OFFICE OF INSPECTOR GENERAL

AUDIT OF USAID/PERU'S MICROENTERPRISE ACTIVITIES

AUDIT REPORT NO.1-527-07-012-P
SEPTEMBER 27, 2007

SAN SALVADOR, EL SALVADOR

Office of Inspector General

September 27, 2007

MEMORANDUM

TO: USAID/Peru Director, Paul E. Weisenfeld
USAID/Washington EGAT/PR Director, Timothy Mahoney

FROM: Regional Inspector General/San Salvador, Timothy E. Cox /s/

SUBJECT: Audit of USAID/Peru's Microenterprise Activities (Report No. 1-527-07-012-P)

This memorandum is our report on the subject audit. In finalizing the report, we carefully considered your comments on the draft report, and we have included USAID/Peru's and EGAT/PR's comments in their entirety in Appendix II.

The report includes four recommendations for your action. Based on the information provided in response to the draft report, management decisions for the recommendations can be recorded when the Mission and EGAT/PR have developed a firm plan of action, with timeframes, for implementing the recommendations. Determination of final action for the report recommendations will be made by the Audit Performance and Compliance Division (M/CFO/APC) upon completion of the actions planned by the Mission.

I appreciate the cooperation and courtesy extended to my staff throughout the audit.

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SUMMARY OF RESULTS

The Peruvian microfinance sector is among the most dynamic in Latin America. The Peruvian government has established a policy to support the development of the microfinance sector through an adequate legal framework and the establishment of funding mechanisms. During FY 2005 and 2006, USAID supported the microfinance sector in Peru through assistance to two local non-governmental organizations, the Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises (COPEME) and Caritas/Peru (Caritas). COPEME provides technical assistance to microfinance institutions while Caritas acts as a microfinance institution itself, providing loans directly to borrowers (see page 2).

As part of a worldwide audit, the Regional Inspector General/San Salvador performed this audit to answer the following questions (see page 3):

- Did USAID/Peru implement its microenterprise activities efficiently?

- Did USAID/Peru's microenterprise activities achieve planned results?

With respect to the first question, based on performance during the last five years, USAID/Peru implemented its microfinance activities efficiently (see page 4). However, the audit found that USAID/Peru did not report suspected fraud involving USAID funds to the Office of the Inspector General as required (see page 10).

With respect to the second question, USAID/Peru microfinance activities achieved planned results in FY 2005 and FY 2006. However, Caritas did not fully achieve performance targets concerning the number of borrowers, the size of its loan portfolio, and the transfer of its portfolio to a regulated institution (see page 12).

In addition, one other matter came to our attention during the course of the audit: the Bureau for Economic Growth, Agriculture and Trade, Office of Poverty Reduction, Microenterprise Development (EGAT/PR/MD) did not follow Automated Directives System (ADS) guidance to ensure that reported data concerning microenterprise results in Peru were accurate (see page 16).

The audit report recommends that USAID/Peru remind its staff of their responsibility to report suspected fraud to the Mission Certifying Officer and the Office of Inspector General (see page 12), make a management decision with regard to the estimated $86,000 lost to suspected fraud and recover from Caritas the amounts determined to be unallowable (see page 12), and assist Caritas in developing a plan to establish a regulated entity to carry on its financial services to better ensure long-term sustainability (see page 15). The audit report also recommends that EGAT/PR/MD establish procedures to verify the accuracy of microenterprise information before reporting it to Congress (see page 18).

USAID/Peru generally agreed with the report findings and recommendations. EGAT/PR agreed with some aspects of the findings but suggested changes to the recommendations directed to EGAT/PR. Management comments and our evaluation are presented after each finding and the comments themselves are in Appendix II.

BACKGROUND

The microfinance[1] sector makes up only about 5 percent of the total value of loans made by the financial sector in Peru, but the loan portfolios of microfinance institutions (MFIs) are growing very rapidly at an average of 32 percent annually over the past ten years. MFIs service an estimated 30 to 40 percent of all borrowers in Peru. The Peruvian microfinance sector, which is among the most dynamic in Latin America, is made up of unregulated institutions (non-governmental organizations) and regulated financial institutions (savings and loan municipal cooperatives, savings and loan rural cooperatives, microenterprise development companies, specialized microfinance institutions and commercial banks). As of June 2006, regulated institutions made 98.7 percent of the microfinance loan disbursements. The Peruvian government has established a policy to support the development of the microfinance sector through an adequate legal framework and the establishment of funding mechanisms.

During FY 2005 and FY 2006, USAID supported the microfinance sector through the Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises (COPEME) and Caritas/Peru (hereafter Caritas).

COPEME is a nonprofit association that provides technical assistance to almost 60 financial institutions, 21 of them nongovernmental organizations with credit programs in urban and rural areas. The USAID-assisted microfinance initiative is designed to improve efficiency, reduce costs, promote expansion and outreach of financial service supply to the rural sector, and serve a greater number of low income clients.

Caritas is the largest non-regulated microfinance institution in Peru. It provides loans directly to borrowers. Caritas launched its microfinance activities in 1997 and in 1999 the program began receiving USAID assistance. As of March 31, 2007, Caritas had a network of 9 agencies, 3 offices, and 24 branch offices in 11 of the 24 regions of Peru. With USAID assistance, Caritas offers financial services to help poor families undertake economic initiatives and small-scale income-producing activities, especially activities undertaken by women, in order to overcome food insecurity. This program was originally planned for the period of FY 2002 to FY 2008, but in light of USAID budget constraints, the Mission has decided to terminate the program at the end of FY 2007.

During the period from October 2002 to March 2007, USAID has provided funding for microfinance activities to Caritas totaling $5.6 million through monetization of food commodities under the P.L. 480 Title II program in Peru. As of March 2007, Caritas has expended $5.4 million on microfinance activities. Also, in FY 2005 and FY 2006, USAID/Peru expended $1.5 million in support of COPEME's microenterprise activities.

[1] According to USAID, microenterprise activities are comprised of four major components: microfinance, enterprise development, financial policy, and microenterprise development policy. The scope of this audit covers the microfinance component, which includes the provision of financial services adapted to the needs of low-income people, especially the provision of small loans, the acceptance of small savings deposits, and simple payment services needed by microentrepreneurs and other poor people.

A Caritas borrower who received a loan of $942 to expand a pig raising operation in San Sebastian, Puno, Peru. Source: Taken by a Regional Inspector General (RIG)/San Salvador auditor on June 15, 2007.

AUDIT OBJECTIVES

In order to be responsive to Congressional interest in the matter, this audit was conducted as part of a worldwide audit of USAID's microfinance activities included in the Office of Inspector's General's fiscal year 2007 annual audit plan. To support this effort, the Regional Inspector General/San Salvador performed this audit to answer the following questions:

- Did USAID/Peru implement its microenterprise activities efficiently?

- Did USAID/Peru's microenterprise activities achieve planned results?

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

AUDIT FINDINGS

Did USAID/Peru implement its microenterprise activities efficiently?

USAID/Peru implemented its microfinance activities efficiently, although an alleged fraud involving approximately $86,000 was not reported to the Office of Inspector General as required. Our conclusion regarding the efficiency of microfinance activities is based primarily on an analysis of the six financial ratios and measures shown in Table 1, as well as some additional ratios and measures that are discussed in the succeeding narrative.

Table 1 displays six standard ratios for Caritas, the only entity assisted by USAID/Peru that directly makes microfinance loans to borrowers. The overall efficiency trend since 2003 has been positive. The narrative following Table 1 discusses some additional ratios and measures that better reflect Caritas' organizational structure, loan products, and monitoring priorities. Including these measures in the analysis reinforces the conclusion that efficiency has improved from FY 2003 through the first half of FY 2007.

