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AUDIT
OF USAID/EL SALVADOR'S
AGRARIAN REFORM CREDIT PROGRAM
PROJECT NO. 519-0263

Audit Report No. 1-519-87-13
January 30, 1987

AGENCY FOR INTERNATIONAL DEVELOPMENT

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January 30, 1987

MEMORANDUM

TO : USAID/El Salvador, Director, Robin Gomez

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

SUBJECT: Audit of USAID/El Salvador's Agrarian Reform Credit Program (Project No. 519-0263), Report No. 1-519-87-13

This report presents the results of audit of the El Salvador Agrarian Reform Credit Program, Project No. 519-0263. The Office of the Regional Inspector General for Audit/Tegucigalpa made a program results audit of the project. The audit objective was to determine if the project had increased the availability of credit to the agrarian reform and traditional farm sectors and had improved the capacity of the national financial system to deliver such credit. Specifically, the audit evaluated the performance of the Salvadoran Agricultural Development Bank in implementing the project and whether project resources were effectively used.

The audit found that while the Agricultural Development Bank had been capitalized and much needed credit increased, the bank's operating expenses were increasing greatly while earnings from loan payment reflows were less than expected because many loans to reform beneficiaries were delinquent, extended, or refinanced.

The report recommends that the bank find ways of reducing operating and administrative costs, increasing earnings, simplifying a cumbersome accounting system, and removing itself from certain non-credit operations it is currently involved in.

You generally agreed with our recommendations and initiated corrective actions. Recommendations 4(b) and (c) are closed upon issuance of this report. Please advise us within 30 days of any additional information relating to actions taken or planned to implement the audit recommendations.

We appreciate your cooperation and courtesy to our staff during the audit.

EXECUTIVE SUMMARY

USAID/El Salvador's Agrarian Reform Credit Program started in June 1980 and was scheduled to end in December 1987. Project funding was $85.8 million in AID funds and the equivalent of $44.1 million in Government of El Salvador funds. The audit covered $72.7 million in AID funds disbursed as of March 31, 1986. The project's objective was to "...increase the availability of credit to the agrarian reform and traditional farm sectors and improve the capacity of the national financial system to deliver such credit." By achieving that objective the project planners sought to improve the economic and social well-being of agrarian reform beneficiaries and other small producers through increased agricultural production and employment.

The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit of USAID/El Salvador's Agrarian Reform Credit Program. Audit objectives were to determine whether: stated project objectives and goals were being achieved; and USAID/El Salvador was managing the project economically and efficiently and was complying with AID regulations.

The project's objectives were only partially achieved. While available credit had increased and the ability of the Agricultural Development Bank to deliver credit had improved, the Bank's long-term capacity to independently provide credit was doubtful. Bank operations needed improvement to operate economically and efficiently. Eight instances of non-compliance were found and four areas of internal controls needed modification.

Project accomplishments had fallen short of expectations partially due to internal political strife and declining world market prices for agricultural commodities. Nevertheless, many reform sector beneficiaries had been able to obtain financing for their crops through loans of up to 18 months. Investment loans for 5 to 20 years were available to improve farms and cooperatives.

The Salvadoran implementing agency, the Agrarian Development Bank, still lacked the financial and managerial capacity to provide sustained credit and ancillary services to project beneficiaries. It was operating at a loss and some loans may be uncollectable. In our opinion, the Bank should not be involved in the purchasing, storing, and marketing of crops. Furthermore, its credit agents did not effectively disseminate information relative to technical assistance that was available to its agrarian reform clients. Finally, because of the Bank's cumbersome accounting system, branch office and central office records did not always reconcile, making full accountability for AID funds questionable.

The audit also identified problems in project evaluation procedures, reimbursement of repair costs and records on contractors, conditions precedent and special covenants.

For a banking enterprise to be self-sufficient, lending operations have to result in a surplus or its capital base will eventually shrink. General and administrative expenses should be in line with earnings. Permanent capitalization of the Bank may not have been adequately ensured because of administrative shortcomings, increased administrative costs and a large number of overdue loans. If decapitalization continues, the Bank will not be able to continue providing the amounts of credit planned in the project in future years. We recommended cost reductions and the Mission concurred.

Proper accounting practice and the project agreement require that problem loans be segregated and reported on separately. However, the Bank's financial statements did not reliably reflect that institution's financial condition because the true delinquency rate on loans made to agrarian reform cooperatives was understated on the Bank's December 31, 1985 financial statements. Refinanced and extended loans totaling over $20 million had not been segregated into a problem category. Bank loans to agrarian reform cooperatives were refinanced and extended to keep the cooperatives financially solvent, thereby making them eligible for new loans. Furthermore, the Bank was unable to provide information on individual Phase III loans refinanced and extended. As a result, not only did the accounts understate the amount of problem loans, but their true extent placed in jeopardy the Bank's ability to meet its obligations under the agrarian reform program. We recommended that the Mission obtain financial statements fully disclosing refinanced and extended loans. The Mission agreed.

The Bank was to coordinate with other government institutions to provide technical assistance to project beneficiaries in both agricultural and credit management. With few exceptions, agrarian reform beneficiaries had not achieved the managerial expertise which, disregarding uncontrollable factors, would have assisted them in making their farms and cooperatives financially viable. Bank credit agents could have been better trained and more effective in teaching beneficiaries how to obtain such assistance from public and private sector agencies. Better use of such technical assistance might have contributed to increased production and income for the beneficiaries. We recommended more effective dissemination of technical assistance. The Mission agreed but wished to strengthen the distinction between the roles of credit agents and agricultural extension agents.

The Bank's information processing systems were experiencing problems. On the one hand, technical assistance provided to design and procure a new computer system encountered incompatibility and other problems. These seriously delayed procurement of a badly needed computer, wasting time and money, and necessitating error-prone manual transfers of data. We recommended staffing and design improvements. On the other hand, preparation of inaccurate records allowed loans to be made with AID funds without a clear determination of their eligibility. We recommended

improved oversight and more intense scrutiny of data supporting disbursement requests. The Mission agreed. Based on actions taken recommendations 4b and c are closed upon issuance of this report.

Mission comments have been considered in the preparation of this report. The entire text of their formal comments is included as Appendix 1.

Office of the Inspector General

AUDIT
OF USAID/EL SALVADOR'S
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PROJECT NO. 519-0263

TABLE OF CONTENTS

		Page
PART I -	INTRODUCTION	1
	A. Background	1
	B. Audit Objectives and Scope	2
PART II -	RESULTS OF AUDIT	4
	A. Findings and Recommendations	5
	1. The Salvadoran Agricultural Development Bank (BFA) Was Operating at a Loss	5
	2. Refinancing or Extension of Debt will Likely Increase BFA's Bad Debt Ratio	8
	3. Better Managerial Capabilities Could Improve Beneficiaries' Well-Being	10
	4. Technical Assistance to BFA in Automating Its Data System Could Have Been Better Utilized	12
	5. USAID/El Salvador Should Seek Improvements In the Accuracy of BFA's Financial Reports	14
	B. Compliance and Internal Controls	17
	C. Other Pertinent Matters	19
PART III -	EXHIBITS AND APPENDICES	
	A. Exhibits	
	1. Summary of Project Agreement and Amendments	
	2. Project Financial Status as of March 31, 1986	
	3. Project Vehicles Observed at BFA Offices	
	B. Appendices	
	1. Mission Comments on Draft Report	
	2. List of Recommendations	
	3. Report Distribution	

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PART I - INTRODUCTION

A. Background

In March 1980, the Government of El Salvador (GOES) instituted sweeping social and economic reforms to transfer ownership of farmlands from large landholders to those who worked the land. These reforms were to be accomplished under a March 6, 1980 decree called the Basic Law of Agrarian Reform, Decree 153. The reform program was to have had three phases, although the order of their implementation was not sequential.

-- Phase I called for the expropriation with compensation of all farms of more than 1235 acres. Under Phase I the expropriated land provided the basis for cooperative agricultural associations managed and operated primarily by those who had worked on the lands when they were privately owned.

-- Phase II called for the expropriation of farms between 250 acres and 1235 acres, if not voluntarily sold by December 20, 1986.

-- Phase III provided for the immediate transfer of land ownership to tillers who had previously rented the land from large landholders. Beneficiaries were entitled to own up to 17.3 acres of expropriated land.

The shift in ownership of over 20 percent of El Salvador's land under the agrarian reform program increased demand for agricultural credit by beneficiaries of the reform. Their need for credit was considered immediate and crucial to the successful implementation of the reform program. However, it was recognized that this need could not be met through existing lines of credit from the Salvadoran Agricultural Development Bank or the existing banking system.

