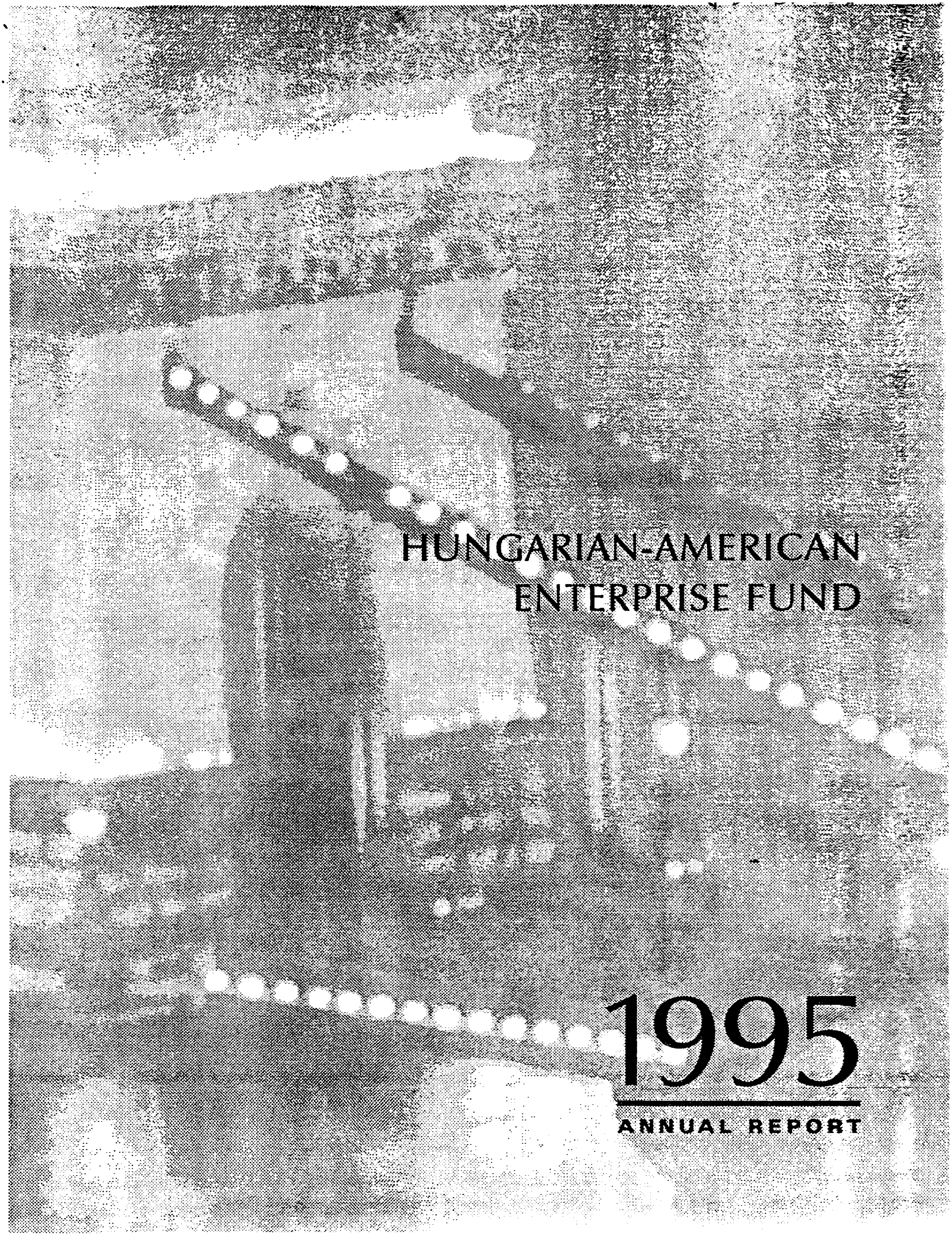
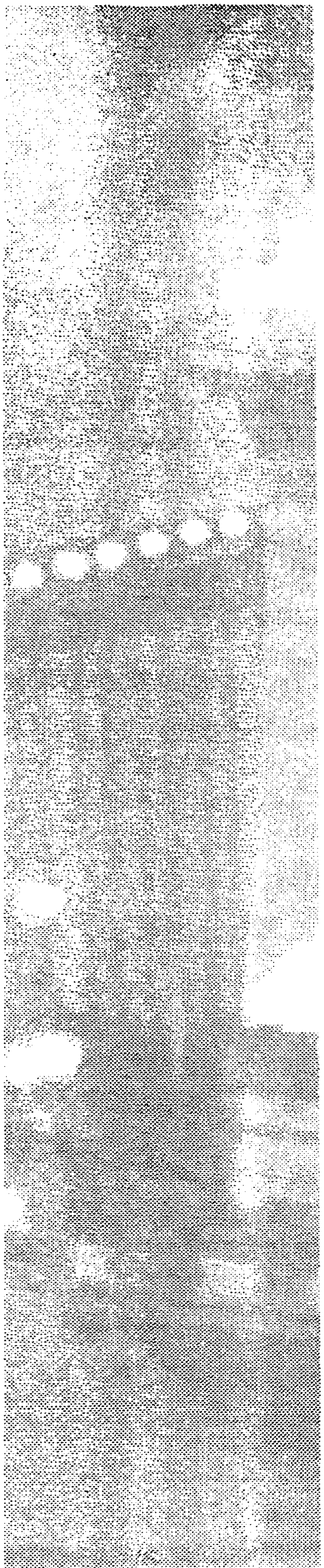


