

ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 86 / 2

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THE AUDIT
COMMITTEE

THE BOARD
OF DIRECTORS
AND
THE INDEPENDENT
ACCOUNTANT

rice
Waterhouse & Co.

Preface

Price Waterhouse & Co. first published *The Audit Committee* in 1973 to increase awareness on the part of directors of the advantages of audit committees and to suggest ways in which such a committee might function effectively. Since then events such as the revelations of "questionable payments" by corporations have focused national attention on the questions of corporate ethics and accountability. Further, there is now greater emphasis on unaudited quarterly reports and corporate systems of management controls. As a result, outside directors and, more particularly, audit committees have additional concern for the responsibilities attributed to them in the areas of financial reporting and corporate conduct. These developments prompt us to revise our booklet to reemphasize the need for the establishment of audit committees and their role in corporate financial reporting and accountability to shareholders.

While financial reports are primarily management's reports to investors and independent accountants are retained to provide expert assurance of the fairness of audited financial statements, it is well established that directors bear certain responsibilities in the financial reporting area. In addition, since the starting point for any system of financial reporting or corporate accountability is a sound network of management controls extending from the board of directors throughout the corporate organization, the directors' duties should include inquiry into the adequacy of the company's internal controls and recommendations made by independent accountants with respect thereto. Price Waterhouse recommends that directors be responsible for overseeing the work of the independent accountants and insuring that the independent accountants are receiving accurate and timely information from management.

The audit committee has been cited repeatedly as the most viable mechanism through which the directors can discharge such responsibilities. Price Waterhouse is committed to doing everything possible to assist directors of our clients in these matters. This booklet has been prepared to serve as a practical tool to assist in the initial implementation and continued functioning of audit committees. This revision to the 1973 edition incorporates knowledge gained through ongoing work with audit committees and reflects additional ideas on the functions and advantages of the audit committee which have developed in the wake of recent events and trends in financial reporting.

The suggested guide to effectively functioning audit committees that appears in Appendix B is also available as a pocket-sized handbook as a ready reminder to audit committee members concerning subjects they might cover to obtain full and complete understanding of the financial reporting processes of their own companies.

Price Waterhouse + Co.

THE AUDIT COMMITTEE THE BOARD OF DIRECTORS AND THE INDEPENDENT ACCOUNTANT

The institution of audit committees is a rapidly growing one that has recently attracted a great deal of attention. There is a growing belief among investors, analysts and regulatory agencies that such committees can improve the quality as well as the general acceptance of financial reporting.

While the ultimate responsibility for approval of financial reports rests with the entire board, a committee of the board can often serve as a better means of dealing with this increasingly complex and sophisticated area. A properly functioning audit committee goes a long way toward demonstrating that the board of directors has taken prudent steps to fulfill its responsibilities associated with the company's financial reporting.

The Securities and Exchange Commission and the American Institute of Certified Public Accountants have both recommended that publicly owned companies establish audit committees. The New York Stock Exchange issued a strong endorsement of a similar recommendation it made years ago.

Recommendations of Price Waterhouse & Co.

As more fully discussed in this booklet, Price Waterhouse & Co. recommends, among other

things, that:

Every corporation whose securities are publicly traded should have an effectively functioning audit committee.

For most effective operation, audit committees should be composed of three to five directors, with the majority and the chairman being outside directors.

Audit committees should be responsible for the nomination of the independent accountants and for discussion of their work with them.

Audit committees should be responsible for the review and evaluation of reports prepared by the independent accountant which describe weaknesses in the company's internal accounting and management controls and contain recommendations for improvements in these controls. Audit committees should also determine if management has taken appropriate action on these recommendations.

Audit committees should be delegated responsibility to review with the independent accountants the annual financial statements and, where practicable, the interim reports prior to their issuance.

Composition of the committee

Usually the full board is too large and has too many other responsibilities to perform such duties with optimum effectiveness. Generally, committees of at least three members provide the diversity of views essential to effective functioning while more than five members increases the probability that efficiency and the sense of personal involvement of committee members will suffer.

A committee composed exclusively of officer directors is in the position of reviewing as directors decisions it has already made as officers. It is on non-officer directors that attention focuses in time of stress. They are also the ones who have the more difficult task of meeting their responsibilities because they do not have the ready access to company information that is available to the officers. For these reasons, we believe that audit committees should be composed principally of outside directors, one of whom should be the chairman.

The qualifications of members do not differ from those required of all board members. The primary considerations should be that those selected to serve must be convinced of the benefits to be derived from active participation in such a committee and must have the time available to devote to this important duty. Frequently, financial experience by at least one member has been found helpful. Although it is usually desirable to rotate the chairmanship, this should not be done at the expense of an active, enthusiastic committee.

Responsibilities of the committee

The two primary responsibilities the audit committee (or the entire board where it exercises these functions) should assume are:

- (1) Provide assistance to the board in fulfilling its fiduciary responsibilities relating to corporate accounting and reporting practices, and
- (2) Maintain, by way of regularly scheduled meetings, a direct line of communications between the directors and independent accountants to provide for exchanges of views and information.

We recommend that audit committees be responsible for the nomination of the independent accountants and for discussion of their work with them. Although an audit committee must take care not to encroach on the duties and prerogatives or the responsibilities of management, the committee can be effective in a broad range of activities beyond the simple reporting to the board on the activities of the independent accountant and the financial reporting decisions of management. Its discussions can be designed to enable the committee to report to the board its appraisal of the adequacy of the audit effort by both the independent accountants and the internal auditors, the accounting policies adopted by management (where alternative practices are available), the adequacy of disclosure of information essential to a fair presentation of the financial affairs of the company and the quality of the company's system of management and internal accounting controls.

The committee in its discussions will ascertain whether there were any significant difficulties encountered by the independent accountants, any important discoveries, or any changes in accounting principles or developments in accounting which may have an effect on the company's financial statements, and it will obtain other information necessary for the committee to report fully to the board of directors.

In any of these actions, the committee would normally ascertain specifically whether any disclosure has been considered or what accounting principles were followed regarding significant events or transactions which have come to their attention through their position on the board of directors, news media or other sources.

Functions of the committee

The activity of a typical effective audit committee in meeting its responsibilities includes the following:

- (1) Review of the financial statements with the independent accountants prior to recommending approval by the board. The purpose of such review is to determine that the independent accountants are

satisfied with the disclosure and content of the financial statements and to obtain sufficient information from the auditors to facilitate analysis of the financial statements submitted to the entire board by the management.

- (2) Appraisal of the effectiveness of the audit effort through regular meetings with the independent accountants. This includes a discussion of the overall approach to and scope of the examination with particular attention focused on those areas where either the committee or the independent accountants believe special emphasis is desirable or necessary. The responsibility for determination of the scope of auditing necessary for the formation of an opinion on the financial statements resides with the independent accountants and that decision must be left to them. For this reason, the committee should not ask for nor be given detailed audit programs.
- (3) Determination through discussions with the independent accountants that no restrictions were placed by management on the scope of the examination or on its implementation.
- (4) Inquiry into the effectiveness of the company's management of financial and accounting functions through discussions with the independent accountants, internal auditors and appropriate officers of the company. Recent developments make it clear this should include inquiries into the possibility of payments or transactions that might be deemed illegal or otherwise improper.
- (5) Review of reports prepared by independent accountants discussing weaknesses in internal control, organization and operations and containing recommendations to improve such weaknesses and consideration of the action taken by management on the independent accountants' suggestions.
- (6) Recommending the appointment of independent accountants for the ensuing year. The actual appointment of the ac-

countants should remain the responsibility of the shareholders, or of the board with subsequent ratification by the shareholders in some cases. Management, through its day-to-day dealings with the independent accountants, normally is in the best position to evaluate the services provided and their input to the committee should be given careful consideration when nominations for independent accountants are being considered. On the other hand, the committee should ascertain independently on behalf of the board that management's recommendations are objective and not based on management's own self-interest.

- (7) Evaluation of the effectiveness of the company's internal auditing methods.

Association with unaudited financial reports

Recent trends in financial reporting have placed greater emphasis on quarterly and other interim reports. In 1976 the involvement of outside auditors with interim financial information was increased significantly and it is clear that quarterly reports should be thought of as a component of the total reporting process, no less significant than any other component.

Some audit committees have been delegated responsibility by the board for review of interim reports prior to their submission to the board. Because such financial statements are normally unaudited, the committee cannot be expected to obtain the same degree of assurance as is possible with regard to the annual financial statements, but certain steps can be taken to gain additional insight into the preparation of such statements and the disclosures included therein. Even without pressure from the SEC, the involvement of independent accountants in this process is clearly in the interests of the directors. Standards of the profession encourage limited reviews of interim data using the following procedures:

- (1) Inquiry concerning any significant changes in the accounting system or the system of internal accounting control, to

ascertain their potential effect on the preparation of interim financial information.

- (2) Analytical review of interim financial information by reference to internal financial statements, trial balances or other financial data, to identify and inquire about relationships and individual items that appear to be unusual.
- (3) Reading the minutes of meetings of stockholders, board of directors and committees of the board of directors to identify actions that may affect the interim financial information.
- (4) Reading the interim financial information to consider, on the basis of information coming to the accountant's attention, whether the information to be reported conforms with generally accepted accounting principles.
- (5) Obtaining letters from other accountants, if any, who have been engaged to make a limited review of the interim financial information of significant segments of the reporting entity, its subsidiaries or other investees.
- (6) Inquiry of officers and other executives having responsibility for financial and accounting matters concerning (a) whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied, (b) changes in the entity's business activities or accounting practices, (c) matters as to which questions have arisen in the course of applying the foregoing procedures, and (d) events subsequent to the date of the interim financial information that would have a material effect on the presentation of such information.

With reviews of this nature, inquiries along the following line would be appropriate:

- (1) Inquiry of the principles employed in reporting any large or unusual transactions and possible need to make specific disclosure of important developments.
- (2) Inquiry of developments in accounting since the previous statements were is-

sued and the effect these developments may have on the company's financial reporting.

- (3) Inquiry of independent accountants and internal auditors regarding their awareness of any changes in the company's systems which have affected the continuing functioning and effectiveness of the company's accounting and operating controls.

Meetings and agenda

The best number of meetings is a subjective determination. Our experience is that one meeting a year is insufficient and more than four meetings a year is unusual. The organization meeting of the committee should be held as soon after the annual meeting as the various participants can be ready. The meeting to discuss the results of the audit and the financial statements should be held immediately prior to the board meeting at which the annual report will be approved. Appendix A sets forth a more elaborate program contemplating four meetings a year; including, in addition to the above two, a meeting late in the year to anticipate financial reporting problems and one in preparation for the annual shareholders' meeting. Obviously, individual combinations of agenda can be worked out appropriately.

The committee should be authorized to request the presence at any meeting of anyone who could contribute substantially to the subject of the meeting. For example, in a meeting dealing with disclosure of contingent liabilities, it may be desirable to have the company's legal counsel present for the portion of the meeting dealing with that subject.

In preparing the agenda for a meeting the chairman should solicit the views of the independent accountants, management and others on subjects to be covered and he may even ask the assistance of one of these groups in the preparation of a tentative agenda. When time is available the independent accountants, management and the internal auditors normally will furnish the committee with reports covering the agenda topics in advance. This allows committee members more opportunity for

preparation and results in better informed discussions. As a matter of good form at some point during one or more of the meetings, it is desirable for the committee to meet separately with management and with the independent accountants in order to maintain such a forum for discussing matters which either might be reluctant to discuss freely with the others present.

When an audit committee is formed it is customary for it to become the informal communication route from the independent accountants to the board of directors, particularly where the committee is predominantly outside directors. It is important that the committee have an established policy whereby the independent accountants may request a special meeting of the committee to discuss any particular topic.

One final word

Many directors, particularly outside directors, have found audit committees of great assistance in the discharge of board of direc-

tors' responsibilities associated with corporate financial reporting. Others' experiences have caused them to believe that such committees are ineffective and simply perform an annual ritual of "approving" the financial statements. The effectiveness of an audit committee is dependent on the nature of the company, the philosophy of management, the experience and interests of the directors and other factors.

