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Report to the Chairman, Subcommittee on Foreign Operations, Export Financing, and Related Programs, Committee on Appropriations, House of Representatives

March 1994

ENTERPRISE FUNDS

Evolving Models for Private Sector Development in Central and Eastern Europe

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International Affairs Division

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The Honorable David R. Obey
Chairman, Subcommittee on Foreign Operations,
Export Financing, and Related Programs
Committee on Appropriations
House of Representatives

Dear Mr. Chairman:

As you requested, this report provides information on the enterprise funds created in four Central and Eastern European countries. We reviewed the implementation of the section of the Support for East European Democracy Act, which was the basis for the creation of enterprise funds in Poland, Hungary, the former Czech and Slovak Federal Republic, and Bulgaria. We make several observations designed to improve the funds' operations.

Unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days after its issue date. At that time, we will send copies to the Director, Office of Management and Budget; the Secretary of State; the Administrator, Agency for International Development; and other interested congressional committees. Copies will also be made available to other interested parties upon request.

Please contact me at (202) 512-4128 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix III.

Sincerely yours,

Harold J. Johnson

Harold J. Johnson, Director
International Affairs Issues

Executive Summary

Purpose

Enterprise funds are an experimental model of assistance delivery to the developing private sectors in selected countries of Central and Eastern Europe as they change from centrally planned to market-oriented economies. The enterprise funds are private U.S. corporations authorized by the Congress and staffed by experienced business managers. They have operated for nearly 4 years in the region. Authorized funding for the first four funds is $250 million to the Polish-American Enterprise Fund, $70 million to the Hungarian-American Enterprise Fund, $65 million to the Czech and Slovak-American Enterprise Fund, and $55 million to the Bulgarian-American Enterprise Fund. Federal contributions to enterprise funds represented about 28 percent of all budgeted U.S. assistance for the region between fiscal years 1990 and 1993.

Since plans for the creation of new enterprise funds in other Central and Eastern European countries and the independent states of the former Soviet Union are being finalized, the Chairman of the Subcommittee on Foreign Operations, Export Financing, and Related Programs, House Committee on Appropriations, asked GAO to review (1) the first four enterprise funds' investment and program strategies and plans for sustainability, (2) their overall performance, (3) their management practices, and (4) oversight by U.S. government agencies.

Background

In November 1989, the Support for East European Democracy (SEED) Act authorized the creation of the enterprise funds in Poland and Hungary to help private sector development in those countries. Enterprise funds for the former Czech and Slovak Federal Republic were created in 1990 and Bulgaria in 1991. The enterprise funds primarily make loans to, or investments in, small and medium businesses in which other financial institutions are reluctant to invest. The enterprise funds are also to provide technical assistance for private sector development in the host country. According to the act, enterprise funds are private corporations, not U.S. government agencies, and their employees are not government officials or employees.

Results in Brief

The four enterprise funds have used a variety of investment approaches to address the conditions they found in each country. Although it is not possible to tell which of the many investments will be ultimately successful, other lenders are beginning to follow the small business loan programs created by the enterprise funds. The enterprise funds have already, through their investments, created jobs and increased business

experience of nationals. Additionally, they have become a resource other investors have turned to for information on the business climate in the countries of operation.

The enterprise funds' strategies to dispose of investments include sale to existing owners, private placement to other investors, or sale to the general public through a stock exchange. The enterprise funds have varied in their interpretation of how technical assistance should be applied between investment and noninvestment related projects.

The enterprise funds encountered problems operating in evolving economies. Loan recipients and other companies in which the enterprise funds invested did not always submit timely, complete, and accurate financial statements to provide information to managers on investment performance. Therefore, this source of information on how well investments were performing was not consistently available to fund managers.

In accordance with the SEED Act, the Agency for International Development (AID) and the State Department gave the funds maximum flexibility in developing their programs, but this approach limited the agencies' ability to ensure that fund programs were in line with U.S. government objectives.

Principal Findings

Enterprise Fund Investment and Technical Assistance Strategies

Policies set by each enterprise fund varied regarding the level of equity held, the mix of equity investments to loans, investment size, and the kind of loan programs developed. Poland and Hungary had taken some steps toward the creation of a private sector before the collapse of communism, affecting the kinds of investments made by these respective enterprise funds. They could invest in businesses with some experience and were not limited to investing in a large proportion of start-up business as were the Czech and Slovak and Bulgarian funds.

The Polish Fund often obtained investment control through majority equity investments, whereas the Hungarian and Czech and Slovak funds generally made minority equity investments. Loan programs developed by the funds addressed some of the previously unmet needs for business

loans with features such as longer terms, less stringent collateral, and in some cases, more attractive interest rates.

All of the funds developed or planned small business loan programs through affiliation with local banks, which handled some of the loan programs' administration. Most of the enterprise funds granted larger loans directly. According to the Hungarian Fund, it made few direct loans because Hungarian law allows such loans only when an equity ownership is present. As a result, most of the Hungarian investments were in equity shares. The Polish Fund also responded to a lack of a credit market by investing in a commercial bank and by starting a mortgage bank.

The enterprise funds have identified a number of strategies to sustain their operations once U.S. government funds have been expended and to exit their investments; however, since the enterprise funds' investments are to a great extent not readily convertible to cash, the viability of these strategies remains to be proven. Enterprise fund investment revenues covered only part of the funds' expenses for fiscal year 1992. All of the funds have sought to expand the amount of capital that they manage, which would provide fees and help cover expenses. The Polish Fund was successful in attracting $101 million of investment capital from outside investors.

Enterprise fund disbursal of technical assistance grants varied from giving nearly all assistance to general private sector development projects to restricting technical assistance to those companies in which the funds either had planned to invest or had actually invested, or a mixture of the two approaches. However, over time officers of the Polish, Hungarian, and Czech and Slovak funds concluded that the level of understanding of business practices at the companies in which they had invested was lower than originally thought. The officials also said that they planned to place greater emphasis in the future on technical assistance to their investments.

Analysis of Fund Investments Hindered by Inconsistent and Incomplete Financial Reporting

Analysis of fund investments was hindered by inconsistent and inaccurate financial reporting. Recipients of assistance from the enterprise funds did not consistently submit timely, accurate, and complete financial statements. Inconsistent requirements in their contracts and lack of training on how to prepare adequate financial reports contribute to the problem. As a result, fund managers lacked adequate information on investment performance.

GAO's analysis of the Polish Fund's investment portfolio revealed net losses in 1991 and 1992 because of low revenues, low manufacturing industry gross margins, high expenses, bad debts, and currency exchange losses. According to the State Department and AID, these conditions were not unexpected given the start-up nature of the enterprise fund and the high-risk environment in Poland. Because of a large number of missing reports and inconsistently applied accounting principles, a financial analysis could not be done on the investments of the Hungarian or the Czech and Slovak funds. The Bulgarian Fund's first investments were made late in 1992 so financial reports were not yet due at the time of GAO's review. Despite the high-risk environment of the venture capital business in these emerging markets, the Polish and Hungarian funds reported having each experienced only two failed investments.

Enterprise Fund Investments Have Encountered Problems

Three enterprise funds reported that initial evaluations and subsequent monitoring of investments were very difficult to conduct because of the lack of comparable information and entrepreneurs' business inexperience in the emerging markets of Central and Eastern Europe. The enterprise funds have had to deal with some unethical business practices, and some investments have faced financial and organizational problems.

For example, an investment services company, EurAmerica, established in April 1992, for which the Hungarian Fund provided about 99 percent of the capital, was not organized following the Fund's policies regarding size of investment and contribution by co-investors. EurAmerica also had management problems that included (1) failure to submit quarterly financial statements, (2) a 2-month delay in the annual audit by the outside auditor, (3) disorganized financial records, and (4) missing minutes of board of directors meetings. In addition, two EurAmerica officials were being paid salaries that far exceeded the salary limit of $150,000 for enterprise fund management set by an informal agreement between the enterprise funds and State, AID, and the House Appropriations Committee. In August 1993, the contracts between the Hungarian Fund and EurAmerica were renegotiated and included a $150,000 salary cap and a partial return of the capital invested in EurAmerica by the Hungarian Fund.

GAO noted two cases of potential conflicts of interest in the application of noninvestment related technical assistance. One case involved paying the salary of a Hungarian government official, and the other involved a Polish Fund Board member's affiliation with a funded program. With the limited

amount of technical assistance funding provided to the enterprise funds and weaknesses found in financial services infrastructure, assistance funds would be better spent on making the funds' investments viable rather than on noninvestment related activities.

Government Oversight of Enterprise Funds

The SEED Act intended that federal oversight of the enterprise funds should be limited. Congressional reports relating to the appropriations bill for fiscal year 1991 called for a hands-off policy for enterprise funds' oversight by the executive branch. The State Department and AID provided limited oversight by the AID Inspector General, the AID project officer, and the SEED Coordinator. This model was chosen for the region in an effort to provide assistance that would be delivered as rapidly as possible and so there would be freedom for each enterprise fund to develop programs customized to fit the needs of each country.

The State Department and AID oversight of the enterprise funds consisted primarily of an annual review by the AID Inspector General of audits performed by certified public accounting firms of the enterprise funds; documentation of fund drawdowns and preparation of a monthly report on the grant cash balance; review of summaries of enterprise funds' investments; brief semiannual reviews in Washington, D.C.; and brief visits to both the U.S. and overseas fund offices.

In 1992, the House Appropriations Committee established requirements for enterprise funds to provide it with more timely information about their activities. In September 1993, the executive branch proposed to the Congress new measures for increasing its oversight.

Recommendations

Because the funds are private enterprises, GAO is not making formal recommendations to them. However, GAO makes a number of suggestions designed to improve management and financial controls in the enterprise funds. (See chs. 3 and 4.)

Agency Comments

The State Department and AID provided joint comments on a draft of this report. They generally agreed with the report's overall conclusions and cited steps taken by the funds to improve the quality of financial reporting by their investments. They further stated that the executive branch is initiating actions designed to improve its oversight of the enterprise funds. Their specific comments have been incorporated into the report where

appropriate. The joint comments of State and AID are presented in their entirety in appendix II.

GAO did not obtain official comments from the enterprise funds, but it discussed a draft of the report with officials representing the funds. These officials generally agreed with the report, but provided some clarifying information that has been incorporated in the report as appropriate. The funds emphasized that improvements, particularly in financial reporting, were occurring during the period covered by GAO's review and that these improvements are continuing.

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Abbreviations

AID	Agency for International Development
GAO	General Accounting Office
OMB	Office of Management and Budget
SEED	Support for East European Democracy

Introduction

Enterprise funds were established as part of the Support for East European Democracy (SEED) Act of 1989 (P.L. 101-179) program in selected countries of Central and Eastern Europe.[1] The act responded to the extraordinary transformations from communism to democracy and the development of market-oriented economies and sought to nurture reform efforts in the region. The enterprise funds are U.S. government-financed, nonprofit private U.S. corporations modeled after venture capital management companies. According to the act, the purpose of enterprise funds was to promote the development of the private sector. They did this primarily by identifying and implementing mechanisms for timely investment where traditional financial institutions chose not to invest.

Enterprise Funds Have a Broad Mandate

The SEED Act initially authorized an assistance program for Poland and Hungary, countries that took the lead in the transformation from communism to democracy and market-oriented economies. The creation of enterprise funds was a large part of the act's provisions for private sector development. The funds originally provided for Poland and Hungary, and funds subsequently provided for all enterprise funds, remain available until expended. In general, enterprise funds receive funding from the Agency for International Development (AID) as they develop proposals for investments. This included a fund's estimate of cash needs for a given month plus an agreed upon cash buffer. As of June 1993, none of the enterprise funds had received their full authorization.

Using funds subsequently provided for SEED activities, enterprise funds were announced for the former Czech and Slovak Federal Republic[2] in November 1990, Bulgaria in July 1991, and the Baltic States (Estonia, Latvia, and Lithuania) in June 1993. Pursuant to the Freedom Support Act of 1992, similar funds were announced for Russia in July 1993;[3] Romania

[1]The term "Central and Eastern Europe" refers to Albania, Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and the former Yugoslavia.

[2]In January 1993, following the division of the Czech and Slovak Federal Republic, the original Czech and Slovak American-Enterprise Fund created two country specific funds—the Czech-American Enterprise Fund and the Slovak-American Enterprise Fund—under separate management teams but sharing a common board of directors. The Washington office acts as a holding company for the two funds. During our fieldwork in November 1992, the Czech and Slovak funds functioned as one fund; therefore, we report on its activities as one organization.

[3]In addition to the enterprise fund for small and medium businesses in Russia that is patterned after the enterprise funds in Central and Eastern Europe, in January 1994 the United States established the Fund for Large Enterprises in Russia that will offer comprehensive financing packages for medium and large enterprises with between 1,000 and 10,000 employees. The latter fund is part of the U.S. contribution for privatization and restructuring by the world's leading seven industrialized nations and will be organized as a private corporation run by a private sector board of directors, appointed by the President of the United States.

and the Central Asian Republics (Kazakhstan, the Krygyz Republic, Tajikistan, Turkmenistan, and Uzbekistan) in December 1993; and Albania and the western New Independent States (Belarus, Moldova, and Ukraine) in January 1994. In this report, we reviewed the operations of the four funds operating in November 1992—the Polish, Hungarian, Czech and Slovak, and Bulgarian funds.

Enterprise funds accounted for about 28 percent of the SEED Act assistance for the region between fiscal years 1990 and 1993.[4] The original authorized funding for the Polish-American Enterprise Fund was $240 million, Hungarian-American Enterprise Fund was $60 million, Czech and Slovak-American Enterprise Fund was $60 million, and Bulgarian-American Enterprise Fund was $50 million. In 1991 and 1992, the enterprise funds received additional authorizations, which were provided for technical assistance, raising the total authorized funding to $250 million for the Polish Fund, $70 million for the Hungarian Fund, $65 million for the Czech and Slovak Fund, and $55 million for the Bulgarian Fund.

The enterprise funds are to assist in developing the private sector, especially small-to-medium size businesses. In 1989, with few precedents for this kind of economic assistance, it was difficult to predict which measures would be the most effective, particularly since the conditions found in each country would likely be different. Consequently, the act indicated that joint ventures, loans, grants, equity investments, feasibility studies, technical assistance, training, insurance, and guarantees were all appropriate enterprise fund activities. While the act provided an operating framework for the enterprise funds, it allowed the organizations substantial latitude in how the funds would actually operate.

According to the act, enterprise funds are private corporations and not U.S. government agencies, and their officers, employees, or members of the board of directors are not government officials or employees. The act states that AID shall grant money to the enterprise funds for their operating and administrative expenses and that the Department of State would provide overall coordination. In implementing the provisions of the act, a key objective set by the executive branch, the Congress, and the enterprise funds was that the funds would become self-sustaining through the reinvestment of earnings and by obtaining outside capital for investments.

[4]Enterprise funds were budgeted $395 million of the $1.4 billion of assistance to the region, between fiscal years 1990 and 1993. Some funds will still be drawing on their authorizations after fiscal year 1993. As of June 1993, $207 million of budgeted funding had been disbursed to the funds.

The act states that each enterprise fund would be governed by a board of directors consisting of private citizens of the United States and the host country who are experienced and knowledgeable in private sector development. The President of the United States, in consultation with the Congress, designated the initial U.S. board members for each fund, who constituted the majority on each board. Successor U.S. directors and host country board members are elected by the boards after receiving the advice of the President. Host country board members must be committed to respect for democracy and a free market economy. Each board was responsible for establishing its organization by appointing officers of the corporation, providing overall management and direction of the enterprise fund, and approving investment decisions. The boards meet for a day and half each quarter to make decisions affecting an enterprise fund's portfolio. U.S. board members, who donate their services, include leaders in venture capital and investment banking industries and senior officers of large companies. As the Department of State and AID have pointed out in their comments on this report, "Each Fund also has its own Board of Directors which must accept the responsibility for the success or failure of these endeavors."

The management of enterprise fund equity and loan investments has been modeled on investment management in the venture capital industry in which venture capital is invested in primarily small, young companies during early stages of their development with the investors being significantly involved in monitoring, advising, and following up on operation results. While the objective of most venture capital firms is to maximize profits, the enterprise funds have multiple objectives that are distinct from the venture capital model in significant ways. These involve working for not only a return on investment but also to benefit the investee and have an overall effect on the host country.

The enterprise funds' professional staffs consist primarily of investment managers[5] who are responsible for reviewing investment proposals, preparing proposals of viable investments for board review and approval, and monitoring the investment after loans are made or equity is acquired. Investment managers also conduct an important element of the investment process known as the "due diligence" review. Such a review examines in detail the quality of a proposed investment's management team, product characteristics, related technologies and vulnerabilities, and market

[5]The title for this position varies by fund. Persons performing these functions are known as investment managers at the Polish Fund, investment associates at the Hungarian Fund, investment officers at the Czech and Slovak Fund, and business development officers and investment officers at the Bulgarian Fund. In this report, we refer to these positions collectively as investment managers.

potential. Investment managers may also seek out investments and negotiate investment terms, sometimes assisted by financial analysts or outside consultants.

