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AUDIT OF AGRICULTURAL AND INDUSTRIAL REACTIVATION PROJECT USAID/COSTA RICA

AUDIT REPORT 1-515-90-018

August 29, 1990

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August 29, 1990

MEMORANDUM

TO: USAID/Costa Rica Director, Ronald F. Venezia

FROM: RIG/A/T, Reginald Howard Daryl T. Burris for

SUBJECT: Audit of Agricultural and Industrial Reactivation Project USAID/Costa Rica, Audit Report 1-515-90-018

Enclosed are five copies of the subject audit report. We provided your office with a draft of the subject report and have included the text of your response as Appendix 1 to the final audit report.

The report contains three recommendations. Recommendation 3 is closed upon report issuance. Recommendations 1 and 2a are resolved and will be closed when we recieve documentation showing the completion of planned actions. Recommendation 2b is unresolved. Please advise me within 30 days of any additional actions taken to implement Recommendations 1 and 2a and further information you might want us to consider on Recommendation 2b.

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

a'

EXECUTIVE SUMMARY

In August 1986 USAID/Costa Rica funded the Agricultural and Industrial Reactivation Project with a loan of $19.65 million and a training and technical assistance grant of $350,000. The goal of the Project was to stimulate economic growth by 1) providing long-term credit to businesses for nontraditional exports and 2) capitalizing a facility in the Central Bank as a permanent source of long-term dollar credit. In June 1989, USAID/Costa Rica reduced the loan portion of the Project to $7.66 million due to a weak demand for loans and extended the completion date to September 30, 1990.

Audit objectives were to evaluate whether the Project had accomplished its goal and to determine whether Project funds were used in compliance with Project Agreement provisions and applicable laws and regulations. We found that:

- **While $6.27 million of A.I.D. funding had entered the Costa Rica economy, the Project's goal of stimulating that economy was largely unachieved. Specifically, subprojects--with potential for developmental impact--had already been started (and in some cases completed) prior to A.I.D. funding. Consequently, A.I.D. cannot claim success in achieving this developmental impact since it merely refinanced such subprojects.**

- **A.I.D. procurement policies were not followed on Project expenditures of over $3.3 million (93 percent of the amount audited) including $1 million for remodeling two hotels having gambling casinos and $100,000 for sewing machines of unallowable origin. Also, the Mission did not start procurement compliance monitoring until the Project's fourth and final year, and $6.03 of the $7.66 million in loan funds had been disbursed.**

- **Training and technical assistance grant funds of $350,000 needed to be deobligated. This Project component could not be implemented due to a Costa Rica legal restriction in effect for the past 15 years.**

The report recommends that the Mission take certain actions regarding project monitoring and the recovery and deobligation of funds. While the Mission did not totally agree with all the findings they did agree with all recommendations.

Office of the Inspector General

Office of the Inspector General
August 29, 1990

AUDIT OF
AGRICULTURAL AND INDUSTRIAL REACTIVATION PROJECT
USAID/COSTA RICA

TABLE OF CONTENTS

C

AUDIT OF
AGRICULTURAL AND INDUSTRIAL REACTIVATION PROJECT
USAID/COSTA RICA

PART I - INTRODUCTION

A. Background

In August 1986, USAID/Costa Rica authorized the Agricultural and Industrial Reactivation Project (Project). As originally conceived and authorized, A.I.D. would loan $19.65 million to the Central Bank of Costa Rica (Central Bank) to capitalize a dollar term-lending facility to be housed there. These dollars would be reloaned and rediscounted to eligible private Costa Rican banks for on-lending to subborrowers who, in turn, were to use the funds to make fixed-asset investments (excluding land) for the purpose of increasing nontraditional exports.

In addition, $350,000 in grant funds would be provided for project evaluations and for training and technical assistance to private lenders not familiar with this type of development lending.

The goal of the Project is to stimulate growth in both the agricultural and industrial sectors of the Costa Rican economy, resulting in increased levels of employment and foreign exchange earnings. The purposes of the Project are to 1) make long-term credit available through the Central Bank for lending to private businesses seeking to expand, establish, or improve their facilities for the production of nontraditional exports and 2) capitalize the Agricultural and Industrial Reactivation facility in the Central Bank as a permanent source of long-term dollar credit. As such, the Project flows directly from the Mission's strategy of expanding and strengthening the role of the private sector in sustained economic development in Costa Rica.

The objectives of the Project as stated in the Project Agreement are to:

- Deepen Costa Rica's financial market by increasing the availability of dollars for term-lending for production of nontraditional exports,

- Assist the Costa Rican private banks in improving their development lending capabilities,

- Strengthen the Costa Rican private banks by channeling Project resources through them and by creating competition among the banks in making the resources available on a first-come first-served basis,

- Increase employment opportunities through increased private sector productivity, and

- Increase Costa Rican foreign exchange earnings through increased export production.

USAID/Costa Rica reduced Project funding from $20 million to approximately $8 million on June 22, 1989, because the demand for loan funds had been slow. In order to increase the demand for the remaining Project funds, the Project Agreement was made less restrictive through several amendments. These amendments authorized loans for international tourism and free-zone related subprojects as well as for working capital purposes.[1] A.I.D. also extended the completion date of the Project from August 28, 1989 to September 30, 1990. As of February 5, 1990, the Central Bank had disbursed, through intermediate credit institutions (ICI), approximately $6.3 million to subborrowers.[2]

B. Audit Objectives, Scope, and Methodology

The Office of the Regional Inspector General for Audit/Tegucigalpa conducted an audit of USAID/Costa Rica's Agricultural and Industrial Reactivation Project (Project 515-0223). Our audit was performed in accordance with generally accepted government auditing standards. Of the $6.27 million disbursed as of February 5, 1990, we tested $3.6 million against our audit objectives.

Specifically these objectives were to determine if:

1) the Project had accomplished its goal,

2) Project funds had been used in compliance with Project Agreement provisions and applicable laws and regulations, and

3) Project components had been implemented in an efficient and effective manner.

In accomplishing these objectives we reviewed Project related documentation and compared expected results with statistical information on Project accomplishments provided by USAID/Costa Rica, the Central Bank, and by selected intermediate credit institutions and subborrowers. We reviewed the

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Loans for working capital would be permitted only if all outstanding applications for fixed-asset loans had first been met.

February 5, 1990 was established as the audit "cutoff" date for review purposes. However, from that date to the time of our exit conference with USAID/Costa Rica, all $7.6 million in loan funds had been disbursed by A.I.D. to the Central Bank.

records (individual subproject files, loan agreements, correspondence files, disbursement and reimbursement requests) maintained by USAID/Costa Rica, the Central Bank, and six intermediate credit institutions who had processed the loans and interviewed responsible officials at those locations.

We also observed subproject operations located throughout Costa Rica between November 2, 1989 and May 10, 1990. The subprojects sampled were selected on a judgmental basis and do not represent a statistically valid sample. There were 25 subprojects which had received Project funded loans as of February 5, 1990. We visited and reviewed the records of 11 subprojects. These 11 subprojects selected in our sample represented 44 percent of the total subprojects and 57 percent of the total funding for the 25 subprojects.

The text of the Mission's comments is presented in Appendix 1. Our review of the Mission response resulted in appropriate changes to the report, however, several of their statements did not coincide with the factual data gathered during the audit and reported herein.

AUDIT OF
AGRICULTURAL AND INDUSTRIAL REACTIVATION PROJECT
USAID/COSTA RICA

PART II - RESULTS OF AUDIT

The audit found that the Project (1) had generally not accomplished its stated goal of stimulating the nontraditional export sector of Costa Rica's economy, (2) had not used Project funds in accordance with the Project Agreement provisions, and (3) had not implemented the Project component of providing technical assistance and training in developmental lending to Costa Rican financial institutions.

The report recommends that USAID/Costa Rica (1) enhance its project monitoring efforts, (2) recover $1.14 million in improper project expenditures, and (3) deobligate the $350,000 grant which was not used.

A. Findings and Recommendations

1. Project Accomplishment Was Minimal

Stimulating growth in the agricultural and industrial sectors of Costa Rica is the goal of this Project. This was to be accomplished by making development credit available to private businesses wanting to establish, expand, or improve nontraditional export production. However, instead of being used as a "stimulant", A.I.D. loan funds are generally (for 10 of the 11 subprojects audited) providing refinancing to projects already in progress or, in some cases, to projects already completed. Since A.I.D. development lending should make credit available to businesses which would have trouble obtaining other financing, Project success cannot be claimed for the accomplishments of the refinanced subprojects. Consequently, $3.1 million of the $3.6 million in loans we reviewed may have been put to better use elsewhere. This problem occurred because loan activity was not appropriately monitored by responsible USAID/Costa Rica staff.

