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OFFICE OF INSPECTOR GENERAL

AUDIT OF USAID/AFGHANISTAN'S AGRICULTURE, RURAL INVESTMENT AND ENTERPRISE STRENGTHENING PROGRAM

AUDIT REPORT NO. 5-306-08-001-P
JANUARY 22, 2008

MANILA, PHILIPPINES

Office of Inspector General

January 22, 2008

MEMORANDUM

TO: USAID/Afghanistan Director, Robin A. Phillips

FROM: Acting Regional Inspector General/Manila, William S. Murphy /s/

SUBJECT: Audit of USAID/Afghanistan's Agriculture, Rural Investment and Enterprise Strengthening Program (Audit Report No. 5-306-08-001-P)

This memorandum transmits the Office of Inspector General's final report on the subject audit. In finalizing the report, we considered your comments to the draft report and included the comments (without attachments) in appendix II.

Based on our review of the mission's comments, detailed actions, and subsequent supporting documents received, we determined that final actions have been taken on Recommendation Nos. 1 through 4 and management decisions have been reached for Recommendation Nos. 5 and 6. A determination of final action for Recommendation Nos. 5 and 6 will be made by the Audit Performance and Compliance Division (M/CFO/APC) upon completion of the proposed corrective actions.

Thanks to you and your staff for the cooperation and courtesy extended to us during the audit.

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SUMMARY OF RESULTS

Access to rural financial services in Afghanistan is severely limited after decades of war and the ouster of the Taliban regime, both of which devastated the country's resources and infrastructure. As a result of these economic hardships, since 2002 many Afghan farmers have become involved in illicit opium production (see page 3).

When it was launched in 2004, USAID/Afghanistan's Alternative Development Program (ADP)[1] was to have included activities to accelerate legitimate economic growth in key poppy-growing provinces in Afghanistan by creating or strengthening credit and financing institutions. However, credit and financing activities were not implemented under the program because of contract restrictions (see page 3).

In September 2006, USAID/Afghanistan awarded a 3-year, $80 million cooperative agreement to Academy for Educational Development (AED) to implement the Agriculture, Rural Investment and Enterprise Strengthening (ARIES) program. The overall purpose of the ARIES program is to provide expanded access to rural financial services, primarily in alternative development regions where farmers grow opium poppy, and to create a strong private sector foundation for a developing rural finance system capable of providing a full spectrum of financial services on a sustainable basis (see page 3).

The Regional Inspector General/Manila conducted this audit to determine whether USAID/Afghanistan's ARIES program was achieving its intended results and what its impact has been (see page 4).

In its first year, the ARIES program achieved or exceeded most of its goals and helped make a significant impact in expanding Afghanistan's licit rural economy by creating 62,674 jobs. Despite its achievements, ARIES could have been more successful with implementing small and medium enterprise (SME) loan segment activities and Investment and Finance Cooperatives (IFCs) (see pages 5 and 6).

In addition, USAID/Afghanistan could improve the implementation and management of the ARIES program in four areas: (1) the program's focus in ADP priority regions was unclear to ARIES' implementing partners; (2) the program's success stories in ADP regions were not being communicated to USAID; (3) improvements were needed in the performance monitoring and evaluation of the program; and (4) IFCs lacked management information systems (see pages 7, 9, 10, and 11).

This report made six recommendations to help USAID/Afghanistan improve its oversight of the ARIES program in the remaining 2 years of the cooperative agreement:

- Require AED to make clear to its partners that the ARIES program is to be implemented primarily in ADP regions and to dovetail with regional ADP priorities as required by the cooperative agreement (see page 8).

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[1] The Alternative Development Program was formerly known as the Alternative Livelihoods Program.

- Work with AED to establish formal goals in its work plan for implementing ARIES activities in ADP regions for the remaining 2 years of the cooperative agreement (see page 8).

- Direct AED to communicate success stories related to shifting opium poppy workers into licit livelihoods as a result of ARIES loans in ADP regions (see page 9).

- Direct AED to revise its ARIES Performance Monitoring Plan to include appropriate performance indicators and targets that measure both micro and SME finance activities by region and by partner and provide quarterly reports of those results to USAID (see page 11).

- Direct AED to ensure that one of its partners, the World Council of Credit Unions (WOCCU), establishes and maintains appropriate systems and processes for recording, reporting, and internal monitoring of the operating activities of its Investment and Finance Cooperatives (IFC) as required by the ARIES work plan (see page 12).

- Direct AED to ensure that WOCCU implements an integrated accounting system at each of its IFCs as required by its subagreement (see page 12).

In its response to the draft report, USAID/Afghanistan generally agreed with the findings and recommendations. Based on a review of the mission's comments, detailed actions, and subsequent supporting documents received, the Regional Inspector General/Manila determined that final actions have been taken on Recommendation Nos. 1 through 4 and management decisions have been reached for Recommendation Nos. 5 and 6 (see page 13).

USAID/ Afghanistan's written comments on the draft report are included in their entirety (without attachments) as appendix II to this report.

BACKGROUND

Access to rural financial services in Afghanistan is severely limited after decades of war and the ouster of the Taliban regime, both of which devastated the country's resources and infrastructure. In several parts of the country, a low-grade civil war is still fueled by insurgents and the legacy of vendetta. Relatively high levels of risk have stalled private investment. As a result of these economic hardships, many Afghan farmers have become involved in illicit opium production since 2002.

