, we believe that tariff codes rather than general commodity descriptions should be used as a basis for selecting transactions.

Follow-Ups

The Department of International Prices had not established procedures to follow-up on its price verification recommendations. When the Department of International Prices forwarded completed verifications to the Department of Exchange Control, it was assumed by all concerned that price verification recommendations would be implemented unless the Department of Exchange Control advised the Department of International Prices that it disagreed. To monitor compliance with its price recommendations, the Department of International Prices should follow-up to ascertain that corrective actions have been taken by the Department of Exchange Control.

Sanctions

Written policies to punish capital flight offenders were not established. Amendment No. 2 to the Memorandum of Understanding, dated July 24, 1984, requires the Central Bank to establish a policy to levy sanctions against those who overvalue imports in their application for foreign exchange. Existing law authorizes taking legal action against capital flight offenders. However, the Central Bank has not developed a written policy to implement those legal provisions.

The USAID advised us that the Central Bank had adopted an unwritten policy to levy sanctions against capital flight offenders but that it is very difficult to prove capital flight. They cited one instance where the Central Bank wanted to take legal action but they had to drop the case for lack of sufficient evidence.

Current procedures only require the offender to resubmit a previously denied application. Presumably, resubmitted applications would include acceptable prices. Hence, capital flight offenders can resubmit as many import applications as they wish without reprisal. Furthermore, given other internal control weaknesses previously cited, it would seem probable that suspect applications previously identified could be resubmitted and processed without detection.

Arthur Young and Co., under contract with AID, indicated they are developing a sanctions policy for Central Bank consideration. The implementation of this policy would be tied to a mechanized system being designed for approving import and export transactions. For example, the first-time offender could be given a warning letter, the second-time offender a 30-day suspension in processing import permits, the third-time offender a fine, and the fourth-time offender judicial action.

Staffing

The Department of International Prices could have done more price verifications if it had been fully staffed. During 1984, the department identified and deterred $4.7 million in capital flight. Although this is a significant amount, it only represents 4/10ths of one percent of the total value of imports approved by the Salvadoran Central Bank. Furthermore, two transactions account for about $3.2 million of potential capital flight. A more accurate appreciation is obtained when one realizes that only 13.8 percent 12/ of the total value of non-price controlled imports for 1984 was verified. In addition to this 13.8 percent, an undetermined number of transactions were not sent to the Department of International Prices for verification because prices of the proposed imports fell within accpetable price ranges.

According to Amendment No. 2 to the Grant Memorandum of Understanding, dated July 27, 1984, the Salvadoran Central Bank agreed to increase the staff of the Department of International Prices to at least 10 professionals. However, we found that there were only 8 professionals working there in December 1984. The USAID said the staff of the Department of International Prices had been increased to 10 professionals in March 1984. The USAID gave us a copy of Central Bank telex which supported their contention that the staff had been increased to ten professionals. We interviewed three of the professional staff reportedly assigned to the Department of International Prices in March 1984. Two of them told us that they had never worked there. The other one said he worked there until March 1983 after which he was assigned to the Department of Exchange Control where be served as a liaison with the Department of International Prices.

Our audit also showed that one of the 8 professionals on board had been detailed for six months to the Agricultural Development Bank to assist in the procurement and importation of agricultural inputs. This person was assigned to the Department of International Prices on July 2, 1983, detailed out on August 1, 1984, and had not returned as of January 31, 1985.

12/ USAID/El Salvador reported to AID/W in 1984 that the Central Bank was reviewing 83 percent of the price and non-price controlled imports. However, this percentage corresponded to planned rather than actual coverage.

Physical Inspection of Imported Goods

The Department of International Prices had not established a procedure to obtain special reports from Customs to verify that selected imports matched what was originally declared in the import documents. In order for the Department of International Prices to be effective in its efforts to curtail abuses in the import system, it is essential that some procedures be established to obtain this information. To implement such a system, the Department of International Prices should make lists of selected imported goods and provide the lists to Customs personnel. When the goods in question arrive, the Customs inspector should verify that the value of goods imported (quantity and quality) agrees with the value authorized for the transaction and provide a report to the Department of International Prices.

Conclusions

In order to effectively deter price manipulation, a major contribution to capital flight, it is essential that the Department of International Prices attain full independence. Since personnel of the Department of Exchange Control continuously meet the public, they are most vulnerable to outside influence in approving transactions. Independent selection of transactions to be reviewed for prices should be an effective deterrent against such influence.

Furthermore, in order to make adequate and sufficient verifications, criteria for selecting transactions for investigation must be clarified, some degree of compliance with the pricing recommendations must be obtained, sanctions must be imposed against capital flight offenders, personnel resources must be maintained at prescribed levels and imported goods should be inspected and appraised on a selective basis to ensure that actual and authorized quantities and qualities coincide. Recommendations in this finding should help to deter capital flight.

2. Export Price Verification

The Department of International Prices has not adequately reviewed export transactions to deter capital flight. The Department of International Prices was established (at the request of AID) to verify prices of both import and export transactions in order to control capital flight. Controls to detect undervalued exports were inadequate and the number of verifications made was limited. In 1984, the Department of International Prices reviewed only 2/10 of one percent of the value of export transactions that would be subject to price verification. Consequently, there was no assurance that exports for 1984 were adequately screened to deter capital flight.

Recommendation No. 11

We recommend that USAID/El Salvador obtain from the Central Bank documentation attesting to the fact that it has:

a) appropriately increased the number of price verifications for export transactions.

b) established procedures for export price verifications similar to those established or recommended for the review of imports (see Recommendation No. 10).

Action Taken by USAID on Audit Recommendations

Recommendation No. 11 is to be closed upon publication of this audit report because USAID/El Salvador contracted Arthur Young and Co. to design a mechanized system for approving import and export transactions for the Central Bank. The Central Bank plans to begin the implementation of the system in August 1985.

Background

Exports are one method by which the Government of El Salvador obtains foreign exchange. Whenever an exporter receives foreign currency for his goods, he must sell it to the Central Bank. If an exporter purposely reports to the Central Bank his exports at a lower value than what was actually shipped, the quantity of foreign exchange received by the Salvadoran exporter beyond the reported export value constitutes capital flight.

Progress has been made regarding the institution of controls over exports and inflows of foreign exchange. For example, a computerized export control system has been designed and implemented which allows automatic verification of exporter data, such as account numbers, amounts authorized for exports, due dates for the return of foreign exchange, and balances pending. These computerized controls, along with other new requirements, should improve the flow of foreign exchange to the Government of El Salvador.

To ensure capital flight is minimized, export transactions must be screened to verify that export prices are not purposely undervalued. Since undervaluations result in reduced foreign exchange flows, preventing this practice is of vital importance. The Department of International Prices was also established to check prices on export requests. The importance of these verifications is more evident when one realizes that exports for 1984 were estimated at $760 million. Of this amount there were $512 million of exports for coffee, sugar and cotton that would not have to be price verified because they were exported and price-controlled by the Government of El Salvador. The balance of the exports ($249 million) could and should have been price verified.

Audit Results

Verification of export prices was inadequately performed. Procedures to require objective and impartial reviews of export transactions were non-existent. Also, the number of export transactions verified (16) was limited. Consequently, there was no assurance that potential price manipulation of export commodities and the resulting capital flight was being detected.

