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AUDIT OF  
USAID/PERU  
PRIVATE SECTOR AGRICULTURAL  
INVESTMENT PROMOTION  
PROJECT NO. 527-0265

Audit Report No. 1-527-86-16  
June 16, 1986

AGENCY FOR INTERNATIONAL DEVELOPMENT

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June 16, 1986

MEMORANDUM

TO : D/USAID/Peru, Mr. John A. Sanbrailo  
FROM : RIG/A/T, *Coinage N. Gothard*  
SUBJECT: Audit of USAID/Peru Private Sector Agricultural Investment  
Promotion, Project No. 527-0265

This report presents the results of audit of USAID/Peru Private Sector Agricultural Investment Promotion, Project No. 527-0265. The specific objectives of this audit were to evaluate project effectiveness in achieving planned results, the efficiency of project operations, the adequacy of internal controls and compliance with AID regulations.

Project effectiveness has been limited by the failure of the Government of Peru (GOP) to (a) obtain \$10 million in loan funds from a United States financial institution or institutions, (b) provide in a timely manner its counterpart and maintenance of value contributions, and (c) implement the planned technical assistance fund. The efficiency of project operations has been reduced by poor cash management of the Agricultural Investment Fund and by cumbersome subloan application procedures. Weaknesses in internal controls has led to (a) insufficient documentation to monitor the provisions of the Fly America Act in this as well as other projects and (b) the use of subproject funds for purposes not authorized in the subloan agreements.

The project will not achieve its planned level of financial results because the Government of Peru, which suffers from a poor credit rating, was unable to obtain \$10 million in loan funds from a United States financial institution or institutions as planned. As a result, USAID/Peru suspended AID disbursements on December 31, 1984. USAID/Peru and the Government of Peru subsequently agreed to eliminate this co-financing requirement and to reduce the total cost of the project from \$35.5 to \$19 million. Other problems that have adversely affected the implementation of the project included the failure by the GOP to provide any of its contribution for counterpart and for maintaining the dollar value of the Agricultural Investment Fund in 1983 and 1984. As a result, USAID/Peru conditioned the renewal of AID loan disbursements (originally

suspended for non-compliance with the co-financing requirement) on GOP compliance with its contribution requirements. In January 1986, the GOP provided most of its agreed counterpart and maintenance of value contributions.

A contribution was needed to maintain the value of the Agricultural Investment Fund mainly because of fund decapitalization caused by the Development Finance Corporation (COFIDE) charging less than market rates of interest on subloans to farmers and because surplus cash was not invested. COFIDE has corrected the interest rate problem and the cash management problem is addressed in this report.

Except as noted above, USAID/Peru and COFIDE have established and implemented an effective system to provide medium-term credit to small and medium-sized farmers which was the major objective of the project. During the 18-month period ending in April 1985, COFIDE working through 12 intermediate credit institutions (ICIs), disbursed about \$5 million in AID loan advances for subloans and has monitored the use of subloan proceeds in an effective manner. Our visits to the subborrowers showed that the medium-sized farmers we visited were highly motivated, well-trained or experienced, and proud of what they were able to accomplish with the subloans. USAID/Peru has done a satisfactory job in identifying and resolving the GOP counterpart, maintenance of value and interest rate problems.

The report recommends that: cash management in the Agricultural Investment Fund be improved; a legal opinion be obtained to determine what rate of exchange should be used to calculate the equivalence of GOP contributions to the project; control over the use of subproject funds provided by the subloan and the farmers be improved; documentation requirements for the preparation of subloan applications be simplified; the technical assistance program for farmers be modified; and improved procedures be followed to verify compliance with the Fly America Act.

USAID/Peru was in general agreement with the audit report. Your complete comments are contained in Appendix 1. This report contains six recommendations of which five are closed upon its publication because of corrective actions taken.

Please advise this office within 30 days of the actions planned or taken to implement Recommendation No. 5 of this report.

## EXECUTIVE SUMMARY

USAID/Peru's Private Sector Agricultural Investment Promotion project was started in March 1983 and is scheduled to end in March 1988. AID has loaned the Government of Peru \$10 million for this project of which almost \$5 million was disbursed as of December 31, 1985. The total cost of the project was to be \$35.5 million. It was to be implemented by the Development Finance Corporation, an autonomous state enterprise. The Development Finance Corporation was to create an Agricultural Investment Fund to finance subloans made by private sector financial institutions or intermediate credit institutions to farmers for medium-term agricultural credit for on-farm improvements.

The Office of the Regional Inspector General for Audit/Tegucigalpa reviewed the Private Sector Agricultural Investment Promotion project, covering activities from March 29, 1983 through January 31, 1986. The audit objectives were to evaluate the project's effectiveness in achieving planned results, the efficiency of project operations, the adequacy of internal controls, and compliance with AID regulations.

The project will not achieve its planned level of financial results because the Government of Peru, which suffers from a poor credit rating, was unable to obtain \$10 million in loan funds from a United States financial institution or institutions as planned. As a result, USAID/Peru suspended AID disbursements on December 31, 1984. USAID/Peru and the Government of Peru subsequently agreed to eliminate this co-financing requirement and to reduce the total cost of the project from \$35.5 to \$19 million. Other problems that have adversely affected the implementation of the project included the failure by the Government of Peru to provide any of its contributions for counterpart and for maintaining the dollar value of the Agricultural Investment Fund in 1983 and 1984. As a result, USAID/Peru conditioned the renewal of AID loan disbursements (originally suspended for non-compliance with the co-financing requirement) on Government of Peru compliance with its contribution requirements. In January 1986, the Government of Peru provided most of its agreed counterpart and maintenance of value contributions.

A contribution was needed to maintain the dollar value of the Agricultural Investment Fund mainly because of fund decapitalization caused by the Development Finance Corporation charging less than market rates of interest on subloans to farmers and because of poor cash management. The Development Finance Corporation has corrected the interest rate problem and the cash management problem is addressed in this audit report.

Except as noted above, USAID/Peru and the Development Finance Corporation have established and implemented an effective system to provide medium-term credit to small and medium-sized farmers which was a major objective of the project. During the 18-month period ending in April 1985, the Development Finance Corporation working through 12 intermediate credit institutions disbursed about \$5 million in AID loan advances for subloans to farmers and has monitored the use of subloan proceeds in an

effective manner. Our visits to the farmers showed that medium-sized farmers were highly motivated, well-trained or experienced, and proud of what they were able to accomplish with the subloans. USAID/Peru has done a satisfactory job in identifying and resolving the Government of Peru counterpart, maintenance of value and interest rate problems.

The Development Finance Corporation did not earn any interest on the cash balances of its Agricultural Investment Fund from November 1983 through January 1986 because it did not follow sound cash management procedures. As a result, the fund was decapitalized by \$831,945. We recommended that the surplus cash of the fund be invested which was done prior to the publication of this report.

AID local currency contributions to the project have been obtained by using the free market (parallel) rate of exchange. However, the dollar equivalence of the Government of Peru contribution has been determined by using the lower official rate of exchange because according to USAID/Peru it is required by the Government of Peru budgetary law. As a result, the real value of the Government of Peru contribution will be understated in terms of dollars and the Government of Peru may not contribute the dollar amounts required by sections 3.2(b) and 6.2(b) of the AID loan agreement. More importantly, this could also lead to situations where the Government of Peru does not contribute at least 25 percent of the total project cost as required by section 110 of the Foreign Assistance Act. We recommended that a legal opinion be obtained which was done prior to publication of this report. The opinion indicated that the rate of exchange to be used to determine the dollar equivalence of host country contributions is a matter of negotiation because of the lack of any legal or policy criteria. We plan to recommend in another audit report that the policy issue be addressed by AID/Washington.

The Development Finance Corporation canceled its financing with the intermediate credit institutions for 10 of 122 subloans because the Development Finance Corporation found that the farmers (subborrowers) had not used the subproject funds as intended. This happened because subloan disbursement controls were not adequate to ensure the proper use of subproject funds. Also, criteria were applied to the cancellation of subloans that did not consider subproject implementation delays outside the control of the farmers. We recommended that the disbursement controls and cancellation criteria be improved which was done prior to publication of this report.

The Development Finance Corporation subloan application requires the preparation of a projected cash flow analysis which is of little value for small loans. This can discourage the farmers from applying for subloans and intermediate credit institutions from participating in the program. We recommended that subloan application procedures be simplified for smaller loans which was done prior to publication of this report.

A technical assistance fund of \$500,000 was to be established to provide technical assistance through the intermediate credit institutions to the subborrowers (farmers) on a loan basis. This technical assistance fund

has not been implemented because detailed plans and procedures were not prepared. If this component of the project is not implemented, the farmers may not benefit from needed technical assistance. We recommended that if a technical assistance is needed, a program should be designed to satisfy those needs and that any funds not needed for the program be reprogrammed. Action was started to correct this problem prior to publication of this report.