# HUNGARIAN-AMERICAN ENTERPRISE FUND

# 1995

ANNUAL REPORT

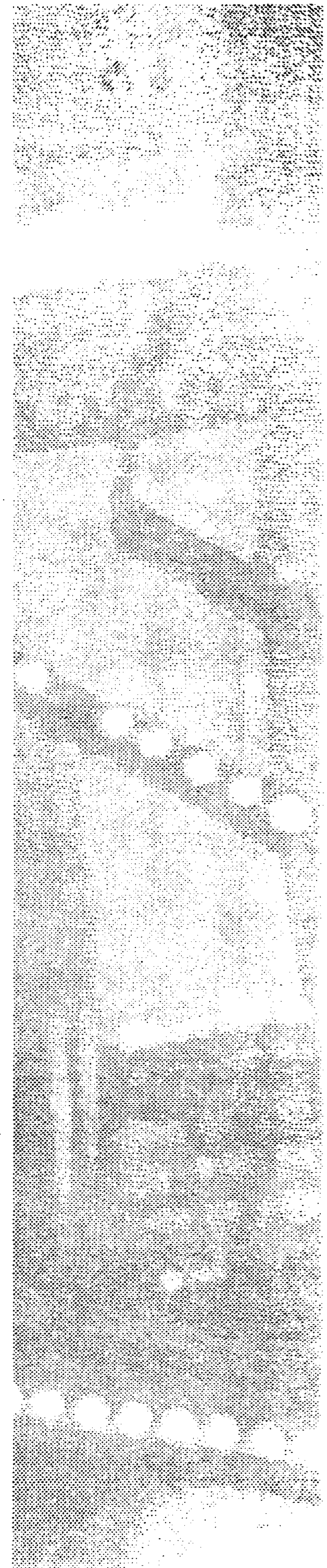


# HUNGARIAN-AMERICAN ENTERPRISE FUND

## Mission Statement

The Hungarian-American Enterprise Fund ("HAEF") was established to promote free enterprise in Hungary by financing successful small and medium-size private enterprises. HAEF's business is developing existing Hungarian enterprises and creating and nurturing new companies through the management of risk capital—capital used for privatizations, growth, turn-arounds and start-up of new ventures—invested over the long-term and for profit in Hungary. The Fund provides equity-type capital, usually in the form of share capital, but also in the form of long-term loans in the case of very small investments.

HAEF takes an active role in growing companies in which it invests by assisting with strategic and financial planning, training, and in identifying strategic partners. In most cases, HAEF invests only where operating management participates in the profits and/or the ownership of the enterprise. HAEF prefers to invest in firms with Hungarian partners, but by exception will finance ventures without local participation. Through successful and efficient use of its resources, HAEF intends to have a long-term presence in Hungary and is dedicated to attract, train, and retain the best investment team in the country.



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## LETTER FROM MANAGEMENT

January 26, 1996

We have completed our fifth full year of operations in Hungary. Having already invested the bulk of the Hungarian-American Enterprise Fund's (HAEF) capital in previous years, we embarked on 1995 with two overriding objectives—the first was to raise additional funds from both public and private sources and the second was to continue building a solid professional organization that could evolve eventually into a fully private investment firm. We are pleased to report substantial progress towards both objectives.

Recently we reached agreement with an investment manager, Foreign & Colonial Emerging Markets Limited, to raise a private fund of at least $30 million that would allow HAEF to leverage its remaining, uninvested capital. These monies will be managed by HAEF's professional Hungarian investment staff and will be used to provide direct equity capital to private enterprises in Hungary in parallel with HAEF. Foreign & Colonial Emerging Markets Limited is one of the world's leading emerging markets investment management groups with over $3.5 billion under management, and its knowledge and experience will add significantly to HAEF's capabilities. Already, capital conditionally committed to the private fund totals $18 million.

With respect to public funding, we are continuing to seek additional capital from the U.S. Government and to work with the Administration and Congress to fulfill the goals for which HAEF was created. HAEF's financing efforts are recognized for the important functions they serve in Hungary, since there are few other sources available that meet the needs of small and medium-sized entrepreneurs for growth capital. The establishment of the new private fund is an essential step in this direction, and we will be enlisting the necessary U.S. Government support for that endeavor.

In the coming year, a portion of the capital HAEF allocated through Hungarian financial institutions to finance small and micro business loans will be repaid; they can then be recycled for the benefit of other entrepreneurs. While we remain hopeful of ultimately receiving additional U.S. Government funding for this program, we are proceeding to maintain our momentum with independent financing. In particular, we are seeking private foundation funds to expand these community lending programs, which are difficult to support as purely market-driven commercial activities.

Our success in raising private funds was made possible primarily by the progress we achieved in our second objective of building a professional organization, fully capable of operating under the rigors demanded of a private investment firm. We began with the seasoned team of Hungarian investment officers, who had put to work much of HAEF's initial capital, overcame the challenges of investing in the early years of Hungary's transitional economy, and learned from their successes and mistakes. Additional professionals, who bring business operations experience, have joined them this year, and we are continuing to improve staff skills through a variety of management training programs. We believe that our all-Hungarian investment team is among the best in the country.

In 1990, HAEF was created as a pioneering development institution to encourage Hungarian private sector growth by providing direct equity and debt financing to viable small and medium-sized businesses. Hungary has changed dramatically in the past five years, and while this development need and purpose remain, we recognize that HAEF's decisions must increasingly be driven by the marketplace. To ensure HAEF's continued viability, we are committed to operate HAEF under the same standards as any other professional investment firm and to continue adhering to commercial objectives as a means of achieving HAEF's development goals.

It was on this basis that a number of difficult business decisions were implemented this past year. In connection with a comprehensive review of HAEF's portfolio, started at the end of the last fiscal year and diligently pursued this year, several early investments were written down to more realistic market values in 1995 by a net amount of $5.5 million. A substantial portion of this diminished value was a result of a drop in share prices on the Budapest Stock Exchange of HAEF's publicly-listed companies reflecting general economic conditions. Although HAEF values these investments at year-end on a mark-to-market basis, we believe that the underlying strengths of the companies will, over time and under better economic circumstances in Hungary, lead to broader recognition of their inherent value. While some portfolio companies were not performing to expectations, only one investment, Duna Elektronika, Rt., was written off. Through the hands-on efforts of our investment group, however, we were able to recover one-third of the $1.5 million HAEF had at risk in that venture. Today, we can attest to a strong investment portfolio that offers real growth potential with fewer significant downside risks.