For all export cases, price verifications are initially performed by the analysts in the Export Section of the Department of Exchange Control. These verifications consist mainly of using subjective judgment as to whether an export price is reasonable or not. This is not an effective system because an individual's perception of undervaluation is subject to numerous factors, including memory and outside influence. Since these analysts have continous contact with exporters, they are most likely to be influenced in their tasks. When an analyst concludes that an export transaction may be undervalued, he will compare the price to past prices for the particular product. Should the disparity in prices be significant, the transaction is either forwarded to the Department of International Prices or sent to the exporter for correction. In most cases, however, the exporter is notified and presumably the required corrections are made.

For the 1984 calendar year, the Department of International Prices reviewed only 16 export transactions valued at about $487,000. This only represents 2/10 of 1 percent of the $249 million of 1984 exports that were susceptible to price verification. More importantly, 4 of the 16 transactions were undervalued in the amount of $13,000. The only reason these prices were verified was because the Department of Exchange Control forwarded these transactions to the Department of International Prices for price verification. Since there are no controls or procedures to dictate what should be forwarded to the Department of International Prices for verification, no determination can be made on the degree of control necessary to prevent undervalued exports.

Conclusion

The undervaluation of exports can have adverse impact on the ability of El Salvador to fully recover from its economic plight. We believe that the Department of International Prices should significantly increase the number of export transactions reviewed and develop procedures to review export transactions similar to those established or recommended for the review of import transactions (see Recommendation No. 10).

USAID/El Salvador Comments

The USAID said that the Central Bank focused its price reviews on imports because AID funds have been used for imports and most of the exports are price controlled. The USAID is not anxious for the Central Bank to increase its review of exports. They believe the current level of review is sufficient; also the Department of International Prices will have to focus more of its efforts on imports starting in 1985 because AID/W has asked the Central Bank to review 100 percent of AID-financed import transactions.

Office of Inspector General Response

We believe a greater balance between the review of import and export transactions is needed to efficiently and effectively deter price manipulation and consequent capital flight. In 1984, 13.8 percent of the value of non-price controlled import transactions were reviewed while only 2/10 of 1 percent of the exports were reviewed. In our considered opinion, it is unnecessary to review 100 percent of the AID-financed imports (as requested by AID/W) to effectively deter capital flight. This can be done more efficiently on a selective basis using existing and recommended procedures. Resources saved by downgrading the review of AID-financed imports could be used to increase the number of export verifications. We strongly suggest that AID/W reconsider its decision to require a 100 percent review of the AID-financed import transactions.

D. Compliance and Internal Controls

1. Statutory Reports

The FY1985 Continuing Resolution required AID to periodically report to Congress on the degree of Government of El Salvador compliance with Memoranda of Understanding regarding the use of local currency. In its first report to AID/W on November 9, 1984, the USAID only reported one area of non-compliance with its 1984 Memorandum of Understanding. While the audit was in process, we advised the USAID that the Government of El Salvador had not complied with other provisions of the 1984 Memorandum of Understanding. In its report to AID/W on April 16, 1985, the USAID correctly reported five areas of non-compliance with the 1984 Memorandum of Understanding. The Government of El Salvador was unable to comply with most of the provisions because of unrealistic assumptions or insufficient resources. In one area, where compliance was feasible, the Government of El Salvador complied by submitting a plan to the USAID on March 19, 1985 for the liquidation of all outstanding self-help obligations established under the 1980-82 P.L. 480 Title I program agreements.

2. Other Areas of Non-Compliance

We also found that the Government of El Salvador had not complied with six other requirements of the program. As stipulated in the 1984 Memorandum of Understanding, the Government of El Salvador had not (1) increased its price verification staff to 10 professionals (see page 49), (2) conducted statistical samples of all approved import transactions (see page 47), (3) adopted a policy to levy sanctions against those who overvalued imports in their applications for foreign exchange (see page 48), and (4) prepared a credit study. Prior to the publication of this report, the Government of El Salvador complied with all of the above provisions except item (3) above. However, Arthur Young and Co. under its contract with AID is developing a sanctions policy. This policy will be linked to a mechanized system which the Central Bank plans to implement in August 1985.

We also found that the Central Bank had not complied with a USAID request to submit substitute transactions for transactions disallowed in Implementation Letter No. 24. On page 10 of this report we have included a recommendation to correct this problem which was closed prior to the publication of this report.

In addition to the above, we found that USAID/El Salvador and the Government of El Salvador had not complied with many of the eligibility criteria established under the program for the attribution of import transactions to cash transfers (see Section A of this report). These attribution deficiencies were corrected prior to the publication of this report.

3. Fragmented Management

At the beginning of our audit, we noted that USAID management of the Private Sector Support Program was fragmented. The USAID had not established centralized monitoring procedures to document and verify Government of El

Salvador compliance with the provisions of the program agreements. The USAID Controller's role in monitoring compliance with the financial provisions of the ESF and P.L. 480 agreements and verifying the accuracy of Government of El Salvador financial reports had been limited. Individual program officers managed their own sub-elements with guidance and supervision coming only from top management. Given the extreme workload at that level of the USAID, this system was not practical because it was not feasible for top management to remain current on all aspects of the program. This situation was corrected during our audit. A Balance of Payments Committee was established to provide oversight and coordination of all activities relating to the implementation of the Private Sector Support Program. Also a centralized procedure was established to document and verify Government of El Salvador compliance with the provisions of program agreements. Finally the USAID plans to increase the role of its Controller in the financial monitoring of the program.

4. Control Improvements

Although the audit disclosed some weaknesses in controls, the USAID has over the life of the program taken many actions to improve controls, as summarized below:

- Arthur Young & Co. was contracted several times to strengthen the procedures of the Department of International Prices to identify and deter capital flight. Many improvements have already been made as a result of their review and more are planned.

- While only a few improvements had been made in the procedures to select transactions for attribution to AID financing, significant improvements are planned to be implemented in 1985. The FY 1985 continuing Resolution required that AID dollar disbursements be placed in a special account to finance eligible import transactions. This will replace the attribution procedure used through 1984. Also, Arthur Young and Co., under a contract with AID is designing a mechanized system to select transactions eligible for AID financing.

- Starting in 1984, the Government of El Salvador was required to deposit ESF local currency generations in special accounts. Prior to this, ESF local currency was accounted for by an attribution process.

- In 1984 the USAID required the Government of El Salvador to audit activities financed with P.L. 480 local currency generations.

E. Other Pertinent Matters

The Private Sector Support Program has made significant progress in helping to stabilize the Salvadoran economy. Since its inception in December 1980, AID had (through December 1984) transferred $399.9 million to the Government of El Salvador for balance of payments support. These funds covered 10.6 percent of the Government of El Salvador foreign exchange requirements for imports.

This program as well as other U.S. government and other donor programs have helped to arrest the decline in real Gross Domestic Product (GDP) which started in 1979. In 1983, the decline was completely arrested. The Central Bank has estimated that a positive growth rate of about 1.5 percent was achieved in 1984. However, real per capita GDP will continue to fall in 1984 since the population is growing at about 3 percent per year. To arrest this decline, the real GDP would have to increase in excess of the population growth rate.

An economic study done by the USAID in November 1984 found that El Salvador's 1984 real per capita GDP stood at only about 65 percent of its 1978 level. To reverse this decline and to equal 1978 real per capital GDP levels by the end of this decade -- which is consistent with the goals set forth by the National Bipartisan Commission on Central America -- real per capital GDP growth of about 3.3 percent per year would be required.

