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AUDIT
OF USAID/EL SALVADOR
LOCAL CURRENCY PROGRAM
PART I - OVERALL
PROGRAM MANAGEMENT

Audit Report No. 1-519-89-21
June 16, 1989

U. S. MAILING ADDRESS:
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AGENCY FOR INTERNATIONAL DEVELOPMENT
OFFICE OF THE REGIONAL INSPECTOR GENERAL
AMERICAN EMBASSY
TEGUCIGALPA - HONDURAS

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32-9987
also 32-3120 EXT. 2701-2703

June 16, 1989

MEMORANDUM

TO: D/USAID/El Salvador, Henry Bassford

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

SUBJECT: Audit of USAID/El Salvador Local Currency Program
Part I - Overall Program Management

The Office of the Regional Inspector General for Audit/Tegucigalpa has completed its audit of USAID/El Salvador Local Currency Program, Part I - Overall Program Management. Five copies of the audit report are enclosed for your action.

The draft audit report was submitted to you for comment and your comments are appended to this report. Because of its size and large number of recommendations, the draft report was divided into three parts. This report, Part I, contains the first three recommendations of the draft report. Recommendation Nos. 1 and 2 are resolved and will be closed upon completion of planned or promised actions. Part "a" of recommendation No. 3, which is directed to the Mission, is unresolved. Please advise me within 30 days of any additional actions taken to implement recommendation Nos. 1 and 2, and further information you might want us to consider on Recommendation No. 3.

I appreciate the cooperation and courtesy extended to my staff during the audit.

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MEMORANDUM

TO: AA/PPC, Richard E. Bissel

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

SUBJECT: Audit of USAID/El Salvador Local Currency Program
Part I - Overall Program Management

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The draft audit report was submitted to you for comment and your comments are appended to this report. Because of its size and large number of recommendations, the draft report was divided into three parts. This report, Part I, contains the first three recommendations of the draft report. Part "b" of recommendation No. 3 is directed to your office. This recommendation is closed and requires no further action.

I appreciate your cooperation with our audit efforts.

EXECUTIVE SUMMARY

The United States provides much of its economic assistance to the Government of El Salvador through A.I.D. under three discrete bilateral assistance programs, the Economic Support Fund, Title I of the Agricultural Trade and Development Act of 1954 and Section 416 of the Agricultural Act of 1949. Common to all three programs is the requirement that the Government of El Salvador provide an equivalent amount of local currency for the resources provided by the United States. In 1985, 1986, and 1987, the Government of El Salvador provided a total of $661.7 million in local currency which it jointly programmed with the United States for various budgetary support and developmental project activities.

The Regional Inspector General for Audit, Tegucigalpa, performed a program and compliance audit of USAID/El Salvador's local currency program. Specific audit objectives were to assess (i) the adequacy of USAID/El Salvador and Government of El Salvador overall financial management of the local currency program, (ii) Government of El Salvador compliance with local currency generation requirements, and (iii) the adequacy of USAID/El Salvador and Government of El Salvador management systems over extraordinary budget activities. This report addresses the first specific objective. The other objectives are addressed in separate reports.

The audit found that USAID/El Salvador and Government of El Salvador management of the local currency program had improved since the last Inspector General audit in 1985 but that further improvements were needed, especially in the area of overall local currency program financial management.

Nevertheless, the audit found that both the Government of El Salvador and USAID/El Salvador had made progress, especially during the past two years, to strengthen the framework of the local currency program by implementing improved procedures to better ensure the effective and proper use of these scarce resources.

The audit found that most of the local currency-financed activities had not been audited as required; USAID/El Salvador did not adequately track and report the status of local currency funds; and USAID/El Salvador had not adequately examined opportunities to increase the availability of local currency funds.

As of December 31, 1987, most local currency program-financed activities had not been audited. Economic Support Fund agreements and local currency program memoranda of understanding generally require audits of local currency financed activities and appropriate resolution of their findings. These memoranda also require that audit reports be shared with A.I.D. Inadequate coverage existed because audit coverage requirements were not clearly defined in the memoranda of understanding or other agreements nor were local currency funds always specifically budgeted for these audit activities. Inadequate audit coverage could prevent the El Salvador Government from detecting and resolving financial management weaknesses and improper uses of local currency program funds. The report recommends that audit provisions be clearly established in all applicable agreements. The Mission generally agreed with the recommendation and was taking action to implement it.

A.I.D. guidelines hold USAID Missions responsible for establishing appropriate monitoring systems to ensure that local currency funds are adequately accounted for and managed in accordance with program agreements. USAID/El Salvador was not adequately tracking and reporting the status of local currency funds. This was because the Mission had not assigned adequate resources for financial monitoring nor had it issued guidance specifying the level or extent of financial monitoring and reporting that should be performed. As a result, the Mission was less likely to detect and correct local currency program financial errors in a timely manner. The report recommends ways that USAID/El Salvador can improve its local currency tracking and reporting performance. The Mission was taking action to implement the recommendation.

USAID/El Salvador did not adequately examine opportunities to increase local currency generations without additional direct United States contributions. Certain Economic Support Fund and Public Law 480 Title I memoranda of understanding with the Government of El Salvador permit, under certain conditions, the earning of interest on local currency deposits. Recent A.I.D. guidance encourage A.I.D. Missions to earn interest on local currency deposits and require Missions to report to A.I.D./Washington when this possibility was not justified. USAID/El Salvador claimed that earning interest on local currency deposits would create an over liquidity problem in the banking system, but it could not support this claim with current economic studies. As a result, the United States may be providing more economic support than necessary. The report recommends that USAID/El Salvador and A.I.D./Washington examine specific opportunities for increasing local currency resources. USAID/El Salvador did not believe it was advisable to earn interest on Economic Support Fund and Public Law-480 generated local currencies. AID/Washington stated that under some circumstances host countries can be required to make available the local currency equivalent for the interest earned on Economic Support Fund dollars deposited in the United States.

Office of the Inspector General

AUDIT
OF USAID/EL SALVADOR
LOCAL CURRENCY PROGRAM
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PART I - INTRODUCTION

A. Background

The United States provides much of its economic assistance to the Government of El Salvador (GOES) through A.I.D. under three discrete bilateral assistance programs, the Economic Support Fund (ESF), Title I of the Agricultural Trade and Development Act of 1954 (Public Law 480) and Section 416 of the Agricultural Act of 1949 (Section 416). Under the ESF program, the United States either grants or loans dollars to the GOES to finance the import of essential commodities. Under the two food aid programs, the United States either sells at concessional terms or donates agricultural commodities to the GOES.

Common to all three programs is the requirement that the GOES provide an equivalent amount of local currency for the resources provided by the United States. Under the ESF program, the GOES agrees to provide the local currency equivalent of each dollar transferred. Under the other two programs, the GOES agrees to provide the local currency equivalent for the value of the commodities procured by the U.S. Government for the GOES. The GOES deposits local currency provided by these three programs in separate Central Bank accounts and jointly programs them annually with the United States through memoranda of understanding (MOU). Although provided in response to United States agreement provisions and jointly programmed, A.I.D. considers the GOES mainly responsible for these local currencies.

