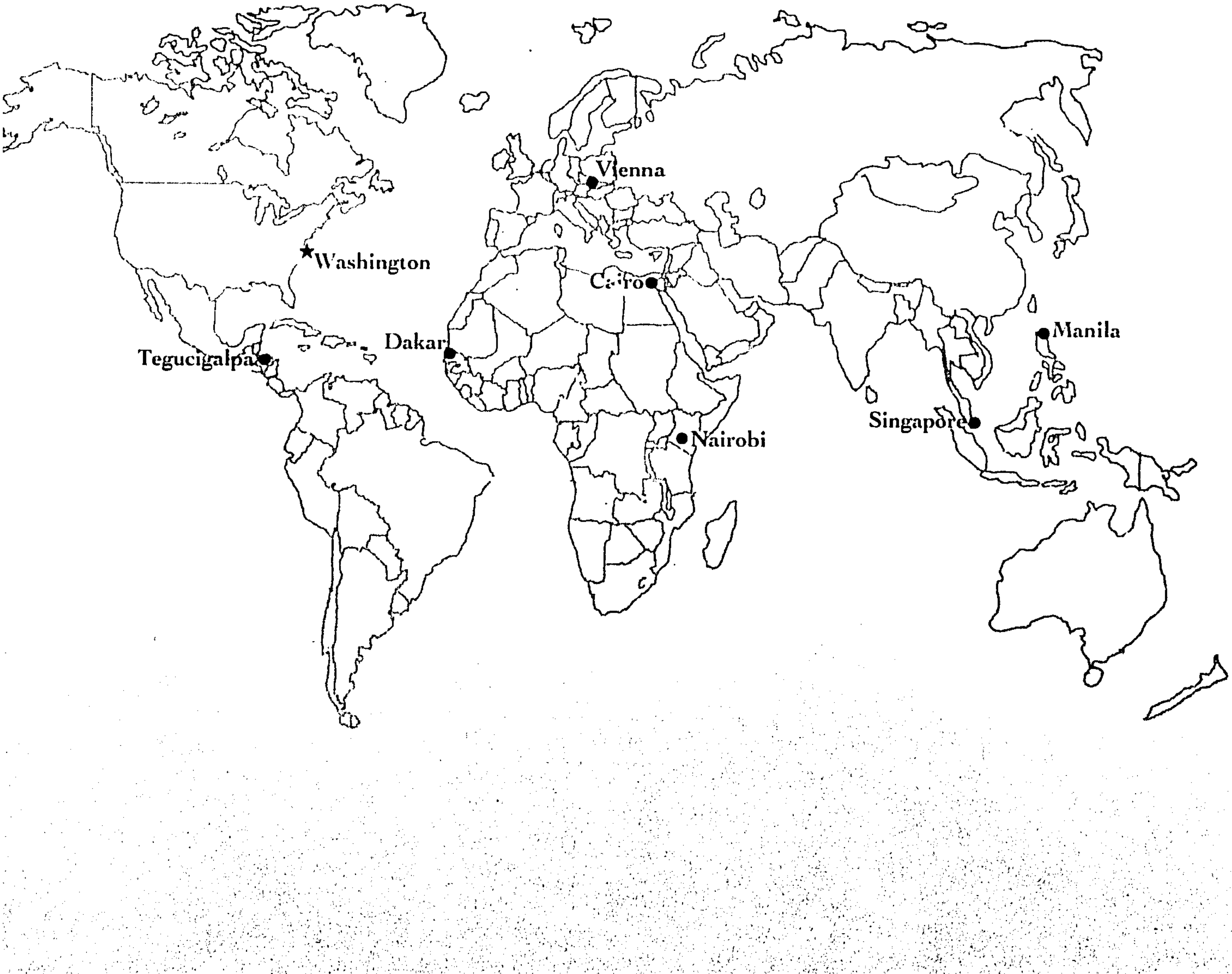
PD-ABH-580

Regional Inspector General for Audit
Bonn

Audit of the Regional Mission for Europe's Management of Cash Held By the Enterprise Funds, Under Project No. 180-0010

Report No. 8-180-94-002
January 31, 1994



INSPECTOR GENERAL

U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT

USAID
U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

January 31, 1994

MEMORANDUM

TO: ENI/EUR/A-DAA, Robert W. Nachtrieb

FROM: for RIG/A/Bonn, John P. Competello James R. Bennett

SUBJECT: Audit Report on the Regional Mission for Europe's Management of Cash Held By the Enterprise Funds, Under Project No. 180-0010 (Audit Report No. 8-180-94-002)

This is the report on our audit of the Regional Mission for Europe's Management of Cash Held by the Enterprise Funds, Under Project No. 180-0010. In preparing the report, we took into consideration your comments provided on a draft of this report. Those comments are attached as Appendix II.

We have excluded from this report a discussion of the cash buffers as they were only recently negotiated with the Enterprise Funds. We noted, however, that the Regional Mission for Europe needs to monitor the appropriateness of the cash buffer amounts, and we may consider them for review in the future.

