Appendix No. 1

Stage II Risk Assessment Report

FROM THE AMERICAN PEOPLE

USAID AFGHANISTAN OFFICE OF FINANCIAL MANAGEMENT

Public Financial Management Risk Assessment Framework

GOVERNMENT OF THE ISLAMIC REPUBLIC OF AFGHANISTAN MINISTRY OF MINES

STAGE II RISK ASSESSMENT REPORT

September 25, 2012

CONTENTS

Background

Founded in 1947, Afghanistan has had a tumultuous existence. Rich with natural resources such as natural gas, petroleum, coal, copper, zinc, and iron, the country has all the necessary elements to jump start its economy. However, the Afghan's economy has been plagued with instability, but is now recovering from decades of conflict. According to Public Expenditure Financial Accountability (PEFA) reports, the economy has improved significantly since the fall of the Taliban regime in 2001 largely because of the infusion of international assistance, the recovery of the agricultural sector, and service sector growth. While the international community remains committed to Afghanistan's development and has pledged significant resources, the Government of the Islamic Republic of Afghanistan (GIRoA) will need to overcome a number of challenges, including low revenue collection, anemic job creation, and high levels of corruption, weak government capacity, and poor public infrastructure. According to a 2008 PEFA report, Afghanistan's public financial management (PFM) system achieved significant improvements between June 2005 and December 2007. However, capacity development in the line ministries needs strengthening. Compared with the progress in the Ministry of Finance (MoF), developments in most line ministries lag behind. For example, cash management and payment scheduling procedures in line ministries have not improved. The internal audit function in line ministries does not meet recognized professional standards. While technical expertise in the line ministries has significantly improved in several areas, long-term fiscal planning remains uncertain.

In 2010, the Obama administration made a public strategic foreign-assistance decision announced at the January 2010 London conference and reaffirmed by Secretary of State Clinton and USAID Administrator Shah at the July 2010 Kabul conference, which committed the U.S. Government to provide at least 50 percent of U.S. Government assistance directly to GIRoA, to be channeled through GIRoA's core budget systems within two years (2012)[1]. In June 2011, USAID/Afghanistan negotiated a scope of work with GIRoA to undertake entity level risk assessments of GIRoA line Ministries. Contracts utilizing the negotiated scope of work were issued to Certified Public Accountant (CPA) firms to undertake the Ministerial engagements. The CPA firm finalized assessment report of the Ministry of Mines (MoM) was issued in October 2011.

The United States is committed to improving the quality of its aid in order to maximize development in Afghanistan. U.S. military action in Afghanistan including USAID's support of the U.S.G. Counterinsurgency strategy is expected to come to an end around December 2014. This counterinsurgency commitment remains in force for an approximate three year period until FY 2015. USAID anticipates that FY 2015 will be the beginning of a transformational decade to a normal USAID longer term development strategy. With that transition to a more robust traditional development strategy will likely result in substantive changes in Government to Government (G2G) assistance.

The G2G commitment comes with the responsibility to ensure effective use of funds provided by U. S. taxpayers and appropriated by Congress, and the need to address

[1] London Conference, January 2010 and the Kabul International Conference of Afghanistan, July 2010.

fiduciary risk in the Partner Country PFM system being considered for direct Government to Government assistance. For that reason the Agency developed the Public Financial Management Risk Assessment Framework (PFMRAF) Stage I Rapid Appraisal Assessment, the Democracy, Human Rights and Governance enhanced (DRG) review, and the PFMRAF Stage II Risk Assessment to enable it to meet that objective [2].