Illicit opium production has become a serious global concern. Warlords and militants, many of whom are connected to the opium poppy trade, frequently cause violence throughout the country, further undermining the ability of Afghans to improve their economic situation. Consequently, moving people out of opium poppy production remains one of the key policy objectives of revitalizing the rural economy around legitimate high-value and modernized agriculture.

Afghanistan once boasted a strong agricultural sector that exported processed and unprocessed horticultural products as well as livestock. This sector is now being rebuilt and upgraded with donor assistance. USAID, among others, has invested heavily in rebuilding agricultural markets and jump-starting alternative development for farmers in opium poppy growing areas. USAID’s market and business development programs already have a pipeline of micro, small, and medium enterprise opportunities that require immediate financing.

When it was launched in 2004, USAID/Afghanistan’s Alternative Development Program (ADP) was to have included activities to accelerate legitimate economic growth in key poppy-growing provinces by creating or strengthening credit and financing institutions. However, credit and financing activities were not implemented under the program because of contract restrictions, which prevented issuing grants to fund such activities.

In September 2006, USAID/Afghanistan awarded a 3-year, $80 million cooperative agreement to Academy for Educational Development (AED) to implement the Agriculture, Rural Investment and Enterprise Strengthening (ARIES) program. The overall purpose of the ARIES program is to provide expanded access to rural financial services, primarily in alternative development regions where farmers grow opium poppy, and to create a strong private sector foundation for a developing rural finance system that is capable of providing a full spectrum of financial services on a sustainable basis.

The ARIES program was designed to support USAID's Strategic Objective No. 5, *A Thriving Licit Economy Led by the Private Sector*, which includes rehabilitating the rural economy, developing financial organizations and services, improving economic policy, increasing trade and export, and repairing and expanding infrastructure to support the improved productivity and profitability of the agricultural sector. ARIES was envisioned to advance private sector involvement in the Afghan economy by developing a sustainable and market-driven rural financial system.

To implement the ARIES program, AED partnered with five implementing partners:

- Agricultural Cooperative Development International/Volunteers in Overseas Cooperative Assistance (ACDI/VOCA), through its newly founded entity Afghanistan Rural Finance Center (ARFC)
- World Council of Credit Unions (WOCCU)
- Foundation for International Community Assistance (FINCA)
- Microfinance Investment Support Facility for Afghanistan (MISFA)
- ShoreBank International (SBI)

Photograph of an Afghan fabric shop whose owner received a microfinance loan to expand his business (Office of Inspector General, October 2007).

The $80 million cooperative agreement was to be distributed over a 3-year period. AED anticipated that it would yield about $209 million in loans disbursed to 162,012 clients or 2.6 times the total program costs. Of the $80 million budgeted, AED anticipated that $41 million would be used for loan and grant capital to clients.

As of September 30, 2007, USAID had obligated about $54 million and disbursed about $30 million for ARIES activities. USAID/Afghanistan's Office of Economic Growth was responsible for managing the ARIES program in Afghanistan and fiscal year (FY) 2007 was the first year of implementing such program activities.

AUDIT OBJECTIVE

As part of the Office of Inspector General's FY 2008 annual audit plan, the Regional Inspector General/Manila conducted this audit to answer the following question:

> **Was USAID/Afghanistan's Agriculture, Rural Investment and Enterprise Strengthening program achieving its intended results and what has been the impact?**

Appendix I contains a discussion of the audit's scope and methodology.

AUDIT FINDINGS

In the first year of implementation, USAID/Afghanistan's Agriculture, Rural Investment and Enterprise Strengthening (ARIES) program achieved or exceeded most of its intended results and helped make a significant impact in expanding Afghanistan's licit rural economy by creating 62,674 jobs. As shown in Table 1 below, ARIES disbursed a total of $27 million in loans, mostly microfinance loans to Afghan individuals or groups.

Table 1: ARIES Loan Disbursements as of September 30, 2007

Level	Loan Segment	Loan Size	Amount of Loans Disbursed
1	Households, livelihood enterprises, smallholder farms	Up to $1,000	$20,988,614
2	Microenterprises, including small-scale commercial farms: lower tier of small and medium enterprises (SMEs)	$1,000 to $7,000	$3,551,039
3	Small enterprises and modernizing farms: middle tier of SMEs	$7,000 to $50,000	$256,000
4	Medium enterprises covering a wide range of agriculture and related industries	$50,000 and higher	$2,303,560
Total			$27,099,213

See Table A-2 in appendix IV for the complete details of USAID/Afghanistan's achievement of its targets for 19 performance indicators as of September 30, 2007.

As shown in Table 1, ARIES made impressive achievements with its microfinance loan segment activities in levels 1 and 2, which was the main factor for exceeding its performance targets on the number and amount of loans disbursed and number of active borrowers. A strong contributor to this achievement was that two of ARIES' partners, Foundation for International Community Assistance (FINCA) and Microfinance Investment Support Facility for Afghanistan (MISFA) were already well established in Afghanistan when the program started. Additionally, FINCA introduced *Sharia*-compliant[2] loan products that were more successful than anticipated. The short payment terms on such products created turnover of clients and loan capital.

One of FINCA's branches that the Office of Inspector General (OIG) reviewed in Jalalabad issued $4.9 million of microfinance loans that created 8,695 jobs during fiscal year (FY) 2007, including a number of jobs that moved people out of opium poppy production. For example, a former opium smuggler received a *Sharia*-compliant loan from FINCA to expand his small general store. With his bigger store, he now earns enough money to support his family without having to work in the opium trade.