Some AID financed contractors did not use U.S. air carriers to leave and return to the U.S. under this project as well as projects 527-0192 and 0178. Documentation in USAID/Peru Controller files was incomplete to verify compliance with the Fly America Act. We recommended that justifying documentation be obtained to determine if refunds had to be made and that monitoring procedures be improved. This was done prior to the publication of this report.

*Office of the Inspector General*

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PART I - INTRODUCTION

A. Background

On March 29, 1983 USAID/Peru and the Government of Peru (GOP) signed a loan agreement for the Private Sector Agricultural Investment Promotion project for \$10 million. The goal of the project was to increase rural incomes in Peru by increasing agricultural productivity.

The project purpose was to increase the availability of medium-term agricultural credit in Peru by strengthening the capacity of private sector financial institutions or intermediate credit institutions (ICIs) to finance medium-term agricultural loans for small to medium-sized farmers. The project was to be implemented by the Development Finance Corporation (COFIDE), an autonomous state enterprise. COFIDE was to create an Agricultural Investment Fund to finance eligible subloans made by ICIs to farmers for medium-term agricultural credits of up to ten years for on-farm improvements.

The project was estimated to cost \$35.5 million of which \$35.2 million was for agricultural credit activities and \$.3 million for technical assistance and training to the ICIs.

The \$35.2 million for agricultural credit activities was to be financed by: \$9.7 million in AID loan funds, \$10.0 million in loans from a United States financial institution or institutions, \$5.0 million from COFIDE as GOP counterpart, and \$10.5 million from participating ICIs and farmers. COFIDE was to finance 70 percent of the cost of each subloan project and the ICIs and farmers were to finance the remaining 30 percent. Of the \$9.7 million in AID loan funds allocated to agriculture credit activities, \$500,000 was to be used as a revolving loan fund to provide technical assistance to farmers.

COFIDE entered into loan agreements with each ICI. The ICIs were to make the subloans to farmers and COFIDE was to finance up to 70 percent of the cost of each subproject. The ICI was to assume the full risk of each subloan. The ICI was obligated to repay COFIDE for its financing of the subloan when the subloan payments fell due even if the farmer did not pay the ICI. The ICI authorized COFIDE to charge or credit its account at the Central Bank of Peru to make the financial transactions agreed to between COFIDE and the ICI.

By the end of the project, COFIDE's medium-term Agricultural Investment Fund was to be operating using reflows from the loans. Approximately nine to twelve ICIs were to have gained experience in making medium-term agricultural investment loans to farmers.

The estimated completion date for the 5-year project was March 31, 1988. As of December 31, 1985, AID had disbursed \$4,976,401 under the loan.

B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit of the Private Sector Agricultural Investment Promotion project. The audit covered expenditures of \$4,976,401 from March 29, 1983 through December 31, 1985 and activities through January 31, 1986. The audit fieldwork was conducted from January 23 through March 18, 1986.

The audit objectives were to evaluate:

- the effectiveness of the project in achieving planned results,
- efficiency of project operations,
- the adequacy of internal controls, and
- compliance with AID regulations.

To accomplish these objectives, we reviewed project files and interviewed officials of USAID/Peru and COFIDE. We also visited five of the thirteen ICIs participating in the program and four of the farmers obtaining subloans from the ICIs. This audit was made in accordance with generally accepted government auditing standards.

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PART II - RESULTS OF AUDIT

Project effectiveness has been limited by the failure of the Government of Peru (GOP) to (a) obtain \$10 million in loan funds from a United States financial institution or institutions, (b) provide in a timely manner its counterpart and maintenance of value contributions, and (c) implement the planned technical assistance fund. The efficiency of project operations has been reduced by poor cash management of the Agricultural Investment Fund and by cumbersome subloan application procedures. Weaknesses in internal controls has led to (a) insufficient documentation to monitor the provisions of the Fly America Act in this as well as other projects and (b) the use of subproject funds for purposes not authorized in the subloan agreements.

The project will not achieve its planned level of financial results because the Government of Peru, which suffers from a poor credit rating, was unable to obtain \$10 million in loan funds from a United States financial institution or institutions as planned. As a result, USAID/Peru suspended AID disbursements on December 31, 1984. USAID/Peru and the Government of Peru subsequently agreed to eliminate this co-financing requirement and to reduce the total cost of the project from \$35.5 to \$19 million. Other problems that have adversely affected the implementation of the project included the failure of the GOP to provide any of its contributions for counterpart and for maintaining the dollar value of the Agricultural Investment Fund in 1983 and 1984. As a result, USAID/Peru conditioned the renewal of AID loan disbursements (originally suspended for non-compliance with the co-financing requirement) on GOP compliance with its contribution requirements. In January 1986, the GOP provided most of its agreed counterpart and maintenance of value contributions.

A contribution was needed to maintain the dollar value of the Agricultural Investment Fund mainly because of fund decapitalization caused by the Development Finance Corporation (COFIDE) charging less than market rates of interest on subloans to farmers and because surplus cash was not invested. COFIDE has corrected the interest rate problem and the cash management problem is addressed in this report.

Except as noted above, USAID/Peru and COFIDE have established and implemented an effective system to provide medium-term credit to small and medium-sized farmers which was the major objective of the project. During the 18-month period ending in April 1985, COFIDE working through 12 intermediate credit institutions (ICIs), disbursed about \$5 million in AID loan advances for subloans and has monitored the use of subloan proceeds in an effective manner. Our visits to the subborrowers showed that the medium-sized farmers we visited were highly motivated, well-trained or experienced, and proud of what they were able to

accomplish with the subloans. USAID/Peru has done a satisfactory job in identifying and resolving the GOP counterpart, maintenance of value and interest rate problems.

The report recommends that: cash management in the Agricultural Investment Fund be improved; a legal opinion be obtained to determine what rate of exchange should be used to calculate the equivalence of GOP contributions to the project; control over the use of subproject funds provided by the subloans and the farmers be improved; documentation requirements for the preparation of subloan applications be simplified; the technical assistance program for farmers be modified; and improved procedures be followed to verify compliance with the Fly America Act.

## A. Findings and Recommendations

### 1. Cash Management Needs to be Improved

Sound cash management principles hold that interest be earned on surplus cash balances. The Development Finance Corporation (COFIDE) did not earn any interest on the cash balances of its Agricultural Investment Fund from November 1983 through January 1986 because it did not follow sound cash management procedures. As a result, the fund had foregone interest earnings of \$831,945 (see Exhibit 1).

#### Recommendation No. 1

We recommend that USAID/Peru obtain evidence that the Development Finance Corporation has invested the cash balances of its Agricultural Investment Fund in low-risk, interest-bearing investments.

#### Discussion

Sound cash management principles require that interest income be earned on surplus cash balances in order to help maintain the purchasing power of this important liquid asset.

The Agricultural Investment Fund had an average monthly cash balance of \$650,000 since it was established in November 1983 through January 1986. However, COFIDE did not earn any interest income on its surplus cash because sound cash management principles were not followed.

During the period from November 1983 through December 1984, the Agricultural Investment fund was almost entirely financed by AID advances totaling almost \$5 million. During that period, monthly cash balances averaged \$505,000. However, USAID/Peru advised COFIDE by Implementation Letter No. 6 that AID advances had to be deposited in a separate non-interest bearing project bank account. We could not find any restriction in the AID project agreement that prohibited the GOP from earning interest on AID funds since this was a loan and not a grant. From January to December 1985 the fund was financed mainly by reflows and monthly cash balances averaged \$460,000. In January 1986, the cash balance of the fund increased greatly to almost \$5 million because of a GOP contribution for maintenance of value and counterpart funding of the project.

Although USAID/Peru has long been aware of COFIDE's cash management problem (which was discussed in a May 1985 project evaluation), the problem has persisted. USAID/Peru and COFIDE have been considering several options. The lowest risk option would be to convince the Central Bank to pay interest on the cash balances of the fund as they are doing on COFIDE's regular account. Other options would be to buy short-term bonds issued by COFIDE or to transfer the cash of the fund to COFIDE's regular interest-bearing account with the Central Bank. If this latter option is implemented, then COFIDE should establish adequate accounting controls to ensure that the cash of the fund is not used for its own operations.

If the Central Bank agrees to pay interest on the fund, or the cash of the fund is transferred to COFIDE's regular interest-bearing account with the Central Bank, then 100 percent of the cash of the fund should be invested. However, if the cash of the fund is invested only in COFIDE's short-term bonds, then an adequate cash balance should be maintained in the fund's non-interest-bearing account to cover the short-term disbursement needs of the project.

In Exhibit 1 we have estimated that the Agricultural Investment Fund has forgone \$831,945 in interest income from November 1983 through January 1986 by not investing the cash of the fund in savings accounts of finance companies. As of February 1, 1986, the fund had a cash balance of almost \$5 million. Assuming that it will take about one year to disburse this amount, the fund could lose about \$800,000 in interest income over the next 12 months at current interest rates of 32 percent (\$2.5 million x 32 percent). Although the GOP has agreed to maintain the dollar value of the fund, annual GOP contributions could be greatly reduced by improving the cash management of the fund, thereby saving scarce GOP resources for other purposes.

