OFFICE OF INSPECTOR GENERAL

AUDIT OF USAID/IRAQ’S MICROFINANCE ACTIVITY UNDER ITS PROVINCIAL ECONOMIC GROWTH PROGRAM

AUDIT REPORT NO. E-267-11-003-P
AUGUST 4, 2011

BAGHDAD, IRAQ

Office of Inspector General

August 4, 2011

MEMORANDUM

TO: USAID/Iraq Mission Director, Alex Dickie

FROM: Office of Inspector General/Iraq, Director, Lloyd Miller /s/

SUBJECT: Audit of USAID/Iraq's Microfinance Activity Under Its Provincial Economic Growth Program (Report No. E-267-11-003-P)

This memorandum transmits our final report on the subject audit. We have carefully considered your comments on the draft report and have included them in their entirety in Appendix II.

This report contains three recommendations to improve the implementation of USAID/Iraq's microfinance activities. Management decisions have been reached on all three recommendations. Please provide the Audit Performance and Compliance Division (M/CFO/APC) with evidence of final action upon completion of the planned corrective actions.

I want to thank you and your staff for the cooperation and courtesies extended to us during this audit.

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SUMMARY OF RESULTS

According to USAID, continued stability in Iraq requires activities that stimulate private sector growth and create jobs, as microfinance activities do. Microfinance provides small amounts of credit to borrowers who lack access to it. In Iraq, because there is little tradition of credit or bank lending and collateral requirements are high, many poor and low-income individuals are excluded from bank services. Microfinance institutions were established in Iraq starting in 2003 with funds from the U.S. Government to provide financial services to this population.

USAID/Iraq's current microfinance activity began in January 2008, when USAID/Iraq awarded a contract to Louis Berger Group, Inc. (Louis Berger, the contractor) for the $121 million Provincial Economic Growth Program, consisting of a 2-year base period and 2 option years. Subsequent contract modifications increased the total estimated costs to $174 million and extended the end date to January 2013. According to USAID/Iraq, as of December 31, 2010, $138 million had been obligated and $89 million had been disbursed. The purpose of the contract was to provide business development and financial services to beneficiaries in strategic locations throughout Iraq. The program encompassed seven areas: (1) business development services, (2) youth initiative, (3) international trade, (4) business enabling environment, (5) investment promotion, (6) small and medium enterprise lending, and (7) microfinance—the focus of the audit.

The audited activity supports microfinance institutions providing loans to owners of small enterprises throughout Iraq. USAID/Iraq's previous microfinance activity was also implemented under a contract with Louis Berger, from September 2004 to March 2008. During that period, Louis Berger reported 12 microfinance institutions funded through grants (for loan capital and operating costs) at a cost of $23 million. Under the current microfinance contract, the contractor funded nine[1] microfinance institutions through grants (primarily for loan capital) at a cost of $29 million, according to contractor records. In addition, the contractor provided technical assistance and training to the microfinance institutions. As of December 31, 2010, the USAID-supported microfinance institutions had provided 257,209 loans valued at $593 million, according to contractor records. From program inception to December 2010, the average loan size was about $2,300; the average size of outstanding loans as of December 2010 had decreased to $1,590 according to contractor reporting.

The objective of our audit was to determine whether USAID/Iraq's microfinance activity was achieving its main goal of increasing access to inclusive and sustainable financial services in Iraq. According to program documents, "inclusive" incorporates two aspects: (1) access to financial services not just by microenterprise owners but also by the poor and (2) the integration of microfinance into the formal financial sector. According to the program performance monitoring plan, "sustainable" microfinance[2] is measured by the number of institutions receiving assistance, the extent to which these institutions are able to establish a presence in their economies (as measured by the number and value of their loans outstanding), and the levels of sustainability achieved.

[1] According to the contractor, three additional microfinance institutions received technical assistance and training, but did not receive grants.