Table 1: Caritas' Performance Using Standard Ratios

Efficiency Ratio	FY 2003	FY 2004	FY 2005	FY 2006	First Half FY 2007
Portfolio at risk more than 30 days	4.6%	2.2%	1.5%	3.1%	4.3%
Writeoff ratio	3.6%	6.0%	1.5%	1.9%	0%[2]
Operating expense ratio	41%	52%	42%	30%	19%
Cost per active client	$63	$90	$102	$101	$72
Borrowers per loan officer	299	218	295	267	268
Active clients per staff member	171	136	159	156	154

We analyzed portfolio quality by reviewing two ratios: (1) portfolio at risk more than 30 days and (2) writeoff ratio. These ratios were calculated as defined by the USAID/Washington Accelerated Microenterprise Advancement Project:[3]

- Portfolio at risk more than 30 days: amount of loans overdue for more than 30 days plus renegotiated/refinanced loans divided by the amount of loans outstanding at the end of the period.

- Write-off ratio: value of loans written off divided by the average loan portfolio.

[2] The write-off ratio for the first half of FY 2007 is 0 percent because Caritas only writes off loans once a year, in September.

[3] Development Alternatives, *Economic Growth and Agricultural Technology, Accelerated Microenterprise Advancement Project, Measuring Performance of Microfinance Institutions: a Framework for Reporting, Analysis and Monitoring*, 2002.

The analysis indicates that Caritas' loan portfolio quality has improved from FY 2003 to FY 2006 with the portfolio at risk more than 30 days decreasing from 4.6 percent to 3.1 percent. The increase of the delinquency ratio in FY 2006 and FY 2007 was due to the implementation of individual loans, a special writeoff associated with the closing of one of Caritas' agencies, and alleged cases of fraud (see the next report section).

A Caritas borrower who operates a handicraft shop in the Pisaq Market, Peru (individual loan of $1,257). Source: Taken by a RIG/San Salvador auditor on June 12, 2007.

The writeoff ratio provides an indication of the past quality of the gross loan portfolio. Writeoffs recognize losses from uncollectible loans. Caritas' policy is to write off loans once each year in September. The writeoff committee evaluates loans overdue more than 120 days and the board of directors approves the amount to be written off. Caritas has implemented strong loan recovery efforts and managers have closely reviewed delinquent loans, resulting in remarkably low writeoffs during our audit period: less than 2 percent since 2005. The writeoff ratio increased in FY 2006 because Caritas started offering individual loans (which are riskier than loans to organizations and groups; see Table 7 below) and because of alleged cases of fraud in two of Caritas' nine agencies.

We measured Caritas' financial efficiency by applying two indicators: (1) operating expense ratio and (2) cost per active client, computed as follows:

- Operating expense ratio: Operating expenses divided by the average gross loan portfolio.

- Cost per active client: Operating expenses divided by the average number of active clients.

These ratios reflect how well Caritas used its financial resources. As shown in Table 1 above, the operating expense ratio has decreased by 11 percentage points, from 41 percent in 2003 to 30 percent in September 2006. This ratio decreased even further to 19 percent by March 2007. Thus, Caritas has significantly improved its profitability by reducing its operating costs.

The cost per active client increased from FY 2003 to FY 2006 but decreased significantly during the first half of FY 2007. It is important to recognize that the trend reflects a decision by Caritas to focus on larger loans, a decision that will likely advance Caritas' long-term financial sustainability. In 2003, 94 percent of the loans were less than $400 compared to 49 percent in 2007. Since Caritas is focusing on larger loans, the operating expense ratio discussed above is probably a better measure of its financial efficiency.

A customer and a Caritas borrower who operated a small jewelry and hair products store in Urubamba, Peru (individual loan of $942). Source: Photograph taken by an auditor from RIG/San Salvador on June 12, 2007.

To measure staff productivity, two indicators were used:

- Borrowers per loan officer: Number of active borrowers divided by the number of loan officers.

- Number of active clients per staff member: Number of active clients divided by the total number of personnel.

Caritas' performance with respect to these indicators showed no clear trend (Table 1). However, if staff productivity is measured by comparing the amount of loans outstanding to the number of staff members, then productivity has clearly increased during the period covered by our audit as shown in Table 2.

Table 2: Staff Productivity Ratios

Recomputed Ratios	FY 2003	FY 2004	FY 2005	FY 2006	First Half FY 2007
Portfolio outstanding per loan officer	$40,983	$50,235	$68,107	$114,009	$135,790
Portfolio outstanding by number of personnel	$28,735	$28,786	$42,428	$61,528	$79,211

In 2003, a loan officer managed an average of $40,983 worth of loans; as of March 2007, this amount had more than tripled to $135,790. A similar trend can be observed in terms of the amount of loans outstanding per number of personnel, with the ratio more than doubling from $28,735 in 2003 to $79,211 in 2007. Considering that Caritas worked in rural areas where follow-up costs and client management expenses were high, and that Caritas did not offer longer-term loans such as mortgages, the progress made in staff productivity was significant.

Caritas' lending strategy emphasized increasing the amount of outstanding loans rather than increasing the number of clients. As shown in Table 3 below, the value of Caritas' outstanding loan portfolio increased by 356 percent from $2.5 million in 2003 to $11.4 million as of March 2007 while the number of active clients increased by 76 percent during the same period. This trend was even more pronounced between 2005 and 2006. The value of the outstanding loan portfolio increased by 50 percent between 2005 and 2006, while the average number of active clients increased by only 12 percent.

Table 3: Value of Loan Portfolio and Number of Clients

Indicator	FY 2003	FY 2004	FY 2005	FY 2006	First Half FY 2007
Value of portfolio	$2,499,982	$2,561,997	$5,176,161	$7,752,580	$11,406,361
Number of clients	13,692	15,671	20,078	22,462	24,151

The terms of the loans, the amounts of the loans, and the types of loan products affected the interpretation and usefulness of the ratios we employed to measure efficiency and productivity. During the period under review, Caritas lengthened the average term of its loans, increased loan amounts, and added a new type of loan. As shown in Table 4, the average loan term increased from 4.7 months in 2003 to 8.3 months in 2007. In 2003, 65 percent of the borrowers had a loan of 4 months or less, versus only 8 percent in 2007. Caritas had no loans longer than 6 months in 2003 but such loans comprised 57 percent of its loans in 2007.

Table 4: Loan Terms

Range	FY 2003	FY 2004	FY 2005	FY 2006	First Half FY 2007
0- 4 months	65%	49%	19%	8%	8%
5-6 months	35%	50%	68%	54%	35%
7-8 months	0%	0%	7%	14%	16%
9 -10 months	0%	0%	3%	10%	13%
11 months or more	0%	1%	3%	14%	28%
Total	100%	100%	100%	100%	100%
Average term	4.7 mos.	5.0 mos.	5.9 mos.	7.3 mos.	8.3 mos.

During FY 2003 to FY 2007, Caritas modified its lending policy to provide larger loans to its current clients in order to reduce operating costs and risks and to improve financial sustainability. For example, as shown in Table 5, the average loan size was $192 in FY 2003 versus $625 in 2007. In 2003, 94 percent of the loans were less than $400 compared to 49 percent in 2007.

Table 5: Loan Amounts

	Percentage of Loan Portfolio				
Loan Amount	FY 2003	FY 2004	FY 2005	FY 2006	First Half FY 2007
$0-$400	94%	92%	74%	58%	49%
$401-$1,000	6%	8%	25%	36%	37%

	Percentage of Loan Portfolio				
Loan Amount	**FY 2003**	**FY 2004**	**FY 2005**	**FY 2006**	**First Half FY 2007**
$1,001- $3,000	0%	0%	1%	6%	12%
More than $3,000	0%	0%	0%	0%	2%
Total	100%	100%	100%	100%	100%
Average loan amount	$192	$222	$320	$455	$625

Caritas also changed the types of financial products it offered. As shown in Table 6, loans to community banks used to represent about half of the loans. As of March 2007, they represented only 11 percent, while individual loans constitute almost half of the loan portfolio. In response to client demand, Caritas started making individual loans in the first quarter of FY 2006, although group loans continue to be an important part of the loan portfolio because they offer lower risk exposure and higher profit margins.