It has been our experience that audit committees function most effectively when they are composed of three to five enthusiastic directors working in cooperation with management and the independent accountants and with a clear understanding of their responsibilities and how to go about discharging them. Appendices A and B that follow have been prepared as guides to better committee functioning. Appendix A suggests for the Chairman possible agenda subjects assuming four meetings per year. Appendix B—A Working Guide For Audit Committee Members—is a ready reminder of subjects they might wish to discuss to obtain a full understanding of the financial reporting of their companies. The latter is available on request in a separate pocket-size booklet form.

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POSSIBLE AGENDA ITEMS FOR MEETINGS WITH INDEPENDENT ACCOUNTANTS

Assuming four regular meetings per year

Meeting 1—Objectives and scope of the audit

scheduled prior to the ensuing examination, as soon after the annual shareholders' meeting as practicable.

1. Reporting requirements of the company:
 - Annual report to shareholders.
 - Other reporting requirements such as reports to the SEC, statutory audit reports, etc.
2. Developments in accounting likely to affect financial reporting:
 - Financial Accounting Standards Board pronouncements or proposed pronouncements.
 - Changes in SEC, NYSE or other agency requirements requiring expanded or different reporting.
 - Changes in company activities likely to require additional reporting or changes in accounting principles to improve the reporting of such activities.
3. The overall plan to accomplish the audit:
 - Locations to be visited, the plan of rotation.
 - Emphasis to be placed on certain areas which are of special concern to the independent accountants or to the board of

- directors or are varied from year to year.
- Timing of the conduct and completion of the audit.
- Degree of coordination with work planned by the internal auditors.
- The background and experience of the principal supervisory personnel of the independent accountants, their policy of rotation and of maintaining continuity of staff.
- Estimated fees for the examination.

Meeting 2—The status of the audit and problems to be solved before closing the accounts

scheduled after completion of the independent accountants' interim review and testing of controls and significant transactions to date but prior to the company's year end.

1. Anticipated problems requiring resolution prior to year end:
 - Sensitive reporting requirements requiring the advice and assistance of legal counsel or other persons familiar with the subject.
 - Changes in accounting policies or proce-

dures which may require mention in the independent accountants' report.

- Disclosure of potential transactions or liabilities requiring estimates to be formulated.
2. Significant matters of importance which the independent accountants may have knowledge of as a result of their work to date:
 - Conclusions as to the overall quality of internal controls and procedures.
 - Any information regarding payments or transactions which may be illegal or otherwise improper.
 - Significant trends of the company.
 - New developments in accounting or differences between the tentative and final requirements since previous discussions.
 3. Status of the current audit:
 - Significant revisions to the preliminary plan and reasons therefor.
 - Difficulties or delays in performing the audit.
 - Restrictions, if any, imposed by management.

Meeting 3—Review of the financial statements to be submitted to the board

scheduled immediately prior to the meeting of the board of directors for approval of the annual report to shareholders.

1. Review the final draft of the financial statements and the independent accountants' report thereon:
 - Significant changes in the format or presentation of the financial statements and the reasons therefor.
 - Reasons for any significant variations in the amounts presented in the financial statements.
 - Significant adjustments required as a result of the audit and the reasons therefor.
 - Major differences of opinion on financial reporting between management and the independent accountants and how such issues were resolved.
 - The independent accountants' draft of their opinion on the financial statements including reasons for any qualification.
 - The independent accountants' views as to

whether the other parts of the annual report reflect a divergence from the presentation in the financial statements.

2. Ascertain whether the independent accountants should meet with the board of directors to discuss any matters relative to the financial statements and to answer any questions the other directors may have.
3. Update as necessary matters discussed at previous meetings.

Meeting 4—Final review of the audit and formulation of the committee's report to the board of directors

scheduled prior to the mailing of the proxy statement or other documents notifying the shareholders of the annual meeting.

1. The independent accountants' report to the audit committee, which should have been submitted in advance, and any actions which may be necessary as a result of recommendations contained therein.
2. The independent accountants' report(s) to management relating to improvements in internal controls, administrative efficiency or other recommendations, including alternatives suggested by management and reasons for rejection of any recommendations.
3. The final completion of the audit, departures from the preliminary plan including reasons for such departures, information relative to the final fee, and reasons for significant variations, if any, from the preliminary estimate.
4. Management's comments on the performance of the independent accountants during the preceding audit.
5. The committee's evaluation of the performance of the independent accountants during the preceding audit.
6. Formulation of the committee's report to the board of directors, including a recommendation for the nomination of independent accountants for the ensuing year.
7. Update as necessary matters discussed at previous meetings.

A WORKING GUIDE FOR AUDIT COMMITTEE MEMBERS

The following material provides an informal guide to members of directors' audit committees of suggested topics which may be discussed during meetings with independent accountants, financial management representatives, internal auditors and others. The topics are not intended to be all inclusive nor appropriate in all circumstances. Knowledge of the topics to be discussed at a given meeting, an understanding of the company's operations, the industry and the general state of the economy are all essential to enable committee members to effectively elicit the information they require in order to fulfill their responsibilities.

REVIEW OF FINANCIAL STATEMENTS WITH INDEPENDENT ACCOUNTANTS

Broad areas of inquiry

1. Changes in accounting principles or practices, or in the application thereof, which had a significant impact on the amounts reported for the current year or which will have a significant impact on future amounts reported and the independent accountants' concurrence with the change and reasons therefor.
2. Sensitive reporting, accounting practices or judgments which may generate adverse comments from business writers, analysts or legal adversaries. Significant unusual items included in current operations but not separately disclosed.
3. Possible adjustments to the financial statements which were discussed with and/or proposed to financial management but not recorded and substantive reasons.
4. Overall evaluation of degree of comparability and conservatism reflected in preparation of the current financial statements as compared to recent prior years. Degree of conformity with accounting policies followed within the industry.
5. All disclosures necessary for a fair presentation or required by the SEC or other agencies made in the financial statements. Any additional disclosure recommended.
 - Litigation which management or the company's legal counsel believes to have possible significant effect.

- Circumstances, such as possible government actions, the loss or anticipated loss of substantial, profitable contracts, etc. which, while not affecting the financial position or results of operations of the current year, may have a serious impact on the company's future profitability.
 - Contracts entered into which the company presently does not have the ability to fulfill without sustaining losses.
 - Unusual transactions with officers or affiliates.
 - Deviations between information in the financial statements and the other sections of the annual report.
6. New pronouncements by the FASB, AICPA, SEC or others having an effective date subsequent to this year end which will require accounting policy changes or additional disclosures in future financial statements and the anticipated effect. The independent accountants' views as to desirability of early adoption for reporting this year.
 7. Any other matters which the independent accountants wish to discuss with the committee or the full board prior to the release of the annual report or the press release announcing the company's earnings.
 8. Status of completion of the examination and the expected form of the opinion.

Other topics which may be relevant dependent on the company and its activities:

1. Formal or informal compensating balances required in connection with loans or other financing agreements or other restrictions on cash items.
2. Bases of accounting for marketable securities, changes in the market value since year end, method of determining market value of securities not publicly traded and marketability of all items included in this classification.
3. Adequacy of the allowance for doubtful receivables, status of collection of receivables, particularly large individual amounts, and credit policy in comparison with previous year. Large or unusual receivables from of-

ficers or other employees.

4. Steps taken to afford physical safeguards of inventories and other portable items, methods of valuing inventories, the adequacy of procedures in effect to identify obsolete inventory.
5. Basis of recording long-term investments and any factors which may indicate a permanent impairment of the value of these investments or substantial exposure to future losses. Any subsidiary or affiliated companies not included in the consolidated amounts or valued on the equity method and reasons therefor.
6. Brief description of the company's capitalization policies regarding property, plant and equipment and methods of depreciation. Method of recording leases and amortization thereof when such leases are capitalized.
7. Basis for the recorded value of intangible assets and how they are amortized.
8. Restrictions on company activities imposed by lenders and compliance with loan covenants.
9. Outstanding assessments of taxes, years still subject to review and the adequacy of the accrual for taxes payable.
10. Senior stock issues which expressly or effectively limit company activities, restrictions on retained earnings, treasury stock acquisitions during the year and the purposes for which treasury stock was acquired. The effect given to any outstanding stock options, convertible debt, etc. in the calculation of earnings per share.
11. Major branches, divisions, subsidiaries or lines of business operating at a loss.

RELATIONS WITH THE INDEPENDENT ACCOUNTANTS

Scope and plan of the audit:

1. The independent accountants' overall evaluation of the audit coverage. Any areas where the independent accountants believe scope has been compromised more than they feel comfortable with because of fee pressures.

2. Those units or companies which are to be examined annually and those which are rotated whereby different ones are examined in different years.
3. Those units or companies not examined by the principal independent accountants and whether they are examined by other independent accountants; their materiality to the consolidated financial statements.
4. The extent to which the examination has been coordinated with the internal auditors in order to avoid unnecessary duplication of work, including reasons for the independent accountants and the internal auditors performing the same or similar work at the same locations and the extent to which the internal auditors will perform certain audit tests as part of the overall internal control procedures.
5. Extent of the review to ascertain the adequacy of the company's "Business Ethics" policy and tests performed to determine compliance with such policy.
6. Extent to which electronic data processing (EDP) is utilized in processing information supporting the financial statements and the extent of the review of the EDP functions.
7. The extent to which changes in the internal accounting controls within the company have been reflected in the audit plan.
8. The extent organizational changes or increases in company activity have been considered in the plan for the examination.

Internal accounting controls, personnel and organization:

1. The independent accountants' evaluation of the overall adequacy of internal controls, including their evaluation of the internal audit function, based on their most recent evaluation and testing of such controls and functions, including an evaluation of whether there is a proper balance between cost of controls and risks assumed.
2. Recommendations made related to internal controls or other procedures which the independent accountants or internal auditors believe will enhance the safeguarding of the company's assets and actions taken by man-

agement or reasons for lack thereof.

3. Observations about the company's system of management reporting or operational controls not strictly in the independent accountants' field or within the scope of their engagement.
4. The independent accountants' evaluation of the staffing, personnel and organizational structure of the controller's department and the internal audit department.
 - Scope of activities and relationship with operating management.
 - Adequacy of subsidiary and branch accounting organizations and staffing.
5. Any areas where alternative or extended audit procedures have been required because of unsatisfactory records or inadequate controls.
6. Internal controls and procedures relating to EDP:
 - Brief explanation of what financial data is processed in whole or in part by EDP, including the significant types of accounting transactions processed and the applications performed.
 - Generally, the types of input-output controls established to facilitate the accuracy of processed data.
 - Organization, staffing and supervision of the EDP Department including an evaluation of whether there is effective control over the use of computer services throughout the corporation.
 - Whether the review of the EDP function indicated that internal controls over processing and the procedures for safeguarding records and files are adequate.

