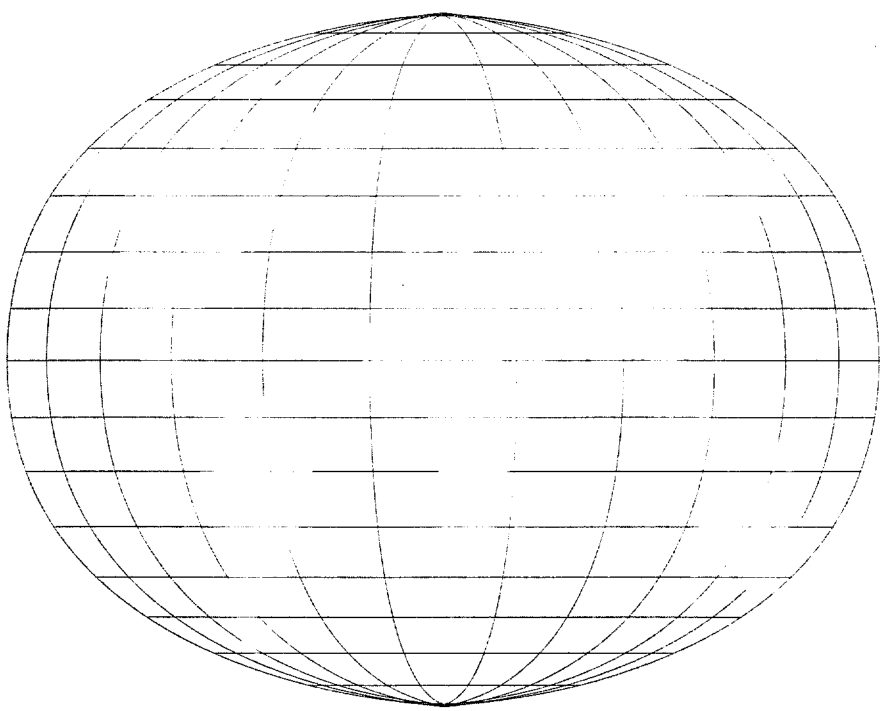
# Report of Audit

## Audit of the Request for Review of the U.S. Russian Investment Fund's Investment in U.S. Global Health Limited

Audit Report No. A-000-97-003P
March 26, 1997



**OFFICE OF INSPECTOR GENERAL**
**U.S. AGENCY FOR INTERNATIONAL DEVELOPMENT**

USAID

U.S. AGENCY FOR
INTERNATIONAL
DEVELOPMENT

*Office of
Inspector General*

March 26, 1997

MEMORANDUM FOR AA/ENI, Thomas A. Dine

FROM: AIG/A, Everette B. Orr Everette B. Orr

SUBJECT: Audit of the Request for Review of the U.S. Russian Investment Fund's Investment in U.S. Global Health Limited

This report responds to requests made by Senator Joseph I. Lieberman, Senator Connie Mack, Congresswoman Ileana Ros-Lehtinen, and Congressman Christopher Shays in September and October 1996 regarding questions surrounding financial losses associated with The U.S. Russian Investment Fund's (TUSRIF) investment in U.S. Global Health Limited, which operated a western-style health clinic in Moscow. TUSRIF, a federally-funded nonprofit fund authorized by the Freedom Support Act of 1992, invested $3.75 million in U.S. Global Health Limited in December of 1994. The clinic ceased operation in October 1995.

## Summary of Results

Our audit work disclosed that the failure of U.S. Global Health Limited was caused by lower than expected revenues combined with start-up and operating costs that depleted the firm's capital before it was able to turn a profit. Several factors contributed to reduced revenues, including a court injunction that prevented the firm from marketing its services to certain U.S. firms doing business in Moscow. After considering the situation and the prospect for future profitability, TUSRIF and its two partners in the investment decided against investing additional funds. As a result, U.S. Global Health Limited is being liquidated. TUSRIF performed various analyses before acquiring a one-third interest in U.S. Global Health Limited, including analyses of the market potential for quality health services, revenue and expense estimates, and risks associated with the investment. TUSRIF also structured its investment in a manner that provided it with rights and risks that were commensurate with other investors. Although TUSRIF has taken action to receive its share of proceeds from liquidation proceedings, it appears that TUSRIF and the other investors will suffer a total or near total loss.

