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AGENCY FOR INTERNATIONAL DEVELOPMENT
Washington, D. C.

OFFICE OF THE AUDITOR GENERAL

AREA AUDITOR GENERAL - LATIN AMERICA

AUDIT REPORT

REGIONAL OFFICE FOR LATIN AMERICAN PROGRAMS

LATIN AMERICAN AGRIBUSINESS DEVELOPMENT CORPORATION
PROJECT No. 596-24-150-039

Audit Report No. 1-596-75-11

Date Issued: August 20, 1974

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PART I

SCOPE OF AUDIT

The Area Auditor General, Latin America, has performed an initial audit of AID Loan No. 596-L-011 for \$6.0 million. Loan funds were made available to the Latin American Agribusiness Development Corporation (LAAD) for lending and investment in Central American agricultural-associated business enterprises.

The audit was made for the primary purpose of evaluating (i) project planning and implementation; (ii) project progress and achievements; and, (iii) compliance with the terms and conditions of the loan agreement.

The audit covered the period from October 26, 1971 through May 31, 1974, with emphasis on current transactions. Audit work was performed at ROCAP, LAAD, and selected sub-borrowers, and it was made in accordance with generally accepted auditing standards, giving due regard to existing AID regulations.

PART II

BACKGROUND

The LAAD project, as one of its basic justifications, is to support efforts to develop basic mechanics for development of a capital market.

One of the major obstacles to entrepreneurial financing in Central America has been the shortage of risk capital. This has been aggravated by the ultra-conservative lending practices employed by Central American financial institutions and their lack of imaginative promotion of new or expanding business enterprises.

While LAAD has the appearance of, and carries out most of the functions of a development banking institution, its activities reach much deeper in finding, investigating and promoting agribusiness opportunities. Its interests are directed toward establishing new ventures as well as expanding existing business through combination of debt and equity financing from its own resources, assistance in arranging other financing, and the extensive use of expertise existing among its own stockholders. By taking an equity position whenever possible, LAAD will also be acting as a quasi-underwriter and will seek a market in the

private sector for disposal of its equity holdings as the companies it finances become attractive in the investment market.

On October 26, 1971, LAAD signed a twenty year ^{3 2/0} loan agreement with AID in the amount of \$6.0 million. About \$3.2 million of the loan had been disbursed at the time of our audit in May, 1974.

PART III

SUMMARY

We have concluded that in general LAAD has exerted its best efforts in achieving the objectives of the AID loan program; and, with the exceptions noted, the program has been effectively and responsibly managed.

LAAD has aggressively promoted the investment program set out in the AID loan agreement. We found numerous instances in which LAAD has taken the initiative in contacting prospective borrowers and assisted them in creating, analyzing and coordinating expansion projects. In some cases, these enterprises would have found extreme difficulty in obtaining financing from conventional sources because their programs were either too innovative, and, therefore, entailed excessive risk; or collateral was insufficient for an absolute guarantee of security.

Also, sub-borrowers had stated that an important reason for dealing with LAAD was LAAD's widespread contact with other businesses in Central America. This was considered highly beneficial in finding other sources of capital, integrating production and marketing activities, and solving problems of transportation. LAAD is presently engaged in efforts to form an integrated system of transportation facilities.

LAAD is actively engaged in providing marketing information and finding new potential markets for sub-borrowers products. For example, a small marketing organization has been formed by LAAD in partnership with two of its sub-borrowers to market flowers in the U.S. LAAD plans to expand activities to eventually include vegetables and other agricultural products produced in Central America. Other market-integration projects are also in various stages of development by LAAD. We were informed the marketing operations will continue to be producer-owned and controlled.

While progress has been made in some areas, opportunities exist for improved procedures and practices in certain other management areas. Improvements in these areas will facilitate effective implementation of the loan agreement.

In Part IV of this report, we have identified in detail the conditions requiring improvements, and have made suggestions which, in our opinion, will assist management and the Borrower in effective utilization and control of resources. ROCAP views on the report contents have been incorporated into this audit report.

