March 11, 2003

MEMORANDUM

FOR: Craig Buck, Director, USAID/Afghanistan

FROM: George R. Jiron, Jr., Acting RIG/Manila /s/

SUBJECT: Risk Assessment of Major Activities Managed by USAID/Afghanistan (Report No. 5-306-03-001-S)

This memorandum is our report on the subject risk assessment. This is not an audit report, and it does not contain any recommendations for you. Your management comments on the draft report are included in their entirety in Appendix II to this report. I appreciate the cooperation and courtesy extended to us during the risk assessment.

Background

Decades of conflict, years of severe drought, governmental mismanagement, and the related loss of livelihoods and educational opportunities for the Afghan people, especially women and girls, have created a humanitarian and development crisis in Afghanistan. The terrorist attacks in New York City and Washington, D.C. on September 11 and subsequent U.S. government actions in Afghanistan have placed that country at or near the top of the U.S. foreign policy agenda. Secretary of State Colin Powell outlined U.S. government development goals for Afghanistan, including high-impact projects that quickly create jobs, generate income, rebuild critical infrastructure, and encourage the successful return of millions of refugees and internally displaced persons. He also mentioned a key goal of restoring the agricultural sector and creating alternatives to poppy cultivation.

During 2002, the U.S. government has provided extensive emergency and humanitarian assistance to Afghanistan. According to a recent USAID Office of U.S. Foreign Disaster Assistance report such assistance amounted to about $530 million in fiscal year 2002.[1] USAID's portion of this emergency and humanitarian assistance for the fiscal year—not counting assistance directly funded and managed by the newly established USAID Mission in Kabul—was about $297 million broken out as follows:

FY 2002 USAID Funding for Afghanistan

Activity	In millions
Office of Foreign Disaster Assistance (OFDA)	$113.4
Office of Food for Peace (FFP)	159.5
Office of Transition Initiatives (OTI)	24.3
Total	$297.2

In contrast, expenditures for assistance to Afghanistan directly funded and managed by the new Mission were negligible in fiscal year 2002. (The Mission's first major contract was only signed on September 30, 2002.) As of December 31, 2002, Mission fiscal year 2003 expenditures amounted to $2.3 million.

Significant funding for Afghanistan will continue in future years but with a shift in the types of assistance. For example, the Congressional Budget Office (CBO) estimates spending for Afghanistan in fiscal years 2003 and 2004 will be $642 and $887 million, respectively. In developing its estimates, the CBO assumed that from 2003 to 2005 the mix of programs will shift from the fast-disbursing humanitarian relief programs executed in 2002 to slower-spending economic assistance efforts. Further, the estimates were based on the authorizations contained in the *Afghanistan Freedom Support Act of 2002* that was pending in

[1] Afghanistan - Complex Emergency Situation Report #1 (FY 2002) October 31, 2002.

the U.S. Congress at the time the estimates were developed in August 2002. The Act has since been passed by the U.S. Congress and was signed by the President on December 4, 2002. This Act authorizes $1.7 billion over four fiscal years (beginning with fiscal year 2003) for economic, humanitarian and development assistance to Afghanistan.[2]

In fact, significant longer-term economic and development assistance has already begun—and is being managed by the USAID mission in Kabul. For example, on September 30, 2002, USAID awarded a contract to the Louis Berger Group, Inc. for the "Rehabilitation of Economic Facilities and Services" Program in Afghanistan. Total contract value is estimated at about $143 million over three years (through December 2005) with an optional $71 million for the year 2006. The purpose of the contract is to promote economic recovery and political stability in Afghanistan by repairing selected infrastructure. This contract—which includes an estimated $80 million for the reconstruction of a major east-west highway—is the first activity to be directly funded and managed by USAID/Afghanistan, the newly established USAID mission in Kabul.

