



Office of Inspector General

September 29, 2010

MEMORANDUM

TO: USAID/Afghanistan Director, Earl W. Gast

FROM: Regional Inspector General/Manila, Bruce N. Boyer /s/

SUBJECT: Review of Security Costs Charged to USAID Projects in Afghanistan
(Review Report No. 5-306-10-002-S)

This memorandum transmits our final report on the subject review. In finalizing the report, we carefully considered your comments to the draft report and included the comments (without attachments) in Appendix I.

Although not an audit, the review report does contain four recommendations to help USAID/Afghanistan reduce the likelihood that subcontractors will misuse USAID funds to pay off Taliban insurgents or other criminal elements and to mitigate the risk of fraud within its Local Governance and Community Development Project.

On the basis of the information provided by the mission in its response to the draft report, we determined that final action has been taken on Recommendation 2, and a management decision has been reached for Recommendation 4. Management decisions for Recommendations 1 and 3 can be reached when we agree with USAID/Afghanistan on firm plans of actions, with timeframes, for implementing the recommendations.

A determination of final action for Recommendation 4 will be made by the Audit Performance and Compliance Division (M/CFO/APC) upon completion of the proposed corrective actions. Please advise our office within 30 days of the actions planned or taken to implement Recommendations 1 and 3.

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

SUMMARY

The Regional Inspector General/Manila conducted a review of Edinburgh International's security costs charged to the following three USAID-funded projects in Afghanistan implemented by Development Alternatives, Inc. (DAI):

- Afghanistan Small and Medium Enterprises Development (ASMED)
- Incentives Driving Economic Alternatives for the North, East, and West (IDEA-NEW)
- Local Governance and Community Development (LGCD)

The objective of this review was to determine whether there has been any indication that Edinburgh International misused USAID funds to pay the Taliban or others in exchange for protection. The review covered the period from January 1 to December 31, 2009.

The review found no indication that Edinburgh International had misused USAID funds to pay the Taliban or others in exchange for protection. However, there were indications that Afghan subcontractors working on the LGCD project had paid insurgents for protection in remote and insecure areas of Afghanistan. The payments were allegedly made as part of a security arrangement with local communities that very likely included the Taliban or groups that support them. We also found indications of pervasive fraud in DAI's LGCD office in Jalalabad and indications of endemic corruption in Nangarhar Province, where Jalalabad is located. We referred these findings to OIG/Investigations for further investigation.

BACKGROUND

USAID/Afghanistan relies on private security contractors (PSCs) to supply an array of security services for contractors and grantees that implement USAID-funded projects in Afghanistan. PSCs free up military forces for their core missions and provide protection to USAID's implementing partners in hostile environments. USAID/Afghanistan's practice has been to delegate responsibility and oversight for security to its implementing partners and factor the cost of security into their program budgets. These implementing partners typically subcontract their security services to PSCs. USAID indirectly pays for PSCs when the implementing partners submit their invoices for payment, which include the cost of security services.

In the past year, news reports have said that U.S. Government funds paid to contractors for reconstruction projects were being siphoned off to Taliban insurgents in exchange for "protection" to prevent attacks. For example, one news article reported that USAID funds were ending up in the hands of the Taliban through a protection racket for contractors. Another article said that in southern Afghanistan, no contract can be implemented unless the Taliban takes a cut, sometimes at various steps along the way. Other news reports said that PSCs were involved in the negotiations with insurgents. Office of Inspector General (OIG) staff met with one of the reporters involved to obtain additional details.

Review Objective

The Regional Inspector General/Manila conducted this review to answer the following question:

- Is there an indication that Edinburgh International misused USAID funds to pay the Taliban or others in exchange for protection?

Page 10 contains a discussion of the review's scope and methodology.

DISCUSSION OF REVIEW FINDINGS

The review found no indication that Edinburgh International had misused USAID funds to pay the Taliban or others in exchange for protection.

A review of Edinburgh International's accounting system and financial records revealed that the firm had employed a strong system of internal controls over cash transactions. These controls reduced the risk of illicit payments, since such payments are often made in cash. Further, an examination of supporting documentation for expenditures of \$3.85 million (34 percent of the total spent by Edinburgh in 2009) revealed no unusual or suspicious payments. Finally, the field staff's authority to make payments was strictly limited, reducing the possibility that the staff could make extortion payments to the Taliban or other insurgent groups without the knowledge of supervisory staff in Kabul.

Edinburgh International provided an armed guard force and security management staff for DAI's project offices and guest houses, as well as security for moving expatriate staff on the ground. However, Edinburgh International did not provide security for DAI's project activities, such as road construction, canal rehabilitation, or other construction activities where Taliban insurgent violence was a risk. As a result, Edinburgh International would not be in a position to negotiate with or make payments to Taliban insurgents or others in exchange for protection at these work sites.

However, USAID, U.S. intelligence, and DAI officials expressed concerns that insurgents may have extorted protection payments from DAI subcontractors implementing stabilization and community development activities. During our review, we also received allegations of fraud involving employees at DAI's LGCD office in Jalalabad. These issues are discussed in the following two sections.

Insurgents May Have