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REPORT

ON

INCAE-ROCAP ANNUAL BUDGET REVIEW MEETING

A.I.D. Loan No. 596-L-012

August 6-8, 1975

TABLE OF CONTENTS

	<u>Page No.</u>
Participants	ii
I. Introduction	1
II. Discussion of Major Issues	2
A. CPA Management Reports	2
B. Student Loan Fund	4
C. Construction	7
D. Budget - July/August 1975 and FY 1976	9
III. Conclusions	13

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INCAE/ROCAP ANNUAL BUDGET REVIEW MEETING - FY 1976

August 6-8, 1975

I. Introduction

ROCAP's primary concern is the viability of INCAE as the institute for advanced management training in Central America. Information brought to ROCAP's attention from a variety of sources (e.g. Auditor's Management Report, AID Audit and others) has shaken ROCAP's confidence in the ability of the Institute to effectively manage itself. Many problems have surfaced which have aroused a sense of skepticism with respect to the probable viability of the Institute in the years following total disbursement of the AID Loan.

The discussions focused on five major subjects which reflect INCAE's problem areas and our mutual concerns. Those subjects are:

- A. Peat, Marwick & Mitchell Management Reports for FYs 1973 and 1974 - These reports outlined in great detail INCAE's numerous accounting deficiencies and are simply another indication of the Institute's inadequate management.
- B. Student Loan Fund - The repayment of student loans is of critical importance to the Institute's viability. ROCAP is concerned that the Fund may not become self-financing including amortization of the \$1 million under the AID Loan earmarked for student loans as originally intended. INCAE must exercise careful management control over the Fund and aggressively pursue the collection of delinquent payments.
- C. Construction - With the construction of the new residences near to completion, INCAE and ROCAP must assure that payments to both the contractor and the A/E firm are accurate and all differences reconciled. The issue of new classroom construction must be resolved.
- D. Budget: FYs 1975 and 1976 - ROCAP needs a detailed analysis of both budgets. Of particular concern is the comparison of the FY 1975 budget to actual FY 1975 figures, and the prospects of achieving projected levels of income for FY 1976 and future years.

- E. Institutional viability - The success INCAE has in resolving its management problems will determine the future of the Institute and its viability. Now, in the last year of disbursement of the AID loan, this issue becomes even more critical than in the past. INCAE must focus on improving its poor working capital condition (cash) if the Institute is to become viable.

During the course of our meetings at INCAE, these issues were discussed at length.

II. Discussion of Major Issues

A. Peat, Marwick & Mitchell Management Reports

The reports were given considerable attention during the meetings. ROCAP's position was that the reports seriously damaged the credibility of data from INCAE. An Institute that professes to be the leader in business management training should not have the numerous deficiencies attributed to it in the reports. Further, ROCAP stressed the damage such a report could ultimately do to the Institute as a result of the "Freedom of Information Act." If such information were to become public, it could seriously threaten INCAE's credibility in both public and private sectors. This could be translated into an unwillingness to support the Institute through 1) contributions, 2) participation in the AMP and Seminars, and 3) contracts to the Advisory Center.

INCAE feels that some of the deficiencies are a result of the complexity of the Fund Balance Accounting System. Few people in Nicaragua know the system, most professional auditors do not use it, and INCAE employees received no training in its application. Because of the many entries required for each transaction, INCAE has found it to be both cumbersome and confusing. For these reasons, INCAE would like to switch to a more conventional accounting system. ROCAP sees no advantage in using the

present system and has no objection to the switch. In fact ROCAP was opposed to the Fund System from the beginning (about two years ago) and cautioned INCAE about adopting it. It did so upon the recommendation of its external auditors. The representative from Arthur Anderson (INCAE's new CPA) who is doing this audit is, coincidentally, the person who designed INCAE's present Fund System and he feels that the switch can be made with a minimum of problems and should save 20%-30% of the present work in the accounting system. Accounts will be consolidated over a period of time so that the move into the new system will be a gradual one.

In addition to the switch to a more conventional accounting system, INCAE is taking actions to correct some of its management deficiencies. The hiring of a new controller (recent MBA graduate) who was put in charge of accounting (for the present) was the first step. While good accountants are scarce in Nicaragua, INCAE believes it has found one who has the credentials to take over the Accounting Department. For the present he will report (when hired) to the Controller. If his work is satisfactory, he will be named Chief of the Accounting Department. INCAE has also signed an agreement with the International Executive Service Corps (IESC) to bring in a retired controller (hopefully with university experience) to help the new Controller and Accounting Department. The IESC is currently seeking a candidate. INCAE hopes he will be available, once identified, by the first of September to help in the switch in accounting systems.