In addition, as of December 2002, a $40 million contract was awarded to the Barents Group for the "Sustainable Economic Policy and Institutional Reform Support" Program in Afghanistan for technical assistance in the area of economic governance. This contract, which has an option for an additional two years at $24.2 million, is also being funded and managed by USAID/Afghanistan.

USAID/Afghanistan is staffing up to manage these two contracts, as well as other activities that are now being planned. As of December 31, 2002, financial reports show that USAID/Afghanistan had obligated approximately $58.1 million for activities it will fund and manage.[3]

Discussion

To prioritize Office of Inspector General (OIG) workload and determine what type of audit coverage is appropriate for each individual activity being funded and managed by the Mission, the OIG performed risk assessments of USAID/Afghanistan's operations as a whole and of those activities planned to date. The results of the risk assessment of USAID/Afghanistan operations as a whole are presented immediately below, and the results of the individual activity assessments are presented under the "Individual Activity Risk Assessments" heading (with details provided in Appendix III).

[2] The Act authorizes $3.3 billion consisting of the $1.7 billion, other authorizations totaling $1.3 billion for military and security assistance, and $300 million for an enterprise fund.

[3] The reports were obtained from USAID/Philippines which serves as the accounting station for USAID/Afghanistan.

Overall Risk Assessment

The OIG assessed the overall risk related to USAID/Afghanistan's ability to manage assistance activities.[4] The overriding constraint to managing assistance activities in Afghanistan is the tenuous security situation in the country. Because of security concerns, travel within and particularly outside of Kabul is heavily restricted. Most U.S. direct hires are required to live and work in the U.S. Embassy compound, and approval is required for all trips outside its walls. For trips outside of Kabul approval is contingent upon taking along at least two vehicles and two armed U.S. military personnel. The Mission fully recognizes these constraints and the risks they pose.

In assessing overall risk, the OIG reviewed the Mission's own candid assessment of risk, which the Mission undertook to meet the annual certification requirement of the Federal Managers' Financial Integrity Act (FMFIA).[5] The OIG—and the mission's own assessment—concluded that overall the risks are high for: program goals not being attained, noncompliance with laws and regulations, inaccurate reporting, and illegal or inappropriate use of assets or resources. These risks will remain high for the foreseeable future.

USAID/Afghanistan's assessment identified three material weaknesses in its system of management controls, all of which are related to the country's difficult security situation:

1. Unsuitable working and living conditions,

2. Inability to readily travel to project sites, and

3. Retention of personnel and delays in the assignment of personnel.

The OIG agrees that each of these weaknesses presents a challenge for the Mission and for the achievement of program objectives. These three weaknesses are discussed below.

The first reported weakness is that "existing working and living conditions in USAID/Afghanistan are unsuitable for carrying out program design and implementation in an effective and efficient manner." Because of security concerns, U.S. direct hire staff must work and live in the Embassy compound. However, the Mission's FMFIA certification states that the Embassy has provided barely enough working space for the 17 USAID staff that are on site and that the

[4] The Mission Director arrived in April 2002, although USAID/Washington-managed emergency and humanitarian activities began in October 2001.

[5] The OIG's risk assessment was conducted from October 30 to November 9, 2002, and the Mission's FMFIA assessment was submitted in October 2002. The FMFIA requires each agency to prepare annual assurance statements regarding the status of management controls.

working space does not comply with the minimum government standards. The 17 staff members occupy 5 small rooms in the Embassy building. As for living conditions, the certification also adds that the Embassy has allotted only 7 living quarters for 12 approved U.S. direct hire and U.S. personnel service contractor positions for FY 2003. (All U.S. direct hire personnel live in tiny trailers in the Embassy compound.) Also, a new building is being planned by the Embassy which could house both Embassy and USAID personnel, but (as of November 2002) USAID estimated that it could house only one third of the 75 employees that USAID projects it will need to manage its programs.