Recommendation No. 1

We recommend that USAID/Costa Rica, in order to better guarantee the success of its projects, take additional steps to ensure that its staff implements A.I.D. requirements with respect to project monitoring and associated reporting.

Discussion

Both the Project Paper and the Project Agreement state:

> The goal of the project is to stimulate growth in both the agricultural and industrial sectors of Costa Rica, resulting in increased levels of employment and foreign exchange earnings. The purposes of the Project are to (1) make long-term credit available through the BCCR for on-lending to private businesses seeking to establish, expand or improve their facilities for the production of nontraditional exports and (2) capitalize the Agricultural and Industrial Reactivation (AIR) facility in the BCCR as a permanent source of long-term credit for this purpose.
>
> The credit will be available to both new and existing firms to finance fixed-asset[3] investment to establish or increase the capacity of

Fixed-assets is defined as tangible property used in the operations of an enterprise but not expected to be consumed or converted into liquid assets in the ordinary course of events. Examples include land, plant machinery and equipment, and fixtures although financing of land with Project funds was specifically excluded in the Project Agreement.

> nontraditional export projects whose output is destined for non-CACM [Central American Common Market] markets.
>
> In the case of loans for fixed-asset investments Project funds will be used to cover a maximum of 70% of the total cost of each proposed investment. The balance of the cost of each investment constitutes the counterpart for the Project and will be provided by the ultimate subborrowers.

Whether it is called a goal, a purpose, or an objective--development lending is what this Project is about. The concept of development lending is that something "happens" as a result of the development loan which would not have taken place without the loan. In this Project what "happens", or the hoped-for effect, is that there is growth in the nontraditional export sector of Costa Rica as a direct result of the loan.

Another word used by A.I.D. to describe the development lending concept is "additionality". In their Development Banking Concept Paper USAID/Costa Rica states:

> Additionality is a key element of development lending from A.I.D.'s point of view. There is no justification for A.I.D.'s intrusion into private financial markets...unless the end result is to make credit available to businesses ("subborrowers") which would have had trouble obtaining adequate finance in the absence of the A.I.D. project. No matter how satisfactory all other aspects of an intermediate credit project may be, A.I.D. is not entitled to claim success if all the subborrowers receiving financing are businesses which could have been adequately funded from ordinary commercial sources.

Our examination of Project loans disclosed that 10 of the 11 loans selected for review were made to subborrowers who had previous financing available to them. Thus, the A.I.D. loans did not have a direct bearing on the accomplishments achieved under these subprojects (i.e. increase in employment) as the accomplishments occurred prior to the A.I.D. loan through other financing. Therefore, USAID/Costa Rica cannot claim success in achieving the Project goal.

The following example demonstrates that Project funds were not instrumental to development lending per se, but rather they were used to refinance or pay for prior expenditures. In the example, funds were also improperly used for working-capital expenses.

COSKOA, a corporate subborrower, signed a $342,000 contract on May 4, 1989, to construct a factory. Included in the terms of this contract was a financing arrangement provided by the builder. This contract shows the work would be completed and paid for by August 31, 1989 (about three and one half months prior to the A.I.D. loan). In addition to the builder's financing, COSKOA obtained another loan commitment of $1 million for this subproject from a U.S. bank.

COSKOA was first offered Project funds on September 26, 1989--after, according to the owner, the building was completed. On October 10, 1989, COSKOA agreed to accept the Project loan if the lending bank would provide an additional $200,000 for a working-capital loan. We believe the owner's statement that the loan was not necessary as other financing was available and the fact that he only wanted the loan if he could obtain funds for working capital indicate that A.I.D. was not instrumental in this company's creation of 500 new jobs.

The $500,000 Project loan was disbursed on December 11, 1989 as follows:

- $348,000 for working capital,
- $132,000 for final payment to the builder, and
- $20,000 for ICI charges.

As can be seen, the largest portion funded working-capital expenses. The use of $348,000 of Project funds for working capital purposes is not permitted by the Project agreement if there are current loan applications to use Project funds for fixed-asset investments. Our review showed that at the time of this loan there were outstanding fixed-asset loan requests which could not be satisfied with remaining Project funds.

In summary, this example demonstrates that this subproject would have "happened" without Project funding, that is, COSKOA had secured financing from other sources prior to the ICI's disbursement of A.I.D. funds.

In total, our review of subprojects showed that $3.1 million of the $3.6 million funded by the A.I.D. loan may have been put to better use elsewhere. Other subprojects where financing prior to the loan was evident or where owners stated that Project funds were not actually needed to finance their subprojects are presented in Exhibit 1. The fact that these subprojects were financed, started, and in some cases completed prior to A.I.D. funding naturally precluded A.I.D.'s monitoring of loan agreement procurement requirements. This problem is discussed in Finding 2.

We believe adequate monitoring and review of ICI loan activity by USAID/Costa Rica personnel could have better ensured Project success. However, reviews of ICI files and activities by responsible USAID/Costa Rica personnel only began on December 22, 1989. In our view, monitoring is a continuous process beginning when a project agreement is signed and ending when a project is completed. The project officer is the key element in the monitoring process, serving not only as the focal point for all contact with the host country entity but also as the funnel through which all communication flows. Thus monitoring imposes upon the Project Officer the responsibility for overseeing virtually every aspect of project implementation.

Monitoring is of vital importance as A.I.D. must provide assurance that U.S. funds are used for their intended purposes. Knowing the project's plan, overseeing that activities are being implemented as intended, and having the information at hand which can be used to make corrective decisions are all part of a project officer's responsibilities. In other words, the project officer is responsible for establishing a suitable project monitoring system. As discussed in the previous paragraph, beginning a serious monitoring effort in the fourth year of the Project and after $6 million had been disbursed, shows that an adequate monitoring system had not been established.

Periodic site visits are an essential element of any monitoring system, and an appraisal of performance based on site-visit findings against plans provides the Project Officer a basis for isolating problem areas and the need for corrective action. To be meaningful, site visits should not only involve physical inspection but also substantive testing/review of Project-related documentation on a selected basis. If plans and schedules and the flow of such documentation are properly established in the beginning, project monitoring can be an effective management tool and less of a physical burden during project implementation. Handbook 3, Chapter 3 states that such planning should be part of project development and shows that a separate section, entitled "Monitoring Plan" should be included in the Project Paper. This was not done.

Handbook 3 further requires that the purpose and coverage of the site visit be documented in a site-visit report prepared by the person conducting the visit. USAID/Costa Rica Order No. 570, dated March 30, 1988, fixes responsibility for site-visit-report preparation on the project officer. On August 23, 1989, the Mission Director, in a memorandum to "all USAID staff (particularly Project Officers)", reemphasized the importance of site visits and written reports. We found it was not until the Project was in its fourth and final year that the first in-depth site-visit review of ICI records was made on December 22, 1989. A memorandum report of this visit was made on March 15, 1990.

Exhibit 2 is a schedule, by subproject, of problems disclosed during our review and shows that Project monitoring efforts by USAID/Costa Rica need improvement. We believe that USAID/Costa Rica, in order to better guarantee the success of its projects, should take additional steps to ensure that its staff implements A.I.D.'s project monitoring requirements.

Management Comments and Our Evaluation

Although Mission management agrees with the recommendation, it disagrees with our finding that project accomplishments were minimal. The Mission states that it substantially accomplished four of the five project objectives. Specifically, the Mission believes the project:

1. Deepened the Costa Rica financial market by increasing the availability of dollars for term-lending...

2. Strengthened Costa Rica banks by channeling project resources through them...

3. Increased employment opportunities...

4. Increased Costa Rica foreign exchange earnings....

We agree with the Mission that the first two objectives were accomplished. However, we must question the significance of this because whenever a project provides such funds the financial market of that country is naturally "deepened" by the amount of the funds provided, and it is also a natural consequence that the banks which receive these funds will benefit. We believe what is significant is whether A.I.D. funds something beneficial for the host country which would not have occurred without A.I.D.'s presence. We do not agree that the Mission Project substantially increased employment (the Mission claims 1400 new jobs were created) and foreign exchange earnings. As discussed on pages 6 and 7 (and not disputed by the Mission) the factory was completed before the loan was even approved and the A.I.D. loan, as applied for, was merely going to be used to refinance a finished effort. Also, in this light, we do not understand comments such as "Nor can we thereby conclude that the subborrower's project would have proceeded in the absence of A.I.D. resources." (See page 4 of the Mission response.)