To help meet this increased demand for credit USAID/El Salvador developed its Agrarian Reform Credit Program, Project 519-0263, in June 1980. On July 7, 1980 the United States and El Salvador signed a combined loan/grant agreement (number 519-T-028) for $10 million to " ... increase the availability of credit to the agrarian reform sector and the capacity of the Agricultural Development Bank (BFA) to provide such credit." Of the $10 million provided, $9.5 million was a loan to provide capital to BFA and $500,000 was a grant to provide it with technical assistance.

At the time of our audit, the agreement had been amended nine times, increasing the assistance to $85.8 million, of which $81.5 million were loan funds and $4.3 million (including $2.1 million authorized in 1985) were grant funds. The GOES was to provide the equivalent in local currency of $44.1 million, bringing total project funding to $129.9

million. The project's purpose, though expanded, remained essentially the same, "...to increase the availability of credit to the agrarian reform and traditional farm sectors and improve the capacity of the national financial system to deliver such credit" (Underscoring added to indicate expanded project purpose). Exhibit 1 shows the dates and amounts of each amendment since July 1980.

Three Salvadoran agencies were designated to implement the project:

-- BFA was to manage a $77.8 million loan-funded Integral Line of Credit, providing short-term credit for crop loans to reform beneficiaries under Phases I and III as well as to traditional farmers; train BFA personnel; and provide technical assistance to Phase I cooperatives.

-- The Salvadoran Central Reserve Bank (BCR) was to manage an Investment Line of Credit providing long-term capital improvement loans, refinancing for Phase I cooperatives, and training of credit agents for the Phase I cooperatives.

-- The Center for Agricultural Technology (CENTA) was to manage an Integrated Pest Management activity.

As of March 31, 1986 AID had disbursed $72,677,000 under this project, of which $68,142,000 was for the Integral Line of Credit -- short-term loans to reform and traditional farmers. The planned completion date for AID's assistance to this project was December 31, 1987, extended from September 30, 1982. Exhibit 2 presents a financial summary of the project, by its various components, as of March 31, 1986.

Under a new project USAID/El Salvador planned to provide a $50,000,000 grant to the GOES for continued support to the reform sector credit program. It was expected that these funds would be made available to the entire Salvadoran banking system, including BFA, for subsequent lending to the agrarian reform sector and traditional farmers.

B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit of USAID/El Salvador's Agrarian Reform Credit Program. The period covered was from June 1980, when the project started, to July 31, 1986, except for financial data, which was as of March 31, 1986 unless otherwise indicated. AID disbursements totaling $72,677,000 as of March 31, 1986 were covered by the audit.

Audit objectives were to determine if:

-- stated project objectives and goal were being achieved;
-- USAID/El Salvador was managing the project economically and efficiently; and
-- the project managers were complying with AID regulations.

Audit fieldwork was done during the period April 28, 1986 to July 31, 1986. We reviewed project files and interviewed project officials at USAID/El Salvador, the Salvadoran Agricultural Development Bank, the Salvadoran Central Bank, the Salvadoran Regulatory Institute for Basic Grains (IRA), coffee procurement and storage agencies and other project-connected agencies as considered necessary. Four branch offices of the Agricultural Development Bank were visited in four zones covering a geographically representative area of El Salvador. A total of 59 agrarian reform and traditional beneficiaries were visited and interviewed in the four zones. Documentation supporting the Government of El Salvador contribution to the project was not audited because nothing came to our attention that would indicate any problems with GOES financial support for the project. To test compliance and internal controls, applicable standard provisions of the project agreement were reviewed as well as AID Handbooks. Where project deficiencies were disclosed, the applicable regulations and internal controls were examined.

Project beneficiaries to be interviewed were randomly selected for the four geographical areas visited. However, of the 59 interviews conducted, only 22 were of beneficiaries selected at random; the remaining 37 interviews were selected by area BFA branch officials. This substitution occurred because the 37 beneficiaries originally selected lived in areas considered by branch officials to be not readily accessible or dangerous.

On December 17, 1981 the AID Inspector General issued Audit Report 1-519-82-4 presenting a limited purpose audit of the project for the period July 7, 1980 to May 30, 1981. Two recommendations in that report addressed issues that were found still to be problems in this current audit: adequate supervision over loans to beneficiaries, and adequate support for loan reports presented to USAID.

The audit was made in accordance with generally accepted government auditing standards.

AUDIT
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PROJECT NO. 519-0263

PART II - RESULTS OF AUDIT

The program was designed to increase the availability of credit to the agrarian reform and traditional small farm sector, and to improve the capacity of the national financial system to deliver such credit, ultimately improving the economic and social well-being of the beneficiaries. The project's objectives were only partially achieved. While available credit had increased and the ability of the Agricultural Development Bank (BFA) to deliver credit had improved, BFA's long-term capacity to independently provide credit was doubtful. Bank operations needed improvement to operate economically and efficiently. Eight instances of non-compliance were found and four areas of internal controls needed strengthening.

Project accomplishments had fallen short of expectations, partially due to declining world market prices for agricultural commodities and internal policitical strife. Nevertheless, reform sector beneficiaries had been able to obtain financing for their crops through loans of up to 18 months. Investment loans for 5 to 20 years were available to improve farms and cooperatives.

The Salvadoran implementing agency, the Agricultural Development Bank, still lacked the financial and managerial capacity to provide sustained credit and ancillary services to project beneficiaries. It was operating at a loss and some loans may be uncollectable. The Bank's officers had not taken effective actions to reduce administrative costs and to become self-sufficient. In our opinion, BFA should not be involved in the purchasing, storing, and marketing of crops. Furthermore, BFA's credit agents did not effectively disseminate information relative to technical assistance that was available to agrarian reform clients. Finally, because of the Bank's cumbersome accounting system, branch office and central office records did not always reconcile. Thus, full accountability for AID funds was questionable. As a result of these conditions, BFA's ability to continue providing loans to the agrarian sector without external infusions of capital was questionable.

The audit also identified problems in project evaluation procedures, reimbursement of repair costs and records on contractors, conditions precedent and special covenants.

We recommended an analysis of the Salvadoran Agricultural Development Bank to find ways of reducing costs, increasing earnings, and simplifying accounting procedures; and the development of means to ensure BFA's future viability. As a result of the audit, USAID/El Salvador also agreed to better utilize the results of project evaluations, take action to seek recuperation of costs to repair defective project vehicles, and improve its administrative procedures for monitoring project conditions precedent, covenants and contract documentation.

A. Findings and Recommendations

1. The Salvadoran Agricultural Development Bank (BFA) Was Operating At A Loss

For a banking enterprise to be self-sufficient, lending operations have to result in a surplus or its capital base will eventually shrink. General and administrative expenses should be in line with earnings. Permanent capitalization of BFA may not have been adequately ensured because of administrative shortcomings, increased administrative costs and a large number of overdue loans. If decapitalization continues, BFA will not be able to continue providing the amounts of credit planned in the project in future years.

Recommendation No. 1

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

a) conduct an analysis of the Salvadoran Agricultural Development Bank to find ways of reducing costs, increasing earnings, and simplifying accounting procedures;

b) develop a time-phased plan under which the Agricultural Development Bank will divest itself of non-banking activities such as fertilizer and pesticide sales, grain storage, and marketing; and

c) clearly define Agricultural Development Bank's role in providing credit to the Agrarian Reform sector.

Discussion

When this project started in 1980, BFA had neither the capital nor the administrative capability to carry out its mandate of providing credit to the agrarian reform sector. To improve this situation USAID/El Salvador and the GOES initiated the Agrarian Reform Credit Project. The project was to provide $77,800,000 in USAID loan funds and $16,700,000 in counterpart funds from PL 480 commodity sales proceeds. These funds were planned to capitalize an Integral Line of Credit at BFA to provide credit for the agrarian reform sector and grant funds to finance technical assistance to BFA for credit administration, control and recuperation of the loan portfolio, bank financing and administration, and accounting and computer data processing.

A June 30, 1985 report prepared by a USAID-financed advisor to BFA concluded that BFA's financial condition had improved from November 1980 to December 31, 1984 in terms of assets, liabilities, working capital, overdue loans and reserves. One area that did not improve was the percentage of uncollected interest to the total loan portfolio, which rose from 5 percent in 1980 to 14.7 percent in 1984.

Although BFA's capital position had indeed improved from its nearly bankrupt condition in 1980, two points should be noted. First, the bank's financial position had deteriorated in the year since the analysis was made, as reflected in its December 31, 1985 financial statements. Second, the Mission's efforts to improve BFA administrative practices had generally fallen short of expectations.

