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# AUDIT OF PL 480 TITLE I LOCAL CURRENCY FUNDS MANAGED BY THE NATIONAL EMERGENCY COMMISSION (USAID/COSTA RICA)

Audit Report No. 1-515-88-07
January 20, 1988

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**AMERICAN EMBASSY**
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January 20, 1988

MEMORANDUM

TO : USAID/Costa Rica Director, Carl Leonard

Coinage N. Gothard

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

SUBJECT: Audit of PL 480 Title I Local Currency Funds Managed by the National Emergency Commission (USAID/Costa Rica)

The Office of the Regional Inspector General for Audit/Tegucigalpa has completed its audit of PL 480 Title I local currency funds managed by the National Emergency Commission. Five copies of the audit report are enclosed for your action.

The draft audit report was submitted to you for comment and your comments are attached to the report. The report contains two recommendations. Recommendation No. 1 is unresolved. Recommendation No. 2 is resolved, and will be closed when the necessary corrective actions have been completed. Please advise me within 30 days of the actions taken to implement Recommemdation No. 2, and any further information you might want us to consider on Recommendation No. 1.

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

## EXECUTIVE SUMMARY

Countries which purchase agricultural commodities under Public Law 480, Title I agree to use the local currency generated from the sale of these commodities for development purposes. Between July 1984 and July 1987, Costa Rica's National Emergency Commission received the equivalent of $9.8 million in Title I local currency to finance six road construction projects and three emergency activities. As of April 3, 1987, the Commission was managing $10.1 million (counting income from all sources) and had a staff of 15, including 3 professionals.

The Office of the Regional Inspector General for Audit/Tegucigalpa conducted a financial and compliance audit of Public Law 480 Title I local currency funds managed by the Commission. The audit objective was to evaluate the Commission's system of internal control over Public Law 480 Title I local currency funds.

The National Emergency Commission did not have adequate internal controls. The Commission did not have written accounting and disbursement procedures, did not promptly and accurately record financial transactions, and did not properly monitor project implementation.

Some of the projects implemented by the Commission were closely monitored by USAID/Costa Rica and the Ministry of National Planning and Economic Policy. Their close involvement in some projects helped to offset the lack of monitoring by the National Emergency Commission.

The first report finding is that little advantage was gained by implementing Public Law 480 Title I projects through the National Emergency Commission, while at the same time the Commission lacked internal controls needed to protect Title I funds from waste or misuse. The second finding is that two road projects implemented by the Commission had been abandoned by the contractors before they were finished.

Institutions chosen to receive Public Law 480 Title I local currency should have the ability to properly manage and account for those funds. The National Emergency Commission had received the equivalent of about $9.8 million in Title I funds, but lacked the qualified staff and administrative systems needed to maintain control over these resources. The Government of Costa Rica, with USAID/Costa Rica's concurrence, channeled the funds through the Commission because the Commission was exempt from most provisions of the Financial Administration Law, including the provision which gave unsuccessful offerors the right to appeal contract awards. The Mission's perception was that Costa Rican businesses often abused this provision of the law, creating unreasonable delays in the contracting process. This perception was not supported by the actual experience in Costa Rica, however. Using the Commission to manage local currency projects introduced an unnecessary risk of waste or misuse of funds without producing a commensurate benefit. At the same time, according to the Commission's Director, using the National Emergency Commission to implement routine public works projects diverted the Commission from its responsibility to plan for and respond to true emergencies. The report recommends that the Commission be used to implement Title I activities only if a bona fide emergency exists. USAID/Costa Rica generally agreed with the facts presented in this finding but disagreed with the recommendation on the basis that this decision should be left to the Government of Costa Rica. AID policy requires that Missions ensure that Title I projects are designed in accordance with sound technical and financial standards. Since these standards would presummably include the use of fully competitive procedures (except where some special urgency dictates the use of less competitive procedures), we have retained the recommendation.

Two road projects financed through the National Emergency Commission had been abandoned by the contractors in a state of partial completion. The first road, between Upala and San Jose (Pizote), was supposed to be delivered by May 11, 1987. The contractor abandoned the project in March 1987 when the consulting engineers asked the company to redo some work which the contractor felt was of acceptable quality. At the end of the audit, the contractor reversed its position and repaired the road, but the repair work had not yet been accepted by the consulting engineers or the Ministry of Public Works and Transport. The second road, between Nicoya and Caimital, was scheduled to be completed in September 1986. It was abandoned by the contractor in April 1986 after the project budget was depleted. The budget was spent before the project was completed because the Ministry of Public Works and Transport significantly underestimated the cost of the road and allowed the contractor to perform some work which was not included in the contract. As a result, the work already done on both roads was deteriorating and, due to the effect of inflation, the cost of eventually repairing and finishing the roads was increasing. The report recommends that the Upala-San Jose (Pizote) road be completed, and that the Nicoya-Caimital road be completed if the Mission decides it is still needed. The Mission generally agreed with this finding and recommendation, but felt that the finding did not adequately recognize the controls implemented and the actions taken to get these projects completed.

USAID/Costa Rica requested that the following summary of its reponse to the draft audit report be included in the Executive Summary:

> USAID/Costa Rica considers its program of regular site visits and the continuing efforts in developing MIDEPLAN into an effective planning and monitoring arm for PL 480 activities, a proper oversight posture in managing PL 480 Title I country-owned resources. The site visit program gives USAID/CR first-hand knowledge of the project status and improves monitoring by MIDEPLAN since personnel from that Ministry normally accompany USAID officers on site visits. MIDEPLAN's new financial management regulations include, among other things, the establishment of an internal audit function within MIDEPLAN and requires approval by MIDEPLAN of the recipient's accounting system. These regulations were thoroughly reviewed and approved by the USAID in Letter of Understanding No. 1 dated September 14, 1987, to the FY PL-480 Title I Sales Agreement. These policies and procedures coupled with

the USAID's monitoring of the PL-480 Title I activities and MIDEPLAN reporting, appear to be sufficient to ascertain compliance with all management and implementation requirements established under the program.