During 1995, we continued to make investment progress. In total, we made investments of $12.2 million by adding new firms and expanding financing for particularly promising ventures in HAEF's existing portfolio. By September 30,1995, HAEF had fully disbursed in the aggregate more than $58.7 million in equity investments and loans to private businesses operating in Hungary. This amount includes recycled proceeds from realized investments.

HAEF's 1995 investment decisions were driven by an increasingly refined strategy designed to strengthen its portfolio companies and achieve solid overall investment returns. Accordingly, we expanded HAEF's position in Petőfi Printing and Packaging Company and consolidated that interest in Petőfi's parent, COFINEC. We also increased our investments in MAVAD, REPL-VSZM, Ametiszt and Bíró Industrial Equipment. Finally, we closed two new direct equity investments—in BCB (formerly Béköt) and Bank 24.

As we husband HAEF's remaining resources, we added to HAEF's publicly-listed holdings with investments in OTP Bank and in EGIS, a generic drug manufacturer. Meanwhile, we exited HAEF's earlier pharmaceutical company investments in Richter and, since year-end in Pharmavit, both of which we sold at a profit.

Further supporting HAEF's ability to operate as a private investment firm, we have strengthened our ability to manage current and future investments through implementation of the advanced Financial Analyst's Management and Authoring System (FAMAS). Shortly after the end of the fiscal year, we also activated HAEF's technical assistance subsidiary, the Hungarian-American Assistance

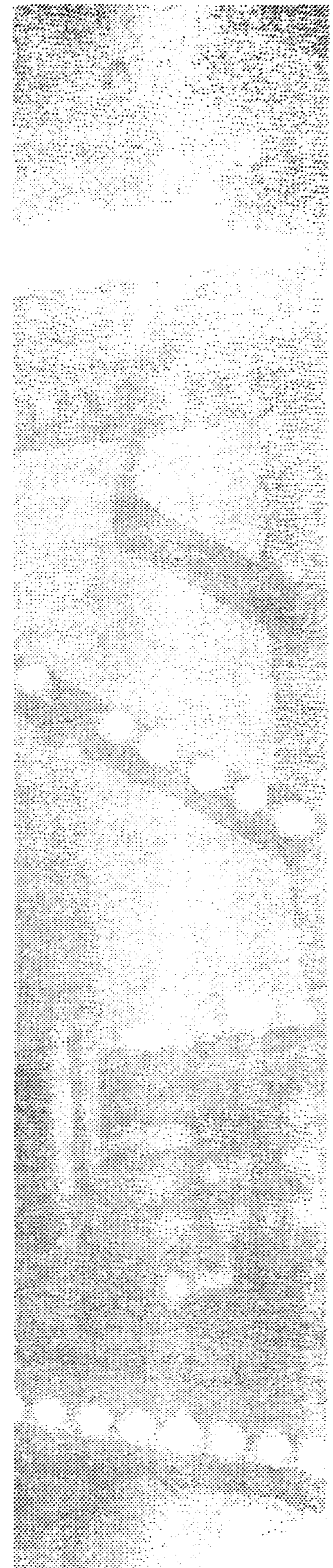
Corporation, in which we established a specialized in-house expertise in cost accounting and management information systems. As of September 30, 1995, HAEF had disbursed $6.8 million in technical assistance, and this capability to supplement its investment activity gives HAEF an edge over traditional private funds.

These achievements of HAEF during 1995 would not have been possible without the efforts of a dedicated and responsible Board of Directors, who have donated their time in overseeing HAEF's investments and guiding its staff to increasingly higher levels of professional accomplishment. While we are proud that Dr. György Surányi was called on to serve his country as Governor of the National Bank of Hungary, we will miss his judgment and guidance. His leadership in setting and implementing a new economic stabilization program this past Spring has been instrumental in rebuilding Hungary's economy. We were fortunate in having István Tömpe join us as a Hungarian board member. Mr. Tömpe brings a wide experience in investment banking and other positions in the Hungarian public and private sectors. Also bringing extensive business experience to the Board is a new American director, Bernard Buonanno, Jr., a Rhode Island lawyer and businessman.

While Hungary has made great strides, it remains a transitional economy with the risks and rewards that typically accompany the uncertainty imposed by constant change. The country continues to face economic and social challenges; yet, it holds great promise and much still-hidden value. As a professional investment organization, the Hungarian-American Enterprise Fund is eager to tap these opportunities. With additional capital, HAEF looks forward to seeking out and financing the best of new and existing ventures.

*George D. Gould*
*Chairman*

*Eriberto R. Scocimara*
*President and*
*Chief Executive Officer*



The Chain Bridge in Budapest illustrated on the cover of this Annual Report was originally built across the Danube River in the 1840's to facilitate commerce and trade. It stands as a symbol of Hungary's historic role as a link between East and West and serves as a reminder of HAEF's more recent role in helping Hungarian entrepreneurs bridge the gap between a planned economy and the rigors of the free market.

### HAEF As An Agent Of Change

It has been more than five years since HAEF was created to encourage the development of the Hungarian private sector through equity investment, loans and technical assistance. Hungary has changed a great deal during this time, and HAEF has likewise evolved to meet the growing needs of small and medium sized businesses for equity capital. In 1990, Hungary was embarking on an unprecedented transformation. Today, Hungary's transition to an economy dominated by private ownership is nearly complete, and Hungary is becoming a Westernized sophisticated market place. Originally, HAEF helped in Hungary's transformation by serving as a model to introduce the capital and disciplines required by private enterprises to succeed. Today, HAEF is operating in a far different world than in 1990, and it too has adjusted to the demands of a market economy.

HAEF has learned that to be an agent of change, it must develop a staff that can take on a more active management role in its investee companies, and it must have sufficient control to introduce and implement change in the company and ensure it can exit when appropriate. Additionally, in a transitional economy where change occurs rapidly—practically collapsing the time frame of traditional economic and social development—it is not sufficient to have a clearly-defined strategy; rather, an investment organization must constantly be taking stock of changing conditions and have the flexibility to be opportunistic.