Table 6: Percentage of Portfolio Outstanding per Financial Product

Loan Product	FY 2003	FY 2004	FY 2005	FY 2006	First Half FY 2007
Community bank	49.9%	41.1%	11.8%	15.8%	11.1%
Solidarity group	50.1%	58.9%	88.2%	59.9%	39.7%
Individual credit	0.0%	0.0%	0.0%	24.3%	49.2%

With regard to the economic activities that the loans from Caritas supported, we did not observe any risks caused by a concentration of loans in any particular sector. The primary activities financed by Caritas are commercial and manufacturing loans.

A Caritas borrower selling jelly and custard at the Central Market in Cusco, Peru. This was her third loan (group loan $942). Source: Photograph taken by a RIG/San Salvador auditor on June 11, 2007.

In response to competition from other lenders, Caritas has tried to increase its efficiency and responsiveness to client needs. This effort is reflected in a trend towards individual lending, an approach that reflects client preferences. Caritas has also improved its loan delivery mechanism by reducing the time needed to approve a loan. By providing more individual loans, which are less costly to manage, and fewer loans to community banks, which are more costly to manage, Caritas has achieved efficiencies. However, individual loans are more risky: the percentage of individual loans at risk is significantly higher than for other loan products as shown in Table 7 below:

Table 7: Percentage of Portfolio at Risk More Than 30 Days by Loan Product

Loan Product	FY 2003	FY 2004	FY 2005	FY 2006	First Half FY 2007
Community bank	1.8%	1.0%	0.5%	0.3%	1.4%
Solidarity group	11.3%	3.6%	2.3%	3.4%	3.1%
Individual credit	0.0%	0.0%	0.0%	4.4%	9.7%

Despite this trend, Caritas has been able to maintain its portfolio-at-risk ratio below 5 percent overall by implementing good controls and follow-up procedures. The increase in portfolio at risk ratios starting in FY 2006 was mostly caused by alleged cases of fraud (see finding below) and the shift toward individual loans.

During the audit period, Caritas strengthened efficiency and staff productivity by improving analysis of loan applications and by managing risk through practices such as the following:

- All applicants are evaluated and screened by a credit bureau.

- Each loan applicant's payment capacity is analyzed taking into account qualitative and quantitative aspects as well as the economic potential of the business sector in which the applicant operates. For example, the levels of indebtedness and coverage and the repayment capacity of the applicants are reviewed in detail and the repayment schedules take into account the borrowers' cash flows.

- With regard to community banks and solidarity groups, careful selection and training of clients translate into low default rates.

- Loan committees meet frequently (almost daily) to review and discuss loan applications, with the final loan verification and approval taken at Caritas' headquarters in Lima.

Caritas's Carabayllo loan officers holding a meeting to determine whether or not to approve a borrowers' loan application. Lima, Peru. Source: Photograph taken by a RIG/San Salvador auditor on June 7, 2007.

- Continuous monitoring of the portfolio allows clients to be identified as soon as they are in arrears. Monitoring is complemented by a collection process that includes sending out letters and following legal procedures to exert pressure and speed up client response.

- The products that Caritas provided were not very different from those of its competitors. However, Caritas has positioned itself with market interest rates, a quick loan approval process, and personalized attention that has created client loyalty. Interviews with 62 clients showed that most had previous loans from Caritas and several had had three to four loan rotations. All of the clients interviewed commented favorably on the quality of services and the amiability and sincerity of the loan officers.

- Loan officers are continuously trained and their salaries are based on an incentive scheme that considers not only the amount of loans disbursed but also delinquency rates.

Despite these measures, Caritas experienced several cases of alleged fraud perpetrated by employees who provided loans to nonapproved applicants or embezzled loan repayments. This issue is discussed in detail below.

A Caritas borrower being interviewed by a RIG/San Salvador auditor. The borrower operates a stall that sells refreshments and snacks in La Laguna, Urcos, Peru (group loan $471). Source: Photograph taken by a RIG/San Salvador auditor on June 13, 2007.

Suspected Fraud Not Reported to Office of Inspector General

Summary: According to USAID guidance, allegations of fraud must be referred to the Office of Inspector General (OIG). Caritas has had six cases of alleged fraud perpetrated by its field staff in two agencies that involved a total amount of $86,376 in USAID funds. Caritas documented the alleged cases of fraud and took proper civil and criminal legal actions to recover the amounts lost. However, this information was not communicated to the OIG because Mission officials overlooked information sent by Caritas about these allegations of fraud. If the OIG is not notified of allegations, alleged fraud cannot be investigated, corrective actions may not be taken, and further losses may occur.

According to the Standards of Ethical Conduct for Employees of the Executive Branch, employees shall disclose waste, fraud, abuse and corruption to appropriate authorities. The Inspector General Act of 1978 states that the OIG is responsible for recommending policies for preventing and detecting fraud and abuse in USAID programs and operations. Within the USAID OIG, the Office of Investigations provides procedures for the mandatory reporting of suspected offenses, including waste, fraud, abuse, and corruption involving USAID programs and operations. One of these procedures is that employees must promptly report any information, allegation, or complaint relating to waste, fraud, abuse, or any violation of law involving USAID programs and operations to the Office of Investigations.

From October 2002 to May 31, 2007, Caritas fired six staff members because they did not follow loan application procedures, issued loans to ghost clients, falsified the signatures of loan officers in order to have these loans approved, and embezzled client repayments. This wrongdoing resulted in writeoffs of approximately $86,376, and the amount of portfolio at risk was negatively affected.

Caritas' loan procedures require that loan applications be reviewed, a credit check requested, and client information verified by a loan officer before loans are submitted to the loan committee for approval. All loan officers including the area office chief and the credit supervisor need to approve the loans and sign the loan application. However, this procedure was not followed by two Caritas offices. For example, at one office, there was no loan supervisor, and two loan officers and the office manager did not follow established procedures and issued loans that did not conform to the requirements of Caritas. In so doing, the agency chief falsified the signatures of other loan committee members to get the loans approved. These loans were not repaid, and Caritas has not been able to locate these clients because the information provided in the loan applications was false. As a result, the portfolio at risk for more than 30 days at this agency increased to 12 percent in March 2007.

In compliance with the terms of its agreement with USAID, annual financial audits of Caritas were conducted. The external auditors engaged by USAID did not report any allegations of fraud in their 2005 and 2006 reports.[4] A separate audit of the microfinance program was also conducted by auditors engaged by Caritas. These auditors reported on allegations of fraud but the allegations were not given prominence in the audit report, and USAID/Peru overlooked the information. As a result, USAID/Peru did not communicate these allegations to the OIG. The failure to report allegations of fraud to the OIG limits the usefulness of financial audits as an internal control. If the Mission does not inform the OIG of an allegation of impropriety, then a determination of fraud will likely not be made, corrective actions may not be taken, and further losses may occur.

Caritas terminated the staff members involved in the suspected fraud and has started criminal legal procedures and civil actions to recover the losses. In July 2007, Caritas sent a report to USAID/Peru that discusses the allegations of fraud and the actions taken to recover the associated losses. As a result of these cases, Caritas has appointed an internal auditor exclusively for the microfinance program. Caritas has further standardized its process of awarding loans, and reinforced internal controls to further

[4] We have contacted the external auditors to obtain an explanation but have not yet received a satisfactory response.

reduce the chances of fraud. A new approval procedure includes a separation of tasks and various levels of verification. Finally, Caritas has appointed two risk analysts who will monitor and supervise area offices, analyze the loan portfolio at risk, and follow up on any identified abnormalities.

Recommendation No. 1: We recommend that USAID/Peru send a reminder to its staff regarding their responsibilities for reporting suspected fraud to the Mission certifying officer and the Office of Inspector General.

Recommendation No. 2: We recommend that USAID/Peru make a management decision with regard to $86,376 lost through alleged fraud by Caritas employees and recover from Caritas the amounts determined to be unallowable.