The second reported weakness is that given the "security restrictions on travel outside the Embassy compound, USAID staff are not able to travel to project sites and monitor project implementation in an adequate manner with the frequency required." Both routine travel and travel for special events present a challenge to Mission personnel. Notably, travel outside of Kabul requires extraordinary planning, including high-level approval, maintenance of radio contact, and heavily armed escorts. Also, such travel is subject to last minute cancellation if security personnel are unavailable. This makes it extremely difficult for the Mission to monitor USAID-funded activities.

The third weakness per the Mission's analysis is that "delays in assignment and retention of qualified personnel are causing vulnerabilities in program implementation and monitoring." The analysis notes that assigning and attracting qualified staff has been hampered by several factors, including the security and space constraints mentioned earlier (making a posting to Afghanistan a less attractive prospect for many potential applicants), and the fact that because of security concerns, family members are not permitted at post (further decreasing the pool of personnel who might be interested in bidding on openings in Afghanistan). Also, according to the certification, staff members at the Mission work seven days a week in order to lessen the impact of this weakness, and burnout is evident as early as two months into a person's tour. In addition, employee tours are only one year long—although one can extend. Such shortened tours, however, lead to a high turnover of staff—not even counting the large numbers of personal service contractors that are being hired for contracts of six months or less. Such short-term contracts of less than six months are easier to negotiate and are not subject to State Department restrictions on the number of full-time U.S. direct hire personnel that are permitted at post. Nevertheless, shortened tours and short-term contracts contribute to a lower than would be expected retention of qualified personnel—and to a lack of continuity in operations.

Overall, the risks associated with these three material weaknesses are amplified by such factors as: (1) the magnitude of the funding being provided to Afghanistan, (2) the pressure to implement activities in extremely short timeframes, (3) the lack of stable host governmental institutions, and (4) the pervasiveness of corruption and lawlessness in the country—not to mention the presence in-country of some 5 to 7 million mines that are buried everywhere.

The Mission reports that because of the three material weaknesses it identified, its ability to (1) achieve objectives is significantly impaired, and (2) obtain, report and use reliable and timely information for decision making is also impaired. The Mission also reported that as a result of these weaknesses, statutory or regulatory requirements could be violated.

While USAID/Afghanistan has proposed a number of corrective actions for the material weaknesses it has identified, most of these proposals are not entirely within its control. Many are under the control of the U.S. Embassy in Kabul—especially those relating to working and living arrangements. As a result, USAID/Afghanistan is looking into the possibility of obtaining its own building and its own employee residences. Additionally, most of the proposed corrective actions which the Mission has identified will take time.

Individual Activity Risk Assessments

The individual activity risk assessments which we performed included an analysis of risk in four distinct areas:

- Implementing Entities – What experience does USAID have with the implementing entity (is the implementing entity new to USAID or does it have lots of USAID experience) and what is the audit history of that entity?

- Implementing Arrangements – Are there any special implementing arrangements that will either increase or decrease risk?

- Nature of Activities Financed – How inherently vulnerable are the activities? (For example, construction activities are inherently much more vulnerable than technical assistance activities.)

- Amount of Funding – All other things being equal, larger activities will receive more audit coverage.

The OIG assessed risk in each of these areas and, based on this information, made judgments about what type of audit coverage would be cost effective and useful. Generally speaking, higher-risk activities will be covered by concurrent financial audits (i.e., financial audits that will be conducted more often than just once a year, such that audit is "concurrent" with the activity's operations). Concurrent audits are often done on a quarterly basis. Lower-risk activities will receive annual financial audits. Financial audits are usually performed by public accounting firms under OIG supervision. As for performance audits, potentially all activities will be subject to such audits—subject to security limitations and the extent to which such coverage can be efficiently and effectively provided by the OIG's U.S. direct hire personnel.

The following table summarizes the results of the individual activity risk assessments by area for the two Mission-funded activities underway at December 31, 2002.