Financial Condition - BFA's most recent financial statement dated December 31, 1985, indicated that its permanent capitalization may not have been adequately ensured because of administrative shortcomings and the uncontrolled growth of expenditures. Interest recorded as earned from loan operations in 1985 ($24,046,868) was slightly less than amounts recorded as earned in 1984 ($24,091,190) even though the portfolio of loans had increased from $211,600,000 to $227,600,000. General and administrative expenditures rose from $13,092,002 in 1984 to $15,983,652 in 1985. Furthermore, if one excluded the commercial operations (sales of fertilizer and pesticides) from the Earnings and Loss Statement, BFA had suffered a substantially larger loss from loan operations ($2,935,979 as of December 31, 1985, versus 1984 losses of $2,160,011). If the full amount of identified past bad debt from overdue loans had been written-off, current losses recorded from loan operations would have been greater and further reduced BFA's assets. Overdue loans consisted of $39,181,400 identified, of which only $3,729,920 had been written-off. Associated interest, which continued to be calculated and added to accounts receivable, consisted of $18,598,157 identified, of which only $1,047,939 had been written-off.

Administrative Capabilities - While efforts to adequately capitalize the bank had been initially successful, attempts to improve the bank's administrative capability had fallen well short of expectations. Five years into the project, as of December 31, 1985, the bank was experiencing severe administrative deficiencies, such as computer system problems. Improvements in the data processing system were to have allowed the bank to eliminate costly manual procedures and excess personnel. Shortcomings such as this caused general and administrative costs to outpace earnings. The bank was able to show a small net profit only because its commercial operations had been profitable and because of questionable valuation of assets. These included receivables for interest earned on uncollectable loans ($18,598,157) and the uncollectable loans themselves ($35,451,480), which probably should have been classified as bad debts long ago. In general, BFA's policy was to extend and refinance delinquent loans rather than to aggressively pursue amounts overdue.

Because BFA was made the implementing agency for the agrarian credit program, it made loans to all eligible beneficiaries regardless of the amount of the loan. Over 91 percent of BFA's December 31, 1985 loan portfolio for agrarian loan recipients was loans whose interest payments did not cover the expense of loan administration. In effect, BFA had been subsidizing small and marginal reform beneficiaries, while in so doing endangering its future viability.

Commodity Purchase and Storage - Other problems diminishing BFA's effectiveness were linked to the Salvadoran Regulatory Institute for Basic Grains (IRA). IRA is a Salvadoran agency that buys such basic grains as rice, corn and beans from producers at subsidized prices and stores them for future sale to consumers. IRA's purpose was to stabilize basic grain prices and supplies. By agreement with the BFA, IRA established a policy of purchasing 70 percent of the basic grain production of Phase I and Phase III agrarian reform beneficiaries for the 1985-86 crop season. But IRA's financial problems, lack of storage facilities, and questionable administrative capacity hampered attempts to reach that goal.

BFA approved crop loans to agrarian reform beneficiaries with little consideration for the future marketability of the crops. Most BFA borrowers had little grain storage capacity themselves; thus, when IRA could not purchase their crops, they had to sell them at prevailing market prices. These were as much as 11 percent lower than those offered by IRA for such crops as corn, beans and rice according to 1985-86 price lists provided by IRA and the Ministry of Agriculture.

These problems caused many BFA borrowers to become delinquent on their loan payments and to accumulate interest which further eroded their financial resources. BFA did not charge penalty interest on overdue loans because in most cases the overdue loans were extended or refinanced for a longer term. However, the end-result was contrary to the project goal of making BFA a self-sufficient organization capable of providing credit to the Agrarian Reform Sector and thereby increasing the beneficiaries' well-being.

Management Comments

Mission officials agreed that BFA's operations needed to be made more profitable and that it needed to reduce administrative expenses. USAID/El Salvador stated that these concerns would be addressed in a planned follow-on credit project.

2. Refinancing or Extension of Debt will Likely Increase BFA's Bad Debt Ratio

Proper accounting practice and the project agreement require that problem loans be segregated and reported on separately. However, BFA's financial statements did not reliably reflect that institution's financial condition because the true delinquency rate on loans made to agrarian reform cooperatives was understated on the Bank's December 31, 1985 financial statements. Refinanced and extended loans totaling over $20 million had not been segregated into a problem category. BFA loans to agrarian reform cooperatives were refinanced and extended to keep the cooperatives financially solvent, thereby making them eligible for new loans. Furthermore, BFA was unable to provide information on individual Phase III loans refinanced and extended. As a result, not only did the accounts understate the amount of problem loans, but their true extent placed in jeopardy BFA's ability to meet its obligations under the agrarian reform program.

Recommendation No. 2

We recommend that USAID/El Salvador, in conjunction with the Government of El Salvador, obtain from the Agricultural Development Bank financial statements on refinanced and extended agrarian reform loans to Phase I and Phase III beneficiaries, including footnotes to the same statements to describe how the condition of the refinanced loan portfolio changed during the period reported on in the statement.

Discussion

The refinancing and/or extension of $21.7 million in BFA loans (Phase I) from 1980 through 1985 will likely increase the Bank's bad debt ratio. The rate of default will be higher than average when applied to a group of loans that were originally in default and then refinanced or extended. While BFA financial reports as of June 30, 1986 showed only about $1.4 million in delinquent loans to agrarian reform cooperatives, many other loans had been refinanced and extended. About $11.8 million in loans made from 1980 to 1985 had their due dates extended by one year, although interest rates remained unchanged. Another $8.5 million in loans to agrarian reform cooperatives were refinanced, interest due was capitalized, and the interest rate lowered by about 7 percent (from 13 percent to 6 percent).

Additionally, BFA's financial records did not disclose the amount of loans made to Phase III (individual) beneficiaries that had been refinanced and extended. The BFA's June 30, 1986 financial reports showed $13,144,904 in loans granted from 1982 through 1985 to Phase III beneficiaries. Of these $1,522,287 were reported delinquent. However, discussions with beneficiaries and a review of loan files at BFA branch offices indicated that some other loans had been refinanced and extended but BFA could not provide figures. Therefore, the total amount of doubtful agrarian reform loans in BFA's loan portfolio could not be determined from available accounting records. However, it should also be noted that some loans were only slighty extended, for three or four months, to allow borrowers to receive money from their harvests.

Generally accepted accounting practice requires that financial statements disclose to the maximum extent possible the true financial position of an entity, including contingencies or other matters that have or may have a material effect on its future operations. These requirements were incorporated in the AID loan agreement with BFA.

Of the loans made from 1980 through 1985, only $1.4 million in USAID loan and GOES funds were shown on BFA's June 30, 1986 financial statements as delinquent loans. Another $20.3 million had been refinanced or extended in order to prevent a large number of cooperatives from going into default and, ultimately, bankrupt. BFA's financial and accounting procedures thus seemed to reflect a larger GOES policy to maintain reform cooperatives' solvency and allow them sufficient time to succeed. However, the result of this policy and accounting practice may be misleading in its presentation of the BFA's and the cooperatives real financial status.

Future BFA financial statements should report the status of agrarian reform problem loans separately and also disclose any changes in their condition. Complete and accurate BFA reporting would indicate to GOES and USAID authorities when further action is warranted. If the delinquency rate were reduced by half under USAID/El Salvador's planned new $50 million loan project, a savings of $5 million in preventable bad debt write-offs could be realized.

Management Comment

The Mission agreed that BFA should fully disclose delinquent and doubtful accounts on its financial statements either through separate disclosure or by establishing more realistic reserves for bad debts.

3. Better Managerial Capabilities Could Improve Beneficiaries' Well-Being

BFA was to coordinate with other government institutions to provide technical assistance to project beneficiaries in both agricultural and credit management. With few exceptions, Agrarian Reform beneficiaries had not achieved the managerial expertise which, disregarding uncontrollable factors, would have assisted them in making their farms and cooperatives financially viable. Bank credit agents could have been better trained and more effective in teaching beneficiaries how to obtain such assistance from public and private sector agencies. Better use of such technical assistance might have contributed to increased production and income for the beneficiaries.

Recommendation No. 3

We recommend that USAID/El Salvador obtain evidence that the Agricultural Development Bank has:

a) adequately trained its credit agents as to all the sources of technical assistance available to the reform sector, including the private sector, and as to how they are to make loan beneficiaries aware of available technical assistance;

b) assigned non-technical administrative duties to staff other than credit agents; and

c) established a training program for credit agents that will include, but not be limited to: advising Phase I beneficiaries of available accounting and management services, and the cultivation of non-traditional crops.

