PD-AAV-094

IAN: 48885

AUDIT OF
USAID/COSTA RICA'S
PRIVATE SECTOR EXPORT CREDIT
PROJECT NO. 515-0187

Audit Report No. 1-515-87-19
March 17, 1987

AGENCY FOR INTERNATIONAL DEVELOPMENT

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March 17, 1987

MEMORANDUM

TO: USAID/Costa Rica, Director, Daniel Chaij

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

SUBJECT: Audit of USAID/Costa Rica's Private Sector Export Credit Project No. 515-0187

This report presents the results of audit of the Costa Rica Private Sector Export Credit Project No. 515-0187. The Office of the Regional Inspector General for Audit/Tegucigalpa made a program results audit of the project. The audit objectives were to determine the success in achieving planned results, compliance with AID and project requirements, and the adequacy of administrative internal controls at the Mission and the borrower.

The audit found that the project had achieved some degree of success in assisting in the resolution of the private sector liquidity crisis, in enhancing the private sector's capacity to earn foreign exchange, and in reestablishing the Costa Rican Industrial Finance Corporation (COFISA) as a development oriented financial institution. Compliance with the AID loan agreement was generally satisfactory except that COFISA's subsidiary, COFISA International, had not established the required reserve for bad debts nor increased its capital as contemplated. Internal control weaknesses were more serious: The local currency loan agreement lacked a clause to renegotiate concessional loan terms to avoid windfall profits to COFISA's stockholders; AID had not obtained from COFISA a repayment guaranty for the AID loan; and insider lending was unrestricted.

The audit found that COFISA International was not maintaining a bad debt reserve as required by the project and generally accepted accounting principles, that COFISA International had fallen significantly short in raising $800,000 in share capital, and that the AID loan was not guaranteed because the loan agreement was never amended to make the parent company (COFISA) responsible for the obligations of its subsidiary (COFISA International).

The report recommends that project agreement and generally accepted accounting principles for bad debt reserve requirements be adhered to, that more effective steps be taken to sell the remainder of the capital stock to raise $800,000 in share capital, and that the AID loan be amended to make the parent company (COFISA) responsible for the obligations of its subsidiary (COFISA International).

The Mission agreed with the recommendation to amend the loan agreement to make the parent company responsible for the obligations of its subsidiary. However, the Mission did not agree with our finding and those of the project evaluators that the COFISA International was not maintaining the required bad debt reserve nor following generally accepted accounting principles. The Mission stated that the accountants of COFISA International and a local American affiliated C.P.A. firm had assured the Mission that they were following general accepted accounting principles and loan agreement requirements. The Mission also disagreed with the recommendation to have COFISA International redouble its efforts to sell the remaining capital shares stating they were in compliance because they had used their best efforts in trying to sell the stock. Mission comments were considered in preparation of this report and are included as Appendix 1.

In order to close the reserve for bad debt recommendation and comply with the loan agreement, COFISA should adopt generally accepted accounting principles and practices.

Please advise us within 30 days of any additional information relating to actions taken or planned to implement the audit recommendations.

We appreciate the Mission's cooperation and courtesy extended to our staff during the audit.

EXECUTIVE SUMMARY

The Costa Rican Industrial Finance Corporation was incorporated in Costa Rica in 1963 as a privately held development finance institution, and has been supported by AID since its creation. With the deterioration of the Costa Rica economy in 1980 and changes in Costa Rican monetary and foreign exchange policies in 1981, the financial viability of the corporation was seriously threatened. Because of these factors and its importance as a major finance institution to the economy, AID loaned the corporation's Panama-based subsidiary, the International Costa Rican Industrial Finance Corporation, $10 million on September 30, 1982. Additionally, on June 22, 1983 the corporation received a $5 million local currency loan. The local currency loan which was generated under AID's Economic Stabilization and Recovery program, was used as the required counterpart contribution to the project.

The goal of the project was to contribute to the reestablishment of dynamic growth of the Costa Rican economy. The project's threefold purpose was to assist in the resolution of the current private sector liquidity crisis, to enhance the private sector's capacity to earn foreign exchange, and to reestablish the corporation as a development oriented financial institution. Project funds were to be used entirely for the development of dollar and colon (local currency) denominated subloan/equity investment portfolios. As of September 30, 1986, $8.3 million of the $10 million AID loan and the entire $5 million local currency loan had been disbursed. Also, the subsidiary had raised the equivalent of $422,326 of $800,000 required in equity contribution. The project assistance completion date, originally set at September 28, 1985, had been extended to December 31, 1986.

The Office of the Regional Inspector General for Audit/Tegucigalpa made a program results audit of USAID/Costa Rica's Private Sector Export Credit project from its inception on September 30, 1982 to November 13, 1986. Audit objectives were to determine the success in achieving planned results, and compliance with AID and project requirements. Administrative internal controls were examined at the Mission and at the corporation and its subsidiary.

As of September 30, 1986, the project had been partially successful in achieving planned results. The project had assisted in the resolution of the private sector liquidity crisis, and had enhanced the sector's capacity to earn foreign exchange by providing scarce dollars to this private sector institution. Also, the corporation had reestablished itself as a viable development oriented financial institution much sooner than planned, mainly as a result of a favorable debt settlement with its foreign creditors in 1985. Compliance with the AID loan agreement was satisfactory except that the the subsidiary had not established a reserve for bad debts nor increased its capital as required. Internal control weaknesses were more serious: AID had not obtained from the corporation a repayment guaranty for the AID loan to the subsidiary; insider lending was unrestricted; and the local currency loan agreement lacked a clause to renegotiate concessional loan terms in order to avoid windfall profits to the corporation's stockholders.

The corporation's financial position had improved more quickly than planned. According to project paper estimates, it was not expected to reach a positive equity of $10 million until after 10 years. However, it actually achieved this in four years. Since the settlement of its debt on favorable terms, the corporation had returned to profitability. Net profits for the year ending September 30, 1986 were equivalent to $1.3 million.

The audit identified several specific problem areas. The subsidiary was neither maintaining a bad debt reserve as required nor was it following generally accepted accounting principles in the treatment of its bad debt reserve and expenses. As of September 30, 1986, the subsidiary had increased its share capital by the equivalent of $422,326, which was $377,674 short of the $800,000 increase the loan agreement contemplated. Finally, the AID loan was not guaranteed since the loan agreement was never amended to make the parent company responsible for the obligations of its subsidiary.

The AID loan agreement required the subsidiary to maintain a reserve for bad debts of not less than two percent of all outstanding loans and to follow generally accepted accounting principles in the preparation of its financial statements. However, the subsidiary had disregarded generally accepted accounting principles since it established a reserve by segregating a portion of retained earnings within the net worth account rather than charging the income statement. In addition, the subsidiary only set up a reserve of one-half of one percent of outstanding loans instead of two percent required by the loan agreement. As a result, the subsidiary had not established the required reserve for bad debts, had overstated profits by about $165,205, and had incorrectly reported assets and equity. The subsidiary's officials did not provide evidence that its Board of Directors had established a policy on reserve for bad debt. Thus, the subsidiary was neither complying with the AID loan agreement nor adequately protecting its loan portfolio against bad debt losses. We recommended that the AID loan agreement be amended and that the subsidiary comply with the bad debt reserve requirement.