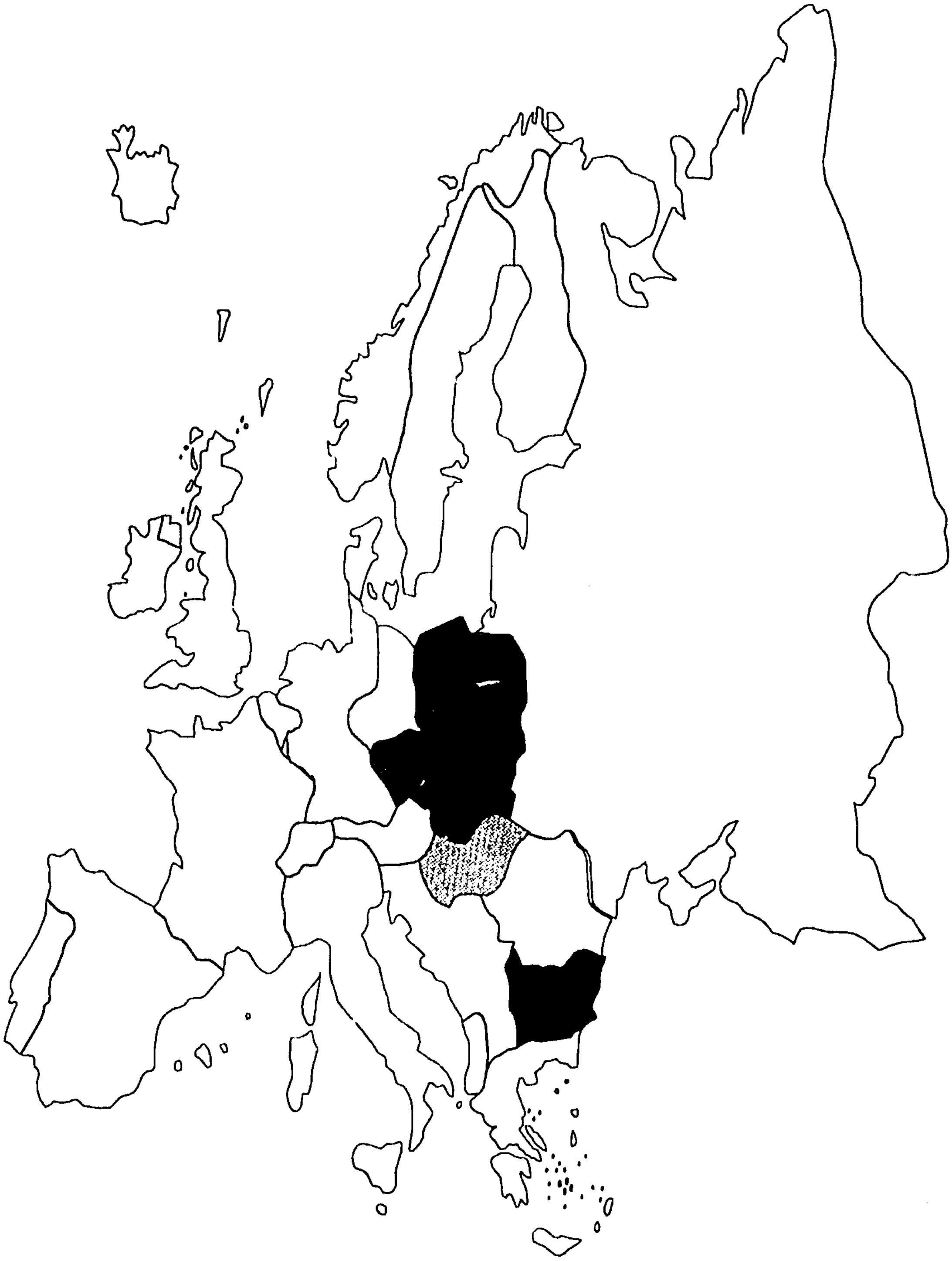
This report contains one recommendation to improve RME's management of the cash held by the Enterprise Funds. In commenting on our draft report, RME stated it believes our recommendation contains good ideas for ways to minimize the Funds' cash balances and indicated it would attempt to include requirements contained in our recommendation in amendments to the four Funds' agreements. However, RME did not agree with our estimated cost savings. IG policy requires that the auditee concur in the amount of savings before the recommendation is resolved. Accordingly, Recommendation No. 1 is considered unresolved until we can reach agreement on the amount of savings.

Please provide us information within 30 days on any actions taken to implement the report recommendations. I appreciate the cooperation and courtesies extended to my staff during the audit.

Background

Enterprise Funds were created and funded by the Support for Eastern European Democracy (SEED) Act of 1989. The Funds were established to provide a new approach to foreign aid, i.e., to affect the private sector through loans, grants, and

EXISTING CEE COUNTRIES WITH ENTERPRISE FUNDS



POLAND
CZECH/SLOVAK
HUNGARY
BULGARIA

equity investments in small businesses, the agriculture sector, and joint ventures with U.S. and host country participants. The Funds were established to function as investment banks, with outside Boards of Directors comprised of distinguished individuals from the United States and the host country participants.

The Enterprise Funds are a significant component of USAID's program to countries in the Central and Eastern European democracies (see map on page 2), and currently include the Polish-American Enterprise Fund (PAEF), the Hungarian-American Enterprise Fund (HAEF), and two additional Funds not included in the SEED Act of 1989: the Czech and Slovak-American Enterprise Fund (CSAEF) and the Bulgarian-American Enterprise Fund (BAEF). As of September 30, 1993, the four Funds have been authorized $440 million, of which approximately $224 million has been advanced.

The Enterprise Fund concept appears to be expanding with one new Fund recently established and others planned. For example, a Russian-American Enterprise Fund with an authorized funding of $340 million was initiated in September 1993 and the concept is also planned for the Ukraine, the Baltic States, Romania, and other countries of Central and Eastern Europe (CEE) and the New Independent States (NIS). Total appropriations for these Funds is expected to grow and could amount to $1.32 billion. (See page 4 for current and projected funding of Enterprise Funds.)