The USAID also stated in its 1984 study that the most important remaining stabilization tasks will be the reduction of the public sector fiscal deficit and the nation's dependence on extraordinary levels of external financing, such as ESF and P.L. 480, to redress the balance of payments deficit.

Government of El Salvador deficits which increased greatly over the past five years have begun to decline. In 1979, the deficit stood at $39.7 million but since then it has averaged $208 million a year. The deficit would have been much higher had AID not provided budgetary support under the Private Sector Support Program. The deficit is due to large increases in current expenditures which have risen nearly twice as fast as current revenues since 1978. The increase in expenditures has been due to increases in defense spending and high priority programs such as public sector restoration, aid to displaced persons and implementation of an agrarian reform. However, that trend was reversed in 1982 and since then current revenues have increased almost twice as fast as current expenditures. As a result, the 1984 estimated fiscal deficit has fallen to its lowest level ($147.5 million) since 1979. Government of El Salvador revenues have increased because of improved administration and tax increases.

The balance of payments deficits for 1984 and 1985 were estimated at $244 and $245 million respectively. These deficits need to be externally financed (mainly with U.S. Government assistance) in order to pay for sufficient imports to maintain and/or increase private sector production. The balance of payments disequilibrium has been due to:

- The internal armed conflict and its effects on export sector production.

- An overvalued exchange rate which discourages exports and encourages imports, thus resulting in a scarcity of foreign exchange.

- Low prices for certain export crops.

- The contracting Central American Common Market, and

- Inappropriate government policies toward the private sector, discouraging production and exports.

To help stabilize the economy, the USAID has tied economic assistance under the Private Sector Support Program to improvements in Government of El Salvador's economic policies and programs.

Policy improvements already made by the Government of El Salvador include:

- Transfer to the parallel market of 28.1 percent of export transactions and 41.9 percent of import transactions since July 1982. This transfer of commercial transactions from the lower official exchange rate (C. 2.50 = $1.00) to the higher parallel market rate (C. 4.00 = $1.00) is resulting in a gradual devaluation of the Salvadoran currency (colon). This provides more colones to the export sector and, thus, encourages increases in investment and production. On the other hand, the devaluation increases the cost of imported goods in terms of colones, which may be inflationary. The devaluation of the colon would encourage exports and discourage imports, helping to reduce the balance of payments deficit and external financing requirements.

- The Government of El Salvador doubled its stamp tax in mid-1983 and increased electric power rates by 40 percent during the first half of 1984. Salary increases to its lowest paid public servants were held to 10 percent and all vacant government positions were abolished. These changes helped reduced the 1984 fiscal deficit.

AUDIT OF
PRIVATE SECTOR SUPPORT PROGRAM AND
P.L. 480 LOCAL CURRENCY GENERATIONS
USAID/EL SALVADOR

PART III - EXHIBITS AND APPENDICES

RESULTS OF STATISTICAL SAMPLE OF 79 TRANSACTIONS 1/
ACCEPTED BY USAID FOR FINAL ATTRIBUTION TO AID
DISBURSEMENTS UNDER AMENDMENT NO. 4 TO THE GRANT AGREEMENT

				Areas of Non Compliance With Eligibility Criteria 3/										
				Documentation				Other Areas						
Sample No.	Importer	Amount Attributed	2/ Type of Transac.	None	Incomplete	Total	5/ FOB Value	Import 4/ Period	Type Of Commodity	Industrial Subsector	U.S. Source	U.S. Origin	Financed By GOES	Cumulative Total
1	Emb.Salvadorena,S.A.	$ 1,982	L/C	-	-	-	-	-	-	-	-	-	-	-
2	Prod.Aliment.Diana	24,705	L/C	-	-	-	-	-	-	-	-	-	-	-
3	Siderurgica Tineti,SA	8,375	L/C	-	-	-	-	-	-	-	-	-	-	-
4	Industrias Duraflex	101,259	L/C	-	-	-	-	-	-	-	-	-	-	-
5	Celpac,S.A.	25,755	L/C	-	-	-	-	-	-	-	-	-	-	-
6	Industrias Plasticas	82,909	L/C	-	-	-	-	-	-	-	-	-	-	-
7	Ing.Oscar M. Jaime	4,833	S/C	X	-	X	-	X	-	-	-	-	-	-
8	Llantas y Renovados,SA	31,023	L/C	-	-	-	X	-	-	-	-	-	-	X
9	Tropigas de Cent.Am.	2,221	S/C	-	X	X	-	X	-	-	-	-	-	-
10	Autom.Salvadorenos,SA	227	S/C	-	X	X	-	X	-	-	-	-	-	X
11	Estereofonica 92	165	S/C	-	X	X	-	-	-	-	-	-	-	X
12	Drog.Centroamericana	888	S/C	-	X	X	-	-	-	X	-	-	-	X
13	R.Nunez,S.A. de C.V.	23,369	S/C	-	X	X	-	X	-	-	-	-	-	-
14	Textufil, S.A.	6,399	S/C	-	X	X	-	X	-	-	-	-	-	X
15	La Aurora,S.A.	1,442	S/C	-	X	X	-	X	-	-	-	-	-	X
16	Dist. Orellana	478	S/C	-	X	X	-	X	-	-	-	-	-	X
17	Kimberly Clark de C.A.	866	S/C	-	X	X	-	X	-	-	-	-	-	X
18	Sigma,S.A.Div.Kontein	5,150	S/C	-	X	X	-	X	-	-	-	-	-	X
19	Talleres Sarti, S.A.	5,154	S/C	-	X	X	-	-	-	-	-	-	-	X
20	Cementos del Salvador	23,041	S/C	X	-	X	-	X	-	-	-	-	-	-
21	Julio Cesar Romero	85,571	S/C	-	X	X	-	-	-	-	-	-	-	X
22	Ind.Nacional Textil	3,180	S/C	-	X	X	-	-	-	-	-	-	-	-
23	Maquinsal, S.A	4,524	S/C	-	X	X	-	-	-	-	-	-	X	X
24	Fab.Helados Rio Soto	398	S/C	-	X	X	X	X	-	-	-	X	-	X
25	Repuestos Didea,S.A.	87	S/C	-	X	X	-	X	-	-	-	-	-	X
26	Pozos y Riego, S.A.	6,638	S/C	-	X	X	-	-	-	-	-	-	-	X
27	Industria Unisola	5,055	S/C	-	X	X	-	-	-	-	-	-	-	-
28	ARCO Ingenieros	35	S/C	-	X	X	X	X	-	-	X	-	-	X
29	Dist.Fotografica	7,355	S/C	-	X	X	-	X	-	-	-	-	-	X
30	Edif.Cuscatlan	2,304	S/C	-	X	X	-	-	-	-	-	-	-	-
31	Corcho & Lata,S.A.	6,857	S/C	-	X	X	-	-	-	-	-	-	-	-

