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AUDIT OF
USAID/COSTA RICA'S
PRIVATE INVESTMENT CORPORATION
PROJECT NO. 515-0204

Audit Report No. 1-515-87-20
March 17, 1987

U. S. MAILING ADDRESS:
RIG/T
APO MIAMI 34022

# AGENCY FOR INTERNATIONAL DEVELOPMENT

OFFICE OF THE REGIONAL INSPECTOR GENERAL
AMERICAN EMBASSY
TEGUCIGALPA — HONDURAS

TELEPHONES:
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also 32-3120/9, EXT. 293 & 296

March 17, 1987

MEMORANDUM

TO : USAID/Costa Rica, Director, Daniel Chaij

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

SUBJECT: Audit of USAID/Costa Rica's Private Investment Corporation, Project No. 515-0204

This report presents the results of audit of USAID/Costa Rica's Private Investment Corporation, Project No. 515-0204. The specific objectives of this audit were to evaluate the accomplishment of project plans and compliance with AID and project requirements.

During the first two years of the project, much less was accomplished than planned because of Private Investment Corporation (PIC) management deficiencies. PIC had not initially complied with AID requirements for procurement and bad debt reserves.

Project projections for PIC loans, equity investments, merchant banking services and net income were not achieved. As of August 31, 1986 PIC had actually made loans of $4,902,473 versus $8 million planned and equity investment of $300,000 versus $3 million planned. In addition, PIC had not earned any income from merchant banking services, even though income of $300,000 was anticipated. Although the volume of PIC operations was significantly less than planned, operating income was in line with projections because administrative expenses were much lower than estimated. However, because of foreign exchange losses on its local currency capital, PIC had a net loss of $427,019 after 28 months of operations compared to a projected net income of $647,321.

Accomplishments were less than planned because PIC management was not adequate. USAID/Costa Rica identified this problem early in the project and was able to obtain a change in top PIC management and improvements in internal controls in late 1985 and 1986 by delaying initial disbursements under the AID loan.

USAID/Costa Rica's Economic Stabilization and Recovery Program (ESR) provided Costa Rica with hundreds of millions of dollars for balance-of-payments support. Contrary to these objectives, PIC converted $5.3 million of AID-generated local currency received from the sale of its stock to dollars and invested those dollars in the United States.

The audit also found that the PIC had invested less than the planned percentage of project funds in equity investments and that PIC procedures for the evaluation of project designs and monitoring project implementation needed improvement.

This report recommends that PIC invest $5.3 million of its equity capital in Costa Rica, formulate a satisfactory equity investment policy and plan, and improve its procedures to evaluate project designs and to monitor project implementation.

USAID/Costa Rica agreed with the three recommendations in this report. Their comments are attached as Appendix 1 and they were considered in preparing this report. Recommendation No. 1 is closed since PIC invested $5.3 of its equity capital in Costa Rica prior to the publication of this report.

Please advise this office within 30 days of the actions planned or taken to implement Recommendations 2 and 3 of this report.

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

# EXECUTIVE SUMMARY

USAID/Costa Rica's Private Investment Corporation project was started on August 31, 1984 and scheduled to be completed in four years. The project is to be implemented by the Private Investment Corporation, a private sector investment finance institution established in April 1984. The purpose of the project was to establish a viable Private Investment Corporation to provide merchant banking services (investment packaging), medium and long-term credit, and equity financing for export oriented investments. AID has loaned the Private Investment Corporation $20 million, of which $3.4 million was disbursed as of August 31, 1986. In addition AID has provided a grant of $1 million. The total estimated cost of the project is $31 million which includes $10 million in equity capital to be provided by the Private Investment Corporation.

The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit of the Private Investment Corporation project covering activities from August 31, 1984 (project inception) through August 31, 1986. The objectives of the audit were to evaluate the accomplishment of project plans and compliance with AID and project requirements.

During the first two years of the project, much less had been accomplished than planned because of Private Investment Corporation management deficiencies. The Private Investment Corporation had not initially complied with AID requirements for procurement and bad debt reserves.

