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**AFGHANISTAN**

11 AUG 2009

Dear Dr. Zakhilwal:

Enclosed is USAID/Afghanistan's Report on the Assessment of the Capability of the Ministry of Finance, Da Afghanistan Bank, and the Control and Audit Office in regard to Managing Direct Donor Assistance. We would like to thank your staff for their cooperation during the assessment.

The assessment is an important step to USAID/Afghanistan's increased direct assistance to the Government of the Islamic Republic of Afghanistan.

Please let us know if you have any questions.

Sincerely,

William M. Frej  
Mission Director

cc: Abdul Qadeer Fitrat, Governor, Da Afghanistan Bank  
Professor Sharif Sharifi, Auditor General, Control and Audit Office

His Excellency

Dr. Omar Zakhilwal,  
Minister of Finance,  
Islamic Republic of Afghanistan,  
Kabul.



# **USAID | AFGHANISTAN**

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**Report Number: HC-306-09-02**

**Report on the Assessment of the Capability of the**  
**Ministry of Finance (MoF),**  
**Da Afghanistan Bank (DAB)**  
**and the**  
**Control and Audit Office (CAO)**  
**in regard to Managing Direct Donor Assistance**

**Prepared by:**  
**Office of Financial Management**  
**July 27, 2009**

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## **1. SUMMARY RESULTS AND RECOMENDATIONS**

Our assessment of the Ministry of Finance (MoF) and Da Afghanistan Bank (DAB) disclosed that the financial management systems and procedures of the MoF and DAB are adequate for purposes of accounting for and managing funds that may be provided directly to the Government of the Islamic Republic of Afghanistan (GIROA) by USAID.

With regard to the Control and Audit Office (CAO), our review disclosed that the CAO has limited capacity to audit donor funds. This limitation, however, could be sufficiently mitigated by providing technical assistance to the CAO and through USAID/Afghanistan's direct contracting for audit services as well as in-house financial reviews performed by USAID/Afghanistan staff or RIG-approved audit firms.

### **Ministry of Finance (MoF)**

Our assessment disclosed that the MoF has adequate financial management capacity to effectively and efficiently record, account for and report on funds that may be provided directly by USAID to the GIROA through direct budget support, sector assistance, host country contracting and/or other implementation modes.

The Budget Directorate (BD) within the MoF has the capacity and capability to manage and monitor donor assistance. The BD has adequate experience in managing direct budget support to the GIROA from other donors, including the World Bank, Asian Development Bank, and the Embassy of Japan among others. It also has the capability to monitor funds directly managed by donors themselves, otherwise referred to as "external" or "off-budget funds". The BD has been successful in introducing reforms such as program budgeting and provincial budgeting to streamline the budget process and enhance budget transparency and accountability. Those reforms were also intended to align the budget with the Afghanistan National Development Strategy.

The Treasury Directorate (TD) within the MoF has made significant improvements in its operations. The government-wide computerized system called Afghanistan Financial Management Information System (AFMIS), which is the official financial management system of the GIROA, has been implemented in 15 line ministries, 14 budget entities, and 18 of the 34 Mastofiat in the provinces. Implementation at the remaining 16 provinces is underway and is expected to be completed by March 31, 2010.

The MoF Internal Audit Department's (MoF-IAD's) capacity has been strengthened since our last review in 2007. With the recent hiring and training of additional staff, there is reasonable assurance that USAID assistance would be adequately safeguarded from fraud, waste and misuse. The MoF-IAD could benefit from some technical assistance that USAID could provide for participation of its staff in study tours, workshops and conferences.

### **Da Afghanistan Bank (DAB)**

DAB has the capacity and capability to provide quality services required of a modern central bank. The bank is rapidly making progress in implementing reforms to its policies and practices and installing modern banking systems.

There is reasonable assurance that DAB could accommodate additional services (e.g. opening of a separate account with the Federal Reserve Bank of New York) that may be required by USAID in the event more direct assistance is granted by USAID to the GIRoA through direct budget support.

### **Control and Audit Office (CAO)**

The Control and Audit Office has limited capacity to conduct audits of donor-funded projects. CAO lacks qualified staff and the resources to build the capacity of its staff through training. The CAO will continue to require technical assistance from international or local audit firms in order to fully comply with USAID's audit requirements. The limited capacity of the CAO to conduct audits of donor-funded projects is mitigated by the existing USAID audit requirements for the funds to be audited by approved audit firms as well as the financial review and oversight of USAID funds by the Mission's Office of Financial Management.

#### **Assessment Team's Recommendation:**

**Should USAID decide to increase the level of direct assistance to the GIRoA through host country contracting, direct budget support, sector assistance and other applicable implementation mechanisms, we believe the following recommendations should be implemented:**

***Recommendation 1:*** *We recommend that the MoF-IAD increase its staff capacity building efforts by soliciting external funding of study tours, seminars/workshops, scholarships and other training opportunities. Similar capacity building support was previously provided to the CAO through USAID's Capacity Development Project.*

***Recommendation 2:*** *We recommend that the CAO formally seek external funding for focused technical assistance to further enhance its staff capabilities and to provide them with the necessary resources (including equipment and facilities) to develop necessary skills required in the performance of their audit responsibilities. The CAO needs more than the limited support previously provided under USAID's Capacity Development Project for attendance of CAO officials in regional conferences.*

## **2. BACKGROUND AND OBJECTIVES**

This assessment was carried out in line with USAID's goal of providing more direct assistance to the GIRoA in accordance with the Paris Declaration and the Accra Agenda for Action. USAID/Afghanistan had initially provided direct assistance to the GIRoA using the host country contracting mode of implementation for programs managed by the Ministry of Public Health and the Ministry of Communication and Information Technology.