USAID/Peru does not believe COFIDE should have invested idle cash balances derived from AID loan advances prior to 1985 in interest-bearing investments because they claim it is contrary to AID policy.

In our opinion, the issue of whether a host government can earn and retain interest on AID loan payments to ICIs is not clearly defined by AID policy. Since our audit of another USAID/Peru project (527-0178) disclosed that another host government institution did invest and earn interest on AID loan payments, we are recommending in that report that USAID/Peru obtain an AID/Washington legal opinion to determine what corrective action is needed.

Prior to the publication of this report USAID/Peru requested and received a guidance cable (State 140362) from the office of the Controller in AID/Washington. The cable stated that when dealing with an ICI a distinction has to be made between advancing funds to assist with implementation or disbursing funds in order to capitalize the ICI. In the case where funds are advanced to assist the ICI in meeting its cash needs, then the AID policy of providing for immediate cash requirements should be followed. They did not feel that an advance, even though issued to an ICI from loan funds, should be permitted to provide income. The cable concluded that they were unable to find any guidance or references that support a different position and added that any specific references that would point them in a different direction would be appreciated and explored.

#### Management Comments

USAID has obtained evidence that COFIDE has invested temporary surplus cash balances of the Credit Fund in low-risk, interest-earning investments by transferring project funds to its regular interest-bearing account with the Central Bank. COFIDE has adopted the policy of investing temporary surplus cash and, further, is seeking from the

Peruvian Central Bank payment of interest on the project's account. This latter procedure will assure maximum liquidity, a good investment return on daily balances and complete segregation of funds. Additionally, USAID will monitor closely COFIDE's requests for AID advances to the Credit Fund to assure that only minimum small balances remain in the project's account before USAID makes available new project advances to fund needed subloan disbursements.

Inspector General Comments

Recommendation No. 1 is to be closed upon publication of this report because the corrective actions described above meet the intent of our recommendation.

## 2. Exchange Rate Used to Determine GOP Counterpart Contributions is Questionable

The rate of exchange used to convert AID's dollars to local currency for its contribution to the project should also be used to determine the dollar equivalent of the GOP's local currency contribution. AID local currency contributions have been obtained by using the free market (parallel) rate of exchange. This is consistent with section 8.4 of the loan agreement which states that AID funds should be converted into local currency at the highest rate of exchange which is not unlawful in Peru and recent AA/LAC guidance on exchange rates (see Exhibit 2). However, the equivalence of the GOP contribution has been determined by using the lower official rate of exchange because according to USAID/Peru it is required by GOP budgetary law. As a result, the real value of the GOP contribution will be understated in terms of dollars and the GOP may not contribute the dollar amounts required by sections 3.2(b) and 6.2(b) of the AID loan agreement. More importantly, this could also lead to situations where the GOP does not contribute at least 25 percent of the total project cost as required by Section 110 of the Foreign Assistance Act. Since AID policy does not address the issue of what rate of exchange should be used to calculate the dollar equivalence of host country contributions, we believe that USAID/Peru should obtain a legal opinion on what rate of exchange should be used.

### Recommendation No. 2

We recommend that USAID/Peru obtain a legal opinion from AID/Washington on what rate of exchange should be used to determine the dollar equivalent of the GOP contributions to the project made under sections 3.2(b) and 6.2(b) of the loan agreement and take any corrective action required by the opinion.

### Discussion

In our opinion, the rate of exchange used to convert AID dollars to local currency for its contribution to the project should also be used to determine the dollar equivalent of the GOP's local currency contributions. AID's local currency contributions have been obtained by using the free market (parallel) rate of exchange. This is consistent with section 8.4 of the loan agreement which states that AID funds should be converted into local currency at the highest rate of exchange which is not unlawful in Peru and recent AA/LAC guidance on exchange rates (see Exhibit 2). However, the equivalence of the GOP contribution has been determined by using the lower official rate of exchange because according to USAID/Peru it is required by GOP budgetary law.

AID Implementation Letter No. 18, dated September 9, 1985, conditioned the renewal of AID loan disbursements on the requirement that the GOP contribute \$4.6 million to the project. This contribution was to consist of \$2.4 million for counterpart, as required under section 3.2(b) of the loan agreement (financed from P.L. 480 Title I), and \$2.2 million for maintaining the dollar value of the Agricultural Investment Fund through March 31, 1985 as required by section 6.2(b) (financed by other donors).

In January 1986, the GOP made a contribution of I/.55,200,000 <sup>1/</sup> to comply with the requirements of Implementation Letter No. 18. Thus, the GOP contribution was equivalent to \$3,962,670 using the official rate of exchange of I/13.93 to \$1.00. However, if the parallel rate of exchange had been used (I/.17.39 to \$1.00), the dollar equivalent of the GOP contribution would only have been \$3,174,238. Thus, by using the official rate of exchange, the value of the GOP contribution was unrealistically overvalued by \$788,432.

Use of a less than best available rate of exchange could lead to situations where the GOP is not in compliance with sections 3.2(b) and 6.2(b) of the AID loan agreement and more importantly section 110 of the Foreign Assistance Act (FAA). Section 110 of the FAA requires the host country to contribute at least 25 percent of the total development assistance funded project cost. To ensure compliance with the FAA, we believe the dollar equivalent of the GOP contributions should be calculated using the same exchange rate that is used to convert AID dollars to local currency.

#### Management Comments

Prior to the publication of this report, the General Counsel for Latin America and the Caribbean (GC/LAC) cabled a legal opinion to USAID/Peru (State 163411) which indicated that the rate of exchange to be used is a matter of negotiation in the absence of any legal or AID policy criteria (see Appendix 2).

#### Inspector General Comments

Recommendation No. 2 is closed upon publication of this report because the requested legal opinion was obtained. However, since AID policy does not address the issue of what rate of exchange should be used to calculate the dollar equivalence of host country contributions in order to verify compliance with section 110 of the Foreign Assistance Act, we believe that policy guidance should be provided by AID/Washington. Such policy guidance should consider situations of both multiple and/or floating exchange rates. We plan to address this issue in another on-going RIG/A/T audit of USAID controls over host country counterpart contributions which will cover most of the AID countries in Latin America and the Caribbean.

<sup>1/</sup> The GOP recently changed its currency from soles to intis. The official rate of exchange for one dollar is 13.93 intis or 13,930 soles.

### 3. Control Over the Use of Subproject Funds Needs Improvement

The subloan agreements specified how the subproject funds (the subloans and contributions from the farmers) were to be used. Since program inception in November 1983 through December 1985, the development finance Corporation (COFIDE) financed 122 subloans made by intermediate credit institutions (ICIs) participating in the program. However, COFIDE canceled its financing with the ICIs for ten of these subloans because COFIDE found that the farmers (subborrowers) had not used the subproject funds as intended. This happened because subloan disbursement controls were not adequate to ensure the proper use of subproject funds. Also, COFIDE applied criteria to the cancellation of some of these subloans that did not consider subproject implementation delays outside the control of the subborrowers that prevented the use of subproject funds as planned. If subproject funds are not used as intended, this could adversely affect the achievement of the project goal to increase agricultural productivity.

#### Recommendation No. 3

We recommend that USAID/Peru obtain evidence that the Development Finance Corporation has established:

- a) improved disbursement control procedures to ensure that subproject funds are used for purposes as specified in the subloan agreements; and
- b) subloan cancellation criteria that consider implementation delays outside the control of the subborrowers that could prevent the use of subproject funds as planned.

#### Discussion

Since program inception in November 1983 through December 1985, COFIDE financed 122 subloans made by ICIs participating in the program. The subloan agreements specified how the subproject funds (subloan proceeds and contributions from the subborrowers) were to be used.

COFIDE cancelled its financing with the ICIs for ten of the subloans by charging the ICI accounts at the Central Bank of Peru because COFIDE found through its field visits that the farmers had not used the subproject funds as specified in the subloan agreements. For example, they found that expense documentation was not sufficient to support the eligible use of subproject funds, cattle were not purchased, and dikes, drainage canals, ponds, retaining walls, houses, and irrigation canals were not constructed. In addition, COFIDE found that two farmers had invested their unused subloan proceeds in foreign certificates of deposit or a savings account. In one instance, a subloan was granted to finance farm improvements that had been made before the subloan was approved.

COFIDE has done an excellent job of following-up on subloans through its Department of Follow-up and Control. COFIDE's follow-up procedures consist of reviewing expense documentation obtained from the ICIs and

making field visits to the farms to verify compliance with the farm plan. As of December 31, 1985, COFIDE had followed-up on 67 percent of the subloans granted from the Agricultural Investment Fund.

The ICIs have also made some field visits but they are more interested in the repayment of subloans rather than whether the funds were used as intended. Some of the ICIs stated that they would prefer that COFIDE make more field visits since the 5 percent margin received by the ICIs is not adequate to cover field trip and other costs, particularly for the smaller subloans. One of the ICIs believed that COFIDE's criteria for the cancellation of subloans has been too strict. For example, one subborrower could not make the required improvements because subloan funds were not received as planned before the beginning of the rainy season.