[2] *Sharia*-compliant loans are based on the Murabaha system of Islamic banking, which is an interest-free way of financing. In this case, FINCA purchased goods requested by a borrower who then repaid FINCA for the price of the goods plus a markup.

Photograph of an Afghan woman receiving a microfinance loan to help expand her small general store (Office of Inspector General, October 2007)

As another example, FINCA gave a *Sharia*-compliant loan to a former opium dealer. He was a tailor by trade, but did not have enough money to open a tailor shop. With the FINCA loan, he was able to purchase sewing machines to start his own tailoring business and stop selling opium. The former opium dealer is now a well-known tailor in his village.

Despite its achievements, ARIES could have been more successful with implementing small and medium enterprise (SME) loan segment activities in levels 3 and 4 as shown in Table 1 above, and with implementing Investment and Finance Cooperatives. ARIES fell short in these areas because such activities were new to Afghanistan and it took about six months to get them started. Yet because the start-up time was not factored into the targets for ARIES' performance indicators and as a result, the targets were based on a full year of activities.

Additionally, 4 of the 5 implementing partners did not receive their full budgets for loan capital in FY 2007. Some partners had to use their own capital to cover the funding shortfalls. This occurred because it took Academy for Educational Development (AED), the prime partner, and USAID/Afghanistan about 6 months combined to process a single modification to the original cooperative agreement. Because many changes had been made to the program design, it was decided to put them all into one large modification instead of making incremental changes. Consequently, this decision held up funding to the ARIES partners, where they received only about 54 percent of their budget for loan capital in FY 2007. This delay primarily affected partners that implemented SME loans.

Nevertheless, ARIES' implementation of SME loans gained momentum in the last quarter of FY 2007. At the time of the audit, one of ARIES' partners had approved a $4.4 million loan to build a state-of-the-art pomegranate juice factory in Kabul, the first of its kind. The juice factory represents a centerpiece in the pomegranate value chain in Afghanistan. It is expected to provide hundreds of direct jobs in the factory and thousands of jobs for farmers in the south, east, and other pomegranate-producing regions of Afghanistan. Growing pomegranate produces a high-value crop and provides a natural deterrent from growing poppy, as the shade from the pomegranate trees blocks sunlight the poppy plants need.

ARIES also could have made more of an impact in Alternative Development Program (ADP) priority regions, but the program's focus in ADP priority regions was unclear to ARIES' implementing partners. This issue is discussed further in the next section of this report.

Because FY 2007 ended and USAID/Afghanistan approved the modification to the original ARIES cooperative agreement on September 29, 2007, this report did not make any recommendations with respect to the program's funding shortfalls or performance targets in the first year. However, the following narrative discusses areas where the mission could improve implementation and management of the ARIES program in the remaining 2 years of the cooperative agreement.

ARIES Focus Unclear in ADP Priority Regions

Summary: According to USAID/Afghanistan's cooperative agreement with AED, the overall purpose of the ARIES program was to provide expanded access to rural financial services, primarily in ADP regions. However, AED placed less emphasis on ADP priority regions and downplayed its relationship to them, as AED considered ARIES to be primarily a rural economic program. The mission did not provide harmonized direction on how ARIES and ADP should work together and did not put measurable goals in place. As a result, ARIES could have done more for Afghans who wanted to move out of opium poppy production and needed financing to pursue alternative livelihoods such as selling shoes, food, clothing, and supplies.

USAID/Afghanistan's cooperative agreement with AED states that the overall purpose of the ARIES program was to provide expanded access to rural financial services, primarily in ADP regions, and to create a strong private sector foundation for an incipient rural finance system that is capable of providing a full spectrum of financial services on a sustainable basis. The agreement strongly emphasizes that moving people out of opium poppy production remains one of the key policy objectives of revitalizing the rural economy around legitimate high value and modernized agriculture. Further, the original intent of ARIES was to dovetail with regional ADP priorities.

However, AED considered ARIES to be primarily a rural economic program and placed less emphasis on linking ARIES to ADP priority regions. For example, in AED's first year work plan and other program documents, they did not emphasize that ARIES was to provide expanded access to rural financial services primarily in ADP regions. Specifically, AED did not include formal goals in its first year work plan for implementing ARIES activities in ADP regions. Further, AED did not report to the mission their success stories that were related to loans given to former opium poppy workers in ADP priority regions. This issue is discussed further in a subsequent finding on page 9.

This occurred because there was no harmonized or coordinated direction coming from the mission on how ARIES and ADP should work together, which resulted from discordance between USAID/Afghanistan's Office of Economic Growth (OEG) and Alternative Development and Agriculture Office (ADAG). Before March 2007, OEG managed both ARIES and ADP. Subsequently, the mission reorganized and it moved ADP to ADAG while ARIES remained with OEG. Since the reorganization, mission officials and ARIES partners said that OEG and ADAG did not communicate very well with each other concerning ARIES and how it should complement ADP. This lack of communication was attributed to the awkward reorganization and personality clashes between the office directors.

As a result, ARIES could have missed opportunities to provide loans to Afghans who wanted to move out of opium poppy production and needed financing to pursue alternative livelihoods such as selling shoes, food, clothing, and supplies. Despite this, some of the implementing partners took it upon themselves to implement their activities in ADP regions because it made good business sense. For example, the Agricultural Cooperative Development International/Volunteers in Overseas Cooperative Assistance (ACDI/VOCA), through its newly founded entity Afghanistan Rural Finance Center collaborated with and leveraged ongoing ADP and other USAID programs in the eastern region to provide loans to clients in the "farm to market" value chain. This value chain linked together various businesses that buy and sell to each other in the agriculture sector. Some partners such as FINCA already had existing activities in ADP priority regions.