In May 2009, the Mission Management deemed it necessary to perform an assessment to determine if the GIRoA's financial management systems and procedures would be adequate for purposes of implementing other modes of assistance such as direct budget support, sector assistance, and other applicable mechanisms. The Office of Financial Management (OFM) thus proceeded with the review during the period May 25, 2009 through June 4, 2009.

Following are the specific objectives of the assessment:

### **Ministry of Finance (MoF)**

1. To obtain a better understanding of the GIRoA's budget process (including program budgeting and provincial budgeting) in relation to donor-funded programs.
2. To obtain information on the current status of implementation of program and provincial budgeting.
3. To gain an understanding of the role of the Aid Management Section (AMS) of the MoF in managing donor funds. And to determine areas where USAID could potentially provide technical assistance to enhance AMS's capability to manage direct assistance under which conditionalities may need to be established, monitored and reported on by GIRoA.
4. To confirm the Treasury Directorate's role in the implementation of the GIRoA's budget and the management of separate bank accounts required under donor-funded programs.
5. To obtain information on the current status of implementation of Afghanistan Financial Management Information System (AFMIS).
6. To gain an understanding of the GIRoA's debt management process as well as the disbursement process for international commitments such as the procurement of commodities (fuel, food, equipment, etc.).
7. To obtain an understanding of the MoF's Internal Audit Department's (IAD's) roles and responsibilities in the management of donor-funded programs and its relationship to the Control and Audit Office (CAO).

### **Da Afghanistan Bank (DAB)**

To obtain an understanding of the DAB's roles and responsibilities in the management of the GIRoA's assets and the disbursement of government funds (both local currency and foreign currency) as well as its relationship to the MoF and other government ministries.

### **Control and Audit Office (CAO)**

To obtain an understanding of the CAO's roles and responsibilities relating to the GIRoA's budget and its implementation and its involvement in the audit of donor-funded programs.

## **3. DETAILED FINDINGS AND OBSERVATIONS**

### **3.1. Ministry of Finance (MoF)**

The Ministry of Finance's (MoF's) responsibilities include the management and execution of the budget, collection of taxes, organization and control of public expenditures and payments to the government, and the management of Customs Affairs. A major portion of the Afghan budget is financed by international donor assistance. As such, the MoF is exerting every effort to train and build the capacity of its staff in order to meet international rules and regulations. The MoF is also doing its best to convince donors to channel more funds through the government treasury.

The MoF is headed by the Minister with three Deputy Ministers for Finance, Customs and Revenue, and Administration who each lead and administer a number of specific departments. The MoF has nine Directorate Generals that function under the Deputy Ministers (DMs).

This review is focused on three directorates or departments of the MoF -- the Budget Directorate, the Treasury Directorate, and the Internal Audit Directorate.

#### **3.1.1. Budget Directorate (BD)**

The Budget Directorate plays a critical role in managing the resources of the government. These resources include internal revenues and external assistance from the donor community.

The BD is currently in the process of restructuring its organization. The restructuring will align the GIRoA's budget processes and the resulting government budget with the Afghanistan National Development Strategy (ANDS). Major changes involve the integration/merger of five sub-directorates (or units) into three main sub-directorates that include: (1) the Aid Management Section; (2) the Budget Execution Unit; and (3) the Budget Policy and ANDS Section.

### **3.1.1.1. Aid Management Section (AMS)**

The AMS (previously the Aid Coordination Unit) is mainly involved in liaising with the donor community, overseeing the effectiveness of development assistance in line with the Paris Declaration, and the management of information related to donor assistance.

#### **Project Development and Approval Process**

The AMS is actively involved in Phase I of the project development process including the preparation/review of concept papers; negotiations with donors; preparation, review, finalization and signing of agreements; and, maintenance of all donor assistance records. Agreements with donors cannot be signed by line ministries without the AMS's approval. Actual project implementation is carried out by the cognizant line ministries.

The AMS is currently developing a new approval mechanism for external (off-budget) funding to the government. Under this new mechanism, all new programs with a total program cost of \$5 million or above, will need to be submitted to a peer review committee which is transparent to all donors. Programs that do not meet the threshold are exempt from the peer review.

The peer review committee is composed of the line ministry, the Ministry of Finance, and the Ministry of Economy. The two pilot sectors for this new mechanism are health and agriculture. The introduction of this new mechanism is intended to increase the coordination and transparency of off-budget funding. However, the AMS continues to encourage donors to provide funds through the core budget.

#### **Data Management**

The AMS maintains and monitors the official records pertaining to all donor assistance to the GIRoA. This includes donor assistance which is part of the core budget and channeled through the government treasury as well as donor assistance which is external to the core budget and managed directly by the donors. In order to track all donor assistance, the AMS maintains the Donor Assistance Database (DAD) and the Project Profile Database (PPD). The DAD is an online system which allows donor agencies to enter data pertinent to activities in Afghanistan which the donor agencies have funded. The PPD on the other hand is a comprehensive system used in the preparation of the budget and maintaining records on donor funding and expenditures.

#### **Experience with Budget Support Programs**

The AMS has previous experience managing resources provided through direct budget support. The GIRoA is currently receiving direct budget support from a number of donors that include among others the World Bank, Asian Development Bank, the Embassy of Japan and the U.S. Government. Some examples of GIRoA programs funded through direct budget support include Afghanistan Reconstruction Trust Fund, the Law and Order Trust Fund for

Afghanistan, the Private Sector Development Program, and the Program Investment Support Program. Japanese budget support was provided for the importation of oil. This budget support involved the monetization of proceeds from the sale of oil that was transported from Japan into Afghanistan.