Projections for loans, equity investments, merchant banking services and net income were not achieved. As of August 31, 1986 the Private Investment Corporation had made loans of $4,902,473 versus $8 million planned and equity investments of $300,000 versus $3 million planned. In addition, the Private Investment Corporation had not earned any income from merchant banking services, even though income of $300,000 had been anticipated. Although the volume of the Private Investment Corporation operations was significantly less than planned, operating income was in line with projections because administrative expenses were much lower than estimated. However, because of foreign exchange losses on its local currency capital, the Private Investment Corporation had a net loss of $427,019 after 28 months of operations compared to a projected net income of $647,321 (see Exhibits 1 and 2).

Accomplishments were less than planned because Private Investment Corporation management was not adequate. USAID/Costa Rica identified this problem early in the project and was able to obtain a change in top management and improvements in internal controls in late 1985 and 1986 by delaying initial disbursements under the AID loan.

The Private Investment Corporation converted the equivalent of $8,153,892 of local currency received from the sale of its stock into dollars and invested most of those dollars in the United States. Included in the amount realized from the stock sale was $5.3 million in local currency generated from the sale of dollars provided under the USAID/Costa Rica

Economic Stabilization and Recovery Program. A principal objective of the program was to provide dollars for balance-of-payments support. Thus, the conversion of local currency generated from the sale of dollars provided under the program back to dollars and the investment of those dollars in the United States was contrary to its objective. The corporation did this to protect its capital from the future devaluation of the Costa Rican local currency. We recommended that the Private Investment Corporation invest $5.3 million in Costa Rica. USAID/Costa Rica implemented our recommendation prior to publication of our report.

As of August 31, 1986 the corporation had disbursed $5,202,473 for development projects but only six percent of $300,000 was for equity investments. The financial plan included in the AID project agreement contemplated that one-third of the corporation's disbursements for development projects would be for equity investments. The corporation had not invested the planned percentage of its funds in equity investments because it lacked an equity investment policy and plan. Since the project paper estimated a higher rate of return on equity investments than on loan investments, the profitability of corporation operations could be adversely affected. We recommended that the Private Investment Corporation establish an equity investment policy and plan. USAID/Costa Rica agreed with our recommendation.

The Private Investment Corporation did not use sound procedures to evaluate loan project designs and monitor project implementation because its procedures were not realistic and the performance of its top management was not satisfactory. As a result, some of its development loan projects have experienced financial problems, some of its sub-loan costs were not eligible for AID reimbursement, and some of its other sub-loan costs have been pending AID reimbursement due to documentation deficiencies. We recommended that the Private Investment Corporation develop and formalize improved procedures. USAID/Costa Rica agreed with our recommendation.

Office of the Inspector General

AUDIT OF

USAID/COSTA RICA'S

PRIVATE INVESTMENT CORPORATION

PROJECT NO. 515-0204

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AUDIT OF
USAID/COSTA RICA'S
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## PART I - INTRODUCTION

### A. Background

Costa Rica has initiated a long-term economic recovery program which emphasizes non-traditional export sectors. USAID/Costa Rica noted a need for greater capital formation to fund this recovery program and developed a project to create a private sector investment corporation which would act as a merchant bank, or catalyst, in the development of projects which would lead to exports for foreign exchange.

Under a project agreement signed on August 31, 1984, AID agreed to provide the Private Investment Corporation (PIC) with a loan of $20 million and a grant of $1 million. PIC was established as a private sector investment finance institution in April 1984.

The goal of the Private Sector Investment Corporation project was to stimulate growth in the productive export sectors of Costa Rica, and thus increase levels of employment and foreign exchange earnings. The purpose of the project was to establish a viable Private Investment Corporation to provide merchant banking services (investment packaging), medium and long-term credit, and equity financing for export-oriented investments.

The total estimated cost of the project was $31 million. PIC was to raise $10 million in equity capital as its contribution to the project. PIC equity capital was to be used to finance equity investments. AID funds of $20 million were to be used to finance PIC loan activities. AID grant funds of $1 million were to be used to finance investor research and identification, specialized investment and technical analysis, and project evaluation.