According to INCAE, the Arthur Anderson representative is pleased with the progress being made in correcting the deficiencies. ROCAP spoke with him and he has agreed that, in addition to the Management Report for FY 1975, he will prepare an interim report verifying the actual progress that has been made. The audited financial statements (June 30,

1975) and Management Report should be ready on schedule - no later than October 15.

ACTIONS REQUIRED

1. INCAE must present to ROCAP a formal request to switch from its present accounting system to a more conventional one.
2. The CPA representative will prepare and submit to ROCAP an interim report on INCAE's progress in correcting the deficiencies identified in Peat, Marwick & Mitchell's Management Report.
3. INCAE will request ROCAP to accept Helmuth Carl (Controller) as an authorized representative under the Loan Agreement, pursuant to Section 9.02 of the Loan Agreement.

B. Student Loan Fund

An effective, well managed Student Loan Fund (SLF) is essential to INCAE in attracting MBA students and maintaining enrollment at the budget levels. It allows a broader range of students to attend the Institute and, as a self-financing fund, which it was designed to be, it should give the Institute revenues to cover its SLF administrative expenses and to amortize \$1 million of the AID loan set aside for the SLF. Now, as we come into the last year of AID disbursements for the SLF a number of serious issues must be confronted and resolved:

- Is it possible to say that the SLF is or will become viable or is this a concept impossible to achieve? Should additional resources be put into the Fund?
- Taking into consideration other sources available, are the overall resources adequate to maintain the Fund?

- What must INCAE do to assure that resources will be forthcoming?
- Has INCAE been successful in managing the Fund and in collecting repayments and, related to this, in lowering the delinquency rate?
- Has INCAE benefited from the poor performance under the pre-AID loan programs or will the same patterned be repeated?

If these issues cannot be satisfactorily resolved and adequate resources are not available, the MBA program will be placed in jeopardy and the concept and viability of the school seriously questioned.

In retrospect, INCAE feels that one serious oversight was underestimating the administrative expenses needed to administer the Fund. The projections called for a limited increase in administrative expenses while the financial and reporting needs (commensurate with delinquencies) of the Fund were expanding. In the future (this should be done immediately) a full-time manager of the Fund will be needed in addition to the two assistants currently handling it.

The Fund due to rising tuition and living costs is inadequate to meet the student loan needs and for that reason INCAE is seeking additional assistance from other sources. To date INCAE has reached agreement with the following institutions to finance student loans:

1. Nicaragua: Asociación Bancaria (Banking Association) will finance 100% of Nicaraguan students' financial needs.
2. Honduras: EDUCREDITO (National Student Loan Fund) will finance 100% of Honduran students' financial needs.

3. Panama: IFARHU (National Student Loan Fund) will finance up to \$4,000 per Panamanian student per year.
4. El Salvador: Fondo de Desarrollo del Banco Central (Development Fund of the Central Bank) will probably finance up to 50% of the needs of Salvadoran students requiring financial assistance.
5. Venezuela: Programa de Becas Gran Mariscal de Azacucho (Government scholarship fund) will finance ten Venezuelan students per year at INCAE.

Negotiations are underway with the Bank of America and the Government of Venezuela to provide financing for students from countries that do not have resources available for student loans.

If the financing explained above can be made available in the future, and the AID-financed SLF can be managed to keep delinquencies at a minimum, INCAE should be in a position to maintain its present admissions policy and have a Fund that will be able to finance a sizeable number of students each year.

Control of the delinquency problem is critical and ROCAP had in depth discussions with INCAE concerning the effectiveness of the measures being employed. As of June 1975, 18% of total payments due were delinquent and 46% of all loans being amortized contained delinquencies of various degrees.

As a result of the findings of the AID Audit Report (August 11, 1975), INCAE administration of the SLF has shown some improvement. ROCAP will continue to monitor the SLF closely, particularly INCAE's ability to control delinquencies.

ACTIONS REQUIRED

1. INCAE will request the Bank of America to record all entries (debits and credits) made to the SLF

account on each monthly bank statement. Without these entries INCAE is unable to reconcile the SLF. INCAE presently has two SLF accounts. Only one is needed and at ROCAP's suggestion INCAE will close one account. This will facilitate reconciliation.

2. INCAE will continue to submit the F-2 Attachment (monthly SLF Report) including the bank statement for the corresponding month. (The F-2 reports for April, May and June were submitted but have to be modified before they can be accepted).
3. INCAE will revise its letter of July 18, 1975 informing ROCAP of a transfer of funds from the SLF repayment account to its operational account reimbursing INCAE for student loans financed from its operational expenses. All of the \$42,296 transferred was used for student loans; \$10,000 was not used for administration as erroneously stated by INCAE in its letter.
4. As mentioned above, INCAE will close one of its SLF accounts with the Bank of America in Panama. In the future all AID loan disbursements and student loan repayments will be made to the same account.
5. INCAE will submit to ROCAP new projections for the SLF.