Budget support funds from certain donors are tied to conditionalities or are earmarked while other budget support funds are only subject to milestones or “soft” conditions. The MoF can accommodate donor earmarking of funds, but they discourage establishing conditionalities because it does not provide the government adequate flexibility to meet its priorities. Budget support funds are considered discretionary funds by MoF and are allocated based on the needs of projects that are unfunded. Earmarking or “preferencing” of funds occurs at the allocation stage.

Tracking of budget support funds occurs at the program allocation level. MoF is able to provide accounting for all funds allocated to a program on a donor-by-donor basis. However, since they are considered discretionary resources, the funds are deposited into a single account; thus, expenditures cannot be tracked by donor.

Reporting on budget support programs depends on each donor agreement. Some donor agreements require submission of progress reports based on the individual tranches released by the donors. Direct budget support program agreements normally do not require progress reports; tranche releases are based on withdrawal applications.

The GIRoA’s budget includes approved projects irrespective of funds availability. Projects in the budget may be fully funded, partially funded or unfunded. Budget support programs can help the government fund both partially funded and unfunded projects.

#### **3.1.1.2. Budget Execution Unit (BEU)**

The BEU is responsible for: (1) executing the approved budget through the issuance of budgetary allotments; (2) serving as the bridge between the Budget and the Treasury Directorates; (3) updating the government chart of accounts; (4) training the line ministries’ budget officials on the process of allotments; and, (5) assisting in the preparation of the GIRoA’s end-of-year financial statements (Qatia Report).

When the budget is approved by the President, the budget is sent to the line ministries’ budgetary units for implementation of their programs. The line ministries then prepare the necessary documents to request allotments of funds.

The BEU issues allotments to the budgetary units. For the ordinary (operating) budget, quarterly allotments are issued. For the development budget, allotments are issued based on the terms and conditions of the contract executed by the respective budgetary units.

The BEU has implemented the use of a comprehensive checklist for every allotment request to facilitate the review and issuance of allotments. The BEU completes the checklist to ensure the completeness and appropriateness of the supporting documentation submitted with

each allotment request. In addition, the BEU also requires the requesting budgetary unit to attach a copy of the previously issued allotments with each new request for allotment. These internal controls provide additional assurance that the funds are being properly used.

### **3.1.1.3. Budget Policy and ANDS (BP/ANDS) Section**

Under the old Budget Directorate structure, the BP/ANDS Section was the Budget Policy, Coordination and Reporting Unit under which a sub-section Budget Integration and Reform Unit (BIRU) existed. A separate Program and Provincial Budgeting Section also existed under the old structure. The current BP/ANDS Section includes two main sub-sections: 1) Budget Policy, Reform and Coordination (BPRC) and (2) Coordination of ANDS Development and Implementation.

The primary responsibility of this unit is to implement Program Budgeting across the line ministries and other independent departments of the Afghan Government. This new system of budgeting is aimed at linking government spending with outcomes. It is expected that once Program Budgeting is fully implemented, accountability over the GIRoA's funds will be greatly enhanced.

#### **Program Budgeting**

The International Monetary Fund and the World Bank recommended that the GIRoA implement program budgeting throughout the government. As a result of this recommendation, program budgeting was introduced in the year 1385 as a pilot activity in three ministries -- the Ministry of Rural and Rehabilitation Development (MRRD), the Ministry of Environment and the Ministry of Public Health (MoPH). In 1386, four additional ministries were included as pilot ministries. At present, Program Budgeting has been rolled out to 12 ministries; by the end of 1389, a total of 20 line ministries are planned to be fully implementing Program Budgeting. Each line ministry submits its budget both in the program budget format as well as in the traditional budget format.

Since Budget Year 1385, the BP/ANDS Section has had many successes that include the following:

- Every pilot ministry has a well-defined program structure that did not exist before.
- The Chart of Accounts has been updated based on the program structure.
- Program budget implementation teams have been established in each ministry and are led by the Deputy Ministers.
- A new Program Budgeting Database has been developed for the preparation of the program budget and expenditure tracking based on the program budget format.

Despite its many successes, the unit still faces a number of challenges. The primary challenge is the low capacity of the civil staff in the line ministries which is an obstacle towards the implementation of this budgeting mechanism. In addition, high staff turnover has also slowed down the process of implementation. The lone remaining Program Budget employee we interviewed planned to leave by the end of June 2009.

## Provincial Budgeting

Provincial budgeting was initially implemented in 2006 in three provinces. It is envisioned that all 34 provinces will be using provincial budgeting by September 2009. This budget process is equivalent to program budgeting at the provincial level. The province directors coordinate with the line ministries in developing their budgets. Provincial authorities prepare their budgets based on priority needs as well as alignment with the ANDS and their budget ceilings.

Some challenges faced by the Provincial Budgeting Section include:

- Staff at the provincial level generally do not understand program budgeting;
- Lack of technical capacity in most provinces;
- Lack of awareness of good governance in most provinces;
- Absence of forms, templates and computer software; and,
- Program budgeting is not yet implemented by all line ministries.

In order to address the issues and challenges being faced by the MoF in implementing Program and Provincial Budgeting, the Budget Directorate has taken/is taking the following actions:

- 1) Program budgeting was expanded to additional line ministries but provincial budgeting was not rolled out to additional provinces;
- 2) The “provincial allocation process” was introduced with the Ministry of Education as pilot.
- 3) Capacity building is continuously being provided at the provincial level with completion expected by September 2009.

## Budget Coordination Unit (BCU)

The primary responsibilities of this unit are:

- Issuance of budget circulars;
- Issuance of budget ceilings;
- Coordination with ANDS;
- Scheduling of budget hearing sessions;
- Preparation of budget statements; and,
- Arrangement of mid-year review sessions.