Objectives, Scope, and Methodology

Since plans for the creation of new enterprise funds in other Central and Eastern European countries and the independent states of the former Soviet Union are being finalized, the Chairman of the Subcommittee on Foreign Operations, Export Financing, and Related Programs, House Committee on Appropriations, requested that we review the enterprise funds established for Central and Eastern European countries. Specifically our objectives were to review (1) the first four enterprise funds' investment and program strategies and plans for sustainability, (2) their overall performance, (3) their management practices, and (4) oversight by U.S. government agencies.

We performed our work at AID headquarters in Washington, D.C., and at AID missions in Poland, Hungary, and the former Czech and Slovak Federal Republic; at the U.S. headquarters of Polish, Hungarian, Czech and Slovak, and Bulgarian funds; and enterprise fund offices and sites of selected fund investments in Poland, Hungary, and the former Czech and Slovak Federal Republic. We interviewed fund management and staff and obtained documents from enterprise fund offices; AID officials and nongovernment organization assistance contractors; host country business people; officials from the Department of State; and representatives of the host governments of the countries where the funds operate. While we discussed the potential for fraud and unethical business practices with enterprise fund managers and the necessity for developing measures to guard against such practices, we did not review all internal control provisions at the enterprise funds or at the companies in which they invested to determine the adequacy of the internal controls. We spoke with officials of development banks and venture capital companies for background information on investing in developing markets. We did not visit Bulgaria because the Bulgarian Fund had only signed agreements on its first investments, and there would have been little to observe in site visits at the time of our fieldwork.

We conducted our review between July 1992 and September 1993 in accordance with generally accepted government auditing standards. The Department of State and AID provided joint comments on a draft of this report. Their specific comments have been incorporated in the report where appropriate, and the entire text of their comments is reprinted in

appendix II. We also discussed the report draft with officials representing the funds and have incorporated their comments as appropriate.

Each Enterprise Fund Has Its Own Investment and Technical Assistance Strategy

Each enterprise fund has followed a distinct investment approach and implemented different types of programs to carry out their mandate to invest in, and help develop, the private sector of their respective countries. These differences were affected by economic conditions in the countries as well as business opportunities for joint ventures, start-up operations, and the privatization of former state-owned enterprises. The policies set by the board of directors of each enterprise fund resulted in unique approaches to small and medium business investment. For example, each enterprise fund had distinct policies on (1) the dollar value of investments, (2) whether the enterprise fund would hold a majority or minority position in equity investments, and (3) the mix of equity or loan investments.

Venture capital companies' investments in equity have provided a model for a large share of the funds' investments. Following this model, the Polish Fund had been successful in attracting $101 million of outside investment capital as of November 1992. All of the funds have incorporated loans into their programs to respond to the lack of credit, and small business loan programs have been successful with low default rates. The Polish Fund pioneered mortgage banking in Poland to promote residential construction and home ownership. At the time of our review, the enterprise funds were developing plans for sustaining operations after AID grant funds are disbursed and have identified several strategies for selling or otherwise disposing of their investments, referred to in this report as an "exit strategy."

Each enterprise fund also interpreted differently their mandate to provide technical assistance to develop the private sector, and they used technical assistance funds for a variety of investment and noninvestment related activities.

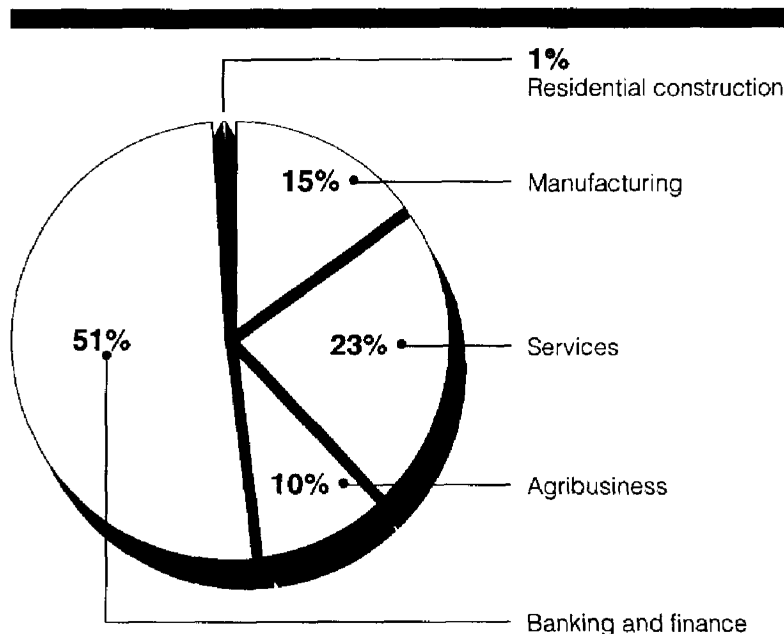
Enterprise Fund Investment Strategies

To help establish a suitable investment strategy, each enterprise fund, as it began to organize, tried to identify and address the unique opportunities and particular needs of its respective host country. The funds identified industries and economic conditions they desired to affect as the focus of their investment strategies, and based their investment strategies on the business conditions found in the country. The boards' and enterprise fund managements' philosophy on how to best pursue investments was also a factor.

The Polish Fund

The Polish Fund's basic strategy was to invest in companies it believed had economic viability and would grow to create profits and jobs. About 51 percent of its investments were in banking and finance (see fig. 2.1), since the Fund identified a lack of capital and experience in small commercial and mortgage lending as a critical area of need. The Fund's investments in services consisted of two retail companies, a newspaper, and two printing companies. As of April 1993, the Fund reported that nearly 6,500 employees were working in businesses that received a small business loan, and over 2,900 were employed at businesses in which the Polish Fund had a direct equity investment.

Figure 2.1: Distribution by Industry of All Polish Fund Investments as of January 31, 1993



Note: Investments are presented at historical costs and total $106 million.

Source: Compiled by GAO from Polish Fund data.

Although all investments in Poland entail risk, the Polish Fund was able to partially ameliorate its investment risk by investing in private-sector companies that had been allowed to function prior to the 1989 reforms and did not have to invest in many start-up companies, which are inherently

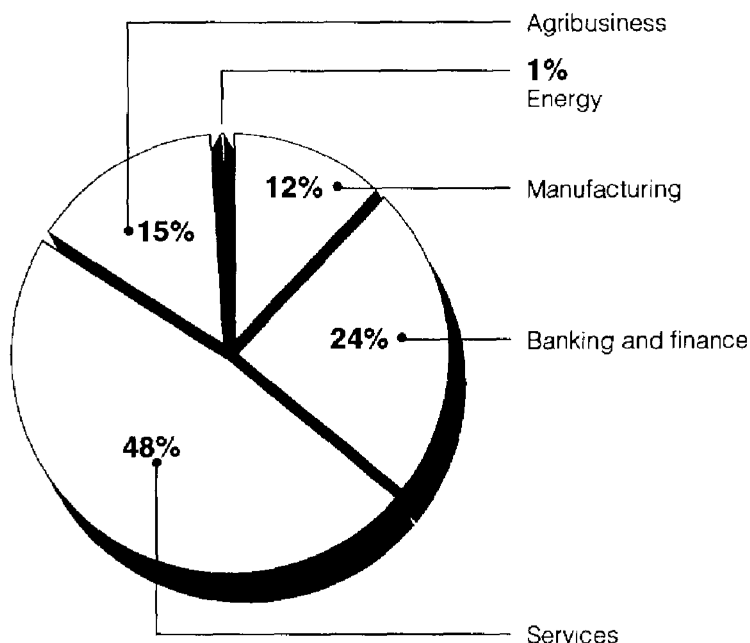
more risky than established businesses. For 12 of 17 of its investments, the Polish Fund invested in existing companies. The Polish Fund's investments in start-up companies accounted for only 13 percent of the Polish Fund's gross investment of $106 million.

Joint ventures with foreign partners are a means of bringing in foreign capital, technical expertise, and management know-how, but only 9 percent of its investments were in joint ventures with private foreign investors, all of which were with U.S. partners. The Polish Fund found that large U.S. investors preferred to develop and formulate their own ventures, while small American investors had little interest in Poland. The Polish Fund had only invested in one former state-owned company that was privatized.

The Hungarian Fund

The Hungarian Fund had the largest proportion (48 percent) of its investments in services. These investments included retail businesses, a printing company, and information and telecommunication companies (see fig. 2.2). In December 1992, the Hungarian Fund reported that companies in which it had invested had a total of 10,726 employees.

Figure 2.2: Distribution by Industry of All Hungarian Fund Investments as of January 31, 1993



Note: Investments are presented at historical cost and total $38 million.

Source: Compiled by GAO from Hungarian Fund data.

Compared with the other enterprise funds, the Hungarian Fund had the largest number of joint ventures with foreign investors because of the higher confidence and interest foreign investors had shown for investment in Hungary. The Hungarian private sector had started to develop before 1989. Joint ventures accounted for about 47 percent of invested funds. About 79 percent[1] of these investments were with U.S. joint venture partners. As of January 1993, the Hungarian Fund had invested in six state-owned companies that had been privatized.

The Hungarian Fund's diverse portfolio included investments in two large publicly traded companies, representing 12 percent of invested capital. The Hungarian Fund's investment in companies that had access to other sources of capital, raises a question of whether such investments were consistent with the Fund's mandate to develop small- and medium-size

[1]Joint ventures with U.S. partners represented 37 percent of all Hungarian Fund investments.

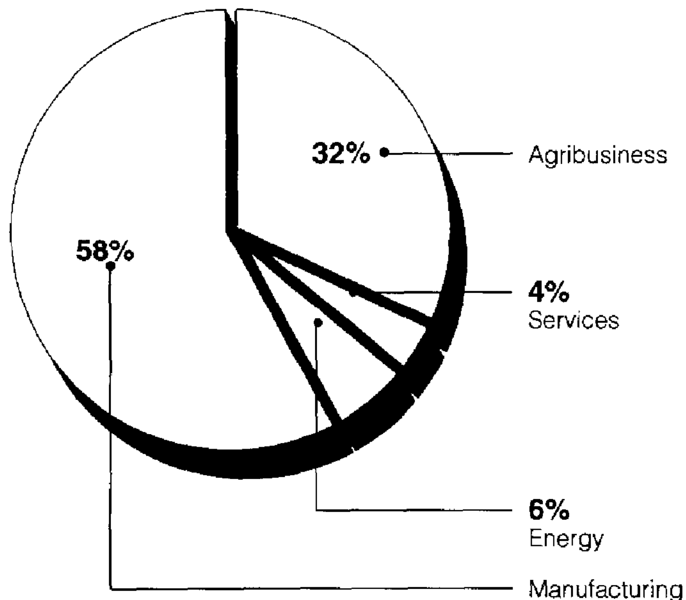
businesses. According to the Fund, its investments in the publicly traded companies leveraged additional investment capital by (1) encouraging other investors to invest and (2) helping to stabilize the stock market, which was not very efficient in pricing stock offerings. Hungarian Fund officials also stated that the investments in public companies provided a balance for the portfolio and enabled the Fund to invest in other riskier businesses.

The Czech and Slovak Fund

The Czech and Slovak Fund's strategy was to seek investments that would create jobs, promote exports, improve the environment and energy efficiency, and develop agriculture. The Czech and Slovak Fund invested 58 percent of its portfolio in manufacturing investments, a greater proportion than the other enterprise funds (see fig. 2.3). The Czech and Slovak Fund also had 6 percent of its portfolio invested in energy related investments. These investments included several small hydroelectric generating systems for small communities. The Czech and Slovak Fund estimated that in 1993 the companies it invested in would employ approximately 1,180 people.[2] The Czech and Slovak Fund investments, on average, were smaller than those made by the other enterprise funds. As of January 1993, the Czech and Slovak Fund had invested about $9.5 million in 32 businesses.

[2]Many of the Czech and Slovak Fund investments were in start-up operations in 1992, and the 1992 employment figures understate the impact these investments were projected to have on employment. Therefore, the Czech and Slovak Fund presented their projected April 1993 employment figures, which we reported.

Figure 2.3: Distribution by Industry of All Czech and Slovak Fund Investments as of January 31, 1993



Note: Investments are presented at historical cost and total $9.5 million.

Source: Compiled by GAO from Czech and Slovak Fund data.

The Czech and Slovak private sectors were slower to develop than the private sectors in Poland and Hungary. Consequently, the Czech and Slovak Fund did not have the option of investing in previously existing companies with a long-track record. The Czech and Slovak Fund has been successful in attracting joint venture investments, which represent 26 percent of its portfolio, all with U.S. partners. Its investments in start-up companies were 28 percent of the portfolio.

The proportion of start-up investments and total investments in the two republics of the former Czech and Slovak Federal Republic were different. In Slovakia, start-up companies represented 56 percent of the Czech and Slovak Fund's investments compared to 59 percent in the Czech Republic. However, about 58 percent of the Czech and Slovak Fund's total

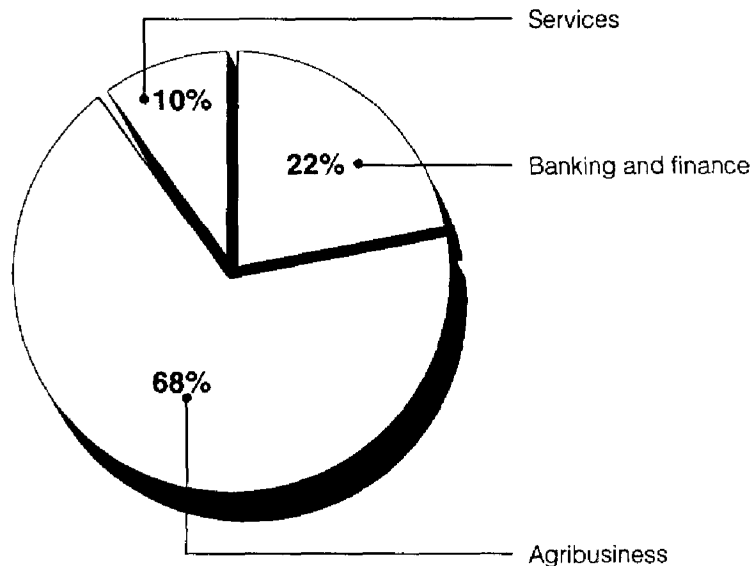
investments were in Slovakia even though the Slovak Republic's gross domestic product was 38 percent of the Czech Republic's. AID and State Department officials in the two republics attributed this greater tendency for investments in Slovakia to the efforts of the director of the Czech and Slovak Fund's Slovak operations, based in Bratislava, Slovakia.

The Czech and Slovak Fund had invested in one former state-owned enterprise that had been privatized. The Fund found that the process of working with a company as it was being privatized very time consuming and resource demanding and had diminished its efforts in this area. The Czech and Slovak Fund decided that further involvement in privatization would be limited to the purchase of equity in the companies that had already been privatized.

The Bulgarian Fund

The Bulgarian Fund's investment strategy emphasized agribusiness, light industry, and tourism (see fig. 2.4). The Bulgarian Fund selected industries where government approvals or permits were not required or that had been given a higher priority for privatization by the Bulgarian government. The largest of the Fund's three investments was an agribusiness factory producing baked goods. The Bulgarian Fund also made a related service sector investment in a wholesale food and dry goods distribution enterprise.

Figure 2.4: Distribution by Industry of All Bulgarian Fund Investments as of January 31, 1993



Note: Investments are presented at historical cost and total $2.3 million.

Source: Compiled by GAO from Bulgarian Fund data.

Like the Czech and Slovak Fund, the Bulgarian Fund expected its investments would primarily be in joint ventures and start-up businesses since Bulgaria's private sector was just beginning to emerge, and there were few existing businesses in which to invest. Two of the three investments were joint ventures, and the third was a business small loan program.

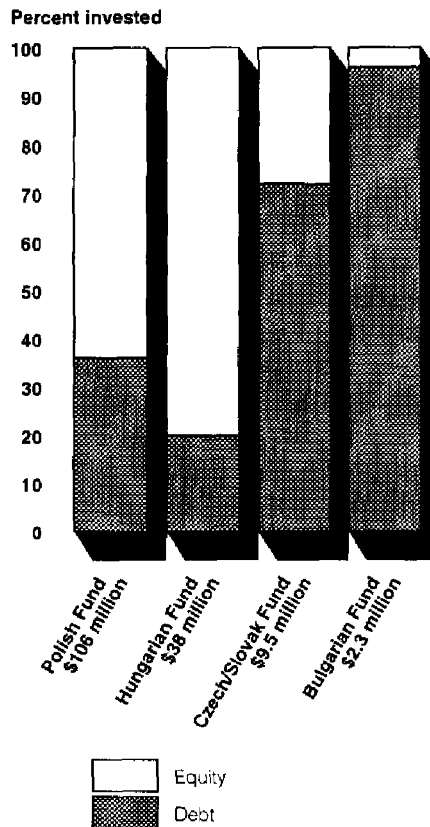
The rate at which the Bulgarian Fund made investments varied considerably from the other enterprise funds' results. During the first 18 months of operation, the Polish Fund had invested 34 percent of its originally authorized funding, the Hungarian Fund 27 percent, the Czech and Slovak Fund 12 percent, while the Bulgarian Fund had invested only 5 percent. A Bulgarian Fund officer attributed the slow rate of investment to several factors, including stalled legal reforms, complex privatization efforts, and little interest from foreign investors. As of June 1993, the Bulgarian Fund had not concluded any additional investments.