Mission-Funded Activities	Implementing Entities	Implementing Arrangements	Nature of Activities Financed	Amount of Funding
Louis Berger Group: Prime contractor for the infrastructure rehabilitation program	High	High	High	High
Barents Group: Contractor for the economic governance program	Medium	Medium	High	High

The overall risk exposure is high for the activity to be managed by the Louis Berger Group and medium for the activity to be managed by the Barents Group. Appendix III discusses in greater detail the risk assessments for these two activities and the types of audit coverage the OIG considered appropriate given the assessed risk exposure.

Conclusion

The overall risk exposure related to USAID/Afghanistan's ability to manage assistance activities is high and will remain so for the foreseeable future. The overriding constraint to managing assistance activities in Afghanistan is the tenuous security situation in the country. Security concerns affect the Mission's ability to (1) provide suitable working and living conditions, (2) readily travel to project sites, and (3) recruit and retain personnel. The Mission fully recognizes these constraints and the risks they pose. Although the Mission has proposed corrective actions for the material weaknesses it identified, most of the proposals will require the support of the U.S. Embassy in Kabul.

The risk exposures for the two activities assessed were high and medium. Based on the assessed risk exposures, we determined the type of audit coverage that would be cost effective and useful for the two activities. (Appendix III).

USAID/Afghanistan is a new mission just beginning to establish and implement its own funded activities. As it continues to establish additional activities, the OIG will perform, as needed, additional risk assessments to determine appropriate audit coverage and to prioritize its workload to assist the Mission in ensuring adequate audit coverage of activities it directly funds and manages.

Management Comments and Our Evaluation

In response to our draft risk assessment report, USAID/Afghanistan provided written comments that are included in their entirety as Appendix II. The Mission generally agreed with the report but made some comments on what it felt were limitations of the risk assessment. Below, we address the Mission's more significant concerns.

The Mission commented that the risk assessment was based on only nine person-days presence in Afghanistan, covered in detail only two project activities and did not cover Mission operational activities such procurement, warehousing or accounting procedures. The Mission was also concerned that such a limited risk assessment could be perceived or even cited as criticism of the Mission's current efforts.

By design, the risk assessment was primarily an assessment of project activities and the two projects that were assessed were the only two that had been established during the period that the risk assessment was conducted. The risk assessment did not cover in any detail the Mission's operational activities because procedures and personnel for those activities were just being put into place. Many of the risks identified in this OIG assessment were also discussed in the Mission's own self assessment, and neither assessment presented the risks as criticism of the Mission's efforts. Rather, the assessments simply presented the realities facing the Mission in the volatile environment that exists in Afghanistan.

The Mission also commented that the risk assessment did not seem to refer to any direct role by the OIG other than a potential performance audit by OIG auditors and the OIG providing overall guidance to private audit firms conducting financial audits on its behalf. The Mission goes on to say that given the high risks identified in the risk assessment, it might be expected that the OIG take a more active and direct role.

The OIG has been and will continue to be directly and actively involved in ensuring adequate audit coverage of USAID/Afghanistan's activities. For example, the OIG has developed a comprehensive audit strategy for Afghanistan. That audit strategy, like similar strategies that were successful in the past, will employ OIG supervised financial audits conducted by private audit firms. That supervision is not superficial but requires the OIG to select qualified audit firms, approve audit reports, and conduct reviews to ensure the audit firms meet U.S. government auditing standards. Higher-risk activities will have financial audits contracted by the Mission, and audit firms conducting those audits will be subject to even more rigorous OIG supervision. Additionally, some of the financial audits will be concurrent audits, meaning they will take place while the project is ongoing rather than after-the-fact. In the past, concurrent audits have proven successful in identifying problems early on and getting them corrected before they become significant. In addition to financial audits, the audit strategy calls for performance audits by OIG staff, where feasible, and OIG cognizance visits to activity work sites. Finally, the strategy outlines audit related activities that the OIG plans for Afghanistan such as providing fraud awareness training to audit firms as well as USAID/Afghanistan and its contractors and grantees.