The AID loan agreement originally required the subsidiary to place at least $800,000 in new US dollar denominated preferred shares with the public during the first three years of the project. On September 30, 1985, USAID/Costa Rica authorized the increase in capital in an equivalent amount of Costa Rican colones and required that at least 50 percent of the new shares be sold to the public. The amended deadline for such an increase was May 15, 1986. As of September 30, 1986 the subsidiary had increased its share capital by the colon equivalent of $422,326, which was $377,674 short of the $800,000 increase AID had required. The subsidiary had been unable to sell enough shares to the public because the corporation, the parent institution, did not have an image as a profitable dividend-paying corporation and the subsidiary did not actively promote the sale of the new shares. As a result, failure by the subsidiary to sell the remainder of the new stock issue was preventing compliance with the terms of the loan agreement, diversification of its stock ownership, and strenghtening of its financial position. We recommended that more effective steps be taken to sell the remainder of the stock.

The subsidiary was the borrower under the AID loan agreement, yet the parent company was not a party to the agreement because the agreement required, as a condition precedent to disbursement, making the subsidiary the parent company through a stock swap. This condition precedent, however, was later deleted from the loan agreement on the basis that emerging Costa Rican monetary laws would adequately protect the subsidiary from legal risks associated with exchange rate fluctuations. However, the AID loan agreement was never amended to make the parent corporation responsible for the subsidiary's obligations to AID. As a result, should the subsidiary, the borrower, ever default in its repayment obligations to AID, USAID/Costa Rica will have no legal recourse against the parent corporation. In addition to the above, the the corporation obtained a $5 million local currency loan that was intended as its subsidiary's counterpart contribution to the project, even though the parent corporation was not legally part of the project. We recommended that the corporation guarantee the repayment of the AID loan.

In Other Pertinent Matters we discuss the issue of concessional rate local currency loans. Under AID's Economic Stabilization and Recovery program, the corporation received a $5 million local currency loan whose concessional interest rate of five percent was no longer justified. However, there was no renegotiation clause in the loan to permit renegotiation of this concessional rate of interest.

Office of the Inspector General

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PART I - INTRODUCTION

A. Background

The Costa Rican Industrial Finance Corporation (COFISA) was incorporated in Costa Rica as a privately held development finance institution. AID made an initial loan for the creation of COFISA in 1963 and a second loan in 1969. As a result of the AID loans and sound management, COFISA grew impressively and contributed significantly to Costa Rican development. However, with the deterioration of the Costa Rican economy in 1980 and changes in Costa Rican monetary and foreign exchange policies in 1981, the financial viability of COFISA was seriously threatened. In July 1981, the Costa Rica Supreme Court ruled that obligations incurred within Costa Rica, denominated in foreign currency, could be repaid in colones (local currency) at the official rate of exchange. This gave COFISA debtors the legal right to service their dollar-denominated debts in colones at a grossly overvalued exchange rate, which resulted in an exchange loss to COFISA equal to almost twice the value of its common stock. By September 1981, COFISA's cash flow problems had become so serious that it was no longer able to service its debt of more than $60 million, and it was thus forced to try to negotiate a debt settlement with about 50 foreign creditors.

Given the importance of COFISA as a major financial institution in the economy, AID loaned COFISA $10 million on September 30, 1982 under project No. 515-0187. Due to legal uncertainity regarding foreign exchange loan transactions, the loan was actually made to COFISA's Panama-based subsidiary, the International Costa Rican Industrial Finance Corporation (COFISA International). In addition to this loan, on June 22, 1983 COFISA, on behalf of its subsidiary, received a $5 million local currency loan. This loan, made from local currency generated under AID's Economic Stabilization and Recovery program, was regarded as part of the required counterpart contribution to the project.

The goal of the project was to contribute to the reestablishment of dynamic growth of the Costa Rican economy. The project's threefold purpose was to assist in the resolution of the private sector's liquidity crisis, to enhance its capacity to earn foreign exchange, and to reestablish COFISA International as a development-oriented financial institution.

The total estimated cost of the project was $15.8 million. This consisted of the $10 million AID loan, the $5 million local currency loan and COFISA International's equity contribution of $800,000. Project funds were to be used entirely for the development of dollar and colon denominated sub-loan/equity investment portfolios. Loans were authorized for producers of both traditional and non-traditonal products; however, no more than 35 percent of the AID-financed sub-loans could be extended to producers of traditional products. It was also expected that the dollar denominated sub-loans would be extended primarily to exporters. Short, medium, and long-term loans could be made, but at least 30 percent of all sub-loans were to be for medium and long-term financing by the end of the project's third year.

As of September 30, 1986, $8.3 million of the $10 million AID loan and the entire $5 million local currency loan had been disbursed. COFISA International had raised the equivalent of $422,326 of its required $800,000 equity contribution. The project assistance completion date, originally set at September 28 1985, had been extended to December 31, 1986.

B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Tegucigalpa made a program results audit of USAID/Costa Rica's Private Sector Export Credit project from its inception on September 30, 1982 to November 13, 1986. The audit covered $8.3 million in accrued and actual AID expenditures as of September 30, 1986. Audit field work was conducted from September 2 to November 13, 1986.

Audit objectives were to determine COFISA's success in achieving planned results, compliance with AID and project requirements, and adequacy of administrative internal controls at the Mission and the borrower.

To accomplish these objectives, we reviewed project files and interviewed project officials at USAID/Costa Rica, COFISA, and COFISA International's offices, located in San Jose, Costa Rica. We also made field verifications and inspections of four different types of activities selected from COFISA International-financed projects to ascertain if these activities were within the purposes of the project. The audit was performed in accordance with generally accepted government auditing standards.

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PART II - RESULTS OF AUDIT

As of September 30, 1986, COFISA International had successfully reestablished itself as a viable development oriented financial institution ahead of schedule mainly as a result of a favorable debt settlement agreement with its foreign creditors in 1985. Compliance with the AID loan agreement was generally satisfactory except that COFISA International had not established the required level of bad debt reserves nor increased its capital as contemplated. Internal control weaknesses were more serious: the local currency loan agreement lacked a clause that would permit AID to renegotiate concessional loan terms to avoid windfall profits to COFISA's stockholders; AID had not obtained from COFISA a repayment guaranty for its loan; and insider lending was unrestricted.

As of September 30, 1986, the project had been partially successful in achieving planned results. The project had assisted in the resolution of the private sector liquidity crisis, and had enhanced the private sector's capacity to earn foreign exchange. Also, COFISA International had reestablished itself as a viable, development-oriented financial institution much sooner than planned, mainly as a result of a favorable debt settlement with its foreign creditors in 1985.