USAID has been assertive in the management of PL 480 Title I funds and has worked through MIDEPLAN as appropriate to correct known deficiencies. The requirement for the 1986 evaluation of MIDEPLAN is one example of the approach taken by the Mission to improve monitoring of PL 480 country-owned resources. Within reason, we attempt to assure adherence to the terms of the joint programming agreement. Considering that PL 480 Title I resources are owned by the GOCR, USAID/CR's assessment is that excluding a bona fide GOCR entity from managing PL 480 Title I funds based solely on an audit based determination of what is a proper emergency is not warranted at this time.

Office of the Inspector General

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LOCAL CURRENCY FUNDS
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(USAID/COSTA RICA)

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## PART I - INTRODUCTION

### A. Background

Title I of the Agricultural Trade Development and Assistance Act of 1954, as amended (Public Law 480) authorizes the President to sell surplus agricultural commodities to friendly countries. These food sales are financed by concessional loans with terms favorable to the recipient countries. In return for this assistance, recipient governments agree to use the local currency earned from the sale of the commodities in their countries for development purposes. The uses of the local currency are jointly agreed upon by AID and the recipient government. However, in accordance with AID's Policy Determination No. 5, the extent of AID's involvement in programming and monitoring the use of local currency varies from country to country.

Costa Rica has participated in the PL 480 Title I program since 1982, and the system for programming and monitoring the use of Title I local currency has evolved over time. Before 1986, local currency was programmed as either "transfers" or "projects." Beneficiary institutions who received "transfers" did not have to report on how they used the funds, and in some cases the intended use of the funds was not well defined. Since 1986, however, all new activities were approved as "projects." These projects were formalized through agreements between the Ministry of National Planning and Economic Policy (MIDEPLAN), the beneficiary institutions, and sometimes USAID/Costa Rica as well. These agreements specified the intended use of the funds, reporting requirements, implementation arrangements, and so on. In general, USAID/Costa Rica participated actively with MIDEPLAN in programming Title I funds, while MIDEPLAN assumed most of the responsibility for monitoring compliance with the agreements.

Costa Rica's National Emergency Commission (CNE), which had received the equivalent of about $9.8 million 1/ in Title I local currency as of July 1987, was created by the National Emergency Law, passed on August 11, 1969. The law authorized the Executive Branch to declare a national emergency wherever it thought it necessary because of a natural phenomenon, epidemic, or human act. The Commission was authorized to plan for and respond to these emergencies, and was made exempt from most of the requirements of Costa Rica's Financial Administration Law (except for periodic after-the-fact reviews by the Controller General).

1 Throughout this report, Title I local currency is converted to dollars at the exchange rate used to generate the local currency through the sale of Title I commodities.

The scope of the Commission's activities increased considerably when the law was amended on September 23, 1983. The amendment gave the Executive Branch power "to declare a condition of national emergency in any part of the national territory or in any sector of national activity, whenever it believes it necessary because of any social contingency." At this time, CNE began to operate as a public works agency. By using CNE to implement a wide variety of routine development projects, the Government (with USAID/Costa Rica's concurrence) was able to avoid complying with what were seen as burdensome requirements of the Financial Administration Law. In particular, a section of the law which gave unsuccessful bidders the right to appeal contract awards was widely perceived as leading to long delays.

Between July 1984 and April 1985, CNE received $968,374 in Title I funds. Of this amount, $232,900 was for a river dredging project, and $735,474 was to be placed in the National Emergency Fund and used as needed.

In June 1985, the local press began to report on an alleged embezzlement of funds from CNE. Although the Government of Costa Rica's investigation was not yet complete, officials involved in the investigation told us that about $2.6 million was stolen. The alleged embezzlement was accomplished by issuing checks to non-existent businesses. It was not possible to determine whether Title I funds were among those reportedly stolen because Title I funds were commingled in a single bank account with CNE's other sources of income. Title I funds made up about eight percent of the funds under CNE's control at the time the alleged fraud occurred.

After the alleged fraud was discovered, some steps were taken to strengthen CNE's internal controls. A new and larger staff was hired and in September 1986 several new administrative procedures were adopted.

Between September 1985 and July 1987, CNE received another $8.8 million in Title I funds. These funds were to provide production credit to cooperatives in Southern Costa Rica and to finance six road construction projects. (An additional $2 million programmed for CNE was disbursed directly to the agency which implemented the production credit activity.) Another $5.8 million in Title I funds was programmed for CNE projects but had not been disbursed as of July 31, 1987. A list of Title I activities implemented through CNE is presented in Exhibit 1.

CNE had a staff of 15, including 3 professionals. As of April 31, 1987, it was managing $10.1 million, including income from all sources.

## B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Tegucigalpa conducted a financial and compliance audit of PL 480 Title I local currency funds managed by CNE, which covered the period from July 1984 through July 1987. The audit objective was to evaluate CNE's system of internal control over PL 480 Title I local currency funds.

To accomplish this objective, documentation such as agreements, accounting records, payment documentation, reports, and correspondence was reviewed. Interviews were conducted with officials in USAID/Costa Rica, CNE, MIDEPLAN, the Ministry of Public Works and Transport, theOffice of the Controller General, the Office of Judicial Investigations, the National Bank of Costa Rica, the Executive Unit for the Southern Zone, and representatives of three consulting and construction firms working on CNE projects. Two of the six road projects financed through CNE were visited. The status of prior audit recommendations made by the Government of Costa Rica's Office of the Controller General was reviewed.

The audit included reviews of compliance with Costa Rica's Financial Administration Law and its implementing regulations, PL 480 Title I Sales Agreements and Memoranda of Understanding, Letters of Understanding, and other guidance. The audit also included an examination of CNE's financial internal control system. The financial internal control system consisted of controls over purchases, the receipt and disbursement of funds, and the recording of transactions, in addition to project monitoring.

The audit field work was conducted from June 20 through September 8, 1987, and covered the equivalent of $9.8 million in disbursements to CNE. The audit was made in accordance with generally accepted government auditing standards.

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## PART II - RESULTS OF AUDIT

The National Emergency Commission (CNE) did not have adequate internal controls. The Commission did not have written accounting and disbursement procedures, did not promptly and accurately record financial transactions, and did not monitor project implementation adequately.

