Islamic Republic of Afghanistan

Expanding Microfinance Outreach and Improving Sustainability Project

Redacted Report

September 2013
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Executive Summary

This report provides the findings of an administrative inquiry (the investigation) by the World Bank Group’s Integrity Vice Presidency (INT) into allegations that Subsidiary 1, an Afghanistan-based NGO and locally registered limited liability company, majority owned by Company A, misrepresented loan repayment rates and improperly manipulated source data in Subsidiary 1/Company A’s Management Information System in order to conceal financial losses and misappropriation of funds under the World Bank-financed Expanding Microfinance Outreach and Improving Sustainability Project in the Islamic Republic of Afghanistan.

INT’s investigation found evidence indicating that Subsidiary 1 staff breached information systems to manipulate indicators of program effectiveness in order to give the impression that Subsidiary 1 was performing better than it actually was. Through an analysis of Company A’s internal investigation, INT found further evidence suggesting that Subsidiary 1 officials had routinely changed reporting figures to match the manipulated information system data.

Based on its review of documents provided by Company A and the Project Implementation Unit (PIU), as well as its own investigation, INT concluded that Company A presented an accurate estimate of fraud losses attributable to Subsidiary 1’s conduct and misappropriation of Bank funds. However, INT emphasized that any estimate of fraud losses in this case is inherently subject to a high level of uncertainty because information system safeguards were breached, data was manipulated, and figures were misreported by Subsidiary 1 staff across many branches.
Background

The Expanding Microfinance Outreach and Improving Sustainability Project (the Project) in the Islamic Republic of Afghanistan aimed to achieve operational sustainability for a majority of local microfinance service providers (MFPs) and help them scale up outreach of financial services to meet the demands and needs of many poor Afghans, especially women. In order to accomplish this objective, the Project sought to increase sustainability of MFPs that have begun the process of diversifying their funding sources to include commercial sources in addition to funds provided by the Government of Afghanistan. In addition, the Project expanded outreach efforts to include increased numbers of poor people in most provinces throughout the country. Financed by an IDA Grant (H348-AF) in the amount of approximately USD 30,000,000.00, the Project became effective in June 2008, and closed in June 2012.

Subsidiary 1, an Afghanistan-based NGO majority owned by Company A, was engaged by the PIU to implement microfinance activities under the Project. Although Company A is a majority owner of Subsidiary 1, the companies are two separate, distinct, corporate entities.

Allegations

In June 2012, INT received a complaint that presented concerns regarding alleged systemic manipulation of data systems under the Project. Subsequent information obtained included evidence concerning Subsidiary 1 as further discussed herein.

INT obtained evidence indicating that, in October 2011, Company A self-reported to the PIU that it had uncovered serious issues within the Management Information System (MIS) used by Subsidiary 1 for the recording of risk information, in addition to uncovering the misrepresentation of financial statistics and misappropriation of funds by staff in some of their branches. According to evidence obtained by INT, Company A’s internal audit found evidence suggesting that Subsidiary 1 managers were misrepresenting loan repayment rates to the beneficiaries in monthly reports and altering inputs in the company’s data system to reflect the reported figures. INT found further evidence indicating that, at the time it self-reported, Company A was unable to quantify the amount of the missing funds.

INT found further evidence indicating that, after Company A self-reported, Company A and the PIU agreed that Company A would engage a third party auditor to review previous Subsidiary 1 loan reporting and financial statements. Such evidence indicates, however, that Company A was unable to retain a third-party auditor and consequently conducted its own internal audit. As discussed below, INT found evidence indicating that Company A’s internal audit was marked by significant limitations.

Methodology

In response to the above-referenced allegations and information, INT conducted its own investigation. INT’s investigation consisted of a review of information provided by the
PIU, which included various correspondence with Company A and Subsidiary 1, as well as financial audit reports and source documents provided by Company A related to its internal audit. INT staff also made several follow-up document requests and interviewed key Company A officials. Due to high security risks in Afghanistan, it was not possible to conduct a forensic audit of Subsidiary 1 during the course of INT’s investigation.

Findings

According to Company A’s internal audit and INT’s investigation, INT found evidence as follows:

1) Evidence indicates that Subsidiary 1 staff manipulated Subsidiary 1/Company A’s MIS in order to conceal financial losses and misappropriation of funds under the Bank-financed Project.

Company A informed INT that in conducting due diligence relevant to the sale of another entity owned by Company A in the same country, Company A staff noticed a rapid deterioration in the risk information of that entity, which was doing small and medium enterprise financing. Company A questioned why they were not seeing such a similar decline in risk information quality from their own internal MIS used by Subsidiary 1. This discrepancy in performance initiated Company A’s internal investigation into Subsidiary 1.

According to Company A, an internal audit team from Company A traveled to Afghanistan to conduct a thorough review of Subsidiary 1. This initial work identified two major issues. First, Company A found that Subsidiary 1’s organizational discipline had broken down and internal controls mechanisms were no longer functioning properly. Specifically, the audit and monitoring units had become ineffective and had been marginalized by Subsidiary 1 management. Second, MIS safeguards had been breached. MIS source code was shared by Company A with the Subsidiary 1 Management team which led to major and significant manipulations of data in many branches by Subsidiary 1 staff. Further, the risk information calculation (an operational indicator of program effectiveness) had been manipulated and misreported by Subsidiary 1 management to both Company A and the PIU. Company A found evidence suggesting that Subsidiary 1 staff misreported figures so that the risk information calculation was lower than it really was in order to give the impression that Subsidiary 1 was performing better than it actually was.