Subproject funds were not used as planned because COFIDE disbursement controls were not adequate. To correct this problem, COFIDE believes a field visit should be made prior to the granting of the subloan to obtain baseline data that would permit it to verify progress after the subloan is granted. Also COFIDE believes that subloan disbursements should not be made in one disbursement as has been done in the past for most loans. Instead, disbursements should be staggered and conditioned upon the project progress as verified through field visits and expense documentation.

To resolve these problems, we believe that COFIDE should establish improved procedures to ensure that subloan proceeds are used as intended and develop criteria that would obviate cancellation of subloans because of implementation delays outside the control of the subborrower.

#### Management Comments

USAID has obtained evidence that COFIDE has now established improved control procedures to continue to ensure, to the maximum extent possible, that subloans are used for the purposes intended. These actions include (1) increased field visits by COFIDE staff prior to and after subloan disbursements, and in conjunction with regular reviews of project progress, and (2) a written policy directive to phase disbursements, for larger subprojects, based on a chronogram of investments. USAID has also obtained evidence that COFIDE has adopted a new policy amending cancellation criteria to consider implementation delays outside the control of the subborrowers.

#### Inspector General Comments

Recommendation No. 3 is closed upon publication of this report based on the corrective actions described above.

#### 4. Documentation Requirements for Preparation of Subloan Applications Were Excessive

Documentation requirements should not be in excess of needs. The Development Finance Corporation (COFIDE) did not fully observe sound principles of management in establishing documentation requirements for the subloan application. The COFIDE subloan application requires the preparation of a projected cash flow analysis which is of little value for small loans. This can discourage farmers from applying for loans and intermediate credit institutions (ICIs) from participating in the program.

##### Recommendation No. 4

We recommend that USAID/Peru obtain evidence that the Development Finance Corporation has simplified the documentation requirements for preparation of subloan applications for the smaller subloans.

##### Discussion

Documentation requirements should not be in excess of needs. COFIDE's subloan application procedures require the preparation of a projected cash flow analysis which is not needed for small subloans. In addition, the procedures require the preparation of an Internal Rate of Return analysis for subloans above \$100,000.

Some of the ICIs told us that COFIDE's subloan application documentation requirements were excessive. In their opinion, the cash flow and Internal Rate of Return analyses were not needed for the smaller subloans. Many farmers were unable to complete this part of the application without assistance from the ICI, COFIDE or others. One ICI felt it was generally protected against bad debts by the collateral used to secure the subloan or the credit record of the subborrower for the smaller subloans.

In our opinion, unnecessary documentation requirements discourage farmers from applying for subloans and the ICIs from participating in the program. Consequently, we believe that COFIDE should simplify its subloan application documentation requirements for the smaller subloans by eliminating the preparation of a cash flow analysis.

##### Management Comments

USAID has obtained evidence that COFIDE has waived, for all subloans not exceeding the equivalent of \$20,000 in aggregate, calculated using the highest lawful rate of exchange, the previous requirement that subborrowers present cash flow projections and internal rate of return calculations. Should the calculations be deemed necessary by COFIDE, they will be performed by COFIDE staff. It should be noted that this new policy will simplify subloan application procedures for over 40 percent of subborrowers.

##### Inspector General Comments

Recommendation No. 4 is closed upon publication of this report based on corrective actions described above.

## 5. Technical Assistance to Subborrowers

A technical assistance fund of \$500,000 was to be established to finance technical assistance through the intermediate credit institutions (ICIs) to the subborrowers (farmers) on a loan basis. This technical assistance fund has not been implemented because detailed plans and procedures were not prepared. The Development Finance Corporation (COFIDE) and the ICIs have provided some of the technical assistance contemplated under the technical assistance fund to the subborrowers at no cost. Other subborrowers have obtained needed technical assistance from other sources. Some subborrowers do not need technical assistance and others do not want to pay for it. The issue of how much or what type of technical assistance is needed and the methods to be used to finance and channel the assistance to the subborrowers should be defined by COFIDE and USAID/Peru. If this component of the project is not implemented, certain subborrowers may not benefit from needed technical assistance.

### Recommendation No. 5

We recommend that USAID/Peru and the Development Finance Corporation determine to what extent a technical assistance program is needed to help the subborrowers and design a viable program to satisfy those needs. Any funds not needed for this purpose should be reprogrammed for other project purposes.

### Discussion

A rotating technical assistance fund of \$500,000 was to be established as separate subloans from the Agricultural Investment Fund. This fund was to be made available to participating ICIs to provide technical assistance to subborrowers (farmers). COFIDE was to initially disburse to the ICIs for the establishment of individual technical assistance funds to be managed by each ICI and maintained by subborrower repayments. Areas of assistance were to include preparation of farm budgets and subloan applications, cash flow analyses, bookkeeping, and equipment procurement, installation, and maintenance. Once subborrowers' repayments for technical assistance begin, additional funds were to be available for technical assistance for new subborrowers.

The technical assistance fund has not been implemented because detailed plans and procedures were not prepared. COFIDE submitted a general technical assistance plan to satisfy the conditions precedent of the loan. This plan stated that COFIDE would establish procedures to implement the plan, but COFIDE has not done this. Also, USAID/Peru approved the general plan with the understanding that COFIDE would prepare a detailed plan with the help of a short-term technical advisor. But a short-term technical advisor was not contracted for this purpose.

The technical assistance program will have to be redesigned to ensure its success. For example, we found that COFIDE and the ICIs have provided some of the technical assistance contemplated (preparation of subloan

applications, cash flow analysis and farm budgets) to the subborrowers free of charge. Other subborrowers have obtained technical assistance from other sources. Some subborrowers do not need technical assistance and others do not want to pay for it.

The issue of how much and what types of technical assistance are needed and the methods to be used to finance and channel the assistance to the subborrowers should be defined by COFIDE and USAID/Peru. If this component of the project is not implemented, certain subborrowers may not benefit from needed technical assistance.

USAID/Peru has long been aware of the technical assistance problem which was presented in an evaluation of the project done in May 1985. Several options have been considered to resolve the problem but no definitive action has been taken yet.

#### Management Comments

COFIDE has determined that a comprehensive, self-financing technical assistance plan is needed both to assist ICIs to continue to expand their agriculture finance activities promoted by the project, and to provide technical assistance to subborrowers on business management skills and on improved farming methods. Consequently, USAID and COFIDE are jointly continuing the design of the technical assistance plan for both ICIs and subborrowers. This is to be completed by July 31, 1986 and is expected to be implemented before the end of CY86. Once the technical assistance program has been approved by USAID, we will reprogram the project's financial plan correspondingly and forward the approved technical assistance plan to RIG/A/T.

#### Inspector General Comments

USAID/Peru has started corrective action on Recommendation No. 5 which can be closed as soon as the self-financing technical assistance plan has been approved and any unneeded funds are reprogrammed.

## 6. Monitoring Provisions of the Fly America Act Can Be Strengthened

The Fly America Act established a legal requirement that all government-financed air travel be performed on U.S. air carriers where such service is available. Some AID financed contractors did not use U.S. air carriers to leave and return to the U.S. under projects 527-0265, 0192 and 0178. This may be contrary to their contracts and the Fly America Act. If USAID/Peru does not enforce the provisions of the Fly America Act by improving its monitoring procedures, U.S. air carriers may not benefit as intended.

### Recommendation No. 6

We recommend that USAID/Peru:

- a. obtain refunds from the three U.S. contractors cited in our finding for non-use of U.S. air carriers when leaving and returning to the U.S., unless the contractors can provide adequate justification for using foreign flag carriers; and
- b. establish improved procedures to enforce the provisions of the Fly America Act.

### Discussion

The Fly America Act established a legal requirement that all government-financed air travel be performed on U.S. air carriers when such service is available. The requirements of the Fly America Act are incorporated into Section 134 of AID Handbook 22 and they cover AID employees, consultants, contractors and grantees.

Based on a selective review of vouchers under projects 527-0265, 0192 and 0178, we found that some AID financed contractors did not take U.S. air carriers when leaving and returning to the U.S. as required by the Fly America Act. Three examples of our findings are given below.

In 1985, a contractor flew from Miami to Lima, Peru and returned to Miami (Voucher 527-86-776, Contract PDC-1406-I-02-4088-00, W.O. No. 2, Project 527-0265). The contractor flew from Miami to Kingston, Jamaica on Air Jamaica, stayed overnight in Kingston and then flew to Lima on Aeroperu. The same routing was followed in returning to Miami. Since U.S. air carrier service was available between Miami and Kingston, a U.S. carrier should have been used for this portion of the trip.

In 1985, a contractor flew from Lima, Peru to Tokyo, Japan via the U.S. and return (Contract 527-0192-C-00-2004-00, Project 527-0192). The contractor used foreign flag carriers for the entire trip (Lan Chile, Japan Airlines and Varig). Since U.S. air carrier service was available from Panama or other connecting points to the U.S. and from the U.S. to Tokyo, a U.S. air carrier should have been used for these portions of the trip.