Other topics related to the independent accountants' service:

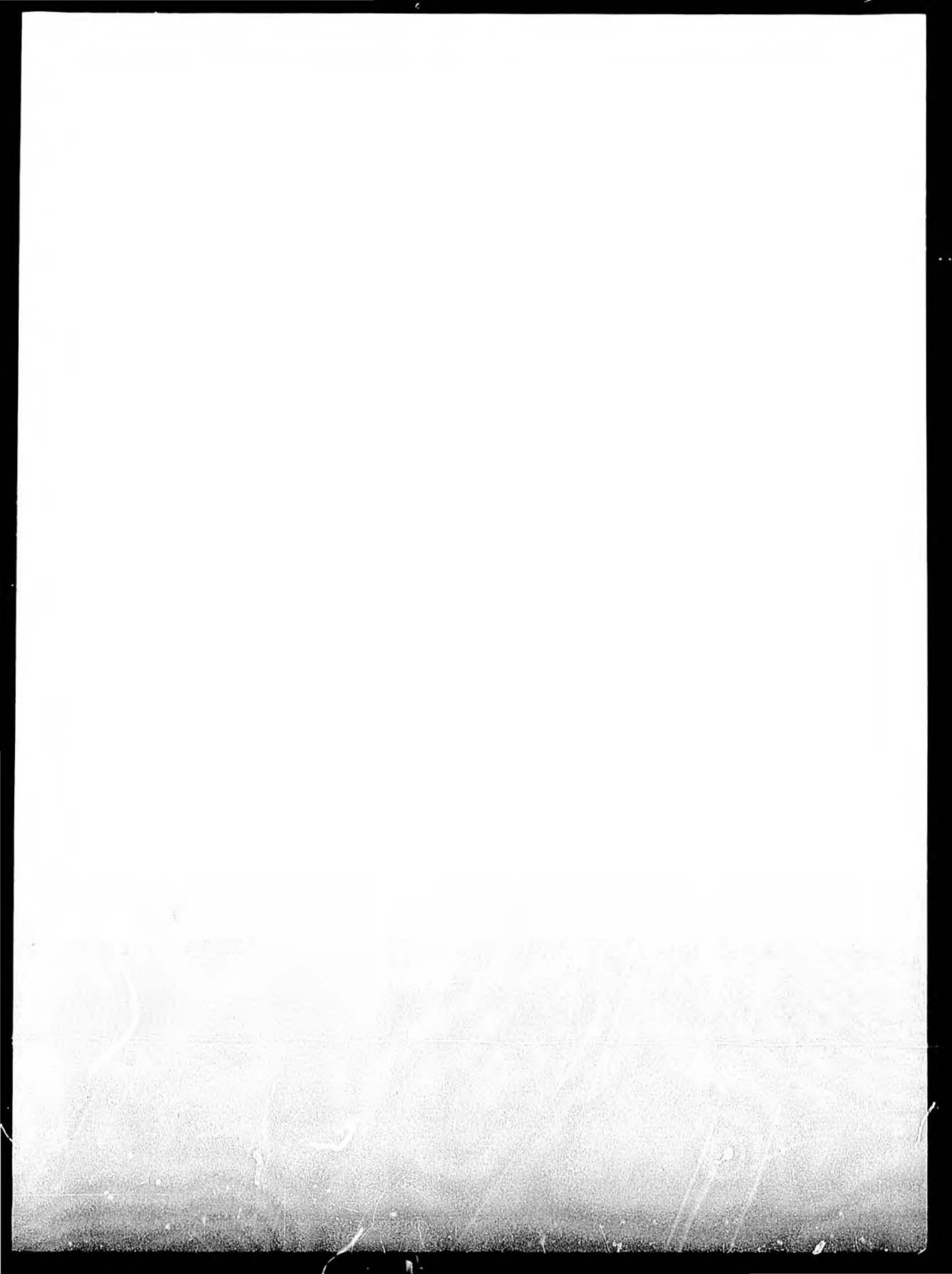
1. Steps taken by the independent accountants to ensure sufficient continuity of staff to enable the examination to be efficiently conducted.
2. Steps taken by the independent accountants to ensure that staff members are rotated in a systematic manner to provide fresh ideas and approaches as well as maintain the

- proper independence of thought necessary.
3. Services available through the independent accountants' firm which enable them to effectively perform the audit of the company and to provide other assistance when necessary.
 4. Reports issued by the independent accountants in connection with their review of companies being considered for acquisition or relating to other special studies requested by management.

Cooperation of management:

1. All information requested by the independent accountants promptly furnished.
2. All reports of the internal auditors made available for the independent accountants' review. The extent the independent accountants have read such reports and reviewed working papers and work programs in support thereof.

3. Whether the independent accountants are satisfied that management at the various operating levels advised them of matters which may have a bearing on the company's financial position, results of operations or future profitability, including any reasons the independent accountants have to believe that information was withheld or that information furnished was incomplete or incorrect.
4. Deviations from the preliminary audit plan, and alternate steps taken to satisfy the independent accountants with regard to the procedures omitted, occasioned by:
 - Restrictions imposed by management
 - Lack of cooperation from management
 - Lack of cooperation from customers, legal counsel or other outsiders
5. Adequacy of improvements in the system of internal control which have been implemented as a result of recommendations made during the current or prior examination.



September 29, 1977

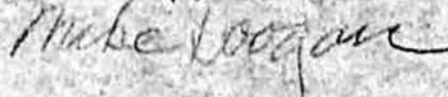
Jay Hogan, Director
Legislative Finance Division
Legislative Affairs Agency
Pouch WF
Juneau, AK 99811

Dear Mr. Hogan:

Enclosed is the original of the contract between Price Waterhouse and the Division of Legislative Finance. It has been signed by the Chairman and Dan Regis of Price Waterhouse. If it is in order, I would appreciate it if you could send copies after you have signed it for our files and those of Price Waterhouse.

The contract with White Weld, signed by the Chairman, has been sent to Ted Swick in New York for his signature and will be forwarded to you.

Sincerely,



Mike Doogan
Administrative Assistant

MD:LAD

Enclosure

CONTRACT BETWEEN
STATE OF ALASKA
DIVISION OF LEGISLATIVE FINANCE
AND

PRICE WATERHOUSE & CO.

The parties of this agreement are the Division of Legislative Finance, hereinafter referred to as the "Division," by and for the House Special Committee on the Permanent Fund, and Price Waterhouse & Co., 601 W. 5th Avenue, Anchorage, Alaska 99501.

THE PURPOSE OF THIS AGREEMENT is to provide, through the Division, professional services in relation to the Alaska Permanent Fund and the Renewable Resources Loan Fund.

IT IS THEREFORE MUTUALLY AGREED THAT:

CLAUSE I. - STATEMENT OF WORK

The Contractor shall provide consultations on:

- . The structures of the organizations.
- . The relationship of the organizations to the Legislature, the State Administration and the public.
- . The selection of the management and policy making board (or boards).
- . Criteria for insuring that the funds retain their integrity.
- . Security and protection from fraud and political influence.
- . Reporting requirements to the public.
- . Such other matters as may reasonably be requested.

The Contractor shall coordinate, work with, and exchange information with White, Weld and Company, New York so as to prevent duplication of effort.

CLAUSE II. - STANDARDS OF PERFORMANCE

The work shall be done in accordance with generally recognized standards of professional consulting services. In the event that any work does not meet these standards, the Project Director may serve written notice and satisfactory correction shall be made within ten (10) days. Completion dates for any portion(s) of the work shall be set by mutual agreement. Failure to com-

plete the work on time shall result in liquidated damages of ten percent of the contract amount plus one hundred dollars (\$100) per day for each day of delay beyond the completion deadline, except for delays due to causes beyond the control and without fault or negligence of the Contractor. Liquidated damages shall not exceed the total payments allowed under the contract and may be deducted from payments that are owing.

Any dispute concerning a question of fact that relates to the Contractor's performance, if not disposed of by agreement between the parties, shall be decided by the Project Director, who shall notify the Contractor. This decision, unless appealed to a court of competent jurisdiction within ninety (90) days of the completion or termination of the contract, shall be final and conclusive.

CLAUSE III. - PERIOD OF PERFORMANCE

- (A) The period of performance under this contract shall commence on August 4, 1977, or on the date both parties sign this agreement and expires on the close of the Second Session, Tenth Alaska State Legislature, provided, however, that the Project Director grants an extension for additional periods in a mutual written agreement of the parties.
- (B) This agreement may be terminated
 - (1) by the Project Director. Written notice of the necessity for doing so shall be delivered to the Contractor. Payment shall be made for satisfactory work; or
 - (2) by mutual consent of the parties to this agreement.

CLAUSE IV. - PROJECT DIRECTOR

Work assignments may be made by Representative Clark Gruening, Chairman of the House Special Committee on the Permanent Fund, upon written notification to the Administration by way of the Commissioner of Revenue.

CLAUSE V. - COMPENSATION AND METHOD OF PAYMENT

- (A) Total compensation under this contract, including travel or other expenses, shall not exceed \$17,500.
- (B) Out of pocket expenses, including economy airfare, communications, lodging, meals and the like shall be billed as separate items. Receipts shall be required.

CLAUSE VI. - REPORTS

The Contractor shall keep the Project Director informed as to the progress of the work performed under this agreement and shall provide progress reports as specified by him.

CLAUSE VII. - RECORDS, DOCUMENTS, AUDIT

The Contractor shall maintain accurate records which are subject to inspection by the Division at all reasonable times. All documents, reports and writings produced in the course of the work performed under this contract are, upon delivery to the Division or at the termination of this agreement, the property of the Division. The Committee shall have the full right to use these documents for its purposes, or otherwise, when and where the Committee may designate without any claim on the part of the Contractor for additional compensation.

CLAUSE VIII. - ALL WRITINGS CONTAINED HEREIN

This agreement contains all the terms and conditions agreed upon by the parties. No other understandings, oral or otherwise, regarding the subject matter of this agreement shall be deemed to exist or to bind either party to this agreement.

IN WITNESS WHEREOF, the parties have executed this agreement on the dates indicated,

CONTRACTOR:

STATE OF ALASKA
DIVISION OF LEGISLATIVE FINANCE:

By: *Daniel C. Rojas*

By: _____

Partner
Title

Title

Sept. 29, 1977
Date

Date

APPROVED BY:

Clark Gruening
Clark Gruening, Chairman
House Permanent Fund Committee

Date

Alaska State Legislature

SPECIAL COMMITTEE ON
THE ALASKA PERMANENT FUND
(907) 276-3433

528 W. 5TH, SUITE 270
ANCHORAGE, AK. 99501
[POUCH V. JUNEAU, AK. 99811]
(907) 465-3873



MEMBERS

REP. CLARK GRUENING, CHMN.
REP. TERRY GARDINER, V. CHMN.
REP. E. J. HAUGEN
REP. RUSS MEEKINS
REP. BILL MILES
REP. LEO SCHAEFFER
REP. RICK URION

House of Representatives

October 6, 1977

Dan Regis
Price Waterhouse & Company
601 West Fifth
Anchorage, AK 99501

Dear Dan:

After conferring with Tom Singer, we would like to change the assignment made to you under your firm's contract with the Division of Legislative Finance. The assignment, as Tom explained it to me, is:

Read the Renewable Resources Development Fund Subcommittee's first interim report and make suggestions on structural alternatives for implementing the Subcommittee's procedures. Such suggestions should be ready for the Committee's meeting October 20 and 21 in Juneau.

This assignment replaces the previous assignment, but the cost estimate request still applies.

Sincerely,

A handwritten signature in cursive script that reads "Mike".

Mike Doogan
Administrative Assistant

MD:LAD

cc: Rep. Terry Gardiner
Tom Singer
Sterling Gallagher
Jim Edenso

October 3, 1977

Dan Regis
Price Waterhouse & Company
601 West Fifth Avenue
Anchorage, AK 99501

Dear Dan:

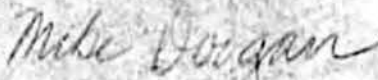
As we discussed, the Committee would like your firm to fulfill the following assignment under the contract with Legislative Finance:

Provide models of venture capital institutions in the private sector. This would include organization, purpose, evaluation criteria, planning and other pertinent functions of independent venture capital organizations and subsidiary venture capital arms of financial institutions. In the latter case you should include a description of the relationship between venture capital subsidiary and parent firm.

Also as we discussed, the Committee would like a cost estimate on this assignment before the work goes forward.

Finally, also under this contract, we request the presence of Peter McDowell at the Committee's Juneau meeting October 20 and 21.