## Background

The Support for Eastern European Democracy (SEED) Act of 1989 authorized the U.S. Agency for International Development (USAID) to sponsor private, nonprofit Enterprise Funds in Eastern Europe. The objective of the Funds is to promote: (a) private sector development including small businesses, the agricultural sector, and joint ventures with United States and host country participants; and (b) policies and practices conducive to private sector development. The Funds were to provide loans, grants, equity investments, feasibility studies, technical assistance, training, and other forms of assistance to these private enterprises.

As originally structured, there was to be limited U.S. government involvement in Fund activities. The only reporting requirement in the original grant agreements involved the publication of an annual report, as called for by the legislation. The 1991 Appropriations Act and the related Senate Conference Committee report include statements such as: "AID's role is simply to write the check;" and "AID is not to attempt to second-guess investment decisions." At the same time, there was a recognition that some oversight was needed: "The Committee expects the Administration to keep it regularly and closely informed about the performance of enterprise funds."

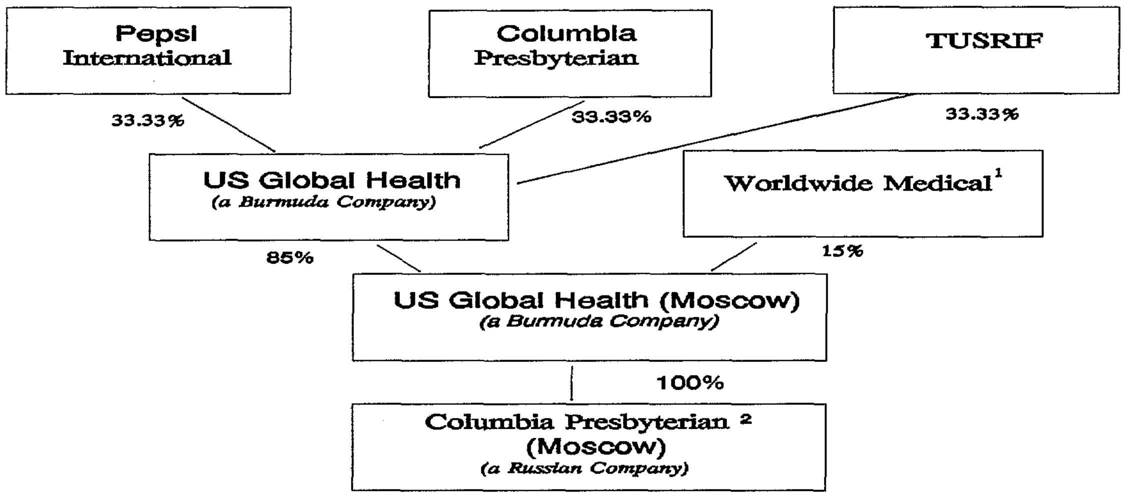
In 1992, the SEED Act was supplemented by the Freedom Support Act which authorized USAID to sponsor enterprise funds in countries that were formerly part of the Soviet Union. Two Funds, the Russian-American Enterprise Fund and the Fund for Large Enterprises, were established as separate investment vehicles to deliver this assistance to the Russian Federation. TUSRIF was created in the Spring of 1995 by consolidating the two funds into a single fund.

In December 1994, TUSRIF's predecessor—the Fund for Large Enterprises in Russia (FLER)—invested a total of $3.75 million to acquire preferred stock, valued at $625,000, and one-third of the common stock, valued at $3.125 million, of U.S. Global Health Limited, a Bermudian-registered company. Two other investors, Pepsi Trading International and Columbia Presbyterian Hospital of New York City, each owned one-third of U.S. Global Health Limited's common stock. This report refers to management actions by the Fund for Large Enterprises in Russia as TUSRIF actions.

U.S. Global Health Limited owned 85 percent of a subsidiary, U.S. Global Health-Moscow—which operated a clinic that marketed its services primarily to Americans, other foreign expatriates, and wealthy Russians in Moscow. The clinic featured American Board Certified physicians and state-of-the-art diagnostic equipment. Individuals and families paid a membership fee to participate as well as separate fees for the health care services provided. Figure I shows the ownership structure.