Because the Congress and the President wanted the Enterprise Funds to initiate private sector activities with a market orientation approach to investing capital, the SEED Act did not require USAID to monitor and control the Funds as it does for other grantees. Instead, at the outset, USAID provided the grant money upon the Funds' request. In fact, under provisions of the Act, the Polish Fund and the Hungarian Fund were allowed to draw down their entire initial FY 1990 grant: approximately $34 million and $5 million, respectively, in May 1990, the month the initial grants were signed. Even though most of these initial outlays were still being held as cash, the initial grants were amended in January 1991 which allowed the Funds to draw another $23 million and $14 million respectively in February 1991. Under the provisions of the Act, the Funds could invest their excess cash in interest-bearing accounts and retain the interest earned for program purposes.

In FY 1991 the funding provisions in the SEED Act were modified as Congress was concerned with the lengthy delays in beginning operations of the Polish-American and Hungarian-American enterprise funds (i.e., the Funds had not invested all of their cash drawdowns within a reasonable time). Therefore, Congress mandated in the 1991 Appropriation Act, that USAID limit cash advances to the Enterprise Funds to "the minimum rate necessary to make timely payment for projects and activities." Inspector General reviews of the Funds' cash management procedures,[1] undertaken

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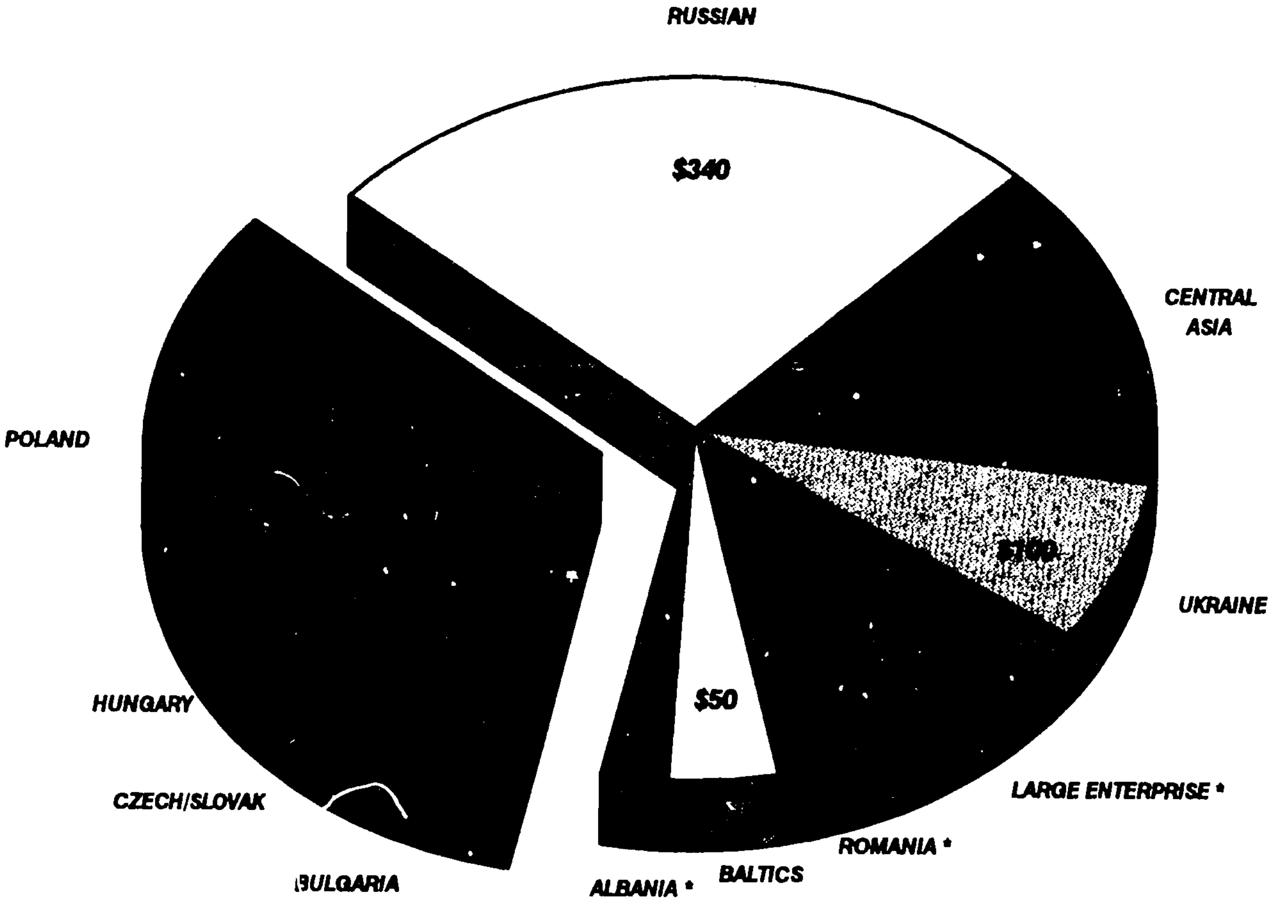
[1] Quality Control Review Letters to the Polish-American Enterprise Fund for Years Ended September 30, 1991 and 1992.