PIC was to finance viable projects of a higher risk than those currently being financed by existing financial institutions in Costa Rica, and use AID funds for the development of new projects which might not otherwise be supported. The project was to be completed within four years, or by August 31, 1988.

### B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Tegucigalpa performed a program results audit of the Private Investment Corporation project. The objectives of the audit were to evaluate the accomplishment of project plans and compliance with AID and project requirements. The audit covered the period from August 31, 1984 (project inception) through August 31, 1986 and included AID loan disbursements of $3,426,364. We did not review disbursements under the AID grant.

To accomplish these objectives, we reviewed project files and interviewed project officials at USAID/Costa Rica, PIC and its sub-borrowers. We visited four of the eight companies that received loans from PIC under the project. We did not review PIC internal accounting controls because Price Waterhouse, an independent auditor, had performed three reviews of these controls in 1985 and 1986. Audit fieldwork was conducted from September 2 to November 13, 1986. The audit was performed in accordance with generally accepted government auditing standards.

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## PART II - RESULTS OF AUDIT

During the first two years of the project, much less had been accomplished than planned because of PIC management deficiencies. PIC had not initially complied with AID requirements for procurement and bad debt reserves.

As of August 31, 1986 PIC had approved eight loans and one equity investment totaling $7,237,000. PIC estimated that this portfolio would generate $13.7 million annually in additional foreign exchange earnings as well as 655 new permanent jobs. According to USAID/Costa Rica's Semiannual Project Status Report, dated September 30, 1986, foreign exchange earnings per dollar invested had been lower than projected in the project paper and cost per job created had been higher. This was partly due to capital intensive sub-loans such as an anhydrous alcohol plant which, while only producing 25 new jobs, indirectly benefits Costa's entire sugar industry.

Project projections for PIC loans, equity investments, merchant banking services and net income were not achieved. As of August 31, 1986 PIC had actually made loans of $4,902,473 versus $8 million planned and equity investments of $300,000 versus $3 million planned. In addition, PIC had not earned any income from merchant banking services, even though income of $300,000 was anticipated. Although the volume of PIC operations was significantly less than planned, operating income was in line with projections because administrative expenses were much lower than estimated. However, because of foreign exhange losses on its local currency capital, the PIC had a net loss of $427,019 after 28 months of operations compared to a projected net income of $647,321 (see Exhibits 1 and 2).

Accomplishments were less than planned because PIC management was not adequate. USAID/Costa Rica identified this problem early in the project and was able to obtain a change in top PIC management and improvements in internal controls in late 1985 and 1986 by delaying initial disbursements under the AID loan.

USAID/Costa Rica's Economic Stabilization and Recovery Program (ESR) provided Costa Rica with hundreds of millions of dollars for balance-of-payments support. Contrary to these objectives, the PIC converted $5.3 million in AID-generated local currency received from the sale of its stock to dollars and invested those dollars in the United States.

The audit also found that the PIC had invested less than the planned percentage of project funds in equity investments and that PIC procedures for the evaluation of project designs and the monitoring of project implementation needed improvement.

This report recommends that the PIC invest $5.3 million of its equity capital in Costa Rica, formulate a satisfactory equity investment policy and business plan, and improve its procedures to evaluate project designs and to monitor project implementation.

## A. Findings and Recommendations

### 1. AID-Generated Local Currency Was Converted to Dollars and Invested in the U.S.

The Private Investment Corporation (PIC) converted the equivalent of $8,153,892 of local currency received from the sale of its stock into dollars and invested most of those dollars in the United States. Included in the amount realized from the stock sale was $5.3 million in local currency generated from the sale of dollars provided under the USAID/Costa Rica Economic Stabilization and Recovery Program (ESR). A principal objective of the ESR program was to provide dollars for balance-of-payments support. Thus, the reconversion of local currency generated from the sale of dollars provided under the ESR program to dollars and the investment of those dollars in the United States was contrary to the objective of the ESR program. PIC took this action to protect its capital from the future devaluation of the Costa Rican local currency.

Recommendation No. 1

We recommend that USAID/Costa Rica obtain evidence that the Private Investment Corporation has invested in Costa Rica the $5.3 million of its equity capital which had been diverted to "off-shore" banks.