Sincerely,



Mike Doogan
Administrative Assistant

MD:LAD

cc: Sterling Gallagher
Rep. Terry Gardner
Tom Singer

REPORT TO THE SENATE AND THE HOUSE COMMITTEES
ON THE PERMANENT FUND

OUTLINE OF PRICE WATERHOUSE CONSULTANCY
DURING 1976 - 1977

PHASE I. PROVISION OF INFORMATION ABOUT ORGANIZATION AND
STRUCTURE ALTERNATIVES

1. Verbal presentations were made to the August and October meetings of the State Investment Advisory Committee. These concerned the organization, management and control of a variety of development institutions, ranging from small to large scale and operating in the developing countries.
2. A Report on the Organization, Management and Control of Development Banks was published on September 29, 1976. The report provided information about five institutions for the Committee's deliberations on: organization structure; relationships with governmental units and the public; selection of management and policy-making boards; and organizational, operating and financial controls which provide security and protection for the integrity of an institution.
3. Further information was provided through a report dated November 5, 1976 and verbal presentations to the November 6 and 7 Committee meetings about specific questions. The questions included examples of development banks which have experienced significant difficulties in meeting their objectives; specific criteria

by which development banks measure success; and suggestions about the overall organization structure for the Permanent Fund. This latter assignment resulted in a suggestion that the fund have a dual board structure, with a popularly elected top policy-making board having the power to select a board of directors to make investment decisions and a chief executive to manage the operations of the fund.

4. All of the preceding presentations and reports were then utilized at the November 16 Committee workshop at which an outline of a preliminary structural design was developed by the members of the Committee attending that workshop.

PHASE II. ASSISTANCE TO THE COMMITTEE WITH INTERPRETATION AND TECHNICAL ANALYSIS OF THEIR OUTLINE PROPOSALS AND DELIBERATIONS

1. A report dated December 15, 1976 was prepared in response to four questions submitted to Price Waterhouse on behalf of the committee. This report included specific examples of broad statements of priority which should be set in enabling legislation and of policies which should be set at board level. It also dealt with suggested loan standards which should apply to prospective funding arrangements, establishing interest rates by statute or at board level and comments on the pros and cons of electing all or part of the board of directors. Finally, the report was addressed to suggestions on alternative structures or modifications to the proposals of the Committee workshop concerning the level of citizen, legislative and executive participation inherent in the design of the Fund.

2. On December 10 Price Waterhouse arranged appointments for a working party of the Committee with four senior executives of development institutions in Washington D.C. Each of these executives was able to comment on practical problems faced by their institutions which appeared to have potential relevance to the Permanent Fund.
3. Price Waterhouse representatives participated with the Committee at their meeting on December 16 and 17. During this meeting the Committee requested that Price Waterhouse participate in the preparation of draft enabling legislation during the following week. This draft was completed on December 21 and sent to all members of the Committee for their consideration.
4. A Price Waterhouse representative met with the Committee on January 6 to assist with their interpretation and understanding of the draft enabling legislation. The product of that meeting of the Committee has been submitted to the Legislature in the form of House Bill number 298.
5. During January and February, additional advice was provided concerning questions and modifications to the draft enabling legislation. House Bill number 300 resulted from the suggested improvements to House Bill number 298 developed during this period.

P. B. McDowell
April 20, 1977

responsible to public.
financial integrity
operating
professional managers

THE FOLLOWING PAGES WERE TREATED AS
A UNIT IN THE ORIGINAL FILE.

September 29, 1976

The Honorable Sterling Gallagher
Commissioner
Department of Revenue
Pouch S
Juneau, Alaska 99811

The Honorable Jalmar Kerttula
Alaska State Senator
Pouch Z
Palmer, Alaska 99645

The Honorable Hugh Malone
Alaska State Representative
P.O. Box 9
Kenai, Alaska 99611

Gentlemen:

" REPORT ON THE ORGANIZATION, MANAGEMENT AND CONTROL
OF DEVELOPMENT BANKS

This letter and attachments have been prepared to assist the State Investment Advisory Committee consider alternative structures for the proposed Alaska Permanent Fund. The report draws upon the considerable experience of our firm with international and local development banks throughout the world. The objective of the report is to provide information for the Committee's deliberations about organization structure; relationships to governmental units and the public; selection of management and policy making boards; and the organizational, operating and financial controls which provide security and protection for the integrity of the institution. It is organized to explain, in some detail, how these institutions are established and managed.

Scope of work

On the basis of our knowledge of institutions active in the field of development banking, we selected the International Finance Corporation (IFC), World Bank, Inter-American Development Bank (IDB) and Overseas Private Investment Corporation (OPIC) Finance Program for detailed review and preparation of case studies. We have

The Honorable Sterling Gallagher
The Honorable Jalmar Kerttula
The Honorable Hugh Malone

- 2 -

September 29, 1976

also included a review and case study of the group of development institutions known as development finance companies (DFCs). The four specified institutions were selected on the basis of our in-depth knowledge and long standing client relationships with them, and the fact that they are prominent, well managed and somewhat diverse organizations representative of the majority of institutions active in the development banking field.

Basic documents describing the organization, management and control of the institutions we selected were reviewed and summarized for each case study. In addition, key executives of each institution were interviewed as were the Price Waterhouse audit personnel who perform work for all four of the specified institutions. This was followed by preparation and review of the detailed attachments (case studies) and this summary report. We have coordinated our study with White, Weld and Co. executives, who have assured us that this report does not duplicate their efforts on behalf of the Committee.

Summary of our findings

There are substantial similarities among the five case studies. They all have a common purpose to provide loan financing for high priority economic development projects in developing countries. The IFC also provides equity financing and the OPIC Finance Program provides loan guaranties. None of the four specified institutions make small loans. These are normally handled by the specialized intermediaries, the development finance companies (DFCs), many of which are funded by the international institutions. The range of activities includes grants and loans for feasibility studies and technical assistance.

The operating philosophies of the organizations are also very similar. All are aggressive in project promotion, preparation and design activities, to a far greater extent than normal commercial banking institutions. They are run on a prudent, business-like basis and expect to generate revenues adequate to fund their operating expenses and provide profits to insure security and growth as continuing institutions.

All of the institutions are quite independent from governments, including OPIC, which has a relatively independent Board of Directors although it is a U.S. government agency. Each institution is organized with Boards of Governors and/or Directors and a strong chief executive officer. The governing bodies (Boards) are selected by the stockholder(s) of each institution and generally represent many diverse interests. With the exception of OPIC, the chief executive officer is chosen by one or the other of the Boards. Key senior management and professional staff personnel are selected by the Board or chief executive officer in all instances. With the exception of a portion of the OPIC staff, the hiring, dismissal,

The Honorable Sterling Gallagher
The Honorable Jalmar Kerttula
The Honorable Hugh Malone

- 3 -

September 29, 1976

organization and remuneration of staff is decided by Board and/or management prerogative in all five cases.

Each institution, again with the qualified exception of OPIC, is independent of any direct control by governmental agencies. All of the institutions, of course, cooperate fully with governments concerning the loans and projects which they finance. In addition, all are required to have independent audits of their financial statements and to submit annual reports to their stockholders and the public.

The institutions share a common control structure. Each institution is organized to provide adequate separation of duties and numerous levels of loan and investment review and approval. Final responsibility and accountability clearly rest with the Board and senior management in every case. Operating controls include planning and budgeting, intensive participation in project design and monitoring, post-audit of projects and comprehensive information systems.

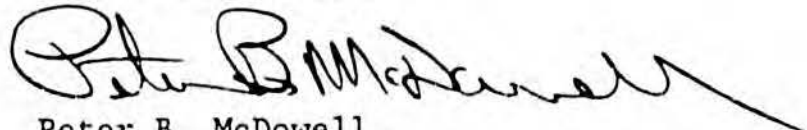
The financial controls include required audits of projects financed, geographic and sectoral diversity of loan/investment portfolios and disbursement controls. External reporting to the stockholders and the public includes audited annual reports and substantial voluntary public information programs.

* * * * *

We are prepared to discuss our report and respond to any questions. Our representatives will be in attendance at the meeting of the State Investment Advisory Committee on October 13, 1976.

We are pleased to be of assistance to the Committee and the State of Alaska in this important undertaking and look forward to a continuing role in the development of the Alaska Permanent Fund. We are prepared to expand this report or review other alternative structures which the Committee may wish to study while developing its recommendations for the structure of the Fund.

Yours very truly,



Peter B. McDowell

Enclosures -
Attachment I - International Finance Corporation
Attachment II - World Bank
Attachment III - Inter-American Development Bank
Attachment IV - Overseas Private Investment Corporation
Attachment V - World Bank/IFC - sponsored Development Finance Companies

INTERNATIONAL FINANCE CORPORATION
(AN AFFILIATE OF THE WORLD BANK)

A. PURPOSE

1. General Statement of Purpose

The International Finance Corporation (IFC) was established in 1956 to assist in the development of private sector economies. The Corporation helps to mobilize both domestic and foreign capital for this purpose. According to the Articles of Agreement, the IFC seeks to further economic development by (1) encouraging the growth of productive private enterprise in less developed areas through participation in financing the establishment, improvement and expansion of productive private enterprises, where sufficient private capital is not available on reasonable terms; (2) seeking to bring together domestic and foreign private capital, experienced management and investment opportunities; and (3) seeking to stimulate the flow of private capital into productive investments in member countries. In carrying out this task the organization does not seek or accept guarantees of repayment by member governments.

In fiscal year 1976 the IFC provided loan and/or equity financing to 33 enterprises. The investments entailed loan commitments of \$225 million and equity financing of almost \$20 million. The magnitude of IFC participations in these projects ranged from \$180,000

to \$50 million but in most cases was in excess of \$1 million. The estimated total cost of these 33 projects is \$1.4 billion.

2. Source of Funds

The IFC has subscribed capital of over \$100 million and is empowered to borrow funds from other sources including the World Bank. The current borrowing authority of IFC enables it to borrow from the World Bank up to four times its own unimpaired subscribed (and paid-in) capital and surplus. It also receives the proceeds of its own operations. The operating expenditures of the IFC are financed from internal resources.

3. Operating Philosophy

Over the past several years the IFC has undertaken an active role in seeking to promote projects which have a reasonable prospect of eventually being suitable for financing. This assistance may take the form of grants to assist in the "front end" study and planning stages of a productive business. In finally selecting investment projects IFC does not choose between the objectives of economic priority and profitability. Rather, it makes an investment only when convinced that both objectives will be satisfied. The nature of the IFC financing in a project involves either equity or loan capital or both. The IFC seeks projects financed in association with private investors and management, in order to combine local knowledge and foreign technical and managerial experience. When providing equity capital, the IFC generally takes a minority position in

an enterprise (less than 25 percent of the outstanding equity). In reviewing investment projects, the organization has found one important measure of success to be the amount of financing from other sources provided to an enterprise in which the IFC is investing. However, co-financing of projects is not specifically required.

As mentioned previously, IFC will provide technical support in the preinvestment stage of potential projects through grants. These grants are designed to pay part of the costs of feasibility studies and, in general, help pay the cost of putting together all the elements of a project (industrial, technical, financial, and including a search for an appropriate business sponsor). In other cases, IFC will join in the equity of private companies together with other members of an investment group who are interested in backing the prospective full-scale company. The embryo company then carries out the necessary detailed study and negotiations needed to implement the project.

An important source of replenishment of IFC's funds is the sale of its commitments in all or in part to other investors. A significant percentage of IFC's total commitments have been revolved in this way, and IFC has had the participation of other investors in more than half of the commitments that it has made. Furthermore, IFC has operated on a profit making basis, thereby protecting its capital structure and providing a sound base for future operations.

IFC has generally avoided entering into individual loan agreements for less than \$1 million. This serves to reduce the number of individual loans and thereby holds down operating costs. IFC does, however, fund development finance corporations (DFC's) which in turn provide smaller scale loans within a more narrow geographic area.

B. ORGANIZATIONAL STRUCTURE

1. Organizational Form and Legal Status

IFC is an affiliate of the World Bank. Like other World Bank affiliates it was created through the adoption of Articles of Agreement. As stated within those Articles, each member government is required to take whatever action is necessary to make the provisions of the Articles effective under its own laws. IFC has full juridical personality with the capacity to make contracts, acquire and dispose of property, and to sue and be sued. IFC, its assets, property, income and authorized operations and transactions are immune from all taxation. IFC employees are also exempt from income taxes except those levied by their own government.

