

**Audit of USAID/Bosnia-Herzegovina's  
Business Development Program  
for the Period April 1, 1999 through March 31, 2000**

**Audit Report No. B-168-01-001-P  
December 21, 2000**

**Budapest, Hungary**



U.S. AGENCY FOR  
INTERNATIONAL  
DEVELOPMENT

*RIG/Budapest*

December 21, 2000

**MEMORANDUM**

**FOR:** USAID/Bosnia-Herzegovina, Edward L. Kadunc, Jr.

**FROM:** Director of Audit Operations, Budapest - Nathan S. Lokos

**SUBJECT:** Audit of USAID/Bosnia-Herzegovina's Business Development Program for the Period April 1, 1999 through March 31, 2000

This is our final report on the subject audit. In finalizing the report, we considered your comments on the draft report and included them in Appendix II.

Based on the results of the audit, we found that the loan volume during this one-year period—\$5.4 million in loans recommended—represented only about 5 percent of the targeted amount of \$120 million. We noted that there were various reasons why loan activity did not meet the targeted amount during this period, including an increasing emphasis on loan quality and monitoring, shifting of resources to pursue delinquent borrowers and fraudulent banking activities, the weakening economy, the Kosovo war in the Balkans, and growing competition from other lenders.

This report makes no new recommendations; therefore, no action on the report is required by USAID/Bosnia-Herzegovina.

We appreciate the cooperation and assistance provided to the auditors on this assignment.

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## Background

Bosnia-Herzegovina declared its independence from the former Socialist Republic of Yugoslavia in March 1992, following the lead of Slovenia and Croatia which declared their independence in 1991. The move to independence precipitated a war in Bosnia-Herzegovina that lasted from 1992 until the signing of the Dayton cease-fire agreement on October 10, 1995. Following the cease-fire, Bosnia-Herzegovina was faced with keeping the peace and restructuring its war-torn economy. The Dayton Agreement viewed economic rehabilitation and reconstruction as an essential element in achieving peace. The Agreement negotiators believed that the people must have an economic stake in the process; therefore, economic reconstruction, economic institution building, and promoting a market economy were deemed to be major factors in ensuring lasting peace.

In 1996, there were signs of economic recovery such as repairs to basic infrastructure. However, many key economic institutions and businesses were not fully functioning. The country's banking system was technically insolvent and burdened with non-performing loans. On March 29, 1996, the House Joint Resolution 170 (Public Law 104-122) appropriated \$198 million for assistance to Bosnia-Herzegovina to address some of these concerns regarding the physical and economic infrastructure. These funds were to be used for economic revitalization (\$145 million); police training and monitors (\$45 million); demining (\$5 million); and operating expenses (\$3 million).

USAID became involved in May 1996 when the Assistant Administrator for the Bureau for Europe and the New Independent States (now called the Bureau for Europe and Eurasia) authorized the five-year \$278 million Bosnian Reconstruction Finance Facility program that is now known as the Bosnia Development Program (BDP). These funds were to be used for financial support of post war reconstruction and economic revitalization, as well as for increasing employment of the general population, refugees, and demobilized soldiers. On May 7, 1996, a grant agreement was signed between the United States and Bosnia-Herzegovina to obligate the program's initial \$27.5 million. This amount was transferred by USAID to Bosnia-Herzegovina in July 1996. As shown in the following table, USAID has not transferred any funds in this reporting period, but has transferred a total of \$232.9 million to Bosnia-Herzegovina since the inception of the program.

**SUMMARY OF OBLIGATIONS AND FUNDS TRANSFERS  
AS OF MARCH 31, 2000**

<b>OBLIGATING DOCUMENT</b>	<b>AMOUNT (millions)</b>	<b>DATE OF FUNDS TRANSFER</b>
Grant Agreement	\$27.5	July 1996
Amendment #1	12.5	November 1996
Amendment #2	19.5	May 1997
Amendment #3	40.0	September 1997
Amendment #4	30.0	April 1998
Amendment #5	65.4	September 1998
Amendment #6	38.0	February 1999
Total Obligated and Transferred	\$232.9	

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## **Audit Objectives**

The objective of this concurrent audit was to determine whether USAID/Bosnia-Herzegovina and the implementing contractors used economic revitalization assistance funds designated for the Business Development Program for the purposes authorized under the Grant Agreement and Public Law 104-122.

The Office of Inspector General has issued periodic reports on the Business Development Program. This report is the ninth such report on the program.<sup>1</sup> Appendix I contains a discussion of the scope and methodology for the audit.

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<sup>1</sup> See Audit Report Nos.: B-168-97-002-P, dated March 26, 1997; B-168-97-006-P, dated June 27, 1997; B-168-98-001-P, dated October 10, 1997; B-168-98-004-P, dated March 26, 1998; B-168-99-001-P, dated October 30, 1998; B-168-99-004-P, dated August 18, 1999; and B-168-00-004-P, dated February 25, 2000. Also, see Memorandum Report No. B-168-98-003-S, dated July 21, 1998.

