Afghanistan Reconstruction Trust Fund (ARTF)
Fiduciary Framework[1]
May 14, 2012

Introduction to Fiduciary Risk Management

The Bank is required by its Articles of Agreement to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due regard to economy and efficiency. Afghanistan Reconstruction Trust Fund (ARTF) funds, and all trust funds under the World Bank (WB), are subject to the same policies, procedures and level of attention as all other World Bank (IDA) financed activities. The agreements, processes and reports applicable to either the borrower or the Bank to provide assurance on due use is known as the fiduciary framework. This framework is set on the basis of a Bank assessment of the risks to due use and the conditions for the project implementation. Agreement is reached on appropriate implementation arrangements, including Bank supervision, which are then documented in a legal agreement or a Project Implementation Plan, as appropriate. In particular, the Borrower has to have, either before implementation begins or agree to establish early in project implementation, adequate procurement and financial management capacity. The Bank continuously reviews the fiduciary arrangements in place for its operations and must have in place risk mitigation measures to keep the fiduciary risk at an acceptable level.

The Bank employs a systematic approach to minimizing trust funds' exposure to fiduciary risk. This includes policies, procedures and practices that work together to identify, analyze, evaluate then address and monitor risk. Strategies for risk management, in the case of trust funds the Bank, do include avoiding unacceptable fiduciary risk by not accepting investment proposals with unacceptably high risk. Where the Bank does accept to fund a proposal, some risk is transferred to Government under the financing agreement since it agrees that ineligible expenditures will be refunded however the principle focus is made on: i) reducing the opportunity for loss through robust controls and ii) timely, competent independent review, to increase the likelihood of detection of loss and consequently the recovery of funds from the counterpart.

There are four basic fiduciary risks which the control framework is designed to address, corruption contributes to all of these risks: i) use of funds are not reported (i.e., funds drawn but never accounted for); ii) use of funds not made for the purposes intended by the Grant (i.e., used for non-budget expenses or security/military expenses); iii) use of funds without due consideration for economy (i.e., agreed procurement guidelines not followed); and iv) use of funds for unsubstantiated expenditures (i.e., expenditures that do not meet the agreed fiduciary standards).

[1] Paul Sisk, Lead Financial Management Specialist, SARFM, World Bank

Fiduciary Framework for ARTF

The ARTF was established in March 2002 by the international community, with the World Bank as Administrator, as a coordinated approach to fund the reconstruction of Afghanistan. The ARTF finances the National Priority Programs, a share of the civil recurrent cost of the annual budget and technical assistance for policy reforms. The ARTF has now been in operation for over ten years and as of April 30, 2012 had received donor contributions from 33 donors of over US$5.3 billion and had made disbursements over US$4.2 billion, comprising US$2.5 for recurrent costs and US$1.6 for investment projects.

The overarching governance framework for the ARTF is provided by a series of legal agreements. In April 2002, the World Bank Board of Directors approved the ARTF Board Document. This document sets out the context, purpose and management structure of the ARTF.

Separate donor (administrative) agreements with standard terms and conditions bind mutual accountability between the World Bank and the ARTF donors. These agreements set out the fiduciary and management responsibilities of the World Bank in its role as Administrator of the fund. Grant agreements establish the terms on which grant financing is provided to the Government of Afghanistan (GoA) by the World Bank as Administrator of ARTF[2].

ARTF operations are governed by a Management Committee, consisting of representatives of the Asian Development Bank (ADB), Islamic Development Bank, UNDP, World Bank and the GIRA. Day-to-day administration is undertaken by the World Bank as the Administrator of the ARTF. The Management Committee meets once a month.

ARTF Donors meet for ARTF Donor Committee Meetings on a quarterly basis to discuss the status and strategic direction of ARTF and to provide policy guidance to the Management Committee. The donor meetings are also an opportunity for the Government to present its priorities for ARTF funding in line with its budget and development strategy. A diagram of the governance structure is attached in Annex 1 below.

As Administrator, the World Bank's has responsibility for both phases implied in all trust operations; the first is to manage, control and report on funds received (contributions) from donors under Administration Agreements which are either in the custody of or disbursed by

[2] This refers to *Recipient-executed activities* - Recipient-executed trust funds involve activities carried out by a recipient third-party executing agency. The Bank enters into grant agreements with and disburses funds to such recipients, who are responsible for complying with the terms and conditions stipulated in the grant agreements, including submission of progress and financial reports for these activities to the Bank.

The ARTF also finances *Bank-executed activities* --Bank-executed trust funds involve the execution by the Bank of activities; specifically to finance the Monitoring Agents. The Bank prepares the terms of reference, procures goods and services, disburses funds, and submits progress and financial reports for these activities to donors.

the Bank; the second phase involves the supervision of the use of funds disbursed to or on behalf of the beneficiaries of the Grant Agreements[3].

For the first phase, the Bank has established effective internal control procedures over financial reporting of trust fund activities. That is, the receipt, cash management and disbursement to beneficiaries are subject to the Bank's Treasury and Accounting operations; the related controls are assessed and reported annually to the donors in a document known as the Single Audit[4]. See Annex 2 for the flow of funds for this phase. These procedures imply that all donor receipts flow to the WB Treasury and remain there until they are disbursed to the beneficiary either as an advance to a Special Account for expenditures to be made in country or as direct payments against contracts reviewed by the WB for overseas suppliers.

The rest of this note presents the fiduciary arrangements applicable to the second phase of trust fund operations that is for the use and reporting of funds disbursed to or on behalf of the GIRA under the authority of Grant Agreements; see Annex 3 for the flow of funds to the recurrent cost budget, which is the same for the other trust funds.