In September 2007, the new director for OEG arrived at post. Shortly thereafter, the director recognized the lack of communication with ADAG and has since taken steps to establish a closer working relationship. Therefore, this report did not make a specific recommendation in this area. However, because the degree to which ARIES activities should be implemented in ADP priority regions was unclear to the partners, the Regional Inspector General/Manila made the following recommendations.

> ***Recommendation No. 1:*** *We recommend that USAID/Afghanistan require Academy for Educational Development to make clear to its partners that the Agriculture, Rural Investment and Enterprise Strengthening program is to be implemented primarily in Alternative Development Program regions and dovetail with regional Alternative Development Program priorities as required by the cooperative agreement.*

> ***Recommendation No. 2:*** *We recommend that USAID/Afghanistan work with Academy for Educational Development to establish formal goals in its work plan for implementing Agriculture, Rural Investment and Enterprise Strengthening program activities in Alternative Development Program regions for the remaining 2 years of the cooperative agreement.*

ARIES Success Stories in ADP Regions Need To Be Communicated to USAID

Summary: According to USAID policy, communicating results achieved and telling the Agency's story are part of the systematic process of monitoring the results of activities. However, AED did not report to USAID/Afghanistan its success stories about loans given to Afghans who formerly worked in opium poppy production. This occurred because AED considered ARIES to be primarily a rural economic program and downplayed its relationship to ADP. Additionally, an AED employee censored such reporting to the mission. As a result, USAID was not receiving the complete picture, which included successes of the ARIES program in ADP priority regions.

USAID's Automated Directives System (ADS) 200.6 defines performance management as "…the systematic process of monitoring the results of activities; collecting and analyzing performance information to track progress toward planned results; using performance information to influence program decision-making and resource allocation; and communicating results achieved, or not attained, to advance organizational learning and tell the Agency's story."

As discussed earlier in this report, AED considered ARIES to be primarily a rural economic program and downplayed its relationship to ADP. Although there was a lack of USAID coordination on how ARIES and ADP should work together, ARIES partners did implement a number of activities in ADP priority regions, especially in the eastern region, during the first year of implementation. The partners reviewed by OIG recorded several success stories of loans given to former opium poppy farmers and traffickers, as well as collaborations between ARIES, ADP, and other USAID programs. The partners reported such collaborative activities and success stories to AED. However, the activities were not communicated to USAID in AED's quarterly progress reports on ARIES.

In addition to the fact that AED viewed ARIES as primarily a rural economic program, one of its employees censored stories with direct linkage between ARIES and ADP because he believed that such communication would put their clients (former opium poppy workers) at risk of personal injury or death. USAID/Afghanistan's cognizant technical officer for ARIES was unaware of this censorship.

Consequently, the mission and stakeholders were not receiving the complete picture, which included successes of the ARIES program in ADP priority regions. The reporting is for USAID's internal use only, and success stories that link ARIES and ADP could be communicated in a way that would protect the identities of the clients. Thus, the Regional Inspector General/Manila made the following recommendation.

> ***Recommendation No. 3:** We recommend that USAID/Afghanistan direct Academy for Educational Development to communicate success stories related to shifting opium poppy workers into licit livelihoods as a result of Agriculture, Rural Investment and Enterprise Strengthening program loans in Alternative Development Program regions.*

Performance Monitoring and Evaluation Need Improvement

Summary: The ARIES cooperative agreement states that AED was to monitor and evaluate performance at the regional and national level within the Performance Monitoring Plan (PMP) framework. Although AED reported national performance at the summary level, it did not report measured results by region or by partner in its quarterly reports to USAID/Afghanistan. This occurred because AED believed it would be difficult to set regional performance targets for each partner, and therefore none were set. Additionally, although the ARIES PMP focused on measuring microfinance activities, it did not include performance indicators and targets that measured small and medium enterprise (SME) loan activities because the need for such did not emerge until about a year into the program. Consequently, AED and the mission could not effectively measure ARIES' performance at the regional level, by partner, or by loan segment.

According to the ARIES cooperative agreement, AED was to monitor and evaluate performance at the regional level within the PMP framework and conduct targeted studies of credit users to determine the uses, success, and sustainability of lending programs. Implementation of the strategic objectives at the national and regional levels was to be measured by intermediate results, performance indicators, and methods in USAID/Afghanistan's Strategic Objective No. 5.[3]

In its mission-approved ARIES PMP, AED, set 19 performance indicators[4] and targets at the national level that aggregated results for all five partners and reported the results to USAID in its quarterly reports. However, AED did not report actual results measured against targets by region or by partner in its quarterly reports. AED did report regional results to USAID in its monthly reports, but the results were not measured against regional targets, because AED did not establish regional targets. AED believed it would be difficult to set regional targets and measure actual results against them.

Further, AED's quarterly reports did not show measured results by each of the five implementing partners. Each partner had its own targets, but the 19 performance indicators were shown only in aggregate for all five partners at the national level. Additionally, the ARIES PMP did not include performance indicators and targets that measured SME loan activities. The ARIES PMP only included performance indicators and targets that were designed to measure microfinance loan activities.