Evaluation of Management Comments – In response to Recommendation No. 1, the Mission stated that the Economic Growth Team will report suspected fraud whenever they are aware of it. Future terms of reference for audits will include a special focus on potential and/or suspected fraud. A management decision on this recommendation can be recorded when USAID/Peru has developed a firm plan of action, with target dates, for implementing the recommendation.

In response to Recommendation No. 2, the Mission stated that on August 1, 2007, it declared ineligible costs totaling $19,932 embezzled from the Chachapoyas agency in FY 2006, and requested additional information to determine the total amount on an alleged fraud in Carabayllo in FY 2007. A management decision on this recommendation can be recorded when USAID/Peru has made a final decision on the total amount to be recovered from Caritas.

A RIG/San Salvador auditor interviewing a Caritas borrower who produces tiles in Pinipampa, Urcos, Peru (individual loan $628). Source: Taken by a RIG/San Salvador auditor on June 13, 2007.

Did USAID/Peru's microenterprise activities achieve planned results?

USAID/Peru achieved all three planned results for its microfinance program in FY 2005 and FY 2006 as shown in Table 8 below.

Table 8: USAID/Peru Microfinance Partners Planned vs. Reported Results, FY 2005 and FY 2006

	FY 2005			FY 2006		
Indicator	**Target**	**Achieved**	**Percent Achieved**	**Target**	**Achieved**	**Percent Achieved**
Value of loan portfolio outstanding ($000)	$165,657	$202,034	122%	$220,588	$253,631	115%
Number of active clients/ borrowers	276,666	281,852	102%	321,036	345,535	108%
Percentage of active women clients	53%	62%	117%	62%	64%	103%

However, as discussed in the following section, Caritas did not fully achieve its performance targets concerning the number of borrowers, the size of the loan portfolio, and the transfer of its portfolio to a regulated institution. Also, as discussed in the section beginning on page 15, USAID/Peru and USAID/Washington Bureau for Economic Growth, Agriculture and Trade, Office of Poverty Reduction (EGAT/PR) took credit for all of the results achieved by the Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises (COPEME), even though not all of the results were attributable to USAID efforts.

Some Caritas Results Were Not Completely Achieved

Summary: Caritas' Development Assistance Program Proposal included six expected results related to microfinance activities. Three of these results were not achieved. Although Caritas met up to 84 percent of the performance targets, the performance targets were not completely met because USAID provided less funding to Caritas than was originally planned and because of competition from other microfinance institutions. Consequently, the program did not deliver the expected level of microfinance services and the long-term sustainability of the program was not ensured.

Caritas' Development Assistance Program Proposal included targets for all six selected performance indicators. Early in 2005, these original targets were revised and reduced since USAID provided less funding than expected. Despite these reductions, Caritas did not fully achieve all of its planned results. As shown in Table 9 below, we judged that Caritas substantially met three planned results dealing with the percentage of the portfolio at risk, the percentage of active women clients and its level of financial sustainability. However, Caritas did not completely achieve the other three results dealing with the value of the outstanding loan portfolio, the number of active clients and the transfer of its loan portfolio and clients to a regulated institution.

Table 9: Comparison of Caritas Planned Targets to Actual Accomplishments, FY 2005 and 2006

	FY 2005			FY 2006		
Indicator	**Target**	**Achieved**	**Percent Achieved**	**Target**	**Achieved**	**Percent Achieved**
Value of the outstanding loan portfolio	$6,430,530	$4,377,878	68%	$9,228,860	$7,752,580	84%
Number of active clients/borrowers	29,512	20,078	68%	27,564	22,467	82%
Transfer of its loan portfolio and clients to a regulated institution	20,078	0	0%	33,300	0	0%
Percentage of portfolio at risk	3.30%	1.80%	183%	2.62%	3.17%	83%[5]
Percentage of active women clients	88%	85%	96%	85%	80%	95%
Level of financial sustainability	106%	96%	91%	102%	101%	99%

These results were not achieved mainly because of the following factors:

- According to the Caritas DAP, the program was expected to receive $11.9 million in monetized P.L. 480 Title II commodities during the life of the project. However, the Mission now expects to provide only $7.4 million to Caritas because of budget constraints and new strategic priorities. In addition, the program implementation timeframe has been shortened by one year and will end at the end of FY 2007 instead of FY 2008.

- Caritas competes with many other institutions that provide loans to the microfinance sector, including municipal loan cooperatives, rural savings cooperatives, microenterprise development companies, specialized microfinance institutions, and commercial banks. These competitors offer a wider range of loan products, including consumer loans and mortgages, that allow them to better leverage managerial and staff resources and may allow them to cross-subsidize loans to microenterprises. Caritas expected to become a "regulated institution" by 2004, a step that would likely have improved its competitiveness. Regulated institutions need not charge borrowers value added tax (19 percent) on interest and commission-based income but nongovernmental organizations (NGOs) like Caritas must charge this tax, increasing the final cost to borrowers. Caritas has not completed its conversion to a regulated institution because the Peruvian Bank Superintendency has tightened the requirements for doing so. For example, the Superintendency previously required

[5] We concluded that Caritas substantially met targets for percentage of portfolio at risk because Caritas greatly exceeded its target in 2005 and achieved 83 percent of the target for 2006.

$250,000 in reserve capital, but now requires $1 million. The Superintendency also imposes requirements with respect to licensing, guidelines on business activities, reporting and supervision, and automated systems for monitoring loans and producing information required by the Superintendency.

As a result, service delivery to beneficiaries has been less than planned in some cases, and, because the conversion to a regulated institution has not been completed, Caritas' competitiveness and the program's continuity and sustainability are not well ensured. To better ensure the program's sustainability after the termination of USAID funding, we are making the following recommendation:

Recommendation No. 3: We recommend that USAID/Peru assist Caritas in the development of a detailed plan that will establish the Caritas microfinance program as a regulated institution.

Evaluation of Management Comments – In response to Recommendation No. 3, the Mission stated that Caritas has recently decided to buy a microfinance institution that is already operating in order to expedite initiation of formal supervised financial operations. USAID/Peru has asked consultants in charge of the final evaluation of the program to make sure they provide recommendations in support of Caritas' supervised financial institution. A management decision on this recommendation can be recorded when USAID/Peru has developed a firm plan of action, with target dates, for implementing the recommendation.

An auditor from RIG/San Salvador interviewing a Caritas borrower who operates a small hotel on the island of Los Uros, Puno, Peru (group loan $3,142). Taken by a RIG/San Salvador auditor on June 15, 2007.

Other Matter

During the course of the audit, one other matter that requires corrective action by USAID came to our attention – USAID/Washington's Bureau for Economic Growth, Agriculture and Trade, Office of Poverty Reduction, Microenterprise Development (EGAT/PR/MD) did not follow Automated Directives System (ADS) guidance to ensure that data reported to Congress concerning microenterprise results in Peru were accurate. This issue is discussed in the following section.

Microenterprise Reports to Congress Were Inaccurate

Summary: According to USAID guidance, performance data should be accurate and reliable. However, the FY 2005 and FY 2006 Microenterprise Results Reports to Congress contained results that were inaccurate and inconsistent with respect to USAID/Peru's activities. EGAT/PR/MD understood that a USAID/Peru staff member would verify the information, but the staff member understood that her role was only to record information in the microenterprise results reporting system. As a result, EGAT/PR reported inaccurate information to Congress, and management decisions may have been negatively affected by inaccurate data.

ADS 203.3.5.2 states that the Operating Unit and Strategic Objective Teams should be aware of the strengths and weaknesses of their data and the extent to which data integrity can be trusted to influence management decisions. As stated in "Analyzing Performance Data" (TIPS 12), results-oriented management requires that reported data be accurate and reliable and missions should take steps to ensure that submitted data are adequately supported. In addition, USAID's "Analyzing Performance Data Toolkit" supplementary guidance states that the goal of assessing data from implementing partners and secondary sources is to be aware of data strengths and weaknesses and the extent to which data can be trusted when making management decisions. As stated in TIPS 12, even valid indicators have little value if the data collected do not correctly measure the variable or characteristic encompassed by the indicator.