COFISA's financial position had improved more quickly than planned. According to project paper estimates, COFISA was not expected to reach a positive equity of $10 million until after 10 years. However, COFISA actually achieved this in four years, six years sooner than planned. Early in 1985, COFISA was able to liquidate a $27.4 million debt owed to 49 foreign creditors with a payment of $11 million. The settlement resulted in a book profit of $16.4 million, which converted a negative equity of $7.5 million into a positive equity of $8.4 million. Since the debt settlement, COFISA has returned to profitability. Net profits for the year ending September 30, 1986 were equivalent to $1.3 million (see Exhibit 1).

As of September 30, 1986, USAID/Costa Rica had disbursed $8.3 million under the AID loan, which COFISA International had in turn sub-lent to generate an estimated $21.8 million in accumulated foreign exchange export earnings and 1,612 new jobs. Under the local currency loan, which had been fully disbursed, COFISA had made 72 subloans, of which 85 percent were long-term.

The audit identified several specific problem areas. COFISA International was not maintaining bad debt reserves as required and was not following generally accepted accounting principles in treating bad debt reserves and expenses. As of September 30, 1986, COFISA International had increased its share capital by the equivalent of

$422,326, which was $377,674 short of the $800,000 increase AID had required. Finally, the AID loan was not guaranteed since the loan agreement was never amended to make the parent company (COFISA) responsible to AID for the obligations of its subsidiary (COFISA International).

In Other Pertinent Matters we discuss a local currency concessional interest rate loan which was no longer justified. Under AID's Economic Stabilization and Recovery (ESR) program, COFISA received, on behalf of COFISA International, a $5 million local currency loan as a counterpart contribution. This loan and its concessional rate of interest (5%) was made available during COFISA's debt settlement negotiations and was based on the assumption of a much less favorable settlement than was finally achieved. The concessional interest rate was no longer justified. However, there was no renegotiation clause in this loan to renegotiate the terms of the loan if COFISA's financial became markedly better.

We have recommended that USAID/Costa Rica: ensure that COFISA International maintains a bad debt reserve as required and follows generally accepted accounting principles in preparing its financial statements; authorize COFISA International to pay cash dividends on stock for 1986 and effectively monitor its efforts to increase its share capital as required; and amend the AID loan agreement to require COFISA, the borrower's parent company, to guarantee repayment of the AID loan.

A. Findings and Recommendations

1. Loan Agreement Provisions for Bad Debt Allowance Were Not Followed

The AID loan agreement required the borrower (COFISA International) to maintain an allowance for bad debts of not less than two percent of all outstanding loans and to follow generally accepted accounting principles in the preparation of its financial statements. However, generally accepted accounting principles were not followed by COFISA International since it established a reserve by segregating a portion of retained earnings within the net worth account rather than charging the income statement. In addition, COFISA International only set up a reserve of one-half of one percent of outstanding loans made with AID funds instead of two percent, as required by the loan agreement. As a result, COFISA International had not established the required reserve for bad debts, had overstated profits by about $165,205, and had incorrectly reported assets and equity. COFISA International's officials did not provide evidence that its Board of Directors had established a policy on reserve for bad debt. Thus, COFISA International was neither complying with the AID loan agreement nor adequately protecting its loan portfolio against bad debts.

Recommendation No. 1

We recommend that USAID/Costa Rica obtain evidence that the International Costa Rican Industrial Finance Corporation:

a) is complying with the AID loan agreement concerning two percent bad debt allowance in accordance with generally accepted accounting principles;

b) has prepared a formal risk assessment of the loan portfolio to establish a reasonably estimated allowance for bad debts and adjusted the allowance accordingly;

c) has adjusted both prior years' retained earnings and the current year's income statement to properly reflect expenses related to the required bad debt reserve; and

d) has a bad debt reserve policy approved by its Board of Directors.

Discussion

Annex I of the AID loan agreement required COFISA International to maintain a reserve for bad debts of not less than two percent of all outstanding loans. Under Annex II, AID also required COFISA International to follow generally accepted accounting principles in the preparation of its financial statements. It was therefore expected that, in handling the AID-required reserve for bad debts, COFISA International would set up the reserve as an offset to an asset account and charge actual bad debt expenses against earnings on its income statement.

Contrary to the AID loan agreement, COFISA International had established a bad debt reserve of only one half of one percent of the outstanding loan portfolio instead of the required two percent and had segregated the reserve in its equity account. No evidence was provided that this policy had been documented and approved by the Board of Directors. As of September 30, 1986 the estimated reserve segregated in COFISA International's equity account amounted to $68,459 for loans made with AID funds. This reserve should be $162,205 in order to comply with loan requirement that the reserve be not less than two percent of outstanding loans. The above practice was brought to USAID/Costa Rica's attention in an interim project evaluation published in August 1986. The evaluation stated that COFISA International, with the approval of its external auditors, had been segregating a portion of retained earnings within the net worth account under a contingency reserve; such practice had the effect of increasing the Corporation's assets and net worth by avoiding an automatic yearly charge against income. As of November 1986, the Mission had not taken any corrective action.

The AID loan agreement required COFISA International to maintain a two percent bad debt reserve for all outstanding loans. Using the two percent provision required by the AID loan agreement, the estimated bad debt reserve, as of September 30, 1986, would have been $165,205 for loans made with AID funds; the actual reserve was $68,459.

Since COFISA International had not established the reserve as required, it had incorrectly reported income and expenses in its financial statements, overstating profits by about $165,205, as well as assets and equity. As a result, COFISA International was not in compliance with the loan agreement. In addition, the $8.3 million which AID had disbursed and which the Corporation had in turn sub-lent to its clients would be better protected against potential bad debt losses if COFISA International had been required to maintain a two percent annual bad debt reserve from project inception.

In light of the above, we concluded that USAID/Costa Rica should obtain evidence that COFISA International is complying with the terms of the loan agreement and generally accepted accounting principles. This would provide the bank with greater protection from likely loan portfolio losses in the future, and reflect the true state of the bank's financial position in accordance with generally accepted accounting principles.

Management Comments

> USAID/CR has consulted COFISA's auditors as well as another U.S. affiliated audit firm regarding the accounting treatment for the reserve for bad debts. Both audit firms concurred that the accounting treatment for the reserve for bad debts was, 1) in accordance with generally accepted accounting principles, and 2) in accordance with the loan agreement. The fact that there is a difference of professional opinion between RIG auditors and local authoritative opinion, does not constitute non-compliance on the part of COFISA. The statement that COFISA "disregarded AID loan provisions regarding bad debt reserves and expenses ..." is not correct. There is no loan

provision regarding bad debt "expense". As further explained below under Part II A.2., COFISA uses both the charge-to-income and the reserve of retained earning method.

Inspector General Comments

Management's comments notwithstanding, COFISA is not abiding by the terms of the loan agreement nor following generally accepted accounting principles in the treatment of bad debt. According to Principles of Auditing, Walter B. Meigs, (fifth edition 1973), page 417, subsection II, the following rule applies:

> If the balance sheet is to reflect fairly the financial position of the business, the receivables must be stated at net realizable value, that is, face value less an adequate allowance for uncollectible notes and accounts. Accurate measurement of income requires an impartial matching of costs and revenues. Since one of the costs involved is the charge for uncollectible notes and accounts, the auditor's review of doubtful receivables should be looked upon as the verification of both income statement and balance sheet accounts. [emphasis added]

According to Jay M. Smith, Jr., in his book Intermediate Accounting, copyright 1981, chapter 7, page 201:

> Almost invariably some receivables will prove uncollectible. Uncollectible amounts must be anticipated if the charge for them is to be related to the period of the sale and if receivables are to be stated at their estimated realizable amounts.
>
> The amount of receivables estimated to be uncollectible is recorded by a debit to expense and a credit to an allowance account.