In 1985, a contractor and his family flew from Lima, Peru to New York City (Voucher 527-85-3501, Contract 527-0178-S-00-4064-00, Project 527-0178). The contractor and his family flew LAN-Chile to New York City. Since U.S. air carrier service was available to New York City from connecting points outside the U.S., such as Guayaquil, Ecuador, a U.S. air carrier should have been used for this portion of the trip.

In two of the projects cited above (527-0265 and 0178), USAID/Peru paid the vouchers. This suggests that adequate procedures were not being followed to prevent ineligible payments. In the other project (527-0192), the voucher was paid under a Federal Reserve Letter of Credit in the U.S. As a result, USAID/Peru did not have the opportunity to review support documentation for payments to this contractor.

According to AID and contractor personnel, U.S. air carriers were not used to fly to and from the U.S. because no U.S. air carriers serviced Peru or because it was cheaper to fly on foreign flag carriers. However, the Fly America Act does not authorize the use of foreign flag carriers for these reasons. We therefore believe that USAID/Peru should establish improved procedures to better enforce the provisions of the act so U.S. air carriers are benefited as intended.

According to USAID/Peru, they have in place a system of controls that includes in-country contractor counseling of U.S. flag transportation requirements, periodic Notices regarding changed circumstances (such as when Eastern flights were stopped) and payment examination procedures to identify travel on foreign-flag airlines and verify that such travel met the requirements of the Fly America Act. To improve payment review procedures USAID/Peru plans to prepare a guidance memorandum to review the requirements of the Fly America Act, review documentation requirements for Contractor transportation payments and distribute copies of AID Handbook 22 to all voucher examination personnel.

#### Management Comments

USAID/Peru Controller obtained from contractors the documentation missing from the Controller files to justify the use of foreign flag carriers. The USAID/Peru Controller also indicated that because of the above indication of isolated cases of contractor reimbursements where the use of non-U.S. carriers was not properly documented, a training session was organized to ensure that all voucher examination personnel understand the Fly America regulations including payment documentation requirements. A guidance memorandum was prepared and distributed to all Controller staff involved in the payment process as well as appropriate Mission management personnel. After Controller personnel had read the memorandum, another training session was held which included all Controller staff.

#### Inspector General Comments

Recommendation No. 6 is closed upon publication of this report based on corrective actions described above.

## B. Compliance and Internal Controls

### 1. Compliance

The audit disclosed that 10 of 122 subborrowers did not use subloan proceeds as required by the subloan agreements. Other than this condition, nothing came to our attention that would indicate that untested items were not in compliance with applicable laws and regulations.

### 2. Internal Controls

Except for procedural weaknesses that caused the compliance exception cited above and incomplete documentation to verify compliance with the Fly America Act, internal controls were found to be adequate and operating in a satisfactory manner.

AUDIT OF  
USAID/PERU  
PRIVATE SECTOR AGRICULTURAL  
INVESTMENT PROMOTION

PART III - EXHIBITS AND APPENDICES

EXHIBIT I

ESTIMATE OF INTEREST INCOME FOREGONE  
 FROM NOVEMBER 1983 THROUGH JANUARY 1986  
 BY NOT INVESTING CASH OF THE LOAN FUND  
 IN FINANCE COMPANY SAVINGS ACCOUNTS  
 (in Millions of Soles)

(1) MONTH	(2) MONTHLY INTEREST RATE	(3) ACTUAL CASH BALANCE	(4) CUMULATIVE INTEREST EARNED PRIOR MONTHS (SUM OF 6)	(5) CALCULATED CASH BALANCE (3 + 4)	(6) INTEREST FOREGONE CURRENT MONTH (5 X 2)
11/83	6.67	230	0	230	15
12/83	6.67	230	15	245	16
01/84	6.67	230	32	262	17
02/84	6.67	230	49	279	19
03/84	6.67	230	66	298	20
04/84	6.67	986	88	1,074	72
05/84	6.67	908	159	1,067	71
06/84	6.67	1,794	230	2,024	135
07/84	6.67	1,244	365	1,611	107
08/84	6.67	1,993	473	2,466	164
09/84	6.67	1,426	637	2,063	138
10/84	6.67	7,869	775	8,644	577
11/84	6.67	4,277	1,352	5,629	375
12/84	6.67	6,690	1,727	8,417	561
01/85	7.50	5,454	2,288	7,742	581
02/85	8.92	4,687	2,869	7,556	674
03/85	8.92	4,297	3,543	7,840	699
04/85	8.92	1,094	4,243	5,337	476
05/85	8.92	-0-	4,719	4,719	421
06/85	8.92	20	5,139	5,159	460
07/85	11.50	2,289	5,600	7,889	907
08/85	6.33	6,847	6,507	13,354	845
09/85	4.29	6,736	7,352	14,088	690
10/85	2.78	9,241	8,042	17,283	480
11/85	2.78	9,208	8,527	17,731	493
12/85	2.78	9,163	9,016	18,179	505
01/86	2.78	69,392	9,521	78,913	2,194
Total Soles					11,712
Total Dollars 1/					\$831,945

1/ Rate of exchange was 13,930 soles to \$1.00

RECEIVED  
US AID  
07 FEB. 1986  
- RIG OFFICE -

MEMORANDUM

TO : ALL AID/LAC Missions  
FROM : AA/LAC, Dwight A. Ink  
SUBJECT: LAC Interim Guidance on Exchange Rates and Local  
Currency Generations

Following several reviews by the Inspector General, I have been concerned with a number of issues regarding exchange rates in LAC countries where U.S. dollars are introduced for the purpose of providing assistance. Such issues encompass a variety of situations, including the conversion of U.S. dollars to local currencies under AID agreements; the deposit of host country-owned local currencies in special accounts pursuant to balance of payments and other, similar agreements; and the various local currency repayment and deposit requirements under the PL-480 sales agreements.

I believe there is a need to clarify and restate our position on exchange rates so that Mission and Bureau Management will have clear guidance on this issue. I consider the guidance important because of the wide impact exchange rates have on our programs and on the scarce resources which we are entrusted to manage. We understand the Agency's policy on exchange rates is in the process of being restated; pending the issuance of such restatement, this will serve as guidance in LAC for actions which may be necessary during the interim. I have recommended that the Agency adopt our position as a part of the overall restatement. We are aware that a divergence of opinions currently exists in the Agency regarding the issues raised, and that this has caused some confusion. The guidance as stated below, however, is reflected in many country Bilateral agreements and is included in the standard language of our loan and grant agreements, although those agreements have been given various interpretations.

- 2 -

Until further notice, this policy is applicable to all assistance whether to governments or to non-governmental entities:

- A. Exchange and Conversion. In all transactions involving the exchange of conversion of U.S. appropriated dollars for local currency, whether by AID or on behalf of AID, the cognizant governmental units of the host country shall allow, or make such arrangements as may be necessary to allow, that such dollars may be exchanged or converted into the local currency of the country at the highest rate of exchange which, at the time the conversion is made, is not unlawful in that country.

The "highest rate not unlawful" is not intended as the highest rate identified or somehow specified under local laws as legal for AID, for other donors, or for certain transactions; rather it is the highest rate not unlawful for any persons, entities or classes of transactions in that country. In other words, the right of AID is to the "most favorable rate" status. Persons, entities or classes of transactions, AID is also guaranteed access to that rate. AID will not agree to be placed in a category which yields a less favorable rate.

- B. Deposit. Deposits of local currencies by host governments pursuant to balance of payments or cash transfer agreements do not come within the normal Bilateral provisions on exchange rates which apply to conversions or exchanges of foreign currency. Such local currencies are not technically converted or "purchased." Nevertheless, in all transactions involving the deposit of local currencies, whether pursuant to a balance of payments or other program agreement, the rate at which such local currencies shall be determined shall be as stated in A. above, i.e., the highest rate not unlawful available to any person, entity, or class of transactions.
- C. PL-480 Agreements. The PL-480 requirements for local currency conversion and deposits are controlled partly by statute and partly by policy established by the Development Coordination Committee's Interagency Working Group. Since the Department of Agriculture and other members of the Interagency Working Group are
- 21

- 3 -

authorized to make such policy for PL-480, it would be inappropriate for the Bureau to render additional guidance. We understand that the exchange rate issued is currently being considered by the Interagency Group.

- D. Compliance. I understand that the majority of the LAC countries is in compliance with our position on the exchange rates. I also realize, however, that there may be need for additional transition time in certain countries, which are not now in compliance, in order to comply with our guidance on exchange rates. Some of AID's bilateral or framework agreements are silent on the exchange rates to be used, and in certain loan and grant agreements exchange rate clauses have been negotiated which do not fully comply with the guidance. Clearly, different circumstances may require different approaches. However, we expect that all new assistance agreements should henceforth be negotiated and implemented in accordance with the standard A.I.D. exchange rate clause. This applies to agreements providing for the deposit of local currency as well as those calling for conversion of U.S. dollars. In addition, we would ask the missions to review existing agreements which do not contain exchange rate clauses, or which provide for rates inconsistent with the policy herein, for the purpose of recommending whether such agreements should be renegotiated to bring them into compliance. Missions enforcing exchange rate clauses should contact the appropriate RLA, GC/LAC and LAC/DE in the Bureau for further guidance.
- E. Exceptions. Exceptions to the guidance as stated herein will not be considered except in those cases which present compelling facts or situations. Understanding the inherent complexities and ambiguities in applying this guidance, we will want to review and approve any request for exceptions in AID/W. Therefore, any deviations from this interim statement on exchange rates shall be approved in writing by the Assistant Administrator; any deviations to standard AID agreement language concerning exchange rates shall be approved in writing by the Assistant Administrator in consultation with GC.
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UNITED STATES GOVERNMENT

# Memorandum

APPENDIX 1  
Page 1 of 5

TO : Mr. Coinage N. Gothard, RIG/A/T

DATE: May 30, 1986.