The PFMRAF is a multi-stage risk-based methodology whereby USAID seeks to understand the fiduciary risk environment in targeted countries to inform decisions whether to use or to increase the use of partner country public financial management systems in delivering aid assistance. The enhanced DRG review, led by a USAID/W team, is undertaken prior to or in conjunction with the Mission-led Stage I Rapid Appraisal, and seeks to determine whether a G2G investment could empower a government at the expense of its people. Unless the macro-level Stage I Rapid Appraisal and enhanced DRG review determine that there is unacceptable or unmitigated country level fiduciary risk, political constraints, or other insurmountable barriers to the use of partner country systems, an in-depth PFMRAF Stage II risk assessment–which is an entity level assessment–may be completed by the Mission. This Stage II assessment will establish the baseline level of ministerial entity level risk corresponding to contemplated funding levels, and identify vulnerabilities of the partner country implementing entity. If the assessment reveals clear evidence of vulnerabilities to corruption and other high levels of control risks, and the partner country government fails to respond or agree to appropriate risk mitigation remedy measures, then the use of partner country systems must not be authorized.

USAID/Afghanistan has never conducted the macro-level enhanced DRG review and the PRMRAF Stage I assessments upon GIRoA as required under currently issued Agency Policy–ADS Chapter 220 issued in draft in August 2011 and substantially updated in March 2012. Given the history of G2G assistance in Afghanistan, this situation is understandable. The macro-level assessments are to guide the decision process about whether G2G assistance should be considered as a bilateral assistance objective. In Afghanistan, that decision was made several years ago at the highest levels of the U.S. Government. The Obama administration's foreign policy decision in January 2010, which was reaffirmed by Secretary Clinton and Administrator Shah at the Kabul conference in July 2010, strongly reiterated the U.S. commitment to direct G2G assistance to GIRoA. This commitment was not made subject to review of macro-level risk in Afghanistan. Essentially, the foreign policy decision to engage in G2G assistance in Afghanistan has replaced the first two steps under the Agency ADS 220 policy–the enhanced DRG review and the PFMRAF Stage I assessment.

[2] In August 2011, the Agency issued a new draft policy - ADS Chapter 220 -pertaining to the use of reliable partner country systems for direct G2G assistance. That policy chapter was substantially updated in late March 2012 and continues to undergo modifications - the latest in July 2012, where risk assessment questionnaire guidelines were modified. This ADS chapter with its latest modifications now requires a three-stage approach in the process leading to a decision of whether USAID should consider use of a partner country's systems to implement direct assistance programs.

Scopes of work for the entity level Ministerial engagements undertaken by GIRoA and USAID may not have complied with every element of the detailed PRMRAF Stage II guidance as currently revised in July 2012, however the Mission believes it has complied with the spirit and purpose of that guidance. In August 2012, USAID/Afghanistan addressed an unofficial Stage I review by internally summarizing responses to assessment guidelines using collective information gathered from public expenditure and financial accountability (PEFA) reports, assessments undertaken by the CPA firms to date, and other informal information available to Mission staff. Using that informal process and the MoM independent CPA firm assessment report issued in October 2011, the Mission is documenting through this framework a Stage II equivalent report based upon the most recently updated ADS Chapter 220 guidance.

Objectives

The overall objective of this Stage II risk assessment is to determine whether the U.S. government can rely on the Ministry of Mines' (MoM) systems operation and internal controls to manage donors' funds. Specifically the assessment will:

- Determine whether MoM's financial management/accounting system is adequate to properly manage and account for donors' funds.
- Determine whether MoM has the financial management capacity to manage proposed activities.
- Determine whether MoM's internal controls are adequate to manage donors' funds.
- Determine whether MoM's procurement management units have sufficient systems and management capacity to implement activities and manage donors' funds.
- Determine whether MoM complied, in all material respects, with applicable laws and regulations.

Executive Summary

The United States Government committed to channeling at least 50 percent of its development assistance through the national budget of the Afghan Government[3]. This commitment comes with the responsibility to ensure effective use of funds provided by U. S. taxpayers and appropriated by Congress, and address fiduciary risk in the Partner Country Public Financial Management (PFM) systems at the entity level being considered for direct implementation of USAID-funded assistance. For that reason USAID developed the Stage II Public Financial Management Risk Assessment to enable it to meet that objective. The Public Financial Management Risk Assessment Framework (PFMRAF) is a multi-stage risk-based methodology whereby USAID seeks to understand the fiduciary risk environment in targeted countries to inform decisions whether to use or increase the use of partner country public financial management systems in delivering aid assistance. If the assessment reveals clear evidence of vulnerabilities to corruption, and the partner country government fails to respond, the use of partner country systems must not be authorized.