Some of the projects implemented by CNE were closely monitored by USAID/Costa Rica and the Ministry of National Planning and Economic Policy. Their close involvement in some CNE projects helped to offset the lack of monitoring by CNE.

The first report finding is that little advantage was gained by implementing PL 480 Title I projects through CNE, while at the same time CNE lacked internal controls needed to protect Title I funds from waste or misuse. The second finding is that two road projects implemented by CNE had been abandoned by the contractors before they were finished.

The first report recommendation is that USAID/Costa Rica agree to implement Title I projects through CNE only if a bona fide emergency exists. The second recommendation is that the road between Upala and San Jose (Pizote) be completed, and that the road between Nicoya and Caimital be completed if USAID/Costa Rica decides that it is still needed.

## A. Audit Findings and Recommendations

### 1. Local Currency Should Not Be Channeled through the National Emergency Commission Unless a Bona Fide Emergency Exists

Institutions chosen to receive PL 480 Title I local currency should have the ability to properly manage and account for those funds. The National Emergency Commission (CNE) had received the equivalent of about $9.8 million in Title I funds, but lacked the qualified staff and administrative systems needed to maintain control over these resources. The Government of Costa Rica, with USAID/Costa Rica's concurrence, channeled the funds through CNE because the Commission was exempt from most provisions of the Financial Administration Law, including the provision which gave unsuccessful offerors the right to appeal contract awards. The Mission's perception was that Costa Rican businesses often abused this provision of the law, creating unreasonable delays in the contracting process. This perception was not supported by the actual experience in Costa Rica, however. Using CNE to manage local currency projects introduced an unnecessary risk of waste or misuse of funds without producing a commensurate benefit. At the same time, according to the Commission's Director, using CNE to implement routine public works projects diverted the Commission from its responsibility to plan for and respond to true emergencies.

Recommendation No. 1

We recommend that USAID/Costa Rica inform the Government of Costa Rica that it will no longer agree to channel PL 480 Title I local currency through the National Emergency Commission (except for projects already being implemented) unless a bona fide emergency exists.

Discussion

Local currency generated through the sale of PL 480 Title I commodities in Costa Rica belonged to the Government of Costa Rica. However, USAID/Costa Rica was involved in programming and monitoring the uses of the local currency. AID's supplemental guidance on programming local currency provides that when AID chooses to directly associate local currency with host government or private sector activities, the Mission should have reasonable assurance that the implementation and monitoring capabilities of the implementing agencies are adequate.

Between July 1984 and July 1987, CNE received the equivalent of $9.8 million in Title I local currency to implement six routine road projects as well as three activities which could be considered related to emergencies of one sort or another. As of July 1987, an additional $5.8 million had been programmed but not disbursed to CNE, for two routine road projects and a drainage project.

No Value Added - The Government of Costa Rica, with the Mission's concurrence, chose to use CNE to implement routine road projects because the Commission was exempt from most provisions of Costa Rica's Financial Administration Law, including the provision which gave unsuccessful offerors the right to appeal contract awards to the Controller General.

Costa Rican and Mission officials believed that Costa Rican road construction firms often abused this provision of the law, creating unreasonable delays in the procurement process. This belief was not supported by the actual experience in Costa Rica, however. According to the regulation implementing the Financial Administration Law, contract appeals must be presented to the Controller General of Costa Rica within three working days after the announcement of the contract award in La Gaceta, the official daily record of government proceedings. Within eight days after the appeal is received the agency that awarded the contract and the company which received the contract must present to the Controller General any information they feel is relevant to the appeal. The Controller General must normally resolve the appeal within 45 working days, but in exceptional cases may take up to a maximum of 90 days.

The Controller General's Office kept statistics on how many contracts were appealed, how long it took to adjudicate the appeals, and how they were resolved. Of the 17 road construction contracts awarded from 1984 through 1987, 4 were appealed. Of the four appeals, one was withdrawn by the complainants after 39 days, and three were decided in favor of the contracting agency in 89, 55, and 22 days respectively. After reviewing these appeals, we concluded that one had no merit. In our opinion, the other three appeals deserved consideration, even though the decisions in favor of the contracting agencies were probably the correct ones. Also, the time permitted to resolve contract appeals in Costa Rica compared favorably with the time permitted in the United States by the Federal Acquisition Regulations. Therefore, we concluded that there was no justification for using CNE to preclude the possibility of contract appeals.

In certain cases, however, CNE was able to speed the procurement process by using less than fully competitive procedures. For example, CNE selected a purchasing agent for a road and bridge project in Southern Costa Rica in only two days, using non-competitive procedures. Similarly, it selected a supplier of concrete bridge elements for this project in only a few days, after soliciting offers from two businesses. If fully competitive procedures had been followed, these procurements would have likely taken several months to accomplish.

While there were substantial time savings in these and other cases, we question the wisdom of using less than fully competitive procurement procedures to implement routine road projects. Against the time savings one m st weigh the benefits of full and open competition and the legitimate right of unsuccessful offerors to appeal what they perceive as unfair contracting actions.

Therefore, there was no unambiguous benefit to using CNE as a conduit for financing routine road projects. At the same time, CNE's internal control weaknesses introduced the risk of waste or misuse of PL 480 Title I funds.

Weak Internal Controls - CNE had not established internal controls adequate to protect the $10 million (counting income from all sources) under its control. The specific internal control problems disclosed by the audit are discussed below.

-- CNE did not have written accounting and disbursement procedures. Adequate written procedures could have prevented many of the other internal control weaknesses discussed in this section.

-- PL 480 Title I expenditures were not properly identified in CNE's accounting records, and the responsible CNE staff were not aware that two activities were financed with Title I funds. To prepare a report on the source and application of the Title I funds, CNE relied on "budget cards" which were not a part of its official accounting system.

-- The source and application of funds report CNE prepared for us contained 22 differences with its accounting records which totaled $411,000. These differences were due to erroneous entries in both the accounting records and the unofficial "budget cards" which would have been detected if CNE routinely reconciled these two sources of information.

-- As of July 1, 1987, CNE's general ledger had only been updated to January 31, 1987. We also found eight entries to the wrong accounts. Later during our audit the general ledger was updated through April 30, 1987.