AED officials stated that the ARIES PMP was approved by USAID/Afghanistan and they thought it was appropriate for monitoring and evaluating the outcome of the program. The need to measure results by partner and to measure SME loan activities did not emerge until about a year into the program. At the time of the audit, AED officials recognized these issues and had started to revise its ARIES PMP.

Without appropriate performance indicators and targets to measure ARIES' loan activities at the regional level, by partner, or by loan type, AED and the mission could not effectively measure ARIES' performance or hold each of the five partners accountable for its

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[3] Strategic Objective No. 5: "a thriving *licit* economy led by the private sector."
[4] Refer to appendix IV for a complete listing of the 19 performance indicators.

performance. Because of this, the Regional Inspector General/Manila made the following recommendation.

> ***Recommendation No. 4:*** *We recommend that USAID/Afghanistan direct Academy for Educational Development to revise its Agriculture, Rural Investment and Enterprise Strengthening program Performance Monitoring Plan to include appropriate performance indicators and targets that measure both micro and small and medium enterprise finance activities by region and by partner and report those results in its quarterly reports to USAID/Afghanistan.*

Investment and Finance Cooperatives Lacked Management Information Systems

Summary: According to the first year work plan for ARIES, AED's chief of party was to ensure that its partners establish and maintain appropriate systems and processes for recording, reporting, and internal monitoring of operating activities. However, one of AED's partners, World Council of Credit Unions (WOCCU), did not establish and maintain a system for its Investment and Finance Cooperatives (IFCs). This occurred because WOCCU did not yet have an office in-country whereby it could implement a system. Additionally, WOCCU was to select and implement an integrated accounting system at each of its IFCs, but this did not happen because WOCCU had not yet selected an accounting system. As a result, WOCCU's manual record keeping increased the risk of error in its data reported to AED and USAID as shown by the audit's discovery of errors in WOCCU's records.

ARIES' first year work plan states that AED's chief of party was to 1) ensure that its partners establish and maintain appropriate systems and processes for recording, reporting, and internal monitoring of operating activities; and 2) stay informed of partner activities in capacity building and external communications to better develop a knowledge base for rural investment and enterprise strengthening.

During the first year of implementation, one of AED's partners—WOCCU—started 7 IFCs in Afghanistan. However, WOCCU did not establish and maintain an appropriate system to capture financial and performance data on each IFC. According to the ARIES cooperative agreement, WOCCU was to establish a head office in Afghanistan in which it could set up a central system to monitor and evaluate all IFCs. However, at the time of the audit, WOCCU did not yet have an office in country whereby it could implement such a system. WOCCU's in-country employees were primarily working out of their guesthouses or at the IFCs they started.

Consequently, WOCCU's manual record keeping increased risk of error in its data reported to AED and USAID. Errors were found in WOCCU's reported results. Specifically, discrepancies were found in the number of jobs created and amount of shares purchased by members of the IFCs, numbers that WOCCU later corrected. Further, WOCCU's lack of an office in Afghanistan made it difficult for AED to ensure that meetings, joint planning, budgeting, evaluation, and problem solving could take place when needed.

In addition to the issues just discussed, WOCCU's subagreement with AED states that WOCCU was to select and implement an integrated accounting system at each of its IFCs 2 months before opening them. However, WOCCU had not yet implemented an integrated accounting system at any of the 7 IFCs that it started in FY 2007. This occurred because WOCCU had not yet selected an accounting system. WOCCU officials explained that because of start-up delays, they were focusing on opening new IFCs, and the accounting system was less of a priority. At the time of the audit, WOCCU was in the process of selecting an accounting system to implement at its IFCs.

At the time of the audit, WOCCU was setting up an office in Kabul where it could establish and maintain an appropriate system to capture financial and performance data on its IFCs. However, because WOCCU has not yet established such a system and did not implement an integrated accounting system at each of its IFCs, the Regional Inspector General/Manila made the following recommendations.

> ***Recommendation No. 5:*** *We recommend that USAID/Afghanistan direct Academy for Educational Development to ensure that the World Council of Credit Unions establishes and maintains appropriate systems and processes for recording, reporting, and internal monitoring of operating activities of its Investment and Finance Cooperatives as required by the Agriculture, Rural Investment and Enterprise Strengthening program work plan.*

> ***Recommendation No. 6:*** *We recommend that USAID/Afghanistan direct Academy for Educational Development to ensure that the World Council of Credit Unions implements an integrated accounting system at each of its Investment and Finance Cooperatives as required by its subagreement.*

EVALUATION OF MANAGEMENT COMMENTS

In its response to the draft report, USAID/Afghanistan generally agreed with the findings and recommendations. Based on the Regional Inspector General/Manila's review of the mission's comments, detailed actions, and subsequent supporting documents received, the audit determined that final actions have been taken on Recommendation Nos. 1 through 4 and management decisions have been reached for Recommendation Nos. 5 and 6.

In response to Recommendation Nos. 5 and 6, USAID/Afghanistan stated that a strategic decision was made in November 2006 to begin installing Micro Banker, an integrated accounting software program, in each Investment and Finance Cooperative (IFC) 6 months after the start-up of operations. The World Council of Credit Unions (WOCCU) is expected to complete the software installation by the end of September 2008. Additionally, the mission stated that WOCCU will adopt International Financial Reporting Standards (IFRS) by the end of December 2008.

To reach final actions on these recommendations, USAID/Afghanistan will need to confirm with Academy for Educational Development that WOCCU implemented Micro Banker in all IFCs that have been open for 6 months or longer, and adopted IFRS.