## Figure 1

## US Global Health - Moscow LTD Group Structure




[1] Worldwide Medical represented the interest of five Russian and American entrepreneurs who originally developed the clinic concept.

[2] Columbia Presbyterian - Moscow managed and operated the clinic's day-to-day operations.

In October 1995, less than a year after TUSRIF's investment, the health clinic closed. Currently, U.S. Global Health Limited is in voluntary liquidation and U.S. Global Health-Moscow is being wound-up in the Bermudian court system.

## Audit Objectives

The objectives of this audit were to answer the following questions:

- What caused the bankruptcy of U.S. Global Health Limited and U.S. Global Health-Moscow?

- What analysis did TUSRIF perform before investing in U.S. Global Health Limited?

- Was the financial condition of U.S. Global Health Limited misrepresented to TUSRIF?

- Was TUSRIF's investment structured in a manner that protected its interests?

- Has TUSRIF taken steps to ensure that it receives its share of proceeds from the liquidation of U.S. Global Health Limited?

## Scope and Methodology

We audited TUSRIF's investment in U.S. Global Health Limited in accordance with generally accepted government auditing standards. The audit was conducted from November 7, 1996 through January 14, 1997.

In order to answer the audit's five objectives, we reviewed TUSRIF's files concerning this investment. Specifically, we examined stockholder agreements; the venture's business plan; financial information, including both projected and actual results; marketing data; legal information; and liquidation procedure documentation.

In addition, we interviewed officials of: First Medical Corp (a competitor providing clinic services in Moscow); TUSRIF in New York City; Pepsi Trading International in Purchase, New York; Columbia Presbyterian in New York City; and Worldwide Medical (a minority owner of U.S. Global Health-Moscow) in Chesapeake, Virginia. In Hamilton, Bermuda, where U.S. Global Health Moscow and U.S. Global Health Limited are registered, we met with the Official Receiver of U.S. Global Health Moscow, a Bermuda Government official; the accounting partner appointed as the official liquidator of U.S. Global Health Limited; and officials of International Advisory Services, the company which provided financial and administrative services to U.S. Global Health Limited.

We requested comments on a draft of this report from USAID's Bureau for Europe and Newly Independent States and the President of TUSRIF. USAID did not provide comments. TUSRIF provided oral comments which were incorporated in the report where appropriate. In addition, the accounting firm engaged in the liquidation process provided suggestions to clarify our description of the liquidation status, which we incorporated in the report.

## What Caused the Bankruptcy of U.S. Global Health Limited and U.S. Global Health-Moscow?

The bankruptcy of U.S. Global Health Limited and U.S. Global Health-Moscow were due to:

(a) lower than expected revenues combined with start-up and operating costs that depleted the Moscow clinic's capital before it turned a profit; and

(b) a decision by the owners of U.S. Global Health Limited to place the firm in bankruptcy rather than invest additional funds.

### Revenues Shortfall and High Start-Up and Operating Costs

The Moscow clinic was not expected to generate significant profits until 1995. Pepsi Trading International and Columbia Presbyterian had funded the initial start up of the operation and TUSRIF's investment was expected, among other things, to fund clinic operation until it produced a positive cash flow. However, higher than expected losses in 1994 and 1995 depleted the invested capital before the clinic could break even.

The Moscow clinic failed to achieve the revenues TUSRIF had projected for the clinic. TUSRIF had projected—in the investment memorandum it prepared for its Board of Directors—clinic revenues using various assumptions based on limited historical data because the clinic had only begun operations in September of 1994. Actual revenues, however, were far less than the worst case scenarios that TUSRIF had developed. Although TUSRIF projected 1994 revenues at $1.18 million, the actual revenue was only $92,446. Similarly, TUSRIF's 1995 revenue projection was $15.9 million under one scenario and $9.82 million under a downside scenario. The actual revenue generated for the first nine months of 1995 was only $820,000.