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Scope and Methodology

Scope

The Regional Inspector General/Manila conducted a risk assessment of USAID/Afghanistan's operations as a whole and all major activities that were underway as of December 31, 2002. This risk assessment was not an audit. The risk assessment fieldwork was conducted at the USAID office in Kabul, Afghanistan from October 30, 2002 to November 9, 2002.

Our risk assessments of USAID/Afghanistan operations have the following limitations in their application.

- First, we assessed risk for activities funded and managed by USAID/Afghanistan, not the activities funded and managed by USAID/Washington.

- Second, we assessed risk only. Our risk assessments were not sufficient to make determinations of the effectiveness of internal controls for major functions. Consequently, we did not generally determine (a) the adequacy of internal control design, (b) if controls were properly implemented, and (c) if transactions were properly documented.

- Third, higher risk exposure assessments are not definitive indicators that program objectives were not being achieved or that irregularities were occurring. A higher risk exposure simply indicates that the particular function is more vulnerable to such events.

- Fourth, risk exposure assessments, in isolation, are not an indicator of management capability due to the fact that risk assessments consider both internal and external factors, some being outside the span of control of management.

Methodology

We interviewed officials and reviewed relevant documentation on the strategic objective activities performed by USAID/Afghanistan. These discussions and documents covered background, organization, management, budget, staffing responsibilities, prior Federal Managers' Financial Integrity Act reviews, internal controls, and vulnerabilities as we considered necessary to gain an understanding of the actual and potential problems in implementing programs.

We determined the overall risk exposure for all activities within USAID/Afghanistan, e.g., the likelihood of significant abuse, illegal acts, misuse of resources, failure to achieve program objectives, and noncompliance with regulations and management policies. We assessed overall risk as high, moderate, or low. Higher risk exposure assessments are not definitive indicators that program objectives are not being achieved or that irregularities are occurring. A higher assessment simply indicates that the particular program is more vulnerable to such events. We considered the following key areas in assessing risk:

- Significance and sensitivity;
- Susceptibility of failure to attain program goals, noncompliance with regulations, inaccurate reporting, or illegal or inappropriate use of assets or resources;
- Management actions to mitigate the implementing risks identified by strategic objective teams;
- Competence and adequacy of number of personnel;
- Relevant internal controls; and
- What is already known about internal control effectiveness.

In addition, we conducted vulnerability assessments of each major activity by assessing risk as high, moderate, or low in each of the four areas (implementing entities, amount of funding, implementing arrangements, and nature of activities financed), and used professional judgment about what type of audit coverage would be useful.

These risk assessments were not sufficient to make definitive determinations of the effectiveness of internal controls for major programs. As part of the effectiveness of internal controls, we did (a) identify, understand, and document (only as necessary) relevant internal controls, and (b) determine what was already known about the effectiveness of internal controls. However, we did not generally (a) assess the adequacy of internal control design, (b) determine if controls were properly implemented, nor (c) determine if transactions were properly documented.

Management Comments

United States Agency for International Development
Office of the Director
USAID/Afghanistan

MEMORANDUM

DATE: February 28, 2002

TO: Bruce N. Boyer, RIG/Manila

FROM: Craig G. Buck, Mission Director /s/

SUBJECT: Response to RIG/Manila's Draft Report "Risk Assessment of Major Activities within USAID/Afghanistan" (Report No. 5-306-03-xxx-S)

We appreciate the opportunity to respond to the subject draft report. Risk assessments are valuable tools for management under any circumstances, but they are especially helpful in the context of the challenging environment that exists in Afghanistan, where the human resources for monitoring development projects are not only limited in number, but they are also constrained from complete and unfettered access by dangerous and difficult conditions.