ARTF Funding Mechanisms: Addressing the four basic fiduciary risks, mentioned in the introduction, is simplified somewhat under ARTF financing by the fact that lending instruments under the ARTF are limited to investment projects (which include the recurrent cost trust). As such, there are no general budget support operations in place or proposed for the ARTF which would expose donors funds to transactions not subject to individual review and expose funding to misuses in any operation under the budget including the security sector, where the Bank performs no supervision. Under investment operations on the other hand, all funding (Bank disbursements) are made against specific inputs which must be deemed eligible as defined in the financing agreements. These transactions are isolated and presented to the Bank for prior review if they exceed the modest thresholds[5] agreed for the Afghanistan portfolio; transactions under these thresholds are subject to review by Bank staff after the transactions in semi-annual Bank supervision missions. All funded transactions are also reported quarterly to the Bank in progress reports and presented in annual financial statements which are audited by the Auditor General (CAO) with the technical support of a firm of qualified auditors selected through an international bidding process.

Use of Country Systems

At the outset of the ARTF Afghanistan's public administration systems were in disarray and there was little human capacity in public financial management (PFM) as such Afghanistan presented high risks, including risks related to the management of public funds. The Bank therefore took extraordinary measures to ensure adequate fiduciary controls; these measures involved, on one hand, technical and emergency assistance to the government to establish basic PFM systems and, on the other hand, intensive supervision by the Bank, or Bank agents in line with the residual fiduciary risk.

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[4] Report on Internal Controls over Financial Reporting & Combined Statement of Receipts, Disbursements and Fund Balance

[5] See footnote 7

The GoA through the MOF made a firm commitment in 2002 to fiscal discipline, with no monetizing of the deficit, and to fiscal transparency through the use of a comprehensive budget and full and reliable reporting.

On the strength of this commitment, the government agreed with the IFIs and donors a plan for the development of a robust public financial management system. However, given the weak state of PFM arrangement in 2002, there was a need for both a program of emergency support for PFM and a plan of reforms. The emergency support was successfully implemented by government very early in the reconstruction which led to the decision that all ARTF (as well as other donor on-budget) funds would flow through the centralized budget, accounting and cash management arrangements in MOF, as opposed to stand alone financial operations in project units. This approach not only reduced transaction costs and contributed to building government-wide systems but it also provided a robust segregation of duties between the agencies which carry-out the operations, and authorize payments, and the budget control, recording keeping, reporting and payments carried-out by the Ministry of Finance.

As such, the first and most important component of the fiduciary arrangements is the very same budgetary operations and related centralized oversight by the GoA itself. Elements of the emergency PFM operations support for these systems, put in place at the outset of the ARTF operations, which still apply today, included the following.

i) Budget Technical Assistance. With extensive donor funded operational support and technical assistance the government is able to prepare a budget that reflects the public spending priorities and is aligned with the Afghanistan National Development Strategy priorities. Budget documents explicitly discuss the alignment and the medium-term fiscal framework and are reviewed and approved by the Cabinet and the Parliament. The core budget classification system does provide a rough picture of general government activities and the budget broadly reflects the principles of comprehensiveness, unity and consistency for revenues and expenditures flowing through the government system.

ii) Procurement Facilitation Consultant. ARDS was established as the centralized procurement oversight and facilitation body with the assistance of a firm of internationally sourced procurement agents. In this regard, MOF issued a Budget Circular which stipulates that all procurement in the civil budget, particularly on donor-funded procurement, over a threshold of US$ 200,000 for goods and services and US$ 500,000 in works must be vetted by ARDS before the contact is given an allotment under the budget.

iii) Financial Management Consultants Firms in Treasury and Budget Depts. MOF had extensive assistance on budget control, accounting, reporting and cash management. This resulted both in a strong legal framework for PFM operations with the introduction of a modern, robust PFM Law. For Treasury's operations a firm has been in place to provide operational support, on-the-job training, strengthen then financial management regulatory framework and assist with the implementation of the Treasury Single Account. Additionally, MOF centralized both accounting and payments in Treasury which was in line with the modernization of their operations and implemented an automated financial management information system (AFMIS).

AFMIS is now the sole means of executing budget transactions in HQ and in all provinces as it is available in real time to all HQ administrative units and moustoufiats. It incorporates and automates budget recording, appropriation and allotment controls (including provincial allotments), general ledger recording and check printing (manual checks replaced with system generated checks). A key strengthening of AFMIS and a major accomplishment for MOF was the development and enforcement of a central vender registration data base in AFMIS whereby all vendors to government (firms or individuals) must hold valid tax numbers. This information, in addition to establishing the bona fides of vendors, has the ancillary benefit enforcing tax withholding.

Related to the form of payment, all vendor payments are made in favor of the vendor bank accounts in commercial banks similarly confirming the bona fide of vendors and reducing transaction costs. Direct transfer of salaries to bank accounts is also in place for more than 50% of civil servants, thereby reducing the incidence of intermediary salary pay offs and ghost employees.

Special Accounts: Notwithstanding the mainstreaming of ARTF funds in AFMIS, all project advances and uses for each individual project flow through a dedicated bank account referred to as a Special Account. Statements of these accounts accompany all requests for reimbursement to the Bank.

iv) Audit Consultants to Support Grant Audits. The Office of the Auditor General (CAO) in Afghanistan works under an out-dated, inadequate legal framework has little capacity to work to any recognized standard and has demonstrated resistance to reforms.

Given this circumstance, the Bank proposed to provide enough direct operational support in terms of services of an international firm of public accountants to the CAO so that the ARTF (and other on-budget donor funded) grant audits could be carried out by CAO in line with international standards on auditing and at the same time carry out on the job training for the grant audits unit staff of CAO. Success of the grant audits approached in this way was not impeded by the poor legal framework or the general lack of capacity of the CAO. In fact the WB assessment of the work by the CAO on grant audits indicates that the quality of assurance as well as the timeliness of the work is that work is satisfactory and that CAO is gaining capacity to conduct grant audits.

The Auditor's Reports generally conclude that overall the financial statements properly present the receipts and payments of ARTF and, where necessary, indicate any adjustments to the expenditures that should be made for ineligible expenditures found in the audit. The World Bank conducts a detailed review of the audit reports and related project financial statements and subsequently conducts follow-up with the borrower on audit findings and does ensure where applicable that funds are recovered.