We found that the data reported to the U.S. Congress by EGAT/PR in its FY 2005 and FY 2006 Annual Reports entitled Microenterprise Results Reporting (MRR) were inaccurate and inconsistent with respect to the data reported by USAID/Peru. As shown in Table 10, there were significant differences between reported and audited figures with regard to two of the three results reported by USAID/Peru's partners in FY 2005.

Table 10: Comparison of Reported and Documented Results for USAID/Peru's Partners for FY 2005

Indicator	Microenterprise Report to Congress	Documented Results	Percentage Over (Under) Reported
Number of borrowers*	50,560	135,131	(63%)
Number of savings account clients*	335,564	82,232	308%
Number of enterprise development clients	1,376	1,376	0%

* The FY 2005 MRR states that borrowers and savings account clients may refer to the same individuals in the case of some institutions that offer both services.

The number of saving clients was overreported by 308 percent while the number of borrowers was underreported by 63 percent. EGAT officials said that the FY 2005 MRR contained a typographical error and the column headings for borrowers and saving clients were mistakenly transposed. However, this explanation does not fully explain why the number reported did not reconcile with the figures from USAID/Peru's partners.

Another issue was that USAID claimed credit for all loans made by COPEME members in 2005, but USAID financing represented only 62 percent of COPEME's total funding. COPEME itself distinguished between results attributable to USAID funding and those attributable to other sources of funding. For example, in FY 2005, although COPEME members provided loans to 279,486 clients, COPEME attributed only 114,239 of these loans to efforts supported with USAID funding. Also, USAID/Peru provided only limited assistance in terms of loan guarantees to three rural cooperatives. The report to Congress included 14,322 borrowers but USAID/Peru reported assisting only 414, based on proper apportionment of assistance provided.

A third issue is that COPEME did not provide any loans itself. Instead, COPEME provided technical assistance to its members which in turn provided loans to borrowers. Thus, it is at least questionable whether USAID should have been reported any borrowers in conjunction with its assistance to COPEME.

A fourth issue is that the amount of obligated funds for USAID/Peru's partners reported in Annex A of the MRR did not reconcile with USAID/Peru's records as shown in Table 11 below. Of the seven institutions reviewed, the amount obligated was significantly misstated for three.

Table 11: FY 2005 Obligations for USAID/Peru's Microenterprise Partners

Institution	Reported ($000)	USAID/Peru Controller's Records ($000)	Percent Over (Under) Reported
CARITAS	$1,500	$1,500	-
Chemonics/Peru	$1,020	$1,798	(43%)
CMAC Piura	$201	$201	-
CMAC Sullana	$208	$208	-
COPEME	$280	$872	(68%)
EDPYME Confianza	$92	$92	-
Nathan Associates	$100	$1,600	(94%)

We also found inconsistencies in the FY 2006 Microenterprise Results Report for the results reported for USAID/Peru in terms of the number of borrowers and saving clients. According to documented results, USAID/Peru provided assistance to 315,117 borrowers while the report to Congress included only 22,467 borrowers because data for COPEME and the rural cooperatives were not included. In its comments on our draft report, EGAT/PR said that this occurred because COPEME reported its information too late for inclusion in the report to Congress.

EGAT/PR did not ask USAID/Peru to validate the quality and accuracy of the information reported by microenterprise implementing partners. For example, COPEME reported to EGAT/PR that the total amount of the portfolio outstanding was $2.16 billion in FY 2005 and that it had 299,762 clients. However, after further review COPEME found out that these amounts included transcription errors and that the actual figures were $216 million for the value of the portfolio and 279,486 clients. COPEME corrected its results and informed USAID/Peru but USAID/Peru did not communicate with EGAT/PR to correct these figures. If EGAT/PR/MD had confirmed this information by communicating with the Mission or COPEME, it would have learned the actual figures. According to a Mission official in the program office, she was appointed this year to record the information in the microenterprise results reporting system, but she did not validate the accuracy of the information. Without a data quality control process and data verification, decision makers may draw erroneous conclusions regarding the performance of the program leading to improper management decisions and the reporting of incorrect information. To improve the quality and reliability of the information reported we are making the following recommendation.

Recommendation No. 4: We recommend that the Economic Growth, Agriculture and Trade Bureau Office of Poverty Reduction Microenterprise Development (EGAT/PR/MD) establish specific procedures to verify the accuracy of information prior to reporting it to Congress.

Evaluation of Management Comments – In response to the draft report, EGAT/PR acknowledged that the above finding points to problems that require serious attention, but it proposed solutions that differed somewhat from the draft report's specific recommendations.

EGAT/PR believed that Recommendation No. 4 should refer to "accuracy" rather than "validity," a point which we accept and have incorporated into Recommendation No. 4 above. EGAT/PR stated that it plans to conduct a data audit to identify potential sources of inaccuracies and appropriate solutions. EGAT/PR mentioned several key improvements under consideration, including asking missions to review the draft MRR, revising guidance to missions on their role in the process, allowing partners to enter amounts in local currency, and conducting consistency checks on data. We believe that EGAT/PR has been responsive to the intent of the recommendation, and a management decision for Recommendation No. 4 can be recorded when EGAT/PR has developed a firm plan of action, with timeframes, to address this issue.

EGAT/PR disagreed with an additional recommendation that was included in our draft report, which asked EGAT/PR to develop a methodology to report only results that are attributable to USAID's efforts. EGAT/PR is convinced that it is not feasible to develop a methodology that plausibly disentangles the respective contributions of the different sources of MFI results. Therefore, EGAT/PR proposed to deal with this issue by including a disclaimer in future MRRs that alerts readers that the results achieved by MFIs and other microenterprise partners reflect the contributions of various parties, sometimes including other donors and always including the efforts of the partner organization itself. After reviewing EGAT/PR's comments, we decided to delete the recommendation from this report. A thorough review of the information in the MRRs and the relevant attribution issues would take us far beyond the scope of this audit and we are reluctant to either agree or disagree with EGAT/PR's proposed approach without undertaking such a review. Moreover, we believe that inclusion of a disclaimer in future MRRs is a useful interim step, even if it does not completely resolve the issue.

SCOPE AND METHODOLOGY

Scope

The Regional Inspector General/San Salvador conducted this audit in accordance with generally accepted government auditing standards. Fieldwork for this audit was performed in Peru from June 4 to June 20, 2007, at USAID and Caritas' offices. Site visits to Caritas Peru's branch offices were also performed and borrowers were interviewed in 3 of the 11 regions covered by Caritas.

This audit is one of a series of worldwide audits and was designed to answer the following questions: (1) Did USAID/Peru implement its microenterprise activities efficiently? (2) Did USAID/Peru's microenterprise activities achieve planned results?

According to USAID, microenterprise activities comprise four major components: microfinance, enterprise development, financial policy, and microenterprise development policy. The scope of this audit covers the microfinance component.

In planning and performing the audit, we obtained an understanding of, and assessed the Mission's controls related to, the management of its microfinance program. The management controls identified included performance management plans, the Mission's annual self-assessment of management controls pursuant to the Federal Managers' Financial Integrity Act, cognizant technical officers' field visits, and reviews of progress reports. We also evaluated Caritas controls over the issuance of loans by reviewing and testing loan applications and by interviewing Caritas personnel and borrowers.