TUSRIF and Pepsi Trading International officials gave several reasons for the serious revenue shortfall. First, individuals and insurance companies were hesitant to pay the high membership fees which were in addition to the cost of services. The annual membership fees cost $1500 for a family, $750 per person, and monthly fees were $90.00 for a walk-in or tourists. In addition, signing up new members took longer than expected because corporations had to go back to their home offices in the United States for approval. The availability of medical service from other countries, such as Finland, was also a competitive factor because companies could fly employees to Finland for emergency or routine medical services fairly cheaply. Additionally, the clinic experienced bureaucratic delays in obtaining hard currency and medical staff licenses which cost the business money.

The clinic was also unable to approach certain U.S. firms operating in Moscow because a court injunction prevented the clinic from doing so. The injunction resulted from a law suit[1] brought by First Medical Corporation. TUSRIF was aware of the lawsuit and injunction and had identified the lawsuit as a potential risk in its investment memorandum. The investment memorandum noted that if the suit was successful, U.S. Global Health Limited could lose a large share of the market.

Some officials we interviewed confirmed that the injunction reduced the clinic's ability to market its services to the 177 companies. In the end, it had a major impact on the venture's ability to survive.

## Depletion of Capital

The clinic's high operating costs and limited revenues quickly depleted available capital. The capital invested by Pepsi Trading International and Columbia Presbyterian had been used to cover start-up costs, including the renovation, equipment, marketing, and staffing costs of the clinic. As a result, most of the $3 million in cash invested by Pepsi Trading International and Columbia Presbyterian had been expended by October 1994.[2] Table I shows how the initial capital was used through October 25, 1994.

**TABLE I**

**INITIAL CAPITAL USED THROUGH OCTOBER 25, 1994**

| | |
|---|---|
| Equipment/office | $ 1,778,697 |
| Physician related expenses | $ 839,031 |
| Marketing | $ 174,105 |
| Professional fee | $ 171,213 |
| Clinic related expenses | $ 54,699 |
| Total | $ 3,017,745 |

[1] Law suit by First Medical Corporation alleges that Pepsi International personnel inappropriately obtained proprietary client information from its Moscow clinic. This lawsuit was on-going at the time this report was finalized.

[2] According to the documents we reviewed, in addition to its $2 million investment in U.S. Global Health Limited, Pepsi International also paid $2.13 million in initial start-up and operating costs for the Moscow clinic. U.S. Global Health Moscow subsequently reimbursed Pepsi International for these payments.

An audit report covering operations during 1994 showed that, as of December 31, 1994, the clinic had only $6,519 in cash.

TUSRIF's December 1994 investment was intended to fund the cash shortfall from operations that was expected through the end of 1995. Although TUSRIF had anticipated only a modest loss from clinic operations during 1995, the clinic's expenses during the first six months of 1995 exceeded revenues by $1.9 million, far more than expected. These losses were quickly exhausting the capabilities of U.S. Global Health Limited to fund clinic operations. Table II shows that between January and June 1995, clinic expenses amounted to $2.4 million while revenues only totalled less than $.5 million.

**TABLE II**

**JANUARY TO JUNE 1995 LOSSES IN $ THOUSANDS**

| | Jan./Feb. | Mar./Apr. | May/June | Total |
|---|---|---|---|---|
| Total Revenue | 126 | 180 | 175 | 481 |
| Total Expenses | 853 | 839 | 661 | 2,353 |
| Operating Loss | 727 | 659 | 486 | 1,872 |

The size of these losses were due, in part, to a decision to begin clinic operations in September 1994, with a complete staff of seven U.S. Board Certified physicians and two nurses. The average cost for each physician, salary plus benefits, totaled about $300,000 annually. Since business was very slow initially, the decision to have a full complement of physicians and nurses turned out to be a drain on cash flow.

Some of these losses may also have been caused by management deficiencies. A 1995 audit firm management letter pointed out that deficient management practices contributed to the clinic's financial failure. The management letter pointed out that neither the General Manager nor the Director of Sales and Marketing were residents in Moscow at the start of the project. Furthermore, the letter also noted that the project was managed by two large corporations accustomed to five-year projections rather than short-term cash management.