CURRENT AND PROJECTED FUNDING FOR CEE AND NIS ENTERPRISE FUNDS



EXISTING ENTERPRISE FUNDS ($440 MILLION)

NEW ENTERPRISE FUNDS ($880 MILLION)

* NOT YET ANNOUNCED

TOTAL FUNDING = $1.32 BILLION

as part of Quality Control Reviews of the Funds' audited financial statements, led us to believe that cash management needed further study. Also, because of the increasing use of Enterprise Funds to assist in economic development of CEE and NIS countries, we included this audit in our fiscal year 1993 audit plan.

Audit Objectives

Based on the Inspector General's Revised Fiscal Year 1993 Audit Plan, we audited the Regional Mission for Europe (RME) to answer the following audit objective:

- **Is the Regional Mission for Europe monitoring and providing cash to the Enterprise Funds in accordance with requirements of the Appropriations Acts and the grant agreements?**

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

Audit Findings

Is the Regional Mission for Europe monitoring and providing cash to the Enterprise Funds in accordance with requirements of the Appropriations Acts and the grant agreements?

The Regional Mission for Europe (RME) has monitored cash provided to the Enterprise Funds in accordance with requirements of the Appropriations Acts and the grant agreements. However, in providing cash to the Funds to meet their needs for investments and operating expenses, RME has allowed the Funds to draw down cash intended for investments on the basis of cash projections. The investments in many cases were delayed or not made thus resulting in excess cash in the hands of the Funds. More effective use of the established Letter of Credit mechanism could help reduce the cash balances held by the Funds and save about $700,000 a year in interest costs to the U.S. Treasury.

RME Has Taken Significant Action
<u>to Monitor Cash Management</u>

In the 1991 Appropriation Bill, Congress mandated for the first time that the flow of cash to the Enterprise Funds be at the "minimum rate necessary to make timely payment for projects and activities." The RME, reacting to this mandate, placed this requirement in the grant agreements for the Polish and Hungarian Funds in January 1991, and later included the same provision in the initiating grant agreements for the Czech-Slovak Fund and the Bulgarian Fund.

From 1991 through 1993, RME took a series of actions to better monitor cash management by the Funds and to help ensure that cash was provided at minimum levels to make payments for projects and activities. Significant among these were the following:

- the Funds were provided with the Letter of Credit mechanism of financing, a mechanism that allows for drawdowns of cash as needed and within three workdays of a request;

- the Funds were required to report their cash disbursements and Federal cash on hand on a monthly basis on form SF-272, Federal Cash Transactions Report;

- the Funds were required to provide forecasts of cash needs (first on a 60-day basis, then reduced to a 30-day basis) when requesting cash; and

- the Funds were required to report cash reflows from their investment activities which gave RME information on the total amount of cash held by the Funds.

Finally, in April 1993, the RME negotiated "cash buffer agreements" with each of the Funds. The purpose of these cash buffers was to establish an amount that each Fund carried as cash on hand to meet operating expenses and contingencies - $2.5 million for the Polish Fund and $1.5 million for the other three Funds - for a total of $7 million. We believe the RME needs to continue to monitor the appropriateness of these cash buffer amounts.

However, even considering this recently agreed-to "buffer" for operating expenses and contingencies, our audit showed that the Funds' cash balances continued to exceed the minimum amounts needed for projects and activities. In our view, more effective use of the Letter of Credit mechanism would ensure that the Funds meet their cash needs for investments and reduce interest costs to the Treasury by $700,000 a year.

More Effective Use of the Letter of Credit Can Reduce Interest Costs to the U.S. Treasury

The Enterprise Funds are authorized to use the Letter of Credit mechanism to help keep cash balances at minimum levels necessary for programs and activities by providing cash within three workdays. However, cash drawdowns made by the Funds using the Letter of Credit mechanism exceeded three workdays because the RME required administrative approval of cash forecasts submitted with the request for cash. Therefore, the Funds submitted forecasts and received cash for investment needs before drawdowns from prior forecasts were used. As a result, for the six month period ending September 30, 1993, cash on hand at the Funds averaged about

$20.7 million, or $13.7 million in excess of the agreed-to buffers for immediate cash needs. More effective use of the Letters of Credit could help reduce these balances and result in a savings of about $700,000 a year in interest costs to the U.S. Treasury.

Recommendation No. 1: We recommend that the Regional Mission for Europe:

1.1 require the Enterprise Funds to:

(a) submit monthly forecasts of their cash needs for projected investment activities for approval, and

(b) separately request cash drawdowns on an investment to investment basis;

1.2 require the Enterprise Funds to return to their Letter of Credit account all cash drawdowns that exceed their cash buffer amount at the end of each month.

According to the 1991 Appropriations Act, the rate at which cash should be provided to the Enterprise Funds is at the minimum rate necessary for the Funds to carry out their grant objectives. Beginning January 1991, USAID instituted the Letter of Credit method for advancing cash to the Funds. This mechanism is intended to provide cash within three workdays of a request and, therefore, to meet grantees' immediate requirements and to minimize their cash on hand.

However, we found that the turn-around time for the Funds to receive cash was not within three workdays. This occurred because RME required a cash forecast simultaneously with each cash drawdown request, and scrutinized the forecast before it approved the cash drawdown request. According to RME, this allowed them more information for their cash monitoring role.

Consequently, because the cash drawdowns were rarely made within the required three workdays, the Funds' retained large cash balances by showing cash needs for new investments, even before previous cash drawdowns and the cash buffer amount had been used. For example:

- One fund had over $12 million in cash on hand as of August 31, 1993,the date it submitted its 30-day forecast with a request for cash. Most of this cash was on hand because prior projected investments had not closed from earlier cash drawdowns. However, because the Fund believed it would still close those earlier projected investments plus close four more new investments in the next 30 days, it requested an additional $7 million. On top of this projection, a cash buffer request was added in at $2.5 million, for a total cash forecast and request for cash of $9.5 million. The Fund was advanced the additional $9.5

million on September 9, 1993, and still had a cash balance on September 30, 1993 of about $7.7 million, or approximately $5.2 million more than the Funds cash buffer amount.