Discussion

According to Amendment No. 9 of the project agreement, BFA was to hire and train field personnel, and coordinate with other GOES institutions in providing technical assistance to project beneficiaries. A total of $500,000 was allocated for BFA's training program ($200,000 loan, $100,000 grant and $200,000 counterpart funds).

BFA was not required to provide project beneficiaries with technical assistance. However, according to the project agreement, BFA was to coordinate with other GOES institutions in providing technical assistance to project beneficiaries. Although BFA credit agents did advise beneficiaries, in some instances, on such things as the use of insecticides and pesticides, they did not effectively disseminate information about technical assistance available to beneficiaries through agricultural extension services.

A major complaint of both Phase I and Phase III beneficiaries was that they were not receiving adequate technical assistance from the GOES. Of 43 Phase I and Phase III beneficiaries interviewed, 17 complained that they received only infrequent or sporadic technical assistance, and almost all stated they would like to receive more.

Both financial and agricultural extension services were hampered by a lack of logistical support. Advice and assistance services pertaining to loan applications and alternative crop analyses was limited by agents' workloads. The number of clients serviced by BFA credit agents in the four zones visited ranged from one cooperative to, in another case, 500 individuals per agent. In addition, agents performed other administrative functions, such as posting loan data to loan record cards, which impeded them from overseeing their assigned loan recipients. Thus, the credit agents covered only about 60 percent of their assigned geographical areas, resulting in inadequate services to project beneficiaries. Furthermore, an agriculture official told us that a problem his Ministry faced throughout El Salvador was a lack of vehicles for extension agents. At present, the Ministry of Agriculture (MAG) can cover only about 60 percent of the area assigned, and, even when the vehicles were available, gasoline was often in short supply.

BFA also did not give credit agents sufficient training in credit analysis, identification of alternative crops, credit supervision, and identification of technical assistance needs. As of March 31, 1986 BFA had provided a total of 51 courses/seminars to its employees. This training program had only begun in 1985 (five years after project inception), and only six courses/seminars given in 1986 dealt with subjects related to credit analysis in general.

Of 152 credit agents responding to audit questionnaires, only 32 claimed to have received some type of training. Moreover, the training received was not always related to the most important functions of the credit agents. In addition, 33 credit agents who provided credit supervision to Phase I beneficiaries claimed not to have received any training related to cooperative organization and management. Though not required, these agents believed such training would be helpful so they could better advise their clients of services available from other agencies.

Because many beneficiaries did not know how to manage their land and agricultural inputs, they sometimes applied too little fertilizer, pesticide too late, or the wrong kind of either or both to their fields. Better use of technical assistance by beneficiaries might have contributed to increased production and higher income to the beneficiaries.

Management Comments

In response to this finding USAID/El Salvador pointed out that MAG was in the process of reorganizing its operations. The USAID believed that once the reorganization is completed, MAG will use its staff and equipment more efficiently. They also suggested that the audit report clarify the roles of credit and agricultural extension agents.

4. Technical Assistance to BFA in Automating Its Data System Could Have Been Better Utilized

Starting in 1983, BFA's data processing system was to be upgraded to permit it to process large amounts of data, produce analyses and reports, and be flexible enough to permit rapid additions and modifications of software. However, after three years of effort and fifteen months of technical assistance, BFA's data processing system was still plagued with defects. This resulted in inaccurate and late reports and inadequate use of computer capabilities. Causes for the lack of progress to date were: (a) a new computer system was taking longer to install than anticipated; (b) BFA had encountered several problems while implementing an interim computer system recommended by an AID funded contractor; and (c) the BFA had problems in staffing key positions in its data center operations.

Recommendation No. 4

We recommend that USAID/El Salvador obtain evidence that:

a) vacant positions in BFA's computer center have been staffed by competent individuals;

b) the design and installation of BFA's new computer system, including its software, will adequately consider the needs of the personnel using the reports which are produced; and

c) effective channels of communications between end-users and programmers exist to ensure that output deficiencies are corrected promptly and accurately by the computer center.

Discussion

BFA began attempts to update its outmoded computer facilities in 1983 but because of multiple problems, will not have a functioning system until December 1987.

Project Paper Amendment No. 3, dated March 29, 1983, included the procurement of hardware, software and system support for an upgraded computer facility at BFA. It concluded that:

> AID loan funds of $700,000 will be used to conduct a thorough systems analysis, procure and install the new computer system and provide for the training of operators and programmers. The computer system will be integrated directly into the accounting and financial information processing activities which are scheduled to receive substantial technical assistance from the [funding] supplement.

Plans to complete the systems analysis, procurement and installation of the new computer system and training of operators and programmers for the new computer system were originally to have been completed by June 30, 1985. These activities were to be performed by an AID-funded contractor, Servicios Tecnicos del Caribe (STC), whose advisers began working at BFA in April 1984.

The STC consultant recommended a temporary system while the new system was being developed but problems developed in the transfer of information from the old system to the interim system. In April 1985, the interim system was dropped and the old system was replaced with a more powerful computer by the original vendor at no extra cost to BFA. However, BFA had expended about $112,000 in hardware and personnel for the interim equipment.

The development of the new computer system was again undertaken, this time by the firm of Deloitte, Haskins and Sells, but the process took much longer than expected. The system analysis, procurement and installation of the new computer system, and training of operators and programmers is now scheduled for completion in December 1987.

Because of these delays, and a lack of properly-trained electronic data processing personnel, BFA reports such as "The Inventory of Loans" were produced late, contained many errors, required extensive reconciliation with manual records, and were seldom used by bank employees in the manner intended. Although BFA was interviewing candidates to fill vacancies in its computer center, some of the positions had been vacant for up to six months. BFA credit agents still manually calculated interest on loans, a process taking about one-and-a half weeks every six months. This was to have been done by the new computer system. Partly as a result of delayed acquisition of automatic data processing equipment and trained personnel, BFA credit agents' time was inefficiently used performing support functions instead of assisting their credit clients.

Management Comments

The Mission concurred with the finding, stating that it would take immediate action to obtain evidence from BFA that the Computer Center has been fully staffed and that a coordinating unit within BFA has been created to ensure communication between end-users and programmers. They agreed that the basic installation of an adequate computer system had been unreasonably delayed, but stressed that the interim system had been utilized by the Bank. Differences of opinions among computer experts, compounded by rapidly changing technology, contributed to the delay. The current Deloitte, Haskins and Sells contract would satisfy the second and third part of the recommendation.

Inspector General Comments

Parts (b) and (c) of Recommendation No. 4 are closed upon the issuance of this report.

5. USAID/El Salvador Should Seek Improvements in the Accuracy of BFA's Financial Reports

Loan Amendment No. 4, dated June 15, 1984, and Amendment No. 9, dated August 19, 1985, both contained requirements that the Agricultural Development Bank was to adequately account for the use of AID funds provided. However, billings were made to obtain AID funds for the project from central office and branch postings which had not been effectively reconciled. A 17 percent discrepancy rate (11 differences in 63 payment cards) existed between source documents submitted by branch offices and the postings made at the central office. USAID/El Salvador considered project financial reports submitted by the bank to be reliable and therefore did not perform its own reviews of BFA's accounting and reporting system. As a result, AID project funds were disbursed for loans which, in some cases, had not been reconciled between branch and central office records. Therefore, these reimbursement documents did not have the degree of reliability expected for disbursement purposes.

Recommendation No. 5

We recommend that USAID/El Salvador:

a) review a statistically valid sample of documentation supporting AID funds disbursed to date to the Agricultural Development Bank to ensure that the funds used under the Integral Line of Credit were for loans to eligible beneficiaries, and recover any AID funds not used for eligible loans;

b) decide, based on the reliability of the reviewed documentation, whether further AID disbursements should be suspended or additional documentation required with reimbursement requests to ensure compliance with Project Agreement terms; and

c) establish a procedure consistent with AID Handbook guidance to periodically review reimbursement documentation submitted by the Agricultural Development Bank in order to ensure that such documentation is supported by reliable source data.

Discussion

Loan amendments Nos. two and nine defined eligible loan beneficiaries and parts of Amendments Nos. four and nine described accounting methods required for managing AID loan funds, including separate accounts and their timely posting and reconciliation. AID Handbook 19 further requires the Mission Controller to review, at least periodically, borrower records for compliance with these requirements.