In 1985, 1986, and 1987, the GOES provided a total of $661.7 million in local currency for the following five major activity categories (see exhibit Nos. 1 and 2 for additional details).

Activities	Implementing Agency	Local Currency Programmed U.S. Dollar Equivalent ($ 000)
Extraordinary Budget Support	Technical Secretariat for External Financing	$249,654
Central Bank Credit Lines and Related Activities	Central Bank	244,415
Ordinary Budget Support	Ministry of Finance	151,476
USAID Trust Fund	USAID/El Salvador	15,662
Reserve Fund	---	462
		$661,669

Extraordinary Budget Support -- The GOES budgeted $250 million in local currencies for its extraordinary budget which is used to finance GOES projects and counterpart contributions for A.I.D. and other donor projects. In April 1983, the Salvadoran National Assembly established the Technical Secretariat for External Financing (the Secretariat) to manage the extraordinary budget for the Ministry of Planning. 1/

Central Bank Credit Lines -- The GOES budgeted $244 million in local currencies to finance ten discrete credit lines, a Private Investment Promotion Fund, a Guaranty Fund and a Rehabilitation of Industrial Enterprises program. The Central Bank, through the country's banking system, is responsible for administering these activities.

Ordinary Budget Support -- The GOES budgeted $151 million in local currency to support GOES ordinary budget activities. The Ministry of Finance is responsible for reporting to A.I.D. on the use and status of these funds in accordance with program agreements.

USAID Trust Fund -- The GOES budgeted $15.7 million in local currency to support the USAID/El Salvador development assistance program. USAID/El Salvador is responsible for managing these funds and periodically reporting on their use to the GOES in accordance with the trust fund agreement.

Reserve Fund -- The GOES and USAID/El Salvador reserved $462,400 in local currency. These funds would eventually be jointly allocated to one or more implementing agencies.

USAID/El Salvador's Office of Development Planning and Programming is responsible for the Mission's overall management of the local currency program. This office is assisted by USAID/El Salvador's Private Enterprise Office, which is responsible for monitoring the Central Bank credit programs, by the USAID/El Salvador Office of the Controller which is responsible for the trust fund, and by USAID/El Salvador technical offices that have projects partially financed with local currencies.

This is one of three Regional Inspector General for Audit, Tegucigalpa (RIG/A/T) reports covering the USAID/El Salvador local currency program. This report addresses overall program management issues. The other two reports address issues related to the generation of local currencies under Public Law 480 and Section 416 programs and to the programming, disbursing, and monitoring of local currencies from the extraordinary budget.

As a result of this audit, the RIG/A/T issued a total of ten audit reports during fiscal year 1989 covering activities financed by or otherwise related to USAID/El Salvador's local currency program. See appendix 1 for a list of the other nine reports.

1/ Extraordinary budget resources include local currencies generated as a result of foreign agreements. This report only covers the administration and use of extraordinary budget resources associated with agreements between the United States and the GOES.

B. Audit Objectives and Scope

The Regional Inspector General for Audit, Tegucigalpa, performed a program and compliance audit of USAID/El Salvador's local currency program. The detailed audit work was conducted from May 2, 1988 to December 14, 1988 and covered the three years from January 1, 1985 through December 31, 1987. During this 3-year period, GOES and USAID/El Salvador jointly programmed the local currency equivalent of $661.7 million of which $563.5 million in local currency had been disbursed to implementing agencies. Specific audit objectives were to assess (i) the adequacy of USAID/El Salvador and GOES overall financial management of the local currency program, (ii) GOES compliance with local currency generation requirements, and (iii) the adequacy of USAID/El Salvador and GOES management systems over extraordinary budget activities.

This report addresses the first specific objective. To accomplish the audit objective, RIG/A/T reviewed program regulations, management records, and other pertinent documents and interviewed officials at USAID/El Salvador, the United States Embassy, the Central Bank of El Salvador, the Technical Secretariat for External Financing, and other GOES institutions.

In addition, we assessed the four major local currency implementing agencies' compliance with agreement requirements pertaining to fund accountability and audit coverage and reviewed USAID/El Salvador's systems and procedures for tracking and reporting the status of local currencies. Among other things, this entailed reviewing activity financial reports, audit reports of local currency-financed activities, and other documents and records used to track and report the uses and status of program funds. In addition, we reviewed USAID/El Salvador's policy and procedures pertaining to earning interest on local currency deposits.

The RIG/A/T audited the USAID/El Salvador local currency program in previous years. The last such audit effort was in 1985. Significant previous findings were that GOES designated commodity sales agents had not always promptly deposited Public Law 480 Title I and II commodity sales proceeds in the Central Bank and that one implementing agency had used some project funds for ineligible purposes (see appendix 2 for a listing of previous years' reports).

USAID/El Salvador financed and contracted Price Waterhouse to assist with this audit. Price Waterhouse auditors worked under the direct supervision of the RIG/A/T auditors. We limited review of internal controls and compliance to the findings in this report and performed the audit in accordance with generally accepted government auditing standards.

AUDIT
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PART II - RESULTS OF AUDIT

The audit found that USAID/El Salvador and Government of El Salvador (GOES) management of the local currency program had improved since the last Inspector General audit in 1985 but that further improvements were needed in the area of overall local currency program financial management.

Nevertheless, the audit found that both the GOES and USAID/El Salvador had made progress, especially during the past two years, to strengthen the framework of the local currency program by implementing improved procedures to better ensure the effective and proper use of these scarce resources.

The three findings in this report discuss overall local currency issues. The audit found that most of the local currency-financed activities had not been audited as required; USAID/El Salvador did not adequately track and report the status of local currency funds; and USAID/El Salvador had not adequately examined opportunities to increase the availability of local currency funds.

The report recommends that the implementing agencies improve their audit coverage of local currency resources; USAID/El Salvador implement measures to improve its tracking and reporting of local currency funds; and that USAID/El Salvador and AID/Washington examine specific opportunities for increasing the availability of local currency.

A. Findings and Recommendations

1. Local Currency-Financed Activities Received Inadequate Audit Coverage

As of December 31, 1987, most local currency program-financed activities had not been audited. Economic Support Fund agreements and local currency program memoranda of understanding generally require audits of local currency financed activities and appropriate resolution of their findings. These memoranda also require that audit reports be shared with A.I.D. Inadequate coverage existed because audit coverage requirements were not clearly defined in the memoranda of understanding or other agreements nor were local currency funds always specifically budgeted for these audit activities. Inadequate audit coverage could prevent the El Salvador Government from detecting and resolving financial management weaknesses and improper uses of local currency program funds.

Recommendation No. 1

We recommend that USAID/El Salvador, in consultation with the Government of El Salvador:

a. establish specific procedures in each of the local currency memoranda of understanding to ensure that all local currency financed activities are subject to audits; track and resolve audit findings in an adequate and timely manner; and distribute promptly all final reports to the appropriate parties; and

b. program adequate local currency to finance these audit activities.