Payroll Payments:
Wages and salaries represent more than 60 percent of the operating budget and since the civilian portion is eligible for financing under the ARTF Recurrent Cost Trust Fund. An overview of related controls is presented below.

Staffing caps allotments and pay scales. Controls over all payroll are based first on the staffing establishments (Tashkeels) which are proposed by the Ministries and approved by the Office of Administrative Affairs (OAA) during the annual budget process. The tashkeel provides the organizational chart for the ministry, detailing staffing positions and levels The other component needed by ministries and departments for processing payrolls is the takhsis (the salary allotment for the budgetary units) this ensures that payroll costs firstly relate to the approved staff levels and secondly that the spending is kept within this limit. In the absence of a centralized nominal roll, actual headcount is determined by the ARTF Recurrent Cost Monitoring Agent on the basis of reports of every payroll prepared by the processing units and sent separately to the Monitoring Agent. Head count reports are used to establish if tashkeel limits are respected.

The rates included in the payrolls are set through the Independent Administrative Reform and Civil Service Commission which is responsible for oversight of appointments and promotions (for positions at grade two and above), civil service management, and administrative reform. Every public employee has a personnel grade. Civil servant wage rates and pay policy are established centrally for all public employees in Afghanistan. Two base pay scales – one for contract staff and another for permanent staff – apply equally everywhere in Afghanistan. There are separate pay scales, however, for teachers, the army, and police. In addition, several new programs allow higher pay rates, based on a clear vision of core responsibilities, structural reorganization, and merit-based appointments. The Government is well advanced with the implementation of a new pay and grading program which addresses the excessive concentration of the current scales and to improve compensation.

Payroll processing: Payroll expense is controlled in aggregate through tashkeel, allotments and uniform pay scales set by central authorities; personnel management and payroll processing, on the other hand, is the responsibility of each primary budget unit which in turn decentralizes this to over 3000 personnel and payroll units. Some Mustofiats prepare payroll for many of the Provincial Budget Units. This decentralization facilitates the timeliness and accuracy of payroll since personnel records can be updated by those conducting the contracting. Payrolls may be prepared manually or may also be prepared from stand-alone automated payroll systems; for instance in the Computerized Payroll System (CSP) developed by MoF in MS-Access. Central authorities do not impose any standard for this processing or establish any minimum requirement to link to personnel records. The request for funds to pay payrolls follows the procedure used for any other payment, with the payroll sheet used as support. After the requisite authorizations in the budgetary unit are given, including that of MoF's Financial Controllers within the budgetary unit, the requests are reviewed by the MoF in Kabul or the Mustoufiats. This review is limited to matching the payroll sheet to the request for funds, viewing the allotment ceiling for salary and for positions (Tashkeel), but does not extend necessarily to underlying records. Actual payment of payroll may be either in total as an advance to a representative of the processing unit (who later distributes the pay to members of the unit) or as bank transfers to the individuals.

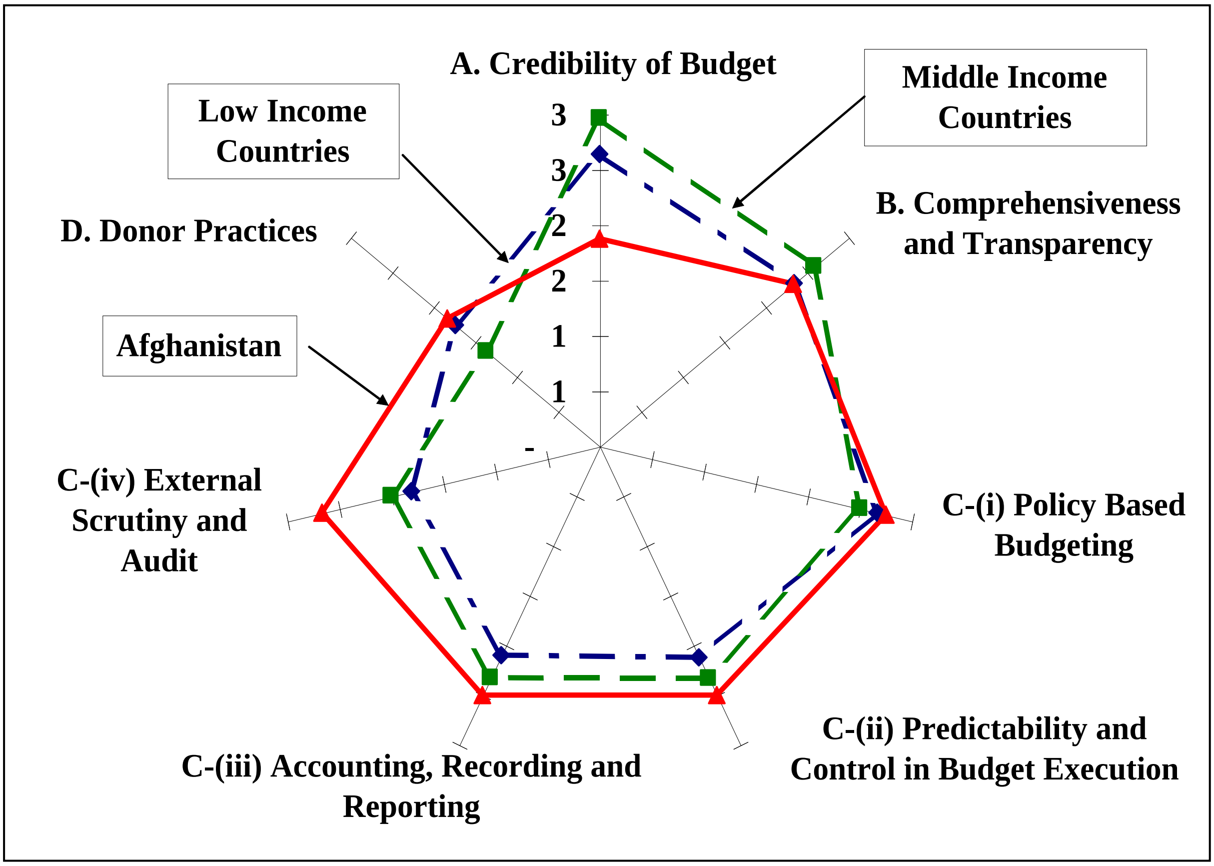
Verified Payroll Program (VPP). MoF is leading an initiative to verify the national payroll. The program aims to eventually make direct bank deposits for all government employees civilian and non-civilian. The program comprises first establishing the bona fides of all members of a payroll unit by reviewing the supporting credentials and matching these to the individual, then incorporating the data of these individuals in a basic personnel data base. The payrolls for the related unit thereafter are generated in a basic payroll application (CPS) provided by MOF or reviewed by MOF, which can generate pay only for those individuals who are in the personnel data base of verified staff. All staff in the personnel data base must equally open a bank account and be issued a bank identification card. The last stage of the program is for the related payroll to be distributed by direct bank deposit in a commercial bank account of staff. About 50% of all government employees are currently receiving direct bank deposit under the program.