Enterprise Fund Strategies on Equity Positions Differed

In venture capital investments, the decisions about the percentage of equity share that will be held affects the role the investor wants to have and is capable of taking in the management of the business. While having a majority equity position does not necessarily require active participation on the boards of directors of the companies, holding majority positions may make it more desirable to do so.

The Polish Fund held majority equity positions and exerted management control in the businesses in which it invested. Limited available capital from other sources was one of the reasons cited by the Fund for its majority equity positions. The Polish Fund held a 50 percent or greater share in 7 of 17 enterprises in which it held equity. About 64 percent of the Polish Fund's portfolio was in equity investments (see fig. 2.5). The remaining 36 percent of the Polish Fund's portfolio consisted of loans repayable in U.S. dollars where the borrower assumed the risk of currency fluctuations. Of the Polish Fund's 17 direct investments, 15 companies received both equity and loans, while 2 companies were exclusively loans.

Figure 2.5: Debt and Equity Investments of Enterprise Funds as of January 31, 1993



Note: Enterprise fund's investments are presented at historical cost.

Source: Compiled by GAO from enterprise fund data.

The Hungarian Fund invested 80 percent of its portfolio in equity investment and only 20 percent in loans made through financial intermediaries. The Fund preferred to take minority equity positions and be a passive investor. The Hungarian Fund president stated that the Fund had enough responsibilities of its own and could not assume the responsibility of running companies. However, the Hungarian Fund has made exceptions to this policy. The Fund had 50 percent or more ownership in three investments, but provided for a buy-out provision to encourage the minority share entrepreneurs to purchase some of the Hungarian Fund's equity.

Approximately 28 percent of the Czech and Slovak Fund capital was invested in equity investments and 72 percent in loans. The original position of the Czech and Slovak Fund was to seek minority equity positions and to make entrepreneurs responsible for day-to-day operations of their firms, even though the Fund expected to serve as a principal funding source. The Fund stated that it preferred to own a range from 10 percent to 35 percent of the equity of businesses in which it invests. In June 1992, the Fund's board of directors reconsidered this position and decided that it would, in certain cases, take a majority position for short-term holding with a plan to sell off a portion to other investors.

The Bulgarian Fund's director of finance and administration said that the Fund preferred that not more than half of its capital be in equity investments. Of the Fund's first three investments, 4 percent was invested in equity and 96 percent of the capital was invested in debt.

Enterprise Fund Loan Programs

The enterprise funds' loans addressed a previously unmet need for differently structured business loans with such features as longer terms, less stringent collateral requirements, and in some cases, more attractive interest rates. The Polish and Hungarian Funds established small loan programs through local banks. The Czech and Slovak and Bulgarian funds were planning small loan programs.[3]

The Polish Fund's business loans were made directly by the Fund or through a small loan "windows" program it had established through state-commercial banks. Small business loans ranged from $5,000 to $75,000, while the Polish Fund directly handled business loans above $100,000. The Polish Fund offered loans that were generally dollar denominated so the borrower assumed the foreign exchange risk.[4]

In December 1990, the Polish Fund and nine regional Polish commercial banks organized the windows program as a Polish Fund subsidiary—Enterprise Credit Corporation. The program was developed to handle small business loans. The South Shore Bank of Chicago, which had experience in small business development lending, trained the state-bank loan officers, who in turn worked on behalf of the Enterprise Credit

[3]In discussing a draft of this report, the Czech and Slovak Fund indicated that joint lending programs were initiated in both the Czech Republic and Slovakia in the third quarter of 1993.

[4]In September 1991, the Polish Fund received from the U.S. Embassy, in zloty, the local currency, a $7.7 million equivalent contribution of residual funds from 1990 agricultural donations. The Polish Fund used these funds for loans to agricultural projects. This money was in addition to the $240 million authorized by the SEED Act.

Corporation in evaluating credit risk and assisting small businesses. By November 1992, the Polish Fund had invested $28 million in this program and had made over 1,500 loans in 49 of the 90 counties in Poland. The default rate has been low—about 3 percent of the portfolio, that is, comparable to U.S. rates.

The windows program had been widely praised as well aligned with the SEED mandate to fund small businesses. At the time we completed our review, at least one Polish state bank subsequently established its own program of small business loans after its positive experience with the Polish Fund's windows program. Applicants of the program, even those who did not obtain loans, said that the application process increased their understanding of the fundamentals of business.

The Polish Fund became a pioneer in mortgage banking in Poland, a form of financing that was previously unavailable. The objective was to promote residential construction and home ownership. The Polish-American Mortgage Bank, which began operations in October 1992, represented a $6-million equity investment plus an additional $4 million in Polish Fund loans, and was a 50-percent joint venture with two Polish institutions. The Polish Fund's legal counsel participated in rewriting Polish laws to provide a legal framework for mortgage lending. The bank operates by first financing residential multifamily construction projects and later provides mortgage loans for the buyers of the units. The loans were dollar denominated with developers being eligible for 1-year loans while buyers of housing could obtain up to 15-year loans. Middle class Poles who worked for western firms were the target market for the mortgages.

According to the Hungarian Fund president, Hungarian law prohibits the Fund from making direct loans to businesses in which it does not have an equity investment; therefore, only 20 percent of the Hungarian Fund's investment portfolio was in debt holdings. Four loans totaling $2.6 million were issued through a Hungarian intermediary financial institution under an arrangement that prevented the Hungarian Fund from realizing a profit on these loans because of the interest margin and administration expenses charged. The Hungarian Fund's investment of $5 million[5] in a small loan program was set up exclusively for developmental purposes using Hungarian banks to administer the loans. This 5-year program was structured to encourage small business loans by Hungarian banks and was not expected to generate any profit for the Fund. These local currency

[5]In September 1992, the Hungarian Fund revalued the $5 million downward by 10 percent to $4.5 million.

loans were equivalent to between $10,000 and $100,000, although a few loans have exceeded this amount. By February 28, 1993, more than 100 loans had been made through the program, and the program funds were nearly fully disbursed. At that date, about 4 percent of the loans were nonperforming. The Hungarian Fund did not plan to invest any more money in this program but had tried to bring in other investors to increase the program's capital base.

The Czech and Slovak Fund portfolio contained predominantly direct loans. In January 1993, the direct loans ranged in size from about $6,000 to $563,000 payable in local currency. The Fund set its loan interest at the lower end of the range for market interest rates. State banks required high collateral—up to 200-percent secured by fixed assets—whereas the Fund was more flexible and accepted less collateral depending on the applicant's resources. Also, the Fund made loans to finance a business' cash flow and had 4- to 6-year maturity dates. The Czech and Slovak Fund believed that debt serves to establish discipline for a business. Loans were approved for a set amount and paid out in phases as needed. Czech and Slovak Fund managers monitored the extent of the progress made on the business' development and required monthly loan payments to (1) reinforce the notion that these were loans, not grants; (2) generate cash flow for relending and to cover Fund operating expenses; and (3) focus business management on its obligations.

The Czech and Slovak Fund plans to establish joint small-business lending programs with local banks. The program will be capitalized at $5 million in the Czech Republic and $3 million in Slovakia, making this program the Fund's largest investment. The value of individual loans will not generally exceed $125,000. The Czech and Slovak Fund's investments are to be matched by the banks, for a total of $16 million of available funding for business loans. The president of the Fund emphasized the social and economic benefits of this program.

Enterprise Funds Seek Additional Venture Capital

The SEED Act provided that the enterprise funds could increase their effectiveness by soliciting additional venture capital for investments. In November 1992, the Polish Fund was the first enterprise fund to interest outside financial institutions and large investors in creating a limited partnership for investment in Poland, with the goal of a high overall rate of return through capital growth. The partnership known as the Polish Private Equity Fund was capitalized at $151 million, of which $50 million was from the Polish Fund, and the balance from outside investors,

including the European Bank for Reconstruction and Development. The Equity Fund was managed by the Polish Fund's management team who would identify investment opportunities and was required by contract to present the same investments in the same proportions to independent investment committees of the Equity Fund and the Polish Fund. The Polish Fund could then choose to co-invest or make individual investment in any proposed investment deal.

The Polish Fund estimated that the two funds could be managed at a lesser combined cost than to operate the funds individually. Since the Equity Fund will be charged a management fee, the Polish Fund expected that proportionally expenses attributable to the Polish Fund's business would decrease. Also, the creation of the Equity Fund provided the management team with the opportunity of earning incentive compensation that was calculated as a percentage of the net realized gains on investment and was sought by the Polish Fund as a mechanism to assure long-term management commitment. The incentive compensation will be calculated on the performance of the capital that was from private sources.

The Polish Fund and the Equity Fund had somewhat dissimilar objectives. The SEED Act had set a broad goal of private sector economic development for the Polish Fund, while the Equity Fund's focus was on the profitability of projects with the objective of seeking superior returns. The Equity Fund would make both equity and loan investments but would not participate in the Polish Fund's small loan program, make high-risk agricultural investments, or use its funds for technical assistance. As of June 1993, the Polish Fund and the Equity Fund had jointly concluded five investments.

The Hungarian and Czech and Slovak funds had expressed an intention to seek outside investment capital. The Hungarian Fund had initiated plans to start its first equity fund for outside investment capital from Hungarian institutions.

In addition to the enterprise funds' activities to introduce outside investment capital into the countries in which they operate, they are turned to for advice by investors interested in exploring business opportunities unrelated to the enterprise funds. The officers of the enterprise funds said they shared their experiences and information on the local investment climate with other potential investors.

Enterprise Fund Plans for Sustainability Are Being Developed

The SEED Act funds are expected to be fully disbursed in several years and according to the State Department Special Advisor for East European Assistance, additional authorizations are not anticipated. Each of the enterprise funds have set goals of sustaining their operations beyond the congressional authorization. Although these plans vary, they include investment revenues, management fees, and the selling off of assets to keep the enterprise funds operational. The enterprise funds have identified several strategies or methods of disposing of investments.

In discussing this report with the enterprise funds, they said that in view of the uncertainty of the investment business in these newly created free markets, it is not practical to assume that a fully developed plan for sustainability would have been able to be achieved yet. However, as the enterprise funds make investments and are able to build portfolios that can be recycled, they envisioned that each fund will more fully develop such a plan.

1992 Investment Revenues Covered Only Part of the Expenses

The cost of operating offices in both the United States and abroad, international communication and travel, professional fees, bad debts, valuation, and currency losses are among the costs incurred by the enterprise funds. As indicated in table 2.1, enterprise funds investment revenues had not covered expenses for the year ended September 30, 1992. For the three oldest enterprise funds—the Polish, Hungarian, and the Czech and Slovak funds that had received revenues from investments in enterprises—these revenues covered between 16 to 39 percent of the expenses.

Table 2.1: Investment Revenues and Expenses of Enterprise Funds for the Year Ended September 30, 1992

Dollars in millions

Enterprise fund	Investment revenues	Expenses	Loss	Revenues/percent of expenses
Polish	$3.95	$10.10	$6.15	39
Hungarian	0.85	2.80	1.95	30
Czech and Slovak	0.31	1.94	1.63	16
Bulgarian	0.02	0.73	0.71	3[a]

[a]Since the Bulgarian Fund has not concluded any investments in the enterprises as of the end of fiscal year 1992, only 3 percent of its expenses were covered by Fund revenues such as interest income.

Source: Compiled by GAO from enterprise fund 1992 audited consolidated financial statements.

As the balance of SEED appropriations are invested, they will have to generate investment revenues at a higher rate than marginal increases in expenses to avoid future losses. Table 2.2 provides a breakdown of the expenses and losses for the enterprise funds in 1992. Compensation and benefits represented the enterprise funds' largest expenses.

Table 2.2: Expenses and Losses of Enterprise Funds for 1992

Dollars in millions

Expenses and losses	Polish	Hungarian	Czech/ Slovak	Bulgarian
Compensation and benefits	$2.21	$1.11	$0.93	$0.43
Bad debts and net valuation losses	4.30	0.04	0.20	0
General and administrative	1.05	0.56	0.19	0.15
Professional services	0.50	0.58	0.24	0.05
Occupancy	0.73	0.22	0.14	0.03
Exchange losses	0.86	0	0	0
Program development	0.22	0.19	0.17	0.03
Depreciation	0.23	0.10	0.07	0.04
Total	**$10.10**	**$2.80**	**$1.94**	**$0.73**

Source: Compiled by GAO from enterprise fund 1992 audited consolidated financial statements.

The Debt to Equity Ratio Affects Cash Reflows

The enterprise funds have had to consider the costs and benefits of the type of investments they make. The Polish Fund investments have been approximately two-thirds equity and one-third debt. The Polish Fund's president stated that the Fund prefers equity investments over loans because the downside risk potential is about the same, in that a business may fail and much of the investment may be lost, but that equity investments have the possibility of larger profits compared to more modest return on debt.

The Polish Fund's strategy in the short run is based on expanding the amount of capital the Fund manages, since the market for its equity investments is still developing. While the management fees paid by the Equity Fund help reduce the Polish Fund's operating expenses, the Fund may sell selected equity holdings. According to its president, the Polish Fund plans to start, possibly in 3 years, another equity fund of outside investment capital. When this additional fund is created, the collection of management fees is anticipated to fully cover all Polish Fund expenses.

The Hungarian Fund's portfolio was comprised of predominately equity investments. The Hungarian Fund president could not predict with any certainty when the Fund may become self-sufficient. The president said the $60-million capital received from the U.S. government was not enough to enable the Hungarian Fund to be self-sustaining, and current dividend and other income received by the Fund has been small. By June 1993, the Hungarian Fund had sold two investments and expected to sell others later in the year. The Hungarian Fund has initiated plans to seek outside investment capital on which it may earn management fees through the creation of new equity funds. The first equity fund is planned to raise between $12 million to $25 million through private placement of capital from Hungarian institutions. Later, an equity fund for international investors in Hungary is envisioned.

The Czech and Slovak Fund has devised a short-term strategy for sustainability by holding about three-quarters of its portfolios in debt investments and one-quarter in equity. This structure provided some assurance that the Fund would be receiving reflows of a predictable size at predictable times and served as a hedge against the slowly developing market for their equity investments. Later, the Fund expected to increase its holding of equity. The Czech and Slovak Fund's strategy was devised so that once the Fund had $20 million invested in debt, the reflows would cover their expenses. By March 1993, the chairman of the Fund said that it had become clear that the goal of sustainability was not going to be reached by the beginning of fiscal year 1994. Nonetheless, this continued to be a financial target for the Fund. Raising outside investment capital will probably be required for the Fund to be sustainable over time.

The president of the Bulgarian Fund said that a formal business plan addressing the issues of investment exit strategies or sustainability of the Fund had not yet been developed, but the Bulgarian Fund's Board had communicated an overall philosophy to establish some broad guidelines. The Fund's president anticipated that once the Fund had invested $40 million, a 10-percent return on its mix of debt and equity would generate sufficient revenues to cover its annual operating costs.

Three Funds Have Identified Exit Strategies

Debt is determined by the life of the loan, which to date the funds have structured short term from 3 years to 8 years. Loans may also be sold to other investors. Strategies for realizing proceeds from equity investments are more varied and generally involve their sale to existing owners, private placement to other investors, or sale to the general public through a stock

exchange. Since the fund's equity investments have been structured primarily for capital appreciation through reinvestment of earnings, they were not expected to produce significant cash dividends in the short term.

As of June 1993, officers of the Polish, Hungarian, and Czech and Slovak funds told us they believed that their portfolios were to a great extent, not liquid as they had not developed sufficiently to attract investor attention. Although in 1992, the Hungarian Fund sold at a profit a major part of its equity shares in a record company. The president of the Polish Fund told us that he expected it would be another 5 years before the Fund would know which investments were going to be successful.

The Polish Fund planned to partially or completely dispose of its equity investments through private placements to buyers, including sales to other investment funds. According to the president of the Polish Fund, when the Fund is ready to sell its investment shares there will generally be no right-of-first-refusal extended to existing shareholders. The Fund expects existing shareholders to compete with other buyers. The Fund is interested in maximizing the Fund's profit and views the right-of-first-refusal as a mechanism that sometimes can delay sale negotiations.