While we appreciate the risk assessment, we would like to make a general comment on what we feel are some of the limitations of the assessment. To be fair, these limitations were completely, accurately and candidly acknowledged in the RIG draft itself, and we compliment the RIG on the transparency and cooperativeness which has characterized the exercise. However, we do caution that the risk assessment which was based upon only nine person-days of presence within Afghanistan itself, which covered in detail only two of the Mission's projects/activities, and which did not look at the adequacy of specific internal controls or whether transactions were properly documented, could be unfairly perceived or even cited as a criticism of current USAID Mission efforts. We would not like to see it used out of context to create reservations about development efforts in Kabul even before these fledgling efforts have had the opportunity to leave the nest.

Some of the more specific comments we would like to make on the draft are as follows:

Page One - The report title, Risk Assessment of Major Activities within USAID/Afghanistan, and the scope of work describe the effort as "a risk assessment of USAID/Afghanistan operations as a whole…", and all major activities that were underway as of December 31, 2002. The narrative however, only comments on two projects being carried out by Louis Berger and the Barents Group (Bearing Point). These are the only two included in the table on page 6, and the only two for which "Individual Activity Risk Assessments" were carried out. There is little mention of any other activities, or of Mission operations, such as procurement, warehousing or accounting procedures, although these activities are ordinarily part and parcel of an overall risk determination.

Page Four - We fully agree with the RIG position that the living conditions, difficulties inherent in traveling within Afghanistan, and the rapid turnover of personnel all combine to produce a high risk environment. As the draft acknowledges, the Mission had already acknowledged these limitations before the RIG visit. We are hopeful that improvements will occur in the monitoring environment, and that the long-range prognosis will **not** be that the risks will remain high for the foreseeable future. Our cautious optimism is based on ongoing improvements in the following weaknesses discussed by the RIG:

Unsuitable living and working conditions - Since the RIG assessment, a significant development has taken place. Due primarily to USAID/Afghanistan efforts, the U.S. Ambassador has agreed to support a waiver of the worldwide co-location policy and the proposed USAID move to separate but much roomier office space in another location in Kabul. This would greatly alleviate the cramped office space situation discussed on page four.

The second weakness regarding travel outside Kabul is not as easy to remedy. However the planning for such trips and the armed escorts they require will improve with the experience gained over time, and hopefully the overall ability of the new Government to maintain stable conditions will also improve.

Page Five – The third weakness regarding the delays in assignment and recruitment of qualified personnel is also expected to improve over time. There were no less than 14 well qualified applicants for a recent Deputy Controller position. Positions previously held by TDY personnel, such as the Executive Officer and Controller, now have individuals permanently assigned to them. Other amenities, such as exercise equipment and video monitors for entertainment centers, have now arrived and are operational, and food facilities are now expanding their operations. We expect greater continuity over time, but in terms of looking at the glass as being half-full, the short-term contracts do provide some benefits in terms of being able to quickly shift resources, providing fresh viewpoints and different perspectives, and new energies that more than offset the lack of continuity in some cases.

Page Six – The judgments which the RIG makes about the type of audit coverage that would be cost-effective and useful do not seem to refer to any direct role for the RIG (except for the overall guidance it will provide to the private firms doing the financial audits). The OIG role seems limited to a potential performance audit, to be carried out (if it can be arranged) by U.S. OIG personnel, a prospect which was already described on page three as an overriding constraint due to the tenuous security situation. If the situation is indeed as "high risk" as the RIG judges it to be, it might be expected that they would take a more activist and direct role.

Page Eleven – To state that subcontractor costs will not likely be audited, which although true in the case of fixed price sub-contracts, gives an impression of a lack of scrutiny. Would it not be preferable to state that the performance and compliance of sub-contractors will be included within audits performed of the prime contractor by the Agency-contracted audit firms?