-- CNE's accountant was not properly supervised and did not exercise due care in maintaining the accounting records.

-- CNE's part-time internal auditor spent most of his time performing operational functions such as preparing financial reports. The auditor stated that he reviewed the documents supporting CNE payments, but he did not document his reviews and had not prepared any audit reports. At the end of our audit, the auditor resigned because he was performing mainly operational functions.

-- CNE did essentially no monitoring of the uses of Title I funds. It lacked the staff needed to monitor Title I projects, and did not as a matter of policy require implementing agencies to submit progress reports.

As a result of these deficiencies, CNE was not adequately protecting PL 480 Title I funds against waste and misuse. It took CNE two months to prepare a report on the source and application of these funds, and the report was useless because it contained so many mistakes. Also, while we found no evidence of misappropriation of funds, we did find one case in which CNE paid a contractor without verifying that funds were available. No funds were in fact available, and the Ministry of National Planning and Economic Policy had decided to suspend disbursements to the project in question until the contractor agreed to correct some deficiencies in his work. CNE covered this erroneous payment with its own funds, and was later reimbursed by the Ministry of Public Works and Transport which had requested the payment.

In conclusion, then, there was no unambiguous benefit to using CNE to implement routine road projects. In those cases where time savings were achieved, they were achieved at the cost of full and open competition and the right of unsuccessful offerors to appeal contract awards. At the same time, CNE's weak internal controls introduced a risk of waste or misuse of Title I funds. Finally, according to the Commission's Director, using CNE to implement routine public works projects diverted the Commission from its responsibility to plan for and respond to true emergencies. USAID/Costa Rica should not agree to channel any additional Title I funds through CNE (except for projects presently being implemented) unless a bona fide emergency exists. We would define an emergency as a sudden, unforseen event which requires an immediate response. We would exclude from this definition crises which result from bureaucratic delays in implementing projects.

Management Comments

USAID/Costa Rica stated that it was managing PL 480 Title I local currency in accordance with AID's Policy Determination No. 5, which states that AID should entrust the recipient country with as much of the work of utilizing and accounting for country - owned local currency as possible. The Mission noted that the decision to use CNE to implement routine development projects (in order to avoid complying with normal contracting procedures) was made by a friendly, democratic government. Therefore, USAID/Costa Rica did not agree with our recommendation that the Mission inform the Government that it would no longer agree to channel PL 480 Title I local currency through CNE unless a bona fide emergency existed. It suggested that the recommendation be changed to read as follows:

> We recommend that USAID/Costa Rica inform [the Government of Costa Rica] that it will have to approve CNE's accounting system prior to channeling additional PL 480 Title I local currency through the CNE.

The Mission also made detailed comments on the body of the finding. For example, it stated that implementing projects through CNE improved the speed and efficiency of contractor selection and project implementation. The Mission also suggested that using CNE to implement routine projects could actually enhance its ability to respond to true emergencies. In addition, the Mission described several actions taken to correct the internal control problems discussed in the finding.

Office of Inspector General Comments

The Mission maintains that the decision to use CNE was made by a sovereign government, and that it would be inappropriate for the Mission to impose its own views on the wisdom of implementing routine Title I activities through CNE. However, the Mission's former Controller indicated to the auditors on a separate assignment that the Mission was behind the decision to use CNE. He stated that the Mission had discovered a loophole in Costa Rican law which would permit faster implementation of local currency projects, and that the Mission had successfully urged the Government of Costa Rica to use CNE to implement certain high priority projects.

Even leaving aside the question of who developed the idea of using CNE to implement Title I projects, we believe that our recommendation, as originally formulated, is appropriate. State 327494 (October 21, 1987) which provides supplemental guidance on programming local currency, states that:

> If AID should choose to directly associate jointly programmed local currency with host government projects or private sector activities, the Mission should have reasonable assurance that the activities have been designed in accordance with sound technical, financial and environmental practices, [and] that implementation and monitoring capabilites of the implementing entities are adequate . . . .

This guidance implies that fully competitive contracting procedures (including provisions for contract appeals) should be followed in implementing local currency projects unless some compelling reason dictates the use of less competitive procedures. Therefore the original recommendation has been retained.

In response to the first of the Mission's detailed comments, it is true that CNE could speed contractor selection by using less than fully competitive procedures, and that these time savings could reduce the total time required to implement a project. As discussed in the finding, however, these time savings were achieved at the cost of full and open competition and the legitimate right of unsuccessful offerors to appeal contracting actions. Second, in theory one could argue, as the Mission does, that implementing routine development projects could give CNE practical experience which could enhance its ability to respond to true emergencies. In practice, CNE acted merely as a conduit for funds, while almost all of the work of designing projects, preparing contracting documents, and monitoring project implementation was performed by other agencies.

## 2. Two Road Projects Had Not Been Completed

Two road projects financed through CNE had been abandoned by the contractors in a state of partial completion. The first road, between Upala and San Jose (Pizote), was supposed to be delivered by May 11, 1987. The contractor abandoned the project in March 1987 when the consulting engineers asked the company to redo some work which the contractor felt was of acceptable quality. At the end of the audit, the contractor reversed its position and repaired the road, but the repair work had not yet been accepted by the consulting engineers or the Ministry of Public Works and Transport (MOPT). The second road, between Nicoya and Caimital, was scheduled to be completed in September 1986. It was abandoned by the contractor in April 1986 after the project budget was depleted. The budget was spent before the project was completed because the MOPT significantly underestimated the cost of the road and allowed the contractor to perform some work which was not included in the contract. As a result, the work already done on both roads was deteriorating, and due to the effect of inflation the cost of eventually repairing and finishing the roads was increasing.

Recommendation No. 2

We recommend that USAID/Costa Rica:

a) obtain evidence from the Government of Costa Rica that the road between San Jose (Pizote) and Upala has been completed, and

b) decide whether the road between Nicoya and Caimital should be completed, and if so, obtain evidence that the road has been completed.

Discussion

Two road projects funded through CNE had been abandoned by the contractors in a state of partial completion. Very little work had been done on either road in more than a year, and in the meantime the work already accomplished had deteriorated due to the effects of traffic and weather. The two projects are discussed in the sections that follow.