The Hungarian Fund has indicated that its preferred method of selling equity investments was going to be through the stock market, once the businesses in the portfolio have been developed so they would be attractive to other investors. The Hungarian Fund's creation of an investment services company was part of its plan to establish an institution that could underwrite public offerings of companies of the size the Hungarian Fund holds. The Polish and Czech and Slovak funds viewed the sale of their holdings through stock exchanges as options that may be possible for them in the future.[6]

The Czech and Slovak Fund emphasized to its clients that the Fund is not a long-term investor and that its basic strategy is for other stockholders to buy its equity shares. The Fund expects to sell its equity in a given business after about 5 years at a fair market value of shares, and the existing owners will be given the right-of-first-refusal. While the Czech and Slovak Fund's board believes that it is necessary to invest in a manner that ensures the future profitability of the Fund, the Fund may be willing to sell an investment sooner at a reasonable profit rather than hold out for

[6]The Budapest Stock Exchange opened in June 1990; the Warsaw Stock Exchange opened in July 1991; the Bratislava Stock Exchange opened in April 1993; and the Prague Stock Exchange began trading securities in June 1993.

greater gain in the future. According to Fund officials, they want to be in position to reinvest and foster other businesses.

Technical Assistance Varies by Enterprise Fund

The SEED Act listed grants and technical assistance as appropriate uses for the monies authorized to the enterprise funds. However, at first there was generally no incentive for the enterprise funds to use the money that they have received from AID to provide technical assistance since these activities do not directly generate profit. The Hungarian Fund's board set a policy limiting the Fund's activities to what they considered their primarily mandate, a focus on securing the long-term viability of the organization by using all monies for investments.

In June 1991, AID committed an additional $5 million each for the Polish, Hungarian, and Czech and Slovak funds and in December 1992, a similar commitment was made to the Bulgarian Fund.[7] These funds were specifically provided for technical assistance. In notification letters to the presidents of the Polish, Hungarian, and Czech and Slovak funds,[8] AID indicated that the technical assistance funds were to be used for providing grants to the private sector in the countries of operation or to assist the governments of the countries to make changes in their investment-related laws and practices that would promote the growth of the private sector. AID did not provide more detailed guidelines for how the technical assistance funds should be used.

Over time, all four enterprise funds developed technical assistance programs. The characteristics of these programs were determined by fund policies that set the degree to which this assistance was tied to investments and noninvestment-related projects. In October 1992, after the Polish and Hungarian funds had disbursed over half and obligated nearly all of their technical assistance funds, they were notified by AID that they would each receive $5 million more for technical assistance projects.

The Czech and Slovak Fund used its technical assistance funding at a much slower rate and did not receive an additional authorization. The Fund established a conservative policy that it would distribute technical assistance monies in proportion to its disbursal of program money, but in

[7]This added to the original authorization for each fund: the Polish Fund's from $240 million to $245 million; the Hungarian Fund's from $60 million to $65 million; the Czech and Slovak Fund's from $60 million to $65 million; and the Bulgarian Fund's from $50 million to $55 million.

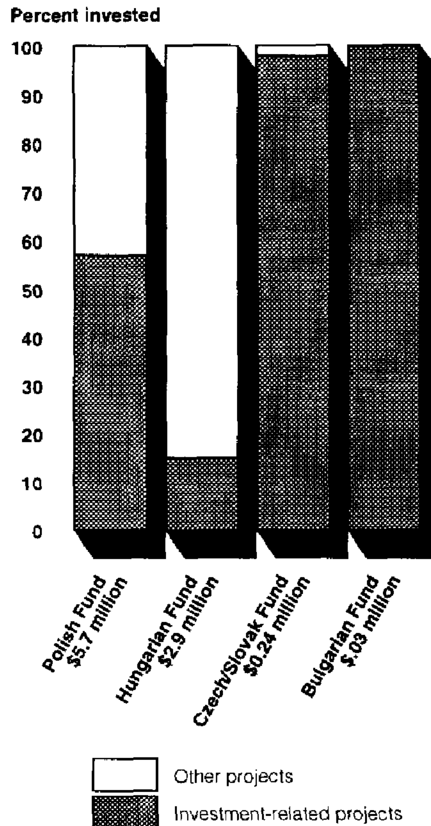
[8]The Bulgarian Fund's chairman was notified by the Secretary of State of the increased authorization for technical assistance activities.

practice, disbursal of technical assistance money lagged far behind investments. The Fund's investments as of January 31, 1993, amounted to nearly $9.5 million, or 16 percent of authorized funding, while only 5 percent of technical assistance funds was spent.

Enterprise Funds' Technical Assistance Projects

The enterprise funds had various interpretations of the broad mandate to provide technical assistance to the private sector. The policies set by each enterprise fund for use of technical assistance ranged from almost exclusively using the grants for support of its direct investments or investment-related projects, to a focus on general assistance activities or noninvestment related projects, or a mixture of the two approaches (see fig. 2.6).

Figure 2.6: Technical Assistance Expenditures of Enterprise Funds as of January 31, 1993



Source: Compiled by GAO from enterprise fund data.

The Polish Fund had used about 57 percent of the $5.7 million spent on technical assistance for projects related to its investments. This assistance was frequently in the early stages of the investment when the Fund perceived weaknesses in the skills of the investment's management team. The Polish Fund's largest technical assistance project was for training in the banking industry.

The majority of the Hungarian Fund's technical assistance programs were not directly tied to the Fund's investments. Of the 23 technical assistance projects financed by the Hungarian Fund, only 7, representing about 15 percent of the $2.9 million technical assistance funds disbursed, were

directly related to investments. The two broad criteria set by the Hungarian Fund for technical assistance grants were that (1) the projects further the development of private enterprise or market economy infrastructure and (2) other sources of funding were not readily available. An example of an investment-related project was the funding of due diligence reviews on prospective investments in the biomedical industry. Noninvestment-related projects included funding of government advisers, studies of the economy, and the development of a training program on business and entrepreneurship. A Hungarian Fund official told us that the Fund did not emphasize direct assistance to its investments because they did not want the management of these companies to view the Hungarian Fund as anything other than an investor.

The Czech and Slovak and the Bulgarian funds used nearly all of their technical assistance funds on investment-related projects. Technical assistance funds were used to hire experts to work with investors and assist in business plan development. While the Czech and Slovak Fund board of directors' position was that AID and other U.S. government agencies were primarily responsible for economywide programs, the Fund's 1992 annual report indicated an interest in expanding technical assistance funds to the wider business community in the countries of operation. The Bulgarian Fund had decided to use its technical assistance to support operations of the companies in which it invested, and expected to commit technical assistance funds to all of the Fund's investments.

Conclusions

The enterprise funds have developed a wide variety of investments, programs, and institutions, some of which will potentially be models for private sector development in their host countries and in countries where new enterprise funds will be established. Each fund has developed its unique approach to respond to country conditions and business opportunities. Although it is too early to determine which of these will be the most successful, early indications are that the small loan programs have been well received and have set an example other financial institutions are beginning to follow. The enterprise funds have already, through their investments, created jobs and increased business experience of nationals. Additionally, they have become a resource other investors have turned to for information on the business climate in the countries of operation.

The enterprise funds have identified a number of strategies to sustain their operations once U.S. government funds have been expended and to exit

their investments. However, since the enterprise funds' investments are to a great extent not liquid, the viability of these strategies remains to be proven.

Analysis of Enterprise Fund Investments Hindered by Inconsistent and Incomplete Financial Reporting

The enterprise funds need accurate and reliable financial information about their investments on a regular and periodic basis in order to assess the investments' performance and identify potential trends and problem areas. This is particularly important in the business environment in Central and Eastern Europe where accounting and auditing standards have not been developed and basic accounting and financial reporting has not been used as a management tool. We found, however, that the enterprise funds did not consistently have such information available to help them manage their portfolios.

The enterprise funds' investment agreements were inconsistent in specifying the accounting principles to be used, the type of financial statements to be submitted, and the time frame for their submittal to fund managers. When investments did submit financial statements, they were of limited use because of missing or incomplete statements, particularly a statement of cash flow. In addition, some of the submitted statements contained inaccuracies or lacked sufficiently detailed information for analysis.

Investment agreements were inconsistent in specifying the auditing standards to be used by independent auditors, and financial statements of enterprise funds' investments we examined were audited using either international or U.S. auditing standards. In addition, the independent audits did not disclose to potential users of the financial statements whether or not material weaknesses in internal controls had been identified.

The Hungarian and the Czech and Slovak funds were unable to provide a sufficient number of financial statements for us to perform a meaningful analysis of their investments. After extensive efforts, we obtained most of the financial statements for the investments of the Polish Fund through September 30, 1992, to perform a portfolio analysis, which is presented in appendix I. Our analysis of the financial statements of investments of the Polish Fund showed a net portfolio loss due to insufficient revenues, low gross margins, and high expenses, particularly bad debts and currency exchange losses. According to the State Department and AID, these conditions were not unexpected given the start-up nature of the enterprise fund and the high-risk environment in Poland.

By June 1993, after 3 years of operations, the Polish and Hungarian funds reported a total of only four failed investments. These failed investments

represented about 3 percent of the funds invested by the Polish Fund and 2 percent of the funds invested by the Hungarian Fund.

Investments Were the Enterprise Funds' Largest Asset

Investments of debt and equity in private sector businesses constituted 68 percent of the Polish, Hungarian, and Czech and Slovak funds' total consolidated assets as of September 30, 1992 (see table 3.1). The Bulgarian Fund was incorporated in November 1991, and had not yet disbursed funds to investments through September 30, 1992.

Table 3.1: Composition of Enterprise Fund Consolidated Assets as of September 30, 1992

Dollars in millions

Enterprise fund	Net investments	Cash	Other assets	Total assets
Polish	$75.9	$38.3	$2.4	**$116.6**
Hungarian	28.4	8.8	0.8	**38.0**
Czech/Slovak	6.9	2.2	0.4	**9.5**

Source: Compiled by GAO from enterprise fund 1992 audited financial statements.

Investments were carried by the enterprise funds at cost net of allowances for bad debts and valuation gains and losses. Most of the enterprise funds' investments were closely held and were not readily marketable. Enterprise fund management conducted a valuation of investments annually, or more often if circumstances warranted. The valuation considered such factors as financial condition and operating results, economic and marketing conditions affecting operations, and other events. Enterprise fund officials told us that most of the investments operated on a calendar year basis as the use of fiscal year-ends was not prevalent or had not yet been permitted by the laws in each country. Investments were also required by the investment agreements to have an annual audit, which were performed by various international certified public accounting firms in accordance with either international or U.S. auditing standards.

Accounting and Reporting Requirements Were Not Consistent

Accounting and reporting requirements established in investment agreements between the enterprise funds and the companies in which they have invested were not consistent. The agreements varied in the accounting principles to be used to maintain financial records and did not require investments to prepare the same type of financial statements. Investment agreements also did not require all investments to submit their financial statements for the same accounting periods and within a

consistent time frame. Enterprise fund presidents and chief financial officers stated that the inconsistencies of accounting and reporting provisions arose during negotiations over each agreement conducted by different individuals at different times. However, the lack of consistent accounting and reporting for investments created an inability to compare performance and identify problems.

We examined all 17 of the Polish Fund investment agreements where we received financial statements as of September 30, 1992, and examined over half of the investment agreements for the Hungarian Fund and the Czech and Slovak Fund. As indicated in table 3.2, the enterprise funds' agreements specified a variety of accounting principles to maintain accounting records, with 30 percent of the agreements we examined having no provision.

Table 3.2: Accounting Principles of Enterprise Funds

Accounting principles	Polish Fund	Hungarian Fund	Czech/Slovak Fund	Total
United States	3	2	0	**5**
United States and local[a]	9	3	0	**12**
United States, local,[a] and local law[b]	3	0	0	**3**
United States and local law[b]	0	1	0	**1**
Local[a]	0	0	3	**3**
Local law[b]	0	0	1	**1**
International	0	6	0	**6**
No provision	2	0	11	**13**
Total	**17**	**12**	**15**	**44**

[a]Local refers to the accounting principles in use or under development within each country.

[b]Local law refers to the basis of accounting prescribed for statutory or tax reporting purposes.

Source: Compiled by GAO from enterprise fund investment agreements.

Commenting on a draft of this report, officials representing the Polish Fund said they had other ways to obtain financial information from the two investments whose contract do not specify reporting requirements. The Fund has a 50-percent ownership interest, sits on the supervisory boards of both companies, and can therefore obtain financial information on the basis of accounting the board directs. One of these companies, the mortgage bank, is also subject to accounting principles and financial report requirements set by the National Bank of Poland.

In discussing a draft of this report, officials representing the Czech and Slovak Fund said they anticipated using financial statements prepared in accordance with local accounting principles or laws and thus had made no specific provisions in most of its agreements.

Both U.S. and international accounting principles require preparation of reports consisting of a balance sheet, statement of income or loss, and statement of cash flow. However, as indicated in table 3.3, 40 investment agreements we examined included differing requirements on the type of financial statements to be prepared and the other four agreements contained no provision at all on the type of statements to be prepared.

Table 3.3: Financial Report Requirements of Enterprise Funds

Financial statement type	Polish Fund	Hungarian Fund	Czech/Slovak Fund	Total
Balance sheet, income and cash flow statement	12	1	7	**20**
Balance sheet and income statement only	2	7	5	**14**
Balance and cash flow statement only	0	3	2	**5**
Income statement only	1	0	0	**1**
No provision	2	1	1	**4**
Total	**17**	**12**	**15**	**44**

Source: Compiled by GAO from enterprise fund investment agreements.

As indicated in table 3.4, the investment agreements we examined were inconsistent in their time reporting requirements for the submittal of both audited annual and unaudited interim financial statements to fund managers. Interim financial statement reporting periods in the investment agreements also varied from monthly to quarterly with 11 percent of the agreements examined having no provision at all.

Table 3.4: Reporting Times and Periods of Enterprise Funds

	Polish Fund	Hungarian Fund	Czech/Slovak Fund	Total
Annual reporting times				
Within 60 days of year-end	1	0	2	**3**
Within 90 days of year-end	9	2	0	**11**
Within 120 days of year-end	1	7	0	**8**
No date specified	6	3	13	**22**
Total	**17**	**12**	**15**	**44**
Interim reporting times				
Within 30 days of period end	11	8	0	**19**
Within 45 days of period end	0	0	7	**7**
Within 60 days of period end	0	1	1	**2**
No date specified	6	3	7	16
Total	**17**	**12**	**15**	**44**
Interim reporting periods				
Monthly	11	2	0	**13**
Quarterly	3	10	13	**26**
No period specified	3	0	2	**5**
Total	**17**	**12**	**15**	**44**

Source: Compiled by GAO from enterprise fund investment agreements.

Enterprise fund managers were generally aware of these inconsistencies and have been working with the investments and their financial reports in order to obtain better financial information. The information taken from individual investment's financial reports was being used to develop automated financial statements that report the results of the investment operations in a more uniform manner. In addition, several cash flow statements have been developed by fund managers to help improve overall financial reporting.

Some Investment Financial Statements Were Missing or Incomplete

Enterprise fund managers could not fully monitor the financial performance of the investments because they did not receive all required financial statements or received statements with incomplete data. In addition, some statements were received months late, which affected the ability to make timely management decisions. Summary level data were often submitted without sufficient detail showing how funds were used. As a result, we were unable to perform a meaningful financial analysis of the Hungarian and the Czech and Slovak funds' investment portfolios as of

December 31, 1991, June 30, 1992, and September 30, 1992. After extensive efforts, we obtained most of the financial statements for the investments of the Polish Fund through September 30, 1992, to perform a portfolio analysis. Table 3.5 shows enterprise funds' missing or incomplete investment financial statements we found for the three periods of our analysis.

Table 3.5: Missing or Incomplete Investment Financial Statements of Enterprise Funds

Date and Fund	Number of investments	Balance sheet		Income Statement		Cash flow Statement	
		Number	Percent	Number	Percent	Number	Percent
Dec. 31, 1991							
Polish	17	0	0	0	0	0	0
Hungarian	14	1	7	3	21	12	86
Czech/Slovak	2	2	100	2	100	2	100
June 30, 1992							
Polish	19	0	0	4	21	13	68
Hungarian	19	3	16	5	26	16	84
Czech/Slovak	20	11	55	11	55	20	100
Sept. 30, 1992							
Polish	17	1	6	3	18	12	71
Hungarian	22	4	18	13	59	19	86
Czech/Slovak	28	12	43	11	39	28	100

Source: Compiled by GAO from enterprise fund data.