Caritas is comprised of a network of 9 agencies, 3 offices, and 24 branch offices located in 11 of the 24 regions of Peru. Caritas offers three loan products: individual loans, solidarity group loans and community bank loans. The majority of these loans have terms of 4 to 6 months and amounts less than $400, which means that they classified as loans for the very poor. The scope of the audit included a universe of 20,344 loans totaling $11.6 million in outstanding loans as of May 31, 2007. For the three regions shown in Table 12 below, we selected a judgmental sample of 138 loan applications. We also visited 88 clients and interviewed 62 of them (18 individuals, 28 groups, and 16 banks) in 3 of the 11 regions served by Caritas. The number of loan applications reviewed and the number of clients visited and interviewed are detailed by region in Table 12 below:

Table 12: Sampled Loan Applications Reviewed and Clients Visited and Interviewed

Region	Total Loans as of May 31, 2007	Loan Applications Reviewed	Total Clients Visited	Total clients Interviewed
Carabayllo (1 branch)	2,035	17	14	5
Cusco (5 of 7 branches)	2,749	88	45	35
Puno (2 of 2 branches)	3,918	33	29	22

Region	Total Loans as of May 31, 2007	Loan Applications Reviewed	Total Clients Visited	Total clients Interviewed
Total	8,702	138	88	62

We judgmentally selected sites to visit, giving preference to regions that had a larger number of clients and a larger outstanding loan portfolio. Logistics were also a factor in our choices. Our site selection was also designed to include a representative mix of loan products and urban and rural communities and to include a higher percentage of loans at risk. The three regions visited represented 43 percent of the loans and the highest percentage of loans at risk. We visited a total of 88 clients and interviewed 62 because 26 were not present at the time of our visit. Among the 62 clients interviewed, 43 were randomly selected from a database of clients maintained by Caritas, and 19 were identified by the loan officers at the time of our visits because of their physical proximity to the borrowers listed in the sample. We used a judgmental sampling methodology because in our view it offered the best tradeoff between reliability and cost.

From October 2002 until March 31, 2007, Caritas received a total of $5.6 million in monetized P.L. 480 Title II commodities and expended $5.4 million on its microfinance-related activities. Also, in FY 2005 and FY 2006, USAID/Peru expended $1.5 million in support of Consortium of Private Organizations to Promote the Development of Small and Micro Enterprises (COPEME) microenterprise activities.

Methodology

We reviewed documentation produced by USAID/Peru, Caritas and COPEME, including the Development Assistance Program Proposal, monitoring plans and progress reports, other studies, and records on the microfinance program.

To answer the first audit objective and to determine the efficiency of USAID/Peru's microfinance activities implemented by Caritas, we computed six performance indicators based on audited financial statements and Caritas records from the database system. The indicators selected were:

- Portfolio at risk more than 30 days.
- Writeoff ratio.
- Operating expense ratio.
- Cost per active client.
- Borrowers per loan officer.
- Active clients per staff member.

To validate the accuracy of the information reported, our tests included reviewing Caritas records and testing 138 loan applications in the selected three regions against the following 10 attributes:

- The borrower's loan application.
- Financial and economic evaluations of business profitability and borrower repayment capacity.
- Credit report from a national credit organization.

- Loan committee evaluation and authorization.
- Signed contract with the borrower.
- Declaration of equity or loan collateral.
- Copy of the borrower's national identification card.
- Any document for proof of address.
- Monthly payment schedule.
- Purpose of the loan.

Our tests also compared information listed on the borrower's loan application, such as the borrowers' name, identification number, gender, loan amount, loan term, and loan balance, to the information recorded in the microfinance organization's loan database and to determine if the borrowers complied with Caritas' loan requirements. Further, we interviewed 62 borrowers to confirm the accuracy of the identity of the borrower, to determine whether the amount and terms of the loans and the repayment schedule, and to determine if the date of the loan's disbursement matched the date recorded in Caritas' loan database. By interviewing 43 borrowers from our sample and 19 identified by the loan officers because of their physical proximity to the borrowers listed in the loan database, we verified that borrower data in Caritas' management information system was complete and accurate. We also verified the balance of the loans outstanding and determined whether the loans were properly categorized as current or overdue. Our tests revealed that all the applicants qualified for the loans and that the information in Caritas' database was accurate.

To answer our second audit objective and to determine whether the Mission achieved its intended results during FY 2005 and 2006, we reviewed the Mission's reported and documented results and visited USAID/Peru partners that had implemented microfinance-related activities during FY 2005 and FY 2006 including: Caritas, COPEME, Chemonics and Nathan Associates.

Only Caritas was providing microfinance services directly to clients. COPEME was providing technical assistance and training to microfinance institutions but did not implement a microfinance program. Nathan Associates and Chemonics were providing productive and commercial technical assistance at the policy level but did not implement microfinance related activities.

To validate the performance results of USAID's Microenterprise Results Reporting (annual reports to Congress), we compared reported to documented results for the Mission partners mentioned above. Our testing consisted of tracing microfinance-related data contained in the members' reports and databases to the Mission's reported results and to the annual report to Congress. To determine if performance results were accurately reported, we allowed a 5 percent variance between reported results and the results attested to by our audit.

MANAGEMENT COMMENTS

September 12, 2007

USAID/Peru's comments to the Findings presented in the RIG's Microfinance Audit Report:

Suspected Fraud Not Reported to Office of Inspector General: According to USAID guidance, allegations of fraud must be referred to the Office of Inspector General (OIG). Caritas has had six cases of alleged fraud perpetrated by its field staff in two agencies that involved an estimated amount of roughly $86,000 in USAID funds. Caritas already documented the alleged cased of fraud and took proper civil and criminal legal actions to recover the amount lost. However, this information was not communicated to the OIG because Mission officials did not know about the problem. If the OIG is not notified of allegations, alleged fraud cannot be investigated, corrective actions may not be taken, and further losses may occur.

Comment: The cause of USAID/Peru's failure to inform the RIG about the alleged fraud is stated in the RIG's description of the issue: "Mission officials did not know about the problem." The RIG's report also states: "The external auditors engaged by USAID did not report any allegations of fraud in their 2005 and 2006 reports."

Regarding Recommendation No. 1: "We recommend that USAID/Peru send a reminder to its staff regarding their responsibilities for reporting suspected fraud to the Mission Certifying Officer and the Office of Inspector General."

Comment: We have nothing to object. Staff will report suspected fraud if they are aware of it. Future Terms of Reference for audits will include a special focus on potential and/or suspected fraud.

Regarding Recommendation No. 2: "We recommend that USAID/Peru make a management decision with regard to $86,376 lost through alleged fraud by Caritas employees and recover from Caritas the amounts determined to be unallowable."

Comment: On August 1, 2007 USAID/Peru declared ineligible cost $19,932 embezzled from the Chachapoyas agency in FY 2006, and requested additional information to determine the total amount on an alleged fraud in Carabayllo in FY 2007. We will request information and take action to recover the rest of the funds included in the RIG's report.

Some of Caritas' Results were not Completely Achieved: Caritas' Development Assistance Program Proposal included six expected results related to microfinance activities. Three of these results were not met. Although Caritas achieved up to 84 percent of the performance targets for these planned results, the performance targets were not completely met because USAID provided less funding to Caritas than was originally planned and because of competition from other microfinance institutions. Consequently, the program did not deliver the expected level of microfinance services and the long-term sustainability of the program was not ensured.

Comment: Funding for Title II programs in Peru has been diminishing for the past five years and the program ends in FY 07.

Regarding Recommendation No. 3: "We recommend that USAID/Peru assist Caritas in the development of a detailed plan that will establish the Caritas microfinance program as a regulated institution."

Comment: Caritas submitted a feasibility study to the Superintendence of Banks requesting authorization to organize a formal microfinance institution. However, recently Caritas has decided to directly buy a microfinance institution that is already operating in order to expedite initiation of formal supervised financial operations. Additionally, given that Caritas' DAP ends in FY07, a final evaluation is underway. USAID/Peru has asked consultants in charge of the evaluation to make sure they provide recommendations in support of Caritas' supervised financial institution.

Microenterprise Reports to Congress were Inaccurate: According to USAID guidance, performance data should be accurate and reliable. However, the FY 2005 and FY 2006 Microenterprise Results Reports (MRR) to Congress contained results that were inaccurate and inconsistent with USAID/Peru's progress achieved in terms of microenterprise activities. EGAT/PR/MD understood that a USAID/Peru staff member would verify the information, but the staff member understood that her role was only to record information in the microenterprise results reporting system. As a result, EGAT/PR reported inaccurate information to Congress, and management decisions could have been negatively impacted by inaccurate data.