As of March 31, 1986 USAID/El Salvador had disbursed a total of $68,142,349 to BFA for its Integral Line of Credit. These expenditures were reimbursed upon BFA's presentation of vouchers with supporting reports of loans made to beneficiaries. BFA submitted loan reports to support the amounts requested and USAID/El Salvador disbursed the amounts requested without periodically verifying the accuracy of the

documentation provided. According to BFA officials, USAID/El Salvador had never performed a review to verify the BFA system's timeliness and reliability. The Mission considered BFA's accounting and reporting systems reliable enough not to conduct a systems review as required by Handbook 19.

Requests for disbursement of AID loan funds were prepared as follows: source documents such as cancelled checks to project beneficiaries and orders for agricultural commodities were filed at the BFA central office, where they were entered into BFA's data system. This provided reports to BFA's financial unit for the preparation of reports supporting reimbursement vouchers submitted to USAID/El Salvador. The financial unit was aware that the reports provided by the data processing unit were not accurate. Although this problem had existed for several years and the financial unit reported it to the data processing unit, no action had been taken to correct the problem, nor did the financial unit verify the information since its main purpose was to put the information in the proper format for submission to the Mission.

For example, one of the reports obtained from the data processing unit containing erroneous information was the Inventory of Loans, which was used as a basis for preparing requests to USAID for reimbursement. Some of the errors noted were: a) loans with negative balances, b) repayment amounts greater than the amount of loans disbursed, c) negative amounts of interest paid, d) loan amount disbursed greater than loan amount authorized, and e) negative delinquency balances.

Similar errors were found in several other reports such as history of loan movement, outstanding checks, and use of funds by activity and sector. These reports were important because they were used for reconciliation and accounting purposes. Yet, not all the supporting documentation in BFA's files identified the source of funds nor whether the loan recipients were Phase I, Phase III or traditional sector beneficiaries. Information such as cancelled checks and agricultural input orders were sent daily to BFA's central office for input into the data system. This information contained not only loans to beneficiaries from AID funds but also loans from BFA's own resources. Sixty-three loan application documents valued at $350,431 were reviewed at four branch BFA offices and later compared to loan reports prepared by the BFA central office. Eleven of these applications (17 percent) valued at $20,636 were listed in the central office as AID eligible loans despite having been approved only for BFA financing by the branch offices. BFA officials at the central office could not explain how the 11 loans totaling $20,636 had become eligible as AID loans.

The illustrated lack of reliable records made it difficult to ensure that all of the $68 million in AID funds had been used for loans to eligible beneficiaries. The 17 percent error rate in loan applications disclosed by the audit represents a 6 percent error rate based on the value of the loans reviewed ($20,636 - $350,431).

Management Comments

Mission management concurred in the recommendation but noted that the questioned loans were eligible for project funding. The loans had only been reclassified for funding from BFA rollover funds to funding directly from AID resources.

B. Compliance and Internal Controls

Compliance

The audit disclosed eight compliance exceptions:

-- The GOES implementing agency was not complying with requirements of Section B.5 Reports, Records, Inspections, Audit, Annex II, to the Project Agreement, which requires that generally accepted accounting principles and practices be consistently applied (Finding 2).

-- The GOES implementing agency was not complying with requirements of Section B.2 Execution of Project, Annex II, to the Project Agreement which requires providing qualified and experienced management, and training such staff for the maintenance and operation of the Project, (unstaffed computer center - Finding 4).

-- USAID project funds were disbursed without periodic verification of reimbursement vouchers and related documentation, as required in AID Handbook 19, Chapter 8A5g (2) (f) (Finding 5).

-- The GOES presented inaccurate documents for reimbursement in violation of Section B.6 (1) Completeness of Information, Annex II, of the project Agreement (Finding 5).

-- The Project Agreement Annex was not amended to reflect the manner in which non-project funds were used to fund the Project's evaluation per Handbook 3, Chapter 12, Section C6 (see Section C, Other Pertinent Matters).

-- The interim Project Evaluation Summary was not completed as required by Handbook 3, Chapter 12, Appendix 12A-1 (Section C).

-- The GOES Implementing agency did not inform AID in a timely fashion of defective vehicles as required in Section B.6 (b) Completeness of Information (Section C).

-- Contractors' files did not contain Biographical Data Sheets, Form AID 1420-17, to permit management to evaluate contractors' past performance and salary histories (Section C).

Other than the conditions cited, tested items were in compliance with applicable laws and regulations and nothing else came to our attention that would indicate that untested items were not in compliance with applicable laws and regulations.

Internal Controls

We noted four internal control exceptions:

-- BFA was liberal in extending and refinancing problem loans rather than aggressively trying to collect them (Finding 1).

-- BFA's reluctance to write off uncollectable loans and to identify problem loans overstated its assets and presented a distorted presentation of BFA's financial condition (Finding 2).

-- Reconciliation procedures for the BFA needed improvement because some of the branch offices records were not effectively reconciled to those maintained by the central office (Finding 5).

-- Documentation on project agreement Conditions Precedent and Special Covenants were scattered throughout files. There was no tracking system that would signal management when Conditions Precedent and Special Covenant deadlines were approaching or had passed. Fifteen Conditions Precedent and twelve Special Covenants were accepted as satisfied after their terminal dates had passed (Section C).

C. Other Pertinent Matters

Six other issues were identified during the audit.

Allocation of Project Evaluation Costs - An interim evaluation of Project 519-0263 was performed in August 1985 but its full cost was divided between two projects and therefore not accurately recorded in project records. The evaluation cost exceeded the budgeted amount by 38 percent, an amount which could have been charged to the contingency component of the project only with GOES approval. Rather than risking GOES rejection of the contingency fund reprogramming, the Mission allocated available funds from Project 519-0167 to cover the evaluation cost overrun. This violates guidance in AID Handbook 3, and Handbook 19. As a result, the evaluation costs for Project 519-0263 were understated by $78,984 and future estimations of evaluation costs for new projects and for annual evaluation planning would be inaccurate.

Project Evaluation Summary - USAID/El Salvador did not effectively complete a Project Evaluation Summary for an interim evaluation of the Agrarian Reform Credit Project. AID Handbook 3, Chapter 12, Appendix 12A-1 requires that evaluation conclusions and recommendations be listed and identified as being accepted or rejected and that personnel be identified to accomplish recommended action. This was not done for an August 1985 evaluation because the Mission considered it a duplication of effort already accomplished when an August 19, 1985 amendment to the project was completed. Nevertheless, the benefits of listing and responding to the issues raised in the evaluation were not made available to all Mission personnel nor were the benefits to the project of tracking those actions realized. The Mission concurred in this finding and agreed to list and follow up the recommendations requiring specific action.

Integrated Pest Management Evaluation - USAID/El Salvador did not effectively follow up on 28 recommendations made by a consultant who did an evaluation of the Integrated Pest Management component of the Agrarian Reform Credit Project. The Mission largely ignored the evaluation because it was done under a contract funded essentially by AID's Regional Office for Central America and Panama, and because the USAID did not consider the undertaking an evaluation but rather a data gathering effort. Nevertheless, the project could have benefited had USAID/El Salvador followed up, and where appropriate, taken action on the recommendations. USAID/El Salvador stated that "we still feel strongly that the Integrated Pest Management 'Evaluation' was not an evaluation, should not be treated as such and is not worth the effort to follow-up on."

Defective Project Vehicles - Of 24 project vehicles inspected during the audit 18 (75 percent) had defective ignition switches and eight had weak spring bolts. These defects appeared shortly after delivery. No action had been taken by the GOES to either report this condition to USAID/El Salvador or to seek recovery for costs incurred to repair the defects. A total of 342 vehicles were purchased with AID funds for this project and the Agrarian Reform Support Project (519-0265). If 75 percent of all 342 vehicles were found to have defects, substantial costs could be incurred

by GOES agencies to repair the vehicles. Conservatively at $100 per vehicle for 256 vehicles (75 percent of 342) the cost could be over $25,000. When brought to the Mission's attention, they agreed to advise the GOES of the issue and suggest that the GOES take whatever steps feasible to recover costs associated with the defects from the local agent or the manufacturer (Exhibit 3).

Incomplete Personnel Files - The Mission did not have Biographical Data Sheets (Forms AID 1420-17) in its file for 10 contractor employees who had been or still were working in El Salvador under an AID contract. AID contracting procedures require that contractors furnish Biographical Data Sheets on their contract employees (Section 752.7001 of Handbook 14). Section 753.270.4 cites AID 1420-17 as the prescribed form. Unless the Mission has such basic documents, informed judgments on individuals' qualifications cannot be made; nor can the individuals' salaries be evaluated in comparison with previous earnings. USAID/El Salvador has stated that it will obtain required Biographical Data Sheets for current and future contractor employees.