A determination of final action for Recommendation Nos. 5 and 6 will be made by the Audit Performance and Compliance Division (M/CFO/APC) upon completion of the proposed corrective actions.

USAID/Afghanistan's written comments on the draft report are included in their entirety (without attachments) as appendix II to this report.

SCOPE AND METHODOLOGY

Scope

The Regional Inspector General/Manila conducted this audit in accordance with generally accepted government auditing standards to determine whether USAID/Afghanistan's Agriculture, Rural Investment and Enterprise Strengthening (ARIES) program was achieving its intended results and what its impact has been.

In September 2006, USAID/Afghanistan awarded a 3-year, $80 million cooperative agreement to Academy for Educational Development (AED) to implement the ARIES program. As of September 30, 2007, USAID had obligated about $54 million and disbursed about $30 million for ARIES activities.

The audit covered ARIES activities implemented by AED and its five partners from September 16, 2006, to September 30, 2007, the first year of implementation. The audit was performed in Afghanistan from October 18 to November 5, 2007.

At the summary level, we compared actual results with targets for all 19 performance indicators contained in the ARIES Performance Monitoring Plan as of September 30, 2007. At the detailed level, we reviewed activities in the Eastern Region, specifically Nangarhar province, and focused on 3 of the 5 implementing partners below:

- Agricultural Cooperative Development International/Volunteers in Overseas Cooperative Assistance (ACDI/VOCA), through its newly founded entity Afghanistan Rural Finance Center (ARFC)
- World Council of Credit Unions (WOCCU)
- Foundation for International Community Assistance (FINCA)

These three partners disbursed about 78 percent ($8.5 million) of $10.9 million in total loan disbursements in the eastern region and more than 64 percent ($17.5 million) of $27 million in total loan disbursements in all four regions of Afghanistan. For more details, see Table A-1 in appendix III. We conducted 100 percent testing of all ARFC loans and selected testing of FINCA and WOCCU loans in their portfolios as of September 30, 2007.

We performed site visits at the following ARIES borrowers/activities in Kabul and Jalalabad, Nangarhar province in the Eastern Region:

Name	Type	Partner	Site Visit Location	Loan Amount
Qurbankhill Brothers Co.	Borrower	ACDI/VOCA	Kabul	$150,000
Spin Ghar Poultry Farm Association	Borrower	ACDI/VOCA	Kabul	$700,000
Sabawoon Feed Mill	Borrower	ACDI/VOCA	Jalalabad	$200,000
Sabawoon Flour Mill	Borrower	ACDI/VOCA	Jalalabad	$500,000
Nangarhar Investment and Finance Cooperative (NIFC)	Activity	WOCCU	Jalalabad	$297,930
FINCA Jalalabad Branch	Activity	FINCA	Jalalabad	$4,931,161
Total				**$6,779,091**

During the site visits, we observed activities funded by ARIES loans, conducted walkthroughs, observed actual loan processing, spot-checked loan documentation, and assessed internal controls at NIFC and FINCA's Jalalabad Branch. We also interviewed clients who received ARIES loans, including two former poppy farmers who received ARIES loans from NIFC to grow vegetables.

We assessed significant internal controls used by USAID/Afghanistan to monitor ARIES activities. The assessment included controls related to whether the mission (1) conducted and documented site visits to evaluate progress and monitor quality, (2) required and approved a work plan, (3) reviewed progress reports submitted by AED, and (4) compared AED's reported progress to planned progress and the mission's own evaluations of progress.

We also assessed significant internal controls used by AED to monitor ARIES activities. The assessment included controls related to AED monitoring and evaluation systems and processes over its five partners. Specifically, we reviewed how AED and its partners ensured compliance with program regulations in granting and monitoring loans.

Methodology

To answer the audit objective, we reviewed and analyzed relevant documents at both the mission and implementing partners. This documentation included performance monitoring plans, the cooperative agreement between USAID/Afghanistan and AED, subagreements, site visit and other monitoring reports, progress reports, and financial records.

We assessed AED's database to track progress on the 19 performance indicators. We compared the performance data reported by AED to USAID/Afghanistan in progress reports to the performance data in the database. We performed a number of steps to test the reasonableness, reliability, and accuracy of the database.

For each selected performance indicator, we established the following materiality threshold criteria to measure progress made on the ARIES program:

- The planned result would be achieved if 90 percent or more of the target was met.

- The planned result would be partly achieved if less than 90 but not less than 70 percent of the target was met.

- The planned result would not be achieved if less than 70 percent of the target was met.

When testing the actual results reported and measuring them against the planned targets for the selected performance indicators, we considered exceptions totaling 5 percent or more to represent significant issues that merit reporting. We not only considered the above threshold criteria, but also used auditor judgment to determine the applicability of the threshold percentages, considering other factors such as significance of the selected performance indicators and timeliness of funds distribution.

MANAGEMENT COMMENTS

USAID | AFGHANISTAN
FROM THE AMERICAN PEOPLE

MEMORANDUM

TO:	RIG/Manila, Catherine Trujillo
FROM:	USAID/Afghanistan Director, Robin Phillips /s/
DATE:	January 12, 2008
SUBJECT:	Audit of USAID/Afghanistan's Agriculture, Rural Investment and Enterprise Strengthening Program (ARIES) (Audit Report No. 5-306-08-00X-P)
REFERENCE:	W/Murphy / R/Phillips memo dated December 13, 2007

Thank you for providing the Mission the opportunity to review the subject draft audit report. We would like to thank the auditors for their professionalism, patience, and hard work while conducting the audit. The draft report contains useful recommendations for strengthening the Mission's ability to monitor and track progress towards achieving intended results and assessing the grantee's performance. We are providing below our comments, other relevant information, and management decisions on the recommendations in the audit report.