In addition, these references are clearly supported by Accounting Standards Board's Accounting Standards (1986), which establish generally accepted accounting principles. (See Section C59 on Contingencies, especially C59.105 and Section V18, Valuation: Use of Valuation Allowances, especially V18.102.)

In order to close this recommendation the Mission will have to obtain evidence that the loan agreement terms and generally accepted accounting principles are being followed. Also, a portfolio risk assessment will need to be obtained. Such an assessment was not contained in the project paper for this or the other two private sector credit projects (BANEX and PIC). All three of these projects have different bad debt reserve requirements even though the activities financed are closely similar. The amount of the bad debt reserve requirement should relate to the risk assumed by the lender, that is the greater the risk, the larger the reserve. Lender risk should be a function of several factors, such as the merits of the project itself, the borrower's equity in the project, and the realizable value of the borrower's collateral.

2. Equity Had Not Been Increased As Required

The AID loan agreement originally required COFISA International to use its best efforts to place at least $800,000 in new US dollar denominated preferred shares with the public during the first three years of the project. On September 30, 1985, USAID/Costa Rica authorized the increase in capital in an equivalent amount of Costa Rican colones and required that at least 50 percent of the new shares be sold to the public. The amended deadline for such an increase was May 15, 1986. As of September 30, 1986, COFISA International had increased its share capital by the colon equivalent of $422,326, which was $377,674 short of the $800,000 increase AID had required. COFISA International had been unable to sell enough shares to the public because it did not have an image as a profitable dividend-paying institution and because it had not actively promoted the sale of new shares. As a result, failure by COFISA International to sell the remainder of the new stock issue was preventing compliance with the terms of the loan agreement, diversification of its stock ownership, and further strengthening of its financial position.

Recommendation No. 2

We recommend that USAID/Costa Rica:

a) authorize the International Costa Rican Industrial Finance Corporation to pay cash dividends on stock for 1986, but only from sources of income earned on non-AID funds and reflows; and

b) authorize the International Costa Rican Industrial Finance Corporation to sell the remainder of the new stock issue to existing shareholders if it is unable to sell it to the public before October 1, 1987.

Discussion

The AID loan agreement, section 6.1.(3), originally required COFISA International to use its best efforts to place the equivalent of at least $800,000 in new US dollar denominated preferred shares with the public during the first three years of the project, that is, by September 30, 1985. While COFISA International's shareholders approved an $800,000 increase in the authorized share capital, the corporation was unable to sell the new stock. Major attention was focused on solving the serious financial problems resulting from the Costa Rica Supreme Court's decisions on currency devaluation. Aware of the crisis the COFISA group was facing, USAID/Costa Rica did not actively pursue COFISA International's compliance with the capital increase requirement. On September 30, 1985, several months after COFISA received a favorable debt settlement with its foreign creditors, USAID/Costa Rica, through Project Implementation Letter No. 11, amended the loan agreement requirement that the capital stock increase be denominated in dollars and authorized the increase to be achieved in an equivalent amount of Costa Rican colones. The implementation letter also required that at least 50 percent of the new shares be sold to the public. The amended deadline for the increase in capitalization was May 15, 1986.

As of September 30, 1986 COFISA International had increased its share capital by the colon equivalent of $422,326, which was $377,674 short of the $800,000 increase AID required. COFISA International had sold, as authorized by AID, the entire 50 percent of the new stock issue to existing shareholders and about 5.6 percent of the other 50 percent to the public. In general, COFISA International had been unable to sell the remainder of the new stock (44.4 percent) to the public because it did not have an image as a profitable dividend-paying institution, and had not aggressively promoted the sale of the new shares. In May 1986 COFISA International contracted brokerage services to sell the remainder of its new shares through the local stock exchange. Commercial advertisements for this purpose started to appear occasionally in local newspapers in July 1986. Notwithstanding COFISA International's selling efforts, failure to more effectively promote new shares with the public will prevent COFISA International from complying with AID loan agreement requirements, diversifying stock ownership, and further strengthening its financial position.

In order to facilitate efforts to sell more stock, USAID/Costa Rica should authorize COFISA International to pay a cash dividend for 1986 because COFISA (COFISA International's parent company) earned a net profit of $1.3 million for the year ending September 30, 1986 and had liquidated the bulk of its foreign debt. However, income earned on AID loan funds and reflows should not be used for the payment of dividends, since the AID loan agreement, section 6.1.(4), states that interest income from AID resources can be used only for the original loan purposes until the AID loan is fully paid.

Management Comments

> The intent of raising the $800,000 additional equity was to provide "another major source of capital" as stated in the loan agreement. Since COFISA in effect was able to provide a substitute major source of capital by way of a major debt settlement with creditors, it is doubtful whether or not the sale of remaining $377,674 of shares will have any significant impact on the project. In addition, the effect of the $377,674 unsold shares is barely 2% of the total project of $15.8 million.

Inspector General Comments

In our view, COFISA International did not exercise its best efforts to sell $800,000 in additional stock to members of the public. Financial statements were not published, and no advertizing attempts were made for over two years. We saw no evidence that COFISA International has any real desire to diversify its stock ownership, thus increasing the private sector base.

One of the goals of raising $800,000 in capital is to maintain the proper leverage between liabilities and owners' equity. This can only be achieved by increasing the equity account. We therefore continue to believe that these recommendations should be implemented.

3. AID Loan Was Not Guaranteed

COFISA International was the borrower under the AID loan agreement, yet COFISA, its parent company, was not a party to the agreement. The agreement required, as a condition precedent to disbursement, that COFISA International be made the parent company through a stock swap. This condition precedent was later deleted from the loan agreement on the basis that emerging Costa Rican monetary laws would adequately protect COFISA International from legal risks associated with exchange rate fluctuations. However, the AID loan agreement was not amended to make COFISA responsible for its subsidiary's obligations to AID. As a result, should COFISA International default on its repayment obligations to AID, USAID/Costa Rica would have no legal recourse against COFISA.

Recommendation No. 3

We recommend that USAID/Costa Rica amend the AID loan agreement to require the Costa Rican Industrial Finance Corporation to guarantee repayment of the AID loan.

Discussion

The project paper indicated that COFISA had nearly undergone bankruptcy in the early 1980's due to unfavorable interpretations of Costa Rican monetary and foreign exchange policies. The Costa Rica Supreme Court rendered two decisions in July 1981 regarding the devaluation of the country's currency. The Court first decided that the Executive branch of government had acted unconstitutionally in emitting its December 1980 decision to allow the colon to float and that the "official rate of exchange" was C8.60 to $1. The second decision concluded that obligations incurred within Costa Rica, denominated in foreign currency, could be repaid in local currency at the official exchange rate. COFISA had to obtain dollars at the higher floating rate to liquidate its foreign dollar debt, but the dollar denominated subloans were repaid at the lower official exchange rate. The shortfall resulting from these two decisions drastically affected COFISA's loan portfolio causing near bankruptcy.