We reiterate that the USAID/Costa Rica Project was not responsible for the developmental impact, eg., the 500 jobs created by this factory, as claimed in the Mission's comment's. The factory was going to "happen" with or without the A.I.D. loan and the Mission should consider researching ways to use A.I.D.'s limited resources to fund sub-projects that need [4] those funds.

Management comments however, were responsive to the recommendation and based on the plan of action outlined in their comments this recommendation is resolved. Upon documented completion of those planned actions, this recommendation can be closed.

Mission comments also stated that "loan necessity" is not a criterion to determine award of a loan.

2. A.I.D. Procurement Provisions Were Not Followed

Borrowers on the 11 subprojects reviewed did not follow A.I.D. procurement provisions as required by the Project loan agreement. Noncompliance with A.I.D. procurement policy was not detected because compliance reviews by the Project office had not been made and because a significant portion of the procurement occurred prior to the subloan disbursal. Noncompliance with regulations was found in the following areas:

- Procurement of construction services and fixed assets without assurance as to reasonableness of price or without A.I.D. approval, when required,
- A.I.D. loans to hotels with gambling facilities,
- Procurement occurring prior to loan disbursal and claimed as A.I.D. reimbursable, and
- Unallowable purchases of imported goods permitted as allocable to the A.I.D. loan.

In total our review disclosed that over $3.3 million, or 93 percent of the amount audited, was not spent in accordance with A.I.D. procurement policy.

Recommendation No. 2

We recommend that USAID/Costa Rica:

a. recover the $1.1 million in Project funds identified by this audit which were used to finance subprojects connected with gambling facilities, and commodities of improper source or origin; and

b. determine the amount, and recover all Project funds used to finance subprojects connected with gambling facilities, commodities of improper source or origin, and land purchases for the subprojects not reviewed under this audit.

Discussion

Throughout the Project Agreement, references are made to the A.I.D. procurement policy to be followed by the Project's subborrowers. USAID/Costa Rica also provided two seminars which explained the Project loan and, according to A.I.D. Project officials, explained A.I.D.'s procurement provisions to all potential intermediate credit institutions (ICIs). USAID/Costa Rica also supplied the ICIs with a "Synopsis of Procurement Guidelines for Intermediate Credit Institutions".

In spite of these initial positive steps by USAID/Costa Rica, our review disclosed that A.I.D. procurement policy was not followed by the ICIs because the Mission did not effectively monitor the Project. The Project Agreement states: "USAID Project management will monitor ICI adherence to the regulations from the outset [emphasis added] of the Project and take appropriate steps during project implementation to assure compliance." Although the first loan was disbursed on October 28, 1987, it was not until over two years later on December 22, 1989, that the first procurement compliance review was made. Project officials explained that these compliance reviews were not started earlier because the Project had progressed slowly and because most of the earlier loans had gone to one particular ICI which, they believed, possessed sufficient experience with A.I.D. procurement regulations and thus did not require such reviews by A.I.D.

The Project Agreement further provides:

> For each loan disbursement, the BCCR (Central Bank) will provide A.I.D. project management with a reimbursement request including copies of loan requests of the ICI and indicating the purpose and conditions of the loan. Included in this package will be a procurement compliance checklist which will enable A.I.D. project management to detect procurement violations and withhold disbursement [emphasis added].

We noted that USAID/Costa Rica personnel who had conducted the compliance reviews recently started at the ICIs did not review the "procurement compliance checklist" to detect procurement violations.

Our audit found noncompliance with procurement regulations with respect to 1) procurement of construction services and fixed assets, 2) loans to hotels with gambling facilities, 3) procurement occurring prior to loan disbursal, and 4) unallowable purchases. In total, our review disclosed that over $3.3 million, or 93 percent of the amount audited, was not spent in accordance with A.I.D. procurement policy (Exhibit 3).

Procurement of Construction Services and Fixed Assets - Annex I of the Project Agreement states that "Procurements by subborrowers with Project loan funds will be made in accordance with A.I.D. procurement policies as described in A.I.D. Handbook 1, Supplement B, Chapter 19." Chapter 19, in turn, refers to other sections of the Handbook. Specifically, regarding paying a reasonable price, Chapter 19 points to the principles set forth in Chapter 17--and when dealing with construction services--Chapter 12. Among the principles espoused in these Chapters are:

- "The buyer shall pay no more than the lowest available competitive price...[This] requirement will be satisfied if the buyer has followed good commercial practices and accepts the most advantageous competitive offer."

- "A.I.D. financed goods and services are awarded on the basis of competitive procedures."
- "Formal competitive bidding among qualified bidders is the normal procedure for awarding contracts for construction services."
- "A.I.D. reviews and approves...when any A.I.D. financing is involved and the total contract is expected to exceed $100,000."

Annex II of the Project Agreement further states that:

(a) the Borrower will furnish to A.I.D. upon preparation, any plans, specifications, procurement or construction schedules, contracts, or other documentation relating to goods or services to be financed under the Assistance, including documentation relating to the pre-qualification and selection of contractors and to the solicitation of bids and proposals. Material modifications in such documentation will likewise be furnished A.I.D. on preparation;

(b) documents related to the pre-qualification of contractors, and to the solicitation of bids or proposals for goods and services financed under the Assistance will be approved by A.I.D. in writing prior to their issuance ...;

(c) contracts and contractors financed under the Assistance for engineering and other professional services, for construction services ... will be approved by A.I.D. in writing prior to execution of the contract.

These provisions were not enforced by the Central Bank or the ICI's nor were they followed by the subborrowers. Most of the subprojects financed with Project funds involved either new construction or the expansion of existing facilities. For example, a $500,000 loan was approved for a Korean-owned company to construct an apparel factory. The approval, however, was granted <u>after</u> the building was completed according to the owner. The factory was already in operation when the loan was disbursed on December 11, 1989. USAID/Costa Rica Project officials were not aware of this project until it was brought to their attention in a December 15, 1989 meeting. Consequently, A.I.D. was not involved in the required approval processes. (Note: The subborrower's construction contract was signed May 4, 1989.) Also, USAID/Costa Rica did not approve any of the other subprojects that we reviewed involving construction loans totaling $2.7 million in Project funds.

It was also uncertain whether a reasonable price was obtained for this factory. Officials of the ICI involved in the loan stated that they knew of no competitive estimates having been made for construction other than the signed contract. The factory owner stated that he had received quotes from several Costa Rican construction companies, however, he was unable to provide these quotes to us during the audit. Allowing that the owner did receive written estimates, we noted that they were not obtained as result of public advertising, which among other requirements, is called for by the Handbook.

Obtaining a reasonable price through competitive procedures is also required in the procurement of project goods when total cost is expected to exceed $100,000. As was the case for construction services, A.I.D. requirements were not followed for purchases of project goods. For example, a subborrower planned to invest $1.3 million of its own capital into a fern-export activity. The subborrower was loaned an additional $500,000 under the Project which, except for approximately $34,000, were to be used to fund two items--seedlings and plastic shade cloth. Although the owner stated that he "had checked around", he had not obtained written estimates or quotes for the seedling purchase. For the shade cloth, totalling approximately $157,000, he said he had received written estimates but could not locate them. There was no public notification involved with either of these purchases.

Loans to Hotels with Gambling Facilities - Chapter 4 of A.I.D. Handbook 1, Supplement B, states that:

> It is A.I.D. policy not to be connected under any circumstances [emphasis added] with financing gambling facilities. No A.I.D. funds...may be used to finance gambling facilities or hotels, casinos, tourist accommodations, or housing which have or plan to install such facilities.

This A.I.D. policy was reaffirmed recently in a State cable to USAID Missions in Latin America under the subject LAC Bureau Tourism Guidance. The guidance states, in part, that: "Missions should exercise careful judgment to insure the exclusion from A.I.D...involvement in politically sensitive activities or problem areas such as casinos, gambling...."