In this regard, it became clear that with the high degree of uncertainty that accompanies rapid change, HAEF had to be prepared to make follow-on investments in its portfolio companies. Furthermore, HAEF found that when making direct investments in Hungary, the same factors of success and the same rigorous business disciplines prevail as in developed markets. Essentially, these are: good and dedicated management with a personal stake in the company, a product or service that is responsive to market demand and an effective management information system, all of which must be subject to sound due diligence and the good judgment of investment managers.

As HAEF's professional managers gained experience in the marketplace, HAEF has continually refined its investment strategy. The "Mission Statement," articulated in HAEF's 1994 Annual Report and reiterated in 1995, forms the foundation for HAEF's future direction and reflects HAEF's objectives as an active agent of change in Hungary today.

### The New Face Of HAEF

As HAEF embarks on 1996, it has taken on a decidedly new face, and it is the face of a future Hungary. In 1990, much of HAEF's professional staff was comprised of Americans, as few Hungarians had the essential investment experience. In the past five years, HAEF has built a solid team of Hungarians with that experience, and today, the baton has passed to a new generation that has acquired the necessary professional skills to manage an investment fund. This generation represents a bridge between Western management education and the needs of Hungarian businesses.

HAEF Investment Director László Oláh, who joined the Fund in 1991, recently completed the Advanced Management Program at INSEAD, one of the leading business schools in Europe. He serves on the Board of the European Venture Capital Association as the first director elected from an Eastern European country.

Another Investment Director, Dr. Zsuzsa Fekete, is currently attending the same Advanced Management Program at INSEAD that Mr. Oláh completed. During the past four years, Dr. Fekete has been the chief architect of HAEF's sophisticated monitoring and control systems. A recent hire, HAEF's Investment Director Ferenc Kovács, was able to complete his advanced degree in business while spending two years studying at the Yale School of Management. When HAEF was organized in 1990, Róbert Balogh, a recently hired Investment Analyst, had not even entered Budapest University of Economics. Róbert is a member of an entire generation of young professionals who started their education and training since the advent of the market economy in Hungary.

HAEF's Investment Directors represent the core of HAEF's investment team. They and the investment managers who work under them have been through a rigorous economic education in Hungary, and HAEF has instituted a comprehensive training program to help hone the analytical skills they need to manage private funds in Hungary. Today, HAEF's Investment Directors measure up against the best in the world's money market capitals.

In 1995, HAEF has taken additional steps to give this team the tools they need to monitor and manage investments. The installation of FAMAS—a leading Financial Analyst's Management and Authoring System used by banking institutions and investment houses—will help HAEF's investment officers better monitor their investments. HAEF's investment team will also be able to draw on the skills of a new team of advisors on cost accounting and management information systems in HAEF's new technical assistance subsidiary—the Hungarian-American Assistance Corporation (HAAC).

This accounting unit conducts pre-investment assessments of the cost data provided by prospective investee companies and on the capabilities of their MIS. Together with the management of such companies, HAAC advisors then develop the appropriate management information system tailored to the specific needs of the given company. Lastly, HAAC's accounting unit assists the company in the implementation of the modern accounting and cost systems essential to facilitate HAEF's investment and to operate in a market economy. HAAC's accounting unit's work also adds value to HAEF's own portfolio companies by helping them collect and analyze the crucial information for good business decision-making.

HAEF's technical assistance program has provided a bridge bringing knowledge of Western techniques and practices to Hungarian entrepreneurs. It reached a milestone in 1995 with the completion of a three-year funding program of $1.5 million for the International Management Center in Budapest. This Center is now an established and successful executive educational institution, operating independently of HAEF's assistance to prepare a new generation of Hungarian business managers.

#### 1995 Investment Progress

While in more developed markets, financing is usually provided by commercial banks, Hungary's financial system is still not fully equipped to meet the needs of small and medium-sized enterprises. In this regard, HAEF serves an important market niche.

Consistent with its investment strategy, HAEF is focused today primarily on providing the later stage financing needed by established middle-sized private enterprises to modernize, expand and compete effectively. It is also financing start-ups that introduce commercially proven technology to Hungary or that can demonstrate competitive advantage in export markets. HAEF seeks to invest in companies, both established and start-ups, that can become competitive at the European level—firms that can develop export markets for their goods and services as well as provide quality alternatives to imports in the domestic market.

In the process of comprehensively evaluating HAEF's portfolio, the better investments have become even more apparent, and adding capital to HAEF's existing investee companies frequently offers the greatest potential for maximizing returns. Accordingly in 1995, HAEF built on its earlier investment in the highly successful Petőfi Printing and Packaging Company, and HAEF expanded and consolidated its interest into Petőfi's parent corporation, COFINEC. That investment now stands at $6.1 million. With another Hungarian printing plant, a packaging and printing facility in the Czech Republic and a new $25 million greenfield operation in Poland, COFINEC is the largest packaging company in the region and able to compete with the multinationals in the Central and Eastern European markets.

This year's expansion of HAEF's interests in MAVAD to $3.0 million places HAEF in a position of control in Hungary's largest processor and exporter of wild game meat. This presents an exciting opportunity to actively encourage MAVAD's management to maximize the potential of the company's commercial game farms and its similar, more personalized business of organizing private wild game hunts. HAEF can now play a more meaningful role in effecting change in MAVAD as well as in an affiliated game processing company, Öreglak, where HAEF's and MAVAD's combined interests also represent a controlling position.

Another investee company, REPL-VSZM, Kft. showed promise that justified additional HAEF's financing, now totaling $1.1 million. This company is expanding its production of high-tech, heat-shrinkable tubing used in cable connection insulation. Similarly, HAEF's follow-on loans of $80,000 to Ametiszt, Kft. in the dry-cleaning business and of $600,000 to Bíró Industrial Equipment, Kft. in tool and die manufacturing allowed these investee companies to make capital expenditures, improve equipment and strengthen working capital.

With regard to new investments in 1995, HAEF closed a $1.5 million investment in BCB (formerly Béköt), a manufacturer in southeastern Hungary of knitted fabrics and ready-made garments. Privatized in 1994, BCB exports 70% of its production to Western

Europe, and HAEF's later stage financing provides a foundation for company growth. Already, there is a clear need for follow-on investments to help BCB respond to the rapidly changing conditions prevailing in Hungary's transitional economy and to strengthen HAEF's position so that it can guide the company's development as an active investor.