To best protect the COFISA International's loan portfolio from these legal risks, the project paper recommended that COFISA International, a subsidiary of COFISA and the borrower of the AID loan, document all lending in Panama, the country of its incorporation. The project paper also recommended that the risks would be further reduced if COFISA were made a wholly-owned subsidiary of COFISA International through a stock swap. The AID loan agreement included a condition precedent to disbursement that required the recommended stock swap. However, this condition precedent was subsequently deleted from the loan agreement on the basis that new Costa Rican monetary laws would protect COFISA International from undergoing the type of financial crisis which COFISA had previously faced. The new monetary laws became effective August 24, 1984. Thus, the stock swap between COFISA and COFISA International never took place, leaving COFISA as the parent company.

As a result of a favorable debt settlement with its foreign creditor banks in 1985, COFISA regained financial strength and consolidated its sole ownership of COFISA International as well as several other profit-making subsidiaries. However, it never legally assumed responsibility for COFISA International's obligations to AID. This places AID in a vulnerable position should COFISA International ever default on its payment obligations.

Management Comments

> Recommendation is accepted as worded. USAID/CR has drafted an amendment in coordination with COFISA. To date, COFISA has agreed in principle and has expressed no objections to the draft amendment.

Inspector General Comments

We will close this recommendation upon receipt of evidence of an appropriate repayment guaranty.

B. Compliance and Internal Controls

Compliance

The audit disclosed two compliance exceptions:

-- AID loan provisions and generally accepted accounting principles were not followed for bad debt reserves; and,

-- as of September 30, 1986 COFISA International had increased its share capital by the colon equivalent of $422,326, which was $377,674 short of the $800,000 increase AID had required that COFISA International to use its best efforts to raise.

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

Internal Controls

The audit disclosed four internal control weaknesses:

-- the AID loan agreement was not amended to make COFISA responsible to AID for the obligations of its subsidiary, COFISA International;

-- COFISA obtained a $5 million local currency loan as a counterpart contribution for the project, even though COFISA was not legally part of the project;

-- No restrictions had been placed on "insider" lending (see comments under "Other Pertinent Matters"); and

-- the local currency loan agreement did not include any renegotiation clause which would give AID the option directly or indirectly to renegotiate the loan in the event of unanticipated improvement in the borrower's financial position (see "Other Pertinent Matters" following).

Other than the conditions cited above, nothing came to our attention that would indicate that untested items were not in compliance with applicable internal control standards.

C. Other Pertinent Matters

The audit identified an internal control weakness stemming from the lack of a conflict-of-interest covenant in the AID loan agreement. No recommendation to address this issue has been made in this report because of Mission objections and lack of AID/Washington policy guidance on conflict-of-interest provisions governing "insider" lending practices.

The AID loan agreement did not contain any provision that restricted "insider" lending within COFISA International. "Insider" lending refers to an activity whereby the directors, officers and/or employees of a business directly or indirectly benefit from loans of the business. In accordance with prudent management practices, the project paper recommended that the AID loan agreement contain the following provision: "Except as AID may otherwise agree in writing, the Borrower (COFISA International) shall not: ... make subloans to businesses or other activities in which any officer or employee (or his/her immediate family) of the Borrower has controlling or beneficial financial interest". The above provision, however, was omitted from the loan agreement.

According to COFISA International's officials, a common inducement for attracting qualified directors or managers to Costa Rican businesses is that they can benefit in good faith from the firm's operations and investments. Unrestricted "insider" lending within COFISA International led to cases of potential conflict of interest since it allowed at least 8 of 14 directors of the COFISA group (including COFISA International's parent company and its subsidiaries) to benefit directly, or through ownership interests in other companies, from COFISA International's investments.

In addition to the above, COFISA obtained a $5 million local currency loan that was intended for the project, even though COFISA was not legally part of the project. The AID loan agreement required COFISA International to provide resources for the project of no less than the equivalent of $5 million. Instead, COFISA obtained a $5 million local currency loan from AID's Economic Stabilization and Recovery (ESR) program as the intended contribution for the project, even though COFISA was not legally part of the project.

The issue of this loan is also of concern because COFISA, on behalf of COFISA International, received the $5 million local currency loan under AID's Economic Stabilization and Recovery (ESR) program number I at a concessional rate of five percent which is no longer justified.

AID's policy statement on Private Enterprise Development contained in AID handbook 1 indicates that concessional financing is, in essence, a grant of capital to the owners of a firm and, therefore, a generally inappropriate use of funds. However, the handbook indicated that concessionality could be warranted to finance unusual innovation, development risks assumed, and extraordinary start-up costs in order to provide a normal profit.

The Central Bank of Costa Rica provided $5 million in local currency generated under AID's Economic Stabilization and Recovery (ESR) program to the Costa Rican Coalition of Development Initiatives (CINDE). CINDE was to lend these funds to COFISA at a concessional interest rate. CINDE signed an agreement with the Agricultural Industrial Export Bank (BANEX) on June 17, 1983 to manage the loan, and BANEX in turn signed the loan agreement with COFISA on June 22, 1983. The loan was for a term of 15 years with a six-year grace period, and carried an interest rate of five percent on the outstanding principal. COFISA which had fully disbursed these monies by September 1984 was to use the loan proceeds to make sub-loans for development purposes at competitive market rates.

In agreement with USAID/Costa Rica, the Central Bank of Costa Rica regulates the special line of credit established under the ESR program. According to Central Bank's regulations, ESR loans to private and cooperative banks are to bear interest rates equal to the basic rate (20 percent as of September 1986) minus 6 percentage points. The Central Bank reviews and adjusts the rate quarterly, and adjustments apply to both the intermediate borrower (the private and cooperative banks) and sub-borrowers.

COFISA enjoyed almost double the normal margin on sub-loans and rollovers financed with the $5 million local currency loan. COFISA charged its clients interest rates ranging from 24 to 28 percent plus commissions but only had to pay five percent interest itself. Other banks, who borrowed local currency funds from the Central Bank under the ESR program, had to pay a competitive market rate, which in September 1986 was 14 percent.

Thus, COFISA earned a spread of nine percent more than the other banks and had an overall loan spread ranging from 19 to 23 percent. We estimated that COFISA earned above normal annual profits of $351,000 on its $5 million local currency loan (nine percent times $3.9 million, which is the current dollar equivalent of the original $5 million local currency loan at current exchange rates).