C. Construction

Even though the cost of constructing student residents increased substantially over the original projections, the rents to be paid by the students are sufficient, according to INCAE, to keep this activity on a self-financing basis. However, these estimates are based on the present market and should housing rentals decrease in the area, INCAE would have to subsidize its student housing. Present

INCAE projections show INCAE covering its housing costs including amortization of that portion of the loan.

With the AID-financed construction drawing to a close, discrepancies have been noted in the contractor's, INCAE's and ROCAP's records concerning amount disbursed and that which is available for disbursement. This is especially true in the case of the A/E consulting firm (Diseños y Construcciones). Because the entire construction program envisioned in the loan and contract with Diseños was not completed, ROCAP feels that there has been an overpayment because of the advance payment given to the consultant at the start of the contract. The scope of work of the consultants contract must be reviewed and revised to fit existing conditions.

There are several options on how to proceed. One would be to negotiate a settlement to the contract as of the termination of the present construction and negotiate a new contract for any additional work that INCAE wants to have done. Another would be to renegotiate the entire contract including those elements not completed but which INCAE expects to do in the future - e.g. classroom design.

INCAE is anxious to at least complete design work for the new classroom so it has an idea as to construction costs. INCAE has made a request for funding from the Banco Central to construct the new classroom. INCAE has received positive indications that something will be forthcoming; however, the amount is not known. If it is a sizeable percentage of what is needed, INCAE hopes to attract other local sources to contribute the remainder.

It is ROCAP's position that the issue of what is to be done with the funds remaining from the A/E contract is only part of a total package which must be

considered in approving the budget. If the position on approval is favorable, ROCAP and INCAE would then move forward in deciding how to best utilize the remaining funds.

ACTIONS REQUIRED

1. No further disbursements will be made under either construction or A/E supervision and design until all differences in amounts paid and due are reconciled.
2. INCAE will begin negotiations with the A/E firm to adjust the scope of contract for the remaining services necessary under the revised construction schedule.
3. ROCAP will decide how it feels INCAE should proceed on terminating the present A/E contract and the possibility of negotiating an additional one for design and supervision (if funds needed are forthcoming) of the classroom.

D. Budget - July/August 1975 and FY 1976

The budget discussion was approached on a Cost Center basis using the INCAE FY 1976 budget as the basic document. Comparisons were made to the actual FY 1975 figures, and, where appropriate, reference was made to the July/August budget. While each Center was discussed, this report will only deal with those most critical to the financial viability of the Institute.

1. MBA Cost Center

As in last year's review, ROCAP noted the deficit in this Cost Center. According to INCAE, economies-of-scale cannot be achieved (increasing students means increasing revenue and,

therefore, a decreasing deficit). The deficit is a function of internal management which decides the expenses that will be charged to the MBA, the seniority of those professors (salaries), and other variables. Decisions on the academic program cannot be based strictly on financial decisions. The main criterion must be academic excellence. Hence, revenue is demanded from other Cost Centers to cover the costs of the MBA.

In terms of enrollment, the picture looks good. FY 1976 will see 70 second year students with projections for 85 first year students. The lower attrition rate, a result of several factors including stricter admissions requirements, a "Head Start" program for students weak in math and accounting, etc., should mean an average enrollment during the year of 150. The ultimate goal is approximately 180 students, all of whom can be accommodated with the rearrangement of classroom seating currently underway. (New capacity of first year classroom will be 105, with 65 for second year classroom.)

2. AMP Cost Center

The design of the AMPs has changed allowing more flexibility and the realization of greater profits. Instead of four-week sessions which made it difficult for many executives to attend, the Programs have been divided in four one-week programs (called modules) with each module focusing on a different subject. This allows much greater flexibility enabling INCAE to skim a regional market, offering the modules in different locales. Executives are more able to get away for one week than four, so enrollment is expected to rise, and the market is left intact for a different module in the following year. A one week session held in Bolivia

this past year was quite successful and lends credibility to the probability of success in the future.

3. Seminar Cost Center

These, too, have been re-structured allowing INCAE to realize greater profits than in the past. Most of the expenses in the past have gone to hotel services. The present theory is to offer fewer services, but charge rates comparable to those in the past. In FY 1976, 30 Seminars will be offered, but only 2 will include full room and board at the hotel. The other 28 will be nonresident and participants will have to pay for their own lunches and other services.