2. Governing Body

The governing body of the IFC is the Board of Governors of the World Bank which includes one representative (Governor) from each member country. This individual is typically the Finance Minister, a central bank governor, etc. Within the Board of Governors the voting power of each Governor is weighted by the capital

contribution of his country. All powers of the IFC are vested in its Board of Governors, which has delegated most authority to the Board of Executive Directors and the President. The Articles of Agreement, however, reserve certain powers to the Board of Governors including the power to: (1) admit or suspend members; (2) increase or decrease capital structure; (3) decide appeals from interpretations of the Articles of Agreement by the Executive Directors; (4) conclude formal cooperative agreements with other international organizations; (5) suspend operations and distribute the assets; and (6) approve amendments to the Articles of Agreement. The Articles of Agreement require that the Board hold at least one annual meeting where a quorum consists of a majority of the Governors representing at least two-thirds of the total voting power.

3. Management Structure

The next level of the organization beneath the Board of Governors is the Board of Executive Directors of the World Bank. There are currently 20 Executive Directors (five appointed by the five largest stockholders and 15 elected by the other Governors). The Executive Directors are responsible to the Board of Governors for the conduct of general operations. The Executive Directors review proposals for loans or other financing, borrowing, major technical assistance projects, operations, budgets, reports and recommendations to the Board of Governors, and matters involving policy issues as submitted by the President for consideration and decision.

Reporting to the Board of Executive Directors and the Chairman of that board is the President of the World Bank. The President is subject to the direction of the Executive Directors on questions of policy. He is responsible for the conduct of the ordinary business of the IFC and for the organization, appointment and dismissal of its officers and staff.

The principal departments reporting to the President through the Executive Vice President of the IFC are the Legal Department, the Engineering Department, the Office of the Economic Advisor, the Finance and Management Department, the four Regional Investment Departments, the Capital Markets Department and Investment Promotion.

C. SELECTION OF BOARDS, SENIOR MANAGEMENT AND STAFF

1. Board of Governors

Each member country appoints one Governor to the Board for a five year term. The Governor serves at the pleasure of his appointing government.

2. Board of Executive Directors

Five members of the 20-member Board are appointed by the five largest shareholding governments. The other 15 are elected by the Governors of the remaining members. All serve two year terms.

3. Senior Management

The chairman of the Board of Executive Directors is the President who is responsible for the conduct of the ordinary business of the IFC. The President is elected by the Board of Executive Directors to a five year term, and serves at their pleasure.

4. Staff

All levels of management and staff below the President are selected by management. Also, hiring and dismissal policies are governed by management prerogative rather than a civil service type arrangement. While quotas are not employed, the IFC seeks to engage individuals from as many member countries as possible.

D. RELATIONSHIPS WITH OTHER ENTITIES

1. Relationships With Governmental Units

As an international agency the IFC is not subject to direction from its member governments. The principal control exercised by these governments is their willingness to subscribe to additional capital shares as the organization from time to time wishes to increase its capital structure. Also, the sale of bonds in any member country must be approved by the government of that country. The IFC is not audited by any governmental agency nor are its budgets reviewed by the agencies of any government. The direct connection between the various member governments and the IFC is through governmental representation on the Board of Governors. The relatively small voting power of any

one Governor serves to shield the institution from undue political influence from any one government. The largest voting power (held by the U.S. Governor) is approximately 28 percent. Thus no one Governor exercises overall control. Additionally, the IFC provides an annual audited statement of its operations to all member countries.

2. Relationships With External Parties

In that most of its borrowed funds are obtained through the World Bank, the organization's contact with underwriters and other members of the financial community frequently moves through the World Bank itself. However, the sale of participations in its investments involve direct contact with major banks and other members of the financial community throughout the world. The financial statements of the IFC are also audited by an international firm of public accountants.

E. CONTROLS

1. Organizational Controls

An important element of the organizational controls governing the operation of the International Finance Corporation is the clear separation of duties between such functions as project promotion, investment review, investment approval, budgeting, disbursement, and project review. This separation creates a step-by-step review and approval process.

A committee of senior executives (the Investment Committee), which includes the Executive Vice President, the General Counsel, the Director of Engineering, the Investment Department Director, the Economic Advisor, and the Director of Finance and Management, reviews each loan proposal. The investment of the IFC's liquid assets is managed by the World Bank. This separation of key functions is outlined in the following chart which indicates the key duties and the organization performing each duty.

<u>Function</u>	<u>Performed by</u>
Project promotion	Investment Promotion Department
Loan and equity investment analysis	Department of Investments
Investment approval	Investment Committee
Contract preparation	Legal Department
Budgeting	Finance and Management Department (Budget Section)
Disbursement	Finance and Management Department (Disburse- ment Section)
Project review	Department of Investments
Investment of liquid assets	World Bank
Portfolio monitoring	Office of Portfolio Supervision

2. Operating Controls

At the operating control level there are a series of long range plans and budgets to guide the growth and direction of the organization. There are also a series of very extensive loan/equity investment review policies. These begin with a feasibility analysis (IFC will in some instances provide financial and technical support in the preinvestment stages of potential projects as described above). There is also an extensive project review where such preliminary information as a description of the enterprise, its legal status, its financial history, its present and proposed operations and their environmental effect, the purposes for which the financing is required, the outlook for profits, and the amount of financing sought are studied. The creditworthiness of the borrower is also examined. The IFC also considers the form of financing to be provided (debt, equity or both).

An additional element of operating control is provided by an active post-investment project review function and by a well-developed accounting/financial reporting system which provides management control data.

3. Financial Controls

The IFC receives no guarantee provisions (these are neither sought nor accepted) from member governments. Therefore, the loan review process as described

above is a critical element in the control structure. The nature of the loan/equity agreement and the collection procedures and measures available to the IFC also serve as important control elements.

By statement of policy the IFC does not take an active voting role in the enterprises in which it holds an equity position, with the exception of DFCs. In virtually all cases where it does maintain an equity position it also serves as a lender. If an investment does reach a troublesome stage, it is the power as a lender that is generally exercised to deal with the situation. This may include the examination of the enterprise by field teams and the engagement of consultants where deemed appropriate. In no case does IFC seek to take over the management of an organization even if it is experiencing financial difficulty. The equity and loan participation of other investors also serves to provide an additional control over the client enterprise, as does the IFC requirement for independent audits.

While IFC has no stated diversification requirement in its Articles of Agreement, it has investments in over 175 different enterprises in more than 50 countries. This diversification in its portfolio provides an added measure of security.

Another important control element maintained by the organization is an effective set of disbursement controls. These include a series of approvals and a clear separation between the duties of loan approval, on-site project review, disbursement approval, and actual disbursement activities. Additional levels of control are provided by post-audits of projects and through the internal audit function performed by the World Bank.

4. External Reporting and Review

The Articles of Agreement require the organization to make available an annual audited report to the public and to member governments. The report includes a detailed breakdown of each outstanding loan/equity investment. The IFC has also published its Articles of Agreement, and numerous World Bank publications outline IFC operating procedures and policies.

WORLD BANK
(INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT)

A. PURPOSE

1. General Statement of Purpose

The World Bank was established in 1944 to assist in the reconstruction after World War II and in the development of productive facilities and resources in less developed countries. Its purpose includes lending for projects that are of high priority, but for which financing is not available through private channels, i.e., the Bank does not compete with private sector financing sources. The Bank is also charged with responsibility to promote growth in international trade and balance of payments equilibrium by encouraging international investment, thereby assisting in raising productivity, living standards and labor conditions in member countries.

The Bank is organized as a continuing (permanent) institution designed to operate on a sound financial basis with funds borrowed in the capital markets. It extends long-term loans to creditworthy developing countries, for projects which the Bank and the country agree have high priority, at rates somewhat lower than, but related to, the market. It also extends long-term credits at concessionary rates of interest through two facilities, one an organization known as International Development Association, the other an interest subsidy fund known as "third window." In fiscal 1976 the Bank made 214 loans and credits totaling \$6.6 billion, and ranging in size from \$1 million to \$200 million.

2. Source of Funds

The principal sources of funds are capital contributions from member countries, funds borrowed in the financial markets, and income from operations. Funds for the concessionary loans and credits are provided primarily by special contributions from the developed member countries. Operating expenditures are financed from the Bank's income.

3. Operating Philosophy

The Bank is required to act prudently in the interests of both the particular member country in which the project is located and of the members as a whole. Its decisions are made on the basis of impartially weighed economic considerations. In addition, its loans are coordinated with international loans through other channels (by formal or ad hoc agreements to cooperate) so that the more useful and urgent projects, large and small alike, will be dealt with first. Lending decisions are also based partially on employment, income distribution, environment, health and social considerations which are an integral part of project planning and execution. The Bank does not, in practice, make loans of less than \$1 million. This serves to avoid the high operating costs of gearing down for small operations. It does, however, provide loans to intermediaries (development finance companies) which in turn relend to medium and small-scale enterprises.

The Bank is authorized to provide finance for productive purposes either by means of guarantees or

participations in loans and other investments made by private investors, or loans out of its own resources. (in practice, the guarantee authority has not been utilized in recent years as it counts equally with direct loans in determining the Bank's total lending authority.) It does not make equity investments in projects. Total loans outstanding may not exceed the total of its unimpaired subscribed capital, reserves and surplus. The present allowable ratio of debt to equity (paid-in capital) is approximately 9:1.

The Bank also provides limited funds and less limited manpower to help member governments formulate development policies and identify and prepare specific development projects. This effort is known by the term "technical assistance" and can include a variety of activities that are supportive to the main purposes of the Bank.

B. ORGANIZATIONAL STRUCTURE

1. Organizational Form and Legal Status

The Bank is an international institution owned by its member nations. The Bank possesses full juridical personality, including the capacity to contract, acquire and dispose of property and institute legal proceedings. It is immune from seizure of its assets, taxation and customs duties, and its archives are inviolable. Its Governors, Executive Directors, officers and staff are also immune from taxation and customs duties, other than in their home countries.

2. Governing Body

The governing body is the Board of Governors. All powers are vested in the Board of Governors, which consists of one member from each member country, whose votes are weighted in accordance with the capital contributions.

The Board of Governors retains sole power to admit or suspend members, increase or decrease capital stock, decide appeals of interpretations of the Articles of Agreement by the Executive Directors, make formal cooperative arrangements with other international organizations, determine the remuneration of the President and Executive Directors, determine the distribution of net income, and suspend permanently the operations of the Bank and distribute its assets. The Board may amend the Articles of Agreement, with approval of three-fifths of the members of the Bank holding at least four-fifths of the voting power. It must meet at least annually, and a quorum consists of an absolute majority of the Governors exercising not less than two-thirds of the total voting power. Decisions are made by a majority of the votes cast.

3. Management Structure

The next level of organization is the Board of Executive Directors. All powers have been delegated to the Executive Directors except those retained solely by the Board of Governors. The Executive Directors are responsible for the conduct of general operations of the Bank, and serve two-year terms in continuous session at Bank Headquarters. A quorum is a simple majority of the Executive Directors exercising not less than half of the voting power which is weighted in accordance with the capital contribution of the member countries

they represent. Decisions are made by a majority of the votes cast.

The President is the Chief of the operating staff, is elected by the Executive Directors and serves at their pleasure. In practice, the President is elected for a five-year term. He also serves as Chairman of the Board of Executive Directors with power to vote only in the case of a tie. The President is responsible for the ordinary business of the Bank and for the organization, appointment and dismissal of all officers and staff.

The principal departments reporting to the President through a Vice President are Finance, Legal, Development Policy, Operations, and External Relations. Operations is divided into seven departments reporting to the Senior Vice President.

4. Advisory Council

The Articles of Agreement provide that seven or more outside experts on banking, commerce, industry, labor and agriculture, from as many nations as possible be selected by the Board of Governors to serve two-year terms on an Advisory Council. The Council is charged with providing advice to the Bank on general policy.