In spite of this guidance, $1 million in Project funds was loaned to a Japanese-owned company (a subsidiary of Sanyo Oil Corporation) to remodel two of Costa Rica's hotels with the goal of upgrading one hotel to a five-star rating and the other to a four-star rating. Both hotels have gambling casinos and should not have received loans under this Project.

Besides USAID/Costa Rica's inadequate monitoring of A.I.D.'s procurement policy in this example, an additional troublesome impact is that A.I.D. is funding individuals or corporations from a country with which the U.S. has continuing balance of trade deficits--currently at $40 billion with Japan. The

LAC Bureau guidance previously mentioned also stated that: "A.I.D.'s role is to support locally owned [emphasis added] micro-, small-, and medium-sized businesses when appropriate." We believe smaller Costa Rican-owned enterprises would have a greater need for this $1 million loan, especially given that the lending ICI manager stated the Japanese subborrower took the loan as a favor after he [the subborrower] had refused it on several prior occasions.

Procurement Occurring Prior to Loan Disbursal - Annex II, Article C, Section C.2 of the Project Agreement states that: "No goods or services may be financed under the assistance which are procured pursuant to orders or contracts firmly placed or entered into prior to the date of this agreement...."

Since the Project Agreement prohibits the financing of preproject costs, we believe it follows that costs submitted by subborrowers which were incurred prior to receipt of their loans are also not allowable in accordance with this section of the agreement.

We found that approximately $2.1 million[5] of the $3.6 million audited fell into this category (as well as into the other categories previously discussed). For example, a U.S. citizen subborrower was loaned $105,000 in Project funds on December 16, 1987, to expand his flower-exporting business. According to the ICI, a significant portion of the Project loan was immediately used to cover a March 17, 1987 "bridge"[6] loan and other prior expenditures. Our analysis of the documents submitted by the subborrower to the ICI showed that at least $101,562 of the $105,000 loan was spent prior to the loan disbursal. In fact, the invoices used by the subborrower and the ICI to support their expenditures under this loan were dated as early as April 1, 1987 or approximately eight and one-half months before the loan. In effect, this A.I.D. loan and others were used to refinance and cancel past expenditures.

Also, if subborrowers are permitted to attribute items to the Project which were procured prior to receipt of the Project subloan, A.I.D. is effectively precluded from monitoring such procurement and from being involved in the required approval processes.

Unallowable Purchases - The Project Agreement Annex I states that the source and origin of all A.I.D. loan-funded procurement are restricted to selected free-

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The $1 million loan to the Japanese-owned hotels was not reviewed for this condition as the ICI had not established the required procurement file for this subproject, thus, none of the $1 million is included in this figure.

A "bridge" loan is short-term financing to accomodate the borrower until more permanent longer-term financing becomes available. The "bridge" loan document in this example shows that the ICI loaned A.I.D. funds to the subborrower at 26-1/2 percent interest plus a 1 percent commission.

world and Central American countries. Also prohibited by the Project Agreement is the use of the A.I.D. loan to procure land.

In spite of these restrictions, the audit disclosed that $101,481 was liquidated against the Project loan for charges related to the purchase of sewing machines which were made in Japan and Germany.[7] It is particularly disturbing to note that the lending institution was aware that Japanese sewing machines (valued at approximately $80,000) were of unallowable origin as early as November 29, 1989. However it was not until after our February 7, 1990 visit that the ICI acknowledged it had made an error by including these costs as allocable to the Project.

The above four areas of noncompliance with A.I.D. procurement provisions were not detected because compliance reviews by the Project office had not been made. Also, because a significant portion of the subborrower procurement occurred prior to the subloan disbursal, subborrowers were not aware of the A.I.D. procurement provisions that needed to be followed.

Procurement problems noted in this finding were evident in all 11 subprojects we selected for review. We believe these problems could have been substantially avoided had USAID/Costa Rica implemented an effective monitoring system and not permitted attribution to the Project of previously procured items. We recommend that USAID/Costa Rica recover the $1 million loan for remodeling two hotels with gambling facilities, and the $101,481 lent to the subborrower who bought sewing machines of unallowable origin. We are not recommending recovery of the other loans (the $3.3 million on page 10 less the above mentioned $1.1 million) because, even though the subborrowers did not follow A.I.D. procurement provisions, it was not their fault that those requirements had not been communicated to them.

Managements Comments and Our Evaluation

The Mission generally agrees with our finding and accepts our recommendation to recover $1.1 million in A.I.D. funding. However, management believes that A.I.D. procurement provisions relating to pricing and A.I.D. approvals need not be followed by Project subborrowers. According to Mission management, "Handbook 11 states that the A.I.D. procurement regulations do not apply to contacts entered into by or on behalf of the subborrowers." In fact, however, the Handbook does not state this at all, but instead refers the reader (as does Annex I of the Project Loan Agreement) to "A.I.D. Handbook 1, Supplement B for contracting policies concerning Intermediate Credit Institutions." We believe the criteria in Handbook 1 are sufficiently clear and have based our report on these criteria.

A.I.D. Handbook 11 excludes Japan and Germany as being an allowable "selected free world" source for A.I.D. funded items.

The Mission position of not requiring A.I.D. approval on contracts over $100,000 (see page 3 of the Management Response) must be reconciled with current A.I.D. guidance, not with "overall A.I.D. policy" as the project office interprets it. For example, page 9 of the Mission response states:

> Annex II of the Standard Combined Loan and Grant Provisions in Section C.3 uses language which <u>seems</u> (emphasis added) to impose an additional approval requirement beyond that required in the Loan Agreement and by overall A.I.D. Policy. <u>This conflict will be resolved by a project implementation letter</u> [Emphasis added]. The Mission believes that because of its standard nature, this provision ought to be interpreted in a general way.

The Standard Provision, C.3, does not only "seem" to impose that approval requirement, it actually does so. The Standard Provisions form part of the model agreement format. In this regard Handbook 3, Chapter 6 requires:

> ... exception from those model formats may be authorized by the responsible Assistant Administrator, in consultation with Agency legal staff. Whenever a significant exception is made, the pertinent office assures that the appropriate file or files contain a written record, in copies of telegrams or otherwise, which reflects the basis for the exception. In addition, because of the annex's greater content of statutory and regulatory material, no changes in a standard provision annex are to be made without the clearance of Agency legal staff.

Based on the above the project office cannot make its own determination as to which of the standard provisions apply and cannot, as it stated in the Mission response, resolve "this conflict" by a project implementation letter.

If the Mission believes A.I.D. policy or guidance to be faulty then it should seek changes only through appropriate means.

With respect to our audit recommendation the Mission accepted both 2.A and 2.B. Comments and planned actions regarding part 2.A were responsive. Therefore, this part is considered resolved and can be closed upon our receipt of USAID/Costa Rica documentation showing the completion of their planned actions. With respect to part 2.B., USAID Costa Rica needs to communicate their plan of action before this part can be considered resolved.

3. Grant Funds for Training and Technical Assistance Were Not Used

Deobligation of funds which cannot be used for intended Project purposes is a basic tenet of sound financial management policy. While $350,000 had been obligated to the Central Bank of Costa Rica to provide training and technical assistance to private financial institution personnel, it was not expended due to restrictions imposed by Costa Rican law. As a result, these funds have remained idle for at least two and one half years.

Recommendation No. 3

We recommend that USAID/Costa Rica deobligate Agricultural and Industrial Reactivation Project grant funds of $350,000 designated for Project training and technical assistance purposes.

Discussion

Deobligation of funds, which cannot be used for intended purposes, is an effective financial management tool for ensuring that Agency funds are made available for other appropriate needs. Our review showed that $350,000 in Project grant funds remained obligated for a substantial period of time after it was determined that the Central Bank of Costa Rica would not be able to use these funds.

Annex I of the Project Agreement, states that grant funds are to be used to provide training and technical assistance in development subproject lending to personnel from private financial institutions. It was intended, as presented in the Project Paper, that this training and technical assistance would fill a need disclosed by a 1986 Booz Allen study. One of their principal findings was that "...formal training for commercial bank personnel in development finance techniques was necessary for successful term-lending"--the very nature of this Project. Such training would have been most effective during the early stages of the Project's implementation.

On August 28, 1986, $100,000 was made available to the Central Bank of Costa Rica as the first increment of the $350,000 grant. (The remaining $250,000 was obligated the following year.) Due to the Project's slow start the Central Bank did not begin the procurement process for training and technical assistance until August 1987. During their procurement process, the Central Bank realized that Article 88 of the Costa Rican banking law would not permit them to continue this procurement action without first receiving the funds from A.I.D. According to a Central Bank official there was some verbal communication between A.I.D. and the Bank during 1987, however, the Central Bank did not formally communicate this legal requirement to USAID/Costa Rica officials until February 24, 1988.