Comment: Information to the MRR is requested and responded directly on-line by beneficiary entities. The staff member assigned to review reported information had no contact with partner organizations. USAID/Peru's EGE will take care of reviewing MRR results in the future.

Regarding Recommendation No. 4: "We recommend that the Economic Growth, Agriculture and Trade Bureau Office of Poverty Reduction Microenterprise Development (EGAT/PR/MD) adhere to USAID requirements and confirm the validity of the information with contributing partners and relevant missions prior to reporting the data to Congress."

Comment: No comment.

Recommendation No. 5: We recommend that the Trade Bureau Office of Poverty Reduction Microenterprise Development (EGAT/PR/MD) develop a methodology to report only results that are attributable to USAID efforts.

Comment: No comment.

September 6, 2007

TO: RIG/San Salvador, Tim Cox

FROM: EGAT/PR, Tim Mahoney

SUBJECT: EGAT/PR/MD comments on selected recommendations in OIG "Audit of USAID/Peru's Microfinance Activities," draft Audit Report No. 1-527-07-0XX-P

Summary: Recommendations 4 and 5 in the above draft report identify issues with the Microenterprise Results Report (MRR) system requiring attention from the EGAT Office of Poverty Reduction, Microenterprise Development team (EGAT/PR/MD). EGAT/PR/MD acknowledges that the recommendations point to problems that require serious attention, though in both cases our understanding of the underlying problem and of the best solution differ from the draft report's specific recommendations. In particular, the problems raised in Recommendation 4 are really ones of data accuracy rather than of data validity as stated in the draft report; this memo outlines a number of planned actions to improve and assure the accuracy of the data summarized in the MRR. Recommendation 5 suggests that EGAT/PR/MD attempt to develop a methodology to allocate and attribute microenterprise results among their different sources. This recommendation is highly problematic, both because it runs directly contrary to USAID policy on microenterprise results reporting, and because the chances for developing such a methodology are minimal. For both reasons, we believe a healthier response would be to include language in the MRR that alerts the reader to the fact that microenterprise results reflect the contributions of multiple parties, including USAID but not confined to USAID.

EGAT/PR/MD would welcome a dialogue with the Office of the Inspector General (OIG) to ensure that we are in agreement on feasible and desirable changes in the MRR system.

EGAT/PR/MD Comments on Recommendations 4 and 5. The following responds to Recommendations 4 and 5, in sequence.

Recommendation 4 urges EGAT/PR/MD to adhere to USAID requirements regarding secondary data quality and confirm the validity of information with contributing partners and relevant missions prior to reporting the data to Congress.

EGAT/PR/MD has carefully reviewed the evidence related to this recommendation, and believes that the essential issue here is one of the *accuracy* of the data on which the MRR is based, rather than of the *validity* of those data as stated in the recommendation. Nothing presented in the draft report raises serious questions regarding whether those data "clearly and adequately represent the intended result," the essence of data validity as defined in ADS 203.3.5.1. Rather, the draft report cites evidence that in some cases, inaccurate data may have been reported to MRR and been incorporated into the draft report. EGAT/PR strongly agrees on the need to assure the accuracy of all data incorporated in the MRR, sees definite room for accomplishing this goal, and plans to conduct a data audit to identify potential sources of inaccuracies and appropriate solutions. Indeed, we already see a number of promising improvements, which we expect to incorporate into the next round of MRR data collection. Several of the key improvements under consideration are reviewed below.

Having said that, we were quite puzzled at the way that the draft report addresses these issues, making no mention of key details that would cast a very different light on the findings. In particular, only two of the inconsistencies cited on pages 16-17 – both from the same source – relate to the FY 2006 MRR; all the rest relate to the FY 2005 edition. Between the FY 2005 and FY 2006 rounds of the MRR, EGAT/PR/MD shifted to a new contractor to implement the system; we believe the substantial reduction in inconsistencies found between these two reports stands as a tribute to the relentless energy with which the new contractor has followed up on missing data and has sought to clarify the source of any inconsistencies between different sources.

Moreover, the manner in which the draft report characterizes the nature of the few problems cited in the FY 2006 report is potentially misleading to the outside reader. The draft report states that "data for COPEME and the rural cooperatives were not included" in the numbers of borrowers and savers reported for USAID/Peru. In fact, by the end of March 2007, when the MRR database had to be closed in order to meet the deadline for getting the report into print and delivered to Congress, MRR staff had still failed to obtain a working contact address at COPEME, despite repeated efforts to do so both through the mission and through the previous addresses at COPEME. COPEME finally got around to submitting its data, but only on August 2, many weeks after the deadline. We cannot prove that this late submission resulted from the pressure COPEME felt as a result of OIG's face-to-face contact with their staff, but the timing of that late submission is hard to ignore. In short, the identified "inconsistencies" in the FY 2006 report were in fact exclusively the result of missing data from one source, not of some kind of mishandling of submitted data. We certainly see this as a problem – see below – but urge the OIG to change the text to make the nature of the problem clear to the outside reader.

With regard to the draft report's broader recommendation that EGAT/PR/MD confirm the [accuracy] of information with contributing partners and relevant missions, we would stress that MRR seeks very different kinds of information from missions and implementing partners, reflecting the almost complete lack of overlap in the kinds of information to which each has direct access. Missions alone know how much funding they've obligated to each implementing partner, and so are asked to provide data on those obligations, plus contact information for each partner. In contrast, only implementing partners are in a position to gather data on their own results, so MRR seeks those data directly from implementing partners. Because missions and implementing partners have access to such different kinds of information, we believe that continuing to ask each to report what they know directly to MRR makes sense. Nothing in the draft report suggests that changing this division of labor – in particular, by asking missions to review partner-provided results data – would improve the accuracy of the data gathered. As a result, the comments below focus on the relative costs and benefits of asking each party to review the data that they themselves have submitted to MRR. Finally, the preceding discussion should make clear that the statement that "EGAT/PR/MD understood that a USAID/Peru staff member would verify the information..." (box on page 15) is incorrect as stated. In this and similar cases, EGAT/PR/MD does not count on mission staff to catch inaccuracies in results data reported by implementing partners; rather, we count on MRR staff to catch those inaccuracies. We request that this statement be revised in light of the actual division of labor between missions and implementing partners. .

In the case of mission-supplied obligations data, we will explore with missions the possibility of asking them to review the draft MRR to make sure that those data have been correctly entered in the system. To ensure that this step does not hold up the reporting process, it would be essential that it be posed as a final opportunity to make any needed corrections, given a very short turnaround, and that non-responses be counted as assent.

More substantively, we plan to review the guidance provided to missions on reporting their obligations, to ensure that it is as clear as possible. The main potential source of inaccuracies in these data appears to involve the way in which missions report the value of obligations that support microenterprise development, in cases where microenterprise development constitutes only a part of a broader program activity. The guidance provided on this issue will receive careful scrutiny.

In addition, we plan to review and, if necessary, clarify the guidance provided to missions on their own role in the process, to avoid any possible misunderstandings of the type cited on page 17 of the draft report. In the particular case cited, COPEME should have reported its corrected figure directly to MRR rather than to USAID/Peru; the easy and correct solution would have been for USAID/Peru simply to tell them that. Revised guidance will make this perfectly clear.

In contrast to the relatively straightforward case of mission obligations data, the suggested review and confirmation of all results data submitted by partner organizations is far more problematic. Asking missions to review these data runs into the problem noted above -- that missions typically do not have direct access to data on which to second-guess what the implementing organizations report. Meanwhile, asking partner organizations to confirm the data that they themselves have reported to MRR would impose a very high cost in terms of the added time this step would require. Based on past experience, MRR staff estimate that doing so would delay submission of the report to Congress by about two months, largely due to the lengthy delays in eliciting responses from many partner organizations – where clearly, the slowest sets the pace of the overall process.