Financial statements for 17 Polish Fund investments as of December 31, 1991, were obtained by the Fund during the period between March 28, 1992, and July 30, 1992. Fifteen of the 17 investments that had activity were audited as of December 31, 1991. The reason for delays was that auditors were completing their first audits of the investments, and this took additional time. Interim financial statements for June 30, 1992, were submitted by 19 investments in July 1992. Most lacked cash flow statements and four provided only summary revenue and expense data. Interim financial statements for September 30, 1992, on 17 investments were not obtained by us until April 1993. One investment—a newspaper publishing company—had ceased operations in September 1992, and no financial statements were prepared, although expenses were incurred and cash disbursed. Two other investments provided only summary revenue and expense data and again, most investments lacked cash flow statements.

According to the Hungarian Fund's chief financial officer, its investments did not submit required financial statements for several reasons. For example, two investments that received almost $1 million did not submit September 30, 1992, financial statements because they were effectively bankrupt and were straightening out their accounting records in an effort to produce reliable financial statements. Also, a $4-million investment in an investment services company did not submit audited financial statements on time. Audited financial statements for the company as of December 31, 1992, were finally received by the Hungarian Fund on May 31, 1993.

The Czech and Slovak Fund investments also did not submit complete financial statements, and we found many cases where investments did not submit any financial statements for more than one reporting period. For example:

- Four investments received about $400,000 as of June 30, 1992, and did not submit any financial statements to the Fund. By September 30, 1992, these four investments had received about $897,000 and still had not submitted financial statements.
- As of September 30, 1992, another five investments had received funding with a carrying value of almost $440,000 and had not submitted any financial statements for that period.
- None of the investments submitted a cash flow statement for three periods we analyzed.

Enterprise fund chief financial officers said that they have been working with their investments to instill a discipline of preparing financial statements that could be used as a management tool by both the investments and the funds. However, local business personnel generally were not trained in U.S. accounting methods and had never had to prepare such financial reports under the former Communist regime. Furthermore, businesses generally did not have appropriate accounting systems and also had to keep books to conform with local laws. According to the officers, everything had to be translated from local languages to English and converted from local currency to U.S. dollars, thus further compounding the financial reporting problems. Although a cash flow statement is a basic financial report required by both U.S. and international accounting principles, the enterprise funds generally emphasized obtaining a balance sheet and income statement from investments. The Czech and Slovak Fund investment agreements did not require a cash flow statement.

Some Financial Statements Were Insufficient or Inaccurate

All three enterprise funds held investments that submitted financial statements without sufficient detailed information to show how the monies were used. While the Polish Fund improved its investment reporting in 1992 by standardizing data to be submitted by all investments, the reports lacked sufficient detail on revenues, expenses, and cash flow. The lack of standardized and detailed reporting was also noted for the Hungarian and Czech and Slovak funds. Such data are essential to monitor key elements of interest earnings, sales growth, gross margin fluctuations, overhead costs, currency effect, interest costs, depreciation charges, and bad debts. A cash flow statement is still only required for year-end reporting purposes. The sources and uses of cash flow are key elements in running a business.

In most cases, financial statements combined all sources of income or all types of expenses, and then reported this information in summary form. For example, investments did not identify and report the different sources of income, such as normal business operations; income from nonbusiness operations, like interest income; and income or loss due to currency exchange. Separate categories of expenses were also not always reported such as the cost of goods sold; selling, general, and administrative expenses; interest expense; bad debts; income taxes; and depreciation.

Investments' financial statements need sufficient detail so that managers can conduct a meaningful analysis of the investment and identify areas that need improvement. For example, interest income may exceed a loss from normal business operations and thus mask the need to improve normal business operations. Expense detail could be used to compare investments against each other or to compare an investment against industry statistics.

Although, we did not review the validity of the financial statements submitted by investments, Hungarian Fund officials have questioned the accuracy of some of the financial reports. For example, they said:

- Accounts receivable and inventory were inaccurately reported on the balance sheet of a company that operated a consignment warehouse.
- An investment submitted its unaudited financial statements from December 1991 that the Hungarian Fund used in its decision to invest in the company in January 1992. When the company was subsequently audited in November 1992, Fund officials concluded that the data provided in December 1991 were not accurate.

Czech and Slovak Fund managers noted the following examples of questionable reporting:

- One investment's accounting system was seriously flawed by incorrectly recording assets as expenses. Consequently, assets were understated while expenses were overstated. The Fund had required that the investment establish a new accounting system and obtain a year-end audit to assure that expenses are fairly presented.
- Another investment reported depreciation expense on its income statement; however, the balance sheet had no amount recorded for accumulated depreciation.
- Balance sheet information on two investments understated Fund loans payable by over $336,000.

Audits of Investments Were Inconsistent and Did Not Disclose Material Weaknesses

Financial statements of enterprise fund investments were audited using either international or U.S. auditing standards,[1] because investment agreements were inconsistent in specifying the auditing standards to be used by independent auditors and local auditing standards are still evolving. In addition, the audit reports did not disclose to potential financial statements users whether material weaknesses had been identified in a firm's internal controls, although such disclosure is not required by either U.S. or international auditing standards.[2]

Of the 15 Polish Fund investments that were audited as of December 31, 1991, 8 investments were audited in accordance with international standards and 7 investments were audited in accordance with U.S. standards. Audited financial statements were not available for investments of the Hungarian Fund as of December 31, 1991; however, the December 31, 1992, financial statements of one Hungarian Fund investment were audited in accordance with U.S. standards. Audited statements were not available for investments of the Czech and Slovak Fund, and the Bulgarian Fund had funded no investments through September 30, 1992. The Polish Fund's chief financial officer stated that the standards used by auditors for its various investments were consistent with the accounting principles specified in the investment agreements.

[1]As indicated earlier, the Czech and Slovak Fund officials followed local auditing standards.

[2]Disclosure of material internal control weaknesses is required by generally accepted government auditing standards issued by the Comptroller General of the United States.

U.S. and international auditing standards require that the independent auditor consider an entity's internal control structure in determining the nature, timing, and extent of audit testing. However, neither the U.S. nor international standards require that the auditor report on internal controls, although commonly an auditor will issue a management letter containing internal control and operational issues requiring management's attention. These standards also do not provide that if a separate internal control report or management letter is prepared that they be issued together with the auditor's opinion on the financial statements, or that a statement be added to the auditor's opinion to indicate that any separate reports have also been issued. The enterprise funds agreed that auditors' internal control reports and management letters are useful for improving operations, but they believe that such reports or letters are costly to produce and that public disclosure of their contents could be misunderstood.

Investment Failures Have Been Few

As of June 1993, the Polish and Hungarian funds had recorded a total of only four investments that had failed. When compared to the total capital invested by each fund, the failed investments represented about 3 percent of the Polish Fund's investments and 2 percent of the Hungarian Fund's investments. The two Polish Fund investments that failed were a newspaper and an agricultural investment. The Hungarian Fund invested in an appliance manufacturing company and an electronics firm, which subsequently declared bankruptcy. Other investments that have not failed but are encountering financial and organizational problems are discussed in the next chapter.

Allowances for partial losses at the Polish, Hungarian, and Czech and Slovak funds had been recognized in the enterprise funds' financial reports. The Bulgarian Fund's first investments were disbursed after September 30, 1992, and no losses or allowances had been recognized through June 1993.

Conclusions

The Polish, Hungarian, and Czech and Slovak funds did not have complete, accurate, and timely financial information on their investments. Among other things, this can be attributed to (1) funding agreements with inconsistent requirements on the accounting principles to be used, the types of financial statements to be submitted, the period of time that the statements should cover, and the dates that investments should submit their statements; (2) nonstandardized financial reporting with an

insufficient level of detail for financial analysis; and (3) the limited capability of some investments to prepare adequate financial statements.

Investment financial statements should complement other program information and enable enterprise fund managers to be more effective in monitoring the performance of each investment. These statements are expected to provide a financial picture of the operations of the enterprise funds' investments that cannot be obtained elsewhere. However, because many of the investment's financial statements were not complete, accurate, and sufficiently detailed the enterprise funds had no assurance that they were sufficiently informed about the financial health of each investment.

Inconsistencies in accounting principles and auditing standards to be used also hindered the comparability of investment financial statements, while the lack of disclosure of material weaknesses or internal control conditions limited the amount of information provided to current and potential investors. Since auditors are already required by existing audit standards to assess internal controls and report to management material weaknesses in internal controls or other reportable conditions, providing this information to all users of the financial reports could be done in a manner which would not lead to misinterpretation and at a cost that would not be prohibitive.

Observations

Because the funds are private enterprises, we do not make recommendations to them. However, we believe the enterprise fund managers could improve their operations by

- developing and enforcing standard and consistent investment agreement provisions that specify the (1) accounting principles to be used, (2) types of financial statements that investments are required to submit to the enterprise funds, (3) period of time that statements should cover, (4) dates that investments should submit their financial statements, and (5) level of detailed financial information required;
- modifying investment agreements where annual audits of investments are required to include the issuance of a report on internal controls or management letter as part of the audit and that the companies make those documents available to potential users of the financial statements; and
- assessing the capability of each investment to prepare complete, accurate, and timely financial statements with the minimum level of required

detailed financial information, prior to disbursing funds, and provide technical assistance as necessary.

Enterprise Fund Investments Have Encountered Problems

While investing in unlisted companies[1] in the United States is considered to be high risk, comparable investments in Central and Eastern Europe face additional risk due to the countries' evolving economies. All four of the enterprise funds reported that initial evaluations and subsequent monitoring of investments were very difficult to conduct because of the lack of comparable business experience and information. On occasions, the funds have had to deal with unethical business practices by individuals with whom they did business. Several of the companies in which the enterprise funds invested were encountering financial and organizational problems. Potential conflicts of interest in the application of noninvestment-related technical assistance were also noted.

Investments Faced Risk in Evolving Economies

Business investments involve an inherent risk of loss or devaluation, particularly in a start-up situation. The risk of failure for the enterprise fund investments is heightened by the struggle to create a private business sector from the ground up while the economies suffer from economic depression. The business infrastructure, including the emerging capital markets, lacked modern production, marketing, and distribution networks, as well as a cadre of skilled managers.

The enterprise funds were under pressure to make investments because of the high expectations raised by early publicity about the funds and demand for their services. The enterprise funds found that they had to invent procedures because the business experience and information they would have relied on in a market economy were just evolving in the countries of operation. Often the proposals submitted to the enterprise funds lacked an appropriate business plan, and the enterprise funds had to work with the applicants to prepare one. Licensing and registration placed additional burdens on the investment process. According to the Polish Fund's managing director in Warsaw, analysis and development of the investment constitutes the smaller portion of effort in the investment process in Poland compared to the United States, and administrative matters such as licensing and registrations require much more effort.

The president of the Hungarian Fund said that when the Fund started, given the economic and political environment, it was exceedingly difficult to perform a detailed evaluation of a potential investment's management team and its business plan, a process known in the industry as a "due diligence" review. Since Western-style methods of review were unavailable in Hungary, it was hard to determine the best evaluation methods to use.

[1]An unlisted company is one not listed on a stock exchange.

He said that even after the Fund's personnel had become more knowledgeable, the process continued to be difficult and time consuming.

The Polish Fund's experience with their first private bank investment illustrates the problems that can occur when a due diligence review is incomplete. In May 1991, the Polish Fund invested in a bank created in 1989 by a group of businessmen. Along with this investment, the Fund inherited many bad loans the co-investors had made after the initial negotiations for the purchase of the bank were concluded, but before the Polish Fund took control of the credit committee. Polish Fund officials said that their review did not follow up on the changes in the bank's lending activities after this investment had been approved by the Fund's board. Despite the inadequacies of the due diligence review, in June 1993 the president of the Fund said that the performance of the bank's loan portfolio had improved after a newly appointed, experienced bank president and new bank directors, with the help of credit managers of the Fund's small loan windows program, created a new credit committee to more thoroughly review new loans and to salvage what they could from the bad loans.

According to the Polish Fund's managing director in Warsaw, decisions regarding investments had to be based on less information than would be considered appropriate in the United States. For example, because of the general absence of credit, there is no credit history information to rely upon. Furthermore, in the U.S. investment decisions would be based at least, in part, on audited financial statements; however, such statements were frequently unavailable for businesses in Central and Eastern Europe.

In the initial days of the enterprise fund operations, all of the investment managers' efforts were focused on the investment process. Subsequently, post-investment monitoring duties were added to the work load of investment managers, most of whom had little experience in this area. Monitoring was done primarily by reviewing financial statements and periodic personal contacts by enterprise fund investment managers. Representatives of the enterprise funds also sat on the boards of directors of the principal investments. In discussing a draft of this report with officials representing the enterprise funds, they said that fund managers also reviewed financial material such as financial forecasts and invoices; attended meetings of supervisory boards and investee management; toured investees' facilities; and met with clients and customers of the investees, municipal authorities, and investees' creditors.

Nevertheless, officials from the Polish, Hungarian, and Czech and Slovak funds acknowledged that investment monitoring needed improvement. They found that some firms were reluctant to share information with the enterprise funds' representatives. The funds attributed this reluctance to the legacy of the Communist system. The Polish Fund's chief financial officer said that the Fund's investment managers try to obtain qualitative as well as quantitative information on which to base their investment decisions. The officer also said that reliable financial information was not easily obtained and traditional financial analysis was difficult and time consuming. The enterprise funds concluded that the business managers of companies in which they invested often were less knowledgeable in financial matters than earlier assessments had indicated.

While most of the enterprise funds continue to hold individual investment managers responsible for monitoring their assigned investments, the funds have begun to provide additional support and oversight of the monitoring activities. We noted that the Polish, Hungarian, and Czech and Slovak funds had begun to (1) assign oversight responsibility for all investment monitoring to a particular fund officer, (2) identify consultants who could work with the firms to help them improve their financial information and accounting systems, and (3) establish or plan computer tracking monitoring systems.

Enterprise Funds Have Encountered Some Unethical Business Practices

The enterprise funds were faced with business environments that at times operated under different standards of ethics than were acceptable for U.S.-funded assistance. The enterprise funds found that they had to be vigilant about the business ethics of those they dealt with, and in some instances, had encountered unethical business practices.

The managing director of the Hungarian Fund acknowledged that a representative of a Western European company had attempted to bribe him to encourage a particular investment by the Fund, but he did not consider bribery to be a significant problem for the Fund. In another instance, the director suspected that a company in which the Hungarian Fund had invested received a kickback when the entrepreneur insisted on dealing with a particular supplier.

The Bulgarian Fund encountered a situation in which an individual fraudulently represented himself as being affiliated with the Enterprise Fund and claimed to be able to guarantee funding from the Bulgarian Fund

for a fee. The Bulgarian Fund obtained a retraction from this person and published the retraction in a local newspaper.

During our review we also noted that in 1991, the Polish Fund had heard allegations that some employees of the participating Polish banks in the Fund's small loan windows program, were demanding bribes in return for assuring bank loans. The Polish Fund and independent parties investigated the allegations, and eventually one loan officer was asked to resign for poor performance, but the Fund was not able to confirm any impropriety. According to the Fund, it was just a coincidence that this resignation was requested at the same time the investigations were occurring.

While the Polish Fund reported that bribery and unethical business practices were commonplace in Poland, the Fund also stated that in no case did any officer of the Polish Fund report that any business person or government official sought to influence the Fund through unethical practices.

The Hungarian Fund's Investment in an Investment Services Company Has Raised Concerns

In April 1992, the Hungarian Fund invested $4 million, about 99 percent of the paid-in capital, in an investment services company, EurAmerica. This investment was atypical for Hungarian Fund investments since it did not comply with Fund policies, which limited investments to $3 million and required a significant capital contribution by co-investors.

From its inception, the Hungarian Fund envisioned the need for an investment services company in Hungary and considered this an integral part of the Fund's strategy for its investments. According to the management plan, the Fund believed that this company would (1) assist in the Hungarian government's privatization program; (2) help develop capital markets in Hungary and underwrite shares of the Hungarian Fund's companies once they were marketable; (3) provide training for Hungarians in financial services; and (4) interest other investors to participate in projects the Fund undertakes. The Hungarian Fund believed that Hungary had the potential of becoming a financial center in Central and Eastern Europe, and this institution was a step in that direction.

The president of the Hungarian Fund said that the size of the Fund's investment of $4 million was determined by EurAmerica's need to hold a substantial amount of capital to establish the organization's credibility in financial markets. Except for the amount used for operations, the president anticipated that the capital was not going to be used for

underwriting activities until the Hungarian Fund's invested capital had been reimbursed. He said EurAmerica was initially to focus on performing financial advisory services to prove that it could support itself on its earnings.

According to the Hungarian Fund, a key problem in establishing the company was to find and compensate experienced investment bankers who were willing to work in Hungary. In April 1992, the Hungarian Fund negotiated contracts with three investment bankers to manage EurAmerica. The contracts called for first-year annual compensation of approximately $400,000 for the company's chief executive officer, $300,000 for the president, and $100,000 for a vice president to be paid from money provided to the Hungarian Fund by the U.S. government. The salaries were guaranteed and not tied to performance during the first compensation period. Salaries were to be reduced by 50 percent if the company did not show a profit after 15 months. The Hungarian Fund's president stated that this compensation was in line with both the market rates for investment bank principals and the salaries these individuals previously received in their prior positions at a large U.S.-based investment bank. However, the Fund could not provide documentation of these assertions.