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## Audit Findings

### **Did USAID/Bosnia-Herzegovina and the Implementing Contractors Use Economic Revitalization Assistance Funds Designated for the Business Development Program for the Purposes Authorized Under the Grant Agreement and Public Law 104-122?**

USAID/Bosnia-Herzegovina and the implementing contractors generally were using the economic revitalization assistance funds designated for the Business Development Program (BDP) for the purposes authorized under the grant agreement and Public Law 104-122. However, of four borrowers visited this period, one did not use loan funds for agreed-upon purposes and the other three had used loan funds to make final payments for goods and/or services that had only been partially delivered. Moreover, civil and criminal cases are being pursued against four agent banks that did not fulfill their responsibilities under bank agency agreements.

The BDP has experienced similar problems with some borrowers and banks in the past. In such cases, USAID/Bosnia-Herzegovina has taken corrective action against those borrowers and banks that include civil and criminal remedies.

#### **BDP—What can funds be used for?**

Bosnia-Herzegovina's physical infrastructure sustained extensive damage during the war. Reconstruction requires financial resources and long-term credit for the rehabilitation and revitalization of Bosnian businesses, which could then offer sustainable employment opportunities for the general population, especially demobilized soldiers and refugees. In response to this requirement, USAID designed the BDP, a \$278 million balance-of-payments initiative intended to "jump-start economic growth and generate employment opportunities for the general population." The program was officially initiated with the signing of the grant agreement on May 7, 1996. Of the planned \$278 million available for the BDP, \$256 million was allocated for the loan program and \$22 million for technical assistance, training, and support costs.

**Loan Program** To implement the BDP, USAID signed a task order with Development Alternatives, Inc., (hereafter referred to as Development Alternatives) on May 16, 1996, to establish and operate Business Finance.

As the primary implementor of the BDP loan program, Business Finance, with offices in Sarajevo, Tuzla, Banja Luka, and Brcko, recommends loans to USAID/Bosnia-Herzegovina for approval. The task order set targets of \$45 million in loan recommendations which were expected to create 6,750 jobs through December 31, 1996. After that time, USAID/Bosnia-Herzegovina expected Business Finance to recommend \$10 million in loans per month, which would generate 1,500 jobs per month. USAID/Bosnia-Herzegovina formalized these targets with Development Alternatives in a task order modification that became effective on May 1, 1997, and continued the targets in a subsequent contract with Development Alternatives that expired on September 30, 1998.

USAID set similar expectations for The Barents Group, the new contractor who assumed responsibility for Business Finance on October 1, 1998. According to the terms of Barents' contract, a volume of \$10 million worth of recommendations on the average, with an associated employment impact of 1,500 jobs was expected each month during the contract period. Applying the contract terms to the one-year period ending March 31, 2000, Business Finance was expected to increase loan recommendations by \$120 million and to create 18,000 new jobs.

The total authorized on-lending program amount is \$256 million. However, USAID has obligated and transferred funds totaling \$232.9 million and believes that it will not need to obligate and transfer the remaining \$23.1 million balance of authorized funds.

**Technical Assistance** The Barents Group's contract also provides for training to (1) enable Bosnian bankers to offer a range of financial services to private sector companies and undertake responsibility for a portion of the lending activity and (2) prepare Bosnian counterparts to eventually assume responsibility for the management of the program.

In addition to creating Business Finance, USAID also signed a task order on June 28, 1996, with The Recovery Group to provide assistance to businesses seeking loans from the BDP and World Bank credit programs and to assist enterprises in achieving long-term viability. To meet its objectives, The Recovery Group established Business Consulting which now has offices in Sarajevo, Tuzla, and Banja Luka. On November 1, 1999, Deloitte & Touche, selected through a competitive procurement, replaced The Recovery Group as the program's Business Consulting contractor.

USAID set work objectives for Deloitte & Touche to facilitate the turnaround of struggling borrowers, provide essential consulting services to all other borrowers, and assist selected firms to prepare for privatization.

### **BDP Status—What were funds used for?**

**Loan Program** Generally, borrowers were using the BDP loan proceeds to finance building reconstruction, equipment purchases, raw material acquisitions, and some operational expenses. Since the program's inception through March 31, 2000, the \$135.7 million in loans recommended by Business Finance fell short of the \$256 million target by \$120.3 million. Furthermore, the Mission had obligated and disbursed \$232.9 million to the Government of Bosnia-Herzegovina to assist with their balance of payment needs by financing the approved loans while the Government of Bosnia-Herzegovina had disbursed \$125.4 million for the loans. (See Appendix IV for details on budgeted, obligated and disbursed amounts.)