Discussion

Most local currency program-financed activities had not been audited. As of December 31, 1987, only 13 percent of the total local currency funds disbursed in 1985, 1986 and 1987 had been covered by audits as shown below:

Local Currency Funds for 1985, 1986, and 1987

Implementing Agencies	Amount Budgeted	Amount Disbursed from Global Acct. To Implementing Agencies ($000)	Amount of Global Disbusements Audited	Percent Audited
Technical Secretariat for External Financing	$ 250.1	$ 196.4	$ 71.5	36
Central Bank	244.4	229.4	- 0 -	- 0 -
Ministry of Finance	151.5	122.0	- 0 -	- 0 -
USAID/El Salvador (Trust Fund)	15.7	15.7	- 0 -	- 0 -
Total	$ 661.7	$ 563.5	$ 71.5	13

A brief description of each of the four implementing agencies and related audit efforts follows.

Technical Secretariat for External Financing (The Secretariat) - The Secretariat received $196.4 million in local currency to finance extraordinary budget project activities. Local currency program memoranda of understanding (MOUs) require the Secretariat to contract with private audit firms to audit project activities and to distribute copies of audit reports to USAID/El Salvador. In addition, the Secretariat is required to inform the Mission on a biannual basis of corrective measures being taken by implementing agencies to resolve problems and address issues raised by the audit findings. At the time of the current audit, the Secretariat had audited $71.5 million or 36 percent of the $196.4 million in local currency disbursed to it during the three year period. In addition, the Secretariat had signed or intended to sign contracts with local audit firms to audit most of the unaudited $124.9 million. However, no contracts were signed to audit any activities funded with local currencies generated under the 1987 Section 416 program.

The Secretariat's audit efforts started off with limited success. Initial audits were poorly designed and not always performed by qualified audit firms. As a result, the quality of many reports was poor and their usefulness limited. In addition, the Secretariat had not implemented adequate procedures to ensure that audit findings were tracked and resolved in a timely manner. During our audit, the Secretariat, with strong support from the Mission, strengthened its audit procedures and took other corrective actions to resolve these deficiencies.

The Central Bank - The Bank received $229.4 million in local currency funds to finance its credit line and related programs. The 1986 Economic Support Fund MOU stated that USAID/El Salvador may request the Bank to conduct audits of these local currency-financed credit lines to ensure the proper use of these funds. The 1987 ESF memorandum is more specific. It states that the Mission would request the Bank to audit the use of these funds. The memorandum further states that Mission approval of the selected audit firm is required and that the Bank would provide the Mission copies of the audit report.

There was no evidence that these credit line activities had been audited. According to a USAID/El Salvador official, audits had not been conducted because the Mission had not specifically requested the Bank to do so and because funds had not been specifically allocated for this purpose. We conducted a separate comprehensive audit of the Bank's local currency-financed credit lines (see appendix 1). This audit identified several deficiencies that probably would have been detected and corrected earlier if annual audits had been performed.

Ministry of Finance - The Ministry received $122.0 million in local currency for general GOES budgetary support including the Agrarian Reform

Compensation Fund. 2/ The Ministry allocated funds to different GOES entities through the regular budgetary system for approved activities. The ESF agreements require that program books and records be regularly audited in accordance with generally accepted auditing standards. However, there was no evidence that disbursed funds (including the liquidation of advances for the compensation fund) had been audited. It appeared that audits were not conducted because of vaguely worded audit provisions in the ESF agreements and the absence of such provisions in the pertinent MOUs.

USAID/El Salvador - The USAID/El Salvador trust fund received $15.7 million in local currency funds to help finance the Mission's development assistance program. The trust fund agreement stated that USAID/El Salvador trust fund disbursement records may be inspected by GOES representatives at any reasonable time. The current audit found no evidence that the GOES had inspected the Mission's trust fund accounting records or audited the use of these funds. We did not determine why the GOES did not audit the trust fund resources.

As noted in all four subheadings, only a small portion of local currency program-financed activities were audited because of inadequate audit requirement provisions in local currency agreements and related MOUs. In addition, adequate local currency funds had not been budgeted to finance these audit activities. This was not to say, however, that USAID/El Salvador and the GOES did not have information on the status of some of these funds. In most cases, the implementing agencies are required to periodically report on the status of these funds. However, these general financial reports are no substitute for financial and program results audits.

As a result of inadequate audit coverage, the GOES and A.I.D. had less assurance that local currency funds are being adequately accounted for and being used for their intended purposes.

In conclusion, the majority of local currency program-funds were not subject to audit because of inadequate audit guidance and procedures. As a result, GOES and A.I.D. officials had less reliable information to make management decisions. Program managers needed to ensure that greater audit coverage was provided to local currency resources. The recommendation provides measures to ensure adequate coverage.

2/ The Agrarian Reform Compensation Fund was established to facilitate the payment for lands that were expropriated by the GOES under the Agrarian Reform Program. The local currency program provided partial financial support for this fund. These funds were provided to the fund through the Ministry of Finance who was responsible for reporting on their use.

Management Comments

The Mission agreed that most local currency program-financed activities had not been audited as of December 31, 1987. However, it stated that considerable progress has been made since then to improve the situation.

The Mission stated that beginning in fiscal year 1988 all memoranda of understanding concerning local currency include audit provisions requiring the GOES to conduct audits of the internal controls and accountability for the uses of the funds provided through the local currency program. The Mission also stated that it had signed a project implementation letter covering the Central Bank credit lines audit rights and responsibilities.

USAID/El Salvador stated that it was not required to monitor the $122 million disbursed to the Ministry of Finance for budgetary support because the GOES Court of Accounts was responsible for auditing these resources. It did recognize however that the quality of the Court of Accounts remains questionable. The Mission also acknowledged that the GOES has not inspected the Mission's trust fund accounting records nor audited the use of these funds; however, the Mission believes it has maintained its trust fund accounting records in accordance with A.I.D. guidance and has used the trust funds in compliance with the Trust Fund Agreement.

In summary, USAID/El Salvador stated it has made substantial progress in the last year and a half to ensure adequate coverage of most of the local currency-financed activities and requested that the recommendation be deleted from the final report.

Office of Inspector General Comments

The recommendation is considered resolved based on USAID/El Salvador actions to improve local currency audit coverage. However, before the recommendation can be closed, USAID/El Salvador needs to submit evidence that (1) all 1988 MOU's contain the new specific audit procedures, (2) a project implementation letter covering the Central Bank lines of credit audit rights and responsibilities has been appropriately signed by all involved parties, and (3) the Court of Accounts in fact audits, in accordance with generally accepted auditing standards, the local currencies disbursed to the Ministry of Finance for budgetary support.

2. The Mission Needed To Improve Its Monitoring Of Local Currency Funds

A.I.D. guidelines hold USAID Missions responsible for establishing appropriate monitoring systems to ensure that local currency funds are adequately accounted for and managed in accordance with program agreements. USAID/El Salvador was not adequately tracking and reporting the status of local currency funds. This was because the Mission had not assigned adequate resources for financial monitoring nor had it issued guidance specifying the level or extent of financial monitoring and reporting that should be performed. As a result, the Mission was less likely to detect and correct local currency program financial errors in a timely manner.