After several contractual agreements with EurAmerica had not been fulfilled, the Hungarian Fund chief financial officer conducted a review of EurAmerica's financial management practices in April 1993. The Hungarian Fund had not received any quarterly financial statements from EurAmerica, as required by the EurAmerica joint venture agreement, and the required annual audit by the outside auditor was delayed.[2] The chief financial officer found that the auditors could not have performed the annual audit at the time designated in the joint venture agreement due to the disorganized condition of EurAmerica's records. The chief financial officer found that the entire EurAmerica administrative staff of four individuals, who were responsible for maintaining the records, had recently resigned. The reasons given for two resignations were personal, and the officer did not learn the reasons for the other resignations. Although he did not believe their resignations were in anticipation of the annual audit, he found their work had been substandard. The chief financial officer also found that EurAmerica had not kept formal minutes

[2]The chief financial officer said that in October or November 1992, EurAmerica management had requested and received approval from the Hungarian Fund president for a postponement of the first annual audit until June 30, 1993. This audit was to have occurred as of December 31, 1992, and reported by March 31, 1993. After EurAmerica was the subject of unfavorable press, the Fund insisted that the audit be completed by May 31, 1993.

recording the board of directors' meetings, and he had to ask the company directors to reconstruct these minutes from their notes.

On May 31, 1993, a certified public accounting firm, which conducted the annual audit of EurAmerica, issued an unqualified opinion[3] on its financial statements in accordance with U.S. auditing standards. However, on June 10, 1993, the accounting firm also issued a separate letter to EurAmerica management and shareholders, including the Hungarian Fund that indicated a number of specific concerns regarding the company's operations. While U.S. auditing standards do not require that the management letter be provided to users of financial statements, a danger exists that other users of the financial statements, such as potential investors, who rely upon the unqualified opinion may be misled if they are not also furnished with the findings contained in the management letter.

On August 24, 1993, the Hungarian Fund announced that the EurAmerica investment had been restructured in order to bring it into voluntary compliance with the informal salary guidelines State, AID, and the House Appropriations Committee set for the enterprise fund staff. This was done even though the EurAmerica staff are not considered to be employees of the Hungarian Fund. This salary cap of $150,000 will be in effect until the Hungarian Fund is reimbursed its initial $4-million investment along with interest, at which time EurAmerica will become a completely independent entity. The Hungarian Fund will continue to receive a percentage of EurAmerica's net profits for 5 years after the payback. Also, as part of the renegotiation agreement, the principals of EurAmerica agreed to return immediately a minimum of $1 million and on August 27, 1993, EurAmerica returned $1.3 million to the Hungarian Fund.

Several Investments Have Encountered Difficulties

The Polish Fund

The Polish Fund's investments in agriculture and a newspaper demonstrate some of the difficulties confronting firms during the transition from a centrally planned economy to a market system. For

[3]The American Institute of Certified Public Accountants definition of an unqualified opinion or an auditor's standard report—"The auditors's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles."

example, an agricultural cooperative that was given a $2.4-million loan from the Polish Fund for upgrading a food storage facility, viewed the loan the same as the "loans" it had previously received from the former Communist government. Borrowers were never expected to repay these loans. The cooperative members also rejected the business advice of an American consultant on food processing who spent 10 months with the cooperative, and the members accused the consultant of wanting to ruin the business so that Western investors could buy it very cheaply. The consultant concluded that many people in the cooperative did not want to work hard and did not consider operating the business efficiently to be a high priority. The Polish Fund did not have an equity position in this business and thus was limited in its ability to influence the business' operations and claim collateral.

In another case, the Polish Fund invested $2.2 million in debt and equity in another agricultural cooperative, but in this instance the Polish Fund managers acted on their prerogative as majority owners and unilaterally decided to delay the start of operations of a produce-sorting plant. This decision was made because a poor growing season and construction delays would have caused the company to operate at an estimated loss of $500,000 during the first season. The Polish Fund was criticized by the cooperative for making the decision for purely financial reasons. The members of the cooperative, who wanted to use the sorting facility in which they had also invested felt that their interests were being disregarded by the Fund. Once the company started production the following year, some members of the cooperative boycotted the operation and marketed their produce through other distribution channels.

The Polish Fund also invested $3 million in a nationwide newspaper that failed before publication began. The newspaper business was considered a high-risk business, and a number of newspapers had previously failed in Poland. According to the Polish Fund's consultant for this investment, the publication, modeled after a USA Today format, had a potential market. Nevertheless, there were circumstances connected with this investment that increased its risk. The Polish Fund's president told us that the Fund lost confidence in this business because the newspaper's poor financial management and the resignations of a number of key personnel. Also, the editor was unclear about how much additional capital the paper needed to start operations after experiencing delays in obtaining equipment. Faced with the decision to invest additional funds or cut its losses, the Polish Fund chose to close down the operation and sell or lease the physical assets acquired. To recover at least part of its investment, in

December 1992, the Polish Fund signed a letter of intent with a joint venture partner interested in co-investing in a publishing business, possibly magazines and books, with control of editorial policy to be in the hands of the joint venture partner.

The Hungarian Fund

The Hungarian Fund also experienced investment failures. For example, the Fund's investment of $370,000 in a systems integrator and process control company failed in September 1992, and a $600,000 loan to an appliance manufacturing company failed in March 1993. The systems integrator company was managed by an American joint venture partner. The company became bankrupt due to the general manager's unauthorized creation of a subsidiary company for which he borrowed funds guaranteed by the company in which the Hungarian Fund invested. The Fund decided that the fees that might be expended in legal action against their joint venture partner were not justified, considering the small size of their investment. Concerning the appliance firm, we noted that the due diligence review did not reveal sufficient information about its financial position at the time of investment. The financial officer of the appliance firm told us that his company concealed information about the company's creditors and outstanding law suits. The Hungarian Fund was, however, able to seize collateral that backed the appliance firm's loan. In comments on a draft of this report, officials representing the Fund, said that this seized collateral was sold for a significant portion of the amount owed on the loan.

The Czech and Slovak Fund

The Czech and Slovak Fund had set up a reserve of $200,000 for possible losses on four investments. Several of the Fund's loans received extensions of grace periods, having fallen behind in starting operations. The Czech and Slovak Fund's loans generally received grace periods on interest and principal during their projected start-up phase. Start-up businesses were the most likely to experience delays due to construction delays or delays in obtaining required permits and land titles. Other companies were operating, but not able to meet their loan payments, which were past due. Of the Fund's 28 investments in November 1992, 6 had been given grace period extensions or were past due. According to its chief financial officer, the Fund tried to hold businesses to the terms of the loan, but considered the circumstances in each case. As of June 1993, the Czech and Slovak Fund had not had any failed investments.

Conflict of Interest and Post-Employment Issues

During our review, we identified two cases of potential or appearance of conflict of interest in the applications of noninvestment-related technical assistance. One case involved paying the salary of a Hungarian government official and the other involved a Polish Fund Board member's affiliation with a funded program. We also noted that the enterprise funds do not restrict employees from subsequently working for companies related to the enterprise fund.

Potential Conflicts of Interest

In the fall of 1992, a senior Hungarian government official and the U.S. Ambassador to Budapest requested that the Hungarian Fund pay the salary of a U.S. citizen to head the Hungarian State Asset Holding Company. The Hungarian Fund agreed to fund this position from its technical assistance account. The individual in question was an employee of the U.S. Department of the Interior who had served from 1990 to 1992 as a senior government adviser to the Hungarian government on energy policy under other sponsorship.

The Hungarian State Asset Holding Company was established as an agency of the Hungarian government to assist the management of the government's privatization program and was given a mandate to arrange for the partial disposition of about 160 enterprises that the Hungarian government had decided to privatize while retaining a portion of the shares. In justifying this use of technical assistance funds, the Hungarian Fund pointed to the notification letter from AID that specified that technical assistance could be used to assist the government of Hungary to make changes in its investment-related laws and practices to promote the growth of the private sector.

The president of the Hungarian Fund said that he did not believe that there was a conflict of interest between the president of the holding company and the interests of the Hungarian Fund because it was Fund policy to limit its investments to a maximum $3 million.[4] The president said that consequently the Hungarian Fund would not be a likely investor in any of the privatized companies because of their size. Furthermore, he said that the salary support was similar to a previous arrangement under which the Fund paid the salary of an adviser from a U.S. private institute to the Hungarian government Minister on Bank Privatization.

[4]As previously noted, this policy was not followed in the case of the $4-million investment in EurAmerica.

The individual's assignment from the U.S. Department of the Interior to the Hungarian Fund was made under provisions of the Intergovernmental Personnel Act which permit the assignment of U.S. government employees to nonprofit organizations that offer professional advisory and development services to governments. However, placing this U.S. government employee with the Hungarian government holding company raised a question concerning the U.S. Constitution's prohibition against a U.S. government official holding any office of a foreign state without congressional consent. During June 1993, while the propriety of this transaction, and use of technical assistance funds to pay for it, were under review by the Office of Personnel Management and the Department of the Interior, newspapers in the United States and Hungary publicized this matter, causing the individual to resign. The case, however, never was adjudicated.

The other situation with the appearance of a conflict of interest involved an April 1991 technical assistance grant of $1 million by the Polish Fund to the Educational Enterprise Foundation. This Foundation is an organization affiliated with a Polish university that sponsors education programs to promote entrepreneurship and gives scholarships for study and training in the United States. The Foundation also received a matching grant of an equivalent of $1 million in local currency from the Polish government. The idea for the Foundation was suggested to the Polish Fund by an individual serving in the Polish government who had previously served on the Polish Fund's Board of Directors.

In May 1991, after the Polish Fund's Board of Directors unanimously voted to make the technical assistance grant, a Fund director was asked to serve as president of the Educational Enterprise Foundation. In addition to receiving a salary for the position as Foundation president and director's fees from the Polish Fund, he was also a professor at the university where the foundation was established. As of June 1993, this person continued to serve in all three capacities. The Educational Enterprise Foundation has not received additional funding from the Polish Fund.

The Polish Fund's general counsel stated that in his opinion a conflict of interest did not exist since the Board member in question did not assume the position of president of the Foundation until after the vote of the Board of Directors approving the technical assistance grant and that in the future he will recuse himself when any matters regarding the Foundation are handled by the Board.

Post-Employment Concerns

The funds do not have a policy restricting employees from accepting positions with investments they had previously managed or other companies with which they were affiliated while employed by an enterprise fund. For example, a former Hungarian Fund analyst subsequently accepted a position with the Fund's co-investor in an investment for which she had performed the due diligence review. Since there are no restrictions preventing former staff from going to work for companies with which they were associated while working for an enterprise fund, there is a chance that staff would be able to negotiate investments that may not be in an enterprise fund's best interests and create advantageous employment opportunities for themselves.

In commenting on a draft of this report, officials representing the enterprise funds indicated that investment proposals are reviewed by multiple levels of management in addition to the board of directors before the board makes investment decisions. They thought that it was unlikely that an investment manager could negotiate an agreement that would be personally advantageous. They also questioned the legal enforceability of employment restrictions in Central and Eastern Europe.

The State Department and AID stated that while this kind of prohibition is appropriate for government employees they believed it less appropriate for private sector employees. They said that in certain cases it may be beneficial for individuals who had been employed with an enterprise fund to later accept positions at fund-related companies. The enterprise funds believe that in certain cases, this kind of move may be instrumental in providing the companies with needed skilled personnel and thus help ensure that the investment becomes successful.

Conclusions

The enterprise funds are operating in a high-risk environment and some business failures can be expected to occur. This risky environment is precisely the reason for creating enterprise funds to establish successful models and encourage other investors to follow. As the funds become more experienced in workable business procedures in their host countries, problems are expected to decline.

With the limited amount of technical assistance funding provided to the enterprise funds and weaknesses found in financial services infrastructure, we believe that assistance funds would be better spent on making the funds' investments more viable rather than on noninvestment related activities. We recognize that the Polish, Hungarian, and Czech and

Slovak funds have identified weaknesses in the business skills of the entrepreneurs of the companies in which they have invested and have begun to shift additional assistance resources into programs to improve these skills. State and AID indicated that the executive branch's new oversight parameters for the enterprise funds will require that a fund obtain prior written approval from AID when it intends to provide technical assistance not directly related to current or potential investment activities.

Enterprise funds' policies prescribing that directors, officers, and employees guard against both actual conflict of interest and the appearance of impropriety do not appear to have been strictly enforced. The potential conflict of interest in the applications of noninvestment related technical assistance indicated that closer scrutiny and additional guidance may be needed in this area, particularly since U.S. government funds are involved.

Observations

Because the funds are private enterprises, we do not make recommendations to them. However, we believe the enterprise fund managers could improve their operations by

- focusing technical assistance resources on investment-related projects and
- enforcing the policies against both actual conflict of interest and appearance of impropriety.

U.S. Government Oversight of Enterprise Funds

The enterprise funds were designed to have limited U.S. government oversight and to permit them to respond quickly to the needs of the developing private sector in Central and Eastern Europe. This structure permitted the funds to operate independently from the traditional AID oversight structures, and AID's role in overseeing this assistance program has been narrowly defined. AID played a more limited advisory role in the implementation and programming of the enterprise funds than they ordinarily do in their grantee programs. The State Department and AID limited oversight of the enterprise funds to (1) an annual review by the AID Inspector General of audits performed by certified public accounting firms of the enterprise funds but not those of the funds' investments; (2) documentation of fund drawdowns and preparation of a monthly report on the grant cash balance; (3) a review of summaries of enterprise funds' investments; (4) brief semiannual reviews in Washington, D.C., on the status of the programs; and (5) brief visits to both the U.S. and overseas fund offices. According to AID officials, AID did not seek access to the books and records of the enterprise funds' investments.

Enterprise Funds Were Exempt From Most Assistance Regulations

The SEED Act intended that the enterprise funds be private, nonprofit corporations freeing them from many bureaucratic constraints. Section 201(c) of the SEED Act states that funding for the enterprise funds will "be made available to the Polish-American Enterprise Fund and the Hungarian-American Enterprise Fund and used for the purposes of this section notwithstanding any other provision of the law." The SEED Coordinator, AID General Counsel, and AID Inspector General interpreted this "notwithstanding" clause as exempting the funds from customary U.S. assistance program regulations.

The SEED Act provided for a State Department coordinator to oversee all SEED programs and activities. AID was charged to act as the grantor of the funding. The act required the enterprise funds to meet certain audit and financial record keeping requirements but did not include specific provisions for program monitoring or oversight by the executive branch agencies. The act required (1) the enterprise funds to have an annual audit by independent auditors and (2) each recipient of assistance to keep separate accounts of the assistance and, for audit purposes, grant full access to enterprise funds or their authorized representatives. The act, enterprise fund certificates of incorporation, and corporate bylaws, all gave the enterprise fund boards of directors authority to control the direction and decisions of the funds and, along with fund management, to design and implement programs.

An additional delineation of AID's oversight activities was made in the grant agreements between AID and the funds in May 1990.[1] These agreements stated that the funds' independent auditors would submit the required annual audits to the AID Inspector General for review of "the quality of audit work and adequacy of audit coverage." The agreements gave the AID Inspector General authority to have audit access to the books and records maintained by the funds on disbursements of grant or technical assistance, but did not provide further access to the enterprise funds' investments. Additionally, the grant agreements provided that AID could participate in semiannual reviews concerning the funds progress in accomplishing the purposes of the grant agreement.

In November 1990, the Foreign Operations, Export Financing, and Related Programs Appropriations Act, 1991 (P.L. 101-513) required that money made available for the Polish and Hungarian enterprise funds be expended "at the minimum rate necessary to make timely payment for projects and activities." The Senate Appropriations Committee report[2] concerning this legislation indicated that AID should limit its oversight, specifying that "AID's role is simply to write the check on a periodic basis when the enterprise funds determine that additional funding is necessary." The Conference Report[3] on this legislation stipulated that the conferees strongly emphasized that "AID is not to attempt to second-guess investment decisions." These reports called for a hands-off policy for enterprise funds' oversight by the executive branch. The SEED Coordinator, AID General Counsel, and AID Inspector General said that the reports reinforced that AID had limited oversight responsibility of the enterprise funds.

Audit guidelines prepared by the AID Inspector General in November 1991 limited its annual reviews to compliance audits.[4] The Inspector General noted in the guidelines that oversight was limited to the enterprise fund policies and procedures and are "not as strict and specific as those applied to other AID grantees." AID cited the grant agreements as the only binding documents for grantee requirements and that the funds were not expected to comply with standard Office of Management and Budget requirements

[1]The Czech and Slovak and Bulgarian funds' grant agreements, in April 1991 and November 1991 respectively, were nearly identical to the Polish and Hungarian funds' grant agreements in May 1990.