Sample No.	Importer	Amount Attributed	Type of Transac.	Areas of Non Compliance With Eligibility Criteria: Documentation None	Documentation Incomplete	Documentation Total	FOB Value	Other Areas: Import Period	Type Of Commodity	Industrial Subsector	U.S. Source	U.S. Origin	Financed By GOES	Cumulative Total
32	ADOC,S.A.	$ 28,080	S/C	-	X	X	X	-	-	-	-	-	-	-
33	Molinos de El Salvador	19,120	S/C	-	X	X	-	-	-	-	-	-	-	-
34	La Princesa, S.A.	92	S/C	-	X	X	-	-	X	-	-	-	-	-
35	MEDIDENT, S.A.	1,724	S/C	-	X	X	-	X	-	-	-	-	-	X
36	Laboratorios Vijosa,SA	570	S/C	-	X	X	-	X	-	-	-	-	-	X
37	Salvador Machinery	55	S/C	-	X	X	-	X	-	-	-	-	-	X
38	Ind.Sintetica, C.A.	126	S/C	-	X	X	X	X	-	-	-	-	-	X
39	Circ.Teatro Nacional	1,612	S/C	-	X	X	X	X	-	-	-	-	-	X
40	Import. de Repuestos	4,651	S/C	-	X	X	-	X	-	X	-	-	-	X
41	Pezca, S.A.	1,515	S/C	-	X	X	-	X	-	-	-	X	-	X
42	Emb.Tropical, S.A.	2,198	S/C	-	X	X	-	-	-	-	-	-	-	-
43	Ref.Pet. Acajutla	149,574	S/C	-	X	X	-	-	-	-	-	-	-	-
44	Radio Cadena Central	21	S/C	-	X	X	-	-	-	-	-	-	-	-
45	Prestegard Electro,SA	595	S/C	X	-	X	-	-	-	X	-	-	-	X
46	Coop.Alg.Cuscatlan	2,314	S/C	-	X	X	-	-	-	-	-	-	-	-
47	Optica Emerson	1,745	S/C	X	-	X	-	-	-	-	X	-	-	X
48	Juan F. Granados	1,402	S/C	X	-	X	-	-	-	-	-	-	-	-
49	Llantas Vifrio	291	S/C	X	-	X	-	-	-	-	-	-	-	-
50	Aguilar A.Hijos & Cia.	1,500	S/C	X	-	X	X	-	-	-	-	-	-	-
51	Drogueria Lainez	7,723	S/C	X	-	X	-	-	-	-	-	-	-	-
52	La Prensa Grafica	465	S/C	X	-	X	-	-	-	-	-	-	-	-
53	Sigma, S.A.	6,825	S/C	X	-	X	X	-	-	-	-	-	-	-
54	Optica Alemana	350	S/C	X	-	X	-	-	-	-	-	-	-	-
55	3M Interamericana	85	S/C	X	-	X	-	-	-	-	-	-	-	-
56	Inmobiliaria Gutierrez	931	S/C	-	X	X	-	-	-	-	-	-	-	-
57	Editora El Mundo,S.A.	1,032	S/C	X	-	X	-	-	-	-	-	-	-	-
58	Lab.Clinica Samayoa	170	S/C	X	-	X	-	-	-	-	-	-	-	-
59	La Constancia	402	S/C	X	-	X	-	-	-	-	-	-	-	-
60	Aparicio & Cia.	6,309	L/C	X	-	X	X	-	-	-	-	-	-	-
61	CONELCA	750	L/C	X	-	X	-	-	-	-	-	-	-	-
62	Ind.Comercial Papelera	30,803	L/C	X	-	X	-	-	-	-	-	-	X	X
63	Siemens, S.A.	8,314	L/C	-	-	-	X	-	-	-	-	-	-	-
64	Agroproesa	99,207	L/C	X	-	X	X	-	-	-	-	-	-	-
65	Industrias Quimicas	850	L/C	-	-	-	X	-	-	-	-	-	-	-

Sample No.	Importer	Amount Attributed	Type of Transac.	Documentation: None	Documentation: Incomplete	Documentation: Total	FOB Value	Other Areas: Import Period	Other Areas: Type Of Commodity	Other Areas: Industrial Subsector	Other Areas: U.S. Source	Other Areas: U.S. Origin	Other Areas: Financed By GOES	Cumulative Total
				Areas of Non Compliance With Eligibility Criteria										
66	Laboratorios Generix	10,055	L/C	X	-	X	-	-	-	-	-	-	-	-
67	Plasticos y Novedades	2,654	L/C	X	-	X	X	-	-	-	-	-	-	-
68	Perfumes Carrel de CA	10,859	L/C	-	-	-	X	-	-	-	-	-	-	-
69	Industrias Unidas	224,378	L/C	X	-	X	-	-	-	-	-	-	-	-
70	Industrias Vimtaza	10,110	L/C	X	-	X	X	-	-	-	-	-	-	-
71	Martinez y Saprissa	34,215	L/C	X	-	X	-	-	-	-	-	-	-	-
72	Corsal, S.A.	23,718	L/C	-	-	-	-	-	-	-	-	-	-	-
73	Fab.C.A. de Lapices	24,688	L/C	-	-	-	-	-	-	-	-	-	-	-
74	Drogueria Cuscatlan	8,123	L/C	X	-	X	-	X	X	-	-	-	-	X
75	Laboratorio Ferson	3,297	L/C	X	-	X	-	-	-	-	-	-	-	-
76	Juan Atala Nasser	57,264	L/C	X	-	X	-	-	-	-	-	-	-	-
77	Cooperativa Cuscachapa	102,821	L/C	X	-	X	-	X	-	-	-	-	-	X
78	Salvaplastic, S.A.	29,485	L/C	-	-	-	-	-	-	-	-	-	-	-
79	Drog.Nueva San Carlos	22,215	L/C	X	-	X	X	-	X	-	-	-	-	X
	TOTALS	$1,417,528		29	37	66	15	22	3	3	2	2	2	30
	PERCENTAGE OF NON-COMPLIANCE			36.7	46.8	83.5	19.0	27.8	3.8	3.8	2.5	2.5	2.5	37.9

1/ We did an attribute sample to determine how many import transactions accepted by the USAID for final attribution against AID disbursements did not comply with the eligibility criteria established for the program. The 79 transactions were randomly selected from an universe of 5116 transactions. representing $75 million disbursed by AID on September 28, 1982 under Amendment No.4 to the grant agreement. Confidence limits were set at 90 percent, the expected error rate at 5 percent and the sample precision size at plus or minus 4 percent. In other words, there is a 90 percent probability that the sample selected will fall between 1 and 9 percent of the true error rate of the population. Since this is an attribute sample, only the number of transactions and not dollar values can be projected. To illustrate this, 65.8 percent of the transactions in the sample were supplier credit transactions but they only represented 30.4 percent of the value of all transactions in the sample.

2/ L/C is the acronym for a letter-of-credit transaction. S/C is the acronym for supplier credit transaction (Sample transaction Nos. 60 through 70 represented letter of credit transactions not liquidated when accepted for attribution by the USAID).

3/ The eligibility criteria established to qualify transactions for attribution were as follows:

- Documentation - Central Bank files were to contain the following documentation to make them eligible for final attribution (Implementation Letter No. 5 dated June 26, 1982).
  a. Letter-of-Credit Transactions
     Application for Foreign Exchange "Form 15"
     Letter of Credit
     Commercial Invoice
     Bill of Lading or Airweigh Bill
     Import Certificate

  b. Supplier Credit Transactions
     Same as above except evidence of payment by the Central Bank instead of a letter of credit.