There was no documentation available either at the USAID/Costa Rica Project office or at the Central Bank indicating an A.I.D. response to this notification. A responsible Central Bank officer stated that A.I.D. had, in fact, not provided a written response. However, an internal USAID/Costa Rica memorandum dated April 21, 1988 stated:

> Despite negotiated assurances two years ago from the BCCR [Central Bank] that arrangements could be made for the BCCR to facilitate, as Grantee, the banking training contemplated under the AIR [Agricultural and Industrial Reactivation Project] grant ($350,000), legal and bureaucratic hurdles at the BCCR have kept this from occurring. OPS [A.I.D.'s Office of Private Sector Development] is rightfully concerned about the lack of movement on the Grant and wishes to explore other options, given a negative experience to date with the BCCR's operational flexibility.

No correspondence from A.I.D. to the Central Bank regarding this grant was written until July 20, 1989, apparently in response to the Central Bank's June 5, 1989 letter which again stated funds had to be at the Bank before a contract could be executed. The A.I.D. response acknowledged the Costa Rican Banking Law requirements as well as the A.I.D. restriction of not being able to provide the Bank with an advance of grant funds. To resolve this impasse the A.I.D. response requested that the Bank temporarily use its own funds to contract the training services, or come up with a better alternative. The A.I.D. letter ended by stating deobligation of these funds might be considered if these arrangements could not be made. Finally, on August 16, 1989, the Central Bank wrote A.I.D., again stating that what A.I.D. proposed was not legally feasible and that they had no other alternatives to offer.

We believe more than sufficient time has elapsed for effective use of these grant funds. In addition, since the time in which training would have been beneficial to the Project implementers is well past, we recommend that these funds be deobligated. We brought this matter to the attention of USAID/Costa Rica management during the audit. Management agreed with our position and has begun the deobligation process.

Management Comments and Our Evaluation

USAID/Costa Rica management agrees with the finding and deobligated the $350,000 grant portion of the Project on April 26, 1990. The Mission's actions regarding this recommendation were responsive and timely. This recommendation is closed upon issuance of this report.

B. Compliance and Internal Controls

Compliance

We limited review of compliance to the issues affected by the audit work performed to accomplish our objectives. Noncompliance is a failure to follow requirements or a violation of prohibitions contained in statutes, regulations, contracts, grants, and binding policies and procedures on entity conduct. Noncompliance where the source of the requirement not followed or prohibition violated is a statute of implementing regulation is an illegal act. A.I.D.'s binding policies and procedures include the review and approval of host country contracts over $100,000. Our audit found six compliance exceptions.

- Although not permitted by Annex I. Section II. A. 5. of the Project agreement, intermediate credit institutions (ICI) loaned Project funds for working-capital purposes even though there were existing fixed-asset loan applications (Finding 1).

- Retail ICIs did not ensure that subborrowers complied with A.I.D. procurement policies as required by Annex I Section IV.C. of the Project agreement (Finding 2).

- Land was purchased with Project funds. This was not permitted by Annex I, Section II. A. (b) of the Project agreement (Finding 2).

- The Central Bank had not established nor prepared an implementation plan to establish the permanent capitalization of the Project loan facility as required by the Project agreement (Other Pertinent Matters).

- USAID/Costa Rica and the Central Bank jointly agreed to a procedure which, while facilitating the placement of Project funds, circumvented Costa Rica's Banking Law, Article 63 (Other Pertinent Matters).

Internal Controls

We limited review of internal controls to the issues affected by the audit work performed in accomplishing our objectives. The review of internal controls covered USAID/Costa Rica's monitoring system. USAID/Costa Rica's system for ensuring compliance with audit requirements was not examined since it was recently audited by RIG/A/T (Audit Report 1-515-89-18).

To evaluate the Mission's monitoring system we reviewed Mission directives and documentation and interviewed officials of the Mission, ICIs and subprojects. Our audit found three internal control weaknesses:

- A monitoring plan for this Project had not been established during project development.

- Substantive site visits, with the purpose of reviewing procurement regulation compliance, were not made.

- Other visits and consultations to monitor Project activities were not documented.

C. **Other Pertinent Matters**

A.I.D. Marking - A.I.D. Handbook 1, Supplement B states:

> a. All A.I.D.-financed equipment and materials and their shipping containers must be suitably marked.
>
> b. Project construction sites and other project locations must display signs suitably marked and indicating participation by the United States in the project. These signs should be erected at an early date in the construction or implementation phase and be replaced by permanent signs, plates, or plaques, suitably marked, at the end of this phase.

None of the 11 subproject sites visited had markings to indicate A.I.D. involvement. We suggest that USAID/Costa Rica ensure the placement of the A.I.D. signs on all Project-financed commodities and construction sites.

Capitalization of the Agricultural and Industrial Reactivation Facility - The establishment of a permanent U.S. dollar term-lending facility was a purpose of the Project. Capitalization of that facility was to be made with the net interest the Central Bank received on its loans. As of November 2, 1989, there had been no capitalization achieved under the Project nor had there been any procedures established to implement this Project purpose. We suggest that USAID/Costa Rica ensure that procedures be established and the capitalization process be implemented as called for by the Project.

Triangulation - Article 63 of the Costa Rican banking law places certain lending restrictions on the Central Bank. These restrictions contributed to the negligible use of Project funds early in the Project. A procedure called "triangulation" was used to bypass Article 63 restrictions. This procedure transferred funds from the Central Bank to a Miami bank account and involved the use of two additional intermediaries, BICSA, and PIC, before the Project funds got to the lending ICI and ultimately to the subborrower.

We have several concerns with this triangulation procedure. First, with two extra intermediaries, each with their own interest spreads and charges, there is less interest available to the Central Bank for capitalization as discussed previously. Second, this procedure circumvents Costa Rican law--and A.I.D. is party to that process. Although A.I.D. officials state that officials of the GOCR know this procedure is used, we believe that USAID/Costa Rica should request GOCR legislative approval to be certain that "triangulation" is a legally permissible alternative and to protect their interests. Finally, BICSA (one of the two added intermediaries) is a parastatal financial institution. A.I.D. Policy Paper, Financial Markets Development, states that parastatals should not be introduced into the on-lending approval process. USAID/Costa Rica should take appropriate action to resolve this matter.

Appearance of Conflict of Interest - The President of the board of directors of PIC, one of the two new intermediaries just mentioned is also the General Manager of one of the lending banks. His bank had received 45 percent of the business under the new "triangulation" process. Both the bank and the individual are stockholders of PIC. We suggest that USAID/Costa Rica work with the organizations involved to resolve this problem.

AUDIT OF
AGRICULTURAL AND INDUSTRIAL REACTIVATION PROJECT
USAID/COSTA RICA

PART III - EXHIBITS AND APPENDICES

EXHIBIT 1

Summary of Projects Reviewed with Prior Project Financing Available and/or Costs Incurred Prior to Approval of Project Loan

Subproject	Amount
Hotels Cariari-Corobicí (2 subprojects)	$1,000,000
COSKOA	500,000
Plantas Madres de Flores	500,000
Inversiones Realtico	147,000
Teneria Primenca	265,923
Finca Nabori	101,562
Zona Franca Metropolitana	281,000
J.P. Nina	223,149
PROCEA	119,500
	$3,138,134

Summary of Project Deficiencies Which May Have Been Prevented Through Improved Monitoring

	Name of Subproject										
Deficiency Noted During Audit	Hotels Cariari/ Corobici	COSKOA	Finca Nabori	Teneria Primenca	Plantas Madres de Flores	J.P. Nina	PROCEA	Servicios Generales del Oeste	Inver- siones Realtico	Zona Franca Metropo- litana	Total by Type of Deficiency
Loan Funded:											
1. Working Capital		X			X		X			X	4
2. Over 70% of Fixed-Asset Investment						X		X			2
3. Land Purchase			X			X					2
"Facesheet":											
1. None Submitted/ Missing Data	X			X		X	X				4
2. Inaccurate					X	X					2
Loan Exceeded $500,000 Limit	X										1
No AID Review of Subproject Files	X	X	X	X	X	X	X	X	X	X	10
No Documented Site Visits	X	X	X	X	X	X	X	X	X	X	10
Loan Not Needed/ Refinanced Prior Loan	X	X	X	X	X	X	X		X	X	9
Questionable Costs				X		X		X	X		4
Two Year Loan Term				X							1
Total Monitoring Problems Noted by Subproject	5	4	4	6	5	8	5	4	4	4	49