Discussion

Between August 1984 and August 1985, the PIC received $8,153,892 from the sale of its capital stock. The Coalition for Development Initiatives (CINDE) purchased $5.3 million of this stock with local currency generated under USAID/Costa Rica's Economic Stabilization and Recovery Program (ESR). Between November 1984 and October 1985, PIC converted the local currency (colones) received from the sale of its stock to dollars in order to protect its capital from the future devaluation of the Costa Rican colon.

PIC invested most of the dollars received from the sale of colones in the United States in U.S. Government securities, and in time and call deposits. As of August 31, 1986 PIC had $5,586,199 of its equity capital invested in the United States.

PIC suffered $1,309,777 in exchange losses from these conversion transactions, only realizing $6,844,115 from the sale of $8,153,892 in local currency. Of the total loss of $1,309,777, $813,538 would have been lost even if the local currency had not been converted to dollars. This loss represented the increase in the interbank exchange rate between the date the local currency was received from the sale of stock and the date the local currency was converted to dollars. The other part of the exchange loss ($496,239) represented the loss on the conversion of local currency to dollars at a rate of exchange higher than the interbank rate.

Although PIC completed the conversion of its equity capital to dollars in October 1985, only $1,257,996 of these dollars were invested in Costa Rica. This represents the difference between the dollars received from the sale of the colones ($6,844,115) and the current amount invested in the United States ($5,586,199).

A principal objective of the ESR program was to provide dollars for balance-of-payments support. Thus, the reconversion of local currency generated from the sale of dollars provided under the ESR program to dollars and the investment of those dollars in the United States was contrary to the objective of the ESR program. USAID/Costa Rica has been encouraging PIC to return its equity capital to Costa Rica and PIC now has under consideration a plan to invest about $3.6 million in dollar time deposits with a Costa Rican state bank.

We believe PIC should invest the entire $5.3 million of ESR local currency received from CINDE in Costa Rica in order to achieve the objectives of the ESR program.

Management Comments

PIC has invested $5,346,868 of its equity capital in Costa Rica as of November 12, 1986. These investments are represented by $4.4 million in certificates of deposit with the Banco de Credito Agricola de Cartago, $300,000 in an equity investment, and $646,868 in loans that were not eligible for reimbursement by AID.

Inspector General Comments

Recommendation No. 1 is closed upon publication of the report because of the corrective actions described above.

## 2. Equity Investments Were Not Achieved As Planned

As of August 31, 1986 PIC had disbursed $5,202,473 for development projects but only six percent, or $300,000, was for equity investments. The financial plan included in the AID project agreement contemplated that one-third of PIC's disbursements for development projects would be for equity investments. PIC had not invested the planned percentage of its funds in equity investments because it lacked an equity investment policy and business plan. Since the project paper estimated a higher rate of return on equity investments than on loan investments, the profitability of PIC operations could be adversely affected.

### Recommendation No. 2

We recommend that USAID/Costa Rica obtain evidence that the Private Investment Corporation has established a satisfactory equity investment policy and business plan to increase the percentage of funds placed in equity investments in accordance with the investment objectives of the project, and modify the project agreement's financial plan as may be required.

### Discussion

The financial plan included in the AID project agreement contemplated that PIC's capital of $10 million would be used for equity investments and the AID loan of $20 million would be used for loans. Thus, one third of all PIC disbursements for development projects were to be used for equity investments.

As of August 31, 1986 PIC had disbursed $5,202,473 for development projects, but only $300,000, or six percent, was for equity investments (see Exhibit 1).

PIC had not invested the planned percentage of its funds in equity investments because it lacked an equity investment policy and business plan. According to PIC management, they are now formulating such a policy and plan. First priority in the policy is to be given to investments in existing companies with unused capacity and export opportunities outside of Central America, but which are unable to service a heavy debt burden. Second priority is to be given to new projects in new industries which, if successful, would attract new capital to the industry.

In addition to the above, PIC is formulating an equity investment plan that projects investments of $5 million through 1988. This, however, would be $5 million less than the $10 million projected in the project paper.