C. SELECTION OF BOARD, SENIOR MANAGEMENT AND STAFF

1. Board of Governors

Each member country appoints one Governor to a term of five years. The Governor serves at the pleasure of his country's government and is eligible for

reappointment. Governors are normally finance ministers, chairmen of central banks or officials of comparable rank.

2. Board of Executive Directors

One Executive Director is appointed by each of the five largest stockholders. The others (15 at present) are elected by the Governors of the other member countries. Executive Directors serve for two-year terms at the pleasure of their governments or the Governors from the countries they represent and may be re-appointed.

3. Senior Management

The President is selected by the Executive Directors, and serves at their pleasure. In practice, the term of the President is five years. The current President, Robert S. McNamara, is a former U.S. Secretary of Defense.

4. Staff

The officers and staff of the Bank are selected by the President on the basis of the highest standards of efficiency and technical competence, with due regard to the importance of achieving the widest possible geographical diversity. Hiring, dismissal and remuneration of staff are matters of management prerogative.

D. RELATIONSHIPS WITH OTHER ENTITIES

1. Relationships with Governmental Units

The Bank is an autonomous international agency. The Articles of Agreement state that member governments

shall refrain from all attempts to influence the President, officers or the staff in the discharge of their duties. Conversely, the Bank shall not interfere in the political affairs of its member countries, and its decisions shall not be influenced by political conditions.

The principal control exercised by the member governments is through their willingness to subscribe to additional capital stock as the Bank from time to time attempts to increase its total lending capacity. It is not audited by any governmental agency, and its budgets are not reviewed by the agencies of any government. The direct connection between member governments and the Bank is through their representation on the Board of Governors and the Board of Executive Directors. No one country has sufficient voting power to control Bank decisions. The United States is the largest shareholder with 22.6 percent of the voting power. In addition, the Bank provides members with quarterly and annual financial statements.

The Bank, of course, maintains constant contact with developing member countries in regard to projects, loans and other development activities.

2. Relationships with External Parties

The Bank may buy and sell securities it has issued, guaranteed, or invested in, in any member country with the explicit permission of the government of that country. As a major borrower, the Bank maintains liaison and contact with underwriters and other members of the financial community in each market in which it is active. Its financial statements are audited by an international firm of public accountants.

E. CONTROLS

1. Organizational Controls

The manner in which the Bank is organized constitutes an essential set of controls over its activities. The organization is established in a manner that will insure that the objectives of the institution are carried out in a prudent and responsible manner.

The Board of Executive Directors functions as a major control over the activities of the Bank. All proposals for loans, borrowings, budgets, reports, and policy issues are submitted by the President to the Board for their review and approval. The Board has several standing committees, the most important of which is the Audit Committee. The independent auditors of the Bank report directly to the Audit Committee, as do the Operations Evaluation Department which conducts the post-audit of projects and the Internal Auditing Department.

Below the Board of Executive Directors is the senior management. In addition to their normal operating responsibilities selected members of senior management participate on standing committees. The Loan Committee reviews all proposed loans, and sets standards and criteria for lending operations and technical assistance. The Policy Review Committee reviews all proposals for policy changes and advises the President on policy matters.

A formal conflict of interest policy is maintained. All officers and staff are required to sign a pledge to uphold it.

Research and preparation of policies for review and approval by the President and Executive Directors, and the preparation of economic analyses and projections used as guidelines by all departments of the Bank, are the responsibility of the Development Policy Staff Department. It also analyzes the general creditworthiness of borrowers as it impacts their capability to absorb new loans.

The preparation of long-range financial plans and review of annual budgets prior to submission to the President and Executive Directors for their approval are performed by the Programming and Budgeting Department. This Department also analyzes the loan portfolio and borrower creditworthiness as it impacts on the Bank's financial position and credit standing in the capital markets.

Accounting records and financial reporting systems are maintained by the Controller's Department. This Department also reviews all applications for disbursements to borrowers and for payments of Bank expenses, for adequate documentation and compliance with policy and regulations. It also arranges and accounts for payments of contributions and capital stock subscription by member countries, and provides statements of account to borrowers.

The raising of funds in the capital markets and the investment of liquid funds and management of the investment portfolio of the Bank are the responsibility of the Treasurer's Department. This Department also controls cash balances and receipts and maintains relations with all depositories and fiscal agents.

Several departments, which may be taken together as a group, plan the lending program for each country; identify, appraise and design development projects that meet Bank standards, in conjunction with borrowers; negotiate the terms of prospective loans with borrowers; present and defend loan projects to the Loan Committee, the President and the Executive Directors for their review and approval; supervise projects to insure that the Bank and its borrowers carry out the provisions of the loan agreements; and monitor project progress in compliance with Bank policies and procedures and help borrowers take corrective actions where necessary.

All purchases are authorized, staff are recruited and personnel records, except the payrolls, are maintained by the Organization, Administration and Personnel department. This department also maintains control over documentation of the organization and procedures and other Bank records. In addition, it provides the normal administrative support to other Bank departments.

The final preparation of all loan agreements is carried out by the Legal Department. This Department also advises on all legal questions.

Audits of financial accounting, administrative and other activities are carried out on a continuing basis by the Internal Auditing Department. This Department reports to the Vice President of Finance and the Audit Committee and coordinates its efforts with the activities of the independent auditors.

Projects and other operations are audited approximately one year after the loan approval and at completion by the Operations Evaluation Department. This Department reports its findings directly to the President, the Executive Directors and the Audit Committee.

2. Operating Controls

The operational activities of the Bank, and the competence with which they are carried out, in themselves represent important controls over the Bank's activities.

Annual administrative budgets are prepared by the staff of the Bank and submitted to the President and Executive Directors for review and approval. Long-range (five year) lending programs and financial plans are also prepared for review and approval by the President and Executive Directors. The plans include quantitative goals and statements of which sectors will be emphasized.

The long- and short-term creditworthiness of the borrowers is carefully reviewed from several aspects by three different departments of the Bank. Project (loan) preparation and follow-up is very extensive. The Bank staff leads the efforts, in conjunction with its borrowers, through all phases including: overall economic analysis and forecasts; basic sector analysis (e.g., transportation); initial project identification (e.g., port expansion); detailed project preparation (e.g., construction costs, management improvements required, financial forecasts, etc.); loan negotiations (e.g., terms, conditions, etc.); project implementation

(e.g., procurement, management, accounting, viability); and future investment needs.

Investments of the Bank's assets and its loan portfolio are managed to provide the maximum income for operations while maintaining the security of its assets.

3. Financial Controls

Disbursements are controlled by the careful review of required documentation to insure compliance with Bank policies, guidelines and procedures. This review applies to both disbursements to borrowers and for operating expenses of the Banks.

The Bank normally requires borrowers to submit audited annual accounts. These accounts are supplemented by periodic progress reports which are also required, as are minimum standards of accounting for loan proceeds and project costs.

All loans made by the Bank must be made to or guaranteed by a member government. In the unlikely event of default on a loan, principal and interest would become payable immediately and the member country government could be suspended from the Bank.

The rules and regulations of the Bank require that most major procurement by borrowers from Bank loan funds is made through competitive bidding.

In practice, a material portion of the Bank's loans is not made in any one country, sector or industry. This diversification provides security and protection of assets.

The Bank maintains comprehensive financial reporting systems. Care is taken to insure that these systems have adequate capacity to handle the volumes of transactions of the Bank for its present and future levels of lending activity.

4. External Reporting and Review

The Articles of Agreement require that an annual report containing audited financial statements be submitted to all member governments. In addition, unaudited quarterly balance sheets and income statements must also be submitted.

The Bank also provides news releases, special studies and many other contributions to the literature of development to the public.

INTER-AMERICAN DEVELOPMENT BANK

A. PURPOSE

1. General Statement of Purpose

The purpose of the Inter-American Development Bank (IDB) which was founded in 1960 is to further economic and social development in Latin America. According to the Agreement establishing the IDB, it has the functions of promoting the investment of public and private capital for development purposes; utilizing its own capital and funds raised in the financial markets and from other sources for financing the development of member countries, giving priority to those loans and guarantees that will contribute most effectively to economic growth; encouraging private investment in projects, enterprises and activities contributing to economic development and to supplement private investment when private capital is not available on reasonable terms and conditions; cooperating with member countries to orient their development policies toward a better utilization of their resources; and providing technical assistance for the preparation, financing and implementation of development plans and projects, including the study of priorities and the formulation of specific project proposals.

In addition to its regular loan fund, the IDB operates several other funds, the most important of which, is a concessionary loan fund financed by capital subscription of members. Combined loan authorizations

from all funds for calendar year 1975 approximated \$1.4 billion on 70 different projects. The purpose of the concessionary loan funds is to enable the IDB to finance projects with a slow return but which are deemed indispensable to the economic development of those on the fringes of the regional economy.

Current interest rates on direct loans from IDB resources are 8.6 percent with terms ranging from 15-30 years. Loans from concessionary resources normally carry an interest rate of 2-4 percent.

2. Source of Funds

The IDB's principal sources of funds are capital subscriptions from member countries, borrowed funds raised in the financial markets and the proceeds from its own operations. The operating expenditures of the IDB are financed from its operating revenues. While the IDB is authorized to raise funds in the debt markets, such borrowing by policy will not exceed the U.S. callable capital for its principal loan fund. This results in an allowable ratio of debt to equity (paid-in capital) of approximately 2 to 1.

3. Operating Philosophy

The IDB intensely promotes potential projects and in some cases provides grants for feasibility studies and institutional strengthening or other technical assistance. In analyzing a potential project, the project is viewed on economic terms only. The two prerequisites for project acceptance are that it must be for development purposes and that it must be economically viable. IDB loans generally relate to financing

of government-sponsored projects, and are not viewed to be in competition with private sector financing sources. The IDB has increased its effort to work in cooperation with traditional financing sources to channel funds towards development projects in Latin America. This is facilitated by IDB loans to projects that also receive private sector financing. The private sector financing source benefits because the IDB has studied the project and acts as the disbursing and collecting agency for the loan and is responsible for monitoring the status of the project and administering the loan until it has been completely repaid. Additionally, participations are sold up to the full amount of the loan to interested financial institutions. The IDB does not take an equity position in any of the projects it finances. While co-financing of a project by local or other sources is not required, it is encouraged. Under current operating procedures, member governments must guarantee all loans.

The IDB generally does not provide loan funds to smaller projects, but does make loans to development finance corporations (DFC's) which in turn provide loans to such projects. Most IDB loans are for amounts in excess of \$1 million - the average hard loan size is \$25 million and the average soft loan size is \$15 million. The DFC approach has proven to be an effective means of avoiding the expense of processing and administering numerous small projects. It also encourages the formation of local development lending capabilities.

The sale of some IDB commitments to other investors provides one source of replenishment of loanable funds. Another important funding consideration is the fact

that the organization has consistently operated on a profit making basis. This has served to protect its capital structure and provide a sound base for future lending.

B. ORGANIZATIONAL STRUCTURE

1. Organizational Form and Legal Status

The IDB was organized as a corporation through the ratification of Articles of Agreement by its member nations. The Articles of Agreement define the legal status of the IDB as possessing juridical personality with full capacity to contract, acquire and dispose of property, and institute legal proceedings. Among other provisions of the Articles are immunities from taxation of its property, assets and income. Additionally, its directors, officials and employees are immune from income taxes except those levied by their own countries.

2. Governing Body

The governing body of the institution is its Board of Governors which is made up of twenty-four Governors, one from each member country, with votes weighted by the capital contribution of that country. All powers of the IDB are vested in its Board of Governors. The Board of Governors may delegate to the Board of Executive Directors all powers except the admission and suspension of members; the increase or decrease of authorized capital stock; the election of the President and the determination of remuneration of the President and

Executive Directors; authority to hear and decide appeals of interpretations of the Articles of Agreement; the conclusion of agreements with other international organizations; the approval of the general balance sheet and statement of profit and loss after reviewing the auditor's report; the determination of reserves and distribution of net profits; the selection of outside auditors; the amendment of the Articles of Agreement; and the termination of operations and distribution of assets.

