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AUDIT OF
THE NICARAGUA ASSISTANCE PROGRAM FUNDED
BY PUBLIC LAW 101-302 AND FISCAL YEAR 1991
APPROPRIATIONS AS OF MAY 31, 1991

Audit Report No. 1-524-91-012
August 23, 1991

While A.I.D. designed the Assistance Program to meet provisions of the Act and additional Congressional guidance and generally followed its established policy, in a number of instances the normal processes required by A.I.D. policy were implemented through alternative methods or bypassed.

AGENCY FOR INTERNATIONAL DEVELOPMENT

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August 23, 1991

MEMORANDUM

TO: USAID/Nicaragua Director, Janet C. Ballantyne

FROM: RIG/A/T, Reginald Howard

SUBJECT: Audit of the Nicaragua Assistance Program Funded by Public Law 101-302 and Fiscal Year 1991 Appropriations as of May 31,1991, Audit Report 1-524-91-012

Enclosed are five copies of the subject audit report. We provided your office with a draft of the subject report and both your written and oral comments were considered in preparing this final report. The status of the report's four recommendations is: Recommendation No. 1.1 is unresolved, Nos. 2, 3, and 4 are resolved, and No. 1.2 is closed upon issuance of the report.

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

Table Of Contents

	Page
EXECUTIVE SUMMARY	i
INTRODUCTION	1
Background	1
Audit Objectives	5
REPORT OF AUDIT FINDINGS	7
Did A.I.D. follow the Act and additional Congressional guidance in designing the Assistance Program?	7
Was A.I.D. following its established policies and procedures which control the implementation of individual Assistance Program activities?	9
The Mission, with A.I.D./Washington Approval, Initiated the Assistance Program without a Country Development Strategy Statement or Action Plan	11
Final Design Documents For Initial Development Projects Did Not Meet Handbook Standards	12
A.I.D. Did Not Notify Congress of Changes in the Scope of Initial Cash Transfer Activities	13
A.I.D.'s Import Financing Arrangements under the Cash Transfer Programs Can Be Strengthened	14

Was A.I.D.'s system for monitoring, evaluating, auditing, and reporting being implemented with regard to Assistance Program activities? 17

The Mission Had Not Formally Established Its Monitoring And Evaluation System 19

The Mission Did Not Prepare Information Plans As Part Of Its Assistance Designs 21

The Mission Did Not Design Initial Bilateral Projects and One Operational Program Grant To Permit Comparison of Planned to Actual Results 22

Local Currency Was Inadvertently Resulting from the Cash Transfer Programs 22

The Mission's Obligation To Follow Local Currency Accountability Requirements Needs To Be Determined 25

Did A.I.D. obligate, expend, and account for the Assistance Program's funds in accordance with Agency policies and procedures? 28

Certain Accrued Expenditures Were Not Recorded 28

Issues Needing Further Study 29

REPORT ON INTERNAL CONTROLS 31

REPORT ON COMPLIANCE 35

APPENDIX I - SCOPE AND METHODOLOGY 37

APPENDIX II - MANAGEMENT COMMENTS 41

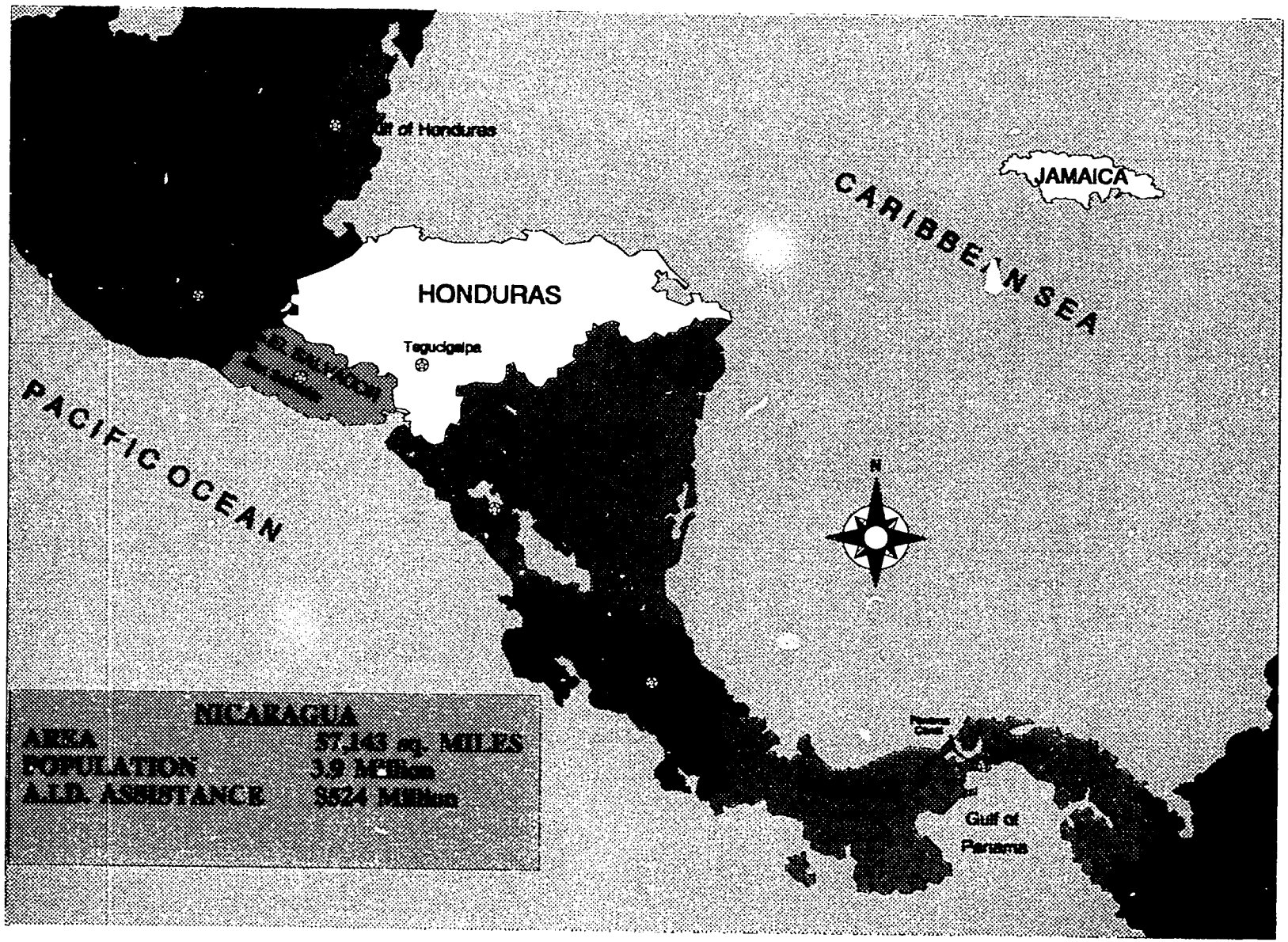
APPENDIX III - PREVIOUSLY REPORTED ISSUES 53

APPENDIX IV - FINANCIAL STATUS OF THE NICARAGUA ASSISTANCE PROGRAM AS OF MAY 31, 1991 57

APPENDIX V - ANALYSIS OF COMPLIANCE WITH SELECTED POLICY/PROCEDURAL REQUIREMENTS ASSOCIATED WITH THE NICARAGUA ASSISTANCE PROGRAM 61

GLOSSARY

Act	Fiscal Year 1990 Dire Emergency Supplemental Appropriations Act
A.I.D.	Agency for International Development
A.I.D. Evaluation Handbook	A.I.D. Handbook 3, Supplement to Chapter 12
AIFLD	American Institute for Free Labor Development
CDSS	country development strategy statement
CN	Congressional Notification
ESR-I	Economic Stabilization and Recovery I Program
FAA	Foreign Assistance Act
LAC Bureau	A.I.D./Washington/Latin America and Caribbean Bureau
MACS	mission accounting control system
MOU	memorandum of understanding
ONUCA	Observer Group for Central America
PID	project identification document
PAAD	program assistance approval document


Gulf of Honduras
JAMAICA
CARIBBEAN SEA
HONDURAS
Tegucigalpa
EL SALVADOR
PACIFIC OCEAN
N
Gulf of Panama
NICARAGUA
AREA 57,143 sq. MILES
POPULATION 3.9 Million
A.I.D. ASSISTANCE $524 Million

EXECUTIVE SUMMARY

PURPOSE

The Congress passed the Fiscal Year 1990 Dire Emergency Supplemental Appropriations Act (Act), and it was signed into law on May 25, 1990. The Act included $300 million in Economic Support Fund assistance to Nicaragua. This assistance was to help Nicaragua restore democracy and its economy which was severely weakened after many years of internal strife. An additional $223.9 million was allotted from the Fiscal Year 1991 appropriations to continue this assistance making the total funding from those two sources $523.9 million. The Congress in providing the Act funds did not follow the normal appropriation process. Normally funds are appropriated after A.I.D. submits a budget request based upon a country development strategy statement and action plan. In this case however, because of the urgent need, funds were made available in the absence of budget requests.

The Act requires the Inspector General, Agency for International Development (A.I.D.) to audit funds provided under the Act in order to assess the financial management and administrative systems established by the Agency to control such programs. The Senate Appropriations Committee report regarding Fiscal Year 1991 assistance funding, expressed concern about the accountability of such a large influx of cash into a country still on the brink of economic and political chaos. The Committee therefore requested the additional funds made available in Fiscal Year 1991 also be audited by the A.I.D. Inspector General.

This report covers the above Assistance Program activities from inception of the Act through May 31, 1991. We conducted the audit from February 18 through July 5, 1991, in accordance with generally accepted government auditing standards (see Appendix I).

Our audit objectives were to determine whether:

- A.I.D. followed the Act and additional Congressional guidance in designing the Assistance Program.

- A.I.D. was following its established policies and procedures which control the implementation of individual Assistance Program activities.

- A.I.D.'s system for monitoring, evaluating, auditing, and reporting was being implemented with regard to Assistance Program activities.

- A.I.D. obligated, expended, and accounted for the Assistance Program funds in accordance with Agency policies and procedures.

BACKGROUND

In providing the Assistance Program funds, the Congress set forth certain provisions in the Act as well as additional guidance concerning specific uses of funds. The Act and this additional guidance provides: (1) $30 million to support voluntary demobilization, repatriation and resettlement of the Nicaraguan resistance; (2) up to $8 million for environmental activities; (3) up to $10 million for A.I.D. administrative expenses; (4) $2 million for the Observer Group for Central America; (5) that A.I.D. provide private sector development and budget support; (6) that A.I.D. show concern for child survival, health and education; and (7) up to $1 million of Fiscal Year 1991 funds to support the Central American Institute of Business Administration.

To achieve these and other goals, A.I.D. has designed and developed three cash transfer programs and five development projects and is planning eight more projects. As of May 31, 1991, A.I.D. had obligated $472 million and had accrued expenditures totaling $281.1 million. The majority of these funds, $315.5 million, was budgeted for the three cash transfer programs which provide U.S. dollars to the Government of Nicaragua for balance of payments support. The dollars are used to finance public and private sector commodity imports--particularly petroleum products--and to help clear the Government of Nicaragua's arrears with international banks.

RESULTS IN BRIEF

Due to Nicaragua's urgent need for assistance, A.I.D. began implementation of the Assistance Program in Washington before it had reestablished a presence in Nicaragua after an absence of eight years. A.I.D./Washington began to transfer its implementation of the Assistance Program to the newly established Mission during the summer of 1990. A.I.D. faced significant problems during this transition period with staffing the Mission and obtaining office space and equipment while concurrently attempting to establish and implement required financial management and administrative control systems. It was during this period that much of initial control

processes that centered around the designing, planning, granting, and contracting of the Assistance Program occurred.

While A.I.D. designed the Assistance Program to meet provisions of the Act and additional Congressional guidance and generally followed its established policy, in a number of instances, the normal processes required by A.I.D. policy were implemented through alternative methods or bypassed. The audit found that A.I.D. followed its normal financial management and administrative control systems except that it did not: (1) develop the normal strategy documents prior to beginning assistance activities; (2) prepare the normal planning documentation for the initial development projects called for by A.I.D. handbooks but instead followed less stringent documentation guidance issued by the A.I.D./Washington/ Latin America and Caribbean Bureau; (3) notify Congress of subsequent changes in the scope of cash transfer program activities initially notified to the Congress; (4) issue a mission order formally establishing its monitoring and evaluation system; (5) prepare information plans as part of its assistance designs; (6) include elements in the design of its initial bilateral projects and one operational program grant to compare results with plans; and (7) accurately report accrued project expenditures.

Furthermore, we believe that: import financing arrangements could be strengthened through the use of commodity price and end use checking; local currency has been generated as a result of cash transfer dollar assistance which may be subject to legal requirements and A.I.D. policy; and local currency under the first two cash transfer programs, which may have been generated inadvertently, was not being monitored.

PRINCIPAL FINDINGS

Import Financing Arrangements under Cash Transfer Programs

The Mission was following A.I.D. policies for the $265.5 million of commodity import activities financed under three cash transfer programs. However, price and end use checking procedures, clearly required in the program assistance approval document (PAAD) for the first cash transfer program, were omitted in the agreement. A.I.D. policy requires that the PAAD be amended if any material deviation occurs when preparing the agreement. The Mission prepared the agreement, however, omitting these important controls and without amending the PAAD. At our request A.I.D./Washington's Office of Procurement/Commodities did a sample pricing analysis of 23 items purchased under this agreement. They found that 35 percent of the suppliers were trading firms who routinely mark-up items 10 to 30 percent over direct suppliers. For example, one shipment

of jars at a cost of $165,000, was about 30 percent higher than could be purchased from a competitor. As end use checks were not required in the agreement they also were not being done. End use checks could verify that conditions were, in fact, assisting in domestic production efforts. Evaluations which could also achieve this goal on a less routine basis, although provided for in the agreement, were not scheduled.

Monitoring and Evaluation System

Because of the diversity of issues faced by missions, A.I.D. policy requires each mission to establish and document a formal monitoring and evaluation system that best meets its needs. USAID/Nicaragua had not initiated such a system and was thereby not achieving the benefits a systematic monitoring and evaluation process could offer. For example, ineligible transactions of about $8.4 million have been financed under the first two cash transfer agreements. The first agreement was signed in May 1990, but it was not until we questioned the eligibility of certain transactions during the early part of our first audit (Audit Report No. 1-524-91-004) that USAID/Nicaragua began reviewing Central Bank of Nicaragua transactions. As of May 31, 1991 the Mission had identified $6.8 million of ineligible transactions under the first cash transfer agreement and an additional $1.6 million under the second agreement. The ineligible transactions included items such as chemical compounds, pesticides, brewery machinery and beer bottles, and petroleum used by the military. As illustrated in this one example there is a need for and clear benefits from effective monitoring. Further, we believe that this example demonstrates the need for the Mission to establish a formal monitoring and evaluation system as required by A.I.D. policy.

Local Currency Was Generated

The Foreign Assistance Act (FAA) provides that, to the maximum extent feasible, funds made available for program assistance be used to generate local currencies. A.I.D., however, believed the FAA gave it authority to determine whether or not local currency would be generated. Given the economic conditions in Nicaragua A.I.D. decided that its first two cash transfers programs would not generate local currency (except for $5 million for A.I.D. expenses). However, in conflict with the agreement, the Mission approved operating procedures for the first cash transfer program which required the generation of local currency. To compound matters, the Central Bank of Nicaragua continued to follow these procedures for the second cash transfer program. As a result, the Government of Nicaragua had on deposit $75.6 million equivalent in a separate bank account. The Central Bank of Nicaragua has frequently requested Mission approval to disburse local currency from the special account. The Bank has also

requested the Mission to give an official opinion on the use of $29 million equivalent it has already expended. The Mission had not replied to these requests.