FROM : Mr. *George A. Hill* Hill, Deputy Director, USAID/Peru

SUBJECT: Mission comments on Draft Audit Report on USAID/Peru Private Sector Agricultural Investment Promotion (PRIDA) Project, No. 527-0265.

## Introduction

The Mission has implemented corrective actions to carry out audit recommendations 1, 2, 3, 4 and 6. The comments detailing these actions are outlined below and, together with the attached supporting documents, are forwarded herewith to close these recommendations. Audit recommendation No. 5 is under implementation as described below.

The draft audit report states that USAID withheld project disbursements due to the inability of Peru to secure a cofinancing loan from a U.S. financial institution as required by the Loan Agreement. While this is correct, USAID applied the cofinancing condition of the loan to withhold disbursements due to the failure (now corrected) of the GOP also to provide counterpart and maintenance of value contributions (TAB A). State 333287 dated July 27, 1983 authorized the Mission to disburse up to \$5 million under the loan without the cofinancing requirement. Thus PILs #4 and #12 limited AID commitments and advances to \$5 million up to December 31, 1984. State 333287 dated November 8, 1984 endorsed Mission decision (LIMA 12961) to amend project authorization and agreement to eliminate the project cofinancing requirement (i.e. Condition Precedent 5.1, subsections C, D, and E) of the Loan Agreement. Since Peru had not provided any of the required \$5 million counterpart contributions up to the time and USAID had disbursed half of the \$10 million AID loan, on February 4, 1986 USAID informed the implementing agency, COFIDE, that further AID disbursements would not take place until the GOP provided the required counterpart contribution. Hence, USAID negotiated during 1985 with the GOP the provision of required counterpart and MOV contributions, now effected, and agreed with Peru in Project Implementation Letter #18 to restructure the project by eliminating the cofinancing requirement. I believe RIG/A could expand its discussion of the reasons why USAID withheld project disbursements in 1985. A more important reason being the failure of the GOP (now corrected) to provide counterpart and maintainance of value contributions to the project.

Also I would request that the final audit report reflect that PRIDA has achieved its major goal, the reintroduction of 11 private sector commercial banks to agricultural lending, which is a significant achievement.



Audit Recommendation No 1:

That USAID obtain evidence that COFIDE will invest surplus cash balances of the PRIDA Fund in low-risk, interest-earning investments. That USAID obtain a legal opinion from AID/W on whether a host government can earn and retain interest on AID loan advances.

USAID Action

USAID has obtained evidence that COFIDE has invested temporary surplus cash balances of the PRIDA Credit Fund in low-risk, interest-earning investments (TAB B). COFIDE has adopted the policy of investing temporary surplus cash (TAB C) and, further, is seeking from the Peruvian Central Bank payment of interest on the project's account. This latter procedure will assure maximum liquidity, a good investment return on daily balances and complete segregation of funds. Additionally, USAID will monitor closely COFIDE's requests for AID advances to the PRIDA Credit Fund to assure that only minimum small balances remain in the project's account before USAID makes available new project advances to fund needed subloan disbursements. In this respect and as recommended by RIG, USAID requested an opinion (LIMA 02809) (TAB D) from AID/W, M/FM/LMD on whether a host government can earn and retain interest on AID loan advances for project implementation. M/FM/LMD stated in (State 140362) (TAB E) that advances for project implementation though issued to an ICI from loan funds, should be provided for immediate cash needs and should not be for the purpose of providing income. Any interest received on AID cash advances to the PRIDA segregated account with the Central Bank will be only incidental, in keeping with the AID cash management emphasis. Finally, it should be noted that COFIDE is now able to predict future cash needs more accurately and that as a result of a fixed exchange rate and a much reduced inflation rate, good cash management has now been made much easier and maintenance of value concerns have become less of a central issue in the project.

Both USAID and COFIDE recognize the need for continued vigilance to ensure proper cash management.

USAID believes the recommendation has been fully implemented and requests RIG/A to report it closed.

Audit Recommendation No. 2

That USAID/Peru obtain a legal opinion from AID/Washington on what rate of exchange should be used to determine the dollar equivalent of the GOP contributions to the project made under sections 3.2(b) and 6.2(b) of the loan agreement and take any corrective action acquired by the opinion. The opinion should consider, if relevant, the sources of the funding of the GOP contributions such as P.L. 480 Title I, Economic Support Funds, other donors, or GOP resources.

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USAID Action

State 163411 (TAB F) provides a detailed legal opinion on the issue raised by the recommendation. In the opinion GC.LAC concludes that USAID/Peru is justified in using the official exchange rate in this case. Additionally, USAID believes that host country contributions from the government, ICIs and subborrowers to the PRIDA project have been fully documented and greatly exceed the 25 percent minimum contribution required of the host country.

As the recommended action has been completed, USAID requests that RIG/A report the recommendation closed.

Audit Recommendation No. 3

That USAID obtain evidence that COFIDE has established: (a) adequate disbursement control procedures to ensure that subloans are used for the purposes intended, and (b) subloan cancellation criteria that consider implementation delays outside the control of the subborrowers.

USAID Action

Given the severe distortions in Peruvian financial markets, in Project Implementation Letter No. 9 dated June 11, 1984 (TAB G), USAID anticipated and asked COFIDE to try to reduce further, any unauthorized use of project resources. USAID feels that COFIDE had reasonable control procedures and cancellation criteria in place. Nevertheless, it should be noted that despite the incentives to speculate (given distorted financial markets), and COFIDE's zeal in that subloans be used solely as intended, only six of 122 subloans (or 5 percent) were used in questionable ways. USAID feels that, under the circumstances, this low rate reflects highly on the control initiated by USAID and implemented by COFIDE. Four other subloans were also cancelled by COFIDE, in an excess of supervisory zeal, relating to one project involving the four individual partners in a farm who had delayed implementation. USAID has obtained evidence that COFIDE has now established improved control procedures to continue to ensure, to the maximum extent possible, that subloans are used for the purposes intended. These actions include (1) increased field visits by COFIDE staff prior to and after subloan disbursements, and in conjunction with regular reviews of project progress (TAB H), and (2) a written policy directive to phase disbursements, for larger subprojects, based on a chronogram of investments (TAB I). USAID has also obtained evidence that COFIDE has adopted a new policy (TAB J) amending cancellation criteria to consider implementation delays outside the control of the subborrowers.

USAID believes the recommendation has been fully implemented and requests RIG/A to report it closed.

Audit Recommendation No. 4

That USAID obtain evidence that COFIDE has simplified the documentation requirements for preparation of applications for the smaller subloans.

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USAID Action

USAID has obtained evidence (TAB K) that COFIDE has waived, for all subloans not exceeding the equivalent of \$20,000 in aggregate, calculated using the highest lawful rate of exchange, the previous requirement that subborrowers present cash flow projections and internal rate of return calculations. Should the calculations be deemed necessary by COFIDE, they will be performed by COFIDE staff. It should be noted that this new policy will simplify subloan application procedures for over 40 percent of subborrowers.

USAID believes the recommendation has been fully implemented and requests RIG/A to report it closed.

Audit Recommendation No. 5

That USAID and COFIDE should determine to what extent a technical assistance program is needed to help subborrowers and design a viable program to satisfy those needs. Any funds not needed for this purpose should be reprogrammed for other project purposes.

Corrective Action

COFIDE has determined that a comprehensive, self-financing technical assistance plan is needed both to assist ICIs to continue to expand their agriculture finance activities promoted by the project, and to provide technical assistance to subborrowers on business management skills and on improved farming methods. Consequently, USAID and COFIDE are jointly continuing the design of the technical assistance plan for both ICIs and subborrowers. This is to be completed by July 31, 1986 and is expected to start implementing before the end of CY86. Once the technical assistance program has been approved by USAID, we will reprogram the project's financial plan correspondingly and forward the approved technical assistance plan to RIG/A/T. We will request closure of this recommendation at that time.

Audit Recommendation No. 6

That USAID a) obtain refunds from the three U.S. contractors cited in our finding for non-use of U.S. air carriers when leaving and returning to the U.S., unless the contractors can provide adequate justification for using foreign flag carriers; and b) establish improved procedures to ensure the provisions of the Ply American Act are enforced.