The letter concluded that:

(a) very little management attention was paid to the operating plan and sensible changes were not made when needed;

(b) cash was used according to the original plan, without regard to the under performance of the clinic, which resulted in a serious cash shortfall; and

(c) a high rate of physician turnover contributed to the clinic's slow start and cash shortfall.

**Investors Were Unwilling to Invest Additional Capital**

By August 1995, U.S. Global Health Limited had expended most of its capital and was unable to provide further funding without additional capital from its owners. TUSRIF, Pepsi Trading International, and Columbia Presbyterian decided against investing additional funds in U.S. Global Health Limited and, as a result, it went into bankruptcy.

The Pepsi Trading International representative on the U.S. Global Health Limited's Board advised the other members of the Board of Directors in August 1995, that his company no longer viewed this investment as desirable and it wished to divest itself of its shares. A request was made that the other shareholders assess a range of options to reorganize and restructure the company. It was noted that an immediate injection of additional capital was needed to meet the month-end payroll. Without Pepsi Trading International's continued participation in the venture, TUSRIF and Columbia Presbyterian decided against investing additional funds in U.S. Global Health Limited. Because U.S. Global Health Limited could not then support the cash flow needs of U.S. Global Health Moscow, it petitioned the Bermuda Court to wind-up the affairs of U.S. Global Health Moscow on the grounds that U.S. Global Health Moscow was insolvent and could not pay its debts as they fell due. U.S. Global Health Limited was later placed into voluntary liquidation by its shareholders.

The Pepsi Trading International official we spoke to told us that his company withdrew its support from the investment because a new management team wanted to divest itself of any investment that was not making money. TUSRIF officials told us that they believed Pepsi Trading International's legal problems and the associated bad publicity from the First Medical Corporation lawsuit (see page 6) were also factors in its decision.

## What Analysis Did TUSRIF Perform Before Investing in U.S. Global Health Limited?

TUSRIF staff performed various analyses before investing in U.S. Global Health Limited and summarized the results in an investment memorandum to the TUSRIF Board of Directors. The investment memorandum describes:

- the purpose of the health clinic project;
- the business experience that co-owners Pepsi Trading International and Columbia Presbyterian would bring to the venture;
- the market potential to provide health services to expatriates living in Russia;
- the competitive advantage that the clinic might have with Columbia Presbyterian's experience;
- revenue and expense projections under various scenarios;
- how the deal would be structured and how TUSRIF invested funds would be used to expand U.S. Global Health Limited's services;
- risks associated with the investment; and
- valuation of the return on investment.

TUSRIF managers told us they knew the Russian medical infrastructure was in poor shape. They believed a need existed for a high-quality medical facility to service the large and growing American population, other foreigners, and wealthy Russians in Moscow. Therefore, if the Moscow clinic proved successful, the operation could be replicated in other Russian cities.

TUSRIF officials also told us that one of the most important factors they considered was the integrity and trustworthiness of the partners. Pepsi Trading International, trading arm of Pepsico, had 30 years of Russian business experience and Columbia Presbyterian Medical Center was a world-renown medical institution.

To analyze the investment, TUSRIF formed an investment team which included a senior staff member who had a background in the Russian medical field—having worked for a U.S. pharmaceutical firm in Russia for five years. The TUSRIF staff also used financial and marketing projections, prepared by Pepsi Trading International, to assess the investment's potential. The staff adjusted the projections to reflect several different assumptions.

One of the major concerns raised in the investment memorandum was the status of the lawsuit filed by First Medical Corporation. The lawsuit prevented the U.S. Global Health Limited from marketing its services to 177 large foreign corporations based in Moscow. The memorandum indicated that approximately 1,750 foreign companies were registered in Moscow and that these companies represented a market of 45,000 potential memberships. The President of TUSRIF advised us that he concluded the injunction would not have a material impact on the success or failure of the clinic and, in his opinion, the failure of the clinic was not due to the injunction but to other marketing problems.

However, TUSRIF was concerned that the lawsuit might place its investment at risk. Therefore, TUSRIF had it's Legal Counsel review the situation. The legal memorandum concluded that TUSRIF should avoid using any of the proprietary client information allegedly obtained inappropriately by Pepsi International personnel. TUSRIF had a provision included in its shareholder agreement prohibiting U.S. Global Health Limited from using TUSRIF's investment to pay legal fees related to the litigation.