In response to its findings, Company A sent an IT team to investigate the manipulation of MIS data. Company A uses micro-finance software which is off-line (branch by branch). Finance and accounts staff does the data entry at the various branches—at the end of the month the data is input either on to a CD, in some cases it is a pen-drive, and then physically sent to the country office, which then runs it through consolidation software upon which various reports are produced. The idea is that any data correction after date of closing can only be done at a certain level of authorization. Through its internal investigation, Company A discovered that Subsidiary 1 Regional Managers routinely had gone back and changed reporting. Subsidiary 1 Regional Managers are not authorized to
change reporting figures and were only able to do so because the authorization passwords had been compromised, via sharing.

According to Company A’s internal audit, the practice of falsifying data had been engaged in for several years, with full knowledge of the former Country Representative and former Program Managers. Company A’s audit found that the former Subsidiary 1 CEO falsified reports to both the PIU and Company A for almost two years. Through examining internal audit reports, Company A also uncovered that internal audit teams had reported branch level fraud that the Country Representative did not act on. Company A did not know these reports were coming in though they had been submitted to Subsidiary 1 management staff.

Company A’s findings revealed wide scale misappropriation of Bank funds by its staff in approximately 21 offices. The total of misappropriated funds was initially reported as over US$ 1.5 million. Additionally, more than US$ 40,000 in cash was misappropriated however it is unclear if these funds belong to the Project or Subsidiary 1. Company A has acknowledged responsibility for the mismanagement and fraud that had occurred and offered to pay the PIU more than US$ 2 million to cover the losses.

As a result of Company A’s investigation of management problems in the field, a number of senior Subsidiary 1 staff were terminated, including the former Country Representative, three Program Managers, nine area and regional managers, and the head of IT, for their roles in manipulating the MIS data and reporting false risk information data. In addition to terminating 18 expatriate employees, Company A terminated nearly 200 national staff from Subsidiary 1 including the former CEO. Company A has filed criminal charges with various local authorities against those Subsidiary 1 staff who were identified as having stolen funds. Company A has also informed the PIU that it intends to exit the microfinance sector in Afghanistan as it considers that it is not possible to "save" the institution. Subsidiary 1 will soon cease operations and be closed. Subsidiary 1’s license to operate in Afghanistan expired in June 2012 and it is currently going through a dissolution process.

2) Evidence indicates that Company A presented an accurate estimate of fraud losses attributable to Subsidiary 1’s misconduct and misappropriation of Bank funds; however any estimated fraud loss is subject to a high level of uncertainty due to case-specific obstacles that prevent a more thorough investigation.

According to Company A, it undertook an internal forensic audit to determine the amount of the funds lost to fraud and misappropriation. Company A’s audit estimated that approximately US$1.8 million of the outstanding funds was a loss attributable to fraud and mismanagement. Company A’s audit faced several intractable obstacles. As noted previously, Company A’s audit found that Subsidiary 1 officials had altered MIS records in order to hide some of Subsidiary 1’s fraudulent activities. Due to this past manipulation of source data, any information extracted from Subsidiary 1/Company A accounting systems is unreliable.
In addition to problems concerning corrupted data systems, there was no realistic ability to conduct on the ground “third-party” forensic audit activities due to the unstable security situation in Afghanistan. It should be noted that Subsidiary 1’s operations under this program were highly decentralized in remote parts of the country, some of which are under Taliban control. Nine Subsidiary 1 staff members were killed during its operations in Afghanistan. These same obstacles prevented INT from conducting its own forensic audit in a reliable, cost-effective, and safe manner.

Based on its review of the documents provided by the PIU and Company A’s internal audit findings as well as information obtained through interviews with top Company A officials, INT did not identify any flaws in the methodology employed by Company A for estimating the fraud losses or locate any information that calls into question Company A’s estimate of those losses. However, because MIS safeguards were breached and data was manipulated and misreported in many branches by Subsidiary 1 staff, any estimate of the fraud losses is inherently subject to a high level of uncertainty.

**Corrective Actions Taken by the Bank**

The Bank engaged an outside consultant to assess the oversight arrangements developed by the PIU for monitoring the use of proceeds made available to Company A, the application of these arrangements, and the timeliness and appropriateness of actions by the PIU in response to information of misuse in Company A. The report concluded that the PIU acted appropriately in this situation in protecting both the interests of IDA as well as the Afghanistan Ministry of Finance.

In response to INT’s findings below, the PIU terminated its financing agreement, termed all funds as “repayable on demand” and subsequently made demands for all outstanding funds. Company A has repaid the balance of the Project funds it held, but the PIU estimates that approximately US$ 9.5 million remains outstanding. Some of those outstanding funds are attributed to the misappropriation and mismanagement that Company A self-reported. The balance of the outstanding funds relates to loans that are unlikely to be repaid.

INT will not seek sanctions against Subsidiary 1 as the entity is being dissolved and as its parent company, Company A, self-reported this matter and promptly took corrective action.