Corrective Action

Upon receipt of the RAP, the Mission contacted Checchi and Company and North Carolina State University and obtained additional information regarding the questioned travel. Their replies are included at (TAB L). Also correspondence was located concerning the circumstances of travel of Mr. Ray Bromley (also included at TAB L).

The Checchi and Co. letter advises that U.S. carrier service was not available in time to accomplish the purpose of travel and the W.C. State letter advises that use of U.S. flag carriers would have caused both an increase of through travel time and interchange point delays sufficient to warrant foreign flag use. As Dr. Bromley's memo indicates, specific authority was requested for his routing. The routing was authorized based on Mrs. Bromley's health condition and the circumstances of travel.

Because of the above indication of isolated cases of contractor reimbursements where the use of non-U.S. carriers was not properly documented, a training session was organized to ensure that all Voucher Examination personnel understand the Fly America regulations including payment documentation requirements. A guidance memorandum (TAB M) was prepared and distributed to all Controller staff involved in the payment process as well as appropriate Mission management personnel. After Controller personnel had read the memorandum, Handbook 22 regulations and the RIG/A/T RAF, another training session was held which included all payables staff. I believe the training obtained the desired results of a better informed staff and supervisory personnel.

USAID believes the recommendation has been fully implemented and requests that it be reported closed.

Please advise me should any further clarification of these comments or corrective actions be needed prior to publication of the final Audit Report.

ACTION: RIG-2 INFO: AMB DCM/4

APPENDIX 2  
Page 1 of 5

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UNCLAS STATE 163411

29-MAY-86 TOR: 00:49  
CN: 40115  
CHRG: AID  
DIST: RIG

AIDAC FOR RIG/A/T, CCOINAGE GOTHARD

FOLLOWING STATE 163411 RPTED FOR YOUR INFO SENT ACTION  
LIMA INFO PANAMA BRIDGETOWN DTD MAY 23;  
QTE: UNCIAS STATE 163411  
ADM AID

E.O. 12356: N/A

TAGS:

SUBJECT: EXCHANGE RATE FOR CALCULATION OF U.S. DOLLAR  
EQUIVALENT OF HOST COUNTRY COUNTERPART CONTRIBUTION  
PRIVATE SECTOR AGRICULTURAL INVESTMENT PROMOTION PROJECT  
(PROJECT NO. 527-0265)

REF: LIMA 4206

1. REFTEL, IN ITS SUMMARY SECTION, REQUESTS THAT QUOTE  
LAC/GC CLARIFY HOW USAID IS TO DETERMINE RATES OF  
EXCHANGE FOR HOST COUNTRY (GOP, ICI AND SUBBORROWERS)  
PROJECT COUNTERPART AND/OR MAINTENANCE OF VALUE (MOV)  
CONTRIBUTIONS FOR SUBJECT PROJECT (AND FOR PROJECT  
PORTFOLIO IN GENEPAI) END QUOTE AND THAT, QUOTE LAC/GC  
PREPARE AND CABLE TO USAMID LEGAL DECISION ON USE OF  
EXCHANGE RATES. END QUOTE. REFTEL ALSO REQUESTS THAT  
QUOTE C/LAC CONFIRM THAT USAID IS NOT REQUIRED TO USE  
ANY RATE OF EXCHANGE, OTHER THAN THE OFFICIAL RATE OF

EXCHANGE ESTABLISHED BY THE HOST GOVERNMENT, TO DETERMINE  
THE U.S. DOLLAR VALUE OF PROJECT CONTRIBUTIONS BY THE  
HOST COUNTRY. END QUOTE. THIS INQUIRY GOES TO A.I.D.  
HANDBOOK 3, CHAPTER 6, APPENDIX 6A, SECTION 3.2 (B) OF  
STANDARD LOAN AND GRANT PROVISIONS WHICH PROVIDES THAT:

QUOTE: (B) THE RESOURCES PROVIDED BY THE COOPERATING  
COUNTRY FOR THE PROJECT WILL BE NOT LESS THAN THE  
EQUIVALENT OF U.S. DOLLARS (BLANK), INCLUDING COSTS BORNE  
ON AN QUOTE IN-KIND END QUOTE BASIS. END QUOTE.

THIS RESPONSE WILL DISCUSS RESULTS OF GC REVIEW OF  
LEGISLATION, POLICY GUIDANCE AND REGULATIONS IN ORDER TO  
ASSIST THE MISSION IN FORMULATING A REASONABLE APPROACH.

2. THE QUESTION OF THE APPROPRIATE EXCHANGE RATE FOR  
CALCULATION OF THE DOLLAR EQUIVALENT OF HOST COUNTRY



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PROJECT COUNTERPART CONTRIBUTIONS HAS RECENTLY BEEN SUBJECT OF DISCUSSION AS RESULT OF INQUIRIES RAISED IN SEVERAL COUNTRIES THROUGH IG AUDIT INVESTIGATIONS.

3. THERE WOULD APPEAR TO BE NO LEGISLATIVE MANDATES, POLICY DETERMINATIONS OR DECISIONS, OR ANY OTHER WRITTEN GUIDANCE AVAILABLE TO AID/W OR MISSIONS WHICH COVERS THE APPROPRIATE RATE OF EXCHANGE OR FORMULAS TO BE USED IN CALCULATION OF HOST COUNTRY COUNTERPART CONTRIBUTIONS TO PROJECTS PURSUANT TO SECTION 3 OF THE PROAG. LIKEWISE, NO GUIDANCE EXISTS ON WHETHER THERE IS AN IMPLIED MAINTENANCE OF VALUE PROVISION FOR THOSE CONTRIBUTIONS.

4. SECTION 110(A) OF THE FOREIGN ASSISTANCE ACT OF 1961, AS AMENDED, REQUIRES THAT COUNTRIES PROVIDE AT LEAST 25 PER CENT OF THE COST OF A PROGRAM, PROJECT OR ACTIVITY FOR WHICH U.S. ASSISTANCE IS FURNISHED UNDER SECTIONS 103 THROUGH 106 OF THE FAA, AND PROVIDES FURTHER THAT SUCH COSTS MAY BE PROVIDED ON AN QUOTE IN-KIND END QUOTE BASIS. LEGISLATIVE HISTORY ON THIS SECTION DOES NOT, HOWEVER, SHED ANY LIGHT ON WHICH EXCHANGE RATE IS APPROPRIATE FOR CALCULATION OF THE U.S. DOLLAR EQUIVALENT OF THE 25 PER CENT CONTRIBUTION. NOR HAVE GC OPINIONS INTERPRETING THIS SECTION INCLUDED DISCUSSIONS ON THIS POINT.

5. EXCHANGE RATE FORMULAS FOR CALCULATING RATES FOR CONVERSION OF U.S. DOLLARS INTO LOCAL CURRENCY ARE USUALLY INCLUDED WITHIN COUNTRY BILATERAL AGREEMENTS AND NORMALLY PROVIDE FOR CONVERSION OF U.S. DOLLARS INTO THE LOCAL CURRENCY OF THE HOST COUNTRY QUOTE AT THE HIGHEST RATE OF EXCHANGE WHICH, AT THE TIME OF THE CONVERSION, IS NOT UNLAWFUL IN THE COUNTRY. END QUOTE. THIS FORMULATION HAS ALSO RECENTLY BEEN USED FOR DETERMINING THE EXCHANGE RATE FOR DEPOSITS OF LOCAL CURRENCY MADE BY RECIPIENT COUNTRIES IN ESF CASH TRANSFER SITUATIONS. SUCH FORMULATIONS FOR BOTH DEPOSIT AND PURCHASES OF LOCAL CURRENCY ARE CONSISTENT WITH THE LAC INTERIM GUIDANCE ON EXCHANGE RATES.

6. IN THE CASE OF PERU, #923;34, THE BILATERAL AGREEMENT (ENTITLED QUOTE GENERAL AGREEMENT FOR TECHNICAL COOPERATION BETWEEN THE UNITED STATES OF AMERICA AND PERU END QUOTE AND ENTERED INTO FORCE ON JANUARY 13, 1953) CONTAINS NO ARTICLE OR PROVISION RELATING EITHER TO EXCHANGE RATES FOR CONVERSION OF U.S. DOLLARS INTO PERUVIAN SOLES, DEPOSITS OF SOLES FOR LOCAL CURRENCY IN CASH TRANSFERS, OR FOR CALCULATION OF THE U.S. DOLLAR EQUIVALENT OF HOST COUNTRY COUNTERPART CONTRIBUTIONS. AS A MATTER OF FACT, THE BILATERAL INCLUDES NO PROVISION ON EXCHANGE RATES WHATEVER. ARTICLE III OF THE BILATERAL (TITLED QUOTE PROGRAM AND PROJECT AGREEMENTS END QUOTE)

STATES, IN SECTIONS 1 AND 3 THEREOF AS FOLLOWS:

QUOTE: 1. THE PROGRAM AND PROJECT AGREEMENTS REFERRED TO IN ARTICLE I, PARAGRAPH 1, ABOVE WILL INCLUDE PROVISIONS RELATING TO POLICIES, ADMINISTRATIVE PROCEDURES, THE DISBURSEMENT OF AND ACCOUNTING OF FUNDS, THE CONTRIBUTION OF EACH PARTY TO THE COST OF THE PROGRAM OR PROJECT, AND THE FURNISHING OF DETAILED INFORMATION OF THE CHARACTER SET FORTH IN ARTICLE II, PARAGRAPH 1 ABOVE.