Performance of Government-Wide Systems:
The government-wide arrangements described above were assessed by the PEFA[6] studies of 2005 and 2008, which depict a framework where all public funds in the general government sector are controlled through a single budget which is prepared in an orderly and transparent manner, approved by Parliament, and under which all uses are permitted only against due approvals of the appropriation holder. Moreover, the basic legal framework underlying the PFM and procurement systems has been established and public finances are by and large being used for their intended purposes as authorized by a budget and the revenue, expenditure and cash position of the Government are reported regularly and reliably and there is adequate external review of the use of most donor funds, although overall audit capacity is weak.

Afghanistan's PEFA ratings compare favorably to a sample of other low-income and middle income countries as presented in Graph 1 below.

[6] See more details in "Afghanistan: Public Financial Management Performance Assessment" (World Bank and DfID, June 2008)

Graph 1: Afghanistan's PEFA Ratings



<u>Corruption Risk:</u>
The risk of corruption as it relates to use of funds for approved purposes deserves separate mention in this discussion of fiduciary control. Transparency International consistently rates Afghanistan among the most corrupt countries in the world. This perception is supported by media reports and the Government's own acknowledgement that corruption is a major problem, as well as by the World Bank's own diagnostics.

The first step in designing the ARTF fiduciary framework to deal with risk was to understand the forms of corruption occurring in Afghanistan and how these could result in misuses of donor funds on budget. The kind of corruption that tends to be most visible to citizens in their daily lives is ***petty corruption***, in the form of ***bribery*** as well as ***extortion*** which involves payments for benefits or favors received by a corrupt person or entity either to i) not apply the rules (selective law enforcement) or ii) apply the rules (gain access to utilities and social services). While prevalent in Afghanistan, these forms of corruption do not directly threaten donor funds on budget since they are directed at the funds of private citizens or firms. Grand corruption and patronage are other forms of corruption which are serious threats to development but again do not represent direct threats to donor funds.

Two forms of corruption which are threats to donor funds are procurement corruption and financial leakages. ***Procurement*** corruption can take place in each step in the procurement process which extends from the identification of the needs up to contract award/acceptance/payments and in the case of works contracts, the implementation stage is particularly vulnerable. This corruption takes the form of bribery to subvert the procurement process, favoritism on the part of the contracting entity and, fraudulent practices to award contracts to pre identified contractors and conceal the true basis for the award. In addition, corruption can be perpetrated by collusive bidding (agreements among bidders to fix high prices and exclude competitors. All of these may involve inappropriate use of donor funds since the price of inputs paid for with donor funds may not be market price, and/or the quality of what is delivered may be inadequate. ***Financial Leakages*** of public funds comprise the misappropriation of funds or others assets and concealment of the loss by misreporting. This may occur through either the deviation of revenue, which is due to the state, or the misuse of funds or assets already under the control of the state.

The key remedies against procurement failures include: a regulatory framework with clear and transparent rules and processes; transparent reporting (at the invitation of bids and at the award stage); strengthened capacity (in public and private sectors); and adequate external oversight. In Afghanistan the legal framework for procurement with donor funds has always been clear since these are specified in donor agreements and provide for fair and transparent procurement; these agreements may allow the use of national procurement procedures. Similarly, transparency is promoted both by donor interventions in their supervision of procurement and by the centralized procurement facilitating advisors under ARDS, who participate in the review of all non-security sector procurement over $200,000 for goods and services and $500,000 for works. In addition, ARDS maintains a web-site where all calls for bids and awards for this procurement is published. An assumption underlying these controls, of course, is that fair and open competition will lead to economic procurement; the framework does not extend to control of how the contractor should invest to obtain the results as long as the bid is responsive to the requirements and compares to market price.

The risk of financial leakages of donor funds is mitigated first by Treasury Department's government wide controls whereby all income and expenditures are subject to recording in an integrated financial management system and are reconciled with DAB bank statements and donor statements of contributions. The state of these controls is regularly reviewed by the World Bank.

In addition to these government-wide controls, as explained below, a Monitoring Agent is hired by the World Bank, as Administrator of the ARTF, who is mandated to review the submissions of the Government for reimbursement of the recurrent costs. The work of the Monitoring Agent and other donor supervision of operations, also described below, contribute to manage fiduciary risks.

As mentioned in the ARTF Funding Mechanism, all ARTF funds are tied to specific inputs and are subject to Bank prior and post review of individual transaction which work together to manage the risk of corruption; this approach focuses on prevention over punitive measures. This approach is in line with the current limited capacities of Afghanistan where enforcement agencies do not yet represent a strong deterrent to corrupt practices. Nevertheless, while prudent measures have been developed and their application is monitored regularly, it must be accepted that, as is the case with all control frameworks, there is no certainty that abuses will not occur or that they will be detected.

Bank's Direct Supervision of ARTF Project Operations

Shortcomings in the Government's framework, however, include an absence of effective internal audit across government and external audit not conducted to an acceptable standard (outside of the annual audit on WB funds under the Recurrent Cost and investment projects), low capacity in procurement in spending ministries, and frequent lack of compliance with the public finance and procurement legal framework. These weaknesses are considered when the Bank sets the implementation arrangements which include the extent and form of its supervision.