The Articles of Agreement require that the Board hold at least one annual meeting where a quorum consists of an absolute majority of the total number of governors representing not less than two-thirds of the total voting power. Decisions are based on a majority of the shares being voted.

3. Management Structure

The next level of the organization beneath the Board of Governors is the Board of Executive Directors. The Board of Executive Directors is responsible for the conduct of the IDB and its day-to-day operations. There are currently nine Executive Directors (one appointed by the largest shareholder and the other eight elected by the remaining Governors). Reporting to the Board of Executive Directors is the President. The President also serves as presiding officer at meetings of the Board of Executive Directors.

The principal departments reporting to the President, through the Executive Vice President, are the Operations (Loan) Department, the Finance Department, the Project Analysis Department, the Legal Department, the Administrative Department, the Secretariat Department, and the Controller.

C. SELECTION OF BOARDS, SENIOR MANAGEMENT AND STAFF

1. Board of Governors

Each member country appoints one Governor to a five-year term. The Governor serves at the pleasure of his government and is usually the finance minister, central bank governor or an official of comparable rank.

2. Board of Executive Directors

One Executive Director is appointed by the member having the largest number of shares in the IDB. The remaining Executive Directors are elected by Governors representing the other members. Executive Directors, either elected or appointed, serve for a term of three years and may be reappointed or re-elected to successive terms. No two Executive Directors may be citizens of the same nation. The Articles of Agreement call for the Executive Directors to be "persons of recognized competence and wide experience in economic and financial matters." The voting power of each Executive Director is determined by the number of votes cast toward his election.

3. Senior Management

Reporting to the Board of Executive Directors is the President, who serves as the Chief of Staff of the organization. The President is elected by the Board of Governors and serves at their pleasure. His term of office is five years and he may be re-elected to successive terms. The current President, Antonio Ortiz Mena, is a former Finance Minister of Mexico.

4. Staff

While members of the Board of Governors are appointed by governmental units, all levels of staff below that are selected by the Governors (each representing a different country) or in most cases by management. Also, hiring and dismissal policies are governed by management prerogative rather than a civil service-type arrangement.

D. RELATIONSHIPS WITH OTHER ENTITIES

1. Relationships with Governmental Units

As an independent international agency, the IDB is not subject to direct control by its member governments. The principal control exercised by these governments is their willingness to subscribe to additional capital shares as the IDB from time-to-time wishes to increase its capital. The IDB is not audited by any governmental agency nor are its budgets reviewed by the agencies of any government. The direct connection between various member governments and the IDB is

through representation on the Boards of Governors and Executive Directors. While each Governor is answerable to his own government, the relatively small voting power of any one Governor serves to shield the institution from undue political influence from any one government. The largest voting power is that of the United States (40 percent).

The IDB provides an annual audited statement of its operations. Each government must also approve any bond offering within its own capital markets prior to issue. The IDB, of course, works directly and closely with developing member country governments with regard to specific lending proposals and other operations.

2. Relationships With External Parties

As a borrower of funds principally through the bond markets, the IDB maintains contact with underwriters and other members of the financial community. It also maintains contacts with the banking industry through the sale of participations, and through cooperative financing arrangements. Its financial statements are audited by a firm of independent accountants.

E. CONTROLS

1. Organizational Controls

The manner in which an entity is organized creates a control structure surrounding its activities. In this regard, the IDB has established a framework for control by the clear separation of such duties as loan

review, loan approval, disbursement, project audit and investment decisions. Proposed loans are reviewed by a Loan Committee (formally known as the Loan and Technical Co-operation Committee) composed of senior executives and headed by the Executive Vice President. The Board of Executive Directors examines each loan prior to approval and performs a final review function. Decisions pertaining to the investment of liquid assets are reviewed by the Finance Committee which is made up of senior financial officials. The Board of Executive Directors also functions as audit committee. The IDB is currently developing a conflict of interest policy.

The strongest of the organizational controls is the separation of duties between organization units. The preparation of long range financial plans and review of annual budgets prior to submission to the President and Executive Directors for their approval are performed by the Budget and Management Accounting Division of the Administrative Department.

Accounting records are maintained by the Financial Information and Control Division of the Finance Department. This group also reviews all authorizations for disbursement to borrowers and for payments of bank operating expenses. This review entails the inspection of supporting documentation and determination of compliance with IDB disbursement policies and regulations.

The Capital and Operations Finance Division of the Finance Department performs final disbursement controls and approves invoices to borrowers. It also is responsible for collecting and accounting for capital subscriptions from member countries.

The Investment and Financial Market Division of the Finance Department is responsible for the management, control and investment of liquid funds and management of the portfolio of current assets. It also secures borrowed funds and seeks to place participations with commercial banks.

Several departments which may be considered as a group plan the lending program for each country; review and evaluate all borrowing requests; negotiate terms of prospective loan agreements with borrowers; and present such loan requests to the Loan Committee, the President and the Executive Directors for their review and approval. These same departments also supervise projects to ensure that the IDB and its borrowers carry out the provisions of the loan agreements and monitor project progress and report project status to senior management.

All staff recruitment and personnel records are maintained by the Personnel Division of the Administrative Department. The Administrative Department also provides the data processing support through its Management System Division.

Final review of all loan agreements is carried out by the Legal Department. This department also advises on all legal questions.

Internal audits of financial accounting, administrative and other activities are carried out on a continuing basis by the Internal Audit group reporting to the Controller. The Controller in turn reports to the President. Additionally, internal audit activities are coordinated with the effort of the independent auditors.

2. Operating Controls

At the operating control level of the IDB there are a series of long range plans over a five year horizon including a five year cash plan. Annual administrative budgets are also prepared by the staff of the IDB and submitted to the President and the Executive Directors for review and approval.

Within the loan area the IDB employs an extensive array of loan review policies. These reviews begin with a feasibility study which is generally performed before loans are approved (the feasibility study may be financed by an IDB grant). The project analysis unit also appraises the viability of each project. The creditworthiness of the borrower is also examined. Within the loan approval process an extensive file is created, prior to loan approval, which includes the feasibility study, an audit report on the enterprise (if applicable), determination if the entity maintains an account with the Central Bank of that country, and the development of a contract which includes a review by the Operations and Legal Departments.

After loan approval there are field controls to ensure that disbursements are provided for only those items approved in the loan contract (generally capital goods or consulting assistance). The field review team also periodically monitors project status and provides extensive reporting on this status to the headquarters. There is also a post-audit process after project completion.

The investment of its liquid assets which includes such instruments as U.S. Treasury bills, U.S. Treasury notes, bank certificates of deposit, bank time deposits, and instruments of U.S. agencies, are protected by a series of controls designed to safeguard this process. These include a daily market appraisal, Finance Committee reviews of investment decisions, the separation of the investment decision from the investment disbursement process, the custody of liquid investment instruments by the Federal Reserve or a commercial bank, and the disbursement of investment funds through wire transactions with the Federal Reserve. At the end of 1975 liquid assets were approximately \$1 billion.

3. Financial Controls

One significant feature of the financial control structure of the IDB is the careful review procedures of the disbursement process. These procedures relate to both disbursements to borrowers and to disbursements for operating expenses. Cash disbursements to borrowers are made through the Central Bank of the borrowers country which provides an additional level of control.

Another important financial control feature is the guarantee provisions which the IDB requires from each government on each loan prior to approval. Each borrowing entity must also submit an audited annual report. However, in that most financing is for government sponsored projects these audits are generally performed by the local equivalent of the U.S. General Accounting Office.

In the collection area, the controls include a clearly defined collection schedule, the distribution of weekly reports to management on collection status of individual loans, the ability to quickly identify overdue balances, the quarterly preparation of a problem loan report with detailed descriptions from the field on project status and the nature of any difficulty, and extensive field office follow-up. There have been only two defaults in the history of the IDB (both by private borrowers before government backing was required on all loans). In the unlikely event of default on a loan, principal and interest would become payable immediately and the member country government could be suspended from the IDB. The widely diversified nature of both the loan portfolio and the portfolio of liquid assets serves to provide an added measure of security.

4. External Reporting and Review

The Articles of Agreement require an annual audited report which is available to the public and to the member governments. This reports includes a detailed breakdown of the loan portfolio in addition to audited financial statements. Additionally, the IDB has published its Articles of Agreement and provides a wide array of other publications describing its operating procedures, organizational structure and overall functions.

OVERSEAS PRIVATE INVESTMENT CORPORATION
FINANCE PROGRAM

A. PURPOSE

1. General Statement of Purpose

The purpose of the Overseas Private Investment Corporation (OPIC), established by the U.S. Government in 1971, is to encourage economic and social development in approximately 80 lesser developed countries considered friendly to the United States. Through its Finance Program, OPIC assists U.S. lenders and business enterprises in searching out and financing worthwhile projects in the developing world. OPIC operates on a self sustaining basis and seeks to accomplish these objectives through its investment guaranty program, its direct investment fund, and its pre-investment assistance program.

The investment guaranty program protects U.S. lenders against loss from commercial and political risk by providing for repayment of principal and interest on loans made to eligible borrowers. The current legislative authority for OPIC loan guaranties is \$320 million. Of this amount OPIC has \$197 million in outstanding commitments.

The direct investment fund totals \$50 million and offers direct dollar lending of OPIC funds. OPIC currently has outstanding commitments of \$34 million from its direct investment fund.

The pre-investment survey program provides funds of up to \$50,000 to assist investors on a risk sharing basis in assessing viable projects in the developing nations. This program is designed to promote selectively U.S. private investment and U.S. small business in the less developed countries.

2. Source of Funds

OPIC's sources of funds are U.S. Congressional appropriations and proceeds from its own operations. In addition, OPIC has the authority to guarantee loans totaling \$320 million from financial institutions to qualified borrowers. OPIC's operating expenditures are financed through its own internal funds.

3. Operating Philosophy

OPIC takes the initiative in identifying investment opportunities and in bringing them to the attention of qualified U.S. investors. OPIC does not compete with the private sector in making loans. It does assist project sponsors in formulating project financial plans and in coordinating them with other lenders. In certain cases, OPIC will share the cost incurred in conducting feasibility studies. All projects OPIC supports must be consistent with the economic interests of the United States. The proceeds of OPIC financing must be spent for capital goods and services in the United States, the host country, or in other less developed countries.

Direct loans from OPIC generally range in amount from \$200 thousand to \$4 million for which OPIC absorbs much of the administrative cost involved. This source of funding is used most commonly in smaller projects. Although sponsors of such projects would be able to borrow with OPIC's guaranty, the cost of legal and placement fees would be almost prohibitive for this size loan.

The financing of larger projects is provided by an issuance of an OPIC guaranty to a U.S. financial institution which furnishes funds to the project. After OPIC has reviewed and approved the project and has negotiated a loan agreement with the company, the U.S. sponsor is responsible for locating the guaranty lender. Guaranteed loans generally range from \$4 million to \$25 million.

OPIC's financing decisions are based primarily on the project's contribution to the host country's development, the project's financial requirements, and the extent to which the financial risks and benefits of the project are shared among investors and lenders. Projects in the poorer of the developing countries involving smaller U.S. firms are of particular interest to OPIC.

Projects financed by OPIC must have U.S. investors owning a meaningful share of the investment (generally considered to be at least 25 percent of the voting shares). Although OPIC does not purchase equity in a project, it may purchase convertible notes and certain other debt instruments with equity participation features.

OPIC does not require co-financing of projects, but does encourage it as a means to reduce the overall project risk and ensure management involvement. Co-financing also creates a greater awareness among U.S. lenders of investment opportunities in the developing countries.

B. ORGANIZATIONAL STRUCTURE

1. Organizational Form and Legal Status

OPIC was established by the U.S. Foreign Assistance Act as a wholly-owned U.S. Government corporation.