Accountability Requirements For Cash Transfer Generated Local Currency

USAID/Nicaragua amended its second cash transfer agreement to disburse $20 million in direct relation to the Government of Nicaragua reducing its number of public sector employees. We believe that this amendment created a local currency program requiring the Mission to ensure accountability requirements are met. Consistent with U.S. legislation, A.I.D. policy guidance governs the use of host country-owned local currency generated by U.S. foreign assistance. If cash transfer dollars are conditioned upon the recipient country making available a local currency equivalent for agreed upon purposes then, in essence, a local currency generation program has been created. USAID/Nicaragua officials stated that, while it was intended to rapidly disburse $20 million to assist Nicaragua in reducing its level of public workers, it did not want nor intend to create a local currency generation program subject to A.I.D.'s accountability requirements. These officials believe they were successful in wording the agreement in such a manner as to avoid such a program. They, however, could not explain, to our satisfaction, how this was actually accomplished as the agreement contains the conditionality and other factors that trigger a local currency generation program.

RECOMMENDATIONS

We recommended that the Director of USAID/Nicaragua:

- require the Government of Nicaragua, through amendments to the cash transfer agreements or program implementation letters, to strengthen control procedures on import financing arrangements by establishing systems for commodity price checking and commodity end use checking and schedule evaluations for the cash transfer programs.

- issue a mission order formally establishing an overall monitoring and evaluation system as required by A.I.D. Handbook 3, including guidelines which emphasize the monitoring of commodity import financing arrangements under the cash transfer programs.

- obtain written guidance from A.I.D./Washington's Office of the General Counsel as to whether, under the legal provisions that were in effect at the time of executing the first two cash transfer programs, local

currency was generated and, if generated, what action the Mission should take with regard to the first two cash transfer programs.

- obtain written guidance from A.I.D./Washington's Office of the General Counsel to determine whether, under A.I.D. policy, the Mission is required to meet accountability requirements for the local currency associated with the Government of Nicaragua's employment reduction program.

AGENCY COMMENTS

In addition to providing a draft of this report to USAID/Nicaragua officials for comment, a discussion draft was provided and meetings held on report content. The Mission's written response to the draft report reiterated certain issues discussed during those meetings and expanded upon the difficulties faced in implementing the second largest Assistance Program in Central America.

In their comments, Mission officials agreed with the report recommendations except that, with regard to Recommendation No. 1.1, they are initiating alternative action. They also stated that the draft report contained factual evidence underlying each of the findings reported but failed to comment on important events leading up to possible deficiencies reported in the Mission's design, control, and monitoring operations. Mission comments expanded upon those events. Appendix II is a complete text of the Mission's comments to this report.

Copies of this report are being sent to the Chairmen, Senate and House Committees on Appropriations, Senate Committee on Foreign Relations, and House Committee on Foreign Affairs; the Administrator, Agency for International Development; and other interested parties.

Office of the Inspector General

Office of the Inspector General
August 23, 1991

INTRODUCTION

Background

On May 25, 1990, President Bush signed into law "The Fiscal Year 1990 Dire Emergency Supplemental Appropriations Act" (Act), Public Law 101-302, which included $300 million in new economic assistance for Nicaragua. The Congress in providing these funds did not follow the normal appropriation process. Normally funds are appropriated after A.I.D. submits a budget request based upon a country development strategy statement and action plan. In this case however, because of the urgent need, funds were made available in the absence of budget requests.

The Act and associated Congressional committee reports intended the $300 million to:

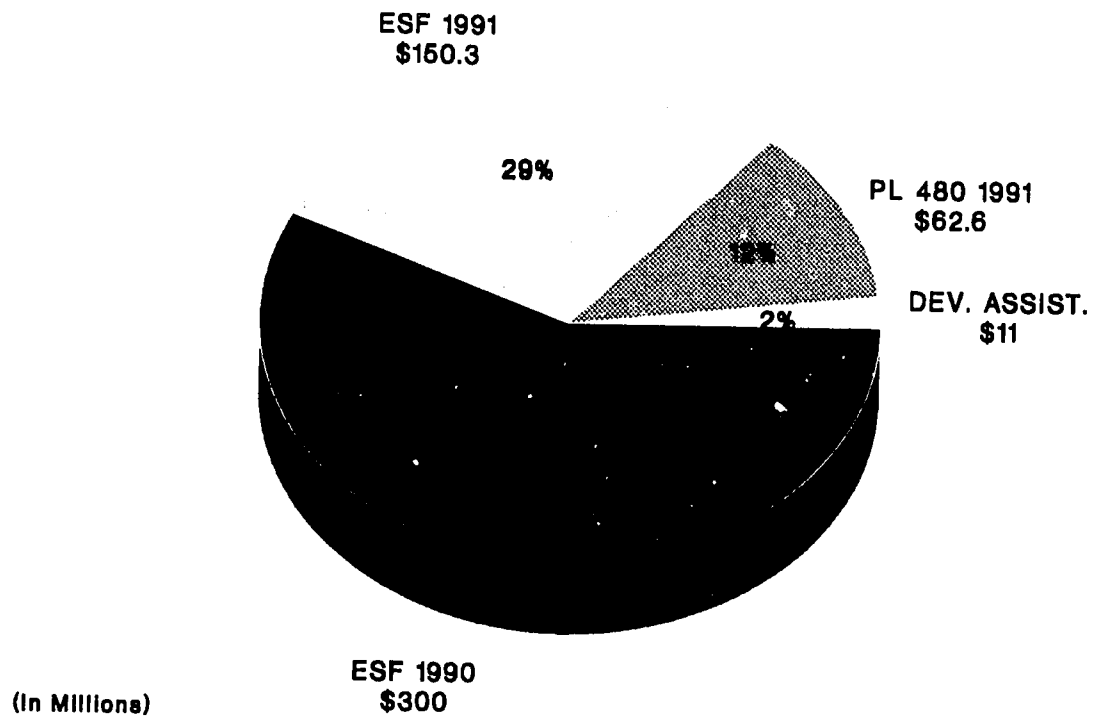
- encourage and assist the Government of Nicaragua in taking the necessary steps to restore the productive capacity of the Nicaraguan economy and achieve long-term economic growth and development;
- help the Government of Nicaragua restore its relations with international financial institutions;
- support international programs for the demobilization and repatriation of the former Nicaraguan Resistance and their families, and also support United Nations observers in that regard; and
- provide funding for child survival, health, education, environmental concerns and private sector development.

To accomplish these tasks, through May 31, 1991 USAID/Nicaragua in conjunction with the A.I.D./Washington/Latin America and Caribbean Bureau (LAC Bureau) designed and developed three cash transfer programs and five projects and was planning eight more projects. A majority of the funding, $315.5 million, has been budgeted for the three cash transfer programs. The first, the Economic Stabilization and Recovery I Program (ESR-I), disbursed $60.0 million to provide the foreign exchange required by the Government of Nicaragua for financing urgently needed public and private sector commodity imports--particularly petroleum products. The

second cash transfer, the ESR-II, had a $68 million component similar to the ESR-I Program, but it also included a $50 million payment to be used to help clear the Government of Nicaragua's arrears with the World Bank and the InterAmerican Development Bank. This second program also included certain conditions which the Government of Nicaragua must meet prior to the disbursal of specified increments of the $118 million. The third cash transfer, ESR-III continues in macroeconomic terms the objectives of the prior programs with additional conditions preceding the disbursement of the budgeted $137.5 million.

From Fiscal Year 1991 appropriations, $150.3 million in Economic Support Funds were provided for Nicaragua. A.I.D. additionally allocated $11.0 million in Development Assistance funds and $62.6 million in Public Law 480 food aid for a total of $223.9 million in Fiscal Year 1991 funding. These funds were to continue the assistance provided under the Act and also to fund projects for family planning, immunization, rural electrification, and support to private voluntary organizations. The following graph shows total A.I.D. assistance to Nicaragua of $523.9 million as of May 31, 1991.

TOTAL A.I.D ASSISTANCE



The Act requires the A.I.D. Inspector General to, "... at least semiannually, beginning six months from the date of enactment of this Act, audit the Economic Support Fund programs provided under this Act for Nicaragua and Panama to assess the financial management and administrative systems established by the Agency to control such programs...." In considering A.I.D.'s request for Economic Support Funds for Nicaragua, the Senate Appropriations Committee requested that the additional funds made available to Nicaragua in Fiscal Year 1991 be audited by the A.I.D. Inspector General consistent with the requirement contained in the supplemental appropriation for Fiscal Year 1990.

The present audit responds to both the audit requirement under the Act and the request for continued audit coverage of Fiscal Year 1991 funding provided for Nicaragua. However, for the present audit we did not review Public Law 480 food activities. With regard to project and nonproject assistance funded under Economic Support Fund and Development Assistance, this report presents the results of the second semiannual audit, covering Assistance Program activities through May 31,1991.

Audit Report No. 1-524-91-004, dated February 8, 1991, covered the first six months (May 25, 1990 through November 30, 1990) of the Nicaragua Assistance Program's implementation. That audit provided our preliminary assessment of vulnerability for each program and project activity, based upon the actual or planned controls to be incorporated into the agreements with external implementing entities. Appendix III shows the apparent weaknesses that were disclosed by that audit and their current resolution status.

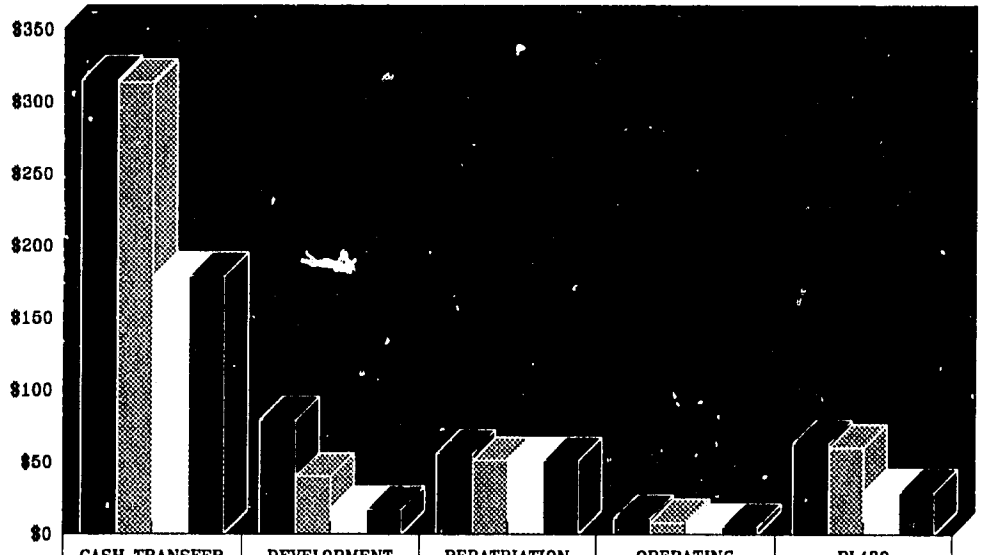
In addition to our internal audit cited above, we issued three reports on Mission-funded non-Federal audits of the Assistance Program. Audit Report No. 1-524-91-30-N dated May 22, 1991 was a review of the Central Bank of Nicaragua's capability to manage cash transfer program activities under the Assistance Program; Audit Report No. 1-524-91-31-N dated May 24, 1991 was a review of the Family Planning Association of Nicaragua's capability to manage a population project under the Assistance Program; and Audit Report No. 1-524-91-32-N dated May 24, 1991, covering the period from May 31 through November 30,1990, was a financial audit of Assistance Program expenditures which could be verified to records available in Nicaragua. (See page 17.)

The present internal audit examines whether A.I.D. designed the Assistance Program to meet the requirements of the Act and additional Congressional

guidance and whether it followed its policies and procedures in implementing, monitoring, and accounting for Assistance Program activities.

As of May 31, 1991, A.I.D. had obligated $472 million of the Assistance Program's funds and had accrued expenditures of $ 281 million. According to information gathered during the audit, the following summarizes the financial status of the Assistance Program in Nicaragua.

UNAUDITED FINANCIAL STATUS
NICARAGUA ASSISTANCE PROGRAM
THROUGH MAY 31, 1991



	CASH TRANSFER	DEVELOPMENT	REPATRIATION	OPERATING	PL480
BUDGETED	$315	$79	$56	$11	$63
OBLIGATED	$313	$40	$51	$8	$60
DISBURSED	$179	$17	$51	$5	$29
EXPENDED	$179	$17	$51	$5	$29

(In Millions)

A financial summary of Assistance Program activities through May 31, 1991, is included as Appendix IV.

Audit Objectives

The Office of the Regional Inspector General for Audit/Tegucigalpa audited A.I.D.'s systems for managing the Assistance Program funded by the Act and Fiscal Year 1991 appropriations to answer the following audit objectives.

1. Did A.I.D. follow the Act and additional Congressional guidance in designing the Assistance Program?

2. Was A.I.D. following its established policies and procedures which control the implementation of individual Assistance Program activities?

3. Was A.I.D.'s system for monitoring, evaluating, auditing, and reporting being implemented with regard to Assistance Program activities?

4. Did A.I.D. obligate, expend, and account for the Assistance Program's funds in accordance with Agency policies and procedures?

Our work to answer these objectives was conducted at USAID/Nicaragua and its accounting station, USAID/Honduras. Therefore, we have answered these objectives mainly in terms of the conditions noted at those A.I.D. Missions. While we did not conduct work in A.I.D./Washington, this report includes references to A.I.D./Washington's role in the Assistance Program to the extent that was verifiable from official documents or was supported by interview with Mission management. In this regard, when reference is made to A.I.D. this most generally refers to USAID/Nicaragua, but in certain instances could also apply to the Agency as a whole.

In answering these audit objectives, we tested whether A.I.D. followed applicable internal control procedures and complied with certain provisions of laws and regulations. Such tests were sufficient to provide reasonable, but not absolute, assurance of detecting abuse or illegal acts that could significantly affect the audit objectives. However, because of limited time and resources, we did not continue testing when we found that, for the items tested, A.I.D. followed its procedures and complied with legal requirements. Therefore, we limited our conclusions concerning these positive findings to the items actually tested.

When we found problem areas, we performed additional work to:

- conclusively determine that A.I.D. was not following a procedure or not complying, in any significant manner, with an A.I.D. policy,
- identify the cause and effect of the problem noted, and
- make recommendations, if appropriate, to correct the condition and cause of these problems.

Appendix I contains a complete discussion of the scope and methodology for this audit.

REPORT OF AUDIT FINDINGS

Did A.I.D. follow the Act and additional Congressional guidance in designing the Assistance Program?

A.I.D. followed the Act and additional Congressional guidance, including the Senate Appropriations Committee report associated with the Fiscal Year 1991 Economic Support Fund appropriation, in designing the Assistance Program.

With regard to specific provisions of the Act:

Voluntary Demobilization, Repatriation, and Resettlement of the Nicaraguan Resistance - The Act provides: "...$30,000,000 shall be for assistance to support the voluntary demobilization, repatriation and resettlement of members of the Nicaraguan resistance and their families...."

A.I.D. has budgeted $43 million to support voluntary demobilization, repatriation, and resettlement of former Nicaraguan Resistance members and their families. A.I.D. transferred, as of May 31, 1991, $38 million of these funds to the Department of State to accomplish these ends. The Department of State, in turn, provided those funds to the Organization of American States for repatriation and relocation activities to include food, shelter, agricultural, and other self-help and training programs.

Environmental Activities - The Act provides: "That up to $8,000,000...may be used for environmental activities, including the preservation of tropical forests, promotion of sustainable agriculture, control of pollution, and restoration of the natural resource base."

The Mission programmed $8 million for the Natural Resources Management Project. This Project, still in design as of May 31, 1991, is directed at improving the management of renewable natural resources and protecting biological diversity at selected sites in Nicaragua. As designed it will support the Government of Nicaragua's environmental strategy.