As of March 31, 2000, the program bank accounts consisted of \$176 million representing undisbursed funds, loan principal and interest payments, and interest earned on the accounts which is to be used for program needs. USAID is working on various strategies to use these funds for future program goals such as: creating a deposit insurance entity, expanding the program into additional areas in Bosnia, and mortgage lending.

In previous reporting periods, shortfalls were attributed to systems and personnel restructuring intended to streamline loan production, a shortage of lending officers available to analyze and process applications and a change in contractors. During this reporting period, loan volume decreased from the prior one-year period—from about \$46.3 million to \$5.4 million. According to program personnel, this shortfall was the result of factors such as the:

- Increasing emphasis on loan quality and loan monitoring
- Shifting of resources to pursue delinquent borrowers and fraudulent banking activities
- Weakening economy and Kosovo war in the Balkans
- Growing competition from other lenders.

**Technical Assistance** Business Finance conducted seminars and workshops for bankers, prospective borrowers, and Business Finance staff during this one-year reporting period. The seminars covered topics such as bank strengthening, the loan application process, and problem loan management. The internal audit group, and other members of Business Finance, provided training in disbursement procedures for agent bank personnel, and field and lending associates.

To further strengthen the banking community, USAID has created another program called the Bank Development and Training Program. This program began operations in late February 2000 and will provide in-bank advisory services and formal classroom training. A team of five resident advisors will transfer banking skills in strategic planning, internal audit and controls, accounting, liquidity management and other treasury functions, bank operations management, and information technology.

Business Consulting has been working with USAID and other parties in developing a program on privatization preparation assistance. It has also coordinated efforts with Business Finance and taken a proactive approach by focusing on companies that could become future delinquents if corrective actions are not taken. New training programs, such as internet marketing and market intelligence surveys, are also being developed.

(See Appendix III for detailed information on the status of the BDP.)

### **Results of Audit Tests**

Our audit this reporting period focused on the status of loan activities and the adequacy of agent bank and loan monitoring efforts. In carrying out our audit work, we determined whether we could rely on the work of the Business Finance Internal Audit Unit which conducts ongoing audits of Business Finance activities. As in previous reporting periods, we reviewed their qualifications and independence and tested the results of their work. Based on our reviews and tests, we concluded that we could rely on the auditors' work. (Appendix I contains a more detailed description of our audit scope and methodology.)

The audit unit, consisting of a Bosnian audit manager and two Bosnian auditors, performs site visits to agent banks and borrowers, and reviews operations within the Business Finance organization. Business Finance appointed the Bosnian audit manager towards the end of the reporting period fulfilling its mandate to move Bosnians into positions of more responsibility in the organization. As previously reported, we believe that this unit plays an important role in ensuring accountability for this USAID-funded program.



## **Borrowers**

Since the program began, RIG/Budapest and Business Finance auditors have performed tests of both borrowers and agent banks. Borrower visits focused on borrowers suspected of possible irregularities in their use of loan funds. During this reporting period, one borrower appeared to have misused about \$175,000 of the loan due to lack of proper documentation. Three other borrowers are being watched closely as the disbursement transactions had not yet been completed. One borrower paid a supplier over \$237,000 based on a preliminary invoice instead of a final invoice. In another case, a borrower paid a supplier \$103,000 for sewing machines, most of which have not yet been delivered, while yet another borrower paid \$47,000 based on an invoice for the construction and installation of a kiln which has not yet been completed.

Business Finance is pursuing claims against borrowers who have not repaid their loans and have not used loan funds for agreed-upon purposes. As of March 31, 2000, Business Finance was actively pursuing 75 court cases involving foreclosure, litigation, and criminal actions that had a total claim value of over \$28 million.

In response to our prior audit recommendation addressing inadequacies in monitoring, Business Finance initiated a monthly borrower contact monitoring program which tracks and reports on site visits and other forms of borrower contacts. Visits by program personnel are currently averaging over 400 each month. This increased monitoring effort has played a role in reducing total delinquencies as of March 2000 to their lowest level since December 1998.

USAID initially loaned funds to state-owned enterprises in order to jump-start the Bosnian economy. However, to support the private sector, USAID ended this practice and shifted its lending exclusively to private enterprises. According to program personnel and relevant documents, loan collection from state-owned enterprises has proven especially difficult as local politicians exert excessive control over company operations. It appears that millions of dollars are being siphoned off in anticipation of future privatization deals. As a consequence, USAID loans and other expenses, such as salaries and utility bills, are not being paid. USAID Business Finance is vigorously pursuing collection of these loans and working with local and international authorities to investigate irregularities. As noted by program personnel and relevant documents, several examples are shown below to illustrate the extent of these problems. Additional examples are shown in Appendix V.