This Stage II assessment was prepared to determine whether USAID can rely on the Ministry of Mines' (MoM) systems operation and internal controls to manage donors' funds. The assessment basically determined that USAID cannot rely on the Ministry of Mines' (MoM) current systems operation and internal controls to manage donors' funds without substantive mitigation measures being incorporated into G2G agreements negotiated with MoM.

Management attitude has a pervasive affect on the culture and attitude of an entity. This attitude affects the integrity and ethical values of the entity, human resources policies, operating philosophy and commitment to organizational competence. Accordingly the risks identified at those levels will be difficult to mitigate. The assessment revealed the governance structure and management accountability needed to insure appropriate policies are developed and applied, code of government ethics enforced, procurement integrity observed, and robust financial controls implemented are lacking. This absence of structure is indicative of a lack of accountability, will, and commitment to enforce best practices and combat wrong doing in the civil service.

In addition to a lack of governance structure, the assessment identified several risk factors that can compromise USAID funding. Examples of these risks are; lack of accountability of public officials, financial data susceptible to manipulation, lack of standards to prevent undue preferential treatment such as nepotism and cronyism, and the likelihood for kickbacks and collusion. Under normal circumstances, the results of this assessment would lead USAID not to engage in Government to Government assistance with the Ministry. Since the U.S. Government commitment has already been made to engage in G2G activity with the Ministry, approaching assistance with precaution and conditions, USAID must reasonably mitigate the identified risks. Appendix A details the identified risks and proposes possible mitigating measures to manage those risks.

[3] London conference on Afghanistan, January 2010 and the Kabul International conference on Afghanistan, July 2010.

Assessment Conclusion & Results

USAID cannot rely on the Ministry of Mines' (MoM) systems operation and internal controls to manage donors' funds.

- MoM's financial management/accounting system is not adequate to properly manage and account for donors'. funds.
- MoM's does not have the financial management capacity to manage proposed activities.
- MoM's internal controls are not adequate to manage donors' funds.
- MoM's procurement management units do not have sufficient systems and management capacity to implement activities and manage donors'. funds.
- Except in few instances where MoM did not fully comply with GIRoA procurement laws, for the most part MoM complied with applicable laws and regulations.

In addition, the internal control environment is not adequate to mitigate the risk of corruption, and it is unclear if there is the will to combat corruption. Nonetheless, we believe the identified risks can be reasonably mitigated. See appendix 1.

Management and governance structure

One of management's responsibilities is to implement a structure that will enable it to execute it responsibilities in an accountable manner. The governance structure and management accountability needed to insure appropriate policies are developed and applied , code of government ethics are enforced, and procurement integrity observed, and robust financial controls put in place is missing. This absence of structure is indicative of a lack of will and commitment to enforce best practices and combat wrong doing in the civil service.

Management attitude has a pervasive affect on the culture and attitude of the entity. This attitude affects the integrity and ethical values of the entity, human resources policies, operating philosophy and commitment to organizational competence. Accordingly the risks identified at that level will be difficult to mitigate. Because of this USAID must engage government to government (G2G) assistance with precaution, and set conditions in its agreements with the Ministry. USAID must also exercise substantial involvement in project implementation until GIRoA achieves satisfactory progress on its management and governance structure challenges.

Financial Management and Accounting Systems

To achieve success in program implementation a reliable public financial management system is vital. The PFM system at MoM is weak and is highly susceptible to fraud, waste and abuse. There is no financial management and accounting system in place to record transactions for both operational and development budget. There is no evidence of reconciliation of monthly payroll records. In fact, staff are receiving bonuses in cash which are not declared on their bank transfer. The same staff is recoding and reconciling transactions.