Page Twelve – We agree that the rapid turn-around envisioned in the system described here is very optimistic. However the phrase "USAID/Manila would then be required to pay LBG in the United States within 14 days" actually understates the difficulty. After USAID/Manila receives the invoices, it must then request and obtain administrative approvals for the vouchers from USAID/Kabul CTOs, who will have only 5 days to review and approve the voucher. Hopefully these things can be done concurrently or prior to USAID/Manila receiving the voucher. However to state only that USAID/Manila has 14 days to check the voucher fails to fully portray the urgency and pressures under with which the process will actually unfold.

Because of the high risk identified in this assessment, we believe even greater RIG oversight is desirable, including performance reviews by RIG staff and/or RIG presence on site.

We appreciate the opportunity to comment on the draft report.

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Individual Activity Risk Assessments

1. Rehabilitation of Economic Facilities and Services (REFS) Program[6]

Implementing Entity	Purpose	Risk Exposure
Louis Berger Group (LBG) is the prime contractor for the REFS program.	Design, implement, and complete rehabilitation of infrastructure such as roads, electric energy networks, schools and health facilities.	High

Planned Audit Coverage
Agency-contracted concurrent financial audits of LBG local costs. Subcontractor compliance and/or performance may be subjected to financial or performance audits. However, subcontractor costs will likely not be audited because subcontracts are to be firm fixed priced (see discussion below under "Implementing Arrangements").

Risk Assessment Factors
Implementing Entities—The LBG, a U.S. engineering firm, will be the prime contractor. Although it is a well-known firm, the LBG has limited experience in Afghanistan. Subcontractors will also probably have limited experience and the Mission is concerned about their capacity to carry out their work. Therefore, the risk is considered high. Amount of Funding—This is a 3-year $143 million contract plus an option year for an additional $71 million. The risk is high both because the funding is significant and because the contractor is under intense pressure to perform in a short period of time in the face of ongoing political instability, limited availability of construction equipment, and the challenge of finding subcontractors able to do the work. Implementing Arrangements—The LBG was awarded a cost-plus-fixed-fee contract. This type of contract is susceptible to significant cost overruns if not carefully managed and monitored. Subcontractors will be awarded firm fixed-priced contracts. Such contracts do not have the risks inherent in cost-plus-fixed-fee contracts. However, there are risks associated with the LBG selecting and employing subcontractors. For example, how transparent and competitive will the process

[6] The REFS is a 3-year $300 million program. The contract with the Louis Berger Group is the first award under the REFS program.

be? What will be the experience and capacity of the subcontractors? What types of arrangements will be made between the LBG and the subcontractors to ensure that work is done on schedule and in accordance with contract requirements. Because of 22 years of fighting, the number of private sector construction companies has greatly declined—and most construction equipment has been destroyed or is inoperable; the risk therefore is high that subcontractors may not be reliable, may be entirely new to Afghanistan, and/or that required heavy equipment may not be readily available.

Another major risk is that subcontractor procurement irregularities could occur. The LBG is required to submit a procurement plan to USAID for its approval. USAID will need to ensure that this plan is followed and procedures for full and open competition are being met. The contract also contains numerous other requirements to help insure that subcontractor costs are reasonable (e.g., the LBG is required to develop information on unit costs on both a national and regional basis). Audit would ensure that such requirements are carried out.

While costs incurred by the subcontractors will likely not be audited (because the subs will have firm fixed-price contracts), one audit concern is that advances could be in excess of subcontractor needs. However, LBG is anticipating that advances will not be necessary because of an expedited payment system for subcontractor invoices.

The system works like this. LBG/Kabul issues invoices for both United States and local costs to USAID/Philippines, the paying station under the contract. USAID/Manila would then be required to pay LBG in the United States. within 14 days. LBG/Kabul would then pay subcontractors 7 days thereafter, for a total 21-day turnaround. The Prompt Payment Act permits a 14-day turnaround in payment for construction progress payments (as opposed to the usual 30 day payment cycle). However, if this system does not work as anticipated, LBG might find itself forced to pay advances after all. If advances are paid, controls must be in place to ensure that funds are not advanced in excess of subcontractor needs.