Recommendation No. 2

We recommend that USAID/El Salvador:

a. assign adequate resources for tracking and reporting the status of local currency funds, and

b. issue written guidance specifying the level of local currency financial tracking and reporting that should be performed. At a minimum, this guidance should require the appropriate Mission office to track and report on the overall status of local currency funds and maintain financial statements by source of local currency funds and by year until fully liquidated.

Discussion

A.I.D. guidelines hold USAID Missions responsible for establishing appropriate monitoring systems to ensure that local currency funds are adequately accounted for and managed in accordance with program agreements. A September 1987 USAID/El Salvador directive assigns overall financial control, including the accounting and tracking of local currency funds to the Mission's Office of Development Planning and Programming (DPPO).

The Mission did not adequately track and report the status of local currency funds as evident by the Mission's limited knowledge of deficiencies in this area. For example, the Mission was apparently unaware that Public Law 480 Title I local currencies had not been fully deposited in the Central Bank and that Section 416 local currencies had not been promptly deposited in the Central Bank. Furthermore, the Mission was unaware of various errors in the Secretariat's financial reports and that funds had been advanced to the Ministry of Finance for the Agrarian Compensation Fund but had not been properly tracked and liquidated.

Also, until recently the Mission did not track and report on local currency funds until the funds were fully liquidated. DPPO prepares monthly summary financial reports by program year which show the status of local currency funds by program source. Until the 1987 program year, the office did not continue to track and report the balances of these sources until fully liquidated. This weakness prevented DPPO staff from readily commenting on the status of earlier local currency generating programs. For example, the staff was unable to give the current status of local currencies which were to be generated under a 1983 Public Law 480 Title II agreement. Finally, DPPO's financial reports were based on GOES monthly financial reports. DPPO did not maintain accounting ledgers or journals, without which, one could not readily determine why certain amounts changed from one report to the next.

A partial cause of inadequate Mission monitoring of local currency funds was that it had not assigned adequate resources for monitoring local currency financial activities. In our opinion, DPPO did not have the staff resources or skills to effectively monitor local currency financial activities. However, in September 1987 the Mission issued a local currency program managing and monitoring directive which provides general background information on the local currency program and identifies responsible Mission offices for specific program activities. Of the 16 activities listed, DPPO is involved in 11 and fully responsible for six including overall financial control. In addition to its financial responsibilities, the office is involved in developing and negotiating program agreements, memoranda of understanding, implementation letters and approves action plans. In addition, the office is responsible for monitoring compliance with the provisions and reporting requirements in these various documents.

Some Mission officials believed that DPPO did not have the resources or expertise to effectively track and report the status of local currency funds. These officials stated that this responsibility should be assigned to the Office of the Controller. The controller initially agreed but said that this was not immediately possible because of limited staff resources and skills in the controller's office. The controller initially stated that his office would be able to assume this responsibility by December 1988. However, the controller subsequently reversed his position and stated that he saw no need to transfer these responsibilities to the controller's office since he believed that DPPO was adequately performing these tasks. The Mission Director concurred that the financial tracking and reporting responsibilities should remain in DPPO. The controller added however that his office had been actively involved in trying to improve the GOES overall management and control activities. This was being done by working with the Secretariat in improving its audit program of local currency-financed activities and by working with the Court of Accounts in training its staff.

The Mission had not issued detailed financial monitoring guidance or instructions that identified (1) what local currency program financial elements needed to be verified and tracked, (2) who was responsible for verifying and tracking these elements, (3) the procedures to be followed in verifying and tracking the elements, and (4) how and to whom this information and any deviations were to be reported and handled. As a minimum, we suggest that the Mission maintain accounting ledgers adequate to verify that:

-- funds generated are deposited in bank accounts as required and are tracked against what should be generated;

-- all available funds are programmed and do not exceed what should be generated; and

-- funds disbursed from the initial ESF program account agree with disbursements authorized by USAID/El Salvador.

As a result of not appropriately monitoring local currency funds, the Mission was less likely to detect and correct program financial deficiencies in a timely manner.

In conclusion, USAID/El Salvador needed to improve its monitoring of local currency funds to better ensure that errors are detected and corrected in a timely manner. The recommendation provides measures for improving the Mission monitoring of local currency funds.

Management Comments

USAID/El Salvador stated that it has substantially increased the staff resources in DPPO assigned to manage the local currency program to enable the Mission to adequately track and report on the status of local currency funds. In addition, USAID/El Salvador stated that it was revising its Mission Order on local currency management which would reflect, in part, its new monitoring and tracking responsibilities. In addition, with the hiring of a management information specialist, the Mission expects to refine its local currency tracking and reporting system. Based on these actions the Mission requested that part "a" of the recommendation be eliminated from the final report and that part "b" be closed.

Office of Inspector General Comments

The recommendation is considered resolved based on USAID/El Salvador actions to improve the tracking and reporting of local currency funds. Part "a" of the recommendation can be closed upon identification of the new staff assigned to DPPO and that their job descriptions and duties involve tracking and reporting the status of local currency funds. Part "b" of the recommendation can be closed upon receipt of the revised local currency Mission Order that requires, at a minimum, that the Mission track and report on the overall status of local currency funds and maintain financial statements by source of local currency funds and by year until fully liquidated.

3. Opportunities To Increase Local Currency Generations Needed To Be Examined

USAID/El Salvador did not adequately examine opportunities to increase local currency generations without additional direct United States contributions. Certain Economic Support Fund and Public Law 480 Title I memoranda of understanding with the Government of El Salvador permit, under certain conditions, the earning of interest on local currency deposits. Recent A.I.D. guidance encourage A.I.D. Missions to earn interest on local currency deposits and require Missions to report to AID/Washington when this possibility was not justified. USAID/El Salvador claimed that earning interest on local currency deposits would create an over liquidity problem in the banking system, but it could not support this claim with current economic studies. As a result, the United States may be providing more economic support than necessary.

Recommendation No. 3

We recommend that:

a. USAID/El Salvador establish procedures to (i) assess and document the impact on the monetary system of placing local currency generations in interest-bearing accounts each time a local currency agreement is signed, (ii) obtain evidence that the Government of El Salvador has deposited local currency funds in interest bearing accounts not detrimental to the country's monetary policy, and (iii) jointly program these additional revenues with the El Salvador Government; and

b. AID/Washington make (i) a policy determination on whether or not host countries should make available the local currency equivalent for the interest earned on the Economic Support Fund dollars deposited in the United States and (ii) issue appropriate guidance to its field offices based on the policy determination.

Discussion

Opportunities to increase local currency generations without additional direct United States contributions have not been adequately considered by USAID/El Salvador. Two potential possibilities for increasing local currency funds are (1) earn interest on the local currency generations deposited in El Salvador and (2) require the Government of El Salvador (GOES) to make available the colon equivalent for the interest earned on its United States Economic Support Fund (ESF) dollar account.