Conditions Precedent and Special Covenant Tracking - The Mission's filing system did not facilitate a ready determination of how project agreement Conditions Precedent and Special Covenants were satisfied under the Agrarian Reform Credit Project. Only after an extensive, time-consuming search of the files by both USAID and audit staff could a determination be made as to which Conditions Precedent and Special Covenants had been satisfied, and an evaluation made of the supporting documentation. Under this project 15 Conditions Precedent and 12 Special Covenants were not accepted by the Mission until after the terminal data had passed, as much as seven months later in one case. After this finding was brought to the Mission's attention, they stated that the existing tracking system, which was inadequate in this case, would be reviewed and improved.

AUDIT
OF USAID/EL SALVADOR'S
AGRARIAN REFORM CREDIT PROGRA
PROJECT NO. 519-0263

PART III - EXHIBITS AND APPENDICES

21

EXHIBIT 1

AUDIT
OF USAID/EL SALVADOR's
AGRARIAN REFORM CREDIT PROGRAM
PROJECT NO. 519-0263

SUMMARY OF PROJECT AGREEMENT
AND AMENDMENTS

AGREEMENT/ AMENDMENTS		DATE	AMOUNT ($000) GRANT	LOAN	TOTAL
Agreement		07-07-80	$ 500	$ 9,500	$ 10,000
Amendment	1	09-03-81	---	1,600	1,600
	2	03-04-82	625	17,000	17,625
	3	06-01-83	500	23,400	23,900
	4	06-15-84	500	17,000	17,500
	5	09-07-84	---	1,500	1,500
	6	12-20-84	100	---	100
	7	03-05-85	---	3,400	3,400
	8	03-05-85	400	---	400
	9	08-19-85	1,700	8,100	9,800
			$ 4,325	$81,500	$85,825

22

AGRARIAN REFORM CREDIT PROGRAM
PROJECT NO. 519-0263
PROJECT FINANCIAL STATUS AS OF MARCH 31, 1986
($000)

	AUTHORIZED					DISBURSED				
	AID Loan	AID Grant	Total AID	Gov. of El Salvador	Total Project	AID Loan	AID Grant	Total AID	Gov. of El Salvador	Total Project
Agricultural Development Bank - Integral Credit Line	$77,800	$---	$77,800	$16,700	$94,500	$68,142	$---	$68,142	$9,242 1/	$77,384
Salvadoran Central Reserve Bank - Investment Credit Line	---	---	---	3,900	3,900	---	---	---	3,900 2/	3,900
Salvadoran Central Reserve Bank - Line or Credit for Refinancing Phase I Cooperatives	---	---	---	19,600	19,600	---	---	---	19,600 2/	19,600
Agricultural Reform Operational Support	---	---	---	3,300	3,300				2,581 3/	2,581
Vehicles and Equipment	3,326	---	3,326	---	3,326	2,129		2,129	---	2,129
Project Evaluation	---	145	145	---	145		121	121	---	121
Technical Assistance	---	3,980	3,980	---	3,980		2,082	2,082	---	2,082
Training - Agricultural Development Bank Personnel	200	100	300	200	500	29	---	29	24	53
Integrated Pest Management	174	---	174	400	574	174	---	174	400 3/	574
Contingency	---	100	100	---	100	---	---	---	---	---
Total	$81,500	$4,325	$85,825	$44,100	$129,925	$70,474	$2,203	$72,677	$35,747	$108,424

1/ GOES contributions are stated in US$ equivalents, including $113,000 provided directly by the GOES-owned Agriculture Development Bank.

2/ Transfered from GOES to Central Bank.

3/ Represents total disbursements as of March 31, 1986 based on a 2.5 Colones to $1 U.S. exchange rate. Amount disbursed from January 1 to March 31, 1986, when exchange rate became 5 colones to $1 U.S. not available.

EXHIBIT 2

AGRARIAN REFORM CREDIT PROGRAM
PROJECT VEHICLES OBSERVED AT BFA OFFICES
USAID/EL SALVADOR

TYPE	LOCATION	SERIAL NUMBER	PLATE NO.	MILEAGE (KMS.)	PROBLEMS
CJ-7	Sonsonate	IJEFM87H0FT114540	90658	10,184	Ignition switch has not turned off motor since shortly after delivery; rear leaf spring bolts broken and subsequently changed; jacks not functional.
CJ-7	Sonsonate	IJEFM87H4FT1145539	90657	9,258	Jacks not functional; rear leaf spring bolts broken; broken straight pipe from motor.
CJ-7	Sonsonate	IJEFM87H4FT113648	90432	10,185	Ignition switch does not always turn off-motor.
CJ-7	Sonsonate	IJEFM87H8FT117654	90443	8,824	Ignition switch has not turned off motor since shortly after delivery.
CJ-7	Sonsonate	IJEFM87H5FT107924	90286	12,963	Ignition switch has not turned off motor since shortly after delivery; voltage meter does not work; rear leaf spring bolts broken.

Note - 24 CJ7's were inspected at 3 BFA Branch offices; 18 of 24 original starters had to be replaced because they would not shut off motors; 8 of 24 had broken bolts in area of rear spring leaves; 3 of 24 hand brakes did not work well; 2 of 24 jacks did not work well.

AGRARIAN REFORM CREDIT PROGRAM
PROJECT VEHICLES OBSERVED AT BFA OFFICES
USAID/EL SALVADOR

TYPE	LOCATION	SERIAL NUMBER	PLATE NO.	MILEAGE (KMS.)	PROBLEMS
CJ-7	Sonsonate	1JEFM87H5FT125256	90078	7,229	Ignition switch has not turned off motor since shortly after delivery; rear leaf spring bolts broken; window on right side does not work.
CJ-7	Sonsonate	1JEFM87H6FT107012	90465	9,639	Ignition switch has not turned off motor since shortly after delivery.
CJ-7	Sonsonate	1JEFM87E2CT064807	P-130930	66,656	Ignition switch has not turned off motor since shortly after delivery.
CJ-7	Santa Ana	1JEFM87E7CT064804	P-130948	77,893	Ignition switch has not turned off motor since shortly after delivery.
CJ-7	Sonsonate	1JEFM87H5FT140890	90069	8,026	Ignition switch has not turned off motor since shortly after delivery.
CJ-7	Chalatenango	1JEFM87E7CT064799	130,926	35,495	Original gear shifter pin broke.
CJ-7	Chalatenango	1JEFM87H8FT107917		20,172	Ignition switch has not turned off motor since shortly after delivery.

AGRARIAN REFORM CREDIT PROGRAM
PROJECT VEHICLES OBSERVED AT BFA OFFICES
USAID/EL SALVADOR

TYPE	LOCATION	SERIAL NUMBER	PLATE NO.	MILEAGE (KMS.)	PROBLEMS
CJ-7	San Miguel	1JEFM87HXFT124413	90143	4,513	Ignition switch has not turned off motor since 10 days after delivery. Hand brake does not work. Broken bolts in rear spring leaf area.
CJ-7	San Miguel	1JEFM87H4FT117652	P-89-922	2,471	Ignition switch has not turned off motor since 8 days after delivery. Broken bolts in rear spring leaf area.
CJ-7	San Miguel	1JEFM87H7FT113644	11,662		Ignition switch has not turned off motor since shortly after delivery; hand brakes do not work very well.
CJ-7	San Miguel	1JEFM87E2CT064824	P-130958	39,389	Ignition switch has not turned off motor since shortly after delivery.
CJ-7	San Miguel	1JEFM87H7FT125261	P-90254	9,294	Ignition switch has not turned off motor since shortly after delivery.

AGRARIAN REFORM CREDIT PROGRAM
PROJECT VEHICLES OBSERVED AT BFA OFFICES
USAID/EL SALVADOR

TYPE	LOCATION	SERIAL NUMBER	PLATE NO.	MILEAGE (KMS.)	PROBLEMS
CJ-7	San Miguel	1JEFM87H4FT117666	P-90636	8,265	Ignition switch has not turned off motor since shortly after delivery. Broken bolts in rear leaf spring area; original tires wore out too quickly.
CJ-7	San Miguel	1JEFM87E1CT06480L		40,858	Ignition switch has not turned off motor since shortly after delivery.
CJ-7	San Miguel	1JEFM87H7FT050416	P-100257	14,730	Hand brakes do not work well; Original shocks too weak.
CJ-7	San Miguel	1JEFM87E1CT064815	P-130-934	45,187	Ignition switch has not turned off motor since shortly after delivery.
CJ-7	San Miguel	1JEFM87E8CT064794	P-130-943	38,379	No problems observed.
CJ-7	San Miguel	1JEFM87H7FT132288	P-89-904	5,216	No problems observed.
CJ-7	San Miguel	1JEFM87H6FT107916	P-90-410	8,944	Ignition switch has not turned off motor since shortly after delivery.