And a final major risk: Afghanistan has a total cash economy. The banking sector is undeveloped, and LBG anticipates that most transactions in-country will have to be made in cash.

In summary, risk exposure is considered high for the reasons detailed above.

<u>Nature of Activities Financed</u>—Planned construction includes rehabilitating the 600-mile east-west highway (in conjunction with Japan and Saudi Arabia), schools, health facilities, and government buildings. Construction activities

are inherently vulnerable to such things as fraud, theft of assets and construction materials, and/or nonperformance or poor performance.

The construction activities planned for Afghanistan face additional risks. For example, security for the road project is a major consideration because the highway traverses mine fields, areas of ongoing military operations, and banditry. (However, it should be noted that the U.S. government plans to secure an agreement with the Afghan government to provide adequate security for engineering and construction crews.) Also, weather is always an intangible when it comes to construction. Rehabilitation of the first 39 kilometers of highway was beginning just before the onset of winter. During winter, construction will switch to the lowlands in the south. The result may be a patchwork of disjointed improved segments of highway—especially as two other sovereign countries are participating in the project.

The participation of other organizations and these two other countries in the highway project poses additional risks—such as construction delays. For example, each segment of highway must be certified as mine-free before reconstruction work can be begun. Mission officials noted that they must negotiate with the United Nations (UN) de-mining organization to clean up the areas in which reconstruction is to be done, and that they do not have control over how quickly the UN organization will respond. In addition, Japan and Saudi Arabia are participating in the reconstruction of the east-west highway. Japan may not begin work until 2004, and the nature of Saudi Arabia's contribution is still uncertain. Specifically, it is unclear whether Saudi Arabia will contribute money to the LBG contract or fund its own construction work using a Saudi contractor. In other words, there is a question as to when all the "financial pipelines will be active."

In summary, the risk is high for "nature of activities financed" based on the concerns discussed above.

2. Sustainable Economic Policy and Institutional Reform Support (SEPIRS) Program[7]

Implementing Entity	Purpose	Risk Exposure
Barents Group is the technical assistance contractor for the SEPIRS program	Implement priority policy and institutional reforms to improve economic management and develop institutions for economic governance.	Medium
Planned Audit Coverage		
Agency-contracted annual financial audit of local costs. A performance audit may be conducted after 12 months if the security situation permits.		
Risk Assessment Factors		
Implementing Entities—The Barents Group is a well-known U.S. consulting firm. Although it is a well-known firm, the Barents Group has had limited experience in Afghanistan. The risk is considered medium. Amount of Funding—This is a 3-year $40 million contract plus two option years for an additional $24.2 million. The risk is high because the funding is significant. Implementing Arrangements—The Barents Group was awarded a cost-plus-fixed-fee contract signed December 31, 2002 for an initial performance period of November 7, 2002 to December 15, 2005. Mission officials estimate that the contractor's level of effort may consist of: 24 expatriate full time staff, over 90 local hires, and as many as 200 temporary consultants throughout the performance period. Most of the work will be done in Kabul. Considering all factors, the risk is medium for implementing arrangements. Nature of Activities Financed—The contractor will provide technical assistance to the Transitional Afghan Authority in implementing fiscal reforms, banking reforms, trade policy, legal and regulatory policy, and privatization. In general, these types of technical assistance activities have less inherent vulnerability than do construction activities. However, these activities are inherently risky because of the challenge of trying to influence host government policies while having little real authority or control. Also, there is a high risk that the security situation may deteriorate to the point where Barents Group cannot fulfill the terms of the contract. In addition, the apparent scope of the		

[7] The SEPIRS is a 3-year, $40 million program. The contract with the Barents Group is the first award under the SEPIRS program.

governmental changes that the contract seeks to bring about will necessitate careful mission scrutiny to ensure that the project remains on track.

In summary, the risk exposure for "nature of activities financed" is high due to the security situation and the oversight needed in managing and monitoring contractor's performance.