In any event, PIC may not be able to fully invest its $10 million of capital in equity investments. As of August 31, 1986 PIC has used some of its capital to finance an accumulated loss of $437,018 and ineligible loan disbursements of $307,953.

PIC's failure to invest the planned percentage of funds in equity investments could adversely affect its profitability. The project paper estimated a 20 percent internal rate of return on equity investments compared to 13.5 percent on loan investments.

Management Comments

USAID/Costa Rica had been insisting since November 1985 that PIC focus more attention on its equity investments, not because they would be more profitable but because they would be advantageous to some of the projects PIC will be assisting.

The formulation of an equity investment policy has been delayed by recent turnover in top PIC management. The financial plan in the AID project agreement, which projects $10 million in equity investments, is illustrative. The Mission does not propose to insist on this figure, in the near term at least, because PIC has been less profitable than projected and because it has used some of its own equity capital to finance portions of loans which are not eligible for AID reimbursement. The Mission does not believe this is an inappropriate use of funds.

Inspector General Comments

Recommendation No. 2 can be closed as soon as the recommended corrective action is taken.

3. Adequate Procedures Were Not Established for the Evaluation of Project Designs and the Monitoring of Project Implementation

Sound procedures for the evaluation of project designs and the monitoring of project implementation should be employed to ensure the success of development loan projects. The Private Investment Corporation (PIC) did not use sound procedures because those for PIC were not realistic and the performance of top PIC management was not satisfactory. As a result, some of PIC's development loan projects have had financial problems, some PIC-financed sub-loan costs have not been eligible for AID reimbursement, and other PIC-financed sub-loan costs have been pending AID reimbursement due to documentation deficiencies.

Recommendation No. 3

We recommend that USAID/Costa Rica obtain evidence that the Private Investment Corporation has developed and formalized improved procedures to evaluate project designs and to monitor project implementation in order to better ensure the success of its projects and compliance with AID requirements.

Discussion

Adequate procedures for the evaluation of project designs and the monitoring of project implementation should be employed to ensure the success of development projects.

The Private Investment Corporation's monitoring and evaluating procedures were inadequate. For example:

- Experts were not always employed to evaluate the technical feasibility of project designs and to monitor project implementation.

- Reliable sources of raw materials were not ensured prior to project approval.

- PIC subloan agreements did not include (a) a financial plan, (b) AID procurement requirements, (c) disbursement documentation requirements and (d) a project description.

- Implementation or business plans which would have provided a basis to monitor project implementation were not required.

The original procedures developed for PIC were not realistic. PIC's procedures were prepared by Price Waterhouse and approved by USAID/Costa Rica. Current PIC management is aware that the procedures are not realistic and they are improving them. They plan to formalize the improved procedures after testing them under three new sub-loans. In addition, the performance of the first top management team hired by PIC was not satisfactory. Top management was replaced in 1986 by individuals with strong professional credentials and track records in finance and project analysis.

The use of inadequate procedures to evaluate project designs and monitor project implementation caused the following adverse effects for the PIC:

- At least two of the eight projects financed by PIC had encountered serious financial problems (which could affect the repayment of the PIC loans) because of design and monitoring deficiencies. PIC loaned $400,000 to Rich Coast Frozen Products to process and export frozen banana and pineapple bits to the United States. The project estimated a profit of $145,950 as of September 30, 1986 but actually had a loss of $108,788 as of June 30, 1986. This occurred because the company was unable to obtain a sufficient supply of exportable pineapple, resulting in production shortfalls. Costa Rica only has one supplier of this grade of pineapple and PIC approved the project even though the borrower did not have a firm supply contract to buy the pineapple.

- PIC also loaned $670,000 to FLOREX, S.A. for the production and export of flowers. This project has suffered from the lack of effective technical monitoring. The project called for the planting of 1-1/2 hectares of roses and 4-1/2 hectares of carnations. Most of the carnations died because of late planting and improper siting of the greenhouses.