UNITED STATES GOVERNMENT

memorandum

DATE: December 18, 1986

REPLY TO ATTN OF: Robin Romez, DIR

SUBJECT: Mission Comments on Draft Audit Report for Agrarian Reform Audit Program, 519-0263

TO: Mr. Coinage Gothard, RIG, Tegucigalpa

The following comments and suggested revisions of the Draft Report are based on Mission review and the discussions/decisions reached during the exit conference held on December 3, 1986.

In the interest of assisting you in trying to publish this report in December, and in the belief that we reached substantial agreement on most points during the exit conference we have not included suggested wordings for Mission comments to be included in the report. If, during your rewrite of the draft, you feel we must continue to disagree on certain points, we would appreciate telephonic clearance for the wording of what will be included as Mission comments.

Following are our specific comments keyed by page numbers in the Executive Summary.

Page ii The second paragraph needs to be changed to eliminate the implication that the whole project was a waste of money. Funds were provided for credit, and credit was made available. Due to a variety of circumstances, as cited by the audit, repayment of the beneficiary loans has not been as rapid as had been hoped for. This does not mean that the project funds "had not had their desired effect." We suggest that the paragraph be reworded as follows:

> Many beneficiaries did not repay their loans in a timely manner. The causes of this range from poor management to unexpected shifts in world commodity prices, internal strife, and inflationary pressures on required inputs, and some of the causes go beyond the control or influence of the project or even the Agrarian Reform. The result has been that expected reflows were not made available for relending.

OPTIONAL FORM NO. 10
(REV. 1-80)
GSA FPMR (41 CFR) 101-11.6
5010-114

☆ U.S.GPO:1984-0-421-526/178

Therefore, project funds were required in excess of original estimates in order to assure continued availability of credit to Agrarian Reform beneficiaries.

The first sentence in the third paragraph should be dropped. The implication to the casual reader is that the whole project is floundering and operating inefficiently and uneconomically. The "results of audit" section in this report certainly does not support such a contention, although improvements need to be made.

Page iii The first paragraph needs to be completely rewritten in order to correct the following:

- The BFA's role is not to improve the Agrarian Reform Sector. It only provides credit and some ancillary services to the beneficiaries.

- The statement on training needs to be made clear and consistent with the body of the report. (An area where we still may differ.)

- We have asked that you determine whether the loans which were switched from one funding source to another were actually made for activities which are clearly ineligible for funding from AID sources. Depending on your conclusion, these comments may have to be rewritten.

Page iv Mr. Shepherd has agreed to rewrite the first paragraph on page iv to reflect the discussion at the exit meeting. We suggest that the first paragraph on page iii and the first paragraph on page iv both relate to the same general subject, the BFA's long range prospects, operations, and problems. They should be either combined or at least follow each other. Mr. Shepherd has offerd to rewrite the first paragraph on page iv along the lines of the discussion which took place in the meeting. Since the discussion was very active, we request that we have the opportunity to give telephonic clearance for this paragraph.

Second paragraph - As agreed in the meeting, this paragraph should be moved to the end of the Executive Summary to more properly reflect the relative importance of the findings contained in it. The comments on the unnecessary expenditure of $112,000 should be dropped, as argued later in this response. In addition the computer problems, which is the real issue, are dealt with in a separate paragraph in the summary (page vi). We suggest the following format:

The audit also identified several other specific problems:

- USAID/ES split funded the costs of a project evaluation between the project and PD&S funds.

- USAID needs to better document and improve follow-up two evaluations.

- The GOES repaired what appeared to be factory defects on many of more than 340 AID funded vehicles under this and a corrolary project. No attempt had been made to have the manufacturers representative make the repairs or to recover the costs.

- Improvements need to be made, by the mission in general, in tracking compliance with conditions precedent and covenants under project agreements.

- The mission had not obtained Biographical Data on all U.S. contractor employees working on the project.

The recommendation in the middle paragraph may need to be changed based on our suggestions contained later in this response.

Page v We suggest the following wording for the last paragraph:

> With few exceptions, Agrarian Reform beneficiaries had not achieved the necessary managerial expertise which, disregarding uncontrollable factors, would have assisted them in making their farms and cooperatives financially viable. Such assistance was available through both public and private sector agencies. BFA credit agents could have been better trained and more effective in providing information to the beneficiaries on how and where to avail themselves of this valuable resource. Better use of such technical assistance by the beneficiaries might have contributed to increased production and higher income to the beneficiaries.

Page vi The first paragraph is not consistent with the recommendations in the body of the report. In any case we can not ensure that the beneficiaries effectively use technical assistance. The most we or the BFA can do is to make them aware of what is available.

Page vii The first paragraph needs to be rewritten based on an analysis of the actual eligibility or ineligibility of the 11 transactions. This is discussed later in this paper.

We continue to disagree with the findings in the last paragraph on this page and the following page. Also, this finding is already included in the paragraph on other matters. We do not feel it is significant to warrant a half page in the summary. Also the summary does not accurately reflect the recommendation in the body of the report.

Following are our comments keyed by page numbers in Part I-Introduction

Page 1 We suggest the following write-up be used as background information for Phase II:

> In 1980 the basic law of Agrarian Reform made all private holdings over 275 acres subject to Phase I type expropriation, but for political and logistical reasons, only farms over 1235 acres were seized. The remainder, the so-called Phase II properties, were in limbo from 1980 until the new constitution was enacted in 1983 which increased the maximum size of private landholdings in El Salvador to open market in excess of 605 acres. Sales must have been completed prior to December 20, 1986.
>
> These sales constitute the implementation of Phase II and have been taking place since 1983. A survey made in early 1985 of the 309 landowners identified as holding more than 605 acres in 1983 revealed that all but 89 of them had sold their excess land, complying with Phase II's implementing regulations. Of the 89 who still held more than 605 acres, all but 22 were trying to sell their excess (much of which was located in guerrilla controlled areas). Indications are that by the December 20, 1986, deadline, only properties which are involved in litigation will not be in compliance. Phase II is, for all intensive purposes, completed.

Page 2 The paragraph stating that Phase II has not been implemented is incorrect and should be dropped.

Page 4 The last paragraph refers to a new project. Despite the auditor's opinion that it is really more of the same, it has been justified and accepted by AID/W as a new project. It should be clearly identified as such in the report and if referred to at all should give a little better explanation of its purpose.

The following are comments relating to Part II - Results of Audit

Page 7 The first and second paragraphs contain assertions about the well being of Phase III farmers which are not supported by facts. The well being of these beneficiaries has improved substantially since 1980. The audit should reflect this. Attached is "A report on Phase III of the Agrarian Reform in El Salvador." This report is a translation and summary of the 1985 PFRM survey of Phase III beneficiaries. It contains information that should be used to present a balanced picture of Phase III.

The second paragraph is misleading. USAID loans are always at concessional terms as a matter of policy. The assertion that the USAID and COFS funds "had not had their desired effects", is wrong. These funds capitalized the BFA and provided a source of credit to the reform sector -- the two major objectives of the Project.

The last sentence in paragraph 2 should read:

> Many beneficiaries did not repay their loans in a timely manner. The causes of this range from poor management to unexpected shifts in world commodity prices, internal strife, and inflationary pressures on required inputs, and some of the causes go beyol the control or influence of the project or even the Agrarian Reform. The result has been that expected reflows were not made available for relending. Therefore, project funds were required in excess of original estimates in order to assure continued availability of credit to Agrarian Reform beneficiaries.

The first sentence in the third paragraph should be dropped. The implication to the casual reader is that the whole project is floundering and operating inefficiently and uneconomically. The report certainly does not support such a contention, although improvements need to be made.

Page 8 The first sentence in the middle paragraph should read "...and effective vehicle for providing credit to the Agrarian Reform Beneficiaries. "

The last paragraph should be reworded along the lines suggested under the executive summary section.

Page 9 The last paragraph will have to be rewritten after taking into consideration the changes requested in the body of the report.

Page 10 Permanent capitalization of the BFA is threatened by increasing administrative costs, poor administrative capability, and high rate of overdue loans. The BFA's efficiency is further diminished by its participation in non-banking activities such as fertilizer and pesticide sales and grain storage and marketing.