MISSION RESPONSES TO AUDIT RECOMMENDATIONS

Recommendation No. 1: We recommend that USAID/Afghanistan require Academy for Educational Development (AED) to make clear to its partners that the ARIES program is to be implemented primarily in Alternative Development Program (ADP) regions and dovetail with regional Alternative Development priorities as required by the Cooperative Agreement.

The Mission agrees with the recommendation. The original Cooperative Agreement stated that the overall purpose of ARIES was to provide expanded access to rural financial services, primarily in Alternative Development Program (ADP) regions, and to create a strong private sector foundation for an incipient rural finance system that is capable of providing a full spectrum of financial services on a sustainable basis. It was clear that ARIES would also provide services in the western region and in parts of the northern region where ADP does not operate and cooperate with other projects outside the ADP regions, such as the Afghanistan Small & Medium Enterprise Development (ASMED).

On September 29, 2007, Modification 4 to the Cooperative Agreement changed the first sentence of the Program Description to: "The overall purpose of the ARIES program is to provide expanded access to rural financial services and to create a strong private sector foundation for an incipient rural finance system that is capable of providing a full spectrum of financial services on a sustainable basis."

Nevertheless, ARIES continues to carry out its activities in the four outlying regions of the country, as laid out in the original Program Description, giving special emphasis to the ADP regions.

Regional targets for loan disbursements approved by the Mission and communicated to the partners resulted in 70 financial service outlets (out of a total of 78, or almost 90%) being supported or created in the three ADP regions of the North, South, and East. All of the 13 new microfinance branches, including those of FINCA, and all of the new Investment and Finance Cooperatives (IFCs) are in the ADP regions. The US$9 million loan capital to Microfinance Institutions (MFIs) through the Microfinance Investment Support Facility for Afghanistan, Limited (MISFA) was allocated to the provinces in the ADP regions. All of the US$8 million in lines of credit or credit guarantee commitments that ARIES made to commercial banks will fund activities in the ADP regions.

We believe that AED did in fact make clear to its partners that the ARIES program was to be implemented primarily in the ADP regions and was to be dovetailed with ADP, but did not expressly note the words "Alternative Development Programs" in its reports to the Mission.

Therefore, the Mission has informed AED that it should emphasize to its partners the importance of reports and publications that accurately reflect the priority given to ADP regions and document how they are dovetailing with the ADP as required by the Cooperative Agreement. Based on the attached communication by the CTO to ARIES (**Attachment 1**), the Mission requests that this audit recommendation be closed.

Recommendation No. 2: We recommend that USAID/Afghanistan work with Academy for Educational Development to establish formal goals in its work plan for implementing ARIES activities in Alternative Development Program regions for the remaining two years of the cooperative agreement.

The Mission agrees with the audit recommendation. The ARIES year-two work plan submitted to and subsequently approved by the Mission clearly describes the provinces where the program creates new financial service outlets, supports existing outlets, and disburses micro and Small and Medium Enterprise (SME) loans (**Attachment 2**). All of the provinces referenced in the work plan are considered part of the ARIES target regions as described in the cooperative agreement as well as fall within the ADP priority areas. The Mission requests that this audit recommendation be closed.

Recommendation No. 3: We recommend that USAID/Afghanistan direct Academy for Educational Development to communicate success stories related to shifting opium poppy workers into licit livelihoods as a result of the ARIES loans in Alternative Development Program regions.

ARIES has provided case studies and success stories, primarily focusing on poverty reduction and economic development aspects of the activities. The Mission has directed AED to submit a minimum of two stories per month and fully agrees with the auditors' recommendation to develop additional stories on issues related to shifting opium poppy farmers into licit livelihoods as result of ARIES loans in the ADP regions as well as the broader socio-economic impacts of its activities. Attached are the two most recent success stories (**Attachment 3**). Based on this, the Mission requests that this audit recommendation be closed.

Recommendation No. 4: We recommend that USAID/Afghanistan direct AED to revise its ARIES Performance Monitoring Plan to include appropriate performance indicators and targets that measure both micro and small and medium enterprise finance activities by region and by partner and report those results in ARIES quarterly reports.

The Mission agrees with the audit recommendation. The revised PMP (**Attachment 4**) for FY2008, which has been submitted for approval to the Mission, includes specific targets in ADP regions for activities in the remaining two years of the cooperative agreement and will measure both micro and SME finance activities. These results will also be submitted on a quarterly basis. Based on this, the Mission requests that this audit finding be closed.

Recommendation No. 5: We recommend that USAID/Afghanistan direct Academy for Educational Development to ensure that World Council of Credit Unions establishes and maintains appropriate systems and processes for recording, reporting, and internal monitoring of operating activities of its Investment and Finance Cooperatives as required by the ARIES work plan.