[2]Senate Report 101-519.

[3]House Report 101-968.

[4]Compliance audits conducted by the Inspector General were to determine the adequacy of an enterprise fund's audit report prepared by nonfederal auditors engaged to perform audits of a fund's programs and through this review determine the enterprise fund's compliance with (1) the SEED Act; (2) the grant agreement; and (3) grantee bylaws, articles of incorporation and policies and procedures.

for grant recipients.[5] The compliance audit guidelines were subsequently applied to all of the enterprise funds and the Inspector General has routinely performed annual compliance audits of the funds.

A February 1992 draft protocol agreement between AID and the funds specified how AID would carry out its responsibilities. The draft agreement provided for (1) documentation of fund drawdowns and preparation of a monthly report on the grant cash balance; (2) review of summaries of enterprise funds' investments; (3) semiannual reviews of the status of the programs; (4) visits to the funds by the AID project officer; and (5) a final evaluation of the funds. The final evaluation was projected to be conducted once the U.S. government funds were sufficiently disbursed to determine the use of enterprise funds as a means of delivering economic assistance. The draft protocol, although never signed, established a basis for a review process between AID and the enterprise funds.

The semiannual reviews, chaired by the State Department, focus on a presentation by an enterprise fund's management of the overall performance of the fund, the status of funding, and the resolution of problems that arise through other monitoring efforts. Prior to a semiannual review, an enterprise fund provides AID with a set of documents summarizing its operations. We attended a semiannual review of the Hungarian Fund in March 1993, which lasted 2 hours, and consisted of an overview of its investments and operations presented by the Fund's president, with limited time for questions. AID, with State's concurrence, denied our request to attend subsequent semiannual reviews. However, we obtained reports of these meetings, and the structure of the other semiannual reviews appeared to be similar to the perfunctory meeting we observed.

The draft protocol agreement provided for up to three visits annually at enterprise funds by the AID project officer, but envisioned that the time the project officer would spend with the enterprise funds would be 3 hours for each fund's U.S. office and 1 day for each fund's in-country office. Such time limitations significantly restrict the project officer's access to information and ability to conduct an in-depth assessment of the funds' performance.

In commenting on a draft of this report, enterprise fund officials noted that some visits to in-country offices by the project officer had lasted longer than the time foreseen by the protocol agreement, included some site

[5]Office of Management and Budget Circulars A-110, A-122, A-128, and A-133.

visits to investments, and meetings with company management. Nevertheless, the AID project officer stated that there had been inadequate time allotted for by the funds for his visits. However, in discussing the funds' assertions with the project officer, he said that during his more recent visits, there was a marked change in his ability to complete his planned review that was characterized by a greater degree of openness and cooperation from the enterprise funds.

The Appropriations Act for fiscal year 1993 (P.L. 102-391) transferred primary responsibility for the day-to-day implementation of SEED programs from AID's headquarters staff in Washington to AID's overseas offices. State and AID said that the overseas offices would be responsible to the Coordinator and subject to the guidance of the in-country Ambassador. AID's enterprise fund project officer in Washington, D.C., told us that while he would still be the contact person for enterprise funds, he was integrating AID field staff into his visits at enterprise fund offices abroad. He was accompanied by an AID field office staff member on his semiannual visits in the host countries in June 1993. According to the Acting Assistant Administrator of AID's Bureau for Europe, the change to field oversight of all SEED programs, including the enterprise funds, was part of a natural evolution from a quick start-up program in two countries to a longer term sustainable program with operations in over a dozen countries.

Congress Changes Monitoring

In 1992, the Congress considered measures that would provide more timely information about enterprise fund programs. In its June 1992 report on the fiscal year 1993 appropriations bill,[6] the House Appropriations Committee stated the Committee's intent that "any new relationships or structures which have not been justified to the Congress, which these Funds may enter utilizing appropriated funds, require notification."

In keeping with this notification directive, in the summer of 1992, the Polish Fund was asked by the House Appropriations Committee to provide additional information on the plans for the creation of the Equity Fund.[7] The original plan for management incentive compensation designed by the Polish Fund was to be calculated as a percentage of the net realized gains on all monies invested by the Equity Fund, including $50 million provided

[6]House Report 102-585.

[7]In discussing a draft of this report, the Polish Fund noted that since December 1991, acting on its own initiative, it had provided information to the State Department and AID and sought their approval of its plans for the creation of the Equity Fund. In February 1992, Fund officials held several meetings with cognizant congressional committees on this matter.

to the Polish Fund by the U.S. government. This plan had the potential of creating a very large compensation package for Fund management that would be based partly on the investment of U.S. government funds. After consultation with the Committee, the Fund changed the management compensation plan to include profit share compensation on only funds obtained from outside investors and not the U.S. government.

In another case, the House Appropriations Committee became concerned that the executive branch had failed to negotiate adequate provisions of the plan for eventual enterprise fund liquidation at the time of the original grant documents and took measures to change them. In December 1992, the Committee placed a hold on disbursal of enterprise funds' 1993 appropriations pending a renegotiation with the enterprise funds of provisions for eventual fund liquidation.

The Committee was concerned that the enterprise fund certificates of incorporation had given the boards of directors all decision-making authority regarding fund liquidation, with only the provisions that any remaining proceeds would be reimbursed to either a nonprofit organization or the U.S. government. The certificates of incorporation did not give the U.S. government a role in the liquidation decision.

In June 1993, AID officials presented the Committee with a revised proposal for liquidation. This proposal included provisions for greater U.S. government control of liquidation within certain time frames,[8] but would allow the enterprise funds to manage the liquidation.

The Committee also initiated its own inquiry of the Hungarian Fund's EurAmerica investment. As a result of this inquiry, the Hungarian Fund renegotiated its contract with the principal officers of the investment services company; a condition the Fund had to meet before it could receive further funding. Furthermore, the Committee specified additional conditions relating to circumstances requiring notification and salary limits for personnel of all the enterprise funds in Central and Eastern Europe or their major investments that it believed should be met before the enterprise funds received further appropriated funds.

In September 1993, AID informed the Committee of new procedures it would follow concerning executive branch oversight of enterprise fund activities. These procedures include consultation with the cognizant

[8]The administration must inform each fund 1 year before the time set for liquidation. This would not occur before 10 years or after 15 years of operation and would be upon mutual agreement.

congressional committees on various matters related to the funds. The new procedures call for written approval by AID of (1) enterprise fund structural changes such as establishing a subsidiary or affiliate with substantially the same personnel as the fund or (2) most investments in companies primarily involved in financial services. Also, a $150,000 cap on salaries of enterprise fund employees or staff of companies in which an enterprise fund holds a majority interest was established. AID said it would provide semiannual briefings to the congressional committees on the progress of each enterprise fund and that all noninvestment related technical assistance will be subject to AID approval. These changes in AID's relationship with the enterprise funds have been incorporated into the grant agreement with the new Russian-American Enterprise Fund. The executive branch will also include them in revised grant agreements currently being negotiated with the existing funds.

AID said that these changes in procedures "would take the burden of review and approval off the Congress and put that burden and the accountability that goes with it squarely with AID (in coordination with State)." It is unclear whether more stringent oversight will include greater access to source documents.

Conclusions

While AID's new approach to dealing with the enterprise funds will improve the executive branch's oversight of them, AID's oversight will still be less than its oversight responsibilities for other grantees. The enterprise funds will retain substantial autonomy in planning and carrying out their investment decisions. State and AID said that dealing with the funds in this manner will maintain the independence of the enterprise funds while ensuring better accountability. However, it is too early to know whether the procedures and agreements outlined by AID will be adequate.

Analysis of the Polish Fund's Investment Portfolio

We performed an analysis of individual companies in the Polish Fund's investment portfolio on December 31, 1991, June 30, 1992, and September 30, 1992. We selected December 31, 1991, as it was the first year for which the investments were audited by independent certified public accounting firms. June 30, 1992, represented 6 months of unaudited interim data, and September 30, 1992, was the last quarter that we could obtain unaudited interim data on investments, as well as it being the end of the Polish Fund's fiscal year. Data were compiled from the financial statements of individual companies in the Polish Fund's investment portfolio and converted from Polish zloty to U.S. dollars at the official exchange rate on the balance sheet dates.

Our analysis indicated that the Polish Fund's investments of equity and debt leveraged additional Polish investments of equity, debt, and vendor trade credit. As indicated in table I.1, every $1 of Polish Fund investment is associated with another $0.50 to $0.61 of other private investment in Poland, which in turn created a ripple effect for additional private sector business activity to supply and finance the investment's growth.

Table I.1: Leveraging Effect of the Polish Fund Investments

Dollars in millions

	Polish fund investment			Other private investment				
Date	Equity[a]	Debt	Total	Equity	Debt	Trade credit	Total	Leverage percent
Dec. 31, 1991	$51	$31	**$82**	$18	$15	$13	**$46**	56
June 30, 1992	70	32	**102**	21	13	17	**51**	50
Sep. 30, 1992	60	33	**93**	21	14	22	**57**	61

[a]At original cost.

Source: Compiled by GAO from financial statements of individual companies in the Polish Fund's investment portfolio.

While the Polish Fund's debt investments steadily increased over the three reporting periods, equity investments decreased as of September 30, 1992, primarily due to a cash refund of $8 million from the Polish Fund's joint venture subsidiary. Polish private investment steadily increased from $46 million as of December 31, 1991, to $57 million as of September 30, 1992, primarily due to growing trade credit as the investments developed their operations.

Other factors that affected the value of individual companies in the Polish Fund's investment portfolio were currency exchange losses and the impact of high inflation. The Polish Fund's equity position ranged from 25-percent to 100-percent ownership of the investment and was converted at the time of investment in Poland from U.S. dollars to Polish zloty. Any subsequent currency fluctuations increase or decrease the dollar equivalent of the original zloty investment, as well as the related subsequent value of earnings or deficits. By September 30, 1992, the Polish Fund's $30 million of zloty equity investments[1] experienced a cumulative loss of $4.6 million or 15 percent of the cost of its original investment. Thus, equity investors may be reluctant to invest where there is significant risk of currency devaluation. However, currency exchange losses affecting equity may be offset by an increase in zloty asset values due to inflation in Poland of 70 percent in 1991 and 43 percent in 1992. The extent of the offset, along with many other business performance factors, will ultimately be reflected in the amount realized upon the sale of the equity share.

The Polish Fund's debt holdings and interest thereon are repayable in U.S. dollars, thus the investments and not the Polish Fund, bear the loss or gain of any currency fluctuations. However, the Polish Fund is also an equity owner in 15 of 17 investments in which it has provided loans, and thus bears its share of currency exchange risk. If currency devaluations become severe, the large quantity of local currency needed to service the debt may threaten the viability of the investment.

We analyzed the composition of investment assets by industry, including the liquidity of cash to other assets and the extent of investment in fixed assets, receivables, inventories, and other assets. We also analyzed investment total revenues, total expenses, and the resulting gain or loss to determine their changes. However, we were precluded from a more detailed analysis because of a lack of detailed revenue and expense information and missing cash flow statements.

Composition of the Polish Fund's Investment Assets by Industry

As indicated in table I.2, the Polish Fund and Polish private equity and debt as of September 30, 1992, the last period of our analysis, were invested in the assets of 17 investments in 5 industries.

[1]The Polish Fund had additional equity investments of $30 million that were dollar denominated.

Table I.2: Composition of the Polish Fund Investment Assets by Industry as of September 30, 1992

Dollars in millions

		As percent of total					
Number	**Industry**	**Cash**	**Fixed assets**	**Receivables**	**Inventory**	**Other assets**	**Total**
4	Banking	62	2	35	0	1	**$64.7**
4	Services	57	25	7	3	8	**30.8**
4	Manufacturing	22	22	14	21	21	**24.3**
4	Agribusiness	2	61	33	3	1	**18.4**
1	Residential construction	1	28	6	55	10	**2.5**
17	Total	45	24	19	6	6	**$140.7**

Source: Compiled by GAO from financial statements of individual companies in the Polish Fund's investment portfolio.

Cash comprised the highest total percentage, or 45 percent of total investment assets as of September 30, 1992, which is highly liquid. The banking investments are the most liquid, with 62 percent of their assets in cash which, after reserve requirements, were available for small business loans and the start-up of the residential mortgage loan program. While the services investments appeared to have excessive cash, some liquidity is needed for working capital to meet start-up and operating expenses primarily for the printing business, and will be drawn down by fixed asset and inventory acquisitions. In the meantime, cash not needed for immediate operating purposes has been earning interest income in a U.S. bank as protection against devaluation of the Polish zloty.

Fixed assets represent amounts invested in equipment, buildings, and land, and comprise a total of 24 percent of total investment assets as of September 30, 1992. Nonbanking industries, particularly agribusiness with 61 percent of their fixed assets, required a significant level of investment in physical plant and equipment. Several facilities were under construction or renovation and most investments required purchase or replacement of capital assets. When placed in service fixed assets were depreciated primarily on a straight line method over their estimated useful service life.

Receivables from customers for loans and trade receivables comprised 19 percent of total investment assets as of September 30, 1992. Loans from banking investments to Polish small businesses represented 35 percent of their total assets and are generally repayable in U.S. dollars at annual interest rates from 12 percent to 16 percent over a period not to exceed

5 years. A few loans in Polish zloty are repayable at annual interest rates from 36 percent to 50 percent over a period from 1 month to 36 months. With 43-percent annual inflation in Poland in 1992, zloty borrowers obtained benefit that offset the higher zloty loan interest rate.

Inventory comprised 6 percent of total investment assets as of September 30, 1992, and were concentrated in the residential construction and manufacturing industries. Inventories comprised 55 percent of the residential construction industry as it starts operations with completed houses purchased by borrowers from the mortgage bank investment.

Other assets, which include prepaid expenses, comprised 6 percent of total investment assets as of September 30, 1992. Other assets consist primarily of goodwill, which is the excess amount of the non-Polish Fund equity over the market value of the investment's tangible fixed assets at the time of Polish Fund purchase. This intangible asset represents the value of the investment's business name, customers, product or service recognition, market area, and established organizational structure. Goodwill is being amortized on a straight-line basis over 5 years to 10 years from the date of Polish Fund purchase.

Investment Total Revenues, Total Expenses, and Resulting Portfolio Loss

The Polish Fund's investments showed a net loss of $4.3 million on $31.8 million of total revenues for the 9 months ended September 30, 1992, or 13.5 percent. Through the year ended December 31, 1991, the portfolio experienced a net loss of $1.6 million on $22.7 million of total revenue, or 7 percent. Financial data on over 21,000 large- and medium-size Polish private sector and public businesses issued by the government of Poland reported net losses of 1.3 percent for 1991 and 1.6 percent for 1992. Our analysis of the Fund's losses showed that they were primarily due to insufficient revenues, low manufacturing industry gross margins, and high expenses, particularly bad debts and currency exchange losses. As indicated in table I.3, the Polish Fund's investment revenue and expenses for the 9 months ended September 30, 1992, were generated from 17 investments in 5 industry segments.

Table I.3: Composition of the Polish Fund Investment Revenues and Expenses by Industry for the 9 Months Ended September 30, 1992

Dollars in millions

Number	Industry	Total revenues	Total expenses	(Loss)
4	Banking	**$4.8**	**$5.1**	($0.3)
4	Services	**10.2**	**10.7**	(0.5)
4	Manufacturing	**11.5**	**13.3**	(1.8)
4	Agribusiness	**4.7**	**6.3**	(1.6)
1	Residential construction	**0.6**	**0.7**	(0.1)
17	Total	**$31.8**	**$36.1**	($4.3)

Source: Compiled from financial statements of individual companies in the Polish Fund's investment portfolio.

Revenues were low as many of the investments were still building their administrative, marketing, supply, and distribution structures, or were just starting operations, such as the warehouse business and the mortgage bank. Polish Fund officials and company managers at the investments stated that they lost many of their former markets. Sales to both Polish state-owned companies and the former Soviet Union have decreased because they could not afford to buy the products. In some cases, barter transactions remain the only way to conduct business. According to an officer at one company we visited, its electronic circuit board products were sold to a former Soviet state enterprise which in turn arranged for a quantity of electric power as payment, which was subsequently brokered in Poland to receive cash.

To increase sales in international markets, the Polish Fund's investments found that they had to improve product quality, which required investment in equipment, the restructuring of operations, and the reorganization of personnel. Long neglected environmental concerns also face the management of investments. For example:

- The director of operations for an investment told us that they had previously manufactured circuit boards for Soviet television sets that had a high-product failure rate due to their lack of testing equipment. Using capital from the Polish Fund, the company purchased computer and testing equipment, which brought the failure rate to zero as defective boards were either reworked or scrapped, instead of shipped to the customer.