[2] According to guidance in USAID's Automated Directives System, "Microenterprise Development: A Mandatory Reference for ADS Series 200" (page 17), a financially sustainable microfinance program requires that income from interest and fees charged to borrowers cover the program's operational and financial costs.

Except for any possible adverse effects of not being able to confirm loans with borrowers (as described in Appendix I, security restrictions prevented auditors from confirming loans), the audit determined that USAID/Iraq's microfinance activity had increased access to sustainable financial services, but the activity did not incorporate metrics for inclusive financial services or a focus on the poor despite statutory and regulatory guidance. Regarding sustainable microfinance, during 2008 and 2009, the contractor's microfinance activity met[3] its annual performance targets for the number of loans and the total value of loans disbursed by microfinance institutions, as shown in the following table.

Loans Disbursed by Microfinance Institutions Met 2008, 2009 Targets

Indicator	2008		2009	
	Target	**Result**	**Target**	**Result**
Number of loans	45,715	43,666	54,287	61,968
Value of loans	$59.7 million	$62.8 million	$70.9 million	$83.0 million

As of December 2010, all nine microfinance institutions that received grant funds had reached operational sustainability, and six of nine had reached financial sustainability.[4] The contractor met targets for these two performance measures in 2008 and 2009. In addition, the microfinance activity had achieved indicator targets in 2009 for *progress in institutional development*. This complex performance indicator[5] quantifies five aspects of performance and other factors including the size of the microfinance institution and converts the summation to a letter score. Details on the indicator are included in Appendix III.

Although the microfinance activity was achieving its sustainability goal, the audit disclosed issues requiring management attention.

- USAID/Iraq's microfinance activity lacked a clear and continuing focus on the poor, as USAID policy prescribes. USAID/Iraq's contract with Louis Berger did not specifically require a focus for loans to the poor, and the activity did not have indicators to measure such lending. Judging by the trends in loan sizes and according to contractor management, a number of microfinance loans were going to the poor. However, this lending was not reflected in performance targets and metrics (page 4).

- Louis Berger did not calculate consistently the *number of jobs (new and existing) that are sustained at firms receiving microloans* (page 5).

To address the issues outlined above, the audit makes three recommendations to the mission:

1. Revise its performance monitoring plan to include performance indicators and targets for reaching poor borrowers for the remaining 2 years of the Provincial Economic Growth Program, particularly for microfinance institutions that have attained performance targets for financial sustainability (page 5).

[3] The audit used a 5 percent materiality threshold in determining whether targets were met.
[4] Operational sustainability and financial sustainability are the same as operational self-sufficiency and financial self-sufficiency and are defined in Appendix III.
[5] The audit verified the following data incorporated into the performance indicator: total number of borrowers, value of loan portfolio, and average loan size.

2. Require the contractor to update its performance monitoring plan to specify data review mechanisms, identify any known data limitations, and clarify data sources (page 6).

3. Perform a data quality assessment of the jobs performance indicator: *number of jobs (new and existing) that are sustained at firms receiving microloans* (page 6).

Detailed findings follow. The evaluation of management comments is on page 7. Appendix I presents the audit scope and methodology. The mission's comments are included in their entirety as Appendix II.

AUDIT FINDINGS

Microfinance Activity Did Not Focus on the Poor

The Microenterprise for Self-Reliance and International Anti-Corruption Act of 2000 (Public Law 106-309, October 17, 2000) set a legislative target of 50 percent of USAID's microfinance resources going to the very poor. The Microenterprise Results and Accountability Act of 2004 (Public Law 108-484, December 23, 2004) defined the very poor as those in the bottom 50 percent below the poverty line of the country or those living on less than the equivalent of $1 per day. In addition, USAID policy states, "USAID support for *any* microenterprise development program requires a clear and continuing focus on providing services to poor microentrepreneurs."[6] This policy further states that USAID views financial sustainability not as an end in itself, but as a means to provide sustainable benefits to poor microentrepreneurs. The USAID mission is responsible for developing a plan for providing services to poor microentrepreneurs. This plan should include appropriate performance measures.