Forestry Protection - The Act provides: "None of the funds appropriated in this Act...shall be used for any project that would result in any significant loss of tropical forests."

The audit disclosed no evidence that the Mission's projects would result in any significant losses of tropical forests.

A.I.D. Administrative Expenses - The Act provides: "Up to $10,000,000...may be used for the purpose of paying administrative expenses incurred by the Agency for International Development in connection with carrying out its functions...."

The $10 million limit imposed by the Act is a cumulative figure for administrative expenses at both the Nicaragua and Panama Missions. A combined budget shows that $10 million of the Act's funds will be used for this purpose--$6.7 million for Nicaragua and $3.3 million for Panama. The Missions report having $5.4 million of accrued expenditures as of May 31, 1991 ($4.2 million for Nicaragua and $1.2 million for Panama).

With regard to additional Congressional guidance:

Observer Group for Central America - The House of Representatives' Conference Report No. 101-493, dated May 22, 1990, provides: "The conferees...have agreed that $2,000,000 of the funds appropriated for Economic Support Fund assistance for Nicaragua may be used to support the Observer Group for Central America (ONUCA)."

In a Memorandum of Agreement signed August 15, 1990, A.I.D. transferred $2 million of the Act's funds to the State Department as the United States' contribution to the Observer Group for Central America.

Private Sector Development and Budget Support - Conference Report No. 101-493 also provides: "Private sector development and budget support are needed for both countries, but assistance for child survival, health and education are also critical needs in both countries. The conferees expect to receive notifications on assistance to Panama and Nicaragua that show a concern for the social as well as the private sector development needs in these countries."

A.I.D. designed two cash transfer programs to strengthen the public and private sectors and restore the productive capacity of the Nicaraguan economy. The first cash transfer program provides $60 million for commodity imports such as petroleum products, raw materials, spare parts, agricultural inputs, and capital goods from the U.S. and Central America. The second cash transfer program provides $68 million for the same purposes but with the requirement that petroleum imports cannot exceed $45 million and that no less than $23 million may be used for private sector imports. The Mission's overall Assistance Program design also includes several development projects, which support the public sector budget. These include, for instance, the $20.9 million Employment

Generation Subproject and the $7.8 million Public Sector Support Subproject.

Child Survival, Health, and Education - The Mission has supported child survival and health in part by contributing to the development of a five-year health plan for Nicaragua which will be supported on a multi-donor basis. Additionally, using funds provided by the Act and Fiscal Year 1991 appropriations, the Mission has budgeted $1.6 million for child immunization activities, $1.5 million for the Medicines Subproject, and $2.5 million for the Hospitals Subproject. Regarding education, the Mission used Act funding for a $12.2 million Textbooks Subproject and $1.7 million for the Salesian Vocational Education Project.

Central American Institute of Business Administration - Senate Report No. 101-519, dated October 10, 1990, states "The Committee has also received a request from President Chamorro for assistance for the Central American Institute of Business Administration [INCAE].... The need for trained managers in both the public and private sectors is particularly acute during this period of economic restructuring in Nicaragua. The Committee, therefore strongly urges AID to target up to $1,000,000 of these funds [Fiscal Year 1991 Economic Support Funds] to support INCAE in Nicaragua in fiscal year 1991."

The Mission obligated $1.1 million of Act funds in June 1990 and at May 31, 1991 had budgeted an additional $2.1 million of Act funds and $110,000 of Fiscal Year 1991 Economic Support Funds to support the Central American Institute of Business Administration.

Was A.I.D. following its established policies and procedures which control the implementation of individual Assistance Program activities?

A.I.D. followed its policies and procedures for project and nonproject assistance except that it: (1) began assistance activities in advance of developing the normal assistance strategy documents due to the emergency situation, (2) did not prepare the normal specified planning documentation called for by A.I.D. handbooks for the initial development projects but instead followed less stringent documentation guidance issued by the LAC Bureau, and (3) did not notify Congress of subsequent changes in the scope of cash transfer program activities initially notified to Congress. Also, we noted that, although the Mission was following A.I.D.'s policies and procedures, the cash transfer programs did not include certain controls to help ensure funds were used most effectively.

For this audit objective we determined whether policies and procedures requiring major planning documents, (i.e. country development strategy statement, action plan, and final design documents on individual assistance activities) had been followed, whether Congressional Notifications had been made in advance of obligating funds for new assistance activities, and whether assistance agreements incorporated relevant aspects of the approved assistance designs and applicable legal and standard provisions. To answer this objective, eight criteria were reviewed: two were complied with, three were partially complied with, and three were not complied with. The specific criteria reviewed and results are detailed in Appendix V.

Because of the emergency nature of the Assistance Program, the Mission did not prepare a country development strategy statement or action plan prior to initiating assistance activities. It did, however, prepare a short term strategy proposal as a temporary strategy document pending the preparation and approval of the normal documents. Also, after the start-up of initial assistance activities it prepared more thoroughly developed design documents for its later activities. A.I.D. notified Congress on the initial assistance activities based upon what was planned at the time. Also Congressional Notifications have been submitted on an individual basis for new programs and projects since the beginning of Fiscal Year 1991. Regarding assistance agreements, except for the first cash transfer program whose approved final design document required certain control mechanisms which were not incorporated into the agreement, the relevant provisions of final design documents were incorporated into the agreements. Additionally, standard agreement language and provisions, specified per A.I.D. handbooks, were also included into the agreements.

The instances where the Mission did not follow A.I.D.'s policies and procedures as well as instances where the Mission could further strengthen controls are detailed in this report under the captions:

- The Mission, with A.I.D./Washington Approval, Initiated the Assistance Program without a Country Development Strategy Statement or Action Plan

- Final Design Documents For Initial Development Projects Did Not Meet Handbook Standards

- A.I.D. Did Not Notify Congress of Changes in the Scope of Initial Cash Transfer Program Activities

- A.I.D.'s Import Financing Arrangements under the Cash Transfer Programs Can Be Strengthened

The Mission, with A.I.D./Washington Approval, Initiated the Assistance Program without a Country Development Strategy Statement or Action Plan

A.I.D. is required to provide assistance within its development strategy for each country. This strategy, developed by A.I.D. missions and approved by their Geographic Bureau in A.I.D./Washington, is called the country development strategy statement (CDSS). The CDSS is a five-year document which is updated as needed to reflect changes in A.I.D.'s objectives or the country's situation. Handbook 3, Chapter 1 states that the CDSS should provide the framework for a mission to respond to a country's development problems. Projects which respond to priority development problems which arise but which are not identified in the strategy statement may be identified and proposed for funding. Such proposals, however, should be accompanied by the functional equivalent of a supplementary CDSS justification. Guidance relating to the development of such strategies is included in Handbooks 1 and 2, and in Agency cables.

Action plans serve as a bridge between the missions' CDSSs and their operational programs. They link the strategies with projects and focus management attention on the effectiveness of the program in achieving CDSS goals. Guidance on the development of action plans is provided in Agency cables and memoranda.

Initial work in developing the Assistance Program took place in the LAC Bureau and neither a CDSS nor its functional equivalent was prepared. Although the initial assistance activities were approved by the LAC Bureau, the Mission was concerned about its lack of an assistance strategy and addressed its concerns by developing the "USAID/Nicaragua Short-term Strategy Proposal, November 1990." The Mission considered that the proposal temporarily served the role of a CDSS. The Mission was in the process of developing a CDSS as of the end of our audit period and informed us that they planned to submit it to the LAC Bureau for approval in July 1991.

An action plan was also not prepared. The Mission intended its short term strategy proposal to also serve as a guide in planning further programs and projects for its portfolio of assistance activities. The Mission is presently developing an action plan for Fiscal Years 1992 and 1993 which it plans to submit to the LAC Bureau in December 1991.

Although the Mission did not prepare a CDSS and action plan prior to initiating Assistance Program activities, this decision had the approval of the LAC Bureau. Since the Mission is preparing the two assistance strategy documents, no recommendation is necessary.

Final Design Documents For Initial Development Projects Did Not Meet Handbook Standards

A.I.D. procedures require that project agreements and, in normal circumstances, nonproject agreements as well, be preceded by a preliminary analysis and summary justification of the assistance. Thereafter, unless an exception applies, a more detailed analysis and full-scale development of assistance design is required. These procedures were not always followed in the development of the Assistance Program design documents.

Regarding the assistance activities funded under the Act, the Mission had signed agreements for two cash transfer programs and four development projects which were preceded by approved final design documents by the audit cutoff date. For the two cash transfer programs, the agreements had been preceded by the detailed analysis and full-scale development of the assistance design required by A.I.D. Handbook 4, Chapter 3. However, the programs could reflect certain additional controls which would help ensure more effective use of funds (see page 12 for further discussion of this issue).

For the four development projects, none of the agreements were preceded by the normal detailed analyses specified by Handbook 3. The agreements for three of the four projects were preceded only by unsolicited proposals. Supplement A to A.I.D. Handbook 3 requires that a project identification document (PID) (a preliminary analysis type document) be prepared after an unsolicited proposal has been received, and that following approval of the PID that a more detailed analysis be prepared. These handbook procedures were not followed.

The fourth project was developed in coordination with the LAC Bureau. It involves six subprojects and the majority of the funds obligated for projects thus far. For this project, A.I.D. decided to shortcut its normal documentation requirements as permitted under a Handbook 3 Chapter 4 exception for projects being funded with Economic Support Funds. Under the exception, a PID or its equivalent is still required. However, A.I.D. did not do the level of analysis needed to prepare this document. Instead it prepared a "PID-like" document which served as the final design document for four of the subprojects but contained little of the analysis specified by Handbook 3, Chapter 2 for a PID. The LAC Bureau directed the Mission to prepare "project paper-like" documents for two of the subprojects. A project paper provides the detailed analysis and full-scale development of the project design. A.I.D. Handbook 3 makes no provision for "project-paper-like" documents. Although the two documents which were prepared contained little of the analysis specified by Handbook 3 they did meet less stringent guidance furnished the Mission by the LAC Bureau.

The Mission is in the process of developing five more projects to be funded under the Act and plans to prepare a project paper for each.

Under its Fiscal Year 1991 Economic Support Fund and Development Assistance funding, the Mission is planning an additional cash transfer program and four new development projects. Agreements on the cash transfer program and one development project have already been signed. Both agreements were preceded by the normal detailed analysis and full-scale development of the assistance design as required by A.I.D. procedures, and the Mission planned to prepare Agency-required project papers on each of the three remaining development projects.

Although the Mission's final design documents for the Assistance Program's initial development project activities did not meet Handbook standards, those projects are already underway and some activities are planned to be completed within the next few months. For this reason we are not making a recommendation concerning documenting the design of these activities.

Mission Comments and Our Evaluation

The Mission stated that the four projects cited in our report were developed in a manner and form specifically authorized by A.I.D. Washington.

The level of project authorization is not the issue. The issue is that the projects' documentation did not meet the normal standards specified by A.I.D. handbooks.

A.I.D. Did Not Notify Congress of Changes in the Scope of Initial Cash Transfer Program Activities

Congressional Notification (CN) requirements are based primarily on Section 634A of the FAA and Section 523 of the Appropriations Act. These Acts require that Congress be notified in advance of obligating funds for a new assistance activity.

A.I.D. initially submitted CNs on its major Assistance Program areas funded under the Act, and since the beginning of Fiscal Year 1991 the Mission has been submitting individual CNs on each new program and project.

Regarding initial Act funded activities, three CNs were submitted: one for a single cash transfer program which was later implemented as two separate programs, another for a single development program consisting of seven areas which was implemented through multiple projects and subprojects, and a third for the Nicaraguan Demobilization, Repatriation and Resettlement Program implemented through the Department of State.

Documentation procedures for CNs are based on joint A.I.D. and Congressional staff agreements and leave considerable leeway for judgment with regard to renotifying Congress in the case of a change to an assistance activity previously notified. According to LAC Bureau Program Guidance No. 91-04, dated March 5, 1991, substantive changes to the scope of a previously notified project require renotification, but a change in activities does not **per se** require a CN if the additional activities are seen as potentially implied within the initial description of the project.

Using this guidance, we believe that subsequent changes in the activities under the initially notified cash transfer program could have been the basis for Congressional renotification by A.I.D. Specifically, the Congress was notified that there would be one cash transfer program. This original notification was silent with regard to conditionality and host country policy reforms. However, during implementation A.I.D. created two cash transfer programs, the second of which required the Government of Nicaragua to make significant economic policy reforms.

We did not note any issues regarding the CNs submitted since the beginning of Fiscal Year 1991.

We are not making a recommendation regarding the initial Act- funded activities because the Congressional Notification guidance cited above is subjective. Also, the General Accounting Office's interim report to Congress dated May 1, 1991, has provided the Congress with information on these activities.

A.I.D.'s Import Financing Arrangements under the Cash Transfer Programs Can Be Strengthened

A.I.D.'s import financing arrangements for $265.5 million of commodities under the first three cash transfer programs in Nicaragua could be strengthened. The use of commodity price and end use checking procedures, although included as a condition prior to disbursements in the first program design document, was not included in the cash transfer agreement. This condition was not included in the agreement because in preparing the agreement A.I.D. apparently used an unapproved version of the document which did not include the condition. Also, program evaluations, an effective management control, have not been scheduled.

As a result, there have been instances in Nicaragua of less than effective use of A.I.D. funds, and there is less assurance that import financing is having the greatest possible impact on the recovery of the Nicaraguan economy.

<u>Recommendation No. 1</u>: We recommend that USAID/Nicaragua:

1.1 require the Government of Nicaragua, through amendments to the cash transfer agreements or program implementation letters, to strengthen control procedures on import financing arrangements by establishing systems for commodity price checking and commodity end use checking; and

1.2 schedule evaluations for its cash transfer programs.

A.I.D. Handbook 4 defines cash transfers as the release of funds without documentation showing the actual use that will be made of the funds. The Handbook also states that cash transfers cannot be used as a method of financing commodities. However subsequent Agency cable guidance on the subject, namely State 325792 of October 1987 and State 194322 of June 1990, allows Missions to use cash transfer funds for import financing and advises Missions to establish separate, noncommingled accounts for cash transfer dollars and to track such funds to their final acceptable uses.

Although the Mission was following the current A.I.D. policies and procedures for cash transfer programs, they could be strengthened by the use of price and end use checking procedures and program evaluations.

Price and end use checking were made a part of the PAAD for the first cash transfer program. The PAAD provided:

> Prior to the disbursement of funds to the separate account, the GON [Government of Nicaragua] must provide in form and substance satisfactory to A.I.D., a letter describing the mechanism by which funds will be disbursed from the account for approved private sector activities as well as the program procedure for...selection criteria, monitoring, end-use and price-checking of dollar-funded transactions and reporting requirements.

This condition was not included in the agreement, apparently because A.I.D. used an unapproved version of the PAAD, which did not include the condition, in preparing the agreement. A.I.D. Handbook 4 Chapter 3 states that any material deviation from the terms of a PAAD during negotiation or implementation of the corresponding agreement requires amendment of the PAAD. The PAAD was not amended.

The absence of price checking controls has in certain instances led to less than effective use of A.I.D. dollars in Nicaragua. At our request, A.I.D./Washington's Office of Procurement/Commodities did a pricing analysis on a sample of 23 transactions selected from the first two cash transfer programs. The results of their analysis showed that at least 8 commodity suppliers or 35 percent appeared to be trading firms. According

to the Office of Procurement/Commodities it is routine for such firms to mark up commodities 10 to 30 percent over the price of the direct supplier. This statement was confirmed by their analysis of the individual transactions. For example, one transaction showed that a distributor's markup for spare aircraft parts, valued at $61,221, ranged from 65 percent to 125 percent higher than a quote from another distributor who is a frequent participant in A.I.D.-financed programs. In another transaction, a company's markup for a shipment of mayonnaise jars, valued at $165,000, was about 30 percent higher than the quote from a competitor. These higher costs may have been avoided had A.I.D. required, in its cash transfer agreements, that the Government of Nicaragua establish a price checking unit.