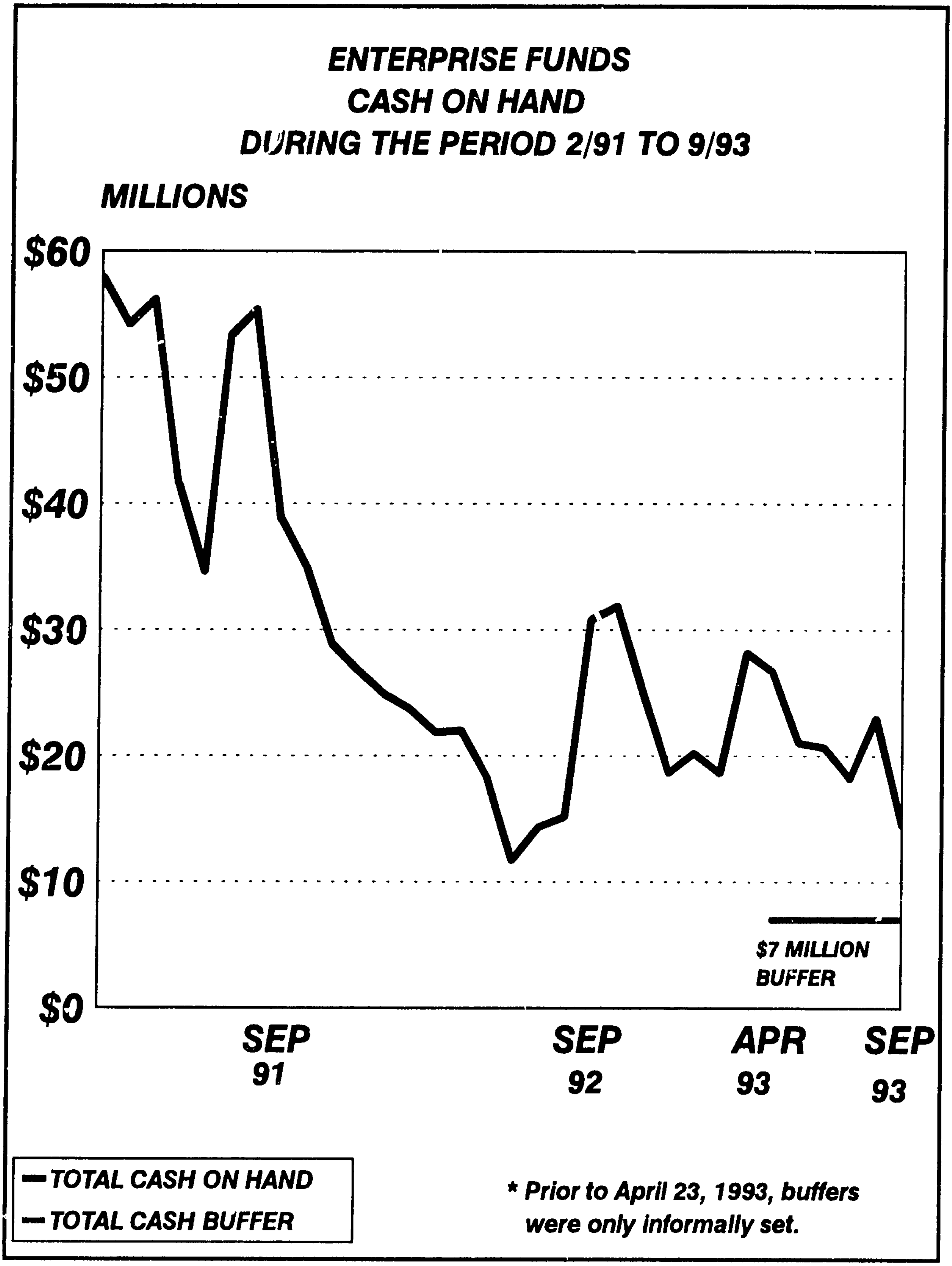
On March 18, 1993 a second fund was advanced approximately $4.8 million based on its March 11, 1993 request for cash and forecast of investment closing for the following 30 days. However, this amount had not been used for its investment closing as planned. Rather, it was invested in a short term money market account for several months, and as of August 31, 1993 the fund had a cash balance of nearly $4.7 million – $3.2 million over its cash buffer of $1.5 million.

Had these funds received cash at the time of investment and returned excess cash at the end of each month, neither one of these Funds would have carried such high balances of cash on hand from the beginning of the month through following months. The Chief Financial Officers of the two Enterprise Funds discussed above justified carrying large cash balances by stating that this allowed them to have cash on hand when an investment was about to close, since they could not rely on the Letter of Credit mechanism for a quick turn-around of their investment cash needs.

....the Enterprise Funds' forecasts are generally overly optimistic in projecting when investment cash will be needed, and end-of-month cash balances consistently exceed their cash buffer amount.

Thus, the Enterprise Funds' forecasts are generally overly optimistic in projecting when investment cash will be needed, and end-of-month cash balances consistently exceed their cash buffer amount. (see graph on page 9 that shows actual cash balances vs. buffer set in April 1993). Moreover, the cash for forecasted investments that do not occur are kept by the Funds in short term deposits and held until the forecasted investment activity does occur, or until a new investment opportunity requires the excess cash on hand.