Although this is a very important unit, it appears that the level of attention required to ensure BCU can meet its responsibilities is not being provided. At the time of our review, only two employees remained in the six-person BCU team with one contract employee leaving in June 2009. With his departure, only one civil servant Budget Analyst working on a contract basis would be left behind. At the exit meeting, the Budget Director General advised that hiring is ongoing to ensure that the implementation schedule for Program Budgeting will be met. In

order to meet the 1389 budget preparation due dates, the BCU will call upon resources from other sections of the Ministry who are fully knowledgeable of the budget process.

#### Coordination of ANDS Development and Implementation Section (ANDS)

The main responsibilities of the ANDS section are to ensure that all ministries' funding priorities and requirements are aligned with the ANDS benchmarks and that the budget is linked to the ANDS framework. The ANDS Section works closely with the respective line ministries in achieving the ANDS benchmarks in each sector strategy. The ANDS Section also coordinates with the Aid Management Section and other ANDS' offices in the Ministry of Economy and the President's Office.

The ANDS Section's achievements to date include:

- A fully-costed ANDS;
- Establishment of 17 inter-ministerial committees;
- Establishment of six cross-cutting issues committees; and,
- Delivery of training programs to the planning departments in the line ministries.

#### **3.1.1.4. Management Information Systems (MIS) Section**

This unit directly reports to the Director General of the Budget Directorate. Its main responsibility is to collect all information related to budget preparation, execution, and public budget decrees. This section manages the two databases and the official websites of the budget department.

This unit maintains the **Project Profile Database (PPD)** which has been locally developed in MS Access and SQL, is password protected, and is based on user roles. The database is administered by the MIS unit. This comprehensive system is used both to prepare the budget and to maintain records on donor funding and expenditures. In addition, the database is used to track donor funding irrespective of its nature (discretionary or non-discretionary). We were able to verify information relating to USAID funding by locating the grant or contract reference numbers. This database has the ability to generate certain standardized reports as well as has the flexibility to generate ad hoc reports based on specific needs.

In addition to the Project Profile Database, the Ministry of Finance maintains the **Development Assistance Database (DAD)**. The DAD is a real time database which contains pertinent information regarding development assistance. This database is housed in two servers - one server is located in the MoF and the other server is located in Washington, DC. The information in the database is accessible to the public. It allows the public to view all information related to donor assistance and spending. In addition, every focal point from each donor agency has been assigned a user ID and a password that allows the user to input and update information pertaining to their donor agency's grants or contracts.

Public expenditure and donor funding information available through this database enhances the overall accountability of the GIROA. The State Budget Preparation System (SBPS) is currently under development and will be used for budget execution.

### **3.1.1.5 Overall Observations – Budget Directorate**

The Budget Directorate has adequate systems and procedures in place to manage additional direct assistance from USAID. However, we noted that most of the Budget Directorate's employees are local contractors (Afghans nationals) funded by donor agencies and that there is a high staff turnover due to salary issues. The capacity of the Budget Directorate's civil service staff needs to be improved to reduce the reliance on external contractors for needed expertise.

The Budget Director General confirmed that the hiring of new employees is ongoing in order to ensure the implementation schedule for Program Budgeting will be met. More than 95% of the current MoF-Budget's staff is Afghan. In the past, the BD was supported by 13 international experts whereas as of June 2009, only one remains. The BD's reduced reliance on international experts is a result of the availability of local Afghan experts with the required skills.

The OFM Assessment Team believes that the actions being taken by the Budget Directorate to address the staffing concerns (high turnover rate and reliance on contractors) that may affect the sustainability of its operations and its ability to meet budget calendar due dates and target implementation dates for program/provincial budgeting are adequate. In addition, it is our understanding that other donors are already providing support to the Budget Directorate in the implementation of program/provincial budgeting. Thus, we are not issuing any recommendation in this regard.

### **3.1.2. Treasury Directorate (TD)**

The Treasury Directorate is responsible for the management of the government's financial resources, managing the treasury bank accounts and payment procedures, implementing financial plans, managing cash assets, implementing the budget and performing expenditure controls in accordance with revenue and expenditure plans. The TD is divided into four units: Special Disbursements, Afghanistan Financial Management Information System (AFMIS), Cash Management and Debt Management Units.

#### **3.1.2.1. Special Disbursements Unit (SDU):**

The SDU is responsible for disbursing the Program Budget on the development side. It is also responsible for maintaining Special Bank Accounts for Donors. Currently, the SDU maintains over 150 Special Accounts. These accounts are maintained for discretionary and non-discretionary funds.

We observed that there were proper procedures in place to track, control, verify and process the payments. These procedures are outlined below:

- The reception receives the M16 (Payment Request Form) and verifies the forms completeness. If the form contains all the required information, the form is logged, assigned a log number, and forwarded to the next section. If the form is not completed correctly, the form is rejected and returned to the originator.
- The approval is provided after a review of all supporting documents and if M16 is properly completed.
- The allotment details and availability of unexpended allotments are checked for each payment request.
- The payment is temporarily saved in AFMIS by the Line Ministry.
- The check is prepared by the SDU and is sent for authorized signature.
- Once the check is signed by the authorized person, the payment is posted in AFMIS by MoF-Treasury.
- The check is then sent to Da Afghanistan Bank for the transfer of funds to the vendor's account.

#### **Funds Transfer to Mastofiats for the Development Budget:**

The process for transferring funds for payments is as follows. The Line Ministries send the payment request form (M16) for the full disbursement amount, to the SDU requesting that funds be transferred to the provinces. The SDU then processes the request and issues a check to Da Afghanistan Bank (DAB). The DAB then transfers the funds to the Mastofiats, making the funds available for disbursement at the provincial level.

When the funds are available at the provincial level, the appropriate provincial department sends a payment request (M16) for each individual payment to the Mastofiats. This payment request will include the amount of the payment and include the supporting documents. Based on a properly supported payment request, the Mastofiats process the payment requests and issue the check payment instructions to DAB. DAB will then process the payment to the payee.