Neither A.I.D. nor the Government of Nicaragua had performed end use checks to verify if usage of such commodities was in fact assisting the domestic production efforts. Also, although A.I.D. has been contemplating performing evaluations on the second and third cash transfer programs, it had not formally scheduled these evaluations to assess the overall effectiveness and impact of the cash transfer programs. Both end use checks and program evaluations are important tools to assist the Mission in its management of the future direction of its programs.

We believe price checking, end use checking, and program evaluations, although not required by A.I.D.'s policies and procedures on cash transfers, could increase the effectiveness of A.I.D's import financing arrangements.

Mission Comments and Our Evaluation

The Mission stated that the establishment of price and end use controls by the Central Bank of Nicaragua would have a negative impact on exchange market liberalization in Nicaragua. Accordingly, the Mission stated that, in conjunction with GC/LAC, it will request that the LAC Assistant Administrator amend the PAAD for ESR I, deleting those provisions that pertain to price and end use checking.

Amending the PAAD is one alternative that A.I.D. can take to effectively resolve the issue of noncompliance regarding the requirement that the agreement contain all significant aspects of the PAAD. While we believe price and end use controls would positively impact the Assistance Program, the responsibility for effective use of cash transfer funds remains with A.I.D. management.

The Mission agreed with Recommendation No.1.2 and has scheduled an evaluation for September/October this year. Consequently, Recommendation No.1.2 is resolved and closed upon issuance of this report.

Was A.I.D.'s system for monitoring, evaluating, auditing, and reporting being implemented with regard to Assistance Program activities?

A.I.D. followed its policies and procedures for monitoring, evaluating, auditing, and reporting except that it did not: (1) issue a mission order formally establishing its monitoring and evaluating system, (2) prepare information plans as part of its assistance designs, and (3) include elements in the design of its initial bilateral projects and one operational program grant to compare results with plans. Furthermore, it appears, in one instance, that local currency had been generated as a result of cash transfer dollar assistance which was subject to legal requirements and A.I.D. policy. These requirements and policy were not being implemented. Also, we noted that local currency may have been generated inadvertently under the first two cash transfer programs.

The Mission was, for the most part, following A.I.D.'s policies and procedures with regard to: 1) the preparation of plans relating to monitoring, evaluating, and auditing, 2) the legal and policy requirements for cash transfer dollars and associated local currency generations, and 3) the reporting requirements to A.I.D./Washington. To answer the objective, nine criteria were reviewed: three were complied with, two were partially complied with, and four were not complied with. The specific criteria reviewed and results are detailed in Appendix V.

Regarding the preparation of plans related to monitoring, evaluation, and auditing, it should be noted that while Handbook 3 specifies a general requirement for information plans for all programs and projects, further specific requirements for the different types of assistance vary. In this regard we noted that of 15 agreements that had been signed through May 31, 1991, 12 had some degree of planning for monitoring, 6 had evaluation plans, and 10 had audit requirements.

With regard to audit, the Mission has additionally funded a financial audit, under our supervision, of all Assistance Program activities that can be verified to records available in Nicaragua, as well as two Mission funded award surveys that were completed during this reporting period.

Audit coverage through November 30, 1990 for the financial report involved $51.3 million of expenditures on the Mission's first cash transfer program and three development projects. The audit scope was limited to expenditures which could be verified to records available in Nicaragua. The audit disclosed $843,236 of questioned costs relating to paid transactions and also noted $532,106 of questionable transactions relating to funds that had been committed but not yet paid. Except for the cited questioned costs

the auditors found that the fund accountability statement for the Assistance Program fairly presented, in all material respects, the locally-executed receipts and disbursements for Assistance Program activities managed by the Government of Nicaragua and the implementing entities for the audit period. The auditors noted material weaknesses in the internal control structure of the Central Bank of Nicaragua, the implementing entity that administers the cash transfer programs. The Bank lacked controls in financial reporting, documentation of use of competitive bidding, and monitoring of program transactions. With respect to compliance, the report disclosed the Bank complied, in all material respects, with agreement terms and applicable laws and regulations.

With regard to the award surveys the report on the Family Planning Association of Nicaragua concluded that the Association had sufficient management capability and internal control structure for project purposes and for the items tested had the capability to comply with laws, regulations, contracts, and grants relevant to the project. But the auditors also concluded that the Association did not have the financial capability required to undertake the project under an expense-reimbursement method. The auditors were not provided the bases, criteria or documentation supporting the proposed direct and indirect costs and, because of this scope limitation, they did not express an opinion on the project's proposed costs. Finally, the report disclosed that the Association did not have adequate manuals to provide guidelines for project execution.

The award survey of the Central Bank of Nicaragua concluded that the Bank had sufficient management capability and span of control to adequately manage the cash transfer program activities and was financially capable of managing these activities. The auditors also concluded that the internal control procedures established at the Bank were generally adequate, although they noted that the Bank could improve program implementation by better defining controls over data processing and by establishing a unit for coordinating program operations. In their tests of the Bank's compliance with the grant agreement's conditions precedent and applicable laws and regulations, the auditors determined that not all implementing officials had been provided with listings of eligible goods, which could result in utilizing program funds for ineligible transactions.

Regarding legal and policy requirements for cash transfer dollars and local currency, we found that the Mission had followed the separate account requirements for the dollars and that the Mission's one apparent instance of noncompliance with accountability requirements for local currency was unintentional. With regard to reporting we found that the Mission had met its reporting requirements to A.I.D./Washington.

In addition, for five agreements reviewed, the Mission had monitored implementing entity compliance with agreement reporting requirements. Lastly, our review of two cash transfer programs and two project activities to assess the effectiveness of the Mission's monitoring revealed that the Mission's monitoring was adequate for one project activity. The Mission was increasing its monitoring efforts on the two cash transfer programs and the other project activity.

The instances where we noted that the Mission did not follow A.I.D.'s policies and procedures as well as one instance needing further attention by the Mission are detailed in this report under the captions:

- The Mission Had Not Formally Established Its Monitoring And Evaluation System
- The Mission Did Not Prepare Information Plans As Part Of Its Assistance Designs
- The Mission Did Not Design Initial Bilateral Projects and One Operational Program Grant To Permit Comparison of Planned to Actual Results
- Local Currency Was Inadvertently Resulting from the Cash Transfer Programs
- The Mission's Obligation To Follow Local Currency Accountability Requirements Needs To Be Determined

The Mission Had Not Formally Established
Its Monitoring And Evaluation System

Each Mission is required to establish its own monitoring and evaluation system and to issue a mission order describing the organization, operation and responsibilities within its system. USAID/Nicaragua had not formally developed such a system and was thereby not achieving the benefits a systematic monitoring and evaluation process could offer.

> **Recommendation No. 2: We recommend that USAID/Nicaragua issue a mission order formally establishing its overall monitoring and evaluation system as required by A.I.D. Handbook 3, including guidelines which emphasize the monitoring of its commodity import financing arrangements under its cash transfer programs.**

A.I.D. Handbook 3, Supplement to Chapter 12 (the A.I.D. Evaluation Handbook), provides general guidance on monitoring and evaluating both

project and nonproject assistance. Further guidance specific to the different types of assistance is provided in the A.I.D. handbooks and in certain Agency cables.

Because of the diversity of problems in developing countries A.I.D. policy requires each mission to establish a monitoring and evaluation system that complies with Agency and Bureau procedures and standards. Missions are also required to issue a mission order which describes the organization and operation of its system and the responsibilities of its project officers.

Although the Mission had not issued a mission order establishing its overall monitoring and evaluation system, it was performing effective monitoring of known problems within available resources. Nonetheless, a formal monitoring system is needed to better ensure all significant problems are identified, especially considering the level of funding provided under the Assistance Program.

The following situations illustrate the need for and benefits that can be derived from an effective monitoring system:

- The Central Bank of Nicaragua, as of May 31, 1991, had financed imports under the first cash transfer program amounting to $60 million. The agreement for this program was signed in May 1990, but it was not until we questioned the eligibility of certain transactions early in our previous audit (Report No. 1-524-91-004) that the Mission began reviewing the Central Bank of Nicaragua transactions. As of May 31, 1991 ineligible transactions identified under this first cash transfer agreement totaled $6.8 million. Under the second cash transfer agreement the Mission has identified an additional $1.6 million of ineligible transactions. The ineligible transactions included items such as chemical compounds, pesticides, brewery machinery and beer bottles, and petroleum which was used by the military.

- The Medicines Subproject resulted from an amendment to a Medicines project started during the immediate phase of assistance to Nicaragua before the passage of the Act. Initially the LAC Bureau managed the project but did not have a written agreement with the Government of Nicaragua to control distribution of medicines to the intended recipients. In response to our noting the potential vulnerability of initial shipments of medicines to misuse, the Mission executed a memorandum of understanding (MOU) with the Government of Nicaragua. This MOU required the Government to provide the Mission with distribution and security plans and shipping reports to assist the Mission in its monitoring activities. However, these requirements were

not met until after three additional shipments of medicines were delivered.

Despite the earlier lack of controls, the Mission has devoted increased effort to monitoring this Subproject. Specifically the Mission has: visited the central warehouse where medicines are delivered prior to their distribution, analyzed shipping and receiving reports, and obtained the reports required under the agreement.

We believe the examples demonstrate the need for the Mission to establish a formal monitoring and evaluation system as required by A.I.D. policy.

Mission Comments and Our Evaluation

The Mission agreed with Recommendation No.2 and indicated it will issue a mission order on its overall monitoring and evaluation systems and procedures.

Recommendation No.2 is resolved and will be closed when the Mission submits the published mission order.

The Mission Did Not Prepare Information Plans As Part Of Its Assistance Designs

The A.I.D. Evaluation Handbook cited in the previous section also states that final planning documents for projects and programs must include an information plan specifying the data collection, monitoring, and evaluation activities to be conducted and the resources and other arrangements necessary to implement the plan. None of the Mission final design documents or agreements contained an information plan. However, certain aspects of information plans were generally covered as part of other plans, e.g. implementation, monitoring and evaluation plans, or were evident from the narrative of the final design document or agreement.

The Mission should assess its ongoing projects against the standards for information plans and modify its monitoring and evaluation activities as appropriate. Also new assistance designs should include specific information plans meeting the standards of the A.I.D. Evaluation Handbook. Since the Mission officials stated information plans would be prepared in the future, we are not making a formal recommendation in this regard.

Mission Comments and Our Evaluation

The Mission stated that all elements of an information plan were included in all Mission project designs except for the four projects obligated in Fiscal Year 1990.

Our review of Fiscal Year 1991 project designs disclosed that at least two did not contain all elements of an information plan.

The Mission Did Not Design Initial Bilateral Projects and One Operational Program Grant To Permit Comparison of Planned to Actual Results

Section 621A(b) of the FAA requires the establishment of a management system that includes a definition of objectives for U.S. foreign assistance, development of quantitative indicators of progress toward those objectives, and adoption of methods for comparing actual results of programs and projects with those anticipated when they were undertaken.

A.I.D. Handbook 3[1] contains implementing guidance for bilateral projects and operational program grants. This guidance specifies five elements to be included in a project design i.e. baseline data, targets, progress indicators, planning assumptions and evaluative factors. Targets, progress indicators and planning assumptions are to be included in a logical framework matrix which defines the expected relationships between the inputs, outputs, purpose, and goal of the project.

The Mission's initial four bilateral subprojects and one operational grant did not include logical frameworks. However, since October 1, 1990, the Mission has generally been implementing Handbook 3 guidance and accordingly we are not making a recommending corrective action.

Local Currency Was Inadvertently Resulting from the Cash Transfer Programs

The FAA requires that local currency generated as a result of A.I.D.'s assistance be placed in noncommingled accounts and A.I.D. policy specifies certain accountability requirements regarding the use of such funds. Until a recent legal interpretation concluded otherwise, A.I.D. assumed that it could decide whether or not local currency would be generated from cash transfers. Following this assumption A.I.D. did not require, given the economic conditions in Nicaragua, the generation of local currency (except

[1] Specifically A.I.D Handbook 3, Chapter 3, Appendix 3K and Chapter 4, Appendix 4B.

for $5 million equivalent to be used for the Mission's operating expenses). However, in conflict with the agreement, the separate account operating procedures approved by the Mission for the first cash transfer program contained a provision to generate local currency which the implementing organization followed for the first and second cash transfer programs. As a result of following this provision, the Government of Nicaragua has on deposit $75.6 million equivalent in a Central Bank special account as of May 31, 1991.

> **Recommendation No. 3: We recommend that USAID/Nicaragua obtain written guidance from A.I.D./Washington's Office of the General Counsel as to whether, under the legal provisions that were in effect at the time of executing the first two cash transfer programs, local currency was generated and, if generated, what action the Mission should take with regard to the first two cash transfer programs.**

For Fiscal Year 1990, Section 531(d) of the FAA provided that, **to the maximum extent feasible, funds made available for program assistance be used to generate local currencies.** FAA Section 609(a) applied to ESF commodity import grants and required a special account (noncommingled bank account into which local currency is deposited) when there are "arrangements which will result in the accrual of proceeds" to the host country from the sale of the commodities. Also, Section 592(a) of the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1990 (the 1990 Appropriations Act) applied the requirement for special accounts to all FAA assistance when there were "arrangements which result in the generation of local currencies". However, none of these provisions provided a definition of the word "generate" or "generations".

In Fiscal Year 1991, Section 575(a) of the 1991 Appropriations Act superseded the above provisions, but did not resolve the issue of when and under what circumstances local currency is "generated". However, an A.I.D. Office of the General Counsel memorandum of March 8, 1991 examined the issue in connection with Section 575(a) and concluded that local currency is generated (thereby triggering the special account requirement) when the use of assistance dollars, or goods or services financed therewith, will directly and foreseeably result in the receipt of local currency by the host government.[2] Under this interpretation, one circumstance in which local currency is generated would be when

[2] The memorandum did not address whether the same interpretation would hold true under Section 592(a) of the previous year, but it indicated that the operative words of both section 575(a) and 592(a) were the same.

assistance dollars are placed in a separate account and used for private sector imports.

Prior to the Office of the General Counsel's March 1991 interpretation, A.I.D. believed, in developing the first two cash transfer programs for Nicaragua in 1990, that Section 531(d) of the FAA gave it the authority to determine whether or not local currency generations were needed.

In exercising this authority, A.I.D. decided that, given the hyper-inflationary economic conditions in Nicaragua in the early 1990s, the first two cash transfer agreements would not require the Government of Nicaragua to make any local currency deposits, except for the equivalent of $5 million to be deposited over a three-year period under the second program. The Mission would use this $5 million for its operating expenses. Accordingly, agreements with the Government of Nicaragua contained no provisions, except as noted above, requiring the deposit of local currency into a special account.

Although the agreements themselves required no deposit of local currency, Mission-approved separate account operating procedures under the first cash transfer program, included by reference in the agreement, required the Government of Nicaragua to make such deposits equivalent to dollars disbursed plus monthly interest. Although these procedures were included only in the first cash transfer program, the Government of Nicaragua has continued depositing local currency under the second program as well.

As of May 31, 1991, the Bank reported to the Mission that local currency valued at $75.6 million equivalent was on deposit in the account.[3] This accumulation of local currency may help the Government of Nicaragua dampen short-term inflationary pressures by taking currency out of circulation. However as noted in a financial analysis for nonproject assistance in A.I.D. Handbook 4, once large local currency balances are created, "...temptation mounts to undertake activities the economy cannot afford."

Consistent with this rationale, Central Bank of Nicaragua officials have frequently requested Mission approval to disburse local currency from the special account. Further, in May 1991, the Central Bank informed the Mission that, out of the local currency resulting from the second cash transfer program, it had already utilized the equivalent of $29 million to finance the Government's Employment Conversion Program and Budgetary Support Program. The Bank also requested the Mission issue an official

[3] After adjustment for devaluations and withdrawals, this reported balance was equivalent to A.I.D. disbursements plus earned interest.

opinion on the utilization of these funds. The Mission had not replied to any of these requests as of the end of our audit period.