As a result, the Funds retained an average of $20.7 million, $13.7 million in excess of the $7 million buffer during the six month period ending September 30, 1993. Thus, by allowing the Funds to draw cash at a level higher than their immediate needs, the U.S. Treasury has incurred a greater interest cost than necessary to fund the Enterprise Funds project. At the current level of excess cash balances on hand at the Funds, we estimate the excess interest cost to the U.S. Government to be nearly $700,000 per year. (Determined by multiplying the Funds' average cash balance of $20.7 million for the six months ended September 30, 1993, less the $7 million buffer, times 5%, the rate provided by the U.S. Treasury based on current yields of 5-year Treasury notes).


ENTERPRISE FUNDS
CASH ON HAND
DURING THE PERIOD 2/91 TO 9/93
MILLIONS
$60
$50
$40
$30
$20
$10
$0
$7 MILLION
BUFFER
SEP 91
SEP 92
APR 93
SEP 93
TOTAL CASH ON HAND
TOTAL CASH BUFFER
* Prior to April 23, 1993, buffers were only informally set.

In order to reduce total cash balances and to eliminate the delays the Funds have in receiving their cash requests, the Letter of Credit mechanism should be more frequently used by the Funds (on an investment by investment basis), and the RME's administrative approval process needs to be disconnected from the Letter of Credit drawdowns. Since substantial cash remains to be disbursed to both the existing and future Funds, we believe this issue requires close attention. (See page 12 for graph of money appropriated versus total cash drawn by the four Funds. Also, refer to chart on page 4 that depicts planned funding.)

Consequently, we believe the submission and approval of the 30-day forecast should be on a monthly basis and should precede cash drawdown requests. This would allow cash to be disbursed by USAID to the Funds as needed (and within 3 work days), rather than on a forecasted basis, and would thereby allow the Funds to reduce their cash on hand. If this reporting system indicates excess cash is being retained, the excess cash amount should be returned to the Fund's Letter of Credit account at USAID.

Management Comments and Our Evaluation

In commenting on the draft report, the Regional Mission for Europe (RME) stated that it found the report to be well balanced and to offer constructive advice on how cash management can be improved. However, RME stated that it did not know whether it would be successful in negotiating our recommended cash management actions with the Funds. Therefore, it requested that the recommendation be worded to reflect the outcome of their negotiations. In addition, RME disagreed with our estimate of $700,000 annual savings for implementing the recommendation. They stated that a "short-term" interest rate instead of a five-year rate should be used to determine interest savings. Also, RME believed that our estimated interest savings should be reduced by the interest the Funds earned on its short-term investments that were made with their excess cash balances, and that the base period for which we calculated the average excess cash balance should be expanded to include November and December 1993. In addition, RME believed that we should recognize that 10 to 14 days are required for the Funds to get the Letter of Credit drawdowns transferred to overseas banks.

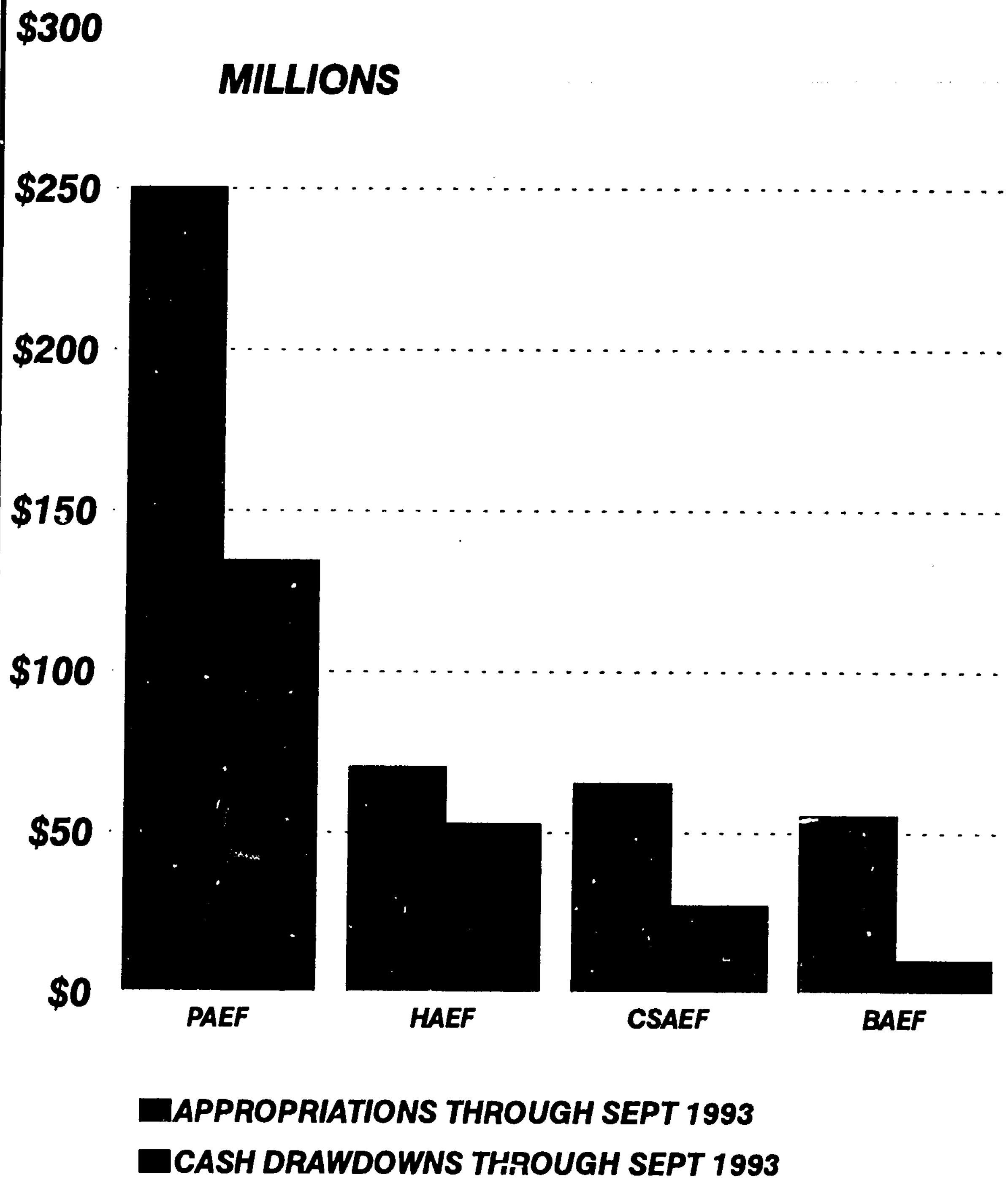
We emphasize that our recommendation is based on our audit results and RME must decide on the appropriate actions to take. Once we are informed of RME's actions taken to resolve the recommendation we will evaluate the response in order to resolve and close the recommendation. The recommendation addresses RME's need to greatly reduce cash on hand at the Funds beyond their immediate needs, and therefore we have not changed the actual wording of our recommendation.