Upala-San Jose (Pizote) - This project consisted of upgrading and applying a fine gravel surface to the 15 kilometer road between Upala and San Jose (Pizote) in Northwestern Costa Rica. (It is customary to include the traditional name of San Jose in parentheses to distinguish this town from the capital city of Costa Rica.) The planned cost was $1.6 million. According to the original contract, the road was to be completed by April 1986. However, the MOPT granted the contractor extensions totaling about 10 months (roughly the term of the original contract). Most of this delay was attributable to the total suspension of work between June 1986 and February 1987 due to heavy rains. When the contractor began work again on February 16, 1987, only eight days remained in the contract term (including all extensions), and on February 24 the contractor asked the MOPT to inspect and receive the road.

The MOPT and its consulting engineers inspected the road on March 11, 1987. The MOPT found the work basically acceptable, but stated that the contractor would have to correct certain deficiencies noted by the consulting engineers. The consulting firm notified the contractor that about 25 percent of the road surface would have to be scarified and recompacted. Several minor deficiencies were also noted.

According to Costa Rican law, the contractor then had two months, or until May 11, 1987, to deliver the road with all deficiencies corrected. The contractor corrected some minor deficiencies but refused to do any further work on the road surface. Representatives of the contractor told us that they had delivered the road in good condition. According to them, the consulting firm's assertion that 25 percent of the road surface was unacceptable implied that their company did poor quality work. They said that they would have been willing to rework perhaps 8 or 10 percent of the surface, but not 25 percent. Therefore, they had removed their equipment from the work site without doing the required work on the road surface.

Because the contractor did not correct the deficiencies noted by the consulting firm by May 11, 1987 the contractor was subject to the fines specified in Costa Rica's "General Specifications for the Construction of Roads, Highways, and Bridges." However, in comparison with the $1.3 million contract cost, the stipulated fine of $80 per day had little more than symbolic significance. Fortunately, performance guarantees totaling $52,894 (roughly equal to the cost of correcting the deficiencies) had been withheld from payments to the contractor.

In the meantime, the condition of the road had deteriorated due to the apparent poor quality of the road surface, lack of maintenance, the effects of heavy rain, and the transit of overloaded trucks. (Many of the overloaded vehicles reportedly belonged to a consortium which was building adjoining road segments financed under USAID/Costa Rica's Northern Zone Infrastructure project.) We traveled the road in July 1987, less than four months after the road surface was completed, and found that many sections were covered with large potholes and corrugations.

At the end of July, the contractor proposed to scarify and recompact the entire 15 kilometer length of the road, absorbing the cost for 4 kilometers (27 percent) and charging the MOPT for the cost of the remaining 11 kilometers. This proposal represented a reversal of the contractor's previous position that it would not redo 25 percent of the road surface. The contractor's representatives explained that they were anxious to put this controversy behind them. This proposal was rejected by the consulting firm, which stated that the price the contractor proposed to charge the MOPT for 11 kilometers ($4,800 per kilometer) was excessive. The consulting firm's position was that the MOPT should terminate the existing contract and invite new bids for repairing the road, charging the cost to the original contractor.

At the end of our audit, the contractor changed its position a second time, and repaired the entire length of the road at its own expense.

However, we did not have the expertise to evaluate the quality of this repair work, and the road had not yet been accepted by the consulting firm or the MOPT.

Nicoya-Caimital - This project was to upgrade and pave nine kilometers of road between Nicoya and Caimital in the Pacifico Seco region of Costa Rica. The estimated cost of this project was about $1 million at the time of our audit. The road was originally scheduled to be completed by September 1986.

The contractor abandoned this project in April 1986 when the project budget was depleted. The original budget proved inadequate because the MOPT used poor cost estimating procedures, and also because the MOPT allowed the contractor to perform work which was not in the contract.

The original budget of $1.6 million for this activity was to pay for the improvement and paving of 40 kilometers of road between Nicoya and Samara as well as the construction of four bridges on a separate route. This budget, which was not carefully reviewed by USAID/Costa Rica, could only have been based on wishful thinking. Nine months later, it was estimated that $648,266 would be needed to upgrade and pave only nine kilometers of road, without building any bridges. At the time of our audit, the estimated cost of the nine kilometer road section had climbed to more than $953,895. This last increase was due to the fact that the MOPT's estimate of earth movement was only one-third of the actual amount required, the fact that the MOPT did not accurately evaluate the condition of existing drainage structures, and other factors. In addition, the MOPT allowed the contractor to perform work worth about $67,000 which was not included in the contract. The MOPT's plan was to retroactively incorporate this work in the contract through a modification order.

Between April 1986, when the contractor abandoned this project, and July 1987, when we traveled part of the road, the work already done had experienced some degradation. At least one kilometer of the three kilometers paved before the contractor left the site had begun to deteriorate. This section had only one layer of asphalt instead of the two layers planned, and in many places the asphalt had worn through to the base material below. The contractor's representatives explained that there were no funds available to lay down a second asphalt treatment before they removed their equipment from the site. They also stated that a four-kilometer section of the base layer had deteriorated somewhat since the aggregate material had not been stabilized with cement before they abandoned the project.

The Government of Costa Rica had taken some steps to find the financing to complete the Nicoya-Caimital road. The Ministry of National Planning and Economic Policy (MIDEPLAN) had withheld disbursement of $75,435 in PL 480 Title I funds until the MOPT provided the additional financing required (estimated by the MOPT at $227,118) from its own budget. According to a MOPT official, about $181,694 from the MOPT's 1988 budget had been programmed for this purpose. This amount was not adequate, in our opinion, since it was $45,424 less than the MOPT's own estimate of the financing needed to complete this road, and since the MOPT's previous cost estimates for this project were unjustifiably optimistic. (More information on the management of the Nicoya-Caimital project is included in the "other pertinent matters" section of this report.)