We believe that the Mission should seek written legal guidance on this issue and, if required by such guidance, make a determination, in coordination with the Government of Nicaragua, how to use the local currency proceeds.

Mission Comments and Our Evaluation

Although the Mission agreed with Recommendation No.3, it stated that the recommendation inferred retroactive application of Section 575(a) of the 1991 Appropriations Act. The Mission also stated that it had sought further clarification and guidance from A.I.D.'s Office of General Counsel via telephone during June 1991.

Our recommendation does not make this inference, but rather asks the Mission to obtain clarifying written guidance. Because the Mission stated that it will seek written guidance from A.I.D./Washington, Recommendation No. 3 is resolved and will be closed upon our receiving evidence to that effect.

The Mission's Obligation To Follow Local Currency Accountability Requirements Needs To Be Determined

Consistent with U.S. legislation, A.I.D. policy guidance governs the use of host country-owned local currency generated by U.S. foreign assistance. If, in a cash transfer program, A.I.D. conditions the disbursement of dollars to the recipient country's generating a local currency equivalent for agreed upon purposes, then, in essence, a local currency generations program has been created. We believe A.I.D. created such a program in Nicaragua when, in response to a host government request for financing a public sector employment reduction program, A.I.D. reprogrammed $20 million under the second cash transfer agreement and conditioned its disbursement upon the Government's commitment to implement the employment reduction program. USAID/Nicaragua did not believe it had created a local currency generations program and consequently did not ensure that accountability requirements for the local currency generated were met.

Recommendation No. 4: We recommend that USAID/Nicaragua obtain written guidance from A.I.D./Washington's Office of the General Counsel to determine whether, under A.I.D. policy, the Mission is required to meet accountability requirements for the local currency associated with the Government of Nicaragua's employment reduction program.

Consistent with U.S. legislation, A.I.D. policy guidance governs the use of host country-owned local currency generated by, or otherwise made

available as a result of, U.S. foreign assistance, including Economic Support Funds. If, in a cash transfer program, A.I.D. conditions the disbursement of dollars to the recipient country's generating a local currency equivalent for agreed upon purposes, then, in essence, a local currency generations program has been created.

Although it is the Mission's position that no local currency program has been created in Nicaragua, we believe that a program was created, albeit unknowingly, when the Mission amended the second cash transfer agreement. The following details how this occurred.

In its economic stabilization and recovery proposal of September 1990, the Government of Nicaragua included a program to rapidly reduce public sector expenditures. Central to that program was the reduction of the public deficit to a level which could be financed without significant currency creation. The program also called for an expedient reduction of the number of government employees.

The Government of Nicaragua decided to achieve its civilian employment reduction by inducing workers to resign voluntarily. However, funding such incentives would increase the fiscal deficit and risk undermining economic stabilization efforts. Thus the Government of Nicaragua sought financial help from A.I.D.

The total cost of employees resigning voluntarily from the government payroll including cash outlays and reduced tax revenues was estimated by the Government of Nicaragua at the equivalent of $21 million. The Government of Nicaragua requested that the Mission finance $20 million of these costs.

In its analysis of this request, the Mission concluded that, if the Government of Nicaragua simply printed local currency to finance the employment reduction program without backing the new currency with further inflows of foreign exchange, rapid inflation would result which the economy could not afford. The Mission concluded it would accelerate the disbursement of cash transfer dollars and alter conditionality for their release specifically to reductions in civilian public sector employment.

In January 1991, the Mission amended the cash transfer agreement to permit $20 million to be disbursed for financing eligible imports but, in direct relation to the Government of Nicaragua's implementation of its employment reduction program. Disbursement of the $20 million was to be made in four tranches of $5 million, each tranche in advance of the reduction of 2,500 public-sector employees. The Mission disbursed the first $5 million tranche but reduction had yet to be achieved to permit further disbursements as of May 31, 1991.

In approving the PAAD amendment, the Mission stated that the cash transfer agreement amendment provided no local currency generations or use tracking. It stated that the dollars would still be for import financing but disbursements would be performance related, triggered by the Government's commitment to reduce public sector employment as well as the actual release of personnel. However we believe the decision to condition the release of dollars on the Government's commitment to implement a specific activity did, in fact, create a local currency generations program subject to A.I.D. policy requirements.

Normally, for local currency programs, certain A.I.D. accountability requirements must be met. Included is the requirement for the host government to establish an interest-bearing special account into which, upon A.I.D.'s disbursement(s) of dollars into a separate account, the local currency equivalent will be deposited. A.I.D. policy explicitly encourages Mission participation in the programming of such local currency generations to achieve developmental objectives. In general, the more a Mission is involved in programming local currency, particularly on a activity-specific basis, the more Mission oversight is required. State cables 327494 of October 1987 and 224820 of July 1988 detail a mission's responsibilities regarding the programming and monitoring of local currency generations according to their level of programming.

USAID/Nicaragua had not planned for these accountability requirements for the local currency generated by the amendment to the second cash transfer agreement because it did not believe a local currency program had been created. We believe the Mission should seek written guidance from the Office of the General Counsel to determine whether A.I.D. accountability requirements apply in this situation.

Mission Comments and Our Evaluation

While agreeing with Recommendation No. 4 the Mission stated that, due to political considerations, it should not be directly involved in the accountability requirements of a local currency generation program. The Mission further stated that the report uses A.I.D. Policy Determination No. 5 as criteria.

The report did not address A.I.D. 's involvement in a political context, only that a local currency program was created thereby requiring A.I.D. accountability. Policy Determination No. 5, although mentioned in an earlier draft, was not used as criteria since the two more recent cables, discussed above, further detailed the Mission's responsibilities with regard to programming and monitoring of local currency generations. Recommendation No. 4 is resolved and will be closed upon receiving

evidence that the Mission has obtained written guidance from General Counsel.

Did A.I.D. obligate, expend, and account for the Assistance Program's funds in accordance with Agency policies and procedures?

A.I.D. was obligating, expending, and accounting for the Assistance Program funds in accordance with Agency policy and procedures. The Mission, however, did not communicate accrued project expenditures to its accounting station, USAID/Honduras, resulting in inaccurate reporting to A.I.D./Washington.

A.I.D. policies and procedures for obligating, expending and accounting for project and nonproject assistance are found in A.I.D. Handbook 19 and the Controller's Guidebook. Accounting controls and processes relate to funds control, payment, closing, and reporting. Funds control relates to organizational control points and assures fund availability prior to any commitment to expend. Payment controls ensure that no funds are disbursed unless properly authorized and that cash advances are not in excess of recipient needs. The closing process comprises controls to assure consistency and data integrity within the Mission accounting system and between the Mission and A.I.D./Washington. The reporting process relates to the transmission of financial data. For the items tested, we found these controls implemented and generally complied with. To answer the objective nine criteria were reviewed: eight were complied with and one was partially complied with. The specific criteria reviewed and results are detailed in Appendix V.

However, there was a problem regarding accrued expenditures which are recorded during the quarterly closing process and reported through the reporting process.

Certain Accrued Expenditures Were Not Recorded

A.I.D. policy requires accounting on an accrual basis. Also, General Accounting Office internal control standards required by the Federal Managers' Financial Integrity Act call for prompt recording of transactions. However, accrued expenditures for three projects were not promptly recorded because USAID/Nicaragua did not report necessary information to its accounting station, USAID/Honduras. As a result, Mission project accruals reported to A.I.D./Washington for March 31, 1991 were understated by $1,139,731.

Chapter 13 of the A.I.D. Controllers Guidebook states that "Project ledgers for both loan and grant projects will be maintained on the accrual basis." In accordance with this policy the Mission's accounting station enters accrued expenditures into the mission accounting control system (MACS) on a quarterly basis. The accounting station relies on the accrual information provided by USAID/Nicaragua.

As of March 31, 1991, the Mission's accounting station did not report accrued expenditures for three of USAID/Nicaragua's projects. However, USAID/Nicaragua grantee reports showed expenditures for these three projects aggregating $1,139,731. At that point in time, USAID/Nicaragua retained accounting responsibility for eight projects and the missing accruals for the three projects represents a significant omission. This resulted in the Mission's quarterly report to A.I.D./Washington and the accrued expenditure report for March 31, 1991 was understated by $1,139,731.

After we informed Mission officials of this problem, they agreed that these accruals should have been reported to the accounting station. Mission management detailed, in writing, the control system they had established to ensure that such accruals were reported to their accounting station. It was also stated that the reported problem was due to human error rather than the lack of established controls. For this reason we are not making a recommendation at this time.

Issues Needing Further Study

As discussed in Appendix III, several issues noted during our first audit for the period ended November 30, 1990 were not resolved during the current audit period nor addressed by a specific recommendation in the present audit. These unresolved issues are:

- The cash transfer programs' implementing entity, the Central Bank of Nicaragua, continues to commit assistance dollars in favor of potential importers in advance of the importers bringing in the local currency equivalent of the dollars set aside to finance the transaction. Potential importers have 45 days to settle their transactions and in some cases are unable to raise the local currency needed. As a result, despite a strong demand for the dollars, assistance funds have lain idle. An assessment should be made to determine the reasonableness of the Central Bank's practice considering the Bank's claim that the Nicaraguan economy is currently illiquid.

- A.I.D. financed oil imports are still benefitting Nicaragua's military and police forces. Nicaragua's Central Bank reimbursed the program $4.3 million for past military consumption and has now proposed an initiative to estimate civilian and military consumption for each shipment of oil, committing A.I.D. dollars only for financing the civilian portion. The Mission plans to monitor this procedure. However, there have been no recoveries for the oil used by Nicaragua's police. The Mission, thus far denied access to the pertinent records in Nicaragua's Ministry of Government, has plans to pursue this matter.

- In a project to support independent democratic labor unions in Nicaragua through technical assistance and training implemented by the American Institute for Free Labor Development (AIFLD), the Mission was not able to resolve AIFLD's refusal to enter into written agreements with the labor unions being supported by the project. Without written agreements A.I.D.'s ability to review union records is in doubt. The Mission-funded financial audit of the Assistance Program should determine whether AIFLD has documentation to support expenditures made by the labor unions. Although this project had nearly expended all of its funds by the audit cut off date, should the Mission further decide to support AIFLD's program, a review of what effect AIFLD's policy has on the Mission's ability to assure the accountability and propriety of project expenditures would be in order.

In addition the following issue was partially reviewed during the present audit and requires further study.

- The Medicines Project, which started before the passage of the Act, and its amendment (called the Medicines Subproject), which was funded by the Act, have only recently begun to receive some Mission monitoring. Whether the Mission's monitoring efforts are now sufficient needs to be reviewed further. This review should consider the results of the current Mission-funded financial audit.

REPORT ON INTERNAL CONTROLS

Scope of Our Internal Control Assessment

We have audited USAID/Nicaragua's Assistance Program funded by Public Law 101-302 and Fiscal Year 1991 appropriations as of May 31, 1991, and have issued our report thereon dated August 23, 1991.

We performed our audit in accordance with generally accepted government auditing standards, which require that we (1) assess the applicable internal controls when necessary to satisfy the audit objectives and (2) report on the controls assessed, the scope of our work, and any significant weaknesses found during the audit. This report provides a summary of our assessment of internal controls applicable to the audit's objectives and does not provide assurance on the auditee's overall internal control structure.

We classified significant internal control policies and procedures applicable to each audit objective by categories. For each category, we identified the relevant policies and procedures and determined whether they have been placed in operation--and we assessed control risk. We have reported these categories as well as any significant weaknesses under the applicable section heading for each audit objective.

General Background on Internal Controls

Under the Federal Managers' Financial Integrity Act and the Office of Management and Budget's implementing policies, A.I.D.'s management is responsible for establishing and maintaining adequate internal controls. The General Accounting Office has issued "Standards for Internal Controls in the Federal Government" to be used by agencies in establishing and maintaining internal controls.

The objectives of internal controls and procedures for Federal foreign assistance are to provide management with reasonable--but not absolute--assurance that resource use is consistent with laws, regulations, and policies; resources are safeguarded against waste, loss, and misuse; and reliable data is obtained, maintained, and fairly disclosed in reports. Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Predicting whether a system will work in the future is risky because (1) changes in conditions may

require additional procedures or (2) the effectiveness of the design and operation of policies and procedures may deteriorate.

Conclusions for Audit Objective One

Our first objective was to determine if A.I.D. followed the Act and additional Congressional guidance in designing the Assistance Program. This involved gathering and verifying information on the programs and projects which make up USAID/Nicaragua's Assistance Program portfolio. For this objective the applicable internal controls are covered under audit objective two, i.e., design planning and implementation.

Conclusions for Audit Objective Two

Our second objective was to determine if A.I.D. followed its policies and procedures which control the implementation, to include planning, of individual Assistance Program activities. For this objective, the following control processes were assessed:

- the country development strategy statement and action plan process,
- the planning documentation process,
- the Congressional notification process, and
- the agreement process.

Our review of the Agency's internal controls for these processes showed that for its initial assistance activities USAID/Nicaragua did not always follow specified controls. Our review noted one area where controls over the Assistance Program needed to be strengthened:

- Price and end use controls specified for A.I.D. commodity import programs should be applied to USAID/Nicaragua's cash transfer financing of commodity imports. We believe that these controls, including price and end use checking, would increase assurance that A.I.D. funds are used effectively and contribute to the Assistance Program's objective to increase the productive capacity of Nicaragua.

Conclusions for Audit Objective Three

Our third objective was to determine if A.I.D.'s system for monitoring, evaluating, and reporting was being implemented with regard to Assistance Program activities. For this objective the following control processes were assessed:

- the monitoring and evaluating processes, and

- the reporting processes.

Our review showed that USAID/Nicaragua had not followed certain of the Agency's internal controls related to monitoring and evaluation but that it had followed controls for reporting. Regarding monitoring and evaluation, the Mission did not include information plans in any of its assistance designs nor include specified information elements to facilitate evaluations in the designs of initial bilateral projects and certain nongovernmental grants. In the following situations failure to follow or exercise controls led to the following problems:

- USAID/Nicaragua did not issue a mission order to guide its monitoring and evaluation activities required by the Supplement to Handbook 3, Chapter 12. Also it had not prepared a specific plan for monitoring commodity import activities under its cash transfer programs and had acknowledged it did not have sufficient staff assigned to monitor those activities. As a result, problems associated with those activities remained unresolved longer than necessary diminishing the effectiveness of A.I.D.'s assistance.

- Separate account operating procedures approved by the Mission for the first cash transfer program included a provision to deposit local currency equivalent to the dollars disbursed plus monthly interest in a noncommingled account. This provision was contrary to what was specified in the approved final design document and was overlooked by the Mission in approving the procedures. Because the Mission did not assure the separate account operating procedures conformed with the approved program design, $62.8 million of local currency was generated on the first cash transfer program.

- The Mission did not follow A.I.D. policy (State cables 327494 of October 1987 and 224820 of July 1988) requirements regarding tracking to final acceptable uses of local currency generated by the second cash transfer program. This happened because the Mission did not recognize, when it conditioned the release dollars to the Government of Nicaragua's making available a local currency equivalent for agreed upon purposes, it created a local currency generations program.

We have stated that the Mission had prepared its 1990 General Assessment as required under A.I.D. Payment Verification Policy No. 1 for consistency with the Federal Managers' Financial Integrity Act. That assessment, except for the issue of staffing, did not identify the above problems as control weaknesses.

Conclusions for Audit Objective Four

Our final objective was to determine if A.I.D. accounted for the Assistance Program's funds in accord with Agency policies and procedures. For this objective the following control processes were assessed:

- the funds control process,
- the payment process,
- the closing process, and
- the reporting process.