Provisions for earning interest on local currency generations are included in certain ESF and Public Law 480 MOUs. In addition, A.I.D. Policy Determination No. 5 dated February 22, 1983, and its Supplemental Guidance on Programming Local Currency dated October 21, 1987 state that it is A.I.D. policy to have host countries place local currency in interest-bearing accounts, if such accounts are permitted under host country law and do not undermine internationally supported stabilization agreements or monetary policy. Furthermore, this guidance states that the highest A.I.D. official at post would make determinations on placing local currency in interest bearing accounts and requires him to report those determinations not to deposit local currency in interest-bearing accounts to AID/Washington. October 1987 A.I.D. guidance also states that interest earned on dollar accounts must be programmed as if it were principal. Although the guidance does not specifically state that local currency equivalent should be made available for interest earned on dollar accounts, it does not prohibit this possibility.

Local currency generations had not been deposited in interest-bearing accounts, with minor exceptions, because the GOES and USAID/El Salvador were concerned that the earned interest would create an over liquidity problem in the banking system and a management problem for the Central Bank. However, there was no documented evidence to support that these claims were based on current economic studies. Furthermore, USAID/El Salvador had no written guidance or position covering earning interest on local currency deposits. With regard to requiring the local currency equivalent for the dollar interest, a previous Mission official saw this as a viable possibility but current management considered it an A.I.D. policy issue for which it had not requested AID/Washington guidance.

The potential impact of one or both of these proposals on increasing the availability of local currency was significant considering the size of the Salvadoran local currency program. For example, the local currency equivalent of nearly $200 million was generated in 1987, not including the interest earned on the GOES's United States dollar accounts, and that much of these funds were not drawn down immediately. If 25 percent, or $50 million, of the local currency equivalent was placed in interest bearing accounts at a 7 percent interest rate for 6 months, an additional local currency equivalent of $1.8 million could be realized. These potential extra earnings could be used to fund additional developmental activities and/or possibly reduce the amount of United States assistance required by the GOES in future years.

Because of the potential benefits that could be derived by the use of interest-bearing accounts, it is important that the GOES and USAID/El Salvador periodically analyze the country's monetary situation for the purpose of taking advantage of interest earning opportunities whenever possible. Furthermore, AID/Washington needs to make a policy determination on whether or not host countries should make available local currency equivalent for the interest earned on the ESF dollars deposited in the United States.

Management Comments

USAID/El Salvador stated that the Central Bank is prohibited by law from paying interest on deposits. In addition, USAID/El Salvador stated it evaluated the potential impact of such interest in conjunction with the 1989 Project Assistance Approval Document submitted to AID/Washington and determined that interest payments on Economic Support Fund and Public Law-480 generated local currency deposits would pose a severe burden on a very fragile financial sector. As such the Mission requested that part "a" of the recommendation be deleted.

In regard to part "b" of the recommendation, USAID/El Salvador stated that it was never A.I.D.'s intent to provide foreign exchange to sit in accounts for the purpose of earning interest. Nevertheless, the Mission stated that the recommendation is directed to AID/Washington and therefore is beyond the direct control of the Mission. AID/Washington stated that such a policy determination had already been made and incorporated into Policy Handbook No. 1, part IV. As stated in the report, this guidance does not specifically state that host countries should make available the local currency equivalent for the interest earned on dollars deposited in the U.S. Nevertheless, AID/Washington comments to the report imply that this practice would be appropriate under some circumstances.

Office of Inspector General Comments

The Mission indicated that one reason interest cannot be earned on local currency deposits is because the Central Bank is prohibited by law from paying such interest. However, as far as we know, there is no legal prohibition from temporarily transferring a part of these funds to interest earning commercial accounts.

The audit found no evidence that the Mission periodically performed economic assessments for the purpose of determining if some or all Economic Support Fund and Public Law-480 generated local currencies could be temporarily deposited in interest earning commercial accounts. The recommendation's intent is to have the Mission establish procedures that require it to make such assessments each time a local currency agreement is signed. Since the Mission is revising its Mission Order on local currency management, it should consider incorporating this assessment requirement in the Mission Order in lieu of a separate order and also to assign its responsibility to the appropriate Mission office. In addition, since AID/Washington has determined that under some circumstances host countries can be required to make available the local currency equivalent for the interest earned on dollars deposited in the United States, USAID/El Salvador also needs to incorporate this assessment requirement in its revised Mission Order.

Based on AID/Washington's interpretation of the existing ESF policy, part "b" of the recommendation is closed upon issuance of the final report. Part "a" of the recommendation will remain open and unresolved until such time the Mission communicates its plans to implement the recommendation.

B. Compliance and Internal Control

1. Compliance

Our review of compliance was limited to the findings presented in this report. The audit identified the following compliance deficiencies.

First, local currency program-financed activities had not been audited as required (see finding No. 1).

Second, USAID/El Salvador had not examined the possibility of depositing local currency program funds in interest bearing accounts as required by AID/Washington guidance (see finding No. 3).

Finally, USAID/El Salvador had not submitted reports on the use of trust funds to the Government of El Salvador as required by the Trust Account agreement (see other pertinent matters section).

2. Internal Control

Our review of internal controls was limited to the findings presented in this report. The audit identified the following internal control weakness. USAID/El Salvador had not assigned adequate resources for financial monitoring nor had it issued guidance specifying the level or extent of financial monitoring and reporting that should be performed (see finding No. 2).

C. Other Pertinent Matters

The following other pertinent matter was identified during the audit.

The Trust Account Agreement establishing the local currency trust fund for USAID/El Salvador requires quarterly reports to be sent to the Government of El Salvador that show the use of such funds. USAID/El Salvador had not prepared required reports for 1985, 1986, or 1987. According to a USAID/El Salvador official this noncompliance occurred because current personnel were not sufficiently aware of reporting requirements, the Mission's numerous moves brought on by the earthquake caused staff to assign a low priority to this activity, and no follow-up by the Government of El Salvador when these reports were not received. The effect of nonreporting is that USAID/El Salvador may have subjected itself to potential criticism from the Government of El Salvador for noncompliance with trust fund reporting requirements and may not be adhering to the same strict standards of accountability as are expected of appropriated funds.