General information on the audit exit conference, and the status of actions on other inspection, appraisal and external reports are presented in Part V of this report.

PART IV

STATEMENTS OF FINDINGS AND RECOMMENDATIONS

FOR THE DIRECTOR, ROCAP

A. Utilization of Loan Funds

In some instances, AID loan funds were utilized for purposes other than that for which planned. In other instances, documentation of utilization of funds, as required by the loan agreement, was not available to determine eligibility of goods and services for AID financing, or determine the purpose for which funds were used.

Several factors contributed to these conditions. There was a lack of pro-forma for utilization of funds by recipients and a lack of documentation of funds expended. In other instances, sub-loan and investment agreements, although subject to the AID/LAAD loan agreement, did not prescribe the specific provisions of the loan agreement to be followed. These conditions precluded LAAD from performing adequate project monitoring. Consequently, LAAD was not fully assured of recipients' effective utilization of loan proceeds.

ROCAP agreed that adequate documentation was needed to assure that AID sub-loan funds are utilized in accordance with provisions of the loan agreement. However, ROCAP does not be-

lieve that AID funds used by LAAD to purchase equity certificates are subject to the same loan agreement provisions applicable to sub-loans.

In our opinion, it appears that both the loan agreement and LAAD require that recipients of AID equity funds maintain documentation to account for utilization of investment funds. To illustrate, Article III, Section 3.01(d) of the loan agreement, as a condition precedent to initial disbursement, requires the Borrower (LAAD) to furnish AID in form and substance satisfactory to AID, the following:

"A statement of the standards and policies Borrower and any subsidiary of Borrower will follow in making and administering investments and sub-loans and in providing technical assistance."

In satisfaction of above condition precedent to disbursement, LAAD submitted, and ROCAP accepted, the following statements:

Standards and Policies of LAAD-CA in Making and Administering Investments and Loans and in Providing Technical Assistance

"AID funds will be utilized to finance eligible goods and services for agribusiness projects in the five Central American countries. These funds will be extended in the form of debt, convertible debt, and equity."

Also, we believe that the language contained in Article V, Section 5.02 (Sub-loans and Equity Investments) of the loan agreement, indicate that adequate documentation will be maintained to show utilization of equity funds. Section 5.02(a) states:

"Borrower covenants to include provisions in all sub-loans and share purchase agreements for the maintenance and audit of records and for inspections by authorized representatives of A.I.D. to the same extent as agreed between Borrower and A.I.D., as set forth in Sections 4.09 and 4.11 of this Agreement."

Section 4.09 of the loan agreement requires the books and records of sub-borrowers to show, among other things, the re-

ceipt and use made of goods and services acquired with funds disbursed pursuant to this loan agreement.

Moreover, equity funds are disbursed by AID based on LAAD's sub-project proposals. The proposals show the purpose for which LAAD will use the funds (purchase equity certificates), and the purpose for which recipients will utilize the equity funds. In addition, LAAD's share purchase agreements include provisions whereby recipients of equity funds will (i) maintain records showing the purpose for which equity funds will be utilized, and (ii) furnish LAAD with whatever information it needs relative to recipients' investment of funds.

Based on the above information, it appears to us that the loan agreement requires LAAD to assure adequate documentation of expenditures utilizing equity funds and that LAAD, in its share purchase agreements, is attempting to comply with this requirement.

Recommendation No. 1

ROCAP should require LAAD to establish a more complete format for sub-loan and investment files with a view to improved evaluation and monitoring of recipient's activities, and documentation of expenditures utilizing loan funds.

Recommendation No. 2

ROCAP should require LAAD to include in all sub-loan and investment agreements the applicable terms and conditions of the AID/LAAD loan agreement.

B. Equity Investments

1. Capital Market

LAAD has had limited success in developing the basic mechanics of a capital market for public investment in commercial securities. LAAD has invested in a small brokerage firm in Honduras where a limited market in high quality securities currently exists. However, efforts to stimulate such a market in

other Central American countries have so far been unsuccessful, although negotiations are still underway with investor groups in Nicaragua and El Salvador.