Providing the later stage financing needed by successful Hungarian businesses is only one area where HAEF has both commercial and developmental impact. Another area of HAEF's impact is providing the capital needed by new businesses in the form of "venture capital." In this regard, Hungary holds significant investment opportunities in financing start-ups that can introduce commercially-proven technologies or demonstrate a competitive advantage in export markets.

One new HAEF investment that offers both of these benefits is HAEF's $1.1 million investment in Bank 24. HAEF provided this start-up venture, managed by an experienced American entrepreneur, with part of the capital to introduce to Hungary technology proven in the West. Bank 24 is installing up to 400 Automated Teller Machines (ATMs) and linking them in an interconnected nationwide network of existing machines. Like COFINEC, Bank 24 is now expanding in Central Europe with a similar venture in Poland and is becoming a regional force.

To be an active investor, HAEF must be attuned to the larger Hungarian marketplace, and accordingly will from time-to-time make smaller investments in selected publicly-listed securities. In this regard, HAEF made earlier investments in Hungary's pharmaceutical industry and, in 1995, added to its portfolio a $200,000 investment in EGIS, a generic drug manufacturer. Similarly in 1995, HAEF took a position in the commercial banking sector with its first investment in a leading Hungarian financial institution, OTP Bank, of $500,000. These investments are giving HAEF a special window on the Hungarian economy.

In the past five years, Hungary has made impressive progress in transforming its economy and allowing its private sector to flourish. Nevertheless, the country remains an emerging market approaching the end of a vast transition. As such, investors face constant change and must be prepared to respond quickly to new conditions.

1995 was a rollercoaster year that tested the flexibility of the investing community. The year began with the cancellation of an already finalized privatization deal, leading privatization efforts to enter a phase of near dormancy which lasted until September. This, combined with the Mexican peso crisis, imposed a chill on foreign investment in Hungary as emerging market investors retrenched. However, 1995 ended on a high note.

In the last three months of the year, Hungary largely completed the privatization of much of its industry with the sale to private investors of a large share of electric utilities, oil and natural gas, telecommunications, pharmaceutical companies and banks. These deals alone brought nearly $3 billion to Hungary in 1995, and as the new managers upgrade plants and equipment in the future, follow-on investments by the new owners are expected to approach an additional $5–6 billion.

Overall, Hungary has an outstanding record of attracting foreign capital, with investments since the transformation began already totaling $13–14 billion. Today, the contribution of the Hungarian private sector to GDP is estimated at 65-70%, the highest among the transformation economies.

Starting in March 1995, the Hungarian Government, with a new economic team led by Lajos Bokros, Minister of Finance and Dr. György Surányi, Governor of the Hungarian National Bank and a former HAEF Director, took decisive action. It implemented a comprehensive economic stabilization program aimed at redeploying natural resources from consumption to investment and modernization of Hungarian industry. This program resulted in the reduction of the trade deficit, increase in hard currency reserves and reduction in government deficits. As a result of these efforts, investor confidence in Hungary has been rejuvenated, and the Budapest Stock Exchange is already reflecting a growing interest.

In Hungary today, there are approximately 2,000-3,000 medium-sized enterprises of 100-1,500 employees. Most have now been privatized and need later stage investment to reach the minimum level of competitiveness of firms in fully developed market economies. It is estimated that between 100-200 of these Hungarian enterprises have the potential to compete at the European level. The estimated $5-6 billion in follow-on investment in the newly-privatized major industries alone will fuel the growth of these and other smaller domestic suppliers, and even more foreign direct investment can be expected as the Hungarian economy improves. Given the commercial banking system's current inability to finance these medium-sized enterprises, the primary source for their development capital will have to be venture capitalists.

HAEF is proud to have contributed to Hungary's unique transformation as the country crosses the bridge to a market economy. HAEF looks forward to its continued involvement in strengthening Hungary's private sector by providing the venture capital and active management small and medium-sized Hungarian firms need for growth.

## REPORT OF INDEPENDENT AUDITORS

**Board of Directors**
**Hungarian-American Enterprise Fund**

We have audited the accompanying consolidated balance sheets of the Hungarian-American Enterprise Fund (the "Fund") as of September 30, 1995 and 1994, and the related consolidated statements of revenues, expenses and changes in fund balance, and cash flows for the year ended September 30, 1995. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation and examination of securities owned as of September 30, 1995 and 1994. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Hungarian-American Enterprise Fund as of September 30, 1995 and 1994, and the consolidated results of its operations and changes in fund balance, and its cash flows for the year ended September 30, 1995 in conformity with generally accepted accounting principles.

As explained in Note 4, the consolidated financial statements include investments valued at $30,205,356 and $31,719,900 (totaling 92% and 80% of net assets) as of September 30, 1995 and 1994, respectively, whose values have been estimated by management and approved by the Board of Directors, in the absence of readily ascertainable market values. We have reviewed the procedures used by management in arriving at its estimate of value of such investments and have inspected underlying documentation and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the investments existed, and the differences could be material.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 30, 1995 on our consideration of the Fund's internal control structure and a report dated November 30, 1995 on its compliance with laws and regulations.