If decapitalization continues the BFA will not be able to continue providing the amounts of credit planned in the project in future years. We suggest the following rewording:

Recommendation No. 1

We recommend that USAID/El Salvador request the Government of El Salvador to:

a) Develop specific steps which demonstrate how and when the BFA will divest itself of non-banking activities such as fertilizer and pesticide sales, grain storage, and marketing.

b) Clearly define the Bank's parameters and its role in providing Credit to the Agrarian Reform Sector.

Page 14 First paragraph, second line, the word "somewhat" should be eliminated or at least substituted by "generally". The Project's success in capitalizing the bank has been one of its best achievements.

Page 18 In the meeting it was agreed that RIG would reword the heading and the narrative to indicate that the refinancing of, or extension of debt might increase the final bad debt percentage, and not imply that all currently refinanced loans might be uncollectible. The comments should indicate that the rate of default will be higher when applied to a group of loans which were originally in default and then refinanced or extended. However, it should also be noted that failure to extend or refinance the loans, and declaring them all bad debts would have resulted in much higher writeoffs. It was also agreed that the narrative and statistics should consider the loans which were only marginally extended, for 3-4 months to allow borrowers to receive money from their harvest, most of which were then paid.

Page 19 The first sentence under the discussion is inaccurate and should be dropped.

Recommendation 2 (b) should be dropped. An analysis of bad coops will not help the good ones. The financial system, including BFA, has rated each of the Phase I coops. This rating was used as one of 21 criteria used to evaluate each cooperative under Project 0265. This evaluation is used to help determine which cooperatives should receive technical, financial and managerial assistance. A copy of the Classification entitled "Estudio y Clasificación de 309 Empresas Cooperativas de la Reforma Agraria Fase I, y Su Estado de Avance de la Cogestion al Auto gestion, en El Marco del Desarrollo Empresarial Cooperativo, "has been attached for your convenience.

Page 22 We suggest that the first paragraph be reworded as follows:

> With few exceptions, Agrarian Reform beneficiaries had not achieved the necessary managerial expertise which, disregarding uncontrollable factors, would have assisted them in making their farms and cooperatives financially viable. Such assistance was available through both public and private sector agencies. BFA credit agents could have been better trained and more effective in providing information to the beneficiaries on how and where to avail themselves of this valuable resource. Better use of such technical assistance by the beneficiaries might have contributed to increased production and higher income to the beneficiaries.

Also, Recommendation 3 (b) should be deleted as it does not relate to Project 263.

Page 23 The two paragraphs on this page appear to be inconsistent as regards a statement of what the BFA responsibilities are in relation to providing Technical Assistance. We agree that the BFA was not to provide technical assistance to the beneficiaries, except in areas directly related to obtaining credit, i.e. loan applications and project analysis, etc.

Page 24 Page 24 again confuses the responsibility of the credit agents with those of the extension service. BFA agents are supposed to give advise and assistance in area pertaining to loan applications and project analysis. The rest of the technical assistance needs of the farmers should be obtained from other sources.

The last paragraph of page 24 should be rewritten deleting the critisism of BFA for not giving their agents training in farm management and cooperatives organization. This never was contemplated in the training of Credit Agents.

Page 25 The last sentence of the middle paragraph should be changed to read:

> Better use of technical assistance by the beneficiaries might have contributed to increased production and higher income to the beneficiaries.

Page 27 The copies of the scope of work for the Deloitte, Haskins & Sells contract with the BFA which the Mission sent to RIG in response to original RAF more than adequatelly addresses the requirements to close recommendations 4 b) and c). The D, H & S contract has completed the first phase which included the concens over the communication between end-users and programmers. Therefore we request that the final report indicate that these recommendations are considered to be closed.

Attached are copies of the D,H, & S reports pertaining to their surveys of end users needs and how to incorporate these needs into the information system program.

The list of documents submitted (attached) are:

1) Annex 1. Defination of tasks and priorities established as per technical proposal.

2) Annex 2. General design of the MIS for BFA

3) Annex 3. Validation of the general design (annex 2) in the form of the minutes of a seminar held by BFA on 11 Nov. 86 and 26 Nov. 86.

Page 28 We suggest that the section on this page and the following regarding the interim system be deleted from the report. We agree that the basic installation of an adequate computer system has been unreasonably delayed. However, the interim system was utilized by the Bank. Perhaps not as originally hoped to provide a quick start on improving their systems and reports, but it was utilized. What we appear to have here is a difference of opinion between experts - BFA, SMV, local consulting firm, D, H, & S , and now the RIG expert. All of this compounded by a rapidily moving technology which virtually changes weekly. The comments on the interim system add little to the major finding of the delay in installation of an adequate system. We request that all references to it be dropped. if it is still maintained in the report, a missioncomment fully incorporating the above arguments should be included at the end of the section.

Page 31-35 We continue to question the statements that the 11 loans identified as ineligible by the auditors are actually anything more that reclassification of funding sources. The workpapers which we reviewed indicated that the 11 loans were originally classified as eligible for funding from "rollover" funds, and subsequently changed at the central office for AID reimbursement. Nothing in the report, or in the workpapers states why, or on what basis the determination has been made that they are inelligible for AID financing. On the contrary, if they had been eligible for rollover financing, one would assume that they would also be eligible for direct financing since rollover funds are to be used for the same purposes as the original funds.

The recommendations, with the last phrase of recommendation 5 a) deleted are acceptable.

Page 36 We recommend this section be dropped in its entirely. If you think it is important enough it might be included in Other Pertinent Matter section. It is purely a matter of interpretation of the regulations which we will continue to disagree on. The effect on project implementation or agency record keeping is non-existent in the first case and minimal in the second. The solution is a purely bureacratic paper exercise which accomplishes little of real use. The thrust of your own part b) of the recommendation allows us to establish a written procedure to do again what we are now being criticised for doing in be past. If you don't feel strongly enough in your interpretation of the regulation to say it is prohibited, then lets drop it.

Page 39 The second item seems to be an overstatement of the understaffing of the computer section, a small part of the total project.

The last paragraph should be dropped as commented on above.

Page 41 We still fell strongly that the Integrated Pest Management "Evaluation" was not an evaluation, should not be treated as such and is not worth the effort to follow-up on. We can not treat every report or analysis done by some academic of organization as an official document to be analysed and responded to.

cc: BSchouten, DDIR
RWitherell, AMDO
KEllis, RDO
DBoyd, PRJ

LIST OF RECOMMENDATIONS

Recommendation No. 1

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

a) conduct an analysis of the Salvadoran Agricultural Development Bank to find ways of reducing costs, increasing earnings, and simplifying accounting procedures;

b) develop a time-phased plan under which the Agricultural Development Bank will divest itself of non-banking activities such as fertilizer and pesticide sales, grain storage, and marketing; and

c) clearly define Agricultural Development Bank's role in providing credit to the Agrarian Reform sector.

Recommendation No. 2

We recommend that USAID/El Salvador, in conjunction with the Government of El Salvador, obtain from the Agricultural Development Bank financial statements on refinanced and extended agrarian reform loans to Phase I and Phase III beneficiaries, including footnotes to the same statements to describe how the condition of the refinanced loan portfolio changed during the period reported on in the statement.

Recommendation No. 3

We recommend that USAID/El Salvador obtain evidence that the Agricultural Development Bank has:

a) adequately trained its credit agents as to all the sources of technical assistance available to the reform sector, including the private sector, and as to how they are to make loan beneficiaries aware of available technical assistance;

b) assigned non-technical administrative duties to staff other than credit agents; and

c) established a training program for credit agents that will include, but not be limited to: advising Phase I beneficiaries of available accounting and management services, and the cultivation of non-traditional crops.

Recommendation No. 4

We recommend that USAID/El Salvador obtain evidence that:

a) vacant positions in BFA's computer center have been staffed by competent individuals;

b) the design and installation of BFA's new computer system, including its software, will adequately consider the needs of the personnel using the reports which are produced; and

c) effective channels of communications between end-users and programmers exist to ensure that output deficiencies are corrected promptly and accurately by the computer center.

Recommendation No. 5

We recommend that USAID/El Salvador:

a) review a statistically valid sample of documentation supporting AID funds disbursed to date to the Agricultural Development Bank to ensure that the funds used under the Integral Line of Credit were for loans to eligible beneficiaries, and recover any AID funds not used for eligible loans;

b) decide, based on the reliability of the reviewed documentation, whether further AID disbursements should be suspended or additional documentation required with reimbursement requests to ensure compliance with Project Agreement terms; and

c) establish a procedure consistent with AID Handbook guidance to periodically review reimbursement documentation submitted by the Agricultural Development Bank in order to ensure that such documentation is supported by reliable source data.

APPENDIX 3

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