On a monthly basis, the Mastofiat Coordination staff brings the expenditure reports to the SDU to record the expenses in AFMIS by object class codes.

The SDU is responsible for reconciling the Special Bank Accounts maintained with the DAB on a monthly basis.

#### **3.1.2.2. Afghanistan Financial Management Information System (AFMIS) Unit:**

The AFMIS Unit is responsible for the rollout of the AFMIS in the Line Ministries and in the provinces. The AFMIS Unit is currently comprised of 15 staff, of whom eight are working in operations and seven are working in information technology (IT).

The system is being implemented in a phased approach. In the first phase of the roll-out, all the Line Ministries (LMs) and Mastofiats have access in AFMIS to temporarily save in AFMIS, the payment transactions under the ordinary budget. The final approval of the

payment request and check issuance is reserved for the Payment Section of the Department of Treasury, thus allowing for stronger control over disbursements.

For the development budget, the LMs and Mastofiat are provided “read only” access in AFMIS; thus, payment requests are still processed manually (offline). In the second phase of the rollout, it is planned that all the Line Ministries and Mastofiat will be given full (read/write) access to the development budget similar to the ordinary budget.

As of June 2009, AFMIS has been rolled out to 15 Line Ministries (LMs) and 14 budget entities as well as 18 (50%) of the 34 provinces. The system is planned to be rolled out to the 16 remaining provinces by the end of year 1388 (March 31, 2010).

Training on AFMIS is provided to users as the IT section installs the system in a LM or Mastofiat. The operational staff arranges seven-day training on the system for the staff upon installation of the system. After the training, the AFMIS staff spends 15 days at the LMs or Mastofiat to monitor, oversee and guide the work of the newly trained staff.

The AFMIS Unit is facing some challenges in the full implementation of AFMIS due to connectivity problems in some Mastofiat and security problems in the remaining provinces scheduled for AFMIS rollout.

#### **3.1.2.3. Cash Management Unit (CMU):**

The Cash Management Unit is responsible for forecasting cash needs under the ordinary and development budgets; managing revenue bank accounts; recording revenues; and disbursing approved payments under the ordinary budget. These disbursements include the transfer of civil service salaries to provinces and offshore GIRoA staff.

#### **3.1.2.4. Debt Management Unit (DMU):**

The Debt Management Unit is responsible for tracking the internal and external debts of the government. To date, the GIRoA has no internal debt. The external debts of Afghanistan total approximately \$2.2 billion. Of the total, approximately \$0.8 billion of this debt was incurred prior to 1381. Approximately \$1.4 billion of the debt was incurred after 1381.

Debts incurred prior to 1381 include \$740 million from Russia and \$117 million from the U.S. These debts are managed by the Paris Club. The U.S. and Germany have unofficially indicated that they will forgive the debts. Russia has stipulated some conditions before they will forgive the debts.

Debts incurred after 1381 were provided by the World Bank, the Asian Development Bank, the Islamic Development Bank and the Saudi Fund. The GIRoA is currently paying \$5 million annually in interest for these debts. This amount will increase each year as the grace period of any loan ends. The GIRoA is working with the Paris Club and other creditors to obtain relief from old debts in line with the policy for Highly Indebted Poor Countries (HIPC).

The Debt Management Unit has successfully installed a debt management system, the Commonwealth Secretariat of Debt Reporting System (CSDRS). This system fulfills the reporting requirement imposed by the Paris Club for HIPC's.

### **3.1.2.5 Overall Observation – Treasury Directorate**

The MoF-Treasury has adequate systems in place to ensure proper disbursement of additional direct assistance that USAID may provide.

Since the last review performed by OFM in 2007, the TD has made significant improvements in its operations. To date, 18 Provincial Mastofiat's (branches of the Ministry of Finance in provinces) and all Line Ministries are connected to the Afghanistan Financial Management Information System (AFMIS), the official financial management system of the GIRoA. A new action plan has been developed by the Treasury Directorate to expedite the rollout of AFMIS to the remaining Mastofiat's and remaining budget entities.

As part of the process of further improving the TD operations, the Director General of Treasury and his advisor plan to visit the Treasury Directorate of Mongolia to learn about their best practices and procedures, which may be tailored for implementation in the GIRoA Treasury Directorate.

### **3.1.3. Internal Audit Directorate (IAD)**

The Internal Audit Directorate (MoF-IAD) is an independent unit that reports to the Minister of Finance. The MoF-IAD provides audit reports and investigative findings on a quarterly basis to the MoF's Internal Audit Committee (IAC). The IAC is composed of the Minister and the three Deputy Ministers. The MoF-IAD Director General acts as secretary of the committee while all the other Director Generals sit as observers.

The MoF-IAD Director is nominated by the Minister of Finance and appointed by Presidential Order. The MoF-IAD is responsible for discharging the internal control functions of the Ministry.

The MoF-IAD was created to ensure adequate accounting, recording policies, recording procedures and business processes are in place. The MoF-IAD assists the Ministry in accomplishing the Ministry's objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

#### **The MoF-IAD's responsibilities include:**

- Securing and protecting the Ministry's assets;
- Securing, justifying and supporting the Minister's decisions;
- Improving the various functions of the Ministry according to current legislation and Ministerial decisions;
- Collaborating with and supporting the Government Audit Authority;

- Conducting audits to verify the use of resources (material, financial, and labor) of the Ministry are in accordance with policies and procedures;
- Evaluating the Ministry's internal controls and proposing improvements to these controls; and,
- Enhancing the internal control system; strengthening material responsibility of employees; safeguarding MoF assets against misuse, abuse and fraud.