2. Governing Body

The governing body of OPIC is its Board of Directors which exercises or delegates all powers of the corporation. The Board of Directors has eleven members, six from the private sector, and five from the United States government (including the President of OPIC). The Chairman of the Board of Directors is the Administrator of the United States Agency for International Development.

Six Directors constitute a quorum for the transaction of business. Meetings are held as required, usually monthly.

3. Management Structure

The next level of authority beneath the Board of Directors is the Chief Executive Officer, the President.

The principal departments reporting to the President, through the Executive Vice President, are the Office of Development, Office of Public Affairs, Office of the Treasurer, Finance Department, Insurance Department, and Office of the General Counsel.

C. SELECTION OF BOARD, SENIOR MANAGEMENT AND STAFF

1. Board of Directors

The six members of the Board of Directors from the private sector, and OPIC's President, are directly appointed by the President of the United States and confirmed by the U.S. Senate. The four other government Directors hold the posts of:

- Administrator of the Agency for International Development,
- Under Secretary of State for Economic Affairs,
- Assistant Secretary of the Treasury for International Affairs, and
- Under Secretary of Commerce.

Each Director from the private sector is appointed for a term of no more than three years and serves at the pleasure of the President of the United States. The terms of no more than two of the private sector Directors can expire in any one year. The government Directors serve at the pleasure of the President of the United States.

2. Senior Management

The President and Executive Vice President are appointed by the President of the United States and are confirmed by the United States Senate. They serve at the pleasure of the President of the United States. Other members of senior management are selected and appointed by the Board of Directors and serve at the Board's pleasure.

3. Staff

The OPIC staff consists of about 130 persons who are primarily Civil Service employees. Policies for hiring, dismissal, and compensation of most employees are according to the U.S. Government practices and regulations. Senior professional staff, however, are recruited and engaged directly by management.

D. RELATIONSHIPS WITH OTHER ENTITIES

1. Relationships With Governmental Units

As a corporation of the United States Government, OPIC is subject to review every four years through the Congressional authorization process. It utilizes U.S. Embassy offices in the countries where its programs operate, and receives assistance from other governmental departments and agencies as needed. OPIC also requires that approval be obtained from the host country indicating that the project contributes to its development.

OPIC is required to have an annual audit of its financial statements conducted by the General Accounting Office.

2. Relationships With External Parties

OPIC's Finance Program is designed to complement and supplement the lending and investing facilities of commercial banks; local, regional, and international development banks; and such entities as the Export-Import Bank of the United States. To encourage such joint participation, OPIC advises and assists U.S. project sponsors in securing debt and equity financing from these institutions. Almost half of OPIC's projects involve at least one other lender, and in large projects there are usually several. OPIC's willingness to commit to a portion of a project's debt requirements, to accept longer or more flexible maturities, and to finance at fixed interest rates often encourages participation by other lenders. OPIC also provides loan guaranties to U.S. lenders for project funds. Such a guaranty is an irrevocable commitment to the lender that the principal and interest on the loan will be paid by OPIC if, for any reason, the borrower fails to pay according to the loan agreement.

E. CONTROLS

1. Organizational Controls

The government members of the Board of Directors are, as U.S. Government employees, required to follow federal guidelines concerning conflicts of interest. It is Corporation practice for private sector Directors to excuse themselves from financing decisions involving their related interests.

OPIC does not have an investment committee for authorization and approval of investment decisions for liquidity instruments, but instead delegates this responsibility to the Treasurer's Office. These investments are restricted to U.S. Government securities.

For loan decisions under \$4 million, authorization is provided by a loan committee comprised of the President, Executive Vice President, and the four department heads from the General Counsel's Office, Finance Department, Insurance Department and Treasurer's Office. For loans exceeding \$4 million, authorization by the Board of Directors is required.

OPIC separates the duties of loan review, loan approval, loan disbursement and loan administration. The Finance Department is responsible for developing and reviewing financing proposals. The loan committee or the Board of Directors (depending on the size of the loan) gives final financing authorization on loan decisions. Loan disbursement and administration are the responsibility of different sections in the Treasurer's Office.

2. Operating Controls

OPIC develops long range plans to facilitate management of its operations. These plans include forecasts of revenues, operating expenses, capital requirements and cash flow.

Project sponsors must submit a comprehensive plan for all proposed projects to OPIC. The plans and supporting data prepared by the project sponsors are carefully analyzed together with the financial forecast.

Audited financial statements for the project sponsors are required and are reviewed by OPIC to determine the financial stability of the borrower.

A feasibility analysis is required of all proposed projects. In some instances, OPIC shares with the project sponsors the cost incurred in carrying out such a study. However, if the project goes ahead, OPIC considers the cost of the study to be a legitimate cost of the project and capitalizes the contribution by the sponsor in the project's financial plan. Projects are reviewed as to their commercial and financial soundness. The project must be within the demonstrated competence of the proposed management and the sponsor, who must have a proven record of success in the particular business, as well as a significant financial risk in the venture.

The Treasurer's Office has responsibility for the settlement or collection of default loans and the evaluation of project failures to determine the causes of unsuccessful projects.

3. Financial Controls

For direct loans, funds are disbursed to project sponsors through the Treasurer's Office. The accounting system includes financial records for each OPIC project including loan disbursements and loan payments. Delinquent payment reports are prepared on a timely basis and project sponsors notified of any payments not received. Payments are submitted directly to OPIC's

Accounting Department. For loan guaranty projects, these administrative functions are performed by the financial institution to which the guaranty was issued.

OPIC does little monitoring of project progress because of the limited size of its staff and the protection OPIC believes it receives from the guarantee provisions of its loans. OPIC requires that that project sponsors enter into an agreement under which they are obligated to provide any additional financing necessary to complete the project and to have adequate working capital when certain operating tests are met. OPIC does require audited quarterly financial reports for a project for the first two years and audited annual reports thereafter until the project is completed and the loan repaid. The auditors must be acceptable to OPIC.

OPIC requires that sponsors and investors be willing to establish sound debt to equity relationships which will not jeopardize the success of the project. An operating guideline of 60 percent debt and 40 percent equity is used.

It is a practice of OPIC to diversify its loans geographically to minimize risk. OPIC also occasionally purchases convertible notes and other debt instruments with equity participation features which it then sells on the basis of the underlying stock. It is thereby able to increase its income to compensate for the risk inherent in its portfolio and revolve its total lending capabilities.

Competitive bidding for goods and services needed in OPIC projects is not required. However, OPIC does require that first-class standards and specifications be employed in the design, engineering, and construction plans of the required facilities.

With the exception of convertible subordinated notes, OPIC requires that its financial participation be on a senior basis, pari passu, with the holders of other senior debt.

4. External Reporting and Review

OPIC is required to have an annual audit of its financial statements by the General Accounting Office in accordance with the guidelines set forth in the Government Corporation Control Act. This report must be submitted to Congress each year.

In addition, OPIC voluntarily testifies before Congress on legislation related to its interests. Informational brochures and material on OPIC programs are also distributed to the public.

WORLD BANK/IFC - SPONSORED
DEVELOPMENT FINANCE COMPANIES

A. PURPOSE

1. General Statement of Purpose

The World Bank and the International Finance Corporation (IFC) have supported the establishment of regional and national development banks for over 25 years. These banks, known as development finance companies (DFCs), receive large loans and equity investments from the World Bank/IFC and other sources, and in turn relend to medium-scale, and in some cases small-scale, enterprises. Worldwide, there are well over 100 DFCs, over 70 of which have received World Bank/IFC support.

Most DFCs are established to promote and finance the expansion of private economic activity in developing countries and are set up as shareholder owned and controlled companies. These two facts impose the necessity of investing only in productive projects likely to return a reasonable profit to the DFC. Another objective is to encourage formation of local capital markets and broader ownership of securities.

2. Source of Funds

The primary sources of funds are capital subscriptions from governments, IFC, commercial banks and other private investors and borrowings from governments and international development banks. Some DFCs are also

able to borrow from the private capital markets. As profit-oriented enterprises, operating expenses are paid from operating revenues. The DFCs tend to have debt to equity ratios in the range of 3:1 to 15:1.

3. Operating Philosophy

The normal operating philosophy is to make loans and equity investments on the basis of financial, economic and technical criteria and not on political considerations. Shareholder expectations also impose the discipline of having to operate in a prudent and profitable way.

The DFC's each have up to \$3 billion in assets, up to 3,000 professional staff, and up to 3,000 loan/investment approvals per year ranging in size from \$20,000 to \$5,000,000. Many have substantial government ownership. Most provide medium and long-term funds at or near normal commercial rates.

As with the international development banks, DFCs are aggressively involved in project promotion and appraisal, sector development, and development policy issues. Promotion often involves organizing foreign and domestic partners to undertake a project, and marshalling debt and equity participations from several sources.

B. ORGANIZATIONAL STRUCTURE, and

C. SELECTION OF BOARD, SENIOR MANAGEMENT AND STAFF

1. Organizational Form and Legal Status

DFCs are legally organized as corporations within each country, with normal corporate personality and capacities. Their organizational structure falls into three main categories - typical multipurpose development bank, usually modeled on the World Bank itself; "mixed bank," i.e., a normal commercial bank with special capability to finance long-term development projects; and sector-specific development bank, i.e., its activities are restricted to one sector, housing for example.

2. Governing Body

The governing body is normally a single board of directors, representing the interests of the various shareholders and elected by them.

3. Management Structure

Each DFC is managed by a strong chief executive officer (CEO) usually elected by the directors. Officers and staff are normally selected by the CEO who has responsibility for the organization, appointment and dismissal of employees. Staff hiring, dismissal and remuneration are matters of management prerogative.

D. RELATIONSHIPS WITH OTHER ENTITIES

1. Relationships with Governmental Units

It has been clearly demonstrated that a DFC, to be effective, must be independent to the extent that it is able to make its investment decisions, choose its staff, and carry on its administration solely on the basis of its own best judgment. Most DFCs are organized as autonomous corporations with non-political board majorities, officers and staff to preserve this essential independence. This structure is critical because the areas of contact with government are numerous, as described in the following paragraphs.

The objectives of a DFC are to maintain adequate profits, sustain its creditworthiness, and make an important contribution to development. The latter is also a public policy goal and often requires some compromises that an ordinary private business institution would not consider.

The DFC also cooperates closely with government in order to represent the private sector when policies and plans that affect the private sector are formulated. The DFC assists its borrowers with meeting government requirements for concessions, appeals, incentives, licensing, etc., during the project development stage.

Governments are also the major source of capital, equity and debt, for most DFCs. This paramount financial influence can dilute independence in several ways:

- pressure to hold interest rates below market,
- pressure to consider projects too small for economic investments and perhaps too risky, and
- pressure to fund projects in least developed regions.

This influence can easily become interference with management decisions on investments, staffing and internal administration. A legitimate channel of influence is inclusion of a government director on the board. This usually permits smooth coordination between the DFC and governmental agencies.

Finally, there is a need for close cooperation between the independent DFC and public financial agencies, such as housing banks and various subsidized loan and loan guarantee programs. The public agencies should not compete with the DFC in its assigned fields of responsibility, in particular by offering below market interest rates and relaxed project appraisal standards, or by offering to finance projects considered unsound by the DFC.

2. Relationships with External Parties

The DFCs are usually major elements of local capital markets through their lending, equity investment and underwriting operations. They normally maintain close contact with all members of the financial community, and deal with them frequently. In addition, most DFCs are audited by independent public accountants.

E. CONTROLS

1. Organizational Controls

Most DFC's are organized along the lines of the World Bank/IFC model described in Attachments I and II. This normally includes standing committees for loans and investment decisions, and adequate separation of duties among project promotion and development, loan approval, disbursement and collection activities.

2. Operating Controls

The successful operation of a DFC requires a certain minimum number of activities designed to produce profits and aid development while maintaining the all-important independence of the DFC. First is the creation of ideas for development projects. The DFC shares the responsibility for ideas equally with the entrepreneurial community and the local government. Normally, the DFC will have a staff of economists and an advisory council to assist business-oriented senior management with this process.