Our review showed USAID/Nicaragua had consistently applied the Agency's controls related to these processes except for the following problem we consider reportable.

- Certain expenditures were not being identified and transmitted to the Mission's accounting station as accruals. As a result, the Mission's accrued expenditures reported to A.I.D./Washington/ FM for the quarter ended March 31,1991 were materially understated.

REPORT ON COMPLIANCE

Scope of Our Compliance Assessment

We have audited USAID/Nicaragua's Assistance Program funded by Public Law 101-302 and Fiscal Year 1991 appropriations as of May 31, 1991, and have issued our report thereon dated August 23, 1991.

We conducted our audit in accordance with generally accepted government auditing standards, which require that we plan and perform the audit to fairly, objectively, and reliably answer the audit objectives. Those standards also require that we:

- assess compliance with applicable requirements of laws and regulations when necessary to satisfy the audit objectives (which includes designing the audit to provide reasonable assurance of detecting abuse or illegal acts that could significantly affect the audit objectives) and

- report all significant instances of noncompliance and abuse, and all indications or instances of illegal acts that could result in criminal prosecution that were found during or in connection with the audit.

We tested USAID/Nicaragua's compliance with the Fiscal Year 1990 Dire Emergency Supplemental Appropriations Act, the Federal Managers' Financial Integrity Act, the Foreign Assistance Act, and the Foreign Operations, Export Financing, and Related Programs Appropriation Act of 1990 (the 1990 Appropriations Act) as they could affect our audit objectives. This report summarizes our conclusions on USAID/Nicaragua's compliance with applicable provisions of these laws. However, our objective was not to provide an opinion on USAID/Nicaragua's overall compliance with such legal provisions.

General Background on Compliance

Noncompliance is a failure to follow requirements, or a violation of prohibitions, contained in statutes, regulations, contracts, grants and binding policies and procedures governing entity conduct. Noncompliance constitutes an illegal act when there is a failure to follow requirements of laws or implementing regulations, including intentional and unintentional noncompliance and criminal acts. Not following internal control policies

and procedures in the A.I.D. Handbooks generally does not fit into this definition of noncompliance and is included in our report on internal controls. Abuse is distinguished from noncompliance in that abusive conditions may not directly violate laws or regulations. Abusive activities may be within the letter of the laws and regulations but violate either their spirit or the more general standards of impartial and ethical behavior.

Compliance with the Fiscal Year 1990 Dire Emergency Supplemental Appropriations Act, the Federal Managers' Financial Integrity Act, the Foreign Assistance Act, and the 1990 Appropriations Act as they relate to the Assistance Program is the overall responsibility of USAID/Nicaragua's management.

Conclusions on Compliance

For the items tested, USAID/Nicaragua complied with the Fiscal Year 1990 Dire Emergency Supplemental Appropriations Act, the Federal Managers' Financial Integrity Act, and the Foreign Assistance Act as they applied to our audit objectives. Also, nothing came to our attention that caused us to believe that USAID/Nicaragua did not comply, in all significant respects, for items not tested.

SCOPE AND METHODOLOGY

Scope

We audited USAID/Nicaragua's Assistance Program funded by Public Law 101-302 and Fiscal Year 1991 appropriations as of May 31, 1991, in accordance with generally accepted government auditing standards. We conducted the audit from February 18 through July 5, 1991, and covered the Assistance Program's design in relation to Public Law 101-302, the Fiscal Year 1991 Appropriations Act, and associated Congressional committee reports as well as A.I.D. systems and procedures relating to implementation, monitoring and accounting for program components, activities, and funds. The audit period was May 25, 1990, through May 31, 1991. Fieldwork was conducted in the offices of USAID/Nicaragua and USAID/Honduras (the official accounting station for USAID/Nicaragua) and at the offices of certain private and Government of Nicaragua implementing entities in Managua. The audit objectives did not cover the following areas:

- Our audit tests of whether the Assistance Program was implemented in accordance with A.I.D.'s policies and procedures was limited to reviewing the Mission's planning for its activities, except for a judgmentally selected sample of programs and projects for which we reviewed the Mission's monitoring of Assistance Program implementation.

- Under Fiscal Year 1991 appropriations, Public Law 480 food activities were authorized. We did not review those activities during this audit.

- We did not audit the assistance for repatriation activities in Nicaragua as it was our understanding that the Congress recognized that the international organizations implementing the assistance would be audited in accordance with their own standard audit policies and procedures.

- We did not audit controls over project development expenses or operating expenses because we believe that the Congressional intent is to audit the direct assistance provided to Nicaragua.

- We did not audit the computerized segment of the mission accounting and control system (MACS). Thus we were only able to observe its workings in terms of original input documents and report outputs.

- Our fieldwork was conducted in Nicaragua and Honduras, we did not audit whether A.I.D./Washington followed A.I.D. policies and procedures with regard to the Assistance Program's activities.

Methodology

The methodology for each audit objective follows.

Audit Objective One

To accomplish the first audit objective, we obtained and reviewed Public Law 101-302 and Congressional committee reports related to Public Law 101-302 and the Fiscal Year 1991 Appropriations Act. We examined the USAID/Nicaragua portfolio of activities planned or in progress designed to carry out the intentions of the Congress. The planned purposes and objectives of these activities were compared with the direction contained in the above documents to determine whether the actions A.I.D. is taking are responsive.

Audit Objective Two

To accomplish the second audit objective, we reviewed A.I.D. criteria and identified key control processes applicable to program and project implementation. As available, we reviewed the CDSS, the action plan, the final design document, the agreement, and the Congressional Notification control documentation to evaluate their compliance with A.I.D. guidance. We analyzed the Assistance Program's two cash transfer programs and four development projects funded under Public Law 101-302 and one cash transfer program and one development project funded under Fiscal Year 1991 appropriations that as of May 31, 1991 had approved final design documents.

Audit Objective Three

To accomplish the third audit objective, we determined whether the monitoring, evaluating, and reporting of USAID/Nicaragua was done in accordance with guidance found in Section 621A of the Foreign Assistance Act, A.I.D. Handbooks 3, 4, and 13, and supplemental guidance.

In performing the analysis of project monitoring, we reviewed Handbook criteria, telex, and other supplemental guidance. For cash transfer

assistance we reviewed legal and A.I.D. policy requirements for dollars and generated local currency regarding the establishment of noncommingled bank accounts and tracking to final acceptable uses.

We reviewed the three cash transfer programs and five development projects funded under Public Law 101-302 or Fiscal Year 1991 appropriations which had final design documents as of May 31, 1991 to assess whether Handbook guidance on planning for monitoring and evaluating activities had been followed. Also from the portion of the Assistance Program funded under Public Law 101-302 we selected the two cash transfer programs and, on a judgmental basis, two development subprojects for detailed review to assess problems regarding the implementation of monitoring and evaluating activities for these programs and projects and to assess the Mission's monitoring of agreement reporting requirements. Judgmental sampling techniques were used because we believed that they were adequate to achieve the audit objective.

Our work included interviews with A.I.D. officials and officials of certain implementing entities and organizations receiving the benefits of the Mission's Assistance Program. We also reviewed Mission reporting under the Federal Managers' Financial Integrity Act and A.I.D.'s Payment Verification Policy No. 1 and a recent project implementation status report submitted by the Mission to the LAC Bureau.

Audit Objective Four

To accomplish the fourth audit objective, we reviewed criteria contained in A.I.D. Handbooks and we interviewed officials at the Mission and at the Mission's accounting station, USAID/Honduras. We examined Mission record files and accounting system reports documenting the budget allowance ledgers, the project agreements and amendments, the project ledger, element control ledgers, earmark control records and earmarking documents, commitment liquidation records, cash advance records, payment and liquidation vouchers, and advices of charge. Our accounting system review for development projects focused on the accounting processes for funds control, payments, closing, and reporting. System review for cash transfers was limited to the Mission's responsibility to certify compliance with conditions precedent prior to disbursal by A.I.D./Washington/FM into a separate account of the Government of Nicaragua.

MANAGEMENT COMMENTS

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USAID
20 AUG. 1991
RIG OFFICE

August 15, 1991

TO: Reginald Howard
RIG/A/T

FROM: Janet Ballantyne
USAID/Managua Director

SUBJECT: Draft Audit Report on the Nicaragua Assistance Program

I would like to take this opportunity to thank you and your staff for the professional and constructive attitude displayed during the performance of this very sensitive and complex evaluation. As I have conveyed to you and your very committed team, we appreciate the effort that RIG/A/T has made over the last year in assisting us in the difficult task of re-opening an A.I.D. presence in Nicaragua after eight years.

We have reviewed the contents of subject report and agree with recommendations 1.2, 2 and 3 which you have made with views toward improving the management of our development assistance program in Nicaragua. With regard to recommendation No. 1.1, we request it be reevaluated in line with our comments (provided below) prior to inclusion in your final audit report.

Although your draft report was found to contain factual evidence underlying each of the findings reported, we feel it has failed to comment on important events which lead to and/or authorized what has been considered by your office as a possible deficiency in the Mission's design, control and monitoring processes. Since USAID Nicaragua considers the omission of this information material to its operations, we request that the information/comments on the seven areas identified below be considered by your office for inclusion in the body of the report, or as an annex to the audit report when issued in final form.

- A short background statement on the limitations the Mission faced in the design and implementation of its congressionally mandated economic assistance program to Nicaragua.

- Details concerning the specific authorities given to the Mission to deviate from standard design procedures contained in A.I.D. Handbooks and/or other directives.

- An explanation of changed conditions in the economic structure in Nicaragua which led the Mission to conclude that the establishment of commodity price and end-use checking was not only not necessary but would have defeated the purpose of A.I.D.'s assistance.

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- Causes for not requesting resolution and closure of previously issued audit report recommendations.

- An explanation of the Mission's monitoring system, the manner in which the systems was carried out and the successes obtained from its effective implementation.

- Background and basis for the Mission's disagreement to the suggested "inadvertent" generation of local currency under its first two cash transfer programs.

- The Mission's position for not agreeing with the suggested "unknown" creation of a local currency generation program under its second cash transfer agreement as amended, in that the program was designed and implemented as performance based disbursement in accordance with the A.I.D. Washington delegation of authority.

A background statement on the limitations the Mission faced in the implementation of its assistance program in Nicaragua, and our comments to the other six areas identified above follow. For easy reference we have included the section and page number in the draft report to which each of our comments apply.

I. BACKGROUND STATEMENT

The draft audit report may have not provided a full, accurate portrayal of the challenge posed to the U.S. Government and the USAID Mission in its efforts to assist the Government of Nicaragua after the unexpected and welcome election of President Chamorro. The USAID Mission had to simultaneously design and implement the second largest economic assistance program in Latin America so as to achieve immediate results; hire and train local staff; identify, rent and rehabilitate suitable housing for its staff; provide temporary office space and equipment; identify, rent and rehabilitate permanent office space; and order, receive, store inventory and deliver warehouse equipment, office equipment, office supplies and office and residential furniture and appliances.

For a relatively long period of time, the USAID Mission to Nicaragua had to do this with a small US Direct hire and tiny foreign service national staff, very few vehicles, limited or unavailable office supplies or rehabilitation equipment and no heavy equipment. Furthermore, our operations have taken place in a country that is still classified as a high intelligence security threat post, which was rendered bankrupt by ten years of misguided economic policies and the theft of government equipment, and one that still suffers from economic and political instability, as evidenced by strikes, take overs and the absence of basic goods and services.

Despite these obstacles, the Mission was able to make great strides forward in all fronts, with priority attention given to getting the programs up and running. Program design and implementation proceeded rapidly due in great part to A.I.D. Washington concurrence in the flexibility in documentation requirements that is a critical subject of this audit report. Our policy reform dialogue, implemented through our economic assistance program, (also discussed in this

report) has already had outstanding results: the size of government (including the military) has been reduced; private banks have been authorized; inflation has been halted; sound economic and monetary policies have been established and are being implemented, and the private sector is emerging as a economic force.

II. MISSION COMMENTS TO DRAFT AUDIT REPORT EXECUTIVE SUMMARY

A. On page (iii) second paragraph we request the following changes:

- First line substitute the words "**it appears that**" to "**we believe that:**";
- Third line substitute the word "**had**" for "**has**";
- Fourth line substitute "**was subject**" to "**may be subject**";

B. On page (iv) second paragraph, sixth line we request you substitute "**A.I.D.**" for "**the Mission**".

C. On page (v) first paragraph last sentence we request you add after the word "**explain**" "**to our satisfaction**".

III. MISSION COMMENTS TO DRAFT AUDIT REPORT FINDINGS AND RECOMMENDATIONS

A: Final design documents for initial development projects did not meet Handbook standards

The last paragraph on page 9 of the draft report describes four projects which were not preceded by the normal detailed analyses specified by A.I.D. Handbooks. As reflected below, each of the projects mentioned in the report was developed by the Mission in a manner and form that was specifically authorized by A.I.D. Washington.

AIFLD: In Managua 5583 (90) USAID requested authority to develop "an action memorandum and authorization prior to signing the cooperative agreement" citing the "small size of the grant, urgency to initiate activities, lack of Mission staff as the reasons for such documentation." The cable also stated that "an action memorandum will serve as the principal project document." State 293337 provided USAID authority to develop the "activity with AIFLD as described in reftel."

NED: Identical exchange of cables as for AIFLD with A.I.D. Washington granting concurrence in State 312725.

SALESIANS: Per action memorandum to the AA/LAC on September 20, 1990 signed by Ambassador Michel, USAID received authority to approve the first SALESIANS proposal as a PID-like document and the revised proposal as a PP-like document.

UMBRELLA IMMEDIATE IMPACT ACTIVITIES: Action memorandum signed by AA/LAC (copy of which was provided to RIG auditors) specifically authorized streamlined documentation based on justification per Handbook 3, Chapter 4 citing urgency, timing and political considerations.

B. A.I.D.'s import financing arrangements under the cash transfer programs can be strengthened.

Our comments in this section are geared to the finding and recommendation No. 1.1 in pages 12 and 13 of the audit report which appears to be based on, among other things, the contents of our ESR I Program Assistance Approval Document (PAAD). The PAAD under our ESR I program differs from the Program Agreement in that it required commodity price-checking and commodity end-use checking for imports financed with the cash transfer resources made available to the Government of Nicaragua (GON) under the Program Agreement.

The PAAD and Grant Agreement for our ESR I were prepared by A.I.D. Washington personnel during the chaotic early days of the recently elected Chamorro administration, and prior to the establishment of the USAID Mission to Nicaragua. The ESR I and ESR II Programs were Cash Transfer Programs designed to support policy reform efforts of the GON. They were not intended to finance the import of specific commodities nor, necessarily, to assure that transactions for which dollars are used minimize the foreign exchange costs (as opposed to the total cost) of the transactions financed. The essence of a balance of payments support cash transfer is that it provides transitional financing for the balance of payments while requiring that the government implement reform measures to eliminate the need for such financing in the short to medium term. The specific use of the dollars, although required to be tracked, is incidental to the implementation of appropriate reforms. In this, a cash transfer differs fundamentally from a commodity import program in which the financing of specific commodities <u>is</u> the essence of the program. It is vitally important for the success of cash transfer programs that disbursement mechanisms, administrative controls, and the use of associated local currencies, <u>not</u> undermine the very reforms that the programs are designed to promote. The establishment of a price and end-use checking bureaucracy in the Central Bank would have precisely this effect, a fact that has been recognized by the LAC Bureau in its decision to drop precisely those mechanisms from the ESR II and subsequent cash transfer programs in Nicaragua.