Although our report did not take a position on the cash buffers established and approved for the Funds by RME, we believe that these buffers are a unique concession to the Fund grantees, and provide several months of operating expenses in cash advances to the Funds. In addition, once RME follows our recommendation to change its procedures for monitoring cash and cash advances, the Funds will be able to meet their investment cash needs through drawdowns using the three day turn-around process provided through their individual Letters of Credit. As to allowing for a delay in transferring funds overseas, our recommendation would allow the Funds to draw down cash for an investment prior to the actual closing of the investment, even though we were told that dollars are not generally transferred by the Funds from their U.S. bank accounts until the investment closing has actually occurred.

In response to RME's questioning of our interest savings calculation, it should be noted that we were conservative in approaching this calculation. We used the last six months of our audit period (September 1993 data was the latest available during our field audit work) for calculating excess cash balances, a period during which cash balances were substantially lower than the earlier balances maintained after the initial drawdowns by the Funds. The interest rate used reflects a five-year rate since the Funds would hold the excess cash for that period as a minimum life-of-project period. Further, as to the interest the Funds earned on excess cash, Congress did not intend for them to have large excess cash balances on hand to be continuously placed in short-term investments, as that is not consistent with their intention of advancing cash at the minimum amount necessary.

In summary, Recommendation No. 1 is considered a monetary recommendation with potential savings we estimate at $700,000 per year. Although RME indicated our recommendation contains good ideas for ways to minimize the Funds' cash balances and would attempt to include these requirements in amendments to the four Funds' agreements, RME did not agree with our estimate of potential savings. Accordingly, the recommendation is considered unresolved until we reach agreement on the amount of savings.

ENTERPRISE FUNDS
APPROPRIATIONS VS. CASH DRAW DOWNS



PAEF - POLISH AMERICAN ENTERPRISE FUND
HAEF - HUNGARIAN AMERICAN ENTERPRISE FUND
CSAEF - CZECH/SLOVAK AMERICAN ENTERPRISE FUND
BAEF - BULGARIAN AMERICAN ENTERPRISE FUND

SCOPE AND METHODOLOGY

We audited the Regional Mission for Europe's (RME) oversight and control of cash released to the Enterprise Funds in accordance with generally accepted government auditing standards. We conducted the audit from August 24 through December 7, 1993, and included all four Enterprise Funds in existence at the start of the audit: the Polish-American Enterprise Fund, the Hungarian-American Enterprise Fund, the Czech and Slovak-American Enterprise Fund, and the Bulgarian-American Enterprise Fund. The audit covered the Mission's cash management and monitoring practices for over $224 million in advances to the above four funds from May 16, 1990, through September 30, 1993. We conducted our audit work in the office of the Regional Mission for Europe and the Financial Management office in Washington, D.C. and at the U.S. headquarters of each of the four Enterprise Funds.

We reviewed the SEED Act, Appropriation Acts, and grant agreements to determine the cash management-related requirements placed on USAID. We also interviewed the RME's officials responsible for the Enterprise Funds and Financial Management's Letter of Credit branch officials, and examined their cash management-related records to determine: (1) the methodology, timing, and amounts of cash released to the Funds; (2) the procedures used throughout the period for releasing and monitoring the cash held by the Funds; and (3) whether methods and procedures used were sufficient to ensure that USAID funds advanced were at the minimum rate necessary for the Funds to carry out their objectives. We did not review the appropriateness of agreements made on April 23, 1993 between the RME and the four Enterprise Funds allowing a total cash buffer of $7 million for operating expenses and contingencies. The provisions of these agreements call for the RME to monitor the buffer and adjust the amount as appropriate.