- As of August 31, 1986 $1,510,504 of PIC's equity capital was tied up in reimbursements pending with AID ($1,202,551) and in sub-loan disbursements for ineligible costs ($307,953). PIC financial statements (see Exhibits 1 and 2) showed outstanding loans of $4,902,473, of which only $3,426,364 had been financed by AID. As of August 31, 1986 PIC had reimbursements pending with USAID/Costa Rica of $1.2 million because it was unable to obtain timely disbursement documentation from its sub-borrowers. This happened because PIC did not include disbursement documentation requirements in loan agreements with its borrowers. Until recently PIC used its own funds to pay for offshore procurement rather than the AID letter of committment procedures under which AID pays offshore suppliers directly.

- PIC has also had to use its funds to finance $307,953 in sub-loan costs for commodities, transportation and citrus investments that were ineligible for reimbursement under the AID loan. This happened because PIC management was not familiar with AID procurement and other requirements and PIC did not include these requirements in loan agreements with its borrowers.

- PIC did not have a sound basis to monitor project implementation because financial plans were not included in the loan agreements with its borrowers and implementation plans were not obtained after execution of the loan agreements.

- PIC did not establish a reserve for bad debts for equity investments as required by the project agreement, but corrective action was taken prior to completion of the audit.

Management Comments

PIC's past problems were due to the incompetence of its management much more than to the state of its operations manual. Future performance will hinge much more on the skill and judgment of the new management than on the details of its own written procedures. We agree that PIC manual of procedures should be revised. We have repeatedly advised PIC for almost a year now that they ought to make better use of grant funds available for independent technical review of certain projects. It is quite unusual for commercial loan agreements to contain financial plans as suggested by the auditors. Financial plans are presented as part of the loan approval process. In late 1985, when the procurement problem became apparent, PIC hired a consultant. In addition, the Mission prepared guidance documentation and presented a seminar on the subject for PIC personnel. The Mission does not view it as inappropriate that PIC use some of its own funds to finance ineligible AID procurement costs in order to serve the needs of its clients. The Mission has requested PIC to present a revised loan procedures manual within sixty days.

Inspector General Comments

Recommendation No. 3 can be closed as soon as the recommended corrective action is taken.

## B. Compliance and Internal Controls

### 1. Compliance

The audit disclosed that the PIC had initially financed some procurements with its own funds because the transactions did not comply with AID procurement requirements. Also PIC did not establish a reserve for bad debts for equity investments as required by the project agreement, but corrective action was taken prior to completion of the audit. Other than these two conditions, nothing came to our attention that would indicate that untested items were not in compliance with applicable laws and regulations.

### 2. Internal Controls

Price Waterhouse, an independent auditor, performed three reviews of PIC internal accounting controls in 1985 and 1986. According to PIC and Price Waterhouse reports, the significant weaknesses have been corrected or are in the process of being corrected.

AUDIT OF
USAID/COSTA RICA'S
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PART III - EXHIBITS AND APPENDICES

# PRIVATE INVESTMENT CORPORATION

## PROJECTED BALANCE SHEET AT END OF THE FIRST 24 MONTHS OF THE PROJECT COMPARED WITH ACTUAL FINANCIAL POSITION AFTER 28 MONTHS OF OPERATION, AS OF AUGUST 31, 1986

| | PROJECTED | ACTUAL 1/ |
|---|---|---|
| **ASSETS** | | |
| Cash | $ 71,457 | $ 16,290 |
| Fixed Deposits | 7,683,935 | 5,586,199 |
| Interest Receivable | 306,408 | 155,766 |
| Loan Investments | 8,000,000 | 4,902,473 |
| Equity Investments | 3,000,000 | 300,000 |
| Less: Reserve of Bad Debts | ( 310,000) | ( 50,085) |
| Other | --- | 290,712 |
| TOTAL ASSETS | $ 18,751,800 | $ 11,201,355 |
| **LIABILITES** | | |
| USAID Loan | $ 8,000,000 | $ 3,426,364 |
| Other | 104,479 | 48,117 |
| TOTAL LIABILITIES | $ 8,104,479 | $ 3,474,481 |
| **STOCKHOLDERS EQUITY** | | |
| Paid-in Capital | $10,000,000 | $ 8,153,892 |
| Returned Earnings | 647,321 | ( 427,018) |
| TOTAL EQUITY | $ 10,647,321 | $ 7,726,874 |
| TOTAL LIABILITIES AND EQUITY | $ 18,751,800 | $ 11,201,355 |

1/ Based on unaudited financial statements of August 31, 1986.