Bank supervision of the projects aims both to monitor progress in all substantive aspects against an agreed set of criteria expressed in a results framework with performance indicators and to establish whether there was compliance with legal agreements, including fiduciary controls. This work involves the review of the client or third party reports agreed with the borrower (physical progress, financial and audit reports), visits to project sites and facilities and detailed discussions with all implementing agencies to establish. In particular, the correspondence of physical progress of operations with the use of funds is reviewed and the application of the agreed implementation arrangements is examined by first hand review, reviewing audit reports and Bank correspondence. In Afghanistan, all projects documents call for semi-annual project supervision and related assessment.

Prior and Post Review: Bank supervision also includes specific transaction review for compliance with procurement and eligibility rules which is effected by means of prior review and post review.

In prior review the Bank conducts an examination of the related documents and issues a requisite no objection letter (NOL) only once the same comply with the procurement guidelines presented in the legal agreements. Prior review in Afghanistan is required for all contracts over modest thresholds[7], which are the same for all projects in Afghanistan since the country is rated as high risk. In the case of goods and work, the prior review calls for the WB task team to review of all draft documents to be used in invitation to prequalify; the report evaluating the applications, the draft bidding documents, detailed report on the evaluation of the bids. For the selection of consultants the Borrower will request a NOL for the Requests for Proposals and short list; the Technical Evaluation Report; the final

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	Selection Method	Prior Review Threshold ($)	Comments
1.	Competitive Methods (Firms)	More than 100,000 equivalent	
2.	Individual Consultant	More than 50,000 equivalent	
3.	Single Source (Firms)	All	
4.	Single Source (Individual)	All	

	Procurement	Prior Review Threshold ($)	Comments
1.	Goods	200,000 Equivalent or more	
2.	Direct Contracting (Goods and Services)	All	

evaluation report and the negotiated contract. Any significant modification to signed contracts, subject to prior review, also needs Bank NOL.

Prior review contracts are entered in the WB Disbursement systems where they are vetted against black lists of debarred suppliers and anti-laundering and anti-terrorists controls. Disbursements against prior review contracts are made on the request of the Borrower; the World Bank Controllers Dept verifies the requests against supporting invoices and the contracts duly vetted in the system. This is done before payment in the case of direct payments and before reimbursement in the case of payments made from the Special Account.

Post review, that is after-the-fact review, is carried out, on a sample basis, on transactions under the prior review threshold. The borrower is required to retain for review by the Bank all documentation with respect to each contract; for goods/ works this includes: the contract, amendments, bid evaluation report, recommendation for award, payment invoices, certificates of inspection/delivery, acceptance of goods and for consultants. For consultants the documentation to retain for review includes: the contract, technical evaluation report, combined evaluation report, recommendation for award, payment invoices and certificates of deliverables. For contract awarded on a single-source selection basis, the justification and qualification of the consultants must also be retained.

Post review also includes the examination by Bank staff of the Statement of Expenditures (SOEs) used to support request for reimbursements. The SOEs are first compared by the WB Disbursement Unit to the statement of the Special Account at the time of reimbursement to establish that the amounts actually were paid from the Special Account. The post review work extends to establish that the Special Account is reconciled to the accounting records and that the documents on hand for a sample of items in the SOEs do substantiate that the payments were goods or services in the project period and for duly approved invoices relating to valid contracts and are supported by evidence of receipt of goods or delivery of reports and time sheet of consultants.

Monitoring Agents

Two needs arise with the ARTF portfolio to complement Bank supervision. The first is for the investment projects with works in rural areas and the second is in expenditures under the Recurrent Cost Trust Fund.

Supervisory Agent for Investment Projects:

To address the difficulty in tracking and monitoring project execution at the field level in particular for asset verification and quality assurance, the Bank contracted a 12-month pilot phase for the 3 projects which spend most at the provincial level: The Education Quality Improvement Program II (EQUIP II); The National Solidarity Program (NSP III); The National Emergency Rural Access Program (NERAP). This service will complement the Bank's own supervision as a total of 1500 project site visits will be effected during the first year of operation. An agreed set of indicators will form the basis of the Monitoring Plan. It is expected that the service will be continued and expanded after the Pilot.

Monitoring Agent for Recurrent Costs:

A Monitoring Agent is also engaged by the Bank to review recurrent cost expenditures for compliance with the eligibility criteria under the ARTF Recurrent Cost Trust Fund. The attached flow chart (Annex 4) presents an overview of the fiduciary arrangements.

The cash flow for the recurrent cost funding, uses an advance to a Special Account and follows standard World Bank practice for investment project operations. The government draws down from the Special Account as it makes expenditures and routinely submits Withdrawal Applications supported by a Statements of Expenditure (SOEs) which is drawn from AFMIS. Reimbursement is made to the Special Account which is continually replenished.

The Monitoring Agent's review of expenditures comprises first, an assessment of the controls applicable to the expenditures to be reimbursed and then based on this assessment the Agent plans and carries out a review in two steps: (i) a desk review of all expenditures and (ii) site visits to test a sample of expenditures against support. Central to the work of the Monitoring Agent is the understanding that all non-security recurrent costs are monitored. In the fiscal year ending March 2011 (SY 1389) non-security expenditures, which are all subject to monitoring, came to US$ 875 million while ARTF disbursements against this was only US$ 288 million or 32%. For the current solar year this drops to less than 20%.

<u>Desk Review:</u> The objective of the Monitoring Agent's desk review is to identify expenditures that are not covered by the ARTF. The desk review is applied to 100% of expenditures recorded in the centralized integrated financial management system against the recurrent budget. The Monitoring Agent performs the desk review before the withdrawal application is submitted to the World Bank.

The desk review is an automated function to identify all expenditures for non-eligible budget entities (i.e., Ministries of Defense, National Security and Interior). These expenditures are then excluded from the submission to the World Bank. Also, expenditures that are charged to suspense accounts and advances are identified and excluded from the submission to the World Bank. Lastly, material items may be queried depending on the history of ineligibility of the budget entity submitting the expenditure. Only the remaining expenditures are included in a Statement of Expenditure (SOE) and submitted for reimbursement by ARTF.