Because of the effects of inflation, delays in completing these two roads increased the cost of eventually repairing and finishing the roads. For example, since the Nicoya-Caimital road work was discontinued in April 1986, the Costa Rican wholesale price index had moved up about 12 percent. USAID/Costa Rica should see that the Upala-San Jose (Pizote) road is completed as soon as possible. In the audit exit conference, USAID/Costa Rica's Agricultural Development Officer stated that the Mission was not certain that the Nicoya-Caimital road would produce enough benefits to justify its completion. The Mission should decide whether the road should be completed, and if so, take whatever actions it deems necessary to finish the work. This will prevent further cost increases and further deterioration of the work already done.

Management Comments

USAID/Costa Rica generally agreed with this finding and recommendation, but felt that the finding did not give adequate recognition to some of the controls implemented and actions taken to get these road projects completed. In particular, the Mission felt that the statement that "fortunately" performance guarantees were withheld from the contractor for the Upala-San Jose (Pizote) road tended to dismiss the internal controls which had been established.

Office of Inspector General Comments

It is true that the finding does not discuss all of the meetings held and letters sent by USAID/Costa Rica and MIDEPLAN in an attempt to have these two projects finished. These actions were probably an important factor in the contractor's decision to repair the Upala-San Jose (Pizote) road. The statement that "fortunately" performance guarantees were withheld is intended to recognize, not to dismiss, the normal safeguards which were established in this case and in most construction contracts.

## B. Compliance and Internal Control

### 1. Compliance

The audit included reviews of compliance with Costa Rica's Financial Administration Law and its implementing regulations, PL 480 Title I Sales Agreements and Memoranda of Understanding, Letters of Understanding, and other guidance. No major instances of non-compliance were disclosed. Except for the minor compliance issues discussed in the following report section, the tested items were in compliance, and nothing came to our attention which would suggest that the untested items were not in compliance with applicable laws and regulations.

### 2. Internal Control

The audit also included an examination of CNE's internal control system. The internal control system consisted of controls over purchases, the receipt and disbursement of funds, and the recording of transactions, in addition to project monitoring. The review of the internal control system showed that there were significant deficiencies in controls over disbursements, recording of transactions, and project monitoring. As discussed in finding No. 1, CNE lacked written disbursement and accounting procedures, did not accurately and promptly record transactions, and did not properly monitor project implementation. Better internal controls were needed to protect against the possibility of waste or misuse of resources. Certain relatively minor internal control weaknesses are described in the following report section.

## C. Other Pertinent Matters

The following sections discuss three relatively minor problems which do not warrant formal recommendations.

Nicoya-Caimital Road As originally conceived, this activity was supposed to be managed by a private sector organization, and was supposed to finance the construction of four bridges and 40 kilometers of road. USAID/Costa Rica's interest in funding road construction in the Nicoya peninsula resulted from a former U.S. Ambassador's desire to build four bridges between Samara and Garza. The Government of Costa Rica, on the other hand, was most interested in improving the road between Nicoya and Samara (a different route). We were told by several officials that former Vice President Arauz, a principal proponent of this idea, wanted this road improved because he owned property in Samara. When USAID/Costa Rica approved this activity in March 1985, it did not specify how many kilometers of road were to be built, or specify that it expected four bridges to also be constructed. It did state that the activity was to be managed by the Association of Highways and Roads, a private sector institution. When the Government of Costa Rica unilaterally decided to implement the project through the MOPT instead, the Mission did not insist that the Government reve se this decision because the MOPT had already issued the invitation for bids. Due to poor cost estimation, and less importantly due to poor project management, the only work actually financed was a nine kilometer road section which had been abandoned when only partially completed for more than a year. USAID/Costa Rica and MIDEPLAN agreed to reduce the financing for this project because they were dissatisfied with the MOPT's management of the activity. We are not making a recommendation because all new Title I activities since 1986 have been funded through formal agreements which describe the activity being financed, management and reporting responsibilities, conditions precedent, and other implementation arrangements.

Conditions Precedent - The activity agreements for the San Jose - Guapiles and Canas - Upala Roads included conditions precedent which required the National Emergency Commission to (1) establish an accounting system which complied with generally accepted accounting principles, and (2) engage the services of an accounting firm which would provide quarterly and final certifications concerning the use of funds under the agreements. The Ministry for National Planning and Economic Policy had not established sound procedures for verifying compliance with conditions precedent, and in fact neither condition had been complied with, even though disbursements of about $4.6 million had been made for both projects. In July 1987, the Ministry adopted new financial management policies and procedures which should provide better assurance that conditions precedent are complied with.

Southern Zone Activity - The Executive Unit for the Southern Zone (UNESUR) was a government entity in charge of promoting economic development in a region adversely affected by the departure of its largest employer, a banana company. UNESUR received about $2.6 million in PL 480 Title I local currency for planting African palm trees and cocoa. We did not do detailed audit work at UNESUR, but limited reviews showed that there were some serious problems in the management of these funds.

-- The agreements between UNESUR and the 10 cooperatives who participated in this activity did not specify how much the cooperatives would receive from (and later have to repay to) UNESUR. In addition, many of the agreements did not adequately identify the party receiving assistance, lacked the signatures of one party or the other, were not dated, or contained other deficiencies. At the time of our audit, UNESUR was trying to get the cooperatives to sign new agreements to document their debt of over $2 million.

-- UNESUR did not know exactly how the cooperatives used the funds they received, because it had not enforced the requirement that the cooperatives submit periodic progress reports and financial statements.

-- Most of the funds for this activity were disbursed directly to UNESUR, even though the funds were programmed for the National Emergency Commission. At the time of the disbursements, CNE had just suffered a large embezzlement, and the responsible officials felt it would be safer to disburse the funds directly to UNESUR. Nonetheless, these disbursements were not in accordance with the Letters of Understanding which programmed these funds for the National Emergency Commission.

While we are not making a formal recommendation, USAID/Costa Rica should not agree to program any additional funds for UNESUR unless the organization can demonstrate through an independent audit that it has implemented acceptable internal controls.