- FOB Value - Implementation Letter No. 5, dated June 26, 1982, provided that the import transactions should be attributed to AID financing at FOB values. Implementation Letter No. 22 dated March 21, 1984 provided that in the event FOB values are not available, they can be derived from CIF values using a table of percentages for all eligibile imports that have arrived in El Salvador since March 26, 1982.

- Import Period - The amended grant agreement provided that over a period of 12 months from the date of each disbursement under the agreement, the GOES would make available an equal amount of foreign exchange for the importation of goods from the United States. The USAID told the auditors that if the commodities arrived in El Salvador as evidenced by the date of the import certificate or the Application for Foreign Exchange "Form 15" was approved during the 12-month period following each disbursement, then the transaction would be eligible for attribution to that period. These were the criteria the auditors used to determine whether a transaction fell withing the eligible import period. USAID implementation letters only indicated that the commodities had be imported before the end of the 12-month period.

- Type Of Commodities - The grant agreement provided foreign exchange made avaliable by the GOES could only be used for the importation of raw materials, capital goods, agricultural imports and spare parts. The auditors used Webster's Dictionary to attempt to define the commodity categories.

- Industrial Subsectors - Amendment No. 4 to the grant agreement provided that the commodities should be imported by the private sector and that the eligible subsectors were manufacturing, agro-industrial, commerce, transportation and energy. The auditors used Webster's Dictionary to help define the industrial subsectors.

- U.S. Source - Amendment No. 4 to grant agreement provided that the commodities be imported from the United States. The USAID expanded the source to include imports from Caribbean Basin Initiative and designated Central American Common Market countries and Panama using grant funds provided under Amendment No. 10 to the grant agreement, dated December 15, 1984.

- U.S. Origin - Implementation Letter No. 22, dated March 21, 1984, which covered Amendement No. 4 and subsequent Amendments to the grant agreement provided that imported commodities should be of U.S. origin. The USAID plans to eliminate the U.S. origin requirement for transactions to be attributed to disbursements retroactive to Amendment No. 3.

- Financed by GOES - The grant agreement provides that the GOES is to make available foreign exchange for the import transactions.

4/ Sufficient information was not available to determine compliance for sample transaction Nos. 23, 34, 48, 60, 62, 66, 67, 70, 71 and 79.

5/ - Sample transaction No. 8 was attributed at less than FOB.
- Sample transaction Nos. 24, 27, 38, 63, 64, 65, and 79 were attribured at more than FOB.
- Sample transaction Nos. 32, 50, 53, 60, 67, 68 and 70 were attributed at CIF. The FOB value were not known for these transactions.
- Sufficient information was not available to determine compliance with sample transaction Nos. 19, 43, 48, 56, 62, 66, 69 and 72.

EXHIBIT 2
Page 1 of 2

INELIGIBLE EXPENSES INCURRED BY CENTRAL ELECTION COUNCIL
CONTAINED IN MINISTRY OF FINANCE
BUDGET REPORT AS OF 12/31/84

Budget Code	Description	IG Draft 1/ Audit Report 6/21/85	GOES Reports 4/23/85	GOES Reports 7/21/85
	Salaries & Wages			
11	Salaries for Service Personnel	C. 796,042.64	C. 48,420.23	C. 962,284.81
12	Sick Pay	-	-	127.00
13	Salaries for Maternity Leave	3,181.03	-	3,181.03
16	Social Security Taxes	20.783.44	-	26,672.55
31	Fees for Board of Directors	26,800.00	-	26,800.00
33	Overtime	247,907.45	-	247,907.45
34	Bonus Pay - Permanent Personnel	13,000.00	-	23,410.32
35	Termination Pay - Labor	-	-	1,850.40
36	Termination Pay - Contractors	-	-	48,006.09
67	Labor	-	-	20,319.49
	Total Salaries & Wages	C.1,107,714.56	C. 48,420.23	C.1,360,559.14
	Publicity			
111	Advertisement and Publicity	C.1,186,976.28	C.1,186,976.28	C.1,186,976.28
	Total Publicity	C.1,186,976.28	C.1,186,976.28	C.1,186,976.28

1/ We only included salaries for management (account 101) and for organization of elections (account 103) since we felt these personnel could have had influence on the outcome of the elections. Account 101 included salaries for the president, vice-president etc. Account 103 included salaries for poll watchers and some computer personnel. All salaries charged to account 102 for general administrative services (drivers, janitors,etc.) were excluded since we did not believe these personnel could influence the outcome of the election.

Budget Code	Description	IG Draft Audit Report 6/21/85	GOES Reports 4/23/85	GOES Reports 7/21/85
	Per Diem			
51	Per Diem to Gov't Personnel	C. 2,770.00	C. -	C. 2,770.00
53	Per Diem to other Countries	14,825.00	-	14,825.00
	Total Per Diem	C. 17,595.00	C. -	C. 17,595.00
	Various Non-Personnel Services			
192	Social Entertainment	C. 598,835.97	C. -	C. 598,835.97
	Total Social Entertainment	C. 598,835.97	C. -	C. 598,835.97
	Nourishment			
201	Food	C. 23,135.40	C. -	C. 23,135.40
202	Alcoholic Beverages	7,703.70	-	7,703.70
	Total Nourishment	C. 30,839.10	C. -	C. 30,839.10
	Grand Total	C.2,941,960.91	C.1,235,396.51	C.3,194,805.49
	Dollar Equivalent	$ 1,176,784.36	$ 494,158.60	$.1,277,922.20

AGENCY FOR INTERNATIONAL DEVELOPMENT
UNITED STATES OF AMERICA A. I. D. MISSION
TO EL SALVADOR
C/O AMERICAN EMBASSY.
SAN SALVADOR, EL SALVADOR, C. A.

MEMORANDUM

TO: Coinege N. Gothard, Jr., RIG

FROM: Ronald A. Witherell, A/DIR

SUBJECT: Comments on Draft Audit of Private Sector Program Support, Project No. 519-0267

DATE: August 23, 1985

The following comments are the USAID's response to the subject Draft. We have attached documents where appropriate to support our position, and where necessary to support actions taken on recommendations contained in the report.

Overall Comments and Observations - The revised draft represents a significant improvement over the previous one. We appreciate the changes and the inclusion of some of our comments or recommended changes. The executive summary, in general, fairly states both the problems found by the auditors and the accomplishment of the objectives of the program. However, we continue to have some problems with certain aspects of the report.

The Mission believes that in general the objectives of the program have been met and dollars provided to support the program were properly expended in accordance with Congressional mandates. While we accept the fact that documentation to support such a position has not always been maintained as well as should be expected, we reject the audit report conclusion that such documentation was never available thus leaving the reader to conclude that a massive misappropriation of taxpayer's funds took place. The Arthur Young & Company Report of 15 August 1985, (Exhibit A) provides the basis for this Mission to believe that while procedures on which the audit report dwells so extensively were not the best, the essence of the program was fully complied with and fully accounted for.

One further overall observation before getting into the details. The report, in several places, states that the observations concerning procedures at the Central Bank are historical in nature and that the USAID and the Bank have taken many steps to correct the problems cited in the report. The sections concerning the local currency program are similar. Procedures already have been changed and/or corrective action was in progress at the time of the audit. However, because of the volume of the report and the format, which discusses in detail the findings after each recommendation, the reader tends to become confused as to what is the real current situation, i.e. which issues demand immediate action, and what has been or is being corrected by the USAID and/or the Bank. If this is corrected by introductory statements and a more concise discussion of findings, the flow of the document and the information passed to the reader would be much improved.