<u>Site Visits.</u> This work is done on a sample basis. The site visit involves the examination of the documentary support for expenditures that were included in the SOEs. The review takes place at the location where the expenditure is paid.

The approach to monitoring expenditures varies by type of expenditure; Payroll, Non Salary Based Payroll, Pension and O&M. The work of the Monitoring Agent for payroll, considers the additional controls applied to payroll: centralized control of authorized posts, centralized head count data base and the verified payroll program. These arrangements contributed to a relatively low level of ineligible expenditures detected in payroll payments. The Monitoring Agent uses statistically representative samples drawn from the expenditures of the whole year and carries out detailed testing back to personnel records, time sheets and witnessing the payee. Pensions are similarly treated although witnessing is not possible since payees are not easily accessible.

For O&M and non-payroll based salary payments, however, the selection of the size of samples is much larger since O&M represent a higher inherent risk due higher control risk of the operations carried out more independently than payroll. The sample, for example, includes all O&M expenditures over a prescribed threshold. Also, individual expenditures raising any fraud flag[8] are selected for testing. Lastly, the balance of O&M is subject to selection by statistical sampling for similar testing. This risk-based approach is designed to reduce the possibility of ineligible expenditures being funded through the "unmonitored" part of expenditures, though it does not eliminate the possibility.

All items found ineligible are subtracted from the following month's request for reimbursement effectively substituting new eligible expenditures for those found ineligible.

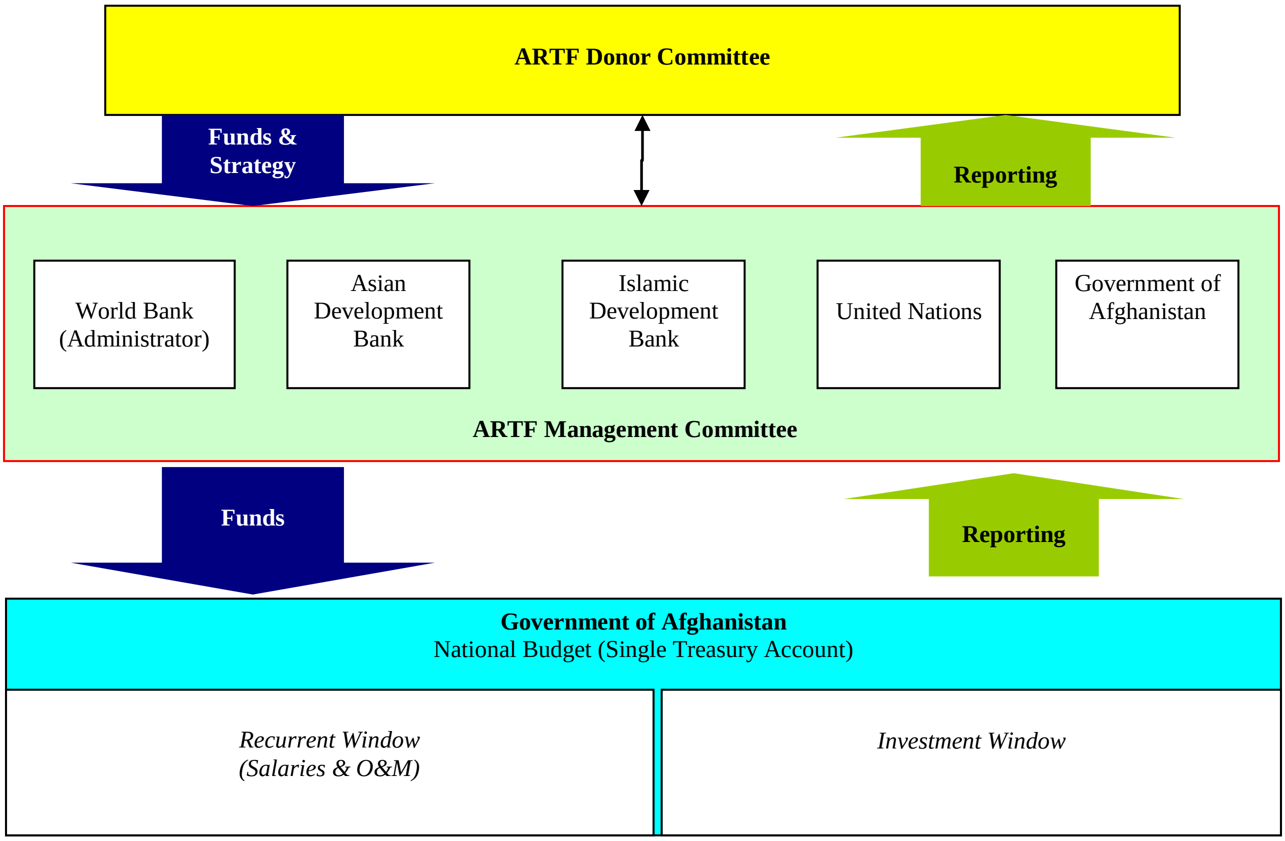
Measuring and Reporting Ineligible Expenditures. Regardless of the level of funding or the specific expenditures reimbursed, the Monitoring Agent reports on the ineligibility of the whole of the non-security recurrent costs. Since most site visits take place late in the year or even after year-end only the final levels of ineligible expenditures are representative. Nevertheless, during the year, the results of the fiduciary work by the MA are reported in detail monthly to the Administrator on monitoring and ineligible expenditures by type of expenditure, cause of ineligibility and by budget unit.

Ineligible Expenditures: Ineligible expenditures are defined as expenditures on ARTF activities that do not adhere to government financial regulations or the agreed fiduciary standards for the ARTF. At the outset of the ARTF high rates of ineligibility translated to less funding because ARTF's contribution to the operating budget was very high. However since SY 1385 (ending March 2007) funding by ARTF has been below 50%. Starting about the same time, and despite steady progress in enhancing PFM capacity and performance in fiscal control and transparency, the share of non-security recurrent costs which are found to be non-compliance with eligibility rules, became excessive and reflect an inability on the part of the GIRA to apply its own rules on procurement and financial management.