AUDIT OF PL 480 TITLE I
LOCAL CURRENCY FUNDS
MANAGED BY THE NATIONAL
EMERGENCY COMMISSION
(USAID/COSTA RICA)

## PART III - EXHIBITS AND APPENDICES

# PL 480 Title I Local Currency Activities Implemented through the National Emergency Commission

| | Programmed 1/ ($000) | Disbursed 1/ ($000) |
|---|---|---|
| Tempisque and Las Palmas River Dredging | 233 | 233 |
| National Emergency Fund | 735 | 735 |
| Upala-San Jose (Pizote) Road | 1,590 | 1,133 |
| Nicoya-Caimital Road | 727 | 651 |
| Canas-Upala Road | 4,076 | 573 |
| Guapiles-Heredia Road | 239 | 0 |
| Improvement of Roads and Bridges in the Southern Zone | 1,521 | 1,420 |
| Planting of African Palms | 607 2/ | 607 2/ |
| San Jose-Guapiles Road | 4,221 | 4,056 |
| Cuatro Bocas-San Jose (Pizote) Road | 814 | 391 |
| Siquirres- Limon Road Maintenance | 620 | 0 |
| Farm Drainage in the Southern Zone | 181 | 0 |
| | 15,564 | 9,799 |

Notes: 1. Local currency is converted to dollars at the exchange rate used to generate the local currency through the sale of Title I commodities. Detail may not add to total due to rounding.

2. These amounts do not include $2,010,297 which was programmed for the National Emergency Commission but disbursed directly to the Executive Unit for the Southern Zone.

MEMORANDUM

November 25, 1987

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

FROM: Richard K. Archi, MDIR, a.i.

SUBJECT: Audit of PL-480 Title I Local Currency Funds Managed by the National Emergency Commission (USAID/COSTA RICA)

USAID/Costa Rica has reviewed the subject draft report and although we cannot quarrel with most of the facts, we do have problems with balance in the report and strong reservations about the wisdom of Recommendation Number 1.

Since 1983, the basic policy governing programming of PL 480 local currency generations has been Policy Determination No. 5. This policy determination encouraged AID's participation in the programming of country-owned local currency generated by the sale of PL 480 Title I commodities and specified that Missions should entrust the recipient country with as much of the work of utilizing and accounting for the country-owned local currency as possible. This Mission has been and is working very closely with MIDEPLAN, our counterpart organization in the PL 480 area, to ensure that MIDEPLAN becomes a viable, effective organization that can design, monitor and implement activities using PL 480 resources. We believe that we have come a long way in implementing the Agency policy expressed in PD 5 and are basically succeeding in assisting in the institutional development of MIDEPLAN.

The audit, in our opinion, goes beyond the stated scope of a financial and compliance audit of PL 480 Title I country-owned local currency and attempts to interject an audit position on oversight of the program in lieu of stated Agency policy. The basic thrust of your report as epitomized in recommendation 1 is to suggest that we, under the guise of "sound management practices", reverse this process of relying on MIDEPLAN and become even more hands-on in managing PL 480 country-owned local currency. Your recommendation number 1 would have us substitute our judgment in declaring emergencies for that of laws passed by a friendly, democratic government.

We are not in disagreement with RIG over the need to improve MIDEPLAN's review and approval of internal controls and accounting procedures of those institutions that they select to implement PL 480 activities including those of the National Emergency Commission. As you note in the report, the Mission was sufficiently concerned with the ability of the National Emergency Commission to properly account for funds, that conditions precedent were inserted in the road agreements covering the establishment of an adequate accounting system and the employment of an accounting firm. While it is regrettable that these actions were not fully complied with, we do not believe that this failure on MIDEPLAN's part to monitor these conditions precedent renders our approach to oversight as ineffective. We believe that a more appropriate recommendation for the National Emergency Commission (CNE) finding would be to have MIDEPLAN continue working with CNE in improving their internal controls and accounting procedures. Such a recommendation instead of the current recommendation number 1 strikes us as particularly pertinent since, as noted throughout the draft report, there are indications of weaknesses in internal controls.

We believe that there is a lack of balance in the report and that some of the conclusions reached are only one of several equally valid conclusions that could be drawn. For example, cannot one conclude on page 7 that using CNE to implement these projects gave them experience in procuring and managing thereby increasing their ability to respond to true emergencies? The report loses sight at times that these are country-owned local currencies and that a conscious decision was made by a responsible, sovereign, democratic government to implement these projects using the procedures established in their laws. While Mission officials may have believed that construction firms often appealed awards creating unreasonable delays in the procurement process, we do not believe the conclusion can be reached that no value was added to the process by using CNE. As acknowledged on page 10 of the report, CNE was able to speed the procurement process by using less than fully competitive procedures which probably speeded up implementation of the projects by several months. Perhaps Government of Cost Rica officials concluded that such substantial time savings made the process worth while.

CNE is not an organization totally bereft of all internal control procedures. As the report notes on page 12, no evidence of misappropriations was uncovered. Even where the CNE's internal control procedures in procurement and payments were adequate and worked perfectly in protecting the interests of the GOCR in ensuring that work was performed according to the contract, the report (page 17) essentially dismisses these internal controls by stating "Fortunately, performance guarantees . . . . had been withheld from payments to the contractor.". There is also scant mention in the report of the USAID monitoring system which attempted in a realistic way to identify and resolve problems in implementation. Our effort in assisting MIDEPLAN in developing their institutional capacity to plan and monitor PL 480 activities should be noted. Equally important and perhaps unique in the breadth of its coverage, is this Mission's attempt to ensure independent audit coverage of all the PL 480 programs to assist our monitoring efforts. All agreements contain this requirement.

I would appreciate your inserting the following paragraphs in the Executive Summary of the final report to insure balance in the report and to convey a more accurate impression to the reader of the prudence with which the Mission is participating in the programming and monitoring of GOCR owned PL-480 Title I Local Currency resources:

"USAID/Costa Rica considers its program of regular site visits and the continuing efforts in developing MIDEPLAN into an effective planning and monitoring arm for PL 480 activities, a proper oversight posture in managing PL-480 Title I country-owned resources. The site visit program gives USAID/CR first-hand knowledge of the project status and improves monitoring by MIDEPLAN since personnel from that Ministry normally accompanies USAID officers on site visits. MIDEPLAN's new financial management regulations include, among other things, the establishment of an internal audit function within MIDEPLAN and requires approval by MIDEPLAN of the recipient's accounting system. These regulations were thoroughly reviewed and approved by the USAID in Letter of Understanding No. 1 dated September 14, 1987, to the FY 1987 PL-480 Title I Sales Agreement. These policies and procedures coupled with the USAID's monitoring of the PL-480 Title I activities and MIDEPLAN reporting, appear to be sufficient to ascertain compliance with all management and implementation requirements established under the program.