Personnel Policies and Procedures

Recruiting, training and retaining qualified staff is vital for any organization's going concern. Management attitude toward recruitment, human resources policy development, and investment in staff affect all level of the organization. It is recognized that MoM is operating in a challenging environment where it is very difficult to find qualify staff. Aside from this challenge it is evident from our observation that MoM has not taken its human resources responsibilities seriously. The Ministry does not have documented Human Resources policies and procedures manual. Employment agreements are not signed, annual employee code of conduct and conflict of interest forms are not documented. Management casual attitude toward recruitment and the lack of basic employment documentation could expose donors funds to cronyism and nepotism.

Procurement and Purchasing system

Procurement is a critical organizational function, as huge amounts of money are spent every year procuring goods and services. Procurement fraud wastes limited funds, and compromises safety. With the award of each contract, potential fraud exists in areas such as product substitution, cost mischarging, and progress payment. The MoM procurement system is vulnerable to all these risks, as the Ministry does not have basic procurement controls. The Ministry has no annual procurement plan, no mechanism to pre-qualify vendors for goods and services where no competitive bidding is required, personnel do not monitor turnaround time or the quality of goods received. The lack of accountability by public officials in the procurement process puts donors' funds at risk.

Program Management and Monitoring

According to USAID's policy, monitoring reveals whether desired results are occurring and whether outcomes are on track. Performance management is a commitment to managing for results in order to achieve the best possible outcomes. The Ministry's inability to develop a monitoring plan and conduct actual monitoring is a fiduciary risk that could lead to funds being used for unintended purposes and/or being utilized for inefficient programs, and not detected timely.

Risk Assessment Measurement

USAID guidance states, once a risk has been identified, the impact and probability of that risk must be determined. The impact measures the severity of an adverse event associated with the risk and is measured as, Negligible, Marginal, Serious, and Catastrophic. Conversely, probability measures the likelihood of the occurrence of the adverse event associated with the risk and is expressed as, Remote, Occasional, Probable, and Frequent. Combining impact and probability factors categorize risks in clusters of Critical, High, Medium and Low categories. Although subjective, it is nonetheless the basis for the Risk Mitigation plan in USAID.

USAID's PFM Risk Matrix

Impact	*Catastrophic*	High	Critical	Critical	Critical
	Serious	High	High	Critical	Critical
	Marginal	Medium	Medium	High	High
	Negligible	Low	Low	Medium	Medium
		Remote	*Occasional*	*Probable*	*Frequent*
		Probability			

Scope and Methodology

The independently contracted auditors conducted the 2011 assessment under a scope of work which focused on five main areas. 1) Procurement, 2) Accounting and internal controls, 3) Monitoring and Evaluation, 4) Audit arrangement, and 5) Human resources. While the auditors conducted an in-depth assessment on the five areas mentioned above, they did not use the Agency's approved Public Financial Management Risk Assessment Framework (PFMRAF) checklist, and did not conform in many ways to the Agency's PFMRAF guidance on risk treatment and risk assessment measurements as that guidance (ADS Chapter 220) was issued subsequent to the negotiation of the scopes of work with GIRoA. However, to ensure the Mission complies with the Agency's guidance and performs required due diligence, we reviewed the auditors' report and we met with the auditors who conducted the assessment to gain a general understanding of the nature of their work. We met and discussed with our internal financial analysts whom had an understanding of the ministry's systems. We conducted limited research on other work performed by DFID on MoM. Based on auditors' work, our reviews, meetings and research, we completed the PFMRAF checklist and risk *mitigation plan* and we summarized our findings and understanding in this report.

At the time of the assessment it was not clear if the auditors understood that they had to define their findings in terms of risks so appropriate risk mitigation measures could be developed to address the identified risks. Because our review was conducted after the auditors had completed the assessment, and could not go back to determine the impact and probability, we relied on the understanding we've gained over the years of collaboration with the government. Based on that understanding we defined the potential risks and we took a conservative approach and considered most risks to be serious and probable unless the contrary was clearly evident.