The Mission agrees with this recommendation, has discussed this with ARIES, and believes that an explanation of the IFC operation is in order. WOCCU does not own the IFCs it helps to establish in the same way that other ARIES partners own their branches and/or subsidiary companies. Each IFC is an independent entity owned and managed by community members. Similar to a franchise operation, WOCCU provides all the systems and processes not only for organizing an IFC but also for recording, reporting and monitoring all its activities, including books of original entry, a chart of accounts, a general ledger, and subsidiary ledgers to support the records in the general ledger. This has been done with each IFC which means that appropriate systems and processes are in place to manually capture financial and performance data on each individual IFC.

A strategic decision was made in November 2006 to begin installing Micro Banker, an integrated accounting software program, in each IFC six months after the start-up of operations in order to increase the efficiency and accuracy of WOCCU's monitoring and reporting as well as to make it easier to consolidate information across different IFCs. This strategy is based on WOCCU's previous experience in Uzbekistan that shows that training IFC staff on a manual accounting system is a necessary prerequisite to introducing an integrated accounting software program. WOCCU will install Micro Banker in all IFCs that have been opened six months or longer by the end of FY 2008.

Recommendation No. 6: We recommend that USAID/Afghanistan direct Academy for Educational Development to ensure that the World Council of Credit Unions implements an integrated accounting system at each of its Investment and Finance Cooperatives as required by their sub-agreement.

The Mission agrees with this recommendation. In accordance with Mission suggestions, WOCCU will adopt the International Financial Reporting Standard (IFRS) for the IFCs by December 2008 and install Micro Banker, an integrated accounting software program, in each IFC six months after the start-up of operations.

<u>Attachments</u>

Attachment 1. Communication by the CTO to ARIES regarding ADP emphasis
Attachment 2. Year Two Work Plan and CTO Approval
Attachment 3. Success Stories
Attachment 4. Performance Monitoring Plan

Table A-1: ARIES Loan Disbursements by Partner as of September 30, 2007

Implementing Partners	Loan Disbursements	Percentage of Total
1. Agricultural Cooperative Development International/Volunteers in Overseas Cooperative Assistance – through the Afghanistan Rural Finance Center*	$2,353,560	8.7%
2. World Council of Credit Unions*	850,070	3.1%
3. Foundation for International Community Assistance*	14,274,245	52.7%
4. Microfinance Investment Support Facility for Afghanistan (Microfinance loan segment)	9,404,338	34.7%
5. Microfinance Investment Support Facility for Afghanistan (small and medium enterprises loan segment)	217,000	0.8%
Total	$27,099,213	100%

*Three implementing partners selected for further audit testing of details.

Table A-2: Achievements for ARIES Activities as of September 30, 2007

Performance Indicators	FY 2007 Targets	Actual Results Tested	Percent Achieved[5]
A Thriving Licit Economy Led by the Private Sector: Growth in Rural Economy Through Financial Services			
1. Number of jobs created	None[6]	62,674	-
Access to Credit Facilities Enhanced			
2. Number of loans disbursed (cumulative)	54,280	80,238	**148%**
3. Amount of loans disbursed (cumulative)	$22,395,000	$27,099,213	**121%**
4. Number of active borrowers	44,798	59,364	**133%**
5. Value of loans outstanding	$20,146,250	$15,268,986	76%
6. Number of financial service outlets	32	78	**244%**
7. Number of members of Investment and Finance Cooperatives (IFC)	15,000	8,498	57%
8. Number of rural cooperatives and enterprises receiving financial services	30	12	40%
9. Number of members of rural cooperatives receiving financial services	7,500	575	8%
Sustainable Rural Financial Services			
10. Number of clients per staff member (higher result is better)	WOCCU: 140	WOCCU: 211	**151%**
	FINCA: 226	FINCA: 93	41%
	MISFA: 130	MISFA: 84	65%
11. Overall operating expense ratio (lower result is better)	ARFC: 56%	ARFC: 12%	**467%**
	WOCCU: 50%	WOCCU: 31%	**161%**
	FINCA: 53%	FINCA: 78%	68%
	MISFA: 10%	MISFA: 34%	29%
12. Overall operating self-sufficiency (higher result is better)	ARFC: 25%	ARFC: 27%	**108%**
	WOCCU: 25%	WOCCU: 61%	**244%**
	FINCA: 36%	FINCA: 50%	**138%**
	MISFA: 70%	MISFA: 82%	**117%**
13. Overall yield on portfolio (higher result is better)	ARFC: 12%	ARFC: 18%	**147%**
	WOCCU: 25%	WOCCU: 25%	**100%**
	FINCA: 41%	FINCA: 40%	**99%**
	MISFA: 28%	MISFA: 34%	**123%**
14. Amount of shares purchased by members of IFCs (cumulative)	$2,250,000	$186,238	8%
15. Portfolio at risk (>30 days)	< 5%	ARFC: 0%	**100%**
		WOCCU: 4%	**100%**
		FINCA: 3%	**100%**
		MISFA: 3%	**100%**
16. Cumulative repayment rate	98%	ARFC: 100%	**102%**
		WOCCU:100%	**102%**
		FINCA: 99%	**101%**
		MISFA: 98%	**100%**
17. Cumulative amount of loans written off	$0	$0	**100%**
18. Cumulative # of loans written off	0	0	**100%**
19. Client dropout ratio	≤ 5%	WOCCU: 1%	**100%**
		FINCA: 4%	**100%**
		MISFA: 2%	**100%**

[5] The percentages shown in bold met or exceeded their targets. See page 15 for the materiality threshold criteria used to measure each performance indicator.
[6] No target was set for this indicator. Data collected in fiscal year 2007 will be used as a baseline to set targets for the next 2 years.

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