### Company 1:

Although Bosnian officials admit that the timber and sawmill divisions have a large volume of sales (e.g. logs valued over \$1 million), they cannot explain where the revenue is going. The Business Finance loan as well as salaries, taxes, electric bills, gas bills, and other expenses have not been paid.

Company 2:

Bosnian officials admit embezzlement of \$700,000 by a director. However, no charges have been filed against this "politically connected" individual. The acting director admitted that monthly sales of up to \$260,000 could easily pay monthly obligations and expenses. Unfortunately, "secret phone calls and threats from powerful people" force him to release finished products for which the company does not get paid. As a result, the Business Finance loan, salaries, and other expenses remain unpaid.

Company 3:

The valuable quarry operation has been split off from the ailing soda factory in a questionable pre-privatization play. Up to 100 private trucks a day leave the quarry loaded with gravel but the director cannot describe where the revenue from those trucks goes as he "could be replaced for divulging that information." Monthly income probably exceeds \$350,000, but the Business Finance loan and other expenses such as salaries remain unpaid. Any worker who protests or does not show up for work is fired.

**Agent Banks**

Although the bank visits identified several problem areas, improvements were noted from prior periods. For example, improvements in the monitoring of loans and the disbursement verification process were noted after Business Finance instituted new disbursement procedures. However, the banks should continue to work on these areas. Of the 19 visits made to 17 agent banks, Business Finance has classified the banks in one of five categories ranging from superior to unacceptable. However, no banks were rated superior. Two banks were rated as satisfactory, five as acceptable but in need of improvement, four banks as marginally acceptable but in need of improvement and four as below acceptable and in need of significant improvement. These four banks were downgraded by Business Finance; two became service banks (i.e. can not generate new loans but can only service existing loans) and two had their agreements cancelled. Two banks were not rated at the time of our audit.

Currently, Business Finance and local authorities are pursuing two civil (claims totaling \$1,330,000) and two criminal cases against four agent banks visited in prior reporting periods. We had recommended that these banks be removed from the program due to violations of their agent bank agreements. Updated details of the cases against these banks are noted below.

#### Bank 1:

This is the first bankruptcy case in the country and has been assigned to the Federation Ministry of Finance. USAID, on behalf of the Government of Bosnia-Herzegovina, has an outstanding claim for an undisbursed amount of \$730,000 which remains at risk in the bank. As this bank is in liquidation, Business Finance has been working with a receiver. An acting receiver has been appointed as the original receiver was attacked and beaten up outside his home.

The criminal court issued a 54 page verdict which convicted numerous bank officials of fraudulent activities. Three bank officials and two cashiers received jail sentences ranging from six months to four years and three months. Two other employees received probation which could result in jail terms of three to six months if they violate the terms of their probation. The director, who received the sentence of four years and three months, served about 13 months in detention in Zenica prison while the case was in deliberations. It's unclear if he served any other jail time after the verdict as Business Finance is no longer tracking the criminal case and there may have been appeals to overturn or reduce the jail sentences.

#### Bank 2:

A civil case resulted in a settlement in June 1999 ordering this bank to pay USAID, on behalf of the Government of Bosnia-Herzegovina, a sum totaling \$600,000 as of December 1999. As no judgement has been paid, penalty interest at the rate of 18% a year will continue to accrue. There were also liabilities to other donors (e.g. Swiss Embassy, American Embassy and World Vision). However, a full balance sheet has never been presented to creditors so the real accountability of the bank is not known. The Swiss Embassy is sponsoring a detailed review of the bank by a major accounting firm, and USAID anticipates criminal charges. Business Finance has been working with the same acting receiver as the previous bank case.

The bank is owned by a well-known family in Bosnia with alleged criminal connections. In August 2000, one of the bank's owners was arrested at night by local police with a U.N. policeman and a local reporter in attendance.

Bank 3:

Business Finance is pursuing foreclosure actions against individual borrowers involved in fraudulent activities. Business Finance is negotiating with the bank to cover any losses on these loans if the borrowers do not pay the outstanding loan balances. If the borrowers do not pay and the bank accepts responsibility, the bank's potential exposure could be as high as \$1.4 million.

As of August 2000, the bank had collapsed, and a criminal trial was scheduled to start in September 2000.

Bank 4:

Business Finance is negotiating with this bank to cover the possible losses arising from a potential foreclosure action against a borrower. Business Finance believes that the bank was negligent in not filing a mortgage for this borrower on a timely basis, thus placing it in a subordinate position. If the borrower does not pay and the bank accepts responsibility, the bank's potential exposure could be as high as \$440,000. Business Finance intends to collect the loan from one or both parties.

Business Finance has also made a claim against three bank officials involving fraudulent activities with another borrower. There is an open investigation regarding a criminal case. Various delays have been encountered in the court system.