The establishment of price and end-use controls would be contrary to our on going policy dialogue objective of eliminating administrative controls on the allocation of foreign exchange and substituting free market allocation. In the specific cases cited in the draft audit report, it is suggested that commodities could have been purchased more cheaply by bypassing trading companies and buying directly from manufacturers. This is entirely possible. However, trading companies do perform a useful service by providing a variety of commodities in small volumes to relatively small purchasers. Since importers are now paying a market clearing price for their foreign exchange, it would appear that this service is worth its cost to them. This decision--to buy through intermediaries or direct--is one for the profit maximizing buyer to make. It is not a decision which should be made by A.I.D. or Central Bank bureaucrats. The reforms which

our cash transfers are supporting are increasing competition in the economy. Those importers whose **total** costs are out of line will price themselves out of the market. Neither we nor the Central Bank of Nicaragua are in a position to second guess this business decision based on a subset of their total costs.

The establishment of price and end use controls by the Central Bank at this point would be such a serious abandonment of exchange market liberalization that, if the GON were to establish such a mechanism on its own initiative, we would regard it as a serious reversal of its liberalization program. It would be so serious a return to administrative control that it would probably call for a suspension of our ESR disbursements. Accordingly, after consultation with the Office of the General Counsel (GC), the USAID and GC/LAC have agreed to request that the LAC Assistant Administrator amend the PAAD for ESR I, deleting those provisions that pertain to price and end use checking.

In regard to section 1.2 of recommendation No. 1, the Mission is drafting the scope of work for an evaluation in September/October this year of its ESR assistance programs to Nicaragua. The results of this evaluation will not only be used to determine the degree of success of the Mission's present cash transfer assistance, but also be used as part of the initial design preparation for our planned ESR IV program for January/February 1992.

Based on the above comments and actions, the Mission requests that the basis for finding and recommendation No. 1.1 be reevaluated, and that recommendation No. 1.2 be resolved and closed upon issuance of the final audit report.

C. Was A.I.D.'s system for monitoring, evaluating, auditing, and reporting being implemented with regard to Assistance Program activities?

1. Page 14 fourth paragraph last sentence states **"Recommendations made under these three audits had not been resolved by the Mission as of May 31, 1991."**

Since the three audits mentioned in this section of the report were not received by the Mission until June 28, 1991 (Managua 5184), the Mission's response to the audit recommendations could not be provided until after that date. On August 7, 1991 the Mission's response to all of the recommendations contained in these three reports was delivered to a RIG/A/T team going to Honduras the following day. In this response the Mission requested all recommendations be resolved and closed. Actions taken to resolve and close each of the audit recommendations were taken during the period from November 1990 through July 1991.

2. Page 17 **"The Mission had not formally established its monitoring and evaluation system."**

The Mission fully agrees with the recommendation in this section of the draft report, but would like to add that a formal and effective monitoring system was in place, albeit not properly documented through a USAID Order. The system in place includes continuous evaluation of the

Central Bank of Nicaragua's (BCN's) import transaction review and approval processes and on-sight verification at the bank of 100% of transactions financed with A.I.D.'s assistance. Complete import transaction verification can only be performed after the commodity is paid for and has entered into the country. Final documents reviewed for eligibility are the evidence of payment under the letter of credit and the import policy "poliza de importacion". Because of delays in the submission by importers of their import policy, many transactions were not detected as ineligible by the Mission until after they were paid for with USG resources. In most if not all cases of ineligible transactions the Government of Nicaragua (GON) has responded quickly to our reimbursement requests. In cases where this has not happened, it has been because of delays at the correspondent commercial banks (CCBs) in the U.S., who have not responded immediately to the GON's request for re-deposit of the funds into the Federal Reserve Bank of New York (FED). In an effort to reduce the number of ineligible import transactions financed with A.I.D.'s assistance, the USAID since December 1990 has required from the GON (prior to approving the transfer of funds from the FED to CCB's in the U.S.) to first back up all transactions with its own funds until reviewed in preliminary form by the USAID. This system, although not completely free of problems, has diminished considerably the number of ineligible transactions paid for with ESR resources. Since the GON's foreign exchange situation has improved considerably, the Mission is envisioning moving from the direct pay procedure (using USG funds for payment to suppliers) to a reimbursement procedure (using GON funds first and then reimbursing the GON with USG funds for eligible imports) for financing imports under our planned ESR IV program. Prior to changing procedures, the feasibility of using the later system (reimbursement) will be further evaluated.

The USAID in discharging its monitoring responsibilities over its Program and Project assistance to Nicaragua, has relied on its limited in-house personnel, personnel from other USAID Missions throughout Central America, and on CPA firms.

The USAID's monitoring efforts have resulted in among other things the following:

a. At the Central Bank of Nicaragua: i) The establishment of acceptable accounting and internal control systems; ii) better coordination and communication among the different units responsible for the review, approval and accounting for our cash transfer assistance; iii) improved management and operation of ADP systems within the Bank; iv) the use of GON funds instead of A.I.D.'s to initially back up letters of credit issued to finance import transactions, and; v) the design and implementation of a better financial reporting system for ESR funded imports.

b. The provision for financial management and oversight services to each of our Host Government recipient institutions. In this regard, adequate accounting and internal controls have been designed, established and monitored.

c. The provision for adequate audit (Federal and Non-Federal) coverage for all FY 1990 and FY 1991 assistance to Nicaragua.

Given the Mission's effective monitoring system and the results of such efforts, we feel that the information provided in **paragraph 1 on page 16 and first "bullet" on page 17** could be modified to better reflect such efforts.

Based on the above, we request recommendation No. 2 be resolved upon issuance of the final report and closed upon publication of a USAID Order on the Mission's overall monitoring and evaluation systems and procedures.

3. Page 18 **"The Mission did not prepare information plans as part of its assistance designs"** and **"The Mission did not design initial bilateral projects and one operational program grant to permit comparison of planned to actual results."**

With regard to these two sections of the draft audit report, we would appreciate a reference to the fact that all elements of an information component or plan as described in the A.I.D. Handbooks were included in all of the Mission's project designs except for the four obligated in FY 1990 for which curtailed project development documentation was specifically authorized by A.I.D. Washington (see Section II-A of this memorandum).

4. Page 19 **"Local currency was inadvertently resulting from the cash transfer programs"** and Page 21 **"The Mission's obligation to follow local currency accountability requirements needs to be determined."**

Although we agree with the audit recommendation that we obtain written guidance from the Office of the General Counsel in Washington, the discussion contained in Audit Recommendation No. 3 could be interpreted as misleading in its omission of several crucial points pertaining to current GC guidance on the generation of local currency under ESR cash transfer programs prior to enactment of the Foreign Appropriations Act on November 5, 1990, and USAID access to that guidance.

The PAAD and ESR I Grant Agreement were signed on May 31, 1990; the PAAD for ESR II was authorized on September 25, 1990, and the Agreement was signed on September 26, 1990, well before the FY 1991 Appropriations Act went into effect. On March 8, 1991, almost one year after the signing of ESR Agreement I, the Office of the General Counsel issued a Memorandum interpreting the provisions of the new section 575(a) in the FY 1991 Foreign Appropriations Act.

A significant fragment of this GC opinion, which is omitted from the audit report, addresses the specific point raised in the recommendation. Page 8 of the aforementioned opinion notes that:

> "A.I.D. has argued over the years that the ultimate use of the dollar proceeds of cash transfers provided for macroeconomic or policy reform purposes is not related to the accomplishment of the A.I.D. purpose in providing the assistance. Getting the foreign exchange into the hands of the host government to be used as

> that government sees fit is the purpose -- the quid pro quo for policy reform or other U.S. objectives. And since the institution of separate account requirements, Congress has included a provision to permit A.I.D. to obligate and the host government to expend these segregated, use-specified cash transfer dollars notwithstanding provisions of law inconsistent with the cash transfer nature of the assistance. Separate account and dollar tracking requirements were instituted to prevent abuse and diversion of the dollar proceeds, not to eliminate the cash transfer method. ... However, it is apparent that Congress has now enacted a comprehensive scheme that ensures (1) that dollars from all cash transfer-type assistance ... are to be put in separate accounts and tracked [Section 575(b)(1]; (2) that a Congressional notification with "a detailed description of how the funds proposed to be made available will be used" [section 575(b)(3)]; and (3) that any use of the separate account dollars that "generates" local currency will be known in fact, and to assure that reality corresponds to the content of the CN, must be included in the agreement providing the assistance.

There is absolutely nothing in the GC opinion, or the FY 1991 Foreign Appropriation Act, that specifically provides for retroactive application of section 575 of the Act, as intimated in the audit recommendation. Indeed, the quoted segment of the GC opinion implies that the official A.I.D. position prior to the issuance of this memorandum of law would not have required the generation and tracking of local currency under cash transfer programs such as the ones in effect in Nicaragua. Furthermore, it would be difficult to presume that the requirements of section 575 noted in the last sentence of the quoted segment could apply to ESR I and II, when, in both instances, the congressional notifications, the authorization and the agreement had been complied with prior to enactment of the law and, in the case of ESR I, the funds had been fully disbursed prior to issuance of the GC memorandum of law.

The audit report also fails to mention that USAID Nicaragua did seek further clarification and GC guidance on this issue upon receipt of a letter from the Central Bank of Nicaragua pertaining to a local currency account it had set up. The first week in June, the Legal Advisor to Nicaragua requested guidance from GC/LAC on whether USAID had the obligation to monitor and track the uses of the local currency reported by the Central Bank. After consultation with the Acting General Counsel of the Agency, GC/LAC responded, again by telephone that, given the fact that both ESR I and II were authorized, signed and implemented well before issuance of A.I.D. legal guidance on this matter and prior to enactment of the FY 1991 Foreign Appropriations Act and, in accordance with both prior A.I.D. policy and the terms of the respective PAADs, the agreements in question did not provide for the generation of local currency, USAID/Nicaragua did not have to follow the new local currency generation and tracking procedures.

USAID/Nicaragua accordingly has provided a letter to the Central Bank stating this advice.

With respect to the inclusion of local currency separate account provisions in the operating procedures to ESR I, it is worth highlighting several facts: (1) the operating procedures were drafted during the early days of U.S. aid to Nicaragua, where fast disbursement was at a premium and a Mission had not yet been established; (2) the PAAD and the Grant Agreement, the two operative documents, expressly provide for no local currency generation; (3) the operating procedures prepared for ESR I were developed from operating procedures for another Central American country, again in the interest of expediency, and were intended to be used in conformity with the PAAD and the Grant Agreement. On this last point clearly the inclusion of the local currency procedures could be characterized as a mistake produced by the hastiness of actions during those chaotic early days. In order to avoid any future misunderstandings regarding provisions for local currency deposits in the operating procedures, we are requesting their deletion.

With regard to Recommendation Number 4 on page 22, the audit finding suggests that USAID/Nicaragua "unknowingly" created a local currency program with the amendment to the ESR II agreement conditioning disbursements on GON progress in implementing its occupational conversion program.

An adequate response to this recommendation requires a brief digression about the nature of policy-based non-project assistance (NPA) in recent A.I.D. experience, and the relevance of that experience to the occupational conversion activity. During the past five years, there has been increasing recognition within A.I.D. that the achievement of the objectives of A.I.D. assistance is critically dependent on the implementation by host governments of essential policy reforms. There has also been recognition that an important obstacle to the implementation of policy reforms is a lack of resources, particularly resources to compensate those who stand to lose from the policy reforms. This recognition represents an important advance over the earlier, somewhat naive, view that saw policy-based NPA as essentially "buying policy reform". In general, NPA is only likely to be successful where there is a firm government commitment to the policy reforms being proposed. But even in the presence of such a commitment, resource constraints may represent an important obstacle to the implementation of policy reform by the host government.

In general, detailed A.I.D. involvement in such a "compensation" process is not necessary and is, from a political point of view, usually highly undesirable. A process of compensation typically involves the balancing of domestic political forces of a particularly sensitive nature. Overt A.I.D. participation changes the nature of that political process in ways which are generally not helpful. The solution to this problem has been to condition A.I.D. assistance on the achievement of a carefully defined result, with the programming of local currency, if any, carried out at a highly aggregate level. The arms-length approach to policy reform not only avoids drawing A.I.D. into a highly charged domestic political process but permits the host government maximum flexibility in deciding how to achieve the agreed-upon results.

The GON's request for support for its occupational conversion program appeared to us to represent a classic opportunity for the use of such performance-based non-project assistance. The resource constraint arose precisely from the need of the GON to finance voluntary separation costs. At the same time, overt A.I.D. involvement in the process would have made the GON's task substantially harder, given the fact that most of the "losers" from the policy reform are hostile to the USG and A.I.D.. The risks of detailed involvement were clearly recognized in the LAC Bureau's delegation of authority to amend the ESR II agreement to accelerate disbursements conditioned on the GON's implementation of its occupational conversion program. In the delegation of authority, contained in 90 State 393240, the USAID was specifically directed not to finance or manage resources involved in the occupational conversion program.

In summary, what USAID/Nicaragua created in the occupational conversion amendment to the ESR II Program was a performance-based disbursement program in which the acceleration of import financing (through the broadening of commodity eligibility) provided a real resource transfer to the GON which enabled it to carry out a policy reform (the reduction of public sector employment in order to reduce the overall level of government expenditures). It was not intended that A.I.D. be involved in any way with the details of that program's implementation and it was our intention that the GON retain total flexibility in regard to the process by which the end result was to be achieved.

In the ESR II program, A.I.D. did not require any local currency generation and this lack of any local currency requirement was carried over into the Occupational Conversion Amendment. If we had had a local currency generation requirement, the local currency would have been programmed to finance the GON's overall fiscal deficit as provided for in the most recent A.I.D. local currency guidance.

The report of audit findings quotes A.I.D. local currency policy to the effect that "if, in a cash transfer program, A.I.D. conditions the disbursement of dollars to the recipient country's generating a local currency equivalent for agreed-upon purposes, then, in essence, a local currency generations program has been created." This provision refers to a situation which is quite different from the Occupational Conversion Amendment. That is the situation in which the use of local currency is part of the conditionality, as when a condition for the assistance is that a specific amount of local currency be devoted to the budget of a specific Ministry or a specific project. The key phrases here are "local currency equivalent", and "agreed-upon purposes". The distinction between requiring that the host government devote a specific sum to a specific purpose and requiring that the host government achieve a specific objective, recognizing that the achievement of that objective is likely to entail a certain resource cost, may seem a subtle one. It is, however, a crucial distinction. In the former case, A.I.D. participates in the selection both of the end and of the means to that end. In the latter, A.I.D. participates only in the selection of ends, leaving the choice of means entirely to the host government.

The general principle of A.I.D.'s local currency policy is that monitoring responsibility is commensurate with A.I.D.'s participation in programming. The guidance on monitoring should not be read to require a degree of participation in programming which undermines the purposes of the assistance. The report of audit findings paraphrases a statement in PD-5 to the effect that A.I.D. policy explicitly encourages Mission participation in the programming of such local currency generations to achieve development objectives. However, what PD-5 actually says is, "accordingly, Agency policy explicitly encourages A.I.D. participation in the programming of country-owned local currency . . . when such involvement promises to help in achieving developmental objectives" (emphasis added). It must be recognized that A.I.D. participation in programming can interfere with the achievement of development objectives. In such circumstances, current Agency policy does not require such counterproductive A.I.D. involvement.

Policy-based non-project assistance is a powerful development tool. To be effective, it requires the judicious tailoring of disbursement criteria (conditionality), with just enough A.I.D. participation in decisions on resource use to assure that the assistance objectives are met. More A.I.D. participation in resource use questions is not necessarily better. This is particularly the case where such A.I.D. involvement injudiciously involves A.I.D. overtly in distribution questions involving powerful domestic political forces. To insist on active A.I.D. participation in resource-use questions is not only not required by current A.I.D. policy, it would effectively eliminate the distinction between NPA to project assistance.

We would appreciate that our comments on this section of the draft report be considered in coming up with the final report on the results of your evaluation. Since we have agreed to the actions in recommendations 3 and 4, we request they be resolved upon issuance of the final audit report. Closure of these two recommendations will be requested upon receipt of GC/LAC's written guidance.

If you should need any additional information concerning the above, please do not hesitate in letting me know.