EXHIBIT 2

EXHIBIT 3

Summary of Projects Reviewed with Procurement Related Problems

Subproject	Amount
Hotels Cariari-Corobicí (2 subprojects)	$1,000,000
COSKOA	500,000
Zona Franca Metropolitana	500,000
Plantas Madres de Flores	500,000
J.P. Nina	210,947
Teneria Primenca	189,750
Inversiones Realtico	147,000
PROCEA	125,000
Servicios Generales del Oeste	120,000
Finca Nabori	48,000
	$3,340,697

AGENCY FOR INTERNATIONAL DEVELOPMENT

UNITED STATES A. I. D. MISSION TO COSTA RICA

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MEMORANDUM
FAS-90/155

DATE : August 3, 1990

TO : Mr. B. Reginald Howard, RIG/A/T

FROM : Douglas L. Tinsler, Acting Mission Director

SUBJECT : MISSION REPLY TO RIG-DRAFT AUDIT REPORT ON AGRICULTURAL AND INDUSTRIAL REACTIVATION PROJECT (AIR)

Introduction

This project has experienced slow disbursement due primarily to changing economic conditions not foreseen at the time of Project design. One of these was increased uncertainty in the stability of the Costa Rican Colon (which devalued 17.5% in 1987 and 14.9% in 1988), which made U.S. Dollar loans highly risky and unattractive for local companies. In addition, at the same time that AIR Dollar funds were made available, substantial Colon resources became available through the BCCR. Local currency borrowing was preferred by local banks and companies, accelerating the rate at which private banks reached their ceilings on access to BCCR funds, a limit mandated under Article 63 of the Banking Law.

The Mission was aware of these difficulties and looked for ways to salvage the project. The Project Agreement was amended twice; first in September 30, 1988 to authorize the financing of tourist and free zone projects and exports to other Central American Common Markets, and again in February, 1989, to authorize "triangulation" and working capital financing. These changes fostered little immediate improvement in the disbursement rate. Consequently, in June, 1989, the Mission decided to deobligate $11,995,000 million of the Project's Loan portion, reducing the loan from $19,650,000 to $7,655,000.

Since June, 1990, however, loan disbursement rates have increased substantially, and added to private banks' borrowing capacity nearly $5 million within one year. This has enabled the project to meet it's primary purpose, to make credit available through the private banks for on-lending to private business.

Following, are the Mission's specific comments to Part II-RESULTS OF AUDIT, Section A. Findings and Recommendations, keyed to RIG/A's draft report.

1. Finding No. 1:
   Project's Accomplishment was Minimal
   (Page 6 of RIG Draft Audit Report)

The Mission disagrees with this finding for the following reasons:

We believe that the project has substantially accomplished its goal of stimulating growth in non-traditional Costa Rican exports by making development credit available to private business. In the Mission's opinion the project has met four of the five project objectives listed in the Project Paper. Therefore, we believe that objectives were substantially accomplished. We do not agree with the opinion that AIR loans were to be exclusively made to businesses which were not eligible for financing from other sources. Nor do we agree with the perspective that "refinancing" is prohibited under the project because it does not provide for additionality. Moreover, we believe that working capital loans are both appropriate and permissible under the project.

The objectives of the AIR Project as stated in the Annex I of the Project Agreement and its amendments are as follows:

a. To deepen the Costa Rican financial market by increasing the availability of Dollars for term lending for production of non-traditional exports.

b. To assist the Costa Rican private banks in improving their lending capabilities.

c. To strengthen the Costa Rican private banks by channeling project resources through them and creating competition among the banks by making resources available on a first-come-first-serve basis.

d. To increase employment opportunities through increased private sector productivity.

e. To increase Costa Rican foreign exchange earnings through increased export production.

The Mission believes that objectives "a" and "c" were achieved satisfactorily. The project channelled nearly $8 million to 11 private banks and one financiera. This is significant since these funds represent approximately 4% of the loan portfolio of all the private banks in the country. Before the project was implemented, only two private banks and no financieras benefitted from AID Dollar funds. The project has deepened the financial markets, improved the development lending capabilities of private banks and contributed to strengthening the private banking sector. The AIR Project also achieved objectives "d" and "e". It has, or projects, the creation of nearly 1,400 new jobs and $24 million Dollars in foreign exchange.

We would agree, however, that objective "b" has not been fully achieved since it was not possible to implement the Grant Fund. Nonetheless, substantial progress has been made even in this area. We expect improvements to continue during the 25 years of the loan's life. A functioning rediscount window in the BCCR for the private banks, which provides credit to private enterprises, has already been established. In addition, the private banks have developed an effective loan analysis capability which did not previously exist.

It may be premature to judge the degree of Project effectiveness after only six months of disbursements* to sub-projects. AID's loan to the Banco Central of Costa Rica is for 25 years with a ten-year grace period, resulting in an average availability of funds for 17.5 years. The average term of the subloans is five years with a one year grace period, resulting in an average availability of the funds to the subborrower of about three years.

This means that funds can be relent, or turned-over, for subloan projects more than five times. Thirty seven projects have been financed so far. Accordingly, during the life of the loan, approximately 185 projects may be financed. The Project Paper projected that only 45 sub-loans would be identified and analyzed with the original Loan Fund of $19,650,000. Although the initial achievements of the project have not met full expectations, the Mission anticipates that the level of achievements will improve during the remainder of the 25 year life of the loan. Frequently, financial projects have a difficult start-up period but, as the examples of Banex, Cofisa, and PIC have shown, they often develop into very successful development activities. A professional project evaluation will be commissioned after the PACD and its findings and recommendations will serve the Mission as guidance for improving project design and performance in this sector.

The Mission acknowledges that certain subloans were used in ways contrary to AID policy and will recover those subloans.

However, certain other findings, such as permitting procurement of goods prior to loan disbursement, lack of AID approval for contracts over $100,000 and availability of funds from other resources are policies, or practices consciously permitted by the Mission In accordance with the Mission's interpretation of the Loan Agreement and prevailing AID Policies. We will discuss our position in more detail in the section entitled "Discussion".

<u>Recommendation No. 1</u>:
That USAID Costa Rica implement AID requirements with respect to project monitoring and associated reporting.
(Page 6 of the Audit Report)

* Major disbursements started under the triangulation mechanism on July 21, 1989.

The Mission accepts this recommendation. We will take the following immediate actions:

a. Visit all project sites during the next six months (by January 30, 1991) and make site visit reports. Thirty seven (37) projects were financed as of June 30, 1987. We will seek to undertake two site visits a week in order to meet this timeframe.

b. We will review the procurement records of all the participating banks for all its AIR clients.

c. We will draft a procurement check list and use it for all new loans.

d. We will have the AID Handclasp sign placed on all project sites.

Discussion
(Page 7 of RIG Draft Audit Report)

The Mission believes that some of the discussion following Recommendation No. 1 incorrectly views the goal, purpose and objectives of the Project in the light of concepts applicable to concessional assistance rather than to a market-rate loan program.

The arguments cited in the discussion utilize a definition of "development lending" taken from a concept paper prepared by the Mission's Private Sector Office in February 1988, ten months after the AIR Project Loan Agreement was signed. The paper was developed as guidance for evaluating three private ICI's (Cofisa, Banex and PIC) as the recipients of long-term, low-interest AID loans. That "development lending" concept, applies to concessional lending activities for the institutional development of private financial intermediaries. With concessional rates, high rates of additionality are expected. However, the same level or type of additionality cannot be achieved from market-rate loans for which the ICI's earn a normal spread of between 3.5% and 4.5%. Neither the Project Paper, Loan Agreement nor the "Reglamento"* require "additionality" or a "loan necessity test" as a criterion for a loan. The definition of "development lending" not intended to be applied to the AIR Loan Agreement, its Amendments or "Reglamento".