**Conclusion**

On behalf of the Government of Bosnia-Herzegovina, USAID and its contractors are pursuing all possible means to collect the loans and to recover funds. Their efforts have been hampered by an environment that is fraught with pervasive fraud and corruption. During this reporting period, USAID and the RIG/Budapest office collaborated with the United States General Accounting Office in their efforts to address this problem. In July, 2000, the United States General Accounting Office issued a report entitled "Bosnia Peace Operation: Crime and Corruption Threaten Successful Implementation of the Dayton Peace Agreement". The report concluded that:

"Endemic crime and corruption is impeding the successful implementation of the economic, political, and judicial reform goals of the Dayton Peace Agreement. According to senior U.S. and international officials and numerous studies, corruption is impeding progress towards implementing the Dayton Agreement, and conditions for the complete withdrawal of NATO-

led forces will not be met unless Bosnian officials make concerted efforts to address this problem. This, however, has not happened: crime and corruption continue to pervade Bosnia's political, judicial, and economic systems."

Furthermore, the report recommended that:

"...the Secretary of State take the lead in conducting a reassessment of the U.S. strategy for assisting Bosnia to achieve the objective of establishing a democratic government and a market economy."

The report's primary recommendation was that:

"...the Department of State evaluate unilateral and multilateral options for modifying the type and amount of assistance provided (including a review of the appropriateness of providing general budget support), place strict conditions on future assistance, and possibly suspend assistance until Bosnian political leaders independently demonstrate their determination to fight organized crime and corruption."

We believe that the problem is of such magnitude that it can only be addressed through a massive and coordinated response on the part of the international community. Although some progress has been made, efforts to date have been inadequate in bringing about substantive change. We are not making a recommendation at this time as the General Accounting Office's recommendation covers all assistance to Bosnia.

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## **Management Comments and Our Evaluation**

USAID/Bosnia-Herzegovina officials agreed with the content of our report and their comments are included as Appendix II to this report.

## **Scope and Methodology**

### **Scope**

The Office of the Regional Inspector General/Budapest (RIG/Budapest) is conducting a concurrent audit of USAID's Business Development Program (BDP) activities in Bosnia-Herzegovina in accordance with generally accepted government auditing standards. From July 1996 through March 2000, USAID/Bosnia-Herzegovina obligated and disbursed \$232.9 million through BDP to the Government of Bosnia-Herzegovina to assist with their balance of payment needs. Of the \$232.9 million transferred to the Government of Bosnia-Herzegovina, \$125.4 million has been disbursed as loans. From April 1999 through March 2000, the reporting period of this audit, USAID/Bosnia-Herzegovina disbursed \$10.2 million.

In conducting our audit, we substantially utilized the work of the Business Finance Internal Audit Unit. In order to rely on their work, we reviewed the generally accepted government auditing standards pertaining to an auditor's reliance on the work of other auditors. In accordance with those standards, we were satisfied as to the auditors' competence and objectivity. We also evaluated and tested their work through inquiries and reviews of internal audit reports, working papers and audit methodologies. We conducted the audit from April 2 through July 1, 2000, at the USAID, Business Finance and Business Consulting offices in Sarajevo.

We did not audit the three BDP bank accounts maintained by the Central Bank of Bosnia-Herzegovina (formerly the National Bank) during this reporting period, but we examined controls over those accounts. We also did not audit the Fund Accountability Statement shown in Appendix IV. We performed limited work on the Business Consulting activities.

### **Methodology**

Audit methodology included file reviews, interviews and data analysis. We reviewed amendments to the Grant Agreement between Bosnia-Herzegovina and the United States of America for Reconstruction Finance Facility, program documents, and contracts to determine BDP objectives and restrictions.

## Appendix I

We reviewed accounting records and tested compliance with the loan procedures and the agent bank agreements to assess whether internal control procedures were adequate and being followed. We interviewed various officials (e.g. USAID, contractor, Bosnian, and others) about problems in the program, and the adequacy of actions taken to address these problems.

Since the inception of the program, RIG/Budapest and Business Finance auditors have visited 119 of the 402 borrowers who have received loan disbursements. In addition, 27 repeat visits have been made to some of the borrowers by both Business Finance and RIG/Budapest. (See table below.) The Business Finance Internal Audit Unit has conducted 70 visits while RIG/Budapest has made 49 visits. The visits were conducted to verify the existence of the borrowers' businesses and their use of the loan proceeds. Equipment and raw material purchases and reconstruction efforts that were funded by the loan proceeds were observed during these visits.

### BORROWER VISITS

	<b>Current Period</b>	<b>Cumulative</b>
First Visits	4	119
Repeat Visits	0	27
Total	4	146

RIG/Budapest and Business Finance auditors have also conducted 70 visits, 44 of which were repeat visits, to agent banks responsible for servicing most of the loans in the program. (See table below.) The Business Finance Internal Audit Unit has made 39 visits while RIG/Budapest auditors have conducted 31 visits. When appropriate, documentation was reviewed to determine how the banks were monitoring the use of the loan proceeds, as well as the agent banks' internal records of receipt and disbursement of loan funds. There was also a selective review of invoices submitted by the borrowers for purchases made using loan proceeds.