Previously Reported Issues

The following are apparent weaknesses which existed in the Assistance Program in Nicaragua as of November 30, 1990, as disclosed in our Audit Report No. 1-524-91-004 dated February 8, 1991, and the resolution status of these weaknesses as of May 31, 1991.

Apparent Weakness Reported	Resolution Status
• Despite the urgent need for dollars in the Nicaraguan economy, in the early stages of A.I.D.'s cash transfer programs the Central Bank of Nicaragua set aside dollars to guarantee financing for potential importers who were eventually unable to provide the required amounts of local currency. This occurred although other importers were available who could meet these requirements.	This remains to be a problem, which the Central Bank has attributed to the current lack of liquidity of the Nicaraguan economy. Thus the Bank continues committing A.I.D. dollars to potential importers even in the absence of their bringing the required amounts of local currency at the front end of the import financing process. The potential importers have up to 45 days to settle their transactions, otherwise they may lose rights to the committed dollars.
• Import transactions were also approved even though importers were not always obtaining competitive quotes for their commodities.	This also remains a problem. The Mission has not followed up on its early recommendation to the Central Bank that it require potential importers to submit at least three quotations in advance of each import transaction. Since this audit disclosed significant instances of commodity overpricing, the Mission plans to press this issue with the Central Bank.
• Although the first two cash transfer agreements precluded the use of grant funds for financing military and police requirements of any kind, preliminary information indicated that since the beginning	A.I.D.-financed oil imports are still benefiting Nicaragua's military and police forces. At first, the Mission relied on ex-post facto analyses and recoveries of oil financing for the military. However, the Central Bank

of July 1990 essentially all of Nicaragua's imports of petroleum and its derivatives were financed under the Assistance Program and that Nicaragua's military was a major consumer of the refined products that resulted from these imports.

now plans to make dollar estimates of both civilian and military consumption for each shipment of oil and commit itself to financing only the civilian portion. The Mission plans to monitor this procedure. As regards oil for the police, the Mission has thus far been denied access to related records but plans to pursue this matter.

- On the Medicines Subproject, information provided to us during our review strongly indicated that an opposition-controlled labor union would ultimately direct, and thus might adversely affect, the final distribution of these commodities to the intended recipients.

The Mission's monitoring of the basic Medicines Project has been weak. However, during this reporting period it has devoted increased effort to monitoring the project. The Government of Nicaragua submitted plans for the distribution and security of the medicines after further shipments of medicines had been received. We did not reach a conclusion on the adequacy of the Mission's monitoring efforts because we received the distribution and security plans after the completion of our fieldwork.

- The Employment Generation Subproject is complex and extensive and, combined with the fact that both the national and local governmental entities implementing it have entirely new administrations, needs close oversight.

This Subproject is progressing well. However, there have been isolated instances of financial mismanagement at the implementing entity level, which have been, or are in the process of being, addressed.

- The Technical Assistance and Training Subproject was being implemented by a technically-bankrupt entity according to its financial statements. This entity had not reported interest it earned on A.I.D. cash advances. Also, the Mission was awaiting the entity's submission of its internal

This Subproject is also progressing well. Being technically bankrupt early on has not affected the implementing entity in its carrying out this activity. The entity's not reporting interest on A.I.D. cash advances was deemed to be an oversight--the Mission has already recovered such interest. Also, it

management policies and procedures.

received to its satisfaction the entity's management policies and procedures.

- The American Institute for Free Labor Development project was flawed in that the Institute had submitted an inadequate final project implementation plan and had not entered into written agreements with recipient Nicaraguan labor organizations. Also, the Institute had not yet submitted to the Mission copies of its internal policies and procedures.

This Project remains flawed. The project implementation plan was not revised nor has the implementing entity entered into written agreements with recipient organizations. Also, there was no evidence that the entity had timely submitted to the Mission copies of its internal policies and procedures. While the Mission pursued these matters, it did not satisfactorily resolve them. Project funds have nearly been exhausted.

- Mission orders on financial management and administrative procedures were in draft and thus were not formally implemented.

All but one of the 22 mission orders proposed thus far on such subjects as training, financial management, project development, and administrative support remain in draft. The Mission has been reluctant to prioritize efforts formalizing mission order procedures.

Financial Status of the Nicaragua Assistance Program
As of May 31, 1991 1/

Economic Support Fund Program Funded Under the Fiscal Year 1990 Dire Emergency Supplemental Appropriations Act (Unaudited)

Program/ Project Number	Title	Implementing Organizations (Primary-Sub)	Budgeted Amount (000s)	Obligated Amount (000s)	Accrued Expendi-tures (000s)	Disbursed Amount (000s)
	CASH TRANSFERS:					
524-0300	ECONOMIC RECOVERY PROGRAM I	BCN	$60,000	$60,000	$60,000	$60,000
524-0311	ECONOMIC RECOVERY PROGRAM II	BCN				
	Commodity Imports		68,000	68,000	54,000	54,000
	Repayment of GON Debt Arrearages		50,000	50,000		
	SUBTOTAL CASH TRANSFERS		**$178,000**	**$178,000**	**$114,000**	**$114,000**
	DEVELOPMENT PROJECTS:					
524-0301	ECONOMIC GROWTH AND DEVELOPMENT					
524-0301.01	Technical Assistance and Training	INCAE	$3,190	$1,100	$910	$1,079
524-0301.03	Employment Generation	INIFOM	20,900	14,400	1,574	2,000
524-0301.04	Public Sector Support	MOP	7,780	5,000	1,914	1,914
524-0301.05	Medicines	USPHS, MOH	1,500	1,450		
524-0301.22	Community Hospitals	P. Hope, MOH	2,500	2,500	601	601
524-0301.23	Textbooks	Aguirre, MOE	12,200	12,200	10,310	10,117
524-0308	AMERICAN INSTITUTE FOR FREE LABOR DEV.	AIFLD	700	700	700	637
524-0309	NATIONAL ENDOWMENT FOR DEMOCRACY	NED	235	235	235	173
524-0310	SALESIAN VOCATIONAL EDUCATION	Salesians	1,700	1,700	869	841
524-0314	NATURAL RESOURCES MANAGEMENT	IRENA, PVOs	8,000			
524-0315	PRIVATE AGRICULTURAL SERVICES	UPANIC, APEN	1,500			
524-0316	STRENGTHENING DEMOCRATIC INSTITUTION	TBD 2/	3,000			
524-0317	PRIVATE SECTOR SUPPORT	TBD 2/	1,000			
524-0318	DEVELOPMENT TRAINING AND SUPPORT	TBD 2/	2,000			
	SUBTOTAL DEVELOPMENT PROJECTS		**$66,205**	**$39,285**	**$17,113**	**$17,362**
524-0307	REPATRIATION OF NICARAGUAN RESISTANCE AND REFUGEES	State Dept. - OAS - UN	$45,000	$40,000	$40,000	$40,000
	SUBTOTAL REPATRIATION		**$45,000**	**$40,000**	**$40,000**	**$40,000**
	USAID MISSION EXPENSES:					
524-0301.02	PROJECT DEVELOPMENT AND SUPPORT	A.I.D.	$4,065	$1,828	$631	$489
	OPERATING EXPENSES	A.I.D.	6,730	5,855	4,170	4,170
	SUBTOTAL MISSION EXPENSES		**$10,795**	**$7,683**	**$4,801**	**$4,659**
	TOTAL FY 1990 DIRE SUPPLEMENTAL		**[illegible]**	**$264,968**	**$175,914**	**$176,021**

1. Based on information provided by USAID/Nicaragua. Much of this information is not included in the Mission's accounting system because some projects are managed and accounted for by A.I.D./Washington. Also accrued expenditures are entered into the system only at the end of each quarter.
2. To Be Determined.

Financial Status of the Nicaragua Assistance Program
As of May 31, 1991 1/

Economic Support Fund, Development Assistance, and P.L. 480 Programs
Funded Under Fiscal Year 1991 Appropriations
(Unaudited)

Program/ Project Number	Title	Implementing Organizations (Primary-Sub)	Budgeted Amount (000s)	Obligated Amount (000s)	Accrued Expendi-tures (000s)	Disbursed Amount (000s)
	ECONOMIC SUPPORT FUND AND DEVELOPMENT ASSISTANCE					
	CASH TRANSFERS:					
524-0319	ECONOMIC RECOVERY PROGRAM III	BCN	$137,500	$135,000	$65,000	$65,000
	SUBTOTAL CASH TRANSFERS		$137,500	$135,000	$65,000	$65,000
	DEVELOPMENT PROJECTS:					
529-0301 524-0301.01	ECONOMIC GROWTH AND DEVELOPMENT Technical Assistance and Training	INCAE	$110 3/			
524-0312	FAMILY PLANNING	PROFAMILIA	1,000			
524-0313	PVO CO-FINANCING	PVOs	4,000			
524-0317	PRIVATE SECTOR SUPPORT	TBD 2/	1,000 3/			
524-0321	IMMUNIZATION ASSISTANCE	PAHO	1,500	$1,016	$200	
524-0324	RURAL ELECTRIFICATION	TBD 2/	5,000			
	SUBTOTAL DEVELOPMENT PROJECTS		$12,610	$1,016	$200	
524-0307	REPATRIATION OF NICARAGUAN RESISTANCE AND REFUGEES	State Dept. - OAS - UN	$10,900	$10,900	$10,900	$10,900
	SUBTOTAL REPATRIATION		$10,900	$10,900	$10,900	$10,900
	USAID MISSION EXPENSES:					
524-0301.02	PROJECT DEVELOPMENT AND SUPPORT	A.I.D.	$250	$59		
	SUBTOTAL MISSION EXPENSES		$250	$59		
	SUBTOTAL ESF AND DA		$161,260	$146,975	$76,100	$75,900
	P.L. 480:					
	FOOD FOR PROGRESS	GON	$57,100	$57,100	$26,133	$26,133
	TITLE II	CARE, ADRA	$5,519	$2,921	$2,921	$2,921
	SUBTOTAL P.L. 480		$62,619	$60,021	$29,054	$29,054
	TOTAL FY 1991 ESF, DA, AND P.L. 480		$223,879	$206,996	$105,154	$104,954

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1. Based on information provided by USAID/Nicaragua. Much of this information is not included in the Mission's accounting system because some projects are managed and accounted for by A.I.D./Washington. Also accrued expenditures are entered into the system only at the end of each quarter.
2. To Be Determined.
3. This is FY 1991 funding increment. Act funds are also budgetted for the Project.

Analysis of Compliance with Selected Policy/Procedural Requirements Associated with the Nicaragua Assistance Program

POLICY/PROCEDURAL REQUIREMENTS	YES	PARTIAL	NO	COMMENTS
OBJECTIVE No. 2				
Prepare country development strategy statement (CDSS). Handbook 3, Chapter 1.			x	This was a new Mission which, with A.I.D./Washington Bureau approval of the Assistance Program, started that Program without a CDSS due to the Emergency situation and the urgency of beginning support to this new Democratic Government. The Mission had developed a short - term strategy and was developing a CDSS at the end of our audit period.
Prepare Action Plan cables LAC/DPP. Memorandum dated October 31, 1990.			x	The above coment is applicable and an Action Plan is currently being developed.
Program/Project was properly authorized. Handbook 3 Chapter 5; Handbook 4.	x			
Agreements are to be preceded by a preliminary analysis and summary justification. Handbook 3, Chapter 2.			x	The four FY 1990 - funded project agreements (including six sub-projects for one of these projects) were preceded by planning documentation that did not meet the minimun standards of A.I.D.
Unless excepted, agreements preceded by detailed analysis and full-scale development documents. Handbook 3, Chapter 3 Handbook 4, Chapter 3.		x		The two FY 1990 - funded cash transfer agreements were preceeded by such documents. Two subproject agreements were not. However, for the FY

POLICY/PROCEDURAL REQUIREMENTS	YES	PARTIAL	NO	COMMENTS
				1991 - funded cash transfer and project that have reached agreement stage, both are preceded by the proper documents leading us to conclude the Mission is now correctly following A.I.D. requirements.
Congressional notifications sent prior to obligating funds. FAA section 634A.	x			
Congressional notification for changes from prior notifications. A.I.D./Washington/LAC program Guidance No. 91-04.		x		Congress was originally notified that, under the Act, there would be one cash transfer. Two cash transfers were developed. Funding allocations changed significantly for the development program and were notified.
Cash transfer agreements incorportate all relevant aspects of the final planning documents. Handbook 4, Chapter 3.		x		One of three cash transfer agreements did not contain one planning provision requiring the establishment of procedures for price - and end-use checking of dollar funded commodities.
Objective No. 2 - Subtotal 8	2	3	3	
OBJECTIVE No. 3				
Prepare plans relating to monitoring evaluating and auditing. Handbooks 3, 4 and 13 (specific requirements for the different types of assistance vary).		x		Of 15 agreements that had been signed, 12 had some degree of planning for monitoring, 6 had evaluation plans, and 10 had audit provisions.
Prepare information plans. A.I.D. Evaluation Handbook.			x	However, certain aspects of information plans were sometimes covered as part of other plans, e.g., implementation, monitoring and evaluation plans, or were evident

POLICY/PROCEDURAL REQUIREMENTS	YES	PARTIAL	NO	COMMENTS
				from the narrative of the final design document or agreement.
Cash transfer dollars are to be maintained in a separate account. 1987 Cable 327494.	x			
Cash transfer dollars are to be trackable to final acceptable end-use. 1987 Cable 327494.	x			
Local currencies generated from cash transfer activities must be maintained in a non-commingled special account. 1987 Cable 327494.		x		For the second cash transfer and amendment, which caused a local currency generation, did not require the local currency to be deposited in a sepcial account. For the first cash transfer and the past of the second cash transfer not associated with the above mentioned amendments, a legal determination is necessary as to whether the local currency actually maintained in a special account falls under this requirement.
Accountability requirements are to be met for local currency generations dependent on A.I.D. involvement. 1988 cable 224820.			x	
Project designs should specify methods for comparing actual progress and results with those anticipated. Handbook 3, Chapter 3, Appendix 3K, and Chapter 4, Appendix 4B.			x	This Handbook requirement for targets, progress indicators, and planning assumptions was not reviewed in detail, but we noted the Mission's initial four bilaterial subprojects and one operational program, grant did not contain these needed elements for comparison.
Issue a Mission Order to formally establish a monitoring and evaluation system. A.I.D.			x	

POLICY/PROCEDURAL REQUIREMENTS	YES	PARTIAL	NO	COMMENTS
Supplement to Chapter 12, Handbook 3.				
Prepare Project Implementation Status Report. Handbook 3, Chapter 11.	x			
Objective No. 3 - Subtotal 9	3	2	4	
OBJECTIVE No. 4				
Budget allowances are to be received prior to obligations. Controllers Guidebook Chapter 13.	x			
Mission project accounting should conform to the A.I.D. Project Accounting System. Controller Guidebook Chapter 13.	x			
Prior to payment, vouchers are properly approved, fund availability is verified, and the voucher is examined. Controller's Guidebook Chapter 5.	x			
Cash advances are not in excess of recipient immediate needs. Controller's Guidebook Chapter 16.	x			
Project ledgers are maintained on an accrual basis. Controllers Guidebook Chapter 13.		x		Accruals were not reported for three of the eight projects for which the Mission retained accounting responsibilities.
Mission accounts are closed monthly. Controllers Guidebook Chapter 13.	x			

POLICY/PROCEDURAL REQUIREMENTS	YES	PARTIAL	NO	COMMENTS
U-IOI reports to A.I.D./Washington are prepared monthly. Handbook 19, Chapter 9.	x			
Prior to making a cash transfer the Mission cables A.I.D./Washington to certify compliance with conditions precedent.	x			
INTERNAL CONTROL REPORT				
Prepare Mission General Assessment. A.I.D. Payment Verification Policy #1.	x			
Objective No. 4 - Subtotal 9	8	1	0	
T O T A L 26	13	6	7	