Another concern cited inthe Draft Report indicated thatsubborrowers had access to "other" funds and, therefore, the use of AID resources may not have been appropriate. The ability of borrowers to access sources of financing varies tremendously. It is unrealistic for a private bank to extend loans to clients only after an exhaustive investigation determines that a client has no other access to funds. Additionally, it is inappropriate to require banks to undertake actions which are not outlined in the "Reglamento". Banks usually reject loan requests only if the client cannot offer the required guarantees or cannot demonstrate reliable source of repayment, but rarely (if ever) because clients may have access to other sources of funds. Some clients have started projects with their own funds or used short-term interim financing (including supplier credits) prior to the ICI's approval for AIR resources. However, this is no indication that clients had access to long-term funds from other sources. Nor can we thereby conclude that the subborrower's project would have proceeded in the absence of AID resources.

The comments on subborrower procurements financed from other sources prior to AID loan approval are also misleading. It is a common practice in Costa Rica to authorize the disbursements of development funds for up to six months after the procurement of goods have actually occurred. The BCCR adopted this policy because of the frequent long delays for loan disbursements, common in the country. The adopted policy applies to BID and World Bank loans, and to AIR loans with AID's full concurrence. As stated above, the use of temporary funds from other sources does not eliminate the need for the long-term financing provided by the project.

The Coskoa example indicates how reasonable persons may draw different conclusions from the same case.

Coskoa is a typical development project established in Costa Rica as an affiliate of two US companies, Gilmore Trading Corporation and Rhythm Inc. Hialeah, Florida. It is engaged in the production and distribution of women's fashion clothes with total US sales of over $315 million. The owners of the group are two US citizens (Mr. Ben Rabiner and Mr. Gury Yavmielli), and a Korean citizen (Mr. Lee) with eighteen years of U.S. residency. Mr. Lee came to Costa Rica on March 3, 1989 to explore the possibility of establishing a manufacturing facility. He also visited the Dominican Republic, Guatemala, Honduras, Ecuador, and Belize.

On March 22, 1989 the Miami-based Board of Directors decided to establish a manufacturing facility in Costa Rica. Although the availability of local financing was not the decisive factor in their decision, CABEI, the Central American Bank of Economic Integration, offered them a $1.5 million long term loan to establish operations in Honduras. CINDE, a local export promotion organization, informed us that they gave substantial support to the project, and had introduced Mr. Lee to various local banks to discuss possible financing for their new project in Costa Rica. Coskoa's total investment in Costa Rica, including the $500,000 AIR Project funded loan, presently amounts to over $1.3 million.

As any successful business will attest, it is prudent business practice to look for alternative sources of financing. It is true that the principals of Coskoa obtained a financing offer from an U.S. bank. However, the financing was offered to their US company, Gilmore Trading Corporation, against US-based collateral; an offer not very attractive to the group (liens on their US based assets would have limited their credit access in the USA, which relies heavily on financing to support their multimillion Dollar business). Coskoa, Costa Rica, also received a financing offer from a local construction company to partially finance the land and building if other sources of financing were unavailable.

*The "Reglamento" is the document approved by the Board of Directors of the Central Bank which establishes the general framework, terms and conditions under which private, profit seeking banks are authorized, accepting full credit risk, to compete for BCCR funds to on-lend to private businesses.

. 29'

This alternative was a precautionary option at uneconomically high interest rates. This option was not excercised because Coskoa obtained AIR funds at a market based interest rate. Banco Banex approved a $500,000 loan to Coskoa. However, Coskoa decided to accept the offer from Banco Interfin, instead. Meanwhile, the Coskoa's US group has invested $800,000 of their own funds borrowed from US banks, in the Coskoa Costa Rica project. Coskoa continues to seek an additional $200,000 to finance the Costa Rican operation which has not yet reached its break-even point.

Coskoa, which presently employs 450 people (and plans to employ 500 people by end of the year) in a poverty pocket outside San José, has spent significant resources to train people. They currently realize a loss of about $35,000 a month, although they hope to reach their break-even point by September of 1990. By that time, the US group will have put more than $1 million of their own funds into the project against $500,000 of AIR Project funds, a very attractive leverage from a development perspective. It is clear to us that the availability of local financing from AIR funds helped to leverage a substantial investment into Costa Rica to help achieve the Project's objectives. Additionally, the Coskoa project has produced a significant development impact, as measured by the Project's Goal and Purpose statement and the "objectively verifiable indicators" of the logical framework. AID is proud to put a handshake plaque in front of such an activity.

2. Finding No. 2:
   AID Procurement Provisions were not Followed
   (Page 13 of RIG Draft Audit Report)

The Mission agrees that subloans were improperly made to hotels with gambling facilities, and that source/origin violations ocurred. However, as explained below, reasonableness of price standards were met, procurements prior to loan disbursal were properly reimbursable, and the Mission will allow the land purchase.

Recommendation No. 2a.:
That USAID recover and deobligate US$1.14 million used to finance subprojects connected with gambling facilities, commodities of improper source or origin, and land purchases.
(Page 14 of RIG Draft Audit Report)

a. Loans totaling $1 million were extended to two tourist hotels on whose property gambling facilities operate. While the companies obtaining the loans neither own or operate the gambling facilities and while no gambling equipment was purchased, the loans were extended by the BCCR and ICI's in violation of AID procurement policies. It is clear that the authorization of these loans by the ICI was incorrect. Consequently, we will ask the BCCR to recover these amounts from the ICI's.

However, after further examination, and contrary to what was initially expressed during the exit conference, the Mission believes that it would not be in the best interest of the US Government to deobligate these amounts from the loan (i.e. to request the BCCR to repay the funds to the US Treasury). This would require the BCCR to prepay a 25 year loan, already reduced by $11.955 million, and preclude eligible uses of the loan fund. Rather, provided that the BCCR can approve eligible uses of the recovered loan prior to the PACD of September 30, 1990, the Mission will allow the recovered money to be relent for eligible project purposes. If the funds cannot be relent within the PACD, then they will be deobligated.

This is our justification. First, requiring the BCCR to repay $1 million to the U.S. Treasury (i.e. project deobligation) would present a significant burden to the country and is contrary to the best interests for meeting U.S. Government development objectives. Costa Rica has a large balance of payments deficit and, at present, its foreign exchange reserves are precariously low. The BCCR is currently seeking Dollar funds to comply with its short-term international commitments. To require additional Dollar funds from the BCCR will constitute an undue burden on their accounts, and partially negate the progress made in the country's debt reduction efforts this past year.

Second, there is a great shortage of long-term loanable funds in the economy and many high-impact development projects are having difficulty obtaining the required financing. For example, there are about $1,500,000 worth of unsatisfied qualifying development projects which have been submitted to the PIC. The recovered resources should be relent to those qualifying activities.

b. In the case of the recommended $100,000 recovery from J.P. Nina for source/origin violations, Banco Banex admits that the lack of coordination between the Letter of Credit Department and the Loan Department fostered this mistake which resulted in the purchase from the U.S. of Japanese and German sewing machines. The funds will be recovered and made available for relending until the PACD.

c. Regarding the J.P. Nina land purchase for approximately $39,000, the Mission maintains that the procurement of land is not a violation of AID Procurement policy, but rather a violation of a provision of the Loan Agreement. Therefore, the Mission has the authority to allow that transaction and judges it appropriate to do so in this case.

The prohibition to finance land was introduced in the Fourth Amendment of the Loan Agreement on September 30, 1988, which reads as follows: "The aquisition of land shall not be an eligible fixed asset investment unless AID agrees otherwise in writing in an exceptional case". According to the Regional Legal Advisor (RLA) "there appears to be no legal prohibition nor written policy barring the use of development assistance Dollars for land financing. However, as a matter of practice, AID permits land to be financed only with host country counterpart. The use of Dollar assistance to purchase land.... is discouraged because of the absence of Dollar development impact."

However, in this case, the land was a minor component ($39,000 or 10%) of the total site and facilities cost. The site and facilities compose a new export industry, which was within the project purpose, and which had a clear development impact.

The other two major procurement violations mentioned on page 16 of the Draft Report, i.e. "Procurement of Construction Services and Fixed Assets", and "Procurement Occurring Prior to Loan Disbursal" are judged to be permissible activities in accordance to the following rationale:

a. Procurement of Construction Services and Fixed Assets -- Reasonable Prices.

The AIR Project is a Private Sector Project. Loans are given by private sector ICI's under their full credit responsibility to private sector companies. Private sector companies compete for the lowest prices, and procure under the most favorable conditions since it is clearly in their interest to do so. (They are responsible for fully repaying the loan and, therefore, are not inclined to enter into arrangements which are non-competitive). In fact, Handbook 1B, chapter 19, A3D4 states clearly that, "It is anticipated that private subborrowers under ICI loans will normally follow negotiated procurement procedures."