Before approaching Congress to seek its endorsement of such a lengthy delay, EGAT/PR/MD believes that we should first identify and correct as many sources of missing or inaccurate partner data as possible – getting the data right the first time, to the greatest possible extent. High-priority areas of attention include the following:

(1) Non-reporting partners. Though noted only indirectly in the draft OIG report in reference to COPEME, non-reporting partners currently represent a rather serious problem for MRR, accounting for about 15 percent of FY 2006 microenterprise obligations worldwide. This does not necessarily mean that the MRR is missing 15 percent of the results data that would be available if all partners reported in a timely fashion, because many startups and several types of organizations (such as credit rating agencies) do not generate results data that fit into MRR. In the absence of the unreported data, it is difficult to be certain about how large a distortion this problem produces in the overall results figures. However, EGAT/PR/MD plans to review options for reducing the degree of non-reporting as much as possible. Striking the right balance

is important here: approaches likely to result in the greatest increase in reporting – especially a binding commitment to withhold future funding from non-reporters – would inevitably narrow the range of organizations eligible for funding in subsequent years, thus making it harder to meet the Congressional target for microenterprise development support. Similarly, the transition to such a "tough love" approach would almost certainly create a large volume of pleas for consideration of special circumstances, which would either have to be refused overall or assessed on their merits on a case-by-case basis. The political cost of following this course would need to be assessed carefully, preferably in consultation with interested Congressional members and staff. In the meantime, EGAT/PR/MD plans to seek less drastic means to improve reporting, especially by launching efforts to obtain contact addresses for implementing partners earlier in the process.

(2) Arithmetic errors by partner organizations. A review of MRR reporting forms suggests room for process improvements that are likely to reduce the incidence of errors by partner organizations. A prime example involves shifting from a reporting form that requires each partner to convert multiple local-currency transactions and balances into U.S. dollar equivalents, to one that seeks data in local-currency terms and then converts those figures automatically into U.S. dollars automatically, using the exchange rate prevailing at the end of each partner's fiscal year. Allowing partners to input their figures in local currency would help them spot "orders of magnitude" problems such as the one cited in connection with COPEME's FY 2005 portfolio outstanding. More broadly, it would allow organizations to transfer information into the system directly from their own books, without the need to do any intervening calculations. Ascertaining the feasibility of this change is a high priority for EGAT/PR/MD.

(3) Transcription errors. At present, partner organizations that, for one reason or another, cannot directly access the online MRR database have the option of instead completing a form in Microsoft Word, and submitting the completed form to MRR staff. In such cases, MRR staff manually transcribe the data into the online system on behalf of the partner organization. Although we have no reason to believe that this step actually results in any errors, it creates the clear possibility of such errors, as well as creating additional drudgery for MRR staff. EGAT/PR/MD plans to examine the potential to eliminate all such hand-transcription, especially by exploiting the basic database capabilities of Microsoft Excel and even Microsoft Word, allowing the completed forms to be extracted directly into the database.

(4) Consistency checks. Currently, the MRR system imposes a number of consistency checks to spot errors in reported data. Although these checks appear to work well, we plan to review their adequacy and look for additional ways to identify likely errors.

(5) Confirming suggested data *changes* with missions and partners. If the process changes to the MRR system outlined above are implemented, it should largely eliminate the scope for errors to creep into the data between the point at which missions or implementing partners enter the data at source, and the appearance of those same data – suitably aggregated or converted into U.S. dollars – in the MRR. Remaining errors should be largely confined to errors in the information entered at source, hopefully reduced in number by the changes in forms outlined in (2) and (3) above. Finally, the consistency checks outlined in (4) above should help spot many or most of the remaining errors.

Rather than bogging down the overall system and the production schedule by asking all missions and partner organizations to confirm the information that they themselves submitted to MRR, EGAT/PR/MD would strongly suggest that we continue seeking confirmation or correction only in those cases where the consistency checks suggest a likely problem, or where other questions arise concerning the data submitted to MRR. Such a “changes only” confirmation process strikes a much better balance between benefits and costs, and moreover seems fully in line with the available guidance on secondary data quality.

Recommendation 5 urges EGAT/PR/MD to “develop a methodology to report only results that are attributable to USAID efforts,” rather than allowing readers of the MRR to come away with the impression that USAID is taking exclusive credit for a microfinance institution’s results, even in cases where USAID assistance has been but one of several sources of those results.

This recommendation is highly problematic as stated, for two reasons.

First, narrowing the focus of microenterprise results reporting to only those results that can be specifically attributed to USAID’s own efforts directly contradicts USAID’s standing policy on such reporting, which specifically focuses on the results achieved by the implementing partner (see ADS 219.3.6 and 219.3.8).

Second, if it were feasible to develop such a methodology, EGAT/PR/MD might agree with this recommendation and attempt to do so, labeling the resulting estimates as supplementary to the partner-focused results reporting cited above. However, after carefully reviewing this suggestion we are convinced that it is *not* feasible to develop a methodology that plausibly disentangles the respective contributions of the different sources of MFI results, especially one that could be applied to the results achieved by hundreds of MFIs worldwide. Moreover, there is nothing in the related legislation that requires or even suggests the need for such a decomposition.

For both these reasons, we plan to deal with this issue in a different way: by including in future MRRs language that clearly alerts readers that the results achieved by MFIs and other microenterprise partners reflect the contributions of various parties, sometimes including other donors and always including the efforts of the partner organization itself. This disclaimer will caution the reader that isolating USAID’s separate contribution to these results is fundamentally impossible; as a result, the results reported should be understood to represent the joint outcomes of the efforts of all involved, rather than those exclusively attributable to USAID.

To appreciate our rationale for taking this approach, consider the range of situations covered by the MRR. At one extreme lie certain situations where attribution might be possible: imagine an institution founded two years ago on the basis of a $3 million grant from USAID and a $1 million grant from some other donor, with no other outside inputs. In this ideal situation, it might be reasonable to give USAID three quarters of the credit for the institution’s results, and the other donor the remaining one quarter. However, even this simple case raises obvious problems: the quality of the institution’s management will certainly play a crucial role in determining the results achieved with the initial infusion of funds, but how to capture this contribution numerically is not at all obvious. Moreover, the problem must necessarily become worse over time, as the initial funding is gradually but relentlessly overshadowed in importance compared with the effectiveness with which the institution puts those funds, along with the retained earnings accumulated after the institution achieves financial sustainability.

The challenge of coming up with a reasonable attribution methodology becomes even more obvious once we shift from the easy case outlined above, to the increasingly prevalent case in which USAID's contribution is not mainly one of supplying capital, but rather of offering technical assistance, either directly or through a network or umbrella organization. In such cases, it is quite hard to see how one would reasonably disentangle USAID's contribution to the overall results achieved by the institution. The problem is analogous to quantifying the pilot's contribution to keeping plane in the air, relative to that of the left wing. There simply is no right answer, and we would be misleading the reader if we were to offer some simplistic methodology that purported to offer one.

For a single institution, it might be possible to mount a special study that would estimate the degree to which USAID assistance has contributed to performance. Doing so would almost certainly be quite data-intensive. Extending the same kind of analysis to the hundreds of institutions covered by the MRR is quite mind-boggling.

In sum, EGAT/PR/MD believes that the only feasible way to avoid having the MRR give the impression that USAID is claiming exclusive credit for the results of its partner institutions is to provide a clear and explicit statement to the contrary. That we intend to do in future editions of the MRR.

Because our proposed solution is consistent with current USAID policy while Recommendation 5 as worded is not, we request that the recommendation either be withdrawn or else brought into line with our proposed solution.

U.S. Agency for International Development
Office of Inspector General
1300 Pennsylvania Ave, NW
Washington, DC 20523
Tel: (202) 712-1150
Fax: (202) 216-3047
www.usaid.gov/oig