3. THE GOVERNMENT OF PERU AGREES TO BEAR A FAIR SHARE OF THE COST OF TECHNICAL COOPERATION PROGRAMS AND PROJECTS. END QUOTE.

ARTICLE I, PARAGRAPH 1, REFERRED TO ABOVE, STATES, IN ESSENCE, THAT THE USG AND GOP WILL COOPERATE WITH EACH OTHER IN THE INTERCHANGE OF TECHNICAL KNOWLEDGE AND SKILLS AND RELATED ACTIVITIES AND THAT PARTICULAR TECHNICAL COOPERATION PROGRAMS AND PROJECTS WILL BE CARRIED OUT QUOTE PURSUANT TO THE PROVISIONS OF SUCH SEPARATE WRITTEN AGREEMENTS OR UNDERTAKINGS AS MAY LATER BE REACHED BY THE DULY DESIGNATED REPRESENTATIVES OF PERU AND (THE U.S.). END QUOTE. IT SEEMS CLEAR, THEN, THAT THE BILATERAL AGREEMENT INTENDED ANY TERMS OR CONDITIONS

NOT COVERED THEREIN TO BE GOVERNED BY THE PROVISIONS OF SEPARATE WRITTEN AGREEMENTS SUBSEQUENTLY ENTERED INTO BY THE PARTIES.

7. IN THE ABSENCE OF A SPECIFIC REFERENCE IN THE BILATERAL AGREEMENT TO THE FORMULA TO BE USED FOR CALCULATION OF EXCHANGE RATES, THE APPLICABLE PROVISIONS OF THE LOAN OR GRANT AGREEMENT IN QUESTION PROVIDE THE LEGAL BASIS, IF ANY, TO DETERMINE WHAT EXCHANGE RATE IS TO BE USED FOR CALCULATION OF THE U.S. DOLLAR EQUIVALENT OF HOST COUNTRY COUNTERPART CONTRIBUTIONS. WE HAVE REVIEWED THE PROJECT LOAN AGREEMENT AND AMENDMENTS IN QUESTION AND CONCLUDE THAT THEY DO NOT CONTAIN PROVISIONS WHICH COVER THE ISSUE OF THE APPROPRIATE RATE TO BE USED IN CALCULATING THE DOLLAR EQUIVALENT OF HOST COUNTRY COUNTERPART CONTRIBUTION. THE LOAN AGREEMENT CONTAINS

THE STANDARD PROVISION ON CONVERSION OF U.S. DOLLARS INTO LOCAL CURRENCY IN ARTICLE 8, DISBURSEMENTS, SECTION 8.4, RATE OF EXCHANGE, WHICH STATES:

QUOTE EXCEPT AS MAY BE MORE SPECIFICALLY PROVIDED UNDER SECTION 8.2, FUNDS PROVIDED UNDER THE LOAN ARE INTRODUCED INTO PERU BY A.I.D. OR ANY PUBLIC OR PRIVATE ENTITY FOR PURPOSES OF CARRYING OUT OBLIGATIONS OF A.I.D. WHEREUNDER, THE BORROWER WILL MAKE SUCH ARRANGEMENTS AS MAY BE NECESSARY SO THAT SUCH FUNDS MAY BE CONVERTED INTO PERUVIAN SOLA AT THE HIGHEST RATE OF EXCHANGE WHICH, AT THE TIME THE CONVERSION IS MADE, IS NOT UNLAWFUL IN PERU. END QUOTE.

8. IN VIEW OF THE LACK OF LEGAL BASIS FOR REQUIRING GOP TO MAKE CONTRIBUTION UNDER SECTION 3 OF THE PROAG USING

THE HIGHEST RATE NOT UNLAWFUL, AND FURTHER THAT SECTION 3 AND THE DERIVATIVE STATUTE, SECTION 112 OF THE FAA EXPRESSLY PROVIDE THAT THE HOST GOVERNMENT MAY MAKE QUOTE "N-KIND UNQUOTE CONTRIBUTIONS, WE BELIEVE THE EXCHANGE RATE CALCULATION IN THIS INSTANCE IS A MATTER OF NEGOTIATION FOR THE PARTIES. WE DO NOT VIEW THE CONTRIBUTION TECHNICALLY AS EITHER A QUOTE CONVERSION UNQUOTE OR A QUOTE DEPOSIT, UNQUOTE AND THUS IT DOES NOT FALL WITHIN THE LAC INTERIM GUIDANCE. OBVIOUSLY NOTHING WOULD PRECLUDE MISSION FROM NEGOTIATING SUCH AN UNDERSTANDING WITH GOP, BUT SUCH CONDITION SHOULD BE NEGOTIATED AT TIME OF AGREEMENT. IF, IN FUTURE AGREEMENTS, YOU WISE TO INCLUDE A PROVISION COVERING THE CALCULATION OF THE DOLLAR EQUIVALENT OF HOST COUNTRY

CONTRIBUTIONS AT A SPECIFIC EXCHANGE RATE, SECTION 8.4 WOULD HAVE TO BE CHANGED TO REFLECT THE NEW REQUIREMENT. USAID SHOULD CONSULT RLA AND FOLLOW BB 3 PROCEDURES FOR ANY SUCH CHANGE.

9. GC IS MINDFUL THAT THIS IS A LOAN FUNDED PROJECT, AND THAT RENEGOTIATION OF TERMS WITH THE GOP WOULD BE DIFFICULT AT THIS STAGE. A.I.D. HANDBOOK 3, APPENDIX 6A, ARTICLE 3, SECTION 3.2Y(A), PROVIDES A COVENANT BY WHICH GOP MUST CONTRIBUTE ANY ADDITIONAL COSTS NOT OTHERWISE MET IN ORDER TO COMPLETE PROJECT, AND WE BELIEVE THAT THIS COVENANT, ALONG WITH SPECIAL COVENANT 6.2 RELATING TO AGRICULTURAL INVESTMENT FUND, CONSTITUTE A QUOTE MAINTENANCE OF VALUE UNQUOTE IN EFFECT WHICH SUFFICIENTLY PROTECTS AID AND PROJECT.

10. CONCLUSION. INASMUCH AS THE MISSION AND GOP WERE, AT THE TIME OF THE EXECUTION AND IMPLEMENTATION OF THE PROJECT AGREEMENT, OPERATING ON THE BASIS OF THE OFFICIAL EXCHANGE RATE TO ASCERTAIN THE DOLLAR EQUIVALENT OF THE HOST COUNTRY CONTRIBUTION, AND INASMUCH AS THE LAC INTERIM GUIDANCE ON EXCHANGE RATES DOES NOT INCLUDE INSTRUCTIONS PERTAINING TO THE APPROPRIATE EXCHANGE RATE TO BE USED FOR CALCULATION OF THE DOLLAR EQUIVALENT OF

HOST COUNTRY PROJECT COUNTERPART CONTRIBUTIONS, GC/LAC  
CONCLUDES THAT USAID WAS JUSTIFIED, IN THIS INSTANCE, IN  
USING THE OFFICIAL RATE OF EXCHANGE FOR SUCH CALCULATION. SHULTZ  
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LIST OF REPORT RECOMMENDATIONS

Recommendation No. 1

We recommend that USAID/Peru obtain evidence that the Development Finance Corporation has invested the cash balances of its Agricultural Investment Fund in low-risk, interest-bearing investments.

Recommendation No. 2

We recommend that USAID/Peru obtain a legal opinion from AID/Washington on what rate of exchange should be used to determine the dollar equivalent of the GOP contributions to the project made under sections 3.2(b) and 6.2(b) of the loan agreement and take any corrective action required by the opinion.

Recommendation No. 3

We recommend that USAID/Peru obtain evidence that the Development Finance Corporation has established:

- a) improved disbursement control procedures to ensure that subproject funds are used for purposes as specified in the subloan agreements; and
- b) subloan cancellation criteria that consider implementation delays outside the control of the subborrowers that could prevent the use of subproject funds as planned.

Recommendation No. 4

We recommend that USAID/Peru obtain evidence that the Development Finance Corporation has simplified the documentation requirements for preparation of subloan applications for the smaller subloans.

Recommendation No. 5

We recommend that USAID/Peru and the Development Finance Corporation determine to what extent a technical assistance program is needed to help the subborrowers and design a viable program to satisfy those needs. Any funds not needed for this purpose should be reprogrammed for other project purposes.

Recommendation No. 6

We recommend that USAID/Peru:

- a. obtain refunds from the three U.S. contractors cited in our finding for non-use of U.S. air carriers when leaving and returning to the U.S., unless the contractors can provide adequate justification for using foreign flag carriers; and
- b. establish improved procedures to enforce the provisions of the Fly America Act.

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