Nevertheless, USAID/Iraq's microfinance activity did not have a "clear and continuing focus" on the poor[7] despite statutory and regulatory guidance. The contractor's performance monitoring plan included four performance indicators measuring sustainability, jobs, the number of loans, and the value of loans. However, no indicators in the performance management plan measured outreach to the poor, and the indicators measuring the number and value of loans did not differentiate between loans to the poor and loans to the nonpoor. The contractor's annual work plans referred to inclusive finance, but did not include metrics specifically aimed at the poor. For example, the second year work plan discussed an increased emphasis on practices such as less formal requirements for collateral, group lending, and outreach to women. Each emphasis, if successfully implemented, might have expanded loans to poor microentrepreneurs. However, these activities in the work plan did not include performance measures. Likewise, the third year work plan did not address measuring progress in expanding lending to poor microentrepreneurs.

Nonetheless, some microfinance institutions' practices in effect addressed poverty lending. For example, three microfinance institutions had targets for average loan size in their grant agreements, and three had targets for loans to women. In addition, contractor reporting showed that three microfinance institutions started offering group loans, a product designed for poor borrowers without collateral.

The lack of a clear and continuing focus on the poor by the USAID/Iraq microfinance activity was attributable to several factors.

- USAID/Iraq's contract with Louis Berger focused on sustainability but did not require the contractor to develop activities and metrics for measuring lending to poor entrepreneurs. This aspect of the contract did not align with USAID/Iraq's 2007 microfinance strategy

[6] "Microenterprise Development: A Mandatory Reference for Automated Directives System Series 200," pages 13 and 18.

[7] According to the World Bank Web site, approximately 23 percent of the Iraqi population is living in poverty. According to the contractor's June 2010 report, "State of Iraq's Microfinance Industry," the poverty line in Iraq is $2.20 per day.

document,[8] which noted that targets related to goals such as poverty reduction should be measured by appropriate indicators.

The microfinance activity has other goals that divert the focus from the poor. For example, in the mission's FY 2009 Performance Plan and Report, USAID/Iraq emphasized stability and jobs as the goals of microenterprise and economic growth activities: "Continued stability in Iraq requires creation of jobs which provide an economic alternative to insurgent activity," and "With an already bloated public sector, the private sector must be the source of new jobs."

- According to USAID officials, microfinance programs typically focus on sustainability in a postconflict environment; in conflict zones, there is a trade-off between outreach and sustainability. For example, the 2007 USAID/Iraq-funded strategy document stated: "In the early phases of transition from conflict, experience shows that efforts to build and strengthen individual retail microfinance providers yield the best results."

- Mission and contractor officials have stated that they do not want to impose unrealistic requirements on microfinance institutions for managing their organizations—e.g., telling them what products to sell and which customers to target.

Judging by loan sizes and according to contractor management, a number of microfinance loans were going to the poor. However, without a clear and continuing focus on the poor, this lending is not reflected in performance management as evidenced by the lack of performance targets and metrics. As a result, the program is currently focused on sustainability to the detriment of poverty reduction.

Recommendation 1. *We recommend that USAID/Iraq revise its performance monitoring plan to include performance indicators and targets for reaching poor borrowers for the remaining 2 years of the Provincial Economic Growth Program, particularly for microfinance institutions that have attained performance targets for financial sustainability.*

Jobs Indicator Data Calculated Inconsistently

Automated Directives System 203.3.5.1 states that, in order for performance data to meet general data quality standards for reliability, the data should reflect stable and consistent data collection processes and analysis methods. Different analysts should come to the same conclusions if they were to repeat the data collection and analysis processes. In addition, Automated Directives System 203.3.8.4 requires missions to conduct quality assessments within the past 3 years for all performance data formally submitted in the mission's annual performance report that will be used to prepare USAID's Performance and Accountability Report.