Ernst + Young LLP

New York, New York
November 30, 1995

September 30, 1995

## Consolidated Balance Sheet

| | September 30 1995 | 1994 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | $ 2,168,392 | $ 7,402,843 |
| Investments, at fair value *(Notes 2 and 4)*: | | |
| Small and micro loan programs | 4,818,478 | 4,862,600 |
| Direct loan program | 1,125,811 | 1,638,083 |
| Equity investments | 24,261,067 | 25,219,217 |
| | 30,205,356 | 31,719,900 |
| Other equity investment | 24,840 | 35,712 |
| Total investments | 30,230,196 | 31,755,612 |
| Prepaid expenses and other assets | 328,302 | 433,224 |
| Accrued interest receivable | 251,995 | 311,881 |
| Fixed assets | 401,133 | 262,932 |
| Total assets | $33,380,018 | $40,166,492 |
| **Liabilities and fund balance** | | |
| Accounts payable and accrued expenses | $ 630,534 | $ 323,165 |
| Commitments *(Notes 3 and 5)* | | |
| Fund balance | 32,749,484 | 39,843,327 |
| Total liabilities and fund balance | $33,380,018 | $40,166,492 |

*See accompanying notes.*

## Consolidated Statement of Revenues, Expenses and Changes in Fund Balance

### Year ended September 30, 1995 with comparative totals for 1994

| | Loan/ Investment Program | Technical Cooperation Program | Totals Year ended September 30 1995 | 1994 |
|---|---|---|---|---|
| **Revenues** | | | | |
| Income from investments & loans | $ 546,660 | $ – | $ 546,660 | $ 848,262 |
| Interest and other income | 467,698 | – | 467,698 | 256,124 |
| Total revenues | 1,014,358 | – | 1,014,358 | 1,104,386 |
| **Expenses** | | | | |
| Employee compensation and benefits | 1,432,504 | 69,224 | 1,501,728 | 1,113,443 |
| Employee business expenses | 211,012 | 3,711 | 214,723 | 150,699 |
| Professional services | 686,292 | 14,215 | 700,507 | 866,573 |
| Depreciation and amortization | 117,713 | 11,130 | 128,843 | 110,465 |
| Occupancy | 274,343 | 25,513 | 299,856 | 280,869 |
| Administrative and other | 500,135 | 24,546 | 524,681 | 402,911 |
| Total expenses | 3,221,999 | 148,339 | 3,370,338 | 2,924,960 |
| **Net operating loss** | (2,207,641) | (148,339) | (2,355,980) | (1,820,574) |
| Net realized gains on direct investments and loans | 697,428 | – | 697,428 | 1,248,850 |
| Unrealized (losses) gains on direct investments and loans | (6,221,419) | – | (6,221,419) | 2,653,401 |
| Total net investment (losses) gains | (5,523,991) | – | (5,523,991) | 3,902,251 |
| **Subtotal** | (7,731,632) | (148,339) | (7,879,971) | 2,081,677 |
| U.S. Federal grant income recognized for program expenditures *(Note 2)* | – | 1,600,000 | 1,600,000 | – |
| Technical cooperation grant expenditures | – | 813,872 | 813,872 | 888,971 |
| **(Deficiency) excess of revenues over expenses and technical cooperation program activities** | (7,731,632) | 637,789 | (7,093,843) | 1,192,706 |
| **Fund balance, beginning of year** | 40,756,127 | (912,800) | 39,843,327 | 38,650,621 |
| **Fund balance, end of year** | $33,024,495 | $ (275,011) | $ 32,749,484 | $ 39,843,327 |

*See accompanying notes.*

September 30, 1995

## Consolidated Statement of Cash Flows

| | September 30 1995 | 1994 |
|---|---|---|
| **Cash flows from operating activities** | | |
| (Deficiency) excess of revenues over expenses and technical cooperation program activities | $ (7,093,843) | $ 1,192,706 |
| Adjustments to reconcile (deficiency) excess of revenues over expenses and technical cooperation program activities to net cash used by operating activities: | | |
| Depreciation, amortization and other noncash charges | 128,843 | 310,465 |
| Net realized and unrealized losses (gains) on investments and loans | 5,523,991 | (3,902,251) |
| Changes in operating assets and liabilities: | | |
| Prepaid expenses and other assets | 104,922 | (73,416) |
| Accrued interest receivable | 59,886 | (7,913) |
| Accounts payable and accrued expenses | 307,369 | (185,931) |
| Net cash used by operating activities | (968,832) | (2,666,340) |
| **Cash flows from investing activities** | | |
| Purchases of fixed assets—net | (267,044) | (55,820) |
| Proceeds from sales and maturities of investments | 8,163,997 | 11,044,925 |
| Purchases of new investments | (12,162,572) | (3,643,456) |
| Net cash (used) provided by investing activities | (4,265,619) | 7,345,649 |
| Net (decrease) increase in cash and cash equivalents | (5,234,451) | 4,679,309 |
| Cash and cash equivalents at beginning of year | 7,402,843 | 2,723,534 |
| Cash and cash equivalents at end of year | $ 2,168,392 | $ 7,402,843 |

*See accompanying notes.*

## 1. Organization of Fund

The Hungarian-American Enterprise Fund (the "Fund") is a not-for-profit corporation formed pursuant to the Support for East European Democracy Act of 1989 (the "SEED Act") for the primary purpose of promoting the development of the Hungarian private sector and policies and practices conducive to such development. As part of the SEED Act, the United States Congress authorized $70 million to be appropriated over a three-year period (subsequently extended to ten to fifteen years) to the Fund by the U.S. Agency for International Development ("AID") to be used for program purposes, technical cooperation grants and administrative expenditures. Grants received from AID are conditioned on the Fund's compliance with the requirements of the SEED Act, which imposes certain U.S. policy objectives and reporting obligations. Under the terms of the grant agreement with AID, the Fund may hold funds in interest–bearing accounts and may retain interest, investment income and investment profits for program purposes. Additionally, the Grant Agreement includes provisions under which the Fund's continuance will be governed.

The consolidated financial statements include the Fund and HAEF Holding Corp., S.A. ("HHC"), a wholly-owned subsidiary established to make certain equity investments. HHC is in process of being liquidated; final dissolution is expected to occur in fiscal 1996.

The Fund's capital is used principally to foster small and medium-sized businesses in Hungary which have a likelihood of becoming commercially viable in a free market environment through equity investments and lending activities. The Fund maintains offices in Greenwich, Connecticut and Budapest, Hungary.

## 2. Summary of Significant Accounting Policies

### Cash Equivalents

For purposes of the statement of cash flows, the Fund considers all highly liquid financial instruments purchased with a maturity of three months or less to be cash equivalents.