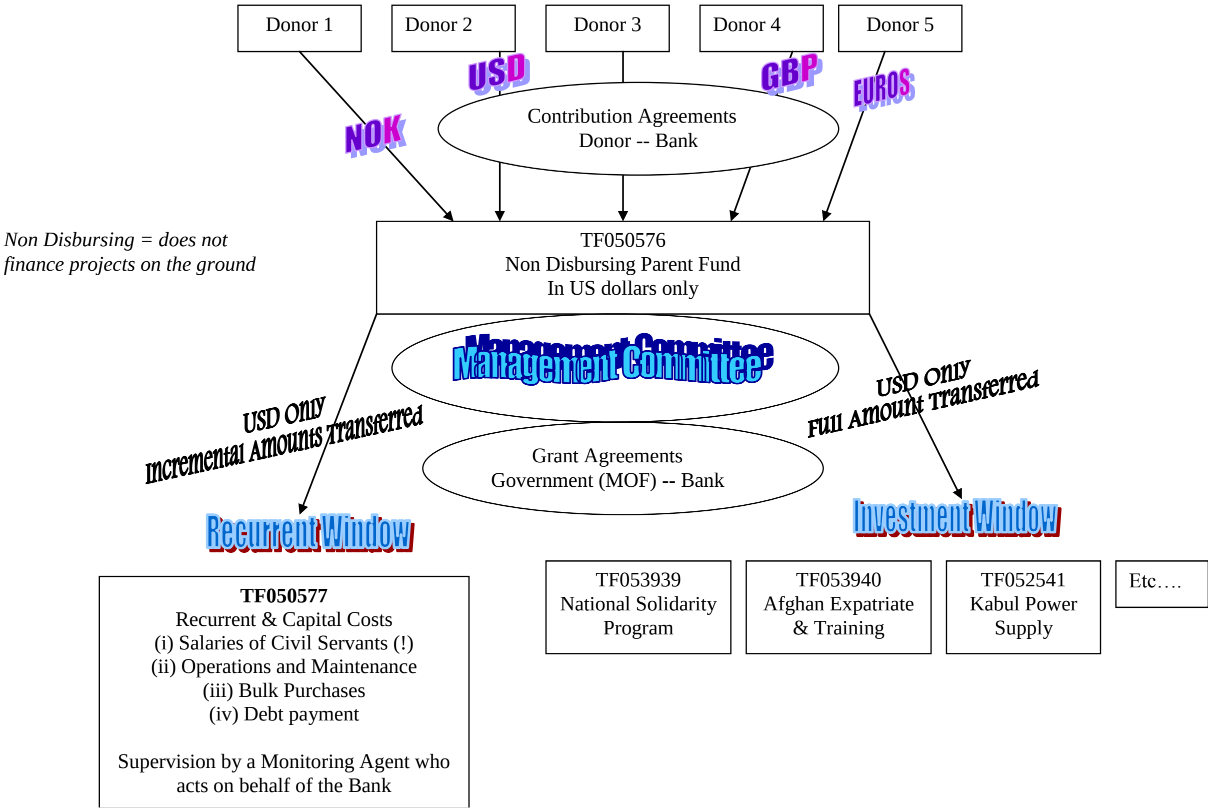
So while the fiduciary arrangement do provide good assurance against reimbursing ineligible expenditures under the recurrent cost trust fund, the high level of non-compliance affects perceptions of accountability and impacts donors' willingness to channel funds through the core budget mechanism and particularly for recurrent cost reimbursement. In particular, it undermines making the case for more support to the GIRA budget on the grounds that the government's fiduciary standards are continuing to improve. It also affects any proposal to adopt performance based funding which imply reliance on government-wide systems with funding of expenditures that are not ringed-fenced; that is, identified separately and subject to prior and post review.

[8] Could be amts pay to particular supplies, in particular amounts or any indication of improper expenditures but also payments made by ministries with a history of higher ineligibility.