At the Enterprise Funds' U.S. headquarters, we interviewed the Chief Financial Officers, and examined their cash-related records to determine: (1) their methods, timing, and substantiation for obtaining cash and then positioning cash for their foreign investments; (2) how long it took the Funds to receive cash once requested; and (3) the actual cash balances held at the end of each month, and whether cash on hand reported to USAID included all cash equivalents. In defining the scope of this audit, we also examined the results of the quality control reviews performed by this audit office of the annual external financial audits.

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INTERNATIONAL
DEVELOPMENT

RECEIVED 1/25/94

MEMORANDUM

TO: RIG/A/Bonn, John Competello

FROM: ENI/EUR/A-DAA, Robert Nachtrieb

SUBJECT: Draft Audit Report on Management of Cash Held by the Enterprise Funds, Under Project No. 180-0010

We received your draft report on the Management of Cash Held by the Enterprise Funds. In general, we find the report to be well balanced and to offer constructive advice on how cash management can be improved. We do have the following comments which we would like to have taken into consideration in your drafting of the final report.

Estimated Savings

RIG estimates the interest savings from tighter cash management to be $700,000 per year based on a cost of capital of five percent and excess cash balances of approximately $14 million. We do not agree that the rate on a five-year Treasury note is the appropriate rate; a short-term rate would result in a much more accurate determination of "savings" as the excess cash balances are not going to be maintained for five years. The average excess cash balance should also be recomputed based on the more recent October and November 1993 data, which indicate an average excess balance for these two months of $7.9 million. In addition, this "greater interest cost" needs to be reduced by interest saved the U.S. Government from delays in new cash drawdowns due to increased cash on hand from the interest earned on the excess cash balances by the enterprise funds.

Time Period for Funds to Receive Drawdowns

The report states that there is a three-day period from the date of the cash request under the LOC to the date the Funds get the cash. It should be recognized in the report that a longer period of 10 to 14 days is required for the Funds to get the LOC drawdowns transferred to their overseas accounts from which disbursements for investments will be made.

Recommendation

RIG's recommendation contains good ideas for ways to minimize cash balances of the Funds. We will discuss these recommended actions during our current negotiations for amendments to the four European enterprise funds with the goal of adding these requirements to the agreements. There is no guarantee, however, at this point that the cash management provisions added to the amendment will be exactly what RIG is recommending. We are therefore requesting that the wording of this recommendation, that RME "require" the Funds to take these actions, be changed to reflect the need to negotiate acceptable cash management arrangements.

We would like to thank RIG for their assistance in improving the cash management of the enterprise funds. We look forward to receiving a copy of the final report.

USAID

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

RECEIVED 1/25/94

TO: RIG/A/Bonn, John P. Competello

SUBJECT: Audit Representation Letter - Audit of the Regional Mission for Europe's Management of Cash Held By the Enterprise Funds, Project No. 180-0010

This representation letter is issued in connection with your audit of the Cash Management of the Enterprise Funds under Project Number 180-0010. Your audit was conducted between August 24, 1993, and December 7, 1993, and was conducted for the purpose of answering the following audit objective:

> Is the Regional Mission for Europe monitoring and providing cash to the Enterprise Funds in accordance with requirements of the Appropriations Acts and the grant agreements?

As of December 7, 1993, and to the best of our knowledge and belief, we confirm the following representations made to you during your audit:

1. Where your audit relates to RME's cash management of the Enterprise Funds, RME is responsible for the monitoring of the providing of cash to the Enterprise Funds and compliance with applicable A.I.D. policies and procedures, as modified for RME, and applicable U.S. laws and regulations.

2. We have asked the most knowledgeable, responsible members of our staff to make available to you all records in our possession for the purposes of this audit. Based on the statements made by these individuals, of which we are aware, and our own personal knowledge, we believe that those records constitute a fair representation as to the status of RME's management of cash provided to the Enterprise Funds. Please note that faxes, notes, and other informal communications, which are not part of the official files, are not systematically kept by our office.

3. To the best of our knowledge and belief, RME has disclosed any known:

   - irregularity involving management or employees who have roles in the internal control structure,

   - irregularity involving any other organizations that could affect the subject audit, and

   - communication from any other organizations that could affect the subject audit.

4. To the best of our knowledge and belief, RME is not aware of any material instance where significant management information has not been accurately reported to responsible management in RME.

5. To the best of our knowledge and belief as laymen, and not as lawyers, RME has not withheld any information of instances of material non-compliance with applicable A.I.D. policies and procedures (as modified by RME policies and procedures) or possible violations of applicable U.S. law or regulations related to cash management of the Enterprise Funds.

6. To the best of our knowledge and belief as laymen, and not as lawyers, RME has not withheld information about material non-compliance with the grant agreements with the Enterprise Funds that could materially affect those agreements.

7. Following our review of your Draft Report and further consultations with my staff, we know of no other facts as of the date of this letter which, to the best of our knowledge and belief, would materially alter the conclusions reached in that document.

We request that this representation letter be included as a part of the official management comments on the draft report and that it be published herewith as an annex to the report.

Sincerely,

Robert Nachtrieb
Acting Deputy Assistant Administrator
Europe and the New Independent States

APPENDIX III

DISTRIBUTION OF AUDIT REPORT

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ENI/EUR/RME/DIR	1
ENI/EUR/RME/FMS	15
ENI/EUR/RFMC/CEE/Budapest	1
AIDREPs/CEE Countries	1
USAID Missions/NIS	1
XA/PR	1
LEG	1
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FA/MCS	2
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IG/A/FA	1
IG/A/PSA	1
RIG/As	1
AIG/RM	12
AIG/S&I	1