- At the Polish Fund's investment of a former state-owned printing plant that services 88 daily newspapers, we observed obsolete line-o-type presses in use. The company president stated that they are in the process of buying new equipment as breakdowns are frequent due to the advanced age of its presses and the thin paper available, which comes apart and clogs the equipment. The president also stated that since parts for the presses are difficult to obtain they must be repaired or made in their machine shop.
- We also observed at the printing plant that many manual operations were being performed, from hand counting and tying bundles of papers as they came off the press to loading the bundles onto waiting trucks for distribution. The company president explained that many workers had been guaranteed a job under the former state system and thus positions were created to employ them, however menial. The company was in the process of reorganization, which included an assessment of staffing requirements.
- Finally, we noted a thick accumulation of black soot covering many surfaces in the printing plant that reflected a lack of environmental and health concerns. The company president stated that they are trying to implement some health and safety regulations and have recently changed from lead based to vegetable based printing inks.

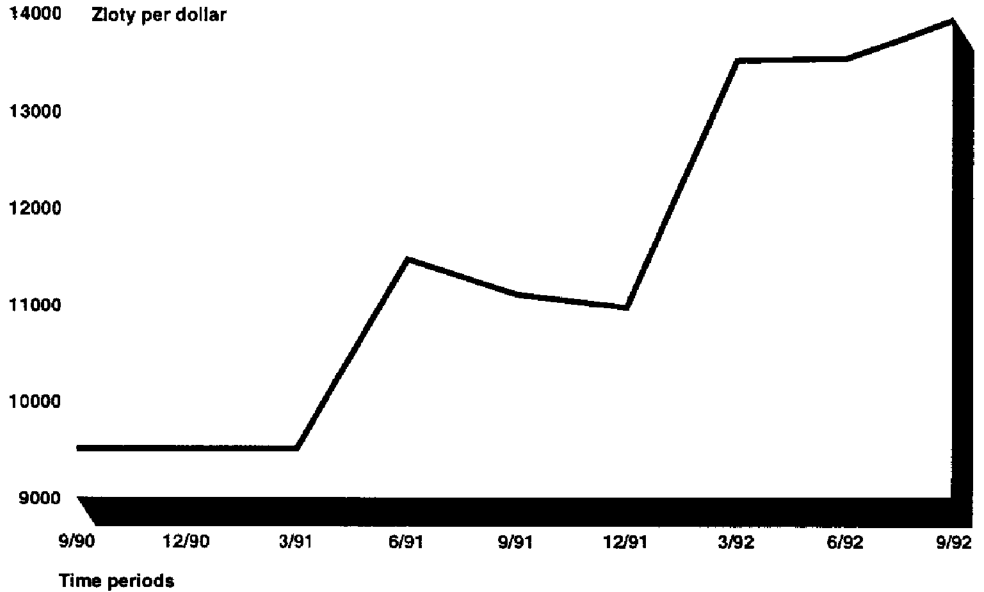
Gross margin is the profit generated from the difference between product sales and the cost to manufacture the product, but before expenses for selling, general, administrative, interest, and currency exchange. From the audited financial statements for the year ended December 31, 1991, the Polish Fund's four manufacturing investments generated an overall gross margin of 16 percent of sales. For three of the four manufacturing investments that reported unaudited detailed information for the 9 months ended September 30, 1992, overall gross margin was 19 percent, indicating some improvement assuming consistent classification and accurate reporting. We were unable to find industry statistics on overall gross margins for Polish manufacturing companies. We recognize that comparison with U.S. business statistics is problematic; however, we noted that U.S. manufacturing businesses surveyed by the 1991 Almanac of Business and Industrial Financial Ratios reported an overall gross margin of 30 percent of sales.

We noted that total expenses were high in relation to total revenue due to start-up situations and the need to build sales. However, expenses that significantly contributed to overall losses through September 30, 1992, were bad debts and currency exchange.

For the year ended December 31, 1991, bad debt expense of $1.2 million for the banking industry and $0.5 million for the manufacturing and services industries amounted to over 10 percent of revenue, and exceeded the overall loss of $1.6 million for the period. For the 9 months ended September 30, 1992, the banking segment recorded $1.2 million of bad debt expense, or 49 percent of interest income. Again, we were unable to find Polish industry statistics; however, these bad debt expense ratios are considerably more than the less than one-half of 1 percent of revenue for U.S. manufacturers and service businesses and 2 percent of interest income for financial institutions as surveyed by the 1991 Almanac of Business and Industrial Financial Ratios. Due diligence failure was a significant factor in the high bad debts in the banking segment. Western management, training, changes in customer attitude, and establishment of critical assessments of customer credit worthiness are factors being implemented by the Polish Fund to reduce bad debts expense in the future.

Currency exchange also contributed significantly to investment losses. When the Polish Fund's investments conduct business in currencies other than zloty, gains or losses result from fluctuations in exchange rates. Normally, these gains or losses do not have a significant effect on financial results when currencies remain fairly stable. However, the Polish zloty has had severe devaluation against the U.S. dollar and other major currencies. This devaluation creates accounting losses due to foreign exchange, particularly since most investment debt is repayable in U.S. dollars. Figure I.1 charts the 46-percent devaluation of the Polish zloty against the U.S. dollar from September 1990 when the Polish Fund began investments through September 1992.

Figure I.1: Devaluation of the Polish Zloty Against the U.S. Dollar



Source: International Monetary Fund, International Financial Statistics.

For the year ended December 31, 1991, we identified $300,000 in net losses due to currency exchange and $2.1 million of net losses for the 9 months ended September 30, 1992. Financial data provided by the Polish Fund's investments did not always identify currency exchange gains or losses and some amounts may be classified in other revenue or expense accounts.

Comments From the Department of State and the Agency for International Development

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

United States Department of State

Washington, D.C. 20520

DEC 23 [illegible]

Dear Mr. Conahan:

We are pleased, on behalf of the Chief Financial Officer, to provide the Department of State and the Agency for International Development joint comments on your draft report, "ENTERPRISE FUNDS: Evolving Models for Private Sector Development in Central and Eastern Europe," GAO/NSIAD-94-77, GAO Job Code 472304.

Thank you for the opportunity to comment on your draft report and for the courtesies extended by your staff in the conduct of this review.

If you have any questions concerning this response, please call Mr. Ralph Johnson, State - EUR/EEA, at 647-0710 or Mr. Daniel Cassidy, AID - ES, at 647-6811.

Sincerely,

Albert E. Fairchild
Acting Director
Office of Management Policy

Enclosure:
As stated.

cc:
GAO - Mr. Richardson
State - Mr. Menzies
AID Mr. Cassidy

Mr. Frank C. Conahan,
Assistant Comptroller General,
National Security and International Affairs,
U.S. General Accounting Office.

GAO Draft Report "ENTERPRISE FUNDS: Evolving Models for Private Sector Development in Central and Eastern Europe, GAO/NSIAD-94-77, GAO Job Code 472304

The GAO report appears to be a balanced and timely assessment of this new foreign assistance vehicle. It highlights many of the early difficulties encountered by the Enterprise Funds and details some of the efforts undertaken to address those difficulties. We fully agree with the overall encouraging conclusion of the report. Even at this early juncture in the Funds' operations, the GAO found that they have already begun to produce positive results -- such as creating jobs, increasing business experience and encouraging local institutions to replicate small loan programs. In this response, we offer information on further steps that have been taken to address operating difficulties since the report was drafted. In addition, the U.S. Agency for International Development (USAID) has committed to doing a mid-term evaluation of the enterprise fund project later in FY94. The GAO's findings and conclusions will be most helpful in orienting that effort.

The Enterprise Fund Concept

As the title of the report suggests, the enterprise funds are an "evolving" model for U.S. foreign assistance. They are private corporations designed as a means to quickly distribute investment capital to countries in Central and Eastern Europe undergoing the difficult transition to market economies. In the belief that the U.S. government was not in a position to judge the best way to achieve this goal, and in accordance with the SEED Act, USAID and State Department gave the Funds maximum flexibility in developing their programs. Each Fund acts independently of the U.S. Government in making loans or other investments and in delivering technical assistance. Each Fund also has its own Board of Directors which must accept the responsibility for the success or failure of these endeavors. Nonetheless, when problematical Enterprise Fund practices came to light in 1993, (as detailed in chapter 4 of the report), the Administration and Congress recognized that more refinement of the oversight role exercised by Enterprise Fund management, their Boards of Directors and the Executive Branch was necessary.

In cooperation with the Congress and the Funds themselves, we fashioned new steps to improve Fund oversight. These are being incorporated into revised grant agreements for the existing enterprise funds and have already been incorporated into the grant agreement with the new Russia Fund. We have also taken steps to improve the cooperative framework within which the Administration and the enterprise funds interact. While we agree with your conclusion (p. 99) that it is "too early to know" whether the new oversight procedures and agreements will preclude

other problematic situations from occurring in the future, we believe that our approach retains the critically important autonomy of the Funds in planning and carrying out their investment decisions.

Comments on Observations in Chapters 3 and 4

The remainder of this appendix outlines our comments on the observations made by the GAO in chapters 3 and 4.

GAO Observations, Chapter 3 concern the Enterprise Funds' need to: 1) develop and enforce standard and consistent investment agreement provisions (e.g., that specify accounting principles, types of financial statements, etc., needed from investees); 2) modify investment agreements to require that annual audits include issuance of a report on internal controls; 3) assess the capability of each investment to prepare appropriate financial statements with the minimum level of financial information prior to disbursing funds; and, 4) provide technical assistance (TA) as necessary to accomplish this.

See comment 1.

Comment. Since the report starts with the inception date of Enterprise Funds, we would like to note that the Funds were under tremendous pressure to set up their operations, hire management teams and make investments quickly. Comprehensive record keeping was understandably not an initial top priority. Moreover, Western accounting methods and conventions were virtually unknown in the countries of Central and Eastern Europe (CEE) when the Enterprise Funds first began operations.

Investee reporting has improved over time and the Enterprise Funds are now putting far more effort into monitoring their investees' performance. We agree with the report's conclusion that it should now be a major focus as portfolios grow and the Enterprise Funds become more established, and note that much has already been done.

As reported to USAID, the Enterprise Funds have all started requiring periodic financial statements (monthly or quarterly) from portfolio companies and annual audits for larger investees, directed responsibility for individual investments and, for equity holdings, seats on the investees' board of directors. The Hungarian American Enterprise Fund, Czech and Slovak American Enterprise Fund (CSAEF) and the Bulgarian American Enterprise Fund have all started utilizing a comprehensive computerized investment tracking system. The CSAEF is also urging its larger investees to use a specified computer software to generate comparable financial statements and is starting to utilize more standardized loan documentation. Finally, there is a realization on the part of all the Enterprise Funds that more technical assistance needs to be employed in this area. More specialists are being hired to undertake management and financial training.

The Executive Branch will discuss with the Boards of Directors of the various Enterprise Funds further steps that might be taken to improve the financial reporting of their portfolio companies.

GAO Observations, Chapter 4 concern the need for the Enterprise Funds to: 1) establish training programs for their investment managers to more effectively function in the local business environment; 2) focus TA resources in the first instance on investment-related projects; 3) establish a policy prohibiting staff from accepting positions with fund-related companies for some specified period of time after terminating their employment with the funds.

See comment 2.

Comment. Regarding the first observation, we agree that effective training programs would be desirable, however, we would note that the enterprise funds are relatively new institutions in new environments. Currently, we are not aware of any formal training programs available that deal specifically with economies in the throes of privatization on the scale of what is happening in CEE. We doubt the Funds themselves have the staff or time to develop formal programs internally. Over time it is likely that the staff's on-the-job training probably will prove to be the most effective learning method available.

See comment 3.

On the second observation, regarding technical assistance on investment-related projects, the Administration's new oversight parameters with the Funds require that the Funds obtain prior written approval from USAID when it intends to provide technical assistance not directly related to current or potential investment activities (as noted above, this requirement is included in the Russian American Enterprise Fund grant and will be incorporated in the revised grants currently being negotiated for the Central and East European Funds).

See comment 4.

A policy of "prohibiting staff from accepting positions with fund-related companies" is an appropriate practice in government circles, but far less so in the private sector in which the enterprise funds operate. We would not support imposing such a prohibition on the Fund's local staff, especially since one of the developmental impacts of the fund's operations is the training of personnel in private sector practices. Subsequent hiring away of these staff because of their competence is a measure of the success of the program. Moreover, there may be cases where the funds, for purposes of sound management, want to place fund staff, etc., with fund-related companies, including investees. We will, however, work with the Enterprise Funds to protect against conflicts of interest in the interactions between fund staff and investees.

The following are GAO's comments on the Department of State and the Agency of International Development's letter dated December 23, 1993.

GAO Comments

1. We recognize the difficult business environments in which the enterprise funds operate. It is precisely for this reason that the enterprise funds have to standardize and enforce the agreements with their investees regarding financial reporting.

2. We have deleted the observation regarding the creation of training programs for investment managers.

3. We have included information on the executive branch's new oversight parameters for technical assistance projects not directly related to current or potential investments.

4. We have revised our report to include this information and have deleted our suggestion that the funds restrict employees from subsequently working for companies related to an enterprise fund.

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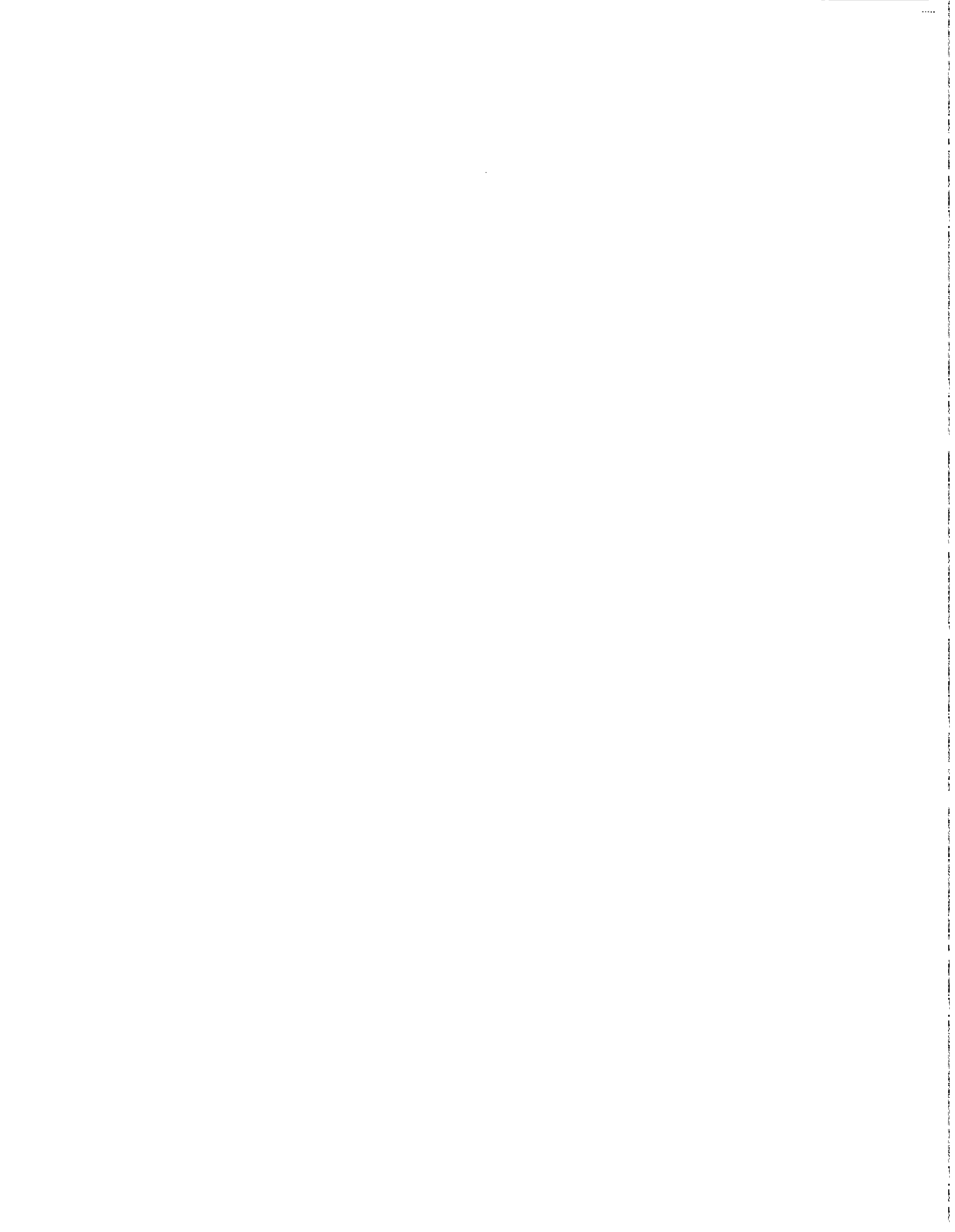

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