## Was the Financial Condition of U.S. Global Health Limited Misrepresented to TUSRIF?

Our discussions with Pepsi Trading International, Columbia Presbyterian, TUSRIF's staff, and our review of TUSRIF's files produced no evidence of financial misrepresentations concerning the soundness of the investment.

## Was TUSRIF's Investment Structured in a Manner That Protected its Interests?

In our opinion, TUSRIF structured its investment in a manner that provided it with rights and risks that were commensurate with those assumed by the other investors. Before making its investment, TUSRIF required modification of U.S. Global Health Limited's shareholder agreement to recognize TUSRIF as an equal investment partner and to ensure that it could participate in making business decisions. In addition, TUSRIF's $625,000 of preferred stock provided it with preference over other shareholders (after payments to creditors) in liquidation proceedings.

Our review of the shareholder's agreement found that TUSRIF was represented on U.S. Global Health Limited's Board of Directors. The agreement also specified the purposes for which TUSRIF's invested funds would be used and did not require additional contributions. TUSRIF's investment was to be used to expand U.S. Global Health Limited's business in Moscow and other cities in Russia. The agreement also prohibited TUSRIF's funds from being used to make any payments in connection with the lawsuit that had been filed against Pepsi Trading International.

The files also showed that TUSRIF's staff actively participated in monitoring U.S. Global Health Limited's operation after the decision was made to invest in the health clinic. These monitoring activities included attending Board of Director's meetings, which were held almost monthly. Records indicate that TUSRIF's staff provided input and participated in making decisions concerning the business during these meetings. Items addressed at the meetings included:

- 1994 Financial Results
- 1994 Key Issues
- 1995 Financial Forecast and Budget
- 1995 Issues and Action Plans
- Marketing and Sales Strategies

Additionally, TUSRIF received a weekly report on the clinic's cash balances, cash disbursements, memberships, and patient information from International Advisory Services (a Bermudian company hired to do the health clinic's financial and administrative tasks). They also obtained account receivable schedules, consolidated schedules of invoices and working capital, a summary of expenditure schedules, and projected income statements.

## Has TUSRIF Taken Steps to Ensure it Receives its Share of Proceeds From the Liquidation of U.S. Global Health Limited's Assets?

TUSRIF has taken action to receive its entitled share of liquidation proceeds. However, it appears that TUSRIF and the other investors will, in all likelihood, suffer a total or near total loss. The liquidators are uncertain, at this time, when the liquidation process will be completed.

On October 30, 1995, U.S. Global Health Limited petitioned for the liquidation of U.S. Global Health-Moscow. Although the petition was opposed by Worldwide Medical Corporation and certain other minority shareholders, the liquidation order was issued on January 12, 1996. According to the liquidator, the order was signed because the Moscow clinic was insolvent and could not pay its debts as they fell due. According to a statement of affairs presented by the accounting firm at a creditors' meeting held on April 10, 1996 (see Appendix I and II), U.S. Global Health Limited has a claim against U.S. Global Health Moscow for approximately $3 million. However, the estimated realizable value of assets was only $302,000 while debts owed to creditors amounted to $1.25 million.

In January 1997, the liquidator told us that since the statement of affairs had been prepared, the realizable value of assets had declined. He stated that only $25,000 of the $185,000 in accounts receivables had been collected. He believed the low collection rate occurred for several reasons. First, the insurance companies who owed money to the clinic had little incentive to pay since the company was in liquidation. Amounts due from insurance companies were also subject to policy deductibles that were not reflected in the statement of affairs. Second, many individuals who owed money for treatments were unwilling to pay because they had already paid in advance for annual memberships which could not be honored by the clinic. Other individuals could not be located because they had moved. Additionally, the liquidator had been unable to take possession of fixed assets located in Moscow, which originally had an estimated realizable value of $86,000. As a result, the Liquidator believes it is unlikely that U.S. Global Health Limited will receive any money after other creditors are paid.