The Regional Contracts Officer, has commented on this point:

> "Most of AID's policies, rules and procedures on procurement relate to public sector entities that do not have the profit motive to seek the best deal. In Chapter 19 of HB 1B, AID recognizes that the private subborrowers are 'unaccustomed and frequently incapable of responding to many of the conditions normally laid down by an international financing agency'. Private sector entities do not normally advertise their contracting requirements and, while AID requires competition, we do not require advertising. We anticipate that the subborrowers will normally follow negotiated procurement procedures. AID rules require that no more than reasonable prices be paid, that sound procurement practices be followed, and that the buyer accept the most advantageous competitive offer. However, private subborrowers under ICI projects are not required to advertise for their commodity requirements."

In addition, the ICI's are careful not to overfinance projects. They have ample experience with the "reasonable" costs of goods and services in various subsectors and can (and do) provide input to the subborrowers' procurement processes. In the case of the Loan Agreement, Annex II, Section C4 says: "Such items will be procured on a fair and, <u>to the maximum extent practicable</u>, on a competitive basis." It is the subborrower's determination as to the "practicality" of full competitive procurement. It is in their best interest to assure competition for their procurement actions since the objective of private subborrowers is profit maximization. AID's concerns regarding reasonable competition are mitigated (if not eliminated entirely) by the fact that these are market-rate <u>loans to be repaid</u>.

b. Procurement of Construction Services and Fixed Assets -- Preapproval of Construction Contracts

We are unable to find a clear policy requirement that procurements financed by ICI's be approved by AID, nor was it the intention of the Mission to incorporate such a provision in the Loan Agreement. As mentioned in our memorandum of May 14, 1990 to RIG/A/T, the Project Agreement states, in Section VII.A, that procurements by subborrowers will be governed by the policies of HB 11. HB 11, Chapter 1, Section 1.1(c) states that the AID procurement regulations do not apply to contracts entered into by or on behalf of the subborrowers. While Chapter 1 refers only to the procurement of professional and technical services, Chapters 2 and 3 which cover the procurement of construction services and of equipment and materials, respectively, contain the same language.

Annex II of the Standard Combined Loan and Grant Provisions in Section C.3 uses language which seems to impose an additional approval requirement beyond that required in the Loan Agreement and by overall AID Policy. This conflict will be resolved by a project implementation letter. The Mission believes that because of its standard nature, this provision ought to be interpreted in a general way. The wording "In order for there to be mutual agreement...", indicates a reservation of AID's right to subsequently object to any plans, specifications or contracts if it were necessary to do so. It should not be interpreted to require specific AID approval for procurements.

c. Procurement Occurring prior to Loan Disbursement.

In view of the long delays common in Costa Rica for the disbursement of loans, Costa Rican clients approached the BCCR and requested authorization of procurements up to a maximum of six months before loan disbursements. The BCCR adopted this FODEIN Policy and, with the concurrence of AID has applied it to the AIR Project.

Additionally, we are unaware of any prohibition in AID procurement policies which would prevent a subborrower from procuring goods and services prior to disbursement of subloans. The Loan Agreement (Annex II, Article C, Section C2) only prohibits financing of goods and services which were procured prior to the Project Loan Agreement, meaning the agreement between AID and the BCCR (not the agreement between the ICI and the subborrowers). No goods or services were financed prior to that date. Additionally, there are no AIR procurements which occurred more than 180 days prior to loan disbursement. In most cases, the ICI's insisted on conforming with prudent banking practice, which requires that clients use their own capital to initiate projects before any disbursement of the ICI loan funds are provided.

Recommendation No. 2b.:
That the Mission determine the amount, recover and deobligate all Project funds used to finance subprojects connected with gambling facilities, commodities of improper source or origin, and land purchases for the subprojects not reviewed under this audit.

The Mission accepts this recommendation.

3. Finding No. 3:
   Grant funds for training and technical assistance were not used.
   (Page 23 of RIG Draft Audit Report)

The Mission accepts the finding.

Recommendation No. 3
That $350,000 Grant Funds designated for Project training and technical assistance be deobligated.

The Mission accepts this recommendation. The $350,000 grant portion of the Loan and Grant Agreement was deobligated on April 26, 1990.

4. Other Pertinent Matters
   (Page 30 of RIG Draft Audit Report)

The Mission has the following comments regarding Part II - RESULTS OF AUDIT, Section C, Other Pertinent Matters.

a. AID Marking.

   The Mission has ordered fifty "AID Handclasp" metal plates which will be placed on all project sites. We anticipate completing this action by January 30, 1991.

b. Capitalization of the Agricultural and Industrial Reactivation Facility.

   With the reduction of the project by $11.995 million, the rate of fund of capitalization was drastically reduced. Nevertheless, the BCCR established the accounting procedures separating the capitalization funds. The capitalization account currently has accumulated the amount of $99,000. Since this is a 25 year loan with capitalization expected over the entire period, judgement regarding effective capitalization may be premature. Reflows are now being relent from the BCCR directly to ICI's without the need for triangulation. This more direct lending process will significantly increase the rate of fund capitalization since the margins paid to the first and second level intermediaries have been eliminated.

c. Triangulation.

   The triangulation process is an accepted mechanism to channel donor funds to private ICI's. The mechanism is approved by the Board of Directors of the BCCR and the Auditor General de Entidades Financieras, the highest banking authority in the country. It is true that the triangulation process marginally affects the spread available for the capitalization account. However, if resources are not passed on to the intermediaries and, subsequently, to end-borrowers (the case prior to the triangulation), no margins would be generated at all for the capitalization account. The resultant reduced margin is better than no margin.

We do not regard the use of a "parastatal entity" as off-limits, to facilitate the channeling of funds to the private sector. At the time, this mechanism was the only available option for channeling the funds into the private sector. Currently, private bank limitations to accessing funds under Article 63 have become less restrictive. Consequently, reflows will begin to be channelled directly from the BCCR to the private ICI's without the need for the triangulation process. The triangulation process was used as a "stopgap" measure and was never regarded as a permanent solution to providing private banking liquidity. Finally, the "parastatal" in question, BICSA Miami, acts like a private bank. It was formed by the four state-owned banks as an alternative to the highly regulated state-owned banks. More importantly, its local subsidiary, Banco Internacional de Costa Rica, S.A., is registered and classified as a private bank by the Auditoría General de Entidades Financieras. As such, it is considered by AID as elegible for channeling donor resources.

d. Appearance of Conflict of Interest.

The Project Paper, Annex VII, Institutional Analysis, under the section "Likely Major Users", cites Banco Interfin as the first and largest likely user of the fund because of its size and its agressiveness. AIR funded loans obtained by Interfin represent only 4.2% of its own portfolio. Other much smaller banks have a much higher percentage of AIR-funded loans in their total loan portfolio. There has not been any implicit or explicit evidence that Banco Interfin has received, or appears to have received, preferential treatment of any kind.

Following is a list of all the private banks showing their AIR funded loans in relation to their total loan portfolio as of June 30, 1990.

	Total Loan Portfolio Colones (000)	AIR-Project Loans Dollars (000)	AIR-Project Loans Colones (000)	Percentage of AIR to Total Loans
Banco Cofisa	418,761	1,373	122,985	29.4%
Banco Banex	2,794,840	685	61,358	2.2%
Banco Interfin	3,685,523	1,721	154,116	4.2%
Bancoop	3,385,992	146	13,092	0.4%
Banco Federado	1,085,989	81	7,299	0.7%
Banco Internacional	1,143,368	14*	1,233	0.1%
Banco Germano	356,323	123	11,046	3.1%
Banco Comercio	1,708,132	98	8,764	0.5%
Banco Fincomer	212,821	452**	40,513	19.0%
Financiera Fincomer	265,343	452**	40,513	15.3%
Bco. Fomento Agricola	1,980,200	669	59,978	0.3%
Banco Continental	758,401	368	32,954	4.3%
	17,795,693	6,182	553,851	3.12%

* Total outstandings of Banco Internacional amounted to $115,500; however, one loan of $100,000 was prepaid and reduction of the $15,500 was done through normal amortization.

** Reduced from original $500,000 through amortization.

35

APPENDIX 2

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