COFISA received very favorable terms under the loan because of the serious financial difficulties it was experiencing when the agreement was signed. These financial difficulties were the result of 1981 Costa Rica Supreme Court rulings regarding the devaluation of the local currency. The Court decided that obligations incurred within Costa Rica and denominated in foreign currency could be repaid in colones at the official exchange rate of C8.6 to $1. 1/ As a result, COFISA's clients paid off over $5.2 million in outstanding loans at the official exchange rate, causing COFISA an exchange loss equal to almost twice the value of its common stock. In light of COFISA's near bankruptcy, USAID/Costa Rica, along with the Central Bank and CINDE, agreed to give COFISA concessional terms under the loan. Early in 1985, however, COFISA's financial fortunes changed when it was able to liquidate a $27.4 million

1/ The colon is the unit of currency in Costa Rica. At the time of the audit, approximately C57 equaled $1.

debt ($12.9 million in principal and $14.5 million in accumulated interest and commissions) to 49 foreign creditors with a payment of $11 million ($1 million in cash and $10 million in Central Bank of Costa Rica dollar-denominated certificates). The settlement resulted in a book profit of $16.4 million, which converted COFISA's negative equity position of $7.5 million into a positive $8.4 million.

Since the debt settlement, COFISA had returned to profitability. As of September 30, 1986, COFISA's equity was equivalent to $10 million and net profits for the year were equivalent to $1.3 million (see Exhibit 1, Pages 1 and 2).

A concessional interest rate under the local currency loan can no longer be justified because COFISA was recapitalized much sooner than anticipated. According to project paper estimates, COFISA was not expected to reach a positive equity of $10 million until after 10 years. However, COFISA actually achieved this in four years. Also, COFISA is more profitable than planned. After four years of project life, COFISA earned a profit of $1.3 million compared to a projected $764,000.

COFISA also compared favorably to BANEX, another AID-assisted private sector development bank. COFISA has an equity of $10 million which is almost three times as large as BANEX's equity. Additionally, COFISA is more profitable than BANEX ($1.3 million for COFISA as of September 31, 1986 compared to a projected $1 million for BANEX as of December 31, 1986). Since BANEX borrows funds from the Central Bank under the ESR program at market rates, AID auditors have raised a question as to why COFISA should be entitled to a concessional interest rate under the loan.

The local currency loan agreement did not include any renegotiation clause which would give AID and CINDE the option directly or indirectly to renegotiate the loan in the event of unanticipated improvement in the borrower's financial position. However, the AID loan agreement with COFISA International included AID's standard renegotiation clause, which could be used by USAID/Costa Rica as leverage to encourage COFISA to renegotiate the interest rate under the local currency loan with CINDE.

Management Comments

USAID/Costa Rica considers it unethical and a breach of contract to attempt to renegotiate or amend loan agreements solely for its own benefit when the borrower has complied with loan covenants. To do so would damage AID's credibility and in turn its effectiveness.

The auditors comment about the AID policy regarding private enterprise development (Handbook 1) is based on an AID policy dated March 1985. The two subject loans in this project are dated September 1982 and June 1983. AID/CR does not consider retroactive application of new AID policies to old agreements acceptable. The auditors' comment that "concessional assistance to private sector firms is...a generally inappropriate use of funds" reflects current thinking on this issue and was unheard of three years ago.

Inspector General Comments

While we agree that our original recommendation (since deleted in view of the Mission's opposition to it) proposed an *ex post facto* remedy, we cannot agree that it was "unethical." AID stood to gain nothing from the recommendation because any benefit would have gone to CINDE, not AID. Since CINDE is already well funded by AID/ESF local currency generations, we concede that asking COFISA to make additional payments would serve no useful purpose except to limit the amount of concessional resources, or the return thereon, to a profit-making enterprise. Another alternative may lie with requesting COFISA to direct such "excess" profits to particularly risky loans or equity investment targets. Thus, while we have agreed to eliminate the recommendation, we continue to believe that the Mission should discuss the use of "excess" earnings from the CINDE concessional loan with COFISA in order to obtain optimum benefits therefrom.

AUDIT OF
USAID/COSTA RICA'S
PRIVATE SECTOR EXPORT CREDIT
PROJECT NO. 515-0187

PART III - EXHIBITS AND APPENDICES

Costa Rican Industrial Finance Corporation and International Costa Rican Industrial Finance Corporation

Consolidated Financial Statements 1/ as of September 30, 1986

Balance Sheet

Assets		
Cash		$ 1,785,055
Marketable Securities		4,209,883
Loans Receivable		17,738,740
Accounts Receivable		2,200,817
Legal Reserve		1,086,187
Fixed Assets		1,224,482
Other Assets		842,188
Total Assets		$29,087,352
Liabilities and Owners' Equity		
Liabilities		
Loans Payable	$13,601,236	
Demand Deposits Payable	3,623,149	
Letters of Credit	306,996	
Accounts Payable	815,168	
Accrued Expenditures	563,893	
Other Liabilities	148,437	
Total Liabilities		$19,058,879
Owners' Equity		
Common Stock	$ 1,765,225	
Retained Earnings	7,826,071	
Adjustments for Foreign Exchange Convertibility	321,630	
Other Equity	115,547	
Total Owners' Equity		10,028,473
Total Liabilities and Owners' Equity		$29,087,352

1/ Financial statements unaudited as of September 30, 1986. Exchange rate of C56.65 to $1 was used for conversion to dollars.

Income Statement

Revenue		
Interests and Commissions	$3,529,687	
Warehouse Operations	543,239	
Other Revenue	455,253	
Total Revenue		$4,528,179
Expenses		
Interest Expenses	$ 953,836	
General and Administrative	1,963,566	
Other Expenses	262,990	
Total Expenses		(3,180,392)
Income Before Taxes		$1,347,787
Income Tax		(61,229)
Net Income		$1,286,558

AGENCIA PARA EL DESARROLLO INTERNACIONAL
MISION ECONOMICA DE LOS ESTADOS UNIDOS EN COSTA RICA

Apartado Postal 10053
1000 San José, Costa Rica
Teléfono 33-11-55
Telex 3550 AIDCR KR

February 5, 1987

MEMORANDUM

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

THRU: Mr. Daniel A. Chaij, MDIR

FROM: Mr. G. Franklin Latham, Audit Liaison Officer

SUBJECT: USAID/CR Response to RIG Draft Audit Report on Project No. 515-0187 (COFISA)

The USAID/CR Controller's Office has reviewed the abovementioned report for the purpose of assisting the Mission in drafting its response to the RIG. We have met with the project officer and other appropriate individuals and have incorporated their comments. The responsibility of the Controller's Office with respect to the draft audit report is to coordinate the Mission's formal response contained herein. The observations made are in the same format as that of the auditors draft report.

"EXECUTIVE SUMMARY" SECTION

Unethical Recommendations

USAID/CR considers it unethical and a breach of contract to attempt to renegotiate or amend loan agreements solely for its own benefit when the borrower has complied with loan covenants. To do so would damage AID's credibility and in turn its effectiveness. The Executive Summary should incorporate this point of view in the final report if the RIG decides to leave such unacceptable recommendations in the report.

Concessional Interest Rate

The auditors comment about the AID policy regarding private enterprise development (Handbook 1) is based on an AID policy dated March 1985. The two subject loans in this project are dated September 1982 and June 1983. AID/CR does not consider retroactive application of new AID policies to old agreements acceptable. The auditors' comment that "concessional assistance to private sector firms is...a generally inappropriate use of funds" reflects current thinking on this issue and was unheard of three years ago.