**AGENT BANK VISITS**

	<b>Current Period</b>	<b>Cumulative</b>
First Visits	5	26
Repeat Visits	14	44
Total	19	70





*United States Agency for International Development*  
Sarajevo, Bosnia and Herzegovina

November 27, 2000

MEMORANDUM

TO: Nathan S. Lokos, RIG/Budapest

FROM: Robert P. Jacobs, Acting Mission Director /s/

SUBJECT: Audit of USAID/Bosnia-Herzegovina's Business Development Program for the Period April 1, 1999 through March 31, 2000

Thank you for your memorandum dated October 26, 2000, and the attached draft report on the subject audit. We continue to be grateful for the rigorous review by your office of this complex program since its inception in 1996. I note that your report makes no new recommendations and am pleased that it highlights several areas in which we have tightened up the program in response to problems our respective offices have identified in the past, often together.

It is encouraging that our increased monitoring efforts, in response to a prior audit recommendation, led to the lowest level of delinquencies since December 1998. Your separate conclusion that you can rely on the Bosnian-staffed audit unit of the Business Finance contractor is also most encouraging as we continue to endeavor to develop local internal capabilities for the implementation and monitoring of this program.

Nonetheless, I can assure you that we have no sense of complacency going forward with the final stages of this lending program as Bosnia continues to face the challenges of making its transition to a democratic society with a market-oriented economy under the rule of law. We will continue to aggressively follow through in the court system each of the loans we referred for foreclosure after exhausting all constructive alternatives. Although this involves a lot of patient effort, we are encouraged by the periodic recoveries that our legal efforts have won thereby restoring loaned grant funds owned by the State of Bosnia and Herzegovina and managed by this program.

**Audited Status of the  
Business Development Program  
*As of March 31, 2000***

The Business Development Program (BDP), a five-year, \$278 million balance-of-payments initiative, approved by the Assistant Administrator for the Bureau of Europe and the New Independent States (now called the Bureau for Europe and Eurasia), on May 3, 1996, is intended to “jump-start economic growth and generate employment opportunities for the general population, including refugees and demobilized soldiers.” The BDP grant agreement, signed on May 7, 1996, provides balance-of-payments assistance to Bosnia-Herzegovina to aid postwar reconstruction, provide credit to the industrial and commercial sectors, and generate employment.

On May 16, 1996, USAID signed a task order with Development Alternatives to establish and operate Business Finance and provide intensive, in-country commercial banker training. Development Alternatives’ team arrived in Sarajevo on June 13, 1996, to begin implementing the program. Their final contract expired September 30, 1998. The new contractor, The Barents Group, assumed responsibility for Business Finance on October 1, 1998.

Business Finance, composed of a team of experienced U.S. bankers, accountants, and Bosnian staff has its headquarters at the Central Bank of Bosnia-Herzegovina, and is the primary administrator of the BDP. Some of Business Finance’s responsibilities include reviewing and recommending loan applications for approval; managing BDP’s lending operations; and monitoring and managing the flow of funds between the BDP, the borrowing enterprises and the agent Bosnian commercial banks, which are licensed by the Central Bank. Agreements between the commercial banks and Business Finance allow the banks to function as agents for Business Finance and to submit client loan applications. Business Finance also works with the Bosnian commercial banks to help educate them in market-oriented lending policies and credit evaluation techniques in an effort to assist the banks to develop a capable financial sector.

In addition to creating Business Finance, USAID signed a task order on June 28, 1996, with The Recovery Group to help Bosnian businesses prepare and present proposals to Business Finance and to assist enterprises in restarting and strengthening their operations. To implement its objectives, The Recovery Group established Business Consulting with headquarters in Sarajevo. On November 1, 1999, Deloitte & Touche, selected through a competitive procurement, replaced The Recovery Group as the program’s Business Consulting contractor.

### **BDP Plan**

Although the BDP is a five-year program, its planned \$278 million budget covers only a three-year period. According to the BDP authorization document, \$278 million was budgeted through fiscal year 1998, with \$256 million allocated for the lending program and \$22 million for technical assistance and implementation costs.

The BDP also provides training for Bosnian commercial bankers concentrating on loan structuring and risk assessment. This training is intended to strengthen the Bosnian commercial banks' ability to meet the credit requirements of the emerging private commercial sector.

### **BDP Status**

Since the program's inception, \$269.5 million of the \$278 million budget has been obligated, of which \$265.7 million has been disbursed. Of the \$269.5 million obligated, \$232.9 million went toward the on-lending program, while the remaining \$36.6 million was allocated for technical assistance and program implementation costs. (See Appendix IV.)