### Investment Valuation

The Fund's loans and equity investments are stated at fair value as determined by management and approved by the Board of Directors. In determining fair value, management considers relevant qualitative and quantitative information available. This includes such factors as the financial condition and operating results of each company, the economic and market conditions affecting its operations, and any subsequent events or financing transactions that may be indicative of a change in value. Cost is used to represent the fair value of investments in the absence of information that would support the need for a lower or higher valuation. The values assigned to investments are based on available information and do not necessarily represent amounts that might ultimately be realized, since such amounts depend on future circumstances. Investment valuation is conducted by management annually, and more often if circumstances warrant.

#### Revenue Recognition

Amounts received from AID are conditioned on the Fund's compliance with the requirements of the AID Grant and the SEED Act, which impose certain U.S. policy objectives and reporting obligations. Under the terms of the AID Grant, the Fund may hold funds in interest–bearing accounts and may retain investment and program income for program purposes. AID has granted the Fund $10 million to provide technical cooperation grants which are managed separately from other program funds.

As of September 30, 1995, the status of the AID Grant was as follows (in millions):

| | Loan/ Investment | Technical Cooperation | **Total** |
|---|---|---|---|
| Funds received from AID: | | | |
| Inception through September 30, 1994 | $ 48.0 | $ 4.4 | **$ 52.4** |
| Fiscal 1995 | – | 1.6 | **1.6** |
| Total funds received | 48.0 | 6.0 | **54.0** |
| Remaining funds available | 12.0 | 4.0 | **16.0** |
| Total authorization | $ 60.0 | $ 10.0 | **$ 70.0** |

The Fund accounts for its grant activities in accordance with generally accepted accounting principles for not-for-profit organizations. Accordingly, the extent to which grant funds are received and disbursed during the year for program purposes is considered revenue. In practice, as disbursements are made, an equal amount of grant funds received is considered utilized and recorded as revenue. In the accompanying consolidated statement of revenues, expenses and changes in fund balance, this revenue is reported as "U.S. federal grants recognized for program expenditures." The Fund's operating cash exceeds the amount of U.S. federal grants received and held for program purposes because, under the terms of the AID Grant, the Fund retains interest income, loan principal repayments and principal from the sale of investments for program purposes.

#### Employee Benefits

The Fund offers its full-time U.S. citizen employees a defined contribution plan under Internal Revenue Service Code Section 403(b)(7). Upon reaching eligibility after one year's service, employees may contribute up to 7% of base salary which is matched by the Fund. The 403(b) plan custodian and administrator is T. Rowe Price Retirement Services, Inc. Fund contributions to the plan totaled approximately $44,000 in fiscal 1995.

Hungarian nationals are covered by an extensive state system which is funded by a 51% employer tax on salaries of Hungarian nationals.

#### Employee Business Expenses

Non-salary employee expenses directly attributable to the Fund's investment and technical cooperation activities (such as travel, lodging, meals, etc.) are classified as employee business expenses.

#### Professional Services

Legal fees, accounting and audit fees and consulting fees are classified as professional services fees.

#### Donated Services

Members of the Fund's Board of Directors donate significant amounts of their time to the Fund's work. No amounts have been reflected in the accompanying financial statements for such donated services inasmuch as no objective basis is available to measure the value of such services.

#### Foreign Currency Translation

The Fund's functional unit of currency is the U.S. dollar. The Fund's operating transactions are initiated in U.S. dollars and exchanged for Hungarian forints only when needed. The Fund's equity investments are purchased in U.S. dollars. The Fund's assets and liabilities reported in the accompanying consolidated balance sheet and schedule of investments at September 30, 1995 and 1994 are primarily denominated in U.S. dollars. The translation losses resulting from devaluation of the Hungarian forint are reflected in the consolidated statement of revenues, expenses and changes in fund balances. Revenues and expenses transacted in Hungarian forints are translated into U.S. dollars at the exchange rate in effect on the date of the transaction.

**Related Parties**

Transactions with related parties are closely monitored by management and the Board of Directors of the Fund. As a matter of Fund policy, directors and members of management who have a related party relationship, if any, do not participate in decisions involving those related parties.

**Technical Cooperation**

The Fund generally disburses funds for technical cooperation grants as expenses on the project are incurred. Funds earmarked for approved grants but not yet disbursed amounted to approximately $792,000 at September 30, 1995.

**Comparative Information**

The revenue and expense information for the year ended September 30, 1994 is presented for comparative purposes and is not intended to be a complete financial statement presentation.

### 3. Lease Commitments and Rental Expense

The Fund is obligated under noncancelable operating leases for its Greenwich, Budapest and former Washington offices. The former Washington office was sub-leased as of October 1, 1994 and the Fund retains the original lease obligation until May 31, 1996. Sublease income of $3,851 per month has been negotiated with a sublessee. Lease terms are five years for the former Washington and Budapest leases and three years for the Greenwich lease. The Budapest lease is denominated in Deutsche Marks and payable in Hungarian forints.

Future commitments under these leases are approximately as follows:

| Fiscal year: | Total |
|---|---|
| 1996 | $275,000 |
| 1997 | 49,000 |
| | $324,000 |

An amount equal to three month's lease expense in Budapest ($40,000) is held in escrow. The leases are subject to annual (Washington and Greenwich) and bi-annual (Budapest) escalations based on increases in the applicable consumer price index.

## 4. Investments

### Small and Micro Loan Programs

The Fund has authorized and utilized $5,000,000 to develop a program to provide loans to small businesses throughout Hungary. This "Small Loan Program" is operated in conjunction with the Széchenyi Bank, a division of the Magyar Hitel (Hungarian Credit) Bank and with MEZÖBANK. Additionally, the Fund operates a "Micro Loan Program" in cooperation with four financial institutions in Hungary. Loans in the range of $1,000 to $10,000 have been disbursed in several economically depressed areas of Hungary.

The participating banks perform all credit checks and administrative and monitoring work, and share credit risk equally with the Fund. The Fund has retained the right to review the banks' credit checks and to veto or override their loan decisions.