Article 61 and Regulation 112 of the new Public Finance and Expenditure Management (PFEM) Law further clarifies the role of the MoF-IAD and appoints it to lead the activities of all the IADs that will exist in other government budgetary units. This article sets forth the following MoF-IAD responsibilities:

- The establishment of an IAD in all government budgetary units for managing their activities;
- The establishment of audit standards and reporting according to international standards for all IADs;
- The audit of governmental organizations according to the government's plan as per the directives of the Minister of Finance;
- Guidance of IADs in other budgetary units as to their plans and scopes of audit; and,
- Making sure the staff of all IADs is trained sufficiently to perform their duties effectively.

The MoF-IAD's primary objectives are:

- Ascertaining the level of compliance with established government laws, policies, procedures, and plans including behavioral and ethical expectations;
- Reviewing and appraising the soundness, adequacy and application of accounting, financial and other controls in place to achieve goals within the MoF;
- Ensuring the economical, effective and efficient use of MoF resources;
- Ascertaining the effectiveness with which the MoF assets are accounted for and safeguarded;
- Conducting special investigations; and,
- Ensuring the integrity and reliability of financial and operational information produced by the MoF departments.

Staffing

The MoF-IAD functions through three main departments: (1) Revenue and Assets Audit; (2) Treasury and Budget Audit; and (3) Compliance, Investigation and System Audit. In 1385, the MoF-IAD had only 15 auditors after which 75 more auditors were hired. Based on its mandate from Article 61 of the PFEM Law, the MoF-IAD has a current "Tashkeel" (staffing plan) of 315 auditors, 120 of whom have already been hired and 96 of them are civil servants, 12 are government contracted staff (Ajeer) paid from the ordinary budget and 12 are contracted staff paid out of the development budget

**Types of Internal Audit conducted by the MoF-IAD:**

- Financial Audit
- Compliance Audit
- Performance Audit
- Information System Audit
- Fraud Investigation
- Other Special Assignments

**The MoF-IAD's achievements over the past two-and-a-half years, include the following:**

- In order to improve the capacity of internal auditors, MoF-IAD has provided several trainings to various government staffs. Staff members who have received classroom training from MoF-IAD include those from MoF departments, Ministry of Defense (MoD) and other government agencies. International experts have provided extensive on-the-job training to 78 employees. Currently, 35 additional employees from MoD and IDLG are undertaking training. In addition, 53 employees were admitted to the Certified Accountancy Technician (CAT) Course in September 2008.
- The Internal Audit manual has been developed and approved. Other audit manuals for Revenue, Customs and Mastofiat have also been developed.
- A new Fraud Investigation Unit was established in December 2007 in the MoF-IAD. A Fraud Investigation Manual was prepared for the unit and 12 staff members have received fraud investigation training; on-the-job training for fraud investigators is in progress.
- The IT Audit unit was established in August 2008 in the MoF-IAD:
  - An IT Audit Manual was drafted and is under review.
  - Basic IT training was conducted for the IT auditors.
  - The AFMIS audit has been finalized and plans are in place to audit the Automated System for Customs Data (ASYCUDA) System.
- From March 2008 through February 2009, the MoF-IAD's major findings included identifying: \$10.7 million revenue collection shortfall; \$6.2 million in unspent advances; and \$123 thousand recomputed revenues/expenditures resulting from calculation errors.

**Actions taken on Monetary Findings and Open Recommendations:**

The audit reports were sent to heads of the audited offices and the cognizant department heads were instructed to collect the questioned amounts. Upon presentation of the findings to the MoF Audit Committee, the committee decided to establish a Memorandum of Understanding with the Ministry of Interior and Independent Directorate of Local Government (IDLG) to provide support in the collection efforts. Furthermore, the MoF-IAD

auditors assigned on subsequent audits to the audited offices have been instructed to follow up on the outstanding audit recommendations.

**Relationship with the Control and Audit Office (CAO) and Other Line Ministries' Internal Audit Departments (LM-IADs):**

*With the CAO:* MoF-IAD submits its annual internal audit plan to the CAO to avoid any overlap in audit work; the MoF-IAD provides the necessary information to the CAO when the CAO performs audits of the Ministry; the MoF-IAD internal audit reports are not sent to the CAO and are restricted for distribution to MoF's management.

*With Other Line Ministries' IADs:* While the MoF-IAD does not have oversight responsibility over other LM-IADs, it does provide training to other ministries' staff. MoF-IAD staff attends regular meetings and fora with other Line Ministries' IADs where they can share ideas, problems and solutions.

**Challenges:**

One challenge faced by the MoF-IAD is the conflict in authorities and responsibilities in relation to those of the Control and Audit Office (CAO). The CAO believes there is a conflict between the MoF-IAD's role and CAO's role.

Under Article 61 of the Public Finance and Expenditure Management (PFEM) Law, MoF is mandated to establish an internal audit administration and appoint auditors to audit the financial and accounting affairs of all government administrations.

Article 59 of the PFEM on the other hand provides for an independent audit of government accounts and states that the "administration for audit and control shall prepare an independent audit report within six months of the fiscal year and submit it to the government." The certification of the government's financial statements is being done by the CAO.

The CAO believes that the MoF-IAD's roles should be limited only to the audit and oversight of the individual MoF departments whereas MoF-IAD feels that in accordance with the law, it should have oversight responsibility for other Line Ministries' IADs. As a result of this conflict, a presidential order has been issued to put Article 61 of the PFEM on hold until the issue is resolved.

The second challenge for MoF-IAD is the lack of funding to support overseas study tours, seminars and workshops of its staff to neighboring and other developed countries. These study tours/seminars and workshops are necessary to expand the experience of the MoF-IAD staff and to provide insight into other countries' internal auditing practices.