**Loan Program.** Business Finance is responsible for reviewing and assessing credit risk on all loan applications and for recommending viable loans to USAID/Bosnia-Herzegovina for approval. Loan proposals classified as "prospective" can potentially be recommended to USAID/Bosnia-Herzegovina for approval. After USAID/Bosnia-Herzegovina approves a loan, the Central Bank of Bosnia-Herzegovina can disburse it with USAID's concurrence. During the one-year period ended March 31, 2000, Business Finance recommended 41 loans valued at \$5.4 million to USAID/Bosnia-Herzegovina. These recommendations anticipated an increase of approximately 243 new jobs. During the same period, the Central Bank disbursed funds for 94 loans, which totaled \$10.2 million.

Since the BDP began, USAID/Bosnia-Herzegovina approved 434 loans totaling \$133.9 million. The Central Bank disbursed \$125.4 million for 402 of the approved loans. Business Finance's cumulative lending activity is shown in the table below:

## BDP LOAN SUMMARY AS OF MARCH 31, 2000

Status of Loans	Number of Loans	Amount <sup>2</sup> (millions)
Applications		
Recommended by Business Finance <sup>3</sup>	523	\$170.3
Prospective <sup>4</sup>	40	11.4
Rejected <sup>4</sup>	<u>515</u>	<u>186.4</u>
TOTAL	<u>1,078</u>	<u>\$368.1</u>
Recommended by Business Finance <sup>3</sup>		
Approved by USAID/B-H	434	\$133.9
Awaiting approval by USAID/B-H	<u>7</u>	<u>1.8</u>
	441	\$135.7
Not Approved by USAID/B-H	<u>82</u>	<u>34.6</u>
TOTAL	<u>523</u>	<u>\$170.3</u>
Approved by USAID/B-H		
Disbursed	402	\$125.4
Not Yet Disbursed	<u>32</u>	<u>8.5</u>
TOTAL	<u>434</u>	<u>\$133.9</u>

<sup>2</sup> Loan amounts are recorded and disbursed in Deutsche Marks, a medium of exchange in Bosnia-Herzegovina. Loan totals were converted using a weighted average exchange rate of 1.7073 Deutsche Marks to \$1.

<sup>3</sup> For discussion purposes in our report, we have considered loan recommendations by Business Finance to consist of those recommended loans which were approved or are awaiting approval. We have presented the loans not approved for information purposes only.

<sup>4</sup> Information obtained from Business Finance's March 31, 2000, report.

In prior reporting periods, shortfalls were attributed to systems and personnel restructuring intended to streamline loan production, a shortage of lending officers available to analyze and process applications and a change in contractors. Loan volume decreased from about \$46.3 million in the prior one-year period to \$5.4 million for the current one-year period. According to program personnel, this decrease was the result of factors such as:

- Increasing emphasis on loan quality and loan monitoring
- Shifting of resources to pursue delinquent borrowers and fraudulent banking activities
- Weakening economy and Kosovo war in the Balkans
- Growing competition from other lenders.

Business Finance sends monthly bills to both the borrowers and the agent banks. Borrowers make interest and/or principal payments to their agent bank which then wires the money to the Bank of America's repayment account at the Central Bank. The interest and/or principal repayments are tracked and recorded by Business Finance. The funds in the repayment account have been used for future lending. According to a Business Finance delinquency report as of March 31, 2000, 109 borrowers were delinquent—a decrease of five from the March 31, 1999 report. The delinquency rate has decreased from 48 percent to 44 percent during this one-year reporting period. Business Finance had stepped up monitoring efforts in response to our previous concerns. Business Finance's loan restructuring and workout group reviews each borrower's situation and attempts to restructure the loan or work out a solution in order to facilitate repayment.

**Technical Assistance.** During this one-year reporting period, Business Finance conducted seminars and workshops for bankers, prospective borrowers, and Business Finance staff. The seminars covered topics such as bank strengthening, the loan application process, and problem loan management. The internal audit group, and other members of Business Finance, also provided training in disbursement procedures for agent bank personnel, and field and lending associates.

To further strengthen the banking community, USAID has created another program called the Bank Development and Training Program. This program began operations in late February 2000 and will provide in-bank advisory services and formal classroom training. A team of five resident advisors will transfer banking skills in strategic planning, internal audit and controls, accounting, liquidity management and other treasury functions, bank operations management, and information technology.

### **Appendix III**

Business Consulting has been working with USAID and other parties in developing a program on privatization preparation assistance. It has also coordinated efforts with Business Finance and taken a proactive approach by focusing on companies who could become future delinquents if corrective actions are not taken. New training programs, such as internet marketing and market intelligence surveys, are also being developed.