# PRIVATE INVESTMENT CORPORATION

## PROJECTED INCOME AND EXPENSE STATEMENT FOR THE FIRST 24 MONTHS OF THE PROJECT COMPARED TO ACTUAL RESULTS FOR THE 28 MONTH PERIOD ENDING AUGUST 31, 1986

| | PROJECTED | ACTUAL 1/ |
|---|---|---|
| **OPERATING INCOME** | | |
| Interest-Fixed Deposits | $ 1,809,274 | $ 1,657,658 |
| Interest-Loans | 945,000 | 448,576 |
| Merchant Banking Services | 300,000 | --- |
| Other | --- | 9,580 |
| Donation | --- | 141,386 |
| TOTAL OPERATING INCOME | $ 3,064,274 | $ 2,257,200 |
| Less Interest Expense | $ 350,000 | $ 100,868 |
| NET OPERATING INCOME | $ 2,714,274 | $ 2,156,332 |
| **LESS OTHER EXPENSES** | | |
| Provision for Bad Debts | $ 310,000 | $ 50,085 |
| Administrative | 1,642,720 | 1,233,068 |
| TOTAL OTHER EXPENSES | $ 1,952,720 | $ 1,283,153 |
| OPERATING INCOME BEFORE EXCHANGE LOSS | 761,554 | 882,759 |
| LESS: Exchange Loss | --- | $ 1,309,777 2/ |
| NET INCOME (LOSS) BEFORE TAXES | 761,554 | ( 427,018) |
| Less Taxes | 114,233 | --- |
| NET INCOME (LOSS) AFTER TAXES | $ 647,321 | ($ 427,018) |

1/ Includes audited financial statements for the 20-month period ending December 31, 1985 only.

2/ Of this total, $813,538 represents the loss in the dollar value of local currency received by PIC from that sale of capital stock before conversion to dollars and $496,239 represents the loss on the reconversion of local currency to dollars at a rate of exchange higher than the official interbank rate.

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

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1000 San José, Costa Rica
Teléfono 33-11-55
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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 515-0204 (PIC)

The USAID/CR Controller's Office has reviewed the abovementioned report for the purpose of assisting the Mission in drafting 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 draft report.

## "EXECUTIVE SUMMARY" SECTION

### Efficiency of Operations Adversely Affected by Conversion of Capital

The PIC's operational efficiency has little to do with the conversion of capital. Although the conversion affected financial results for the period, USAID/CR does not agree that the institution's efficiency was affected and maintains that there is little, if any, correlation between the conversion of capital and efficiency.

### Poor Management and Conversion of Capital

While true that PIC's management was lacking in some areas, it is irrelevant to the issue of the conversion of capital. The auditors should stress the poor management issue and not exchange losses. For purposes of the Executive Summary, USAID/CR recommends that more emphasis be placed on the issue of poor management and less on the conversion of capital.

### Sub-loan Costs Not Eligible for AID Reimbursement

This issue is not significant enough to be included in the Executive Summary because any loans not eligible for AID reimbursement were funded out of PIC's own resources; USAID/CR does not believe this constitutes a problem.

Significant Achievements

While true PIC's management was lacking in some areas, the Executive Summary does not highlight significant achievements even though the related data is included elsewhere in the auditors draft report. USAID/CR requests that the following achievements be included in the final report:

1. Although the volume of operations of PIC was significantly less than expected, the income statement (Exhibit 2 to the report) shows that it made a profit from its recurring business operations of $882,759 which is nearly 16% better than projected. In terms of the profitability of business operations actually conducted, PIC was efficient. It was the non-operations, or extraordinary item of the exchange loss which was the determining factor in the net loss for the period. Changes in exchange rates are external to management's sphere of control and can cause losses (and gains) regardless of management ability.

USAID/CR has no other comments on the Executive Summary section of the auditors' draft report.

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"PART I - INTRODUCTION" SECTION

Page three of this section reads "... eight companies that reviewed loans..." should be companies that "received" loans.