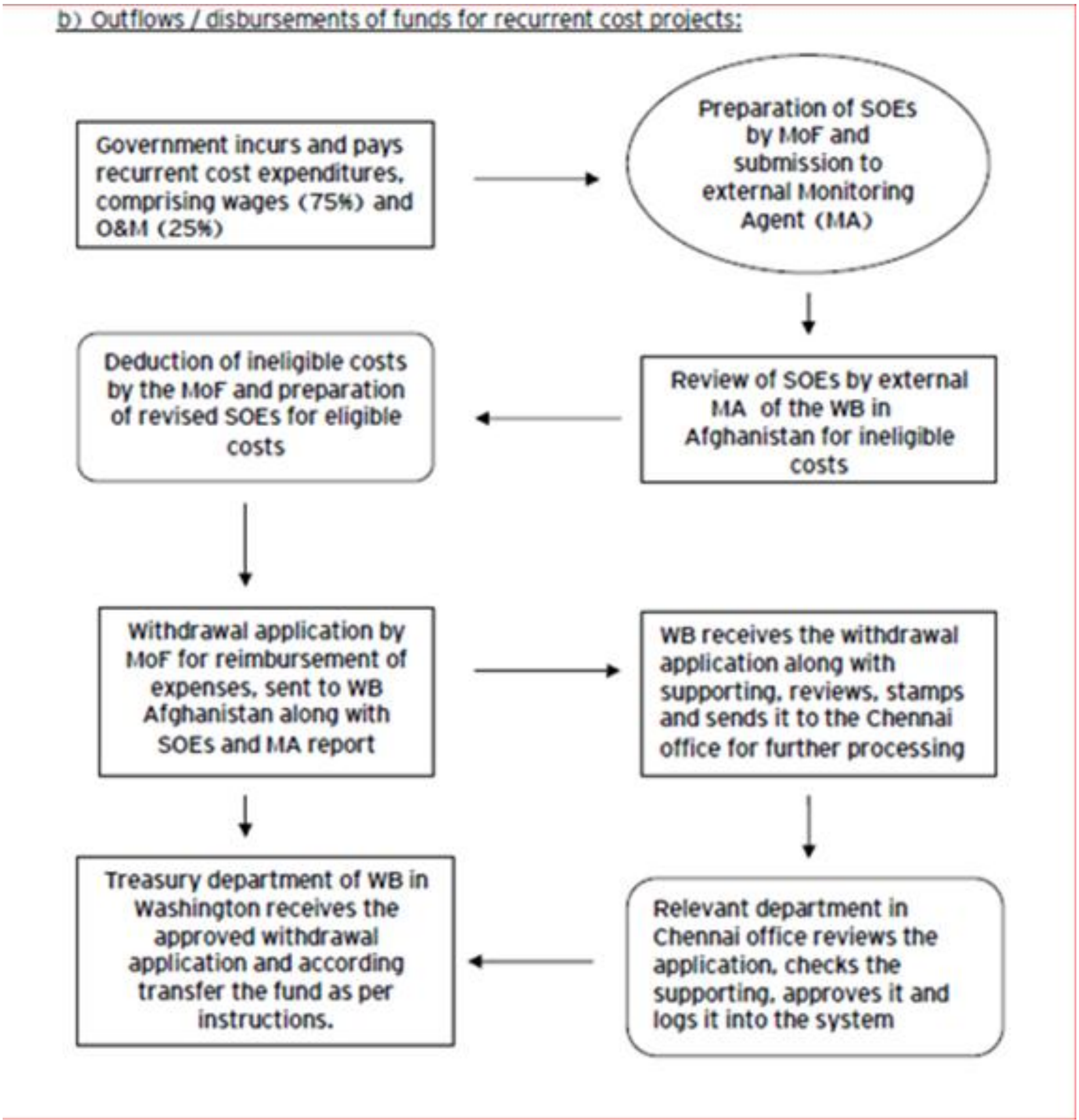
Annex 1
ARTF Governance Structure



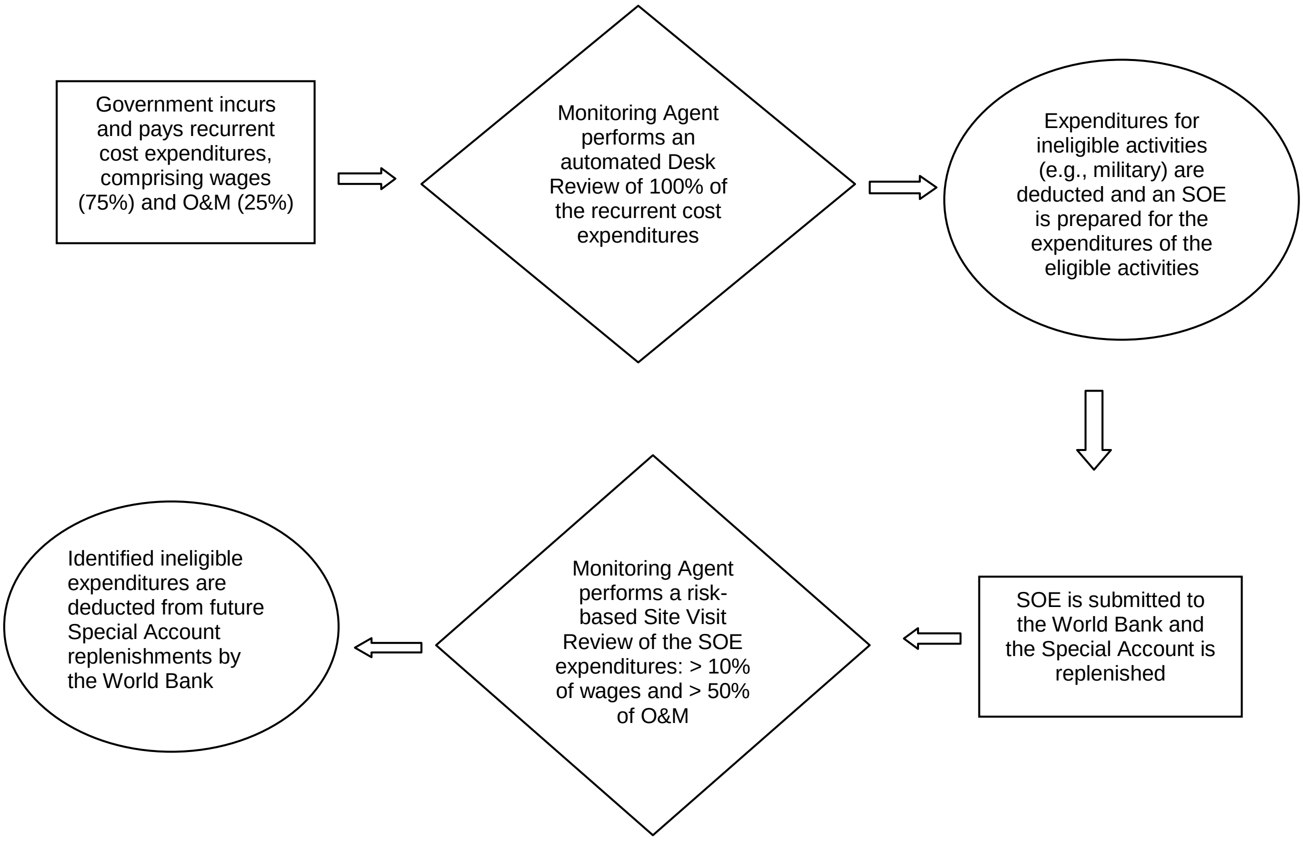
Annex 2
Funds Flow Diagram



Annex 3
Recurrent Cost Flow of Funds



Annex 4
ARTF Recurrent Cost Monitoring Process



Impact of External Audit: Ineligible expenditures identified in the annual external audit of the government's financial statements are reviewed by the World Bank and Monitoring Agent and deducted from future SOEs.