PART III - EXHIBITS AND APPENDICES

NOTE TO THE EXHIBITS

Following are acronyms frequently used in the exhibits:

MOU - Memorandum of Understanding

ESF - Economic Support Fund

PL - Public Law

SETEFE - Executive Secretariat for External Financing

C - Colones, local currency of El Salvador

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UNAUDITED FINANCIAL COMPILATION OF USAID EL SALVADOR
LOCAL CURRENCY PROGRAM AS SHOWN IN DOLLARS
FOR CALENDAR YEARS 1985, 1986 AND 1987 AS OF DECEMBER 31, 1987

By Source of Funds, Implementing Agencies, and Years	LOCAL CURRENCY GENERATIONS					
	GENERATIONS					
	Projected	Actual	Budgeted in MOUs	Budgeted by Implementing Agencies	Received by Implementing Agencies	Disbursed by Implementing Agencies
1. Source of Funds						
- ESF	$ 529,000,000	$ 529,000,000	$ 529,000,000	$ 521,727,402	$ 448,481,036	$ 321,211,913
- P.L. 480 Title I	128,519,490	110,784,847	126,851,263	130,125,280	110,784,847	87,556,600
- Section 416	4,100,000	1,937,774	4,100,000	3,057,400	1,937,774	1,357,188
- Interest earned	3,341,149	2,288,831	1,717,975	1,530,375	2,288,831	1,427,451
Total	$ 661,960,639	$ 644,011,455	$ 661,669,238	$ 656,440,457	$ 563,492,591	$ 411,553,152
2. Implementing Agencies						
- Central Bank	-	-	$ 244,415,030 1/	$ 229,415,030 2/	$ 229,415,030	$ 132,923,465
- Ministry of Finance	-	-	151,175,805	152,036,686	121,970,685	119,769,328
- SETEFE	-	-	249,653,848	259,326,586	196,444,651	146,430,263
- USAID/El Salvador	-	-	15,662,155	15,662,155	15,662,155	12,430,096
- Reserve Fund	-	-	162,400	-	-	-
Total	$ 661,960,639	$ 644,011,455	$ 661,669,238	$ 656,440,457	$ 563,492,591	$ 411,553,152
3. Years						
- 1985	$ 273,741,242	$ 274,793,582	$ 257,424,112	$ 265,046,452	$ 262,591,551	$ 218,153,844
- 1986	186,998,906	186,804,156	196,527,717	207,799,005	197,360,159	117,148,445
- 1987	202,217,491	182,413,717	207,717,409	183,595,000	103,527,781	76,250,863
Total	$ 661,960,639	$ 644,011,455	$ 661,669,238	$ 656,440,457	$ 563,492,591	$ 411,553,152

EXHIBIT 1
Page 1 of 2

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1/ Consists of the following:

- Ten credit lines	$171,373,129
- Private Investment Promotion Fund	53,641,901
- Guaranty Fund	13,000,000
- Rehabilitation Industrial Enterprises	6,400,000
	$244,415,030
	===========

2/ Consists of the following:

- Ten credit lines	$156,373,129
- Private Investment Promotion Fund	53,641,901
- Guaranty Fund	13,000,000
- Rehabilitation Industrial Enterprises	6,400,000
Total	$229,415,030
	===========

UNAUDITED FINANCIAL COMPILATION OF USAID/EL SALVADOR
LOCAL CURRENCY PROGRAM AS SHOWN IN COLONES
FOR CALENDAR YEARS 1985, 1986 AND 1987 AS OF DECEMBER 31, 1987

By Source of Funds, Implementing Agencies, and Years	LOCAL CURRENCY GENERATIONS					
	GENERATIONS Projected	GENERATIONS Actual	Budgeted in MOUs	Budgeted by Implementing Agencies	Received by Implementing Agencies	Disbursed by Implementing Agencies
1. Source of Funds						
- ESF	C2,097,500,000	C2,097,500,000	C2,097,500,000	C1,952,239,852	C1,597,709,325	C1,092,906,981
- P.L. 480 Title I	521,118,000	433,011,424	512,728,116	527,813,201	433,040,624	348,085,680
- Section 416	20,500,000	9,688,871	20,500,000	15,287,000	9,685,871	5,785,959
- Interest earned	16,705,745	11,444,171	8,589,879	7,651,879	11,444,171	7,137,253
Total	C2,566,123,745	C2,461,674,466	C2,519,317,995	C2,502,991,932	C2,051,882,991	C1,451,914,953
2. Implementing Agencies						
- Central Bank	-	-	C 910,000,000 1/	C 835,000,000 2/	C 835,000,000	C 415,558,441
- Ministry of Finance	-	-	572,008,011	574,400,000	427,217,366	123,070,601
- SETEFE	-	-	1,002,997,954	1,031,591,932	727,665,625	570,446,198
- USAID/El Salvador	-	-	62,000,000	62,000,000	62,000,000	45,839,707
- Reserve Fund	-	-	2,312,000	-	-	-
Total	C2,566,123,745	C2,461,671,466	C2,519,317,995	C2,502,991,932	C2,051,882,991	C1,451,914,953
3. Years						
- 1985	C 695,041,761	C 690,584,299	C 616,507,480	C 665,094,330	C 659,861,797	C 517,605,884
- 1986	859,994,533	859,020,783	864,223,469	919,922,602	873,882,291	526,051,754
- 1987	1,011,087,451	912,069,386	1,038,587,046	917,975,000	518,138,903	381,254,315
Total	C2,566,123,745	C2,461,671,466	C2,519,317,995	C2,502,991,932	C2,051,882,991	C1,451,914,953

1/ Consists of the following:

- Ten credit lines	C587,000,000
- Private Investment Promotion Fund	242,000,000
- Guaranty Fund	65,000,000
- Rehabilitation Industrial Enterprises	16,000,000
	C910,000,000

2/ Consists of the following:

- Ten Credit lines	C512,000,000
- Private Investment Promotion Fund	242,000,000
- Guaranty Fund	65,000,000
- Rehabilitation Industrial Enterprises	16,000,000
Total	C835,000,000

Related Local Currency Audit Reports

Audit Report No.	Title	Date Issued
1-519-89-08	Follow-up Review of Recommendations No. 6 and No. 4 b), Audit Report No. 1-519-85-13, USAID/El Salvador Private Sector Support Program and Public Law 480 Local Currency Generations, Dated September 26, 1985	01/30/89
1-519-89-10	Audit of USAID/El Salvador Balance of Payments Program	03/15/89
1-519-89-11	Audit of Selected Local Currency-Financed Activities of the National Commission for Assisting Displaced Population in El Salvador	03/16/89
1-519-89-12	Audit of Selected Local Currency-Financed Activities of the El Salvador Ministry of Public Health and Social Assistance	03/17/89
1-519-89-13	Audit of Selected Local Currency-Financed Activities of the National Plan for Basic Rural Sanitation in El Salvador	03/20/89
1-519-89-16	Audit of the Salvadoran Court of Accounts' Review and Implementation of Local Currency-Financed Activities	03/30/89
1-519-89-17	Audit of the Local Currency-Financed Central Bank Credit Line Program	03/31/89
1-519-89-22	Audit of USAID/El Salvador Local Currency Program, Part II - Generations	06/16/89
1-519-89-23	Audit of USAID/El Salvador Local Currency Program, Part III - Extraordinary Budget Activities	06/16/89

Previous Years' El Salvador Local Currency Reports

Report No.	Title	Date
1-519-82-5	Private Sector Support Program Grant No. 519-0267 (Loan No. 519-K-030) USAID/El Salvador	01/20/82
1-519-83-8	Private Sector Support Program Grant No. 519-0267 (Loan No. 519-K-030) USAID/El Salvador	04/20/83
1-519-85-13	Audit of Private Sector Support Program and P.L. 480 Local Currency USAID/El Salvador	09/26/85

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.