#### MoF-IAD's Planned Activities:

- Further specialized training;
- Scholarships for five people to the American University of Afghanistan;
- Establishment of an accounting school;
- Overseas study tours, seminars and workshops;
- Action plan for anti-corruption activity of MoF; and,
- Automated System for Customs Data (ASYCUDA) and payroll audit.

#### **3.1.3.1 Overall Observations – Internal Audit Directorate (IAD)**

The MoF-IAD's capacity has been strengthened from the last USAID review in 2007. With additional staff being hired and trained, there is reasonable assurance that USAID's direct assistance would be adequately safeguarded from fraud, waste and misuse.

We believe that the MoF-IAD could benefit from support to help sustain capacity building of the MoF-IAD staff. The possibility of funding study tours, seminars/workshops, scholarships and other training opportunities should be explored. Similar assistance through USAID's Capacity Development Project has been provided to the CAO.

#### **3.2. Da Afghanistan Bank (DAB)**

The DAB is responsible for providing monetary stability in Afghanistan; for fostering the liquidity, solvency and proper functioning of a stable market-based financial system; and for promoting a safe, sound and efficient national payment system.

The main tasks of DAB are listed below.

- To hold and to manage the country's foreign exchange reserves;
- To maintain and issue the Afghani currency;
- To provide quality banking services to the GIRoA enabling the effective implementation of government fiscal policies and plans;
- To provide accurate, timely and relevant information to the public;
- To develop monetary policies to achieve price and exchange rate stability;
- To supervise all financial institutions; and,
- To develop an electronic payments system to serve all provinces of Afghanistan.

The DAB maintains \$3.5 billion in reserves of which \$500 million constitute government claims.

#### **Organizational Structure:**

DAB is operating through eleven different departments, namely:

1. Monetary Policy Directorate

2. Bank Operations (Payment Unit, Treasury Unit, Branches Unit, Banking Relation Unit, Current Account, Transfer Unit, and ISP Unit)
3. General Counsel
4. Chief Financial Office (CFO)
5. Chief Information Office
6. Financial Supervision
7. General Services
8. Human Resources
9. Market Operations
10. Information Technology (IT)
11. Financial Intelligence Unit (FIU)

#### Process for Establishing Government Bank Accounts:

To open a bank account with DAB, MoF sends a written request to the DAB with necessary information on the ministry, NGO or donor, requesting a special account to be opened. Prior to making a request to establish an account for a line ministry, MoF ensures that the activity is included in the approved GIRoA budget.

The DAB processes the requests within a three-day time period and establishes a bank account for the activity. When the account is established, the DAB sends a confirmation letter to MoF with details of the bank account. The DAB currently maintains between 200 and 300 special accounts, denominated in Afghanis or foreign currencies, for various government institutions.

The DAB has stopped providing commercial banking services except to a few international NGOs. The DAB does not maintain personal bank accounts or accounts for commercial entities.

#### Policy/Practice regarding Interest Payment on Government Bank Accounts

Under Article 80 of the DAB Law, the bank has the option to pay interest on funds maintained by the Afghan government and government agencies. Specifically,

*“1. Da Afghanistan Bank may accept deposits from the State and from such State agencies as the Minister of Finance shall determine. As depository, Da Afghanistan Bank shall receive and disburse monies and keep account thereof and provide other financial services related thereto. Da Afghanistan Bank shall pay to the limits of the deposited amounts against orders to pay from such accounts. Da Afghanistan Bank may agree to pay interest on such deposits.*

*2. Da Afghanistan Bank may authorize other financial institutions to receive such deposits in compliance with conditions prescribed by Da Afghanistan Bank.”*

Based on mutual agreement, DAB does not pay interest on funds deposited into special accounts by the Ministry of Finance, by other Line Ministries or by donors. In turn, the DAB does not charge fees for its services. The DAB is receiving interests on funds/investments

maintained in foreign banks. Since the DAB does not receive direct government funding, the DAB uses these earnings to finance its operating costs.

#### Procedures for Establishing Daily Exchange Rates

Per article 72 of the DAB Law, DAB is responsible for the issuance of exchange rate regulations, guidelines and instructions required for the execution of exchange rate policy and for foreign exchange market operations within the territory of Afghanistan.

The Market Operations Department (MOD) of DAB is tasked to collect market exchange rate of Afghani vis-à-vis nine major foreign currencies from the local money market. Ten licensed money exchange dealers randomly selected each day on a prescribed official form. The MOD calculates the average exchange rate for each foreign currency, and this average exchange rate establishes the basis for the DAB's daily exchange rate. This daily exchange rate is then circulated to different financial institutions and the MoF.

#### Disbursement Process

To initiate payments, DAB receives the check or payment instruction from MoF-Treasury Directorate. The check is forwarded to the Payment Department where the check or payment instruction is verified for authorized signatory, beneficiary details, available balance in the account, etc. After successful verification, a voucher is drafted and forwarded to the Deputy Director General - Payments for approval. If the amount is beyond the authority of the Deputy DG-Payments, the check is forwarded to the Director General - Payments for approval. Upon approval, the information is entered into the computerized payment system for processing.

#### Reconciliation Procedures with MoF

On a daily basis, the DAB sends bank account statements for all MoF bank accounts to the MoF-Treasury for reconciliation. The DAB and the MoF-Treasury convene bi-weekly to resolve any reconciliation or policy issues.

#### Innovations to the DAB Systems

The DAB has taken positive steps towards the modernization of banking system both in Kabul and other branches around the country. The DAB has installed Core Banking Solutions (CBS) in its headquarters and at all branches. The Core Banking System has replaced the manual processing of transactions within different units of the DAB.

The DAB recently implemented the Afghanistan Fund Transfer System (AFTS) and the Afghanistan Clearing & Settlement System (ACSS). The AFTS is used for the DAB's inter-branch transfers while the ACSS is used for interbank clearance and settlements. These systems greatly facilitate the disbursement and transfer of funds.