<p><b>Unaudited Business Development Program Fund Accountability Statement as of March 31, 2000</b></p>
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The Business Development Program is a five-year program that has a three-year budget. The amounts that USAID/Bosnia-Herzegovina obligated and disbursed for the program are shown below. The amount obligated for the On-Lending Program represents the balance-of-payments support to Bosnia-Herzegovina. Of the \$232.9 million transferred to Bosnia-Herzegovina, \$125.4 million<sup>5</sup> has been disbursed as loans to borrowers. The disbursed implementation costs are amounts paid by USAID.

	<b>3-Year Program Budget (millions)</b>	<b>Amount Obligated (millions)</b>	<b>Amount Disbursed (millions)</b>
<b>On-Lending Program</b>	\$256.0	\$232.9	\$232.9
<b>Implementation Costs:</b>			
<b>Contractors<sup>6</sup></b>	17.5	35.9	32.3
<b>Audit, Program and Evaluation</b>	1.5	0	0
<b>Environmental Monitoring</b>	.6	0	0
<b>USAID Program Management</b>	0	.7	.5
<b>Contingencies</b>	2.4	0	0
<b>Totals</b>	<u>\$278.0</u>	<u>\$269.5</u>	<u>\$265.7</u>

<sup>5</sup> Loans were disbursed in Deutsche Marks, a medium of exchange in Bosnia-Herzegovina. A total of 214 million Deutsche Marks were disbursed and converted using a weighted average exchange rate of 1.7073 Deutsche Marks to \$1.

<sup>6</sup> USAID is not including the Business Consulting contract in the BDP budget. Additional obligations and disbursements under that contract total \$23.1 million and \$20.2 Million, respectively.

## Problems with State-Owned Enterprises

The “Results of Audit Tests” section discussed problems with state-owned enterprises as noted by program personnel and relevant documents. Shown below are additional examples of these problems.

### Company 1:

The directors of this company and its related holding company have impugned each other’s integrity. The sawmill has sales of up to \$470,000 per month but the Business Finance loan and other expenses remain unpaid. A director proclaimed, "While your embezzlement allegations are true, I don't like them!"

### Company 2:

In an organizational reshuffling, this company was burdened with \$4.7 million in liabilities while the sawmill which was split off, is debt-free and has monthly sales of at least \$380,000. The Business Finance loan as well as other expenses such as salaries remain unpaid. Unpaid employees have demanded a criminal investigation.

### Company 3:

A previous director and an agent bank were involved in a false document embezzlement. However, no prosecutions are expected due to his political connections. Monthly sales of up to \$175,000 are reported but the revenue seems to disappear so that the Business Finance loan and other expenses remain unpaid. A director uses the sawmill to cut logs from his own forest and rents out the sawmill for others to use without any record of revenue to the company. It appears that the director is attempting to manipulate company assets in anticipation of a privatization deal.

### Company 4:

Although there was monthly production, the Business Finance loan and other expenses remained unpaid. Chickens were slaughtered off-book each month to avoid taxes. Presently, the facility has been leased to another company. The local government, who is in charge of the board, unsuccessfully attempted to sell the company for cash without the knowledge of Business Finance and other creditors. The company and its bank are the subject of a criminal investigation.



Company 5:

After a change in management due to political reasons, its grain inventory seemed to disappear for the last two years. Grain and milk sales are reported to exceed \$530,000 yearly but the Business Finance loan and other expenses remain unpaid. A director claims a zero grain harvest, yet another company, a flour mill, continues to receive tons of wheat from this company.

Company 6:

Two former directors were fired for admitted embezzlement but the local government prefers not to prosecute them. The company has monthly sales of \$530,000 but the Business Finance loan and other expenses remain unpaid. Criminal indictments are expected to be filed in a case involving the Business Finance loan and the agent bank.

Company 7:

A director of the company for 25 years uses company facilities to complete contracts under other company names. A former employee attempted to reveal the details of the irregularities but kept silent after threats by the director. A government privatization agency attempted a "quiet" privatization without contacting the company's largest creditor, Business Finance. Although yearly sales are in excess of \$2.9 million, the Business Finance loan and other expenses remain unpaid.

Company 8:

The directors of the company appear to have siphoned off income. Revenue in 1999 exceeded \$290,000 but the Business Finance loan and other expenses remain unpaid.

Company 9:

Company refuses to disclose its income from its profitable business lines or from its joint venture. A director threatened an associate to remain silent about the company's dealings. Yearly revenue probably exceeds \$1.5 million but is not accounted for. A criminal investigation is in process.

Company 10:

The company may have been illegally privatized in order to qualify for a Business Finance loan at a time when USAID had prohibited loans to state-owned enterprises. A state-owned company is extracting the largest amount of gravel without payment. Monthly gravel sales total \$120,000 but the Business Finance loan and other expenses remain unpaid. A criminal investigation is in process.