USAID has been assertive in the management of PL 480 Title I funds and has worked through MIDEPLAN as appropriate to correct known deficiencies. The requirement for the 1986 evaluation of MIDEPLAN is one example of the approach taken by the Mission to improve monitoring of PL 480 country-owned resources. Within reason, we attempt to assure adherence to the terms of the joint programming agreement. Considering that PL 480 Title I resources are owned by the GOCR, USAID/CR's assessment is that excluding a bona fide GOCR entity from managing PL 480 Title I funds based solely on an audit based determination of what is a proper emergency is not warranted at this time."

We are attaching our detailed comments on the draft report. These comments follow the outline of the draft report to assist in incorporating them in the body of the report if such is deemed desirable or feasible. We ask that Recommendation Number 1 be rewritten as suggested above.

Annexes a/s

USAID/CR Response to RIG's Draft Audit Report on PL 480 Title I Local Currency Funds Managed by the National Emergency Commission (CNE)

The USAID has reviewed the above mentioned draft audit report and our observations are presented in the same format as that of the auditors' draft report.

## EXECUTIVE SUMMARY SECTION

We suggest that the first sentence which reads "Countries which receive agriculture commodities under Public Law 480, . . . . " have the word "receive" changed to "purchase". Title I is a sales program and the word "receive" may leave the impression in the reader's mind that it is a grant program. The first paragraph of this section mentions a total of $10.1 million being managed by the National Emergency Commission (CNE). There is similar language on page 2 of the PART I - INTRODUCTION Section. The annex, on the other hand, shows $15.5 million programmed and $9.8 disbursed. The final report should clarify these amounts and indicate how much of the amounts are PL 480 Title I funds.

The last sentence starting on page -ii- of this Section infers that USAID/Costa Rica uses the CNE, which is not correct; it is the Government of Costa Rica (GOCR) which chose the CNE for the implementation of PL 480 Title I country-owned local currency activities.

## PART I - INTRODUCTION SECTION

### A. Background

The first paragraph of this Section should state that Policy Determination No. 5 issued in 1983 covers the programming and monitoring of PL 480 local currency. The extent of involvement in programming and monitoring PL 480 local currency activities was left somewhat flexible. This explains the auditors' observation that involvement varies from country to country.

The first paragraph on page 3 of this Section leaves the impression that the variety of routine development projects implemented by the CNE are all implemented with the Mission's concurrence, which is not true. The Mission has concurred only on the PL 480 Title I projects. We also believe stating that the Government in using CNE was exempt from the requirements of the Financial Administration Law is more accurate than stating that they were able to avoid complying with the law.

Page 4 discusses the amount of monies managed by the CNE, but the information is confusing when compared to EXHIBIT 1 and to the first paragraph of the EXECUTIVE SUMMARY Section as commented on above.

## PART II - RESULTS OF AUDIT SECTION

### A. Audit Findings and Recommendations

#### 1. Local Currency Should Not Be Channeled through the CNE Unless a Bona Fide Emergency Exists

The Mission, as pointed out in the transmittal memorandum, is very concerned about the wisdom of this recommendation. Our approach to oversight of the PL 480 local currency program has been to work closely with MIDEPLAN to improve the implementing unit's ability to plan, implement and monitor the activities. We are opposed to interjecting our decision on what is an emergency for those of the proper authorities in the Government of Costa Rica. We strongly suggest a redrafting of the recommendation, as indicated below, to require MIDEPLAN to continue working with the CNE to further improve their internal controls and accounting procedures. We suggest the following recommendation wording:

"Recommendation No. 1

We recommend that USAID/Costa Rica inform MIDEPLAN that it will have to approve CNE's accounting system prior to channeling additional PL 480 Title I Local Currency through the CNE."

Discussion

On page 8 of this Section, we suggest a rethinking of the "no value added" conclusion and a down playing of what Mission officials thought about Costa Rican construction firms since the most important opinion is that of the responsible Government of Costa Rica officials.

We believe that greater emphasis should be placed in the first three paragraphs of page 10 of this section, of the other important factors contributing to the use of the CNE, such as speed and efficiency in getting to the point of selection and, once selection is made, executing implementation and payment.

Page 11 and 12 of the draft audit report refer to various internal control deficiencies. The CNE is in the process of correcting these and MIDEPLAN has also adopted the policy of verifying the existence of separate accounting records prior to the first disbursement. MIDEPLAN also developed a financial management guide for PL 480 Title I sub-grantees. The Mission reviewed and approved the guide prior to its issuance and reports on PL 480 Title I sub-grantee accounting systems are already coming in.

With regard to the progress reports referred to in the second paragraph of page 12, the Mission is now requiring that the reports be made in a timely manner as disbursements are requested by the beneficiary institutions.

Also on page 12, last paragraph, the fact that only one case of payment without verification of availability of funds could be found, and that that case was properly resolved, suggests that the issue should not be included in the report.

Paragraph one of page 13 discusses the bona fide emergency issue. The Mission does not see any problem with the GOCR establishing a mechanism which is exempt from certain bureaucratic procedures if it considers the exemption appropriate regardless of whether the issue at hand is an emergency or not.

The Mission, based on a reading of the Costa Rican law, believes that the GOCR has a different idea of what a bona fide emergency is. We believe that the GOCR should be left to determine what the legitimate jurisdiction of the Commission should be.

2. Two Partially Completed Road Projects Had Been Abandoned

Discussion

Since a major thrust of the report is that CNE did not have adequate internal controls which introduced an unnecessary risk of waste or misuse, we believe the treatment of their contracting and payment procedures on page 17 of the report is unfair. Why is it "fortunate" that their procedures called for withholding of performance guarantees and were complied with in overseeing the project? We believe that the section should be rewritten giving credit to the organization for controls adequate to protect the interests of the Government of Costa Rica.

Appendix 2

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