However, the contractor reported data for the jobs performance indicator, *number of jobs (new and existing) that are sustained at firms receiving microloans*, that had been calculated inconsistently. The program goal was to create and sustain 119,148 jobs in the first 3 years of

[8] *The Iraq Microfinance Strategy*, February 25, 2007.

the contract.[9] The contractor reported 81,636 jobs sustained in its first year, meeting the annual target of 79,432. In the second year, the contractor reported 156,789 jobs, exceeding its annual target of 94,325.

According to the contractor, the results far exceeded the second-year target because of a change in methodology for calculating jobs created and sustained. At the beginning of the program, USAID/Iraq applied a ratio of 1.3 jobs (the borrower's and an additional third of a job) for every $1,000 in loans disbursed. In the second year of the program, USAID revised the methodology, abandoning calculation in favor of directly reporting the actual number of jobs. On loan applications submitted to microfinance institutions, borrowers reported the number of employees, which the institutions entered into a database. Loan officers would verify this number during borrower visits and revise the information as necessary. However, one microfinance institution did not apply the revised methodology for second-year reporting, instead using the prior formula.

In addition to the inconsistent method for calculating data, the performance monitoring plan did not clearly distinguish the data source, listing only the loan officer. Data in loan files at two of the three tested microfinance institutions did not match information in the contractor database for the jobs indicator. This occurred because loan officers were recording data changes directly into the database based on site visits to borrowers without annotating the borrower loan files kept at their institutions to indicate changes in jobs created and sustained.

This inconsistent data calculation methodology came about for several reasons. First, a contractor official explained that the microfinance institution that continued using the old method for calculating the number of jobs created and sustained did so because its information system lacked a field for entering data on the number of actual jobs. Second, although required, USAID/Iraq has not conducted a data quality assessment for this indicator. Third, during site visits, USAID/Iraq personnel did not verify reported data. Fourth, the performance monitoring plan did not specify how data was to be reviewed or list any known data limitations.

As a result of the inconsistent calculation methodologies employed, the reliability of data reported to USAID was diminished. Without reliable performance data, decision makers have less assurance about whether a program met, exceeded, or fell short in achieving its program objectives and related targets.

> ***Recommendation 2.*** *We recommend that USAID/Iraq require the contractor to update its performance monitoring plan to specify data review mechanisms, identify any known data limitations, and clarify data sources.*

> ***Recommendation 3.*** *We recommend that USAID/Iraq perform a data quality assessment of the jobs performance indicator:* number of jobs (new and existing) that are sustained at firms receiving microloans.

[9] USAID/Iraq has extended the contract to 5 years.

EVALUATION OF MANAGEMENT COMMENTS

In its response to the draft report, the mission agreed with the three recommendations and described planned corrective actions. Based on the mission's response and planned actions, we consider that management decisions have been reached on all three recommendations.

Regarding Recommendations 1 and 2, the mission required the contractor to revise its performance monitoring plan to include indicators and targets for reaching poor borrowers. The revision to the performance management plan also included updating the Performance Indicator Reference Sheets to explain known data limitations and data sources. The contractor submitted the revised performance-monitoring plan to the mission for review and approval in May 2011. The mission expects to complete its implementation of these actions by September 30, 2011.

Regarding recommendation 3, the mission plans to conduct a data quality assessment in October 2011. The contractor is including in the revised performance monitoring plan a data review mechanism to verify and validate the data on jobs created and sustained. The mission will inspect these systems and document the review in a formal data quality assessment. The mission expects to complete the data quality assessment by December 30, 2011.

A determination of final action on these recommendations will be made by the Audit Performance and Compliance Division on completion of the planned corrective actions.

The mission's written comments on the draft report are included in their entirety in Appendix II.

SCOPE AND METHODOLOGY

Scope

The Office of Inspector General conducted this audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions in accordance with our audit objective. Except for any adverse effects of not being able to confirm loans and balances with borrowers (security and logistical restrictions prevented us from doing so), we believe that the evidence obtained provides that reasonable basis. The objective of this audit was to determine whether USAID/Iraq's microfinance activity was achieving its main goal of increasing access to inclusive and sustainable financial services in Iraq.