For example, in the past, the salaries of line ministry employees were paid through a “committee” composed of representatives from the line ministries. The DAB and the MoF would physically carry the cash and distribute cash salaries to employees. With the installation of AFTS, civil servants’ salaries are electronically transferred by the DAB to their bank accounts maintained in commercial banks.

### **Overall Observations – Da Afghanistan Bank**

The DAB has the capacity and capability to provide quality services required of a modern central bank. The bank is rapidly making progress in implementing reforms to its policies and practices and installing modern banking systems.

There is reasonable assurance that the DAB could accommodate additional services (e.g. opening of a separate account with the Federal Reserve Bank of New York) that may be required by USAID in the event additional direct assistance is granted by USAID to the GIRoA.

### **3.3. Control and Audit Office (CAO)**

The Control and Audit Office currently serves as the Supreme Audit Institution (SAI) of Afghanistan with direct reporting responsibility to the President. New legislation that would formalize the CAO’s designation as the SAI is under review by the Ministry of Justice and is expected to be forwarded to the National Assembly before the elections in August 2009. The new law would also require the CAO to report to the Parliament instead of the President to ensure its independence.

The main objectives of the CAO are to protect public funds and take action against errors, irregularities and misuse of public property; to prevent illegal expenditures; to review the systems of control over government receipts and payments; to identify fraud and ensure that accused individuals are brought to justice; to certify the financial statements of the government; to identify shortfalls in the government budget; and to guarantee the accuracy of aid and grants provided by donor countries.

#### **Organizational Structure and Staffing**

There are nine separate audit units under CAO:

1. Foreign Grants Audit Directorate
2. Internal Audit Directorate
3. Construction Affairs Audit Directorate
4. Organizations and Enterprises Audit Directorate
5. Provincial Budgetary Administration and Municipalities Audit Directorate
6. Central Budgetary Administration Audit Directorate
7. Coordination Directorate
8. Environmental Audit Department
9. Controlling and Monitoring Directorate

The Foreign Grants Audit Directorate is the department responsible for performing financial audits of the World Bank and other donor-funded projects upon request. Currently, PKF, an international auditing firm, is assisting the CAO in performing audits of World Bank projects, ARTF and UNDP funded projects. PKF is also assisting the CAO by providing technical training courses to the CAO staff as well as the internal audit staff of other government agencies. PKF is contracted by the World Bank.

At present, the CAO has 215 auditors on board all of whom are civil servants hired through the PRR process. There are 22 Grants Auditors who are considered as specialized auditors.

### CAO Achievements

Since the fall of the Taliban regime, the CAO has regained its membership in several international auditing organizations like the International Organization of Supreme Audit Institutes, the Asian Organization of Supreme Audit Institutes, and the Economic Organization of Supreme Audit Institutes.

Since 2001 the CAO has performed annual audits of projects funded by the Asian Development Bank, UNDP, and World Bank projects with technical assistance provided by the India-based audit firm Deloitte and beginning in 2002 by the international audit firm PKF.

The CAO is committed to auditing more than 670 budgetary units per year. In the fiscal years 1384 and 1385, the CAO conducted 569 and 615 audits, respectively, in Kabul and in the provinces. Over the past four years, several cases of misuse of public property, uncollected revenues, unpaid taxes, price discrepancies in procurements and other instances of errors/discrepancies were identified and referred by the CAO to the Attorney General's Office for investigation,

### Issues and Challenges

There is a lack of clarity in existing laws on the specific roles, responsibilities and authorities of the CAO and the MoF-IAD in regard to internal auditing. The CAO maintains that the MoF does not have oversight responsibility over other ministries' IADs and that the IADs in 39 audit entities were established by the CAO. The MoF-IAD on the other hand argues that the CAO is responsible for external audits only and that the MoF is responsible for internal audits. Due to these conflicting views, a presidential decree was issued to put Article 61 of the PFEM Law on hold until the passage of the CAO law.

We observed that the CAO lacks qualified staff. Currently there are no Afghan staff members who hold a CPA or equivalent qualification as there is no such program available in Afghanistan. There is a severe need for capacity building of the CAO staff.

In addition to staff resources, the CAO lacks other resources to fulfill its audit responsibilities. For example:

- There are currently insufficient computer resources for the staff.
- The staff needs technical assistance in report writing skills, especially in the English language.
- The staff needs training in AFMIS to be able to access the AFMIS database and effectively conduct their audit work. The auditors are not fully knowledgeable about IT audits.

### **Overall Observation – Control and Audit Office**

The CAO has limited capability to conduct audits of donor-funded projects. The CAO auditors are able to perform the required field work and prepare basic audit reports in the local language. However, preparing reports in English is a challenge.

The CAO would need technical assistance from international or local audit firms in order to fully comply with USAID’s audit requirements. Moreover, international advisors would be required to provide on-the-job training to the CAO auditors to improve their capacity and be able to fully comply with international auditing standards.

It is recommended that the CAO receive focused technical assistance to further enhance its staff capabilities and to provide them with the necessary resources (including equipment and facilities) to develop necessary skills required in the performance of their audit responsibilities. The CAO needs more than the limited support previously provided under USAID’s Capacity Development Project for attendance of CAO officials in regional conferences.

## **4. METHODOLOGY AND TEAM COMPOSITION**

The assessment methodology included interviews and walk-through of operating processes as well as observations of the work flow in the offices involved. Organizational diagrams and flowcharts were reviewed to obtain an understanding of the processes, flow of documents, and the sequence of procedures that are followed by the host government organizations visited.

The OFM Assessment Team was composed of:

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Jamaluddin Meraj	Financial Analyst
Masood Ashraf	Financial Analyst
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Mir Ubaid	Project Accountant
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