APPENDIX I

# US GLOBAL HEALTH-MOSCOW LIMITED
## STATEMENT OF AFFAIRS
## As of April 10, 1996
**(Amounts in US Dollars)**

ASSETS

| | Balance | Estimated Realizable Value | Comments |
|---|---|---|---|
| Cash | 10,645.12 | 10,645.12 | Accounts maintained at The Bank of N.T. Butterfield |
| Accounts Receivable | | | |
| Memberships | 104,752.25 | 0.00 | |
| Medical Services - Insurance | 231,761.50 | 185,409.20 | Realizable Value Estimated at 85% |
| Rental Deposit | 61,200.00 | 0.00 | Offset Against CASA Rent (Accounts Payable) |
| Fixed Assets | | | |
| Assets Located in Bermuda | 49,768.00 | 12,442.00 | |
| Assets Located in Moscow | 1,869,988.00 | 86,187.43 | |
| Total Gross Fixed Assets | 1,919,756.00 | 98,629.43 | |
| Due From Global Physicians Associates, Ltd. | 14,432.00 | 0.00 | Offset Against Accounts Payable Position |
| Due From Columbia Presbyterian Moscow A/O | 77,425.00 | 7,742.50 | Wholly-owned sub. In Liquidation - Recovery estimated at 10% |
| Investment in Columbia Presbyterian Moscow A/O | 130,000.00 | 0.00 | Wholly-owned sub. In Liquidation - No recovery for shareholders |
| Capitalized Incorporation Costs | 341,619.55 | 0.00 | "Soft" assets; No recoveries estimated |
| TOTAL ASSETS | $ 2,891,591.42 | $ 302,462.25 | |

LIABILITIES

| | Balance | Estimated Net Liability | Comments |
|---|---|---|---|
| Accounts Payable | 1,252,012.42 | 1,176,380.42 | See Appendix II |
| Unearned Membership Revenues | 219,276.38 | 219,276.38 | Unsecured |
| Due to US Global Health Limited | 3,152,058.51 | 3,152,058.51 | Unsecured |
| TOTAL LIABILITIES | $ 4,622,347.31 | $4,546,715.31 | |

| | |
|---|---|
| Estimated Realizable Value of Assets | $302,426.25 |
| Estimated Net Liabilities | $4,546,715.31 |
| Excess (Deficit) | $(4,244,289.06) |

13

US Global Health-Moscow Limited
as of April 10, 1996
Statement of Affairs

| Debtor | Amount Payable | Description |
|---|---|---|
| A.O.Z.T. Harbord Russia | 218.00 | Advertising |
| American Chamber of Commerce in Russia | 4,815.00 | Advertising |
| American Medical Association | 1,940.00 | Advertising |
| Baxter | 6,072.53 | Medical Supplies / Scientific Products |
| CASA | 232,200.00 | Moscow Apartment Rents |
| Clarion | 60,109.78 | Marketing |
| Columbia Presbyterian Hospital | 100,292.93 | Medical Supplies / Scientific Products |
| Conyers, Dill & Pearman | 5,922.86 | Legal Services |
| Cravath, Swaine & Moore | 6,661.65 | Legal Services |
| Direct Net | 4,212.83 | Communication Services |
| Dr. Bruce Barron | 272.75 | Professional Services - Expenses |
| Dr. George Goluhov | 100,000.00 | Medical Consulting Services |
| E.M.A. | 2,850.00 | |
| Giles Communications | 23,740.34 | Advertising |
| Global Physicians Associates | 119,456.92 | Professional staff services |
| Harbord Publishing | 3,000.00 | Advertising |
| International Advisory Services, Ltd. | 188,272.26 | Professional Administrative Services |
| KPMG Peat Marwick | 10,081.48 | Accounting Services |
| Moscow Revue | 720.00 | Advertising |
| PBN | 79,049.98 | Advertising |
| Post International | 3,252.00 | Relocation Services |
| Probity | 22,146.70 | Software Maintenance |
| Sprint | 5,655.74 | Communication Services |
| Sprint East Op. Inc. | 6,068.67 | Communication Services |
| Worldwide Medical Services, Inc. | 100,000.00 | Consulting Services |
| YAR Communications | 165,000.00 | Marketing Services |
| Total Debtors | $ 1,252,012.42 | |