Credit experience has caused management to establish a valuation reserve for the Small Loan Program investment of $500,000 at September 30, 1995 and 1994. In addition, valuation reserves of $80,694 and $36,572 were recorded for the Micro Loan Program as of September 30, 1995 and 1994, respectively. Arrangements under the agreements between the Fund and the banks may lead to recovery of all or a portion of losses experienced by the Fund over the life of the agreements.

### Direct Investments and Loans

As of September 30, 1995 and 1994, the Fund had invested in direct loans and equity investments with a net carrying value totaling $25,386,878 and $26,857,300, respectively. The loans to Budapest Veneer Works Kft. and Bíró Kft. are denominated in Hungarian forints.

Outstanding investments and loans at cost, with net valuation adjustments, as of September 30, 1995 and 1994 are as follows:

September 30, 1995

| Investment | Type | 1995 | 1994 |
|---|---|---|---|
| Alfa Trading Company, Rt. | Equity | $ 3,000,000 | $ 3,000,000 |
| Ametiszt, Kft. | Equity | 620,048 | 620,048 |
| Ametiszt, Kft. | Loan (US$) | 80,541 | – |
| Bank 24 | Equity | 1,050,100 | – |
| BCB (Békőt) | Equity | 1,450,905 | – |
| Bíró Industrial Equipment, Kft. | Loan (US$/HUF) | 720,755 | 259,548 |
| Bíró Industrial Equipment, Kft. | Equity | 264,638 | 264,638 |
| Budapest Veneer Works, Kft. | Loans (US$/HUF) | 324,515 | 578,535 |
| Central European Franchise Group, Rt. | Equity | 3,000,000 | 3,000,000 |
| COFINEC | Equity | 6,138,456 | – |
| Duna Elektronika, Rt. | Equity | – | 500,000 |
| EGIS | Equity | 211,159 | – |
| First Pest Telephone, Rt. | Equity | – | 1,550,575 |
| Fornax, Rt. | Equity | 596,564 | 596,564 |
| Fotex, Rt. | Equity | 486,138 | 486,138 |
| International Fashion House, Rt. | Equity | 636,585 | 636,585 |
| Irodáház, Kft. | Equity | 79,998 | 79,998 |
| Irodáház, Kft. | Loan (DEM) | 800,000 | 800,000 |
| Loranger Ipari, Kft. | Equity | 987,962 | 1,250,000 |
| Mavad, Rt. | Equity | 3,005,396 | 2,527,565 |
| OTP | Equity | 503,500 | – |
| Öreglak, Kft. | Equity | 515,000 | 515,000 |
| Petőfi Printing and Packaging Co. Ltd. | Equity | – | 2,524,280 |
| Pharmavit, Rt. | Equity | 235,750 | 235,750 |
| Pick Szeged, Rt. | Equity | 1,073,000 | 1,290,500 |
| Recognita Software, Rt. | Equity | 572,279 | 572,279 |
| REPL-VSZM, Kft. | Equity | 1,108,478 | 585,504 |
| Resomont, Kft. | Equity | 379,132 | 379,132 |
| Richter Gedeon Pharmaceutical Works, Ltd. | Equity | 15 | 221,400 |
| Rogerson Hungarian Aviation, Ltd. | Equity | – | 660,000 |
| Semilab, Kft. | Equity | 152,550 | 152,550 |
| Stewart Information Hungary, Kft. | Equity | 224,000 | 224,000 |
| Total—equity and direct loans at cost | | 28,217,464 | 23,510,589 |
| Net valuation adjustment | | $ (2,830,586) | $ 3,346,711 |

| Investment | 1995 | 1994 |
|---|---|---|
| Total—equity and direct loans at carrying value | **25,386,878** | 26,857,300 |
| Small loan program | **5,000,000** | 5,000,000 |
| Micro loan program | **399,172** | 399,712 |
| Total—small and micro loans at cost | **5,399,172** | 5,399,172 |
| Net valuation reserve | **(580,694)** | (536,572) |
| Total—small and micro loans at carrying value | **4,818,478** | 4,862,600 |
| Other equity investment | **24,840** | 35,712 |
| Total investments at carrying value | **$30,230,196** | $31,755,612 |

#### Loan Guarantee

During fiscal 1994, the Fund guaranteed a loan made by the Inter-Europa Bank, Budapest ("IEB") to one of the Fund's investees in an amount up to $1,000,000 in return for a loan guarantee fee. During fiscal 1995, the investee, as a result of financial difficulties, defaulted on the terms of the loan. The Fund was required to pay IEB approximately $538,000 as a result of its obligation as loan guarantor. The Fund does not expect to receive reimbursement for its payment. Such amount has been recorded in the accompanying financial statements as a realized loss on investments.

### 5. Tax Status

#### United States

The Fund has received a determination from the Internal Revenue Service that it is exempt from Federal income tax under Internal Revenue Code Section 501(c)(3). It has also received exemption from Connecticut State corporate income and franchise taxes.

#### Hungary

The tax status of the Fund's Budapest office is currently being negotiated by the U.S. Department of State with the Republic of Hungary. A bilateral agreement covering this issue is expected to be concluded and management expects that this agreement will result in the exemption of the Fund from tax in the Republic of Hungary.

### 6. Accounting for Contributions and Financial Statement Display

In June 1993, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 116, Accounting for Contributions Received and Contributions Made ("SFAS 116"), and Statement of Financial Accounting Standards No. 117, Financial Statements of Not-for-Profit Organizations ("SFAS 117").

SFAS 116 establishes standards of accounting for contributions and applies to all entities that receive or make contributions. SFAS 117 establishes broad standards for reporting information in general-purpose external financial statements issued by not-for-profit organizations, and requires that all not-for-profit organizations provide a statement of financial position, a statement of activities and a statement of cash flows that focus on the entity as a whole. Amounts related to an organization's financial position and activities are to be reported in three classes of net assets—permanently restricted, temporarily restricted and unrestricted.

SFAS 116 and 117 will be effective for the Fund's fiscal year ending September 30, 1996. Management has not yet completed its analysis to determine the impact of SFAS 116 and 117 on its operations or presentation of financial statements.

## HUNGARIAN-AMERICAN ENTERPRISE FUND

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