June 2, 1989

MEMORANDUM

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

FROM: Henry H. Bassford, Mission Director, USAID/El Salvador

SUBJECT: Mission's Response to the Draft Audit Report on the Local Currency Program [Part I - Overall Program Management]

Please find attached the Mission's response to the twelve [three] recommendations contained in the above mentioned draft audit report. We sincerely appreciate the extension granted to the Mission in responding to this draft report and feel inclusion of our comments should strengthen the report as a viable management tool.

We are sending this response today, both by FAX and via DHL.

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Recommendation No. 1

"That USAID/El Salvador, in consultation with the Government of El Salvador (GOES):

a. establish specific procedures in each of the local currency memoranda of understanding to ensure that all local currency financed activities are subject to audits, track and resolve audit findings in an adequate and timely manner and distribute promptly all final reports to the appropriate parties and;

b. program adequate local currency to finance these audit activities."

The Mission agrees with the statement that "As of December 31, 1987, most local currency program-financed activities had not been audited." The record would support this statement for the period cited. The Technical Secretariat for External Financing (SETEFE), the GOES entity responsible for auditing the Extraordinary Budget, had attempted its first program of audits in 1986, covering 1983 through 1985, using a broad range of local accounting firms. Attention to audits became a lesser priority when SETEFE was charged with the immediate implementation of the November 1986 Earthquake program.

SETEFE's initial attempt to implement an audit program proved unsatisfactory, as the quality of most of the reports was not acceptable. The audits covered the period from 1983 to 1985 for an equivalent of $150 million in auditable local currency project costs, a total of 69 audits were conducted and delivered to A.I.D. The table on page 9 of the report should be adjusted accordingly.

However, beginning in FY 1988, USAID, via the inclusion of clauses in all memoranda of understanding concerning local currency, has required the GOES to conduct audits of the internal controls and accountability for the uses of the funds provided through the local currency program. The audits were contracted to United States affiliated public accounting firms. Moreover, the Mission, in late 1987, requested and received technical assistance from the RIG/T Office for Non-Federal Audits to implement this program. When the majority of its disaster relief program was completed, SETEFE began to focus its attention on better accountability. First, SETEFE altered its position of utilizing as many firms as possible, to only contracting with quality U.S. CPA affiliated firms. The RIG assisted SETEFE in pre-qualifying the local firms. Second, agreements were amended to include right to audit clauses and, for the first time, required the use of U.S. auditing standards, (GAO for Government audits). The Mission and RIG then held meetings with SETEFE and all the firms selected to explain GAO standards in detail and develop a standardized reporting format. SETEFE then prepared its 1988 audit program, requiring 54 audit contracts covering 160 local currency activities for the period 1986/1987. The Mission accepted the plan as a valid representation based on priority programs and available local auditing resources. To date, the

Mission has received 33 audit draft reports, 19 which have been analyzed and are being used to improve local currency program management. Final reports will be distributed accordingly.

At present, SETEFE's staff has been augmented by three professionals to assure the necessary coordination between the auditees, the seven pre-qualified U.S. CPA affiliate firms and GOES institutions. SETEFE received funding of over $3.6 million equivalent for audits ($.5 million in 1987, $.7 million in 1988 and $2.4 million in 1989) to be shared in conjunction with the GOES' Court of Accounts, the GOES equivalent of the U.S. GAO.

Concerning the Central Bank's lines of credit, the RIG performed this examination with the assistance of the local offices of Price Waterhouse. The Mission agrees with the RIG that if the audit had been conducted earlier it might have disclosed the reported deficiencies sooner. However, it should be noted that during this period the RIG had been using on other audits the only local auditing firm of sufficiently high quality to ensure the delivery of a comprehensive report. The Mission considers RIG audits as a major component to the audit coverage over projects and programs, therefore, the listing of audit coverage on page 13 of the draft report should include the recent RIG audits, such as the one performed on the Central Bank's lines of credit, especially considering it was the Mission who requested the majority of these audits. Future audit assignments can be performed more timely based upon the experience that was gained in performing this audit. Moreover, a PIL for the BCR lines of credit's audit rights and responsibilities has been signed. Again, this is not to say that presently all selected local CPA firms are fully capable of performing GAO quality audits and we will continue to request assistance from RIG's office of Non-Federal Audits. However, it is important to note that audit requirements have been established and the related set of standards have been cited.

Funds programmed to the Ministry of Finance are for budgetary support and, according to present Agency guidance (STATE 313159), the Mission is not required to perform monitoring functions on Budgetary Support. These audits are the responsibility of the GOES' Court of Accounts. While the quality of the Court of Accounts' work remains questionable, their role as the supreme audit agency is a matter of law. Efforts have been directed towards improving and modernizing the Court of Accounts. Continued improvement is currently being programmed through the LAC Regional Financial Management Project and through the Mission's funding of both local currency and dollar projects.

Concerning trust funds, while the GOES to date has not inspected the Mission's trust fund accounting records or audited the use of these funds, they were included in the RIG's scope of work for their audit of the local currency program. If deficiencies were detected, this audit should have reported them so that timely corrective actions could be made. The Mission believes that it has and will continue to maintain its trust fund accounting records in accordance with A.I.D. guidance and has used the trust funds in compliance with the Trust Fund Agreement.

In summary, the situation prior to December 31, 1987 relating to the accountability of local currency was, and we agree, inadequate. The current situation, towards which the recommendation should be directed, has greatly improved since December 31, 1987, and does not warrant the issuance of an audit recommendation. The Mission has, in the last year and a half, taken the steps cited in this recommendation and, therefore, requests that it be deleted from the final report. The Mission also requests that the RIG's Non-Federal Audit Office continues to give high priority to this Mission's local currency program, and that the significant accomplishments that have been made to date are recognized by the RIG.

Recommendation No. 2

"That USAID/El Salvador:

a. assign adequate resources for tracking and reporting the status of local currency funds; and

b. issue written guidance specifying the level of local currency financial tracking and reporting that should be performed. At a minimum, this guidance should require the appropriate Mission office to track and report on the overall status of local currency funds and maintain financial statements by source of local currency funds and by year until fully liquidated."

The Mission has no substantive disagreement with this recommendation. However, there are several points of clarification that must be made. First, as was reported to the RIG at the exit conference, the Office of Development Programs (DPP) is the Mission office that will continue to have principal responsibility for the programming and tracking of local currency resources (this position is stated clearly in the current Mission's Operations Manual (MOM) on the topic that was issued in October of 1987). It is also important to note that the Mission, over the past year, has doubled the size of the staff (from 3 to 6 individuals) within DPP assigned to management of the local currency program. A USDH, the Deputy Director of DPP, has been recruited and given the responsibility of supervising the local currency division within the Program Office. In addition, the Mission has added a professional level FSN-PSC and a FSN secretary to this division. We believe that with these additions, the resource levels assigned by the Mission to track and report on the status of local currency funds are adequate. Accordingly, it is our judgment that Recommendation 2.a, should be eliminated from the final report.