Specific Comments:

Page ii - The last sentence of the first paragraph refers to export price checks and "capital flight."

Throughout the report the use of the term "capital flight" as it relates to import/export pricing should be changed to "over/under invoicing." In addition, price manipulation should not be referred to as a "cause" of capital flight. It is a means of capital flight.

However, all available evidence points to the conclusion that this particular means of capital flight has been stemmed. An important indicator is the level of Private capital flows, which includes Errors and Omissions in the balance of payments. This item went from being large and negative in the first year's of El Salvador's current crisis, suggesting large capital outflows, to small and/or positive, which is regarded as normal, in 1983 and 1984. These figures are presented in Attachment A where the Balance of Payment figures for the last ten years are presented.

If references to capital flight appear in the final report the following USAID comment should be included.

> The USAID does not believe that capital flight through over/under invoicing is currently a problem as evidenced by BCR balance of payment data and corroborated by other observations (e.g., return of the wealthy elite) which have indicated an absence of capital flight starting in 1983.

Page iii- We request that the third sentence read "Our review confirmed the findings of USAID/ES and Arthur Young & Co. . . ."

In reference to the third paragraph we comment later on a GC opinion concerning retained interest on PL 480 credit sales. You may wish to change this paragraph based on our later comments.

In page iii of the Executive Summary part of the report, the auditors mention that since 1980 the ESF grant agreements govern the use of local currency funds generated from the sale of P.L. 480 commodities. In 1984 and 1985, the instruments which govern P.L. 480 generations have been the P.L. 480 Memoranda of Understanding. The ESF MOU, however, incorporates the ESF MOUs as a reference. (Attachment B)

3 - The second and third full paragraphs are somewhat unclear as to whether the statements are background or criticisms. We believe that the elimination of the words "However" in both paragraphs would make clear that it is background.

In addition, the report states that starting in 1982 and continuing through 1983, the local currency made available was not tied to specific uses. This is incorrect. Uses of PL 480 and ESF generated currencies were governed by separate MOUs which were part of the 1982 and 1983 Fiscal and Monetary Program. All the local currency was atributed to specific budgetary support uses. (Attachment C)

We request that the second and third paragraph be rewritten accordingly.

10 - We request that the following note be inserted at the bottom of this page as follows:

> Pursuant to USAID contract No. 519-0177-C-00-5410-00 with Arthur Young & Company (AY), a complete review of the transactions attributed under Amendment 2,3,and 4, was undertaken. The report contains a listing of transactions deemed eligible and attributable for Amendments 2, 3 and 4.

11 - We request that the last paragraph on this page be moved to become the opening paragraph under "Part II - Results of Audit." The first sentence should then be changed to delete "this and the following report sections" and to insert in lieu thereof "Section A and B which follow."

14 - As stated in the opening comments above, we accept that many of those transactions selected by the IG could not be located in the files extant at the BCR at the time of the IG review. We do not concur that at the time of attribution the documentation was not available to support attribution. In fact, while conducting their review of transactions for attribution to amendments 2,3 and 4, AY was unable to find a significant number of the files which were reviewed by the auditors. Therefore, while the finding supports poor filing procedures by the BCR, the same cannot be used to reach the conclusion that "many of the transactions did not qualify for attribution." Our position is supported by the auditor's own conclusions (Second paragraph on page 16.) and the AY report.

We therefore request that the wording of the second sentence read, "During our review we were unable to determine whether all transactions reviewed would qualify for attribution because . . ."

Alternatively the paragraph should include USAID comments as follow:

> USAID/ES agrees with the findings indicating the BCR's poor filing procedures. However the USAID does not agree that documentation was never available to support attribution. This conclusion is based on the auditor's comments in the draft report and the results of the AY review.

17 - The USAID comment should read, "The USAID commented that it believed past documentation requirements had been unrealistic and that they plan to reduce the requirements to the minimum necessary to provide adequate information to ascertain that transactions have been completed and paid and meet all eligibility requirements."

20 - We do not agree with the term "lacking" in the heading for the section starting on this page. While the criteria and procedures referenced may have been somewhat general, they allowed sufficient flexibility to permit the program to function without undue rigidity.

This is obviously an area of subjective judgement. The audit report comments themselves are subjective. We agree with the general objectives stated by the report in the last paragraph on page 20. However, the report describes a suggested program significantly different from the existing one.

	Report Suggestions	Project 0267
Commodities -		
	raw materials	raw materials
	intermediate goods	intermediate goods
	capital goods	capital goods
		spare parts
		agricultural inputs
Sectors -		
	industry	manufacturing
	agribusiness	agroindustrial
	agriculture	commerce
	construction	transportation
		energy

The suggestions in the draft audit report are no more definitive and are more limited than those in the existing project. We recommend that the whole section be deleted. If not, the following USAID comment should be included:

The USAID believes that the existing categories and sectors are an appropriate level of definition to permit accomplishment of project objectives, and that the alternative commodities and sectors offered by the auditors are no more definitive than the ones now in use. Moreover, the new computer selection process of the Central Bank will assist in assuring that transaction selected fall within the established categories. The system uses the International Tariff Code (NAUCA) and Industrial Use Code (CIIU) to assist in identifying eligible transactions. Physical review of some of the documentation will still be required to assure eligibility. The NAUCA code has been used in the BCR since 1980; the CIIU code since 1984.

22 - We disagree with the ineligibility of three of the seven transactions on page 22. AY reviewed the documentation on all transactions. In some cases this required visits to the importers. As a result of their review we have the following comments:

> A close examination of the documentation (Attachment D) for sample No. 29 which referred to "Films" and the "retail market" revealed the products to consist of KODAK bulk processing chemicals and X-Ray films, neither of which were destined for the retail market. Moreover, we do not believe that "finished product" would be a rationale sufficient to determine ineligibility, particularly in view of the fact that tractors, fertilizers, machinery and the like, which are eligible, are also finished products.
>
> Transactions No. 11 and 44 were rejected by the auditors because they considered a commercial radio station to be outside the eligible subsectors. In our opinion, privately owned radio stations are part of the commercial sector in a free enterprise economy and are thus eligible under the criteria. Moreover, replacement parts for electronic equipment are commodities reasonably included in the program.

The result is that the above three examples inflated the IG statistics by 75%.

The bottom line, however, is that, as mentioned earlier, we have established procedures to record both NAUCA and CIJU codes as well as conduct a physical review of the documents to determine eligibility. However, it will and should continue to remain a partly subjective process.

If you decide to include any of the above transactions in the report, our comments should also be included.

23 - Obviously from the above, we do not concur in the conclusion at the top of the page to the degree implied by the report. If the final report contains this conclusion then it should also contain a comment on our objection along the following lines:

> While the mission agrees to some refinement in the procedure for the application of appropriate NAUCA and CIIU codes to assist in determining product eligibility, it maintains that a flexible interpretation is required and final decisions must be based on a direct review of the documents involved.

26 - The first full sentence on the page starting "Our sample.." should be modified to insert after "files" the words "which we reviewed."

27-30 - The discussion of the eligible import period and the 22 transactions considered ineligible by the auditors should be reviewed to assure consistent application of the eligibility criteria. There is a significant difference in the actual date between "arrival in El Salvador" and the date of the import certificate. This is the case if one interprets "arrival in El Salvador" to be arrival at customs. The report is not consistent in the use of terms to define eligibility periods. See pages 24 and 28 and the footnote on import period to Table I.