Enrollment has also increased in the Seminars during the past year so INCAE is projecting seminars of 40 students instead of the 35 in the past.

4. Fund Raising Cost Center

Fund raising is also an income producing center for INCAE but once again it is ROCAP's view that, based on past experience, the projections for income are too high. The projection for FY 1976 is equal to that projected (but not realized) for FY 1975.

INCAE does not feel that it can go to its Board of Directors with a budget that asks for less than last year's in fund raising. At the present time, promises have been received from the governments of Panama, El Salvador, Guatemala, Nicaragua, and Honduras totalling \$178,400. Goals have been set for each country toward obtaining the additional \$91,600 budgeted.

Programs for raising funds will be strengthened in those countries that have had weak ones in the past, and increased efforts will be made to obtain contributions from US companies

operating in Central America. (According to Dr. Cruz INCAE continues to work on obtaining a classification from the IRS of nonprofit status so that contributions from those firms in the US are tax deductible.)

5. Advisory Center Cost Center

Virtually all income projected for this Center for FY 1976 and a good deal for succeeding years is predicated on a proposed second GON/INCAE \$1 million contract for further services (\$500,000 from USAID/Managua and \$500,000 from the GON) which was to have been signed last February. To date there is no clear indication as to when it will be signed.

The GON has yet to reimburse almost \$400,000 to INCAE for services under the initial 1973 contract establishing this Center. This partially explains the deterioration of INCAE's working capital, for since the Center's inception INCAE has been relying on its income for 20-22% of all budgeted expenses, making the Center vital to the operation of the Institute.

INCAE therefore finds itself without sufficient cash resources to meet the current payroll of the Advisory Center, not to mention future commitments under contractual arrangements recently made with several professionals for the next year. In short, INCAE has budgeted expenses (largely a fixed commitment in salaries) at \$495,000 with no assurance, until the GON contract is signed, that these expenses will be offset by revenues budgeted at \$630,000. To meet its payroll INCAE advised that it has no recourse but to seek commercial bank financing. (Note: any INCAE borrowing in excess of one year is subject to AID approval.)

ACTIONS REQUIRED

INCAE will submit to ROCAP:

1. "Sources and Application of Funds" tables for FYs 1975 and 1976;
2. Proforma Balance Sheets for the periods June 30, 1975, August 31, 1975, and August 31, 1976;
3. Analysis (aging) of its accounts receivable;
4. July/August 1975 budget: a letter advising of those items that have changed since budget was submitted to ROCAP in March, notably those affected by recent salary increases.

III. CONCLUSIONS

1. Institutional Viability

The purpose of the AID Loan was to help INCAE become viable over a six to seven-year period. In this connection, an important INCAE goal was to build up cash reserves and working capital so it could operate in the black. During the first three years of the Loan INCAE operated with deficits as anticipated and as the CAP projected; however, INCAE now finds itself during the fourth and final year of the Loan (FY 1976) still operating at a deficit and with slight prospects of being able to operate in the black or to live within its means in the years ahead. Furthermore, INCAE has insufficient working capital (cash) to operate at present levels. Whatever cash INCAE has had primarily as a result of the AID Loan has gone into (1) capital expenditures, (2) completion of construction including temporary facilities and remodeling, and (3) meeting working capital needs. The latter are high and have a direct bearing on INCAE's inability to exercise control over expenses (e.g. recent salary increases). The prospects for viability are further shaken by INCAE's resorting to commercial bank loans to meet payroll obligations.

2. Loan Compliance

Pursuant to Section 3.02 of the Loan Agreement, disbursements cannot continue until ROCAP approves the FY 1976 budget. This will depend on ROCAP's receipt and evaluation of additional information requested at the Review and described in this report. ROCAP's approval of the budget will take into consideration two primary issues effecting the program:

- a. Based largely upon INCAE's monthly reports beginning in April of this year, ROCAP will determine if INCAE management has taken and will continue to take stringent actions and controls to keep student loan delinquencies at minimal levels.
- b. Based largely on a report from INCAE's external auditors, Arthur Anderson, ROCAP will determine if INCAE is making adequate progress in correcting its management deficiencies, the time and factors involved in removing all deficiencies and whether INCAE management has the capability to effectively operate the Institute. (The Arthur Anderson report is essential to offset the damaging Peat, Marwick and Mitchell Management Reports. Reference: ROCAP letter to INCAE dated July 30, 1975.)

From the standpoint of putting all the issues on the table the Review was successful; finding solutions to these issues is another matter. Overcoming its severe management deficiencies to ROCAP's satisfaction will be difficult for INCAE, but even more difficult will be finding solutions to its deteriorating cash situation, which is largely in the hands of the GON.