The difficulties can be attributed to (i) reluctance of Central American businessmen to accept outside investors and resistance to placing equity ownership on the open market, (ii) reluctance of prospective investors to place their funds without an almost ironclad guarantee of an immediate and profitable return, and (iii) lack of an effective securities market in Central America to stimulate trading activities.

It appears that development of an effective capital market in Central America may be very slow to materialize.

In view of LAAD's continuing efforts to establish the basic mechanics of a capital market, we make no recommendation in this area.

C. Financial Statements

A substantial number of sub-loan and investment proposals were not supported by audited financial statements, or other documented verification of assets and liabilities. In other instances, recipients of LAAD's funds failed to provide required independent audited financial statements as required by the loan agreement. In our opinion, it is impractical, if not impossible, to evaluate potential financial worth without an adequate audit performed by qualified independent auditors, or to assess the results of financial operations. In addition, only limited reliance can be placed on financial projections based on financial statements prepared by the recipients themselves due to the unknown quality of accounting practices.

We believe a minimum requirement should be (i) an unqualified opinion audit by a qualified auditing firm, or (ii) where recipients have never been audited, qualified appraisers should perform independent valuations of their assets and liabilities.

Recommendation No. 3

ROCAP should require that LAAD obtain adequate financial data to support sub-loans and investments.

D. ROCAP Monitoring

ROCAP files contain limited data on the conduct of LAAD's sub-loans made with AID funds. Documentation evidencing adequate monitoring of sub-loans to assure effective utilization of loan funds was inadequate.

ROCAP believed that it should not be overly active in conduct of LAAD's activities. In principle, we agree with ROCAP's position. However, we believe that the findings presented in this report indicate that ROCAP should be more involved to assure that the project is being effectively implemented, and that sufficient information exists to analyze and react constructively to the innovations, knowledge and experience gained by LAAD in the utilization of AID loan funds.

Recommendation No. 4

ROCAP should initiate an effective system of on-site monitoring of LAAD sub-borrowers, utilizing a standardized checklist to verify compliance with AID policies and procedures; and to monitor progress and problems in the utilization of sub-loans made with AID funds.

PART V

GENERAL COMMENTS

A. LAAD Investment Portfolio

The loan agreement provides that approximately \$4.0 million is expected to be used for long-term financing with equity features. In some cases, this financing will be supplemental to loans extended by CABEI and other Central American financial institutions. In other cases, the funds will be used for direct equity participation.

At the time of our audit in June 1974, LAAD had placed about \$1.8 million in equity certificates, and loans with equity conversion features. Most of the equity certificates were in the form of non-voting preferred stock with a fixed interest rate and a fixed redemption date.

We were informed by LAAD and ROCAP that, for the present time, sale of equity investment certificates with redemption features is a stepping stone to establishing a viable securities market in Central America. Without redemption features, sale of securities at the present time is impractical in Central America. In addition, LAAD must have assurance that AID funds used for equity investment are recoverable within the time limits of the AID loan maturity to permit timely repayment of the loan.

B. Exit Conference

A formal exit conference was held on August 14, 1974 with the ROCAP Deputy Director and his senior staff, to discuss the audit report.

C. Prior AID Auditor General Reports, Inspections and Appraisals

This was the initial audit of this loan.

D. External Audit Reports and Inspections

The Mission files contained an external audit report dated May 27, 1971, made by the Inspector General for Foreign Assistance. The contents of this report were considered to the extent deemed necessary in our audit.

EXHIBIT A

DISTRIBUTION OF AUDIT REPORT

	<u>No. of Copies</u>
Mission Director, ROCAP	4
ROCAP Desk Officer, AID/W	1
LA/OPNS, AID/W	2
AG/AUD, AID/W	5
AG/OAS, AID/W	1
IIS, AID/W	1
LA/DR, AID/W	1
Office of Engineering, AID/W	1
IGA/W	1