[Note: Since the first recommendation has been dropped at the Mission request recommendation numbers in Mission comments do not correspond to audit report. Number 2 corresponds to number 1 in the report and so forth.]

USAID/CR requests that all reference to this issue be eliminated from the Executive Summary and that the above comments be included in the auditors final report under Part II A.1. (See also USAID/CR comments herein for Part II A.1. below).

Reserve for Bad Debts

USAID/CR has consulted COFISA's auditors as well as another U.S. affiliated audit firm regarding the accounting treatment for the reserve for bad debts. Both audit firms concurred that the accounting treatment for the reserve for bad debts was, 1) in accordance with generally accepted accounting principles and 2) in accordance with the loan agreement. The fact that there is a difference of professional opinion between RIG auditors and local authoritative opinion, does not constitute non-compliance on the part of COFISA. The statement that COFISA "disregarded AID loan provisions regarding bad debt reserves and expenses ..." is not correct. There is no loan provision regarding bad debt "expense". As further explained below under Part II A.2., COFISA uses both the charge-to-income and the reserve of retained earnings method.

The auditors apparently assume that protection against loan portfolio losses is afforded by bad debt reserves. Not true. Protection against loan portfolio losses is afforded first by effective management of individual loans including adequate evaluation of the prospective borrower and project, terms of payment, collateral, credit officer training and experience, and collection procedures. Hence, any reserve for bad debts is merely an allowance for potential errors in judgement on the part of the credit committee or loan officer and is not intended in and of itself to provide protection against bad debt losses. AID has also protected itself against loan default due to bad debts (or any other reason) by limiting dividends. These factors, when taken as a whole, provide adequate protection against loan losses and against deteriorization of the overall financial position of the company.

Further, neither the loan agreement, local law, nor generally accepted accounting principles require that the Board of Directors establish the policy for bad debt reserves as recommended by the auditors.

USAID/CR requests that all reference to these issues in the Executive Summary be eliminated and the discussion, if any, be limited to Part II A.2. of the auditors' final report. See also USAID/CR comments on this issue under Part II A.2. below.

Equity Contribution

The increase of $800,000 in equity capital was not "required" as stated in the auditors' report, rather the loan agreement says that COFISA would "use its best efforts" to raise this capital. Consequently, there is no non-compliance as stated by the auditors. Part II A.3., of the auditors report gives no evidence that COFISA did not use its best efforts, only that the goal was not achieved. In the opinion of USAID/CR, COFISA did use and, continues to use "best efforts" to raise the $800,000.

The intent of raising the $800,000 additional equity was to provide "another major source of capital" as stated in the loan agreement. Since COFISA in effect was able to provide a substitute major source of capital by way of a major debt settlement with creditors, it is doubtful whether or not the sale of remaining $377,674 of shares will have any significant impact on the project. In addition, the effect of the $377,674 unsold shares is barely 2% of the total project of $15.8 million.

In any event, the issue is not worthy of inclusion in the Executive Summary because of there was full compliance; and USAID/CR requests that it be eliminated therefrom. See AID/CR also comments below under Part II A.3.

Guaranty of Parent Corporation Not Obtained

It is correct that COFISA did not guarantee the loan to its Panamanian subsidiary COFISA International. No further clarification needed in the Executive Summary.

Insider Lending

While USAID/CR recognizes that insider lending was unrestricted from the standpoint of the loan agreement, the auditors were unable to find a single case of preferential treatment of insiders with regard to terms of payment, interest rates, collection, or collateralization, nor did they find any lack of good faith. To exclude insider lending totalling would be to exclude many of those who make up the private sector thereby jeopardizing the growth of the private sector base in turn the success of the project. See USAID/CR comments included herein under Part II 8 below. Such facts should be included in the Executive Summary to keep it from being misleading.

Significant Achievements

Reporting standards for audit of governmental organizations, programs, activities and functions, require for efficiency ard program audits that a description of noteworthy accomplishments be included in the auditors report.

The Executive Summary section is weak in not highlighting significant achievements noted even though such achievements are noted elsewhere in the report. USAID/CR believes that the following significant achievements should be included in the Executive Summary:

1. Having expended only $13.3 million of the $15 million loan package (per page 3 and 5 of the auditors' report) COFISA had generated an estimated $21.8 million in foreign exchange earnings and over 1,600 new jobs.

v²

2. COFISA, in 4 years time (per page 4 of the auditors' report) succeeded in converting its negative equity of $7.5 million into a positive equity of $8.4 million. This issue is treated lightly in the Executive Summary and buried in a paragraph (page -ii-) which deals with numerous other issues.

3. COFISA's portfolio is composed mainly of projects which would have had difficulty in securing financing from other existing conventional sources; thus the additionality of the project is very strong.

"TABLE OF CONTENTS" PAGE

The Table of Contents contains various errors as follows:

A. Reference to Page	Should Be
16	17
19	21
22	24
24	26

"PART I - INTRODUCTION" SECTION

Project Purpose

Page 2 of this section states a threefold project purpose:

1. Assist the resolution of the current private sector liquidity crisis,

2. Enhance the sector's capacity to earn foreign exchange, and

3. Reestablish COFISA International as a development-oriented financial institution.

Despite the clearly stated project purpose in this part of the report, the Audit Objectives and Scope (page 3 of the auditors report) omits all reference to the first two purposes and includes only the third. No reason for the omission is apparent from reading the report. Some reference to these project purposes having been successfully achieved is included in the top paragraph on page 5 of the report.

The auditors should clarify their omission of two-thirds of the project purpose in the final report.

"PART II - RESULTS OF AUDIT" SECTION

A. Findings and Recommendations

1. Concessional Interest Rate Under Local Currency Loan Was No Longer Justified

- Recommendation No.1

USAID/CR believe that it would be ethical and impossible to insist on renegotiation of the local currency loan considering that COFISA was substantially in compliance with all requirements. Further, the local currency loan is not between COFISA and AID, it is between CINDE and COFISA. A renegotiation of the local currency loan would consequently be even more irregular. COFISA has done a good job and should not be penalized for doing so. Following the logic of the auditors, had the project been a failure, the concessional rate probably would have continued. Hence, the concessional rate should remain for the term of the loan.

The auditors comment on AID policy that "concessional financing is ... a grant of capital to the owners of the firm ..." was not AID policy at the time the loans were made. See USAID/CR comments on this issue included herein under the Executive Summary section above.

USAID/CR requests that this recommendation be eliminated.

2. Loan Agreement Provisions Were Not Followed For Bad Debt Reserves

USAID/CR is in total disagreement with the auditors on this point (see comments herein under Executive Summary above).

A clarification is necessary as to COFISA's accounting treatment for loan collectibility. COFISA uses two methods of providing for bad debts: (1) charge the estimated expense for the period and credit an allowance for doubtful accounts in the asset section of the balance sheet, and (2) appropriate (i.e. "reserve") a portion of retained earnings by charging and crediting sub-accounts within the retained earnings account - with no effect on income for the period nor on total assets. COFISA uses both methods.