We conducted fieldwork at USAID/Iraq and at Louis Berger's office in the Mansoor District of Baghdad. We also conducted a site visit to one microfinance organization and met with representatives from two others at a secure third location. The organizations were Al-Bashaer, in Baghdad, and Al-Aman and Al-Thiqa in Kirkuk. We judgmentally selected these three microfinance institutions (out of nine) for testing based on funding amounts, diversity of location, and nationality. Concerning the last factor, we selected two indigenous microfinance organizations and one (Al-Thiqa) that was created by an international organization. In all, our three selected microfinance institutions represented 66 percent of the value of all outstanding loans held by program grant recipients.

We identified and reviewed the internal controls employed by both USAID/Iraq and the contractor that were significant to answer the audit objective. At USAID/Iraq, we reviewed controls for monitoring and oversight by mission personnel, portfolio reviews by USAID management, performance monitoring plan reviews by USAID, data quality assessments, voucher reviews and approvals, and designation letters outlining the responsibilities of the contracting officer's technical representative. At the contractor's office, we reviewed controls for the collection and reporting of financial data from microfinance institutions, verification of reported indicator results, award and management of grants and subcontracts, and monitoring and oversight conducted by contractor personnel.

The scope of the audit focused on reported results for the microfinance activity's second year, from April 2009 until March 2010. The microfinance activity has three main components: grant making, institutional development through training and technical assistance, and industry building. The audit covered the first two activities. As of December 31, 2010, USAID/Iraq had obligated $137,772,580 and had expended $88,610,824 on the Provincial Economic Growth Program contract. The mission (through the contract) did not require Louis Berger to break out financial data uniquely for the microfinance activity. We conducted our fieldwork between April 18, 2010, and March 1, 2011.

Methodology

To answer the audit objective, we identified the activity's goals, interviewed mission and contractor officials, and reviewed program documents including the contract, contract modifications, the contractor's performance monitoring plan, and contractor annual work plans.

We interviewed key contractor personnel in Baghdad, including senior management, the microfinance director, monitoring and evaluation director, senior grants manager, and training advisor. We also interviewed managers from the microfinance institutions examined. We also reviewed USAID policy and guidance specific to microfinance, including Automated Directives System 219, "Microenterprise Development," and "Microenterprise Development: A Mandatory Reference for Automated Directives System Series 200." We also reviewed USAID guidance on performance management.

We tested three microfinance institutions' loan portfolios to determine whether the number of loans and the value of loans disbursed reported to USAID were reliable. For each microfinance institution judgmentally selected, we drew a random sample of borrowers at a 90 percent confidence level and 4 percent precision. We examined borrower files and compared key data points with data stored in the contractor's database. These data points were loan amount, loan balance, disbursement date, delinquency status, borrower sex, and number of jobs sustained. We determined that, for the three microfinance institutions tested, the data were reliable with the one exception of jobs sustained. We did not visit actual borrowers to verify the information in the files due to security and logistical restrictions.

We tested or reviewed supporting documentation for two performance indicators measuring the effectiveness of training and technical assistance. We confirmed whether these indicators had undergone any data quality assessments or other independent verification. We also examined supporting documentation for training conducted and interviewed beneficiary microfinance institutions to obtain feedback on the quality of training and technical assistance. We reviewed grant agreements with three microfinance institutions and compliance with grant requirements including policies and procedures at the contractor.

During fieldwork, we relied on staff employed by USAID/Iraq and by the U.S. Provincial Reconstruction Team in Kirkuk to assist in reviewing loan documents written in Arabic. All interviews were conducted in English. The audit used a 5 percent materiality threshold in determining whether performance targets were met for the loan portfolios of microfinance institutions.