With respect to Recommendation 2.b, the Mission is revising its Mission Order on local currency management. This revised order will be issued by July, 1989. The revised MOM will reflect the recently agreed upon modifications in our mode of local currency programming--viz., a reduction in "projectized" assistance, limiting such assistance to counterpart to A.I.D. dollar funded projects and selected other important local currency investments, and an increase in budgetary support. The new MOM will state the monitoring and tracking responsibilities of the local currency program (to repeat, DPP will play the lead role). In addition, with the hiring of a Management Information Specialist, to be on-board in DPP by September 1, 1989, the Mission will refine its tracking and reporting system. Accordingly, with the issuance of the revised local currency MOM and the upgraded tracking system Recommendation 2.b should be closed.

Recommendation No. 3

"That USAID/El Salvador:

a. establish procedures to (i) assess and document the impact of the monetary system on placing local currency generations in interest-bearing accounts each time a local currency agreement is signed, (ii) obtain evidence that the GOES has deposited local currency funds in interest bearing accounts not detrimental to the country's monetary policy, and (iii) jointly program these additional revenues with the GOES; and

b. that AID/W make (i) a policy determination on whether or not host countries should make available the local currency equivalent for the interest earned on the Economic Support Fund dollars deposited in the United States and (ii) issue appropriate guidance to its field offices based on the policy determination."

With respect to recommendation 3.a.i., the BCR is prohibited by law from paying interest on these deposits (see Attachment No. 1). In addition to this legal prohibition, the Mission evaluated the potential economic impact of such payments in conjunction with the 1989 PAAD submitted to AID/W.

In short, the Mission believes that it is not practical nor advisable to ask the BCR to pay interest on the local currency counterpart of the ESF cash transfer disbursements. These deposits are simply too large relative to the domestic money supply. As of March 31, 1989 ESF and PL-480 generated local currency deposits in the BCR amounted to 19 percent of the money stock (M2). If the BCR were required to pay interest on these deposits at a rate equal to the rate paid on monetary stabilization bonds (currently about 14 percent) this would total some colones 225 million, an amount equal to 50 percent of the growth in the money supply from March 1988 to March 1989.

Clearly, interest payments on these deposits would pose a severe burden on a very fragile financial sector. They would add considerably to the financial losses already suffered by a banking system whose credit portfolio is extensively saddled with non-performing assets. Furthermore, given their size, the interest payments would complicate monetary programming, which is already a formidable task.

Recomendations 3.a.ii. and 3.a.iii. depend on actions proposed in recommendation 3.a.i., which the Mission feels is not a viable course of action. As such, the Mission requests that all three parts of recommendation 3.a. be deleted from the final report.

Concerning part 3.b. of this Recommendation, it is directed towards AID/W, and therefore is beyond the direct control of the Mission and the Mission must await a response. Recommendations directed to AID/W should be issued to AID/W and not to the Mission as is recommended in section 26 of chapter 7 of the 1988 revision to the GAO standards. However, the Mission would like to add that title to the funds in a cash transfer changes according to physical possession. Once funds are received by the host government, the funds are its property and title to ownership has passed. For countries who can and do earn interest on the dollar deposits, one must question the rate of delivery of the cash transfer disbursements. ESF funds are for immediate use and must be viewed as such. For the marginal amounts earned, these interest earnings are required by all agreements to be used for the same purpose as the principal amount of the cash transfer.

It is inconsistent with past practice to charge a Grantee interest in the form of requiring additional local currency equivalents on project disbursements. Moreover, sizeable interest amounts by definition should not occur. This problem can be and is being controlled by tranching disbursements based upon the gap in foreign exchange. Every agreement's disbursement schedule is developed to preclude such an event. In the rare cases where sizable interest earnings occur on dollar deposits, a practical problem begins to grow with disposition of the interest on the interest, or the interest on the interest on the interest, and so on. Where does A.I.D. legally draw the line?

The Mission believes the system as currently designed is manageable and offers the controls to preclude material interest earnings. Again, the problem is not with the host country's interest earning abilities, but with A.I.D.'s correct disbursement planning in providing only immediately required foreign exchange. It was never the intent of A.I.D. to provide foreign exchange to sit in accounts for the purpose of earning interest. This applies to all project funds, not just ESF cash transfers.

ASSISTANT
ADMINISTRATOR

MAY 23 [illegible]

MEMORANDUM

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

FROM: AA/PPC, Richard E. Bissell

SUBJECT: Draft Audit Report of USAID/El Salvador Local Currency Program

Your memorandum of April 17 points out that part "b" of Recommendation No. 3 of the subject draft audit is directed to this office. Part "b" of Recommendation No. 3 is that "A.I.D./Washington make (i) a policy determination on whether or not host countries should make available the local currency equivalent for the interest earned on the Economic Support Fund dollars deposited in the United States and (ii) issue appropriate guidance to its field offices based on the policy determination."

A.I.D./Washington has made such a policy determination. It was originally issued as a cable (State 050845, October 20, 1987) and later incorporated into Policy Handbook No. 1, Part IV. It is identified as "ESF Cash Transfer Assistance - Amplified Policy Guidance" (attached). Accordingly, I recommend that the recommendation not be included in the final audit report.

The elements of the policy directly relevant to the proposed recommendation in the draft audit are included in the fourth paragraph: "as a matter of A.I.D. policy, dollar or local currency separate accounts are to be interest-bearing, to the extent such accounts are permitted under host country law or regulation and, in the case of local currency accounts, do not undermine internationally-supported stabilization agreements or sound monetary policy. Any interest earned on dollar or local currency accounts must be programmed and used as if it were principal." In short, any dollar interest earned on dollars in the dollar special account are to be held in the dollar special account and used for agreed upon dollar purposes. Similarly, any interest earned on the local currency special account (if such a local currency account has been established) is to be held in the local currency special account and used for agreed upon purposes.

As implied above, the policy does not require that a local currency special account be established under cash transfer assistance; the third paragraph states that "if the cash transfer assistance agreement does not provide for local currency deposits, separate local currency account(s) are not required."

Under some circumstances, the local currency equivalent of the interest earned on the dollar special account would be deposited into the local currency special account (if such an account were established) as follows: assume the purpose of a $20 million cash transfer was to provide the foreign exchange to finance imports from the U.S.; at the end of one year, $1 million remains in the dollar special account, including $0.5 million of principal and $0.5 million of interest; the recipient country (private sector or public sector) deposits $1 million of local currency into the local currency special account; simultaneously, an order is placed in the U.S. for $1 million of imports; $1 million is withdrawn from the dollar special account and transfered to the U.S. exporter; the dollar special account is now zero; the importer (public sector or private sector) in the recipient country receives the imports; the local currency in the local currency special account (including the local currency equivalent of the interest earned in the dollar special account) is jointly programmed as provided for in the agreement.

I appreciate the opportunity to review the draft audit.

Attachment: as stated.

REPORT DISTRIBUTION

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LAC/DR	1
LAC/DP	1
LAC/CAP/EN	1
LAC/CONT	1
LAC/GC	1
RLA	1
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GC	1
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