32 - The reference to U.S. origin is innappropiate since it misleads the reader into believing U.S. origin to be an eligibility criteria. An AID legal opinion specifically struck down U.S. origin as being a requirement for the 0267 program (Attachment E). This decision was made retroactive to Amendment No. 3, not just those subsequent to Amendment #4 While the Mission and the BCR were aware of this eligibility change, and had taken it into consideration, no Implementation Letter was issued to reflect the change of policy until P.I.L. No. 32 (Attachment F).

If changes are not made then the following USAID comment is to be included:

> USAID/ES maintains that based on a GC opinion dated April 16, 1984 and the language of the Authorization for the project, origin is not a criteria in determining eligibility. While operating on this assumption for some time, on June 5, 1985 in PIL No. 32 the mission formally clarified this position retroactive to Amendment No. 3.

33 - The Mission's policy, as reflected in P.I.L. No. 32, is to accept for attribution all eligible transactions at CIF value. In order to comply with the spirit and intent of the ESF program, CIF values should be used if they correspond with the foreign exchange amount paid by the bank. Therefore, the IG suggestion to use FOB values is inappropriate and is not in conformance with mission decisions.

If changes are not made then the following USAID comment should be included:

> USAID/ES disagrees with attribution of only FOB values. The full value of U.S. Dollars made available, including insurance and freight, should be used in calculating the value of eligible transactions.

40-42 - We appreciate the credit advanced the Mission for its effort in the area of Price Checking as witnessed by the closing of recommendations Nos. 6, 10 and 11. We are of the opinion that in view of the closing of these recommendations the accompanying comments seem superfluous and seem to attempt to highlight negative aspects of our program which were identified and in process of correction by the mission.

43-50 - This section contains several comments concerning the retention of interest on credit sales by the Salvadoran banks. The implication is that the banks or the GOES are in some sort of violation of project conditions and that the USAID has been delinquent in not correcting this situation. The last sentence on page 44 contains a weak statement of our position. The IG has a copy of a GC opinion that states that the interest earned in these circumstances is not considered part of the PL 480 proceeds and is not subject to AID control (Attachment G). We have no objection to the IG expressing their opinion on how the GOES ought to use its money. However, the rewrite of this section should clearly state the GC opinon, and that the IG is recommending another policy for USAID consideration even though not required.

However, in spite of the above comments and the request that the section be rewritten, the GOES on its own has included provisions in its new agreements to recapture interest. Agreement has been reached with both the BHN and the Agricultural Development Bank. (See Attachments O and P)

We have no evidence to support the allegation that there was ever any delay in implementation of any projects as a result of delay in deposit of PL 480 proceeds. Unless the IG has adequate documentation to back up the allegation it should be dropped from the report.

We have no evidence to support the allegation on page 47 that the Agricultural Development Bank either intended to purchase a building or intended to utilize PL 480 proceeds to do so. Unless the IG has adequate documentation to support this allegation it should be dropped from the report.

50-55 - Our main problem with this section is one of timing. The auditors reviewed the situation at a time when the process of review and acceptance of transactions was in process and not complete. This is evidenced by the statement that some ₡ 406,170 were still unliquidated. These items should not be termed by the report as ineligible since there was no basis for determination one way or the other. While we do not have any problem with the substance of the recommendation, except that it is premature to imply we had not done our job, the recommendation should be dropped and the section rewritten to place the comments in their proper time frame and to include observations by the auditors, but not a formal recommendation.

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Disbursements for expenses of the Elections Central Council (CCE), for the 1984 elections process, were covered by the GOES' own resources until the end of the year, when these expenses were submitted to A.I.D. for reimbursement. The GOES submitted the first preliminary report on February 28, 1985, (Attachment H) which included the CCE in global figures. On April 23, 1985, (Attachment I), only a few days before the auditors concluded their field work, the USAID received an additional report with a detailed breakdown of expenses. This latter report appears to have been the basis for the comments made by the auditors.

Following receipt of these documents, the USAID held discussions with the Ministry of Finance. The above documentation was insufficient to determine the eligibility of the expenses incurred. Accordingly, we jointly constructed the attached table which shows a breakout of total expenses, eligible and ineligible. This was officially transmitted to the USAID on July 25, 1985 by the GOES (Attachment J).

The table shows total expenditures in the amount of ₡11,853,049.52, of which eligible expenses of ₡8,658,244.03 and ineligible expenses of ₡3,194,805.49 were identified. The ₡1,741,755.97 disallowed expenditures (the difference between the ₡10.4 million allocated and the ₡8.6 million of eligible costs to be financed) are being reprogrammed as requested by the GOES in their letter of July 25, 1985 mentioned above.

With respect to the observation that the CCE and Ministry of Finance personnel interviewed by the auditors were not aware of the restrictions on the use of ESF funds, regretably some Ministry personnal apparantly were unaware of the restrictions. However, the senior officials in charge were fully aware of the restrictions. As GOES expenditures are identifiable under their "Expenditures Classification Manual," identifying eligible and ineligible expenditures after the fact and makeing necessary adjustments was not difficult.

If the changes recommended are not made then the following USAID comments should be included:

> USAID/ES disagrees with the comments and recommendations. The audit comments and recommendtions were based on preliminary, incomplete GOES reports. At the time audit work was completed the GOES had not yet submitted to USAID a final report for attribution. The GOES final report was received by the Mission and only ₡8.6 million were accepted as eligible. The difference, ₡1.8 million is being jointly reprogrammed with the GOES.

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Closure of Recommendations: At the time of issuance of the report, it should note that all recommendations have been closed. Comments on each recom - mendation with references to relevant documents follows.

Recommendation Nos. 1(a), 1(b), 2, 3(a), 3(b), 4(a), 4(b), 4(c), 4(d), 4(e), 4(f), 5(a), and 5(b).

All of the above deal with the procedures for determining attribution of eligible transactions to ammendments 2, 3 and 4. The attached report from Arthur Young and Company describes the complete procedure used by them to select and verify all transactions attributable to the above ammendments. With the completion of this exhaustive review and the AY certification we believe a certification by the Superintendent of the Financial System would be superfluous and request closure of the recommendations.

With respect to 4(b), the BCR has used the NAUCA code since 1980. New F-10 procedures require the CIIU code as evidenced by newspaper articles.

With respect to recommendation 4. (e), the AY contractor has ascertained payment on attributed transactions under Amendments Nos. 2, 3 and 4. They will continue the process for all remaining amendments.

Other documents attached attest to the completion of actions in response to the recommendations. Attachments in support of closing the recommendations are:

> Annex A - Arthur Young & Company Report on project No.519-0267 dated 15 August 1985. (1.(a), 1.(b), 2, 3.(a), 3.(b), 4.(a), 4.(c), 4.(e).
> Attachment F - PIL No. 32 (4.(b), 4.(d), 5.(b)).
> Attachment L - PIL No. 33 (3.(b), 4.(f)).
> Attachment M - News clip from local newspaper regarding F-10 procedures (4.(b)).

Recommendation No. 6 has already been closed by the report based on the issuance of the Arthur Young contract.

Recommendation Nos. 7.(a), 7.(b), 7.(c).