MANAGEMENT COMMENTS

July 14, 2011

MEMORANDUM
UNCLASSIFIED

TO: Lloyd Miller, Director Office of Inspector General/Iraq

FROM: Alex Deprez, Acting Mission Director /s/

SUBJECT: Management Response to Draft Audit Report E-267-11-00x-P

REFERENCE: Office of Inspector General (OIG)/Iraq draft report entitled "Audit of USAID/Iraq's Microfinance Activity Under its Provincial Economic Growth Program" transmitted to the Mission Director dated June 19, 2011

Thank you for the opportunity to comment on the referenced draft audit report of USAID's Microfinance Activity Under its Provincial Economic Growth Program. USAID/Iraq concurs with the audit findings and recommendations with the Management comments embedded in responses to the recommendations. Specifically we have responded to the three recommendations outlined in the draft OIG audit report, addressing actions which are soon to be implemented.

Each of the findings and recommendations have been examined to determine 1) whether the Mission is in agreement, and 2) what actions should be undertaken in response to the audit.

USAID/Iraq recognizes the value of this audit as a management tool to further strengthen our programs. We extend our appreciation to OIG/Iraq for the cooperation exhibited throughout the production of this report.

<u>Recommendation No. 1:</u>

We recommend that USAID/Iraq revise its performance monitoring plan to include performance indicators and targets for reaching poor borrowers for the remaining 2 years of the Provincial Economic Growth Program, particularly for microfinance institutions that have attained performance targets for financial sustainability.

Recommendation No. 2:

We recommend that USAID/Iraq require the contractor to update its performance monitoring plan to specify data review mechanisms, identify any known data limitations, and clarify data sources.

Management Comments: USAID/Iraq agrees to the recommendations (No. 1 and No. 2)

Based on the recommendation, the contractor revised and submitted the Performance Monitoring Plan (PMP) to the Contracting Officer's Technical Representative (COTR) on May 22, 2011 for review and approval. It now includes indicators and targets for reaching poor borrowers. The revised PMP covers the period February 2011-January 2013, or until the end of the project. Further review is ongoing by the COTR.

In addition, the Performance Indicator Reference Sheets (PIRS) in the PMP clearly explains known data limitations and data sources. It also includes a description of the data management systems to ensure verification and continued quality assurance.

Target date for completion: September 30, 2011

Recommendation No. 3:

We recommend that USAID/Iraq perform a data quality assessment of the jobs performance indicator: number of jobs (new and existing) that are sustained at firms receiving microloans.

Management Comments: USAID/Iraq agrees with the recommendation.

A data quality assessment (DQA) will be conducted in October 2011. In the revised PMP, the contractor plans to introduce a rigorous data review mechanism to verify and validate the data on jobs created and sustained furnished by the partner microfinance institutions. Consistency and reliability of the data submitted by the partner microfinance institutions will be ensured by visiting clients in the field. The clients and loan officers will be primary sources of information. EGA will inspect these systems once operational and document this review in a formal DQA.

Target date for completion: December 30, 2011

Composite Indicator: Progress in Institutional Development

This complex performance indicator quantifies five aspects of performance—portfolio at risk, operating expense cost ratio, loan officer productivity, operational self-sufficiency, and financial self-sufficiency—and other factors including the size of the microfinance institution and converts the summation to a letter score.

Definitions of the five performance components follow:

- *Portfolio at risk.* Portfolio at risk is the percent of total portfolio in arrears for more than 30 days.

- *Operating expense cost ratio.* Operating expense cost ratio is total operation expenses divided by average total assets.

- *Loan officer productivity.* Loan officer productivity is the value of the outstanding loan portfolio divided by number of loan officers.

- *Operational self-sufficiency.* Operational self-sufficiency is total operating income divided by all direct (nonfinancial) costs.

- *Financial self-sufficiency.* Financial self-sufficiency is total operating income divided by total operating costs adjusted for inflation and subsidies.

The audit verified data for the following components of the performance indicator: total number of borrowers, value of loan portfolio, and average loan size.

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