The first method is reflected by a charge to general and administrative expenses in the amount of ₡149,931,553 (per Sept. 30, 1985 audited financial statements) irrespective of the AID bad debt reserve issue. The charge of ₡149,931,553 is included in total general and administrative expenses for that period of ₡248,449,847.

The second method is reflected by charges and credits within sub-accounts of the retained earnings account as clearly reflected in the audited financial statements (see the "Estado Consolidado del Patrimonio" and notes 1(j), 4, 9 and 14).

- Non-Compliance With Reserve Requirement

As noted herein under the Executive Summary section above, COFISA complied with the reserve requirement as stipulated in the loan agreement.

- Board of Directors Establishment of Bad Debt Reserve Policy

As noted herein under the Executive Summary section above, the lack of explicit involvement of COFISA's board of directors in this issue is of no significance.

- Reserve Requirement Too Low

Conceptually, if COFISA were to reserve 2% of its average annual loan and investment portfolio over 20 years that would be 40%. If there were any reasonable probability of the bank losing 40% of its entire portfolio, neither COFISA nor AID would have entered into a loan agreement. Although loan collections must be watched continuously, USAID/CR believes that increasing the bad debt reserve during the life of the loan from 2% to 40% (conceptually) is without merit.

- Recommendation No.2

Due to the explanation outlined above, USAID/CR requests that all parts a) through c) of this recommendation be eliminated from the auditors final report.

- Management Comments

Page 15 states that "COFISA will adjust reserve requirements according to stipulations of the loan agreement" which is not technically correct. COFISA has always maintained the reserve in accordance with stipulations of the loan agreement. In good faith, nevertheless, COFISA has agreed to go one step further and charge the 2% to the income statement.

USAID/CR maintains that bad debt reserves should be established only in relation to non-performing loans rather than the overall loan and investment porfolio.

In spite of COFISA's agreeing to charge income for the amount of the reserve, it should be understood that it has not agreed to a 2% charge to income every year as recommended by the auditors. COFISA has already made significant charges to the income statement for estimated bad debts as explained above. Adding another 2% charge would add nothing. COFISA has always complied with their loan covenant.

3. Equity Had Not Been Increased As Required

As commented on herein under the Executive Summary section above, the achievement of the $800,000 increase in equity was not a requirement. The fact that deadlines were amended does not change the nature of this provision that "best efforts" be used in raising equity capital. Perhaps "deadline" is not an appropriate term.

- Recommendation No.3

Part a) of the recommendation was already in process before the auditors had made the recommendation and AID has since authorized COFISA to pay the dividend.

Part b) of the recommendation is being done and has always been done. The wording of this recommendation implies that monitoring of COFISA's efforts is not being done. The auditors were unable to substantiate that USAID/CR was not monitoring COFISA's capital raising activities. The Mission has always monitored this activity and COFISA is in full compliance as such, the recommendation has no impact on USAID/CR nor COFISA.

Part c) of the recommendation merely reflects USAID/CR's plan of action as it was before the auditors came to Costa Rica.

Consequently, USAID/CR accepts the auditors recommendations as follows:

a. accepted as worded to pay dividends.
b. accepted as worded with the understanding explained above that achievement of the $800,000 equity capital mark is not a "requirement", and
c. accepted as worded to authorize the sale of new stock to existing stockholders.

Discussion

Page 18 states that "USAID/Costa Rica did not actively pursue COFISA International's compliance with the capital increase requirement." The reference to "requirement" should be eliminated here and elsewhere in this paragraph.

The auditors should be aware that Costa Rica does not have a highly developed investment sindication and placement infrastructure. Capital markets, as such, are a foreign phenomenon although significant strides have been made in this area over the last 10 years. USAID/CR considers COFISA to be in compliance with the "best efforts" requirement. All reference to this issue should be eliminated from the auditors' final report.

4. AID Loan Was Not Guaranteed

- Recommendation No.4

Recommendation accepted as worded. USAID/CR has drafted an amendment in coordination with COFISA. To date, COFISA has agreed in principle and has expressed no objections to the draft amendment.

B. Compliance and Internal Controls

Compliance

USAID/CR does not agree with either of the two compliance exceptions noted. Adequate explanation and detail are provided above. USAID/CR requests that both compliance exceptions be eliminated from the final report and this section be left only with the negative assurance wording.

Internal Control

- Renegotiation Clause

USAID/CR does not see the relationship between this issue and internal control. The local currency loan agreement was not between COFISA and AID. Consequently, the auditors' comment should be eliminated.

- Loan Agreement Not Amended for Loan Guarantee by COFISA

Observation of the auditors is correct.

- Insider Lending

COFISA's own internal controls are obviously adequate to avoid conflicts of interest. The auditors comment on this, while conceptually sound in some economic environments, is not appropriate for Costa Rica.

USAID/CR objects to such extensive treatment of this issue in light of (1) no AID/Washington policy, and (2) the well-justified and documented special situation of Costa Rica, and (3) the absence of any finding of abuse by COFISA. Further, COFISA loans involving any "insiders" constitute a very small portion of its portfolio; there has been no exclusion of "outsiders."

Generally accepted government auditing standards require objectivity in reporting audit findings. The extensive treatment of this issue (or better "non-issue") implies a possible lack of objectivity. This issue is discussed further herein under the Executive Summary section above. Since no lack of good faith was found by the auditors, this comment should be eliminated as an internal control issue.

C. Other Pertinent Matters

The wording of this section regarding conflict of interest should include USAID/CR comments in point B above as well as those included in the Executive Summary section.

"PART III - EXHIBITS AND APPENDICES" SECTION

USAID/CR has no comments on this section of the auditors draft report.

CONCLUSION

The only issue of relative significance in the auditors report is the lack of COFISA's guarantee of its subsidiary's debt with AID. This condition is in the proceces of being rectified. By way of context, it should be noted that none of the issues noted by the auditors has had any significant impact on the success or failure of the project to date.

LIST OF RECOMMENDATIONS

Recommendation No. 1

We recommend that USAID/Costa Rica obtain evidence that thé International Costa Rican Industrial Finance Corporation:

a) is complying with the AID loan agreement concerning two percent bad debt allowance in accordance with generally accepted accounting principles;

b) has prepared a formal risk assessment of the loan portfolio to establish a reasonably estimated allowance for bad debts and adjusted the allowance accordingly;

c) has adjusted both prior years' retained earnings and the current year's income statement to properly reflect expenses related to the required bad debt reserve; and

d) has a bad debt reserve policy approved by its Board of Directors.

Recommendation No. 2

We recommend that USAID/Costa Rica:

a) authorize the International Costa Rican Industrial Finance Corporation to pay cash dividends on stock for 1986, but only from sources of income earned on non-AID funds and reflows; and

b) authorize the International Costa Rican Industrial Finance Corporation to sell the remainder of the new stock issue to existing shareholders if it is unable to sell it to the public before October 1, 1987.

Recommendation No. 3

We recommend that USAID/Costa Rica amend the AID loan agreement to require the Costa Rican Industrial Finance Corporation to guarantee repayment of the AID loan.

APPENDIX 3

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