All of the conditions required under this recommendation have been complied with and documentation is attached evidencing such compliance.

> Attachment O - PL-480 agreements between the GOES and the implementing banks.
> Attachment P - SETEFE letter No. 836/85 dated 19 August, 1985.
> Attachment Q - Letter dated 25 July 1985 from USAID to MINPLAN requesting changes to agreements in accordance with the recommendations.
> Attachment R - Copy of report evidencing receipt of ₡22,782,538.08 from the Mortgage Bank, which was the amount outstanding at that time.
> Attachment U - SETEFE Letter dated 24 July 1985 outlining their procedure to assure compliance with the sales agreements.

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Attachment G - Memorandum dated March 26, 1985 from the Regional Legal Advisor on use of interest on credit sales.

Recommendation No. 8:

This recommendation should be removed from the report. However, for your information, the following documentation is provided in response to the recommendation.

Attachment H - Ministry of Finance letter dated 28 February, 1985
Attachment I - Ministry of Finance letter dated 23 April, 1985
Attachment J - Final liquidation report from Ministry of Finance dated 25 July, 1985 with a request for reprogramming the balance of the ESF local currency.

Recommendation No. 9:

Even though there is no specific requirement in the MOL that the GOES must submit bank reconciliations on a monthly basis, SETEFE submitted the bank reconciliations thru May 31, 1985, on July 2, 1985. On July 12, 1985, in SETEFE's letter 681/85, A.I.D. was informed that the GOES is opening the necessary bank accounts in order to segregate the funds provided by the different agreements. In addition, in the same letter the GOES informed us that the bank reconciliations will be submitted on a monthly basis.

Attachment S - SETEFE letter 634/85 dated 2 July, 1985.
Attachment T - SETEFE letter 681/85 dated 12 July, 1985.

Recommendation Nos. 10 and 11 have been closed by the report.

cc: Mr. T. Stukel, AID/W, LAC/CAP

Cleared by: Mr. Robin Gomez, DIR, USAID/El Salvador (in draft)

List of Recommendations

Page

Recommendation No. 1 9

We recommend that USAID/El Salvador:

(a) determine the eligibility of all transactions accepted for final attribution to the AID disbursement under Amendment No. 4 to the Grant Agreement and disallow any ineligible transactions.

(b) in the event that the Central Bank is unable to provide enough substitute transactions to fully attribute AID disbursements under Amendments 2, 3 and 4 of the Grant Agreement, then the USAID in consultation with appropriate legal counsel, should determine what remedies are available to correct the problem.

Recommendation No. 2 10

We recommend that USAID/El Salvador obtain from the Central Bank $5,042,911 in eligible import transactions in order to complete its attribution to AID disbursements under Amendments 2, 3 and 4 of the Grant Agreement.

Recommendation No. 3 12

We recommend that USAID/El Salvador obtain evidence from the Central Bank that:

a) the required documentation exists to support the final attribution of AID's $75 million disbursement under Amendment No. 4 to the grant agreement.

b) written filing procedures have been established to maintain the required documentation for each transaction.

Recommendation No. 4 15

We recommend that USAID/El Salvador:

a) obtain evidence from the Central Bank attesting to the fact that it has reviewed the transactions approved for AID's disbursement of $75 million under Amendment No. 4 to the grant agreement so as to ensure that the transactions were: (1) for eligible commodities and industrial subsectors, (2) financed by the Central Bank, (3) applied to the eligible import period, (4) accepted at FOB values, (5) not duplicate, and (6) in compliance with AID source and origin requirements. (Any transactions that do not meet these criteria should be disallowed by the USAID and eligible transactions should be substituted for them.)

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b) define the criteria for eligible commodities and industrial subsectors and obtain from the Central Bank evidence that it has implemented procedures to use those definitions to record the commodity and industrial subsector classification on a source document such as the Import Permit Application "Form 10".

c) approve only completed transactions for attribution.

d) clearly define criteria for classifying transactions by eligible import periods.

e) obtain evidence from the Central Bank that it has instituted a procedure to obtain evidence of payment from commercial banks for supplier credit transactions.

f) disallow two transactions for a total of $45,941.78 approved twice per Implementation Letter No. 19 and obtain eligible substitutes.

Recommendation No. 5 27

We recommend that USAID/El Salvador:

a) obtain the certification of the Superintendent of Banks for uncertified transactions attributed to the AID disbursement under Amendment No. 4 and disallow any transactions that cannot be certified.

b) issue a revised implementation letter to clearly define the certification responsibilities of the Superintendent of Banks to ensure the Superintendent certifies transactions against all eligibility criteria (this can be done by including a list of the eligibility criteria in the Superintendent's statement of responsibility).

Recommendation No. 6 30

We recommend that USAID/El Salvador verify that the Central Bank has installed a computerized selection system for attribution of import transactions to AID financing.

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Recommendation No. 7 33

We recommend that USAID/El Salvador:

a) obtain evidence from the GOES that its sales agreements with the Agricultural Development Bank and the Mortgage Bank have been modified to require the deposit into the special account within a specified number of days after generation of: (1) sales proceeds and (2) any interest earned on credit sales (less a reasonable administrative fee).

b) ensure that SETEFE obtains from the Mortgage Bank the $9.4 million sales proceeds retained since September 1984.

c) obtain evidence that SETEFE has established a procedure to verify that the Agricultural Development Bank, the Mortgage Bank and the Institute of Food Regulation deposit their sales proceeds and interest earned into the special accounts when required by their sales agreements and comply with the credit provisions of their agreements.

Recommendation No. 8 37

We recommend that USAID/El Salvador require the GOES to:

a) review all expenditures incurred by the Central Election Council and attribute to ESF funds only expenses allowable under the terms of the 1984 Memorandum of Understanding.

b) retur to the Ministry of Finance special account any ESF funds not attributed to allowable expenses and reprogram these funds.

Recommendation No. 9 42

We recommend that USAID/El Salvador obtain from SETEFE evidence that it has undertaken to establish a procedure to reconcile its bank accounts on a monthly basis and submit these reports to USAID/El Salvador.

Recommendation No. 10 — Page 45

We recommend that USAID/El Salvador require the Department of International Prices of the Central Bank to:

a) exercise independence in accordance with Amendment No. 2 of the Memorandum of Understanding, dated July 24, 1984, by conducting statistically significant random samples of all approved import transactions.

b) establish procedures to ensure that all import transactions meeting the selection criteria established by the Department of International Prices are selected for price verification reviews.

c) revise criteria for selecting transactions for price investigation by using specific criteria such as tariff codes.

d) follow-up on price investigation recommendations.

e) establish a written policy to establish and enforce sanctions against capital flight offenders by adhering to Amendment No. 2 of the Memorandum of Understanding, dated July 24, 1984 (this recommendation is for the President of the Central Bank).

f) increase its staff to and maintain its level at ten professionals, as required by Amendment No. 2 of the Memorandum of Understanding, dated July 27, 1984.

g) obtain special reports from Customs on inspections of selected imports to verify that the value (quantity and quality) of goods imported coincide with the value authorized for the transaction.

Recommendation No. 11 — 51

We recommend that USAID/El Salvador obtain from the Central Bank documentation attesting to the fact that it has:

a) appropriately increased the number of price verifications for export transactions.

b) established procedures for export price verifications similar to those established or recommended for the review of imports (see Recommendation No. 10).

APPENDIX 3

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