"PART II - RESULTS OF AUDIT" SECTION

As noted herein under the Executive Summary section, the "poor financial results..." which are due to the "unanticipated foreign exchange loss...", is not properly blamed on inadequate management. The auditors should clarify the correlation between foreign exchange losses and poor management or omit it altogether.

A. Findings and Recommendations

1. AID - Generated Local Currency Was Converted to Dollars and Invested in the U.S.

Recommendation No.1

This recommendation was closed as indicated on page 9. No further comment or clarification necessary. Nevertheless, see the Discussion comments below.

Discussion

The financial data included by the auditors in this section has an unexplained difference as follows:

| | |
|---|---|
| Proceeds from the sale of capital stock | $ 8,153,892 |
| Amount realized on conversion | 6,884,115 |
| | 1,269,777 |
| Unexplained difference | 40,000 |
| Amount per PIC's income statement | $ 1,309,777 |

Although the $1,309,777 ties to Exhibit 2, the details provided by the auditors leaves $40,000 unexplained. An additional error in the data is as follows:

| | |
|---|---|
| Amount which would have been lost even without conversion to dollars | $ 813,538 |
| Loss on the conversion of local currency to dollars | 496,279 |
| | 1,309,817 |
| Unexplained difference | (40) |
| Amount per PIC's income statement | $ 1,309,777 |

The above discrepancies should be corrected in the final report.

2. Equity Investments Were Not Achieved As Planned

Recommendation No.2

USAID/CR agrees with the recommendation as stated, but the auditors should note that this is not a new issue and has been under discussion with PIC for some time, and that AID management deliberately chose not to insist on immediate resolution of this issue during the lengthy period of PIC's management reorganization. Immediately after PIC's new management was in place, the issue was pressed again and a schedule for equity investments has been agreed upon.

Discussion

USAID/CR believes in retrospect that the original estimate of a 20% internal rate of return was an optimistic projection.

3. Adequate Procedures Were Not Established for the Evaluation of Project Designs and the Monitoring of Project Implementation

RIG comment is correct but USAID/CR suggests some changes in wording. Terms like "project designs" and "monitoring of project implementation" are non-profit, or public sector concepts and do not reflect appropriate private sector criteria and/or terminology. USAID/CR suggests something like "applications for loan and equity investments should be analyzed more closely by technical experts before an investment decision is made" and "follow-up procedures should be developed to track the performance of investments made on both an individual investment as well as a portfolio basis".

Recommendation No.3

Recommendation accepted as stated but consider USAID/CR wording observations above.

B. Compliance and Internal Controls

1. Compliance

All loans funded with AID monies complied with AID procurement policies although PIC did finance other loans out of its own funds which might not have complied. The PIC is not out of compliance on this issue nor does the auditors' "Recommendation No.3 of the Report" deal with AID procurement requirements as stated by the auditors in this paragraph.

Nevertheless, a procurement specialist from ROCAP provided special training in this area to strengthen compliance even further.

AID requests that the issue of AID procurement requirements be eliminated in the auditors' final report because there was no ocurrence of non-compliance. The negative assurance wording should also be modified accordingly.

CONCLUSION

The items of relative significance in the auditors report are PIC's poor management and the conversion of local currency to dollars. Steps have already been taken to rectify both situations.

## LIST OF RECOMMENDATIONS

### Recommendation No. 1

We recommend that USAID/Costa Rica obtain evidence that the Private Investment Corporation has invested in Costa Rica the $5.3 million of its equity capital which had been diverted to "off-shore" banks.

### Recommendation No. 2

We recommend that USAID/Costa Rica obtain evidence that the Private Investment Corporation has established a satisfactory equity investment policy and business plan to increase the percentage of funds placed in equity investments in accordance with the investment objectives of the project, and modify the project agreement's financial plan as may be required.

### Recommendation No. 3

We recommend that USAID/Costa Rica obtain evidence that the Private Investment Corporation has developed and formalized improved procedures to evaluate project designs and to monitor project implementation in order to better ensure the success of its projects and compliance with AID requirements.

APPENDIX 3

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