Appendix 1

Risk Schedule:

	Risks Identified	Impact	Probality	Score	Suggested Mitigation Measures
1.	Public officials not being accountable.	Serious	Probable	Critical	Transfer all assistance funding in escrow bank accounts.
2.	Management not being able and competent to manage USAID's fund.	Serious	Probable	Critical	Substantial involvement of USAID's staff in the implementation of projects and/or hiring third party monitors. USAID audits all projects annually.
3.	Violating laws and regulations	Serious	Remote	High	1.Conduct periodic surprise investigations of suspicious activities. 2.Hold employees accountable to the fullest extent of law if violated.
4.	Waste, fraud and abuse may go undetected.	Serious	Probable	Critical	1.Conduct audits to prevent fraud, waste and abuse. 2.Conduct Ethics trainings as well.
5.	Financial data being manipulated	Serious	Frequent	Critical	1.Proper segregation of duties among Accounting staff. 2. Rotations of assignments within the staff to ensure all staff know and understand different levels of responsibility 3.Request the installation of computerized financial sytem with built-in controls. 4. Conduct yearly audits of financial transactions.
6.	Critical data will be lost and may be irretrievable	Catastrophic	Probable	Critical	1.Encourage data storage and validation for all USAID funded activities to ensure accountibility and reliability of information. 2. Back up information on a daily basis.

	Risks Identified	Impact	Probality	Score	Suggested Mitigation Measures
7.	USAID will rely on erroneous data collected to make management decisions.	Marginal	Probable	High	1.Conduct monitoring and evaluations of all USAID-funded activities. 2.Conduct audits of the on-budget programs annually.
8.	Engaging in off balance sheet financing for resources diversion.				1.Conducting regular audits of all assets on the balance sheet. 2. Evaluating revenue generation systems within the ministry to make sure all revenues are recognized. 3- Request OAA's involvement in all critical procurement or third party monitor.
9.	Funds being used for unintended purposes. Funding ghost employee Improper payments to employees.	Serious	Probable	Critical	1.Conduct employee validation surveys of payroll to ensure all employees are properly accounted for. 2-Conduct yearly payroll audits.
10.	Paying higher prices for commodities and services to finance kickbacks and bribes.	Serious	Probable	Critical	1.Conducting market price analysis/surveys to ensure proper prices are being paid for goods and services. 2- Request OAA's involvement in all critical procurement or third party monitor decisions. 3-Obtain signed conflict of interest forms from senior staff.
11.	Collusion to skim liquid assets such as cash.	Serious	Probable	Critical	1.Conduct Fraud Awareness Trainings and briefings to employees. 2. Conducting surprise inspections and evaluations of

	Risks Identified	Impact	Probality	Score	Suggested Mitigation Measures
					petty cash practices within the ministry for proper accountibility. 3-Perform yearly audits.
12.	Unauthorized use of Government property including cash.	Serious	Probable	Critical	1.Conduct regular audits of cash and property to insure proper accountibility.
13.	Diverting government property for personal use.	Serious	Probable	Critical	1.Maintain accurate asset registers within the ministry. 2.Conduct regular audits and physical inspections of all assets.
14.	Not implementing standards so to facilitate illegal acts.	Serious	Probable	Critical	1. Institute more stringent accountibility standards and policies to hold individuals accountible. 2. Set individual benchmarks before any funds are disbursed for goods and services.
15.	Vendor selecting scheme to defraud the government.	Serious	Probable	Critical	1.Conduct pre-selection of vendors to ensure acceptable quality standards are maintained. 2. Acquire USAID approval on major procurement of goods and services.
16.	Acquiring substandard goods, to finance kickbacks and bribes.	Serious	Probable	Critical	1.Conduct physical inspections of goods at delivery to verify quality. 2.Pre-selection of vendors to ensure acceptable quality standards are maintained. 3-Request OAAs involvement in all key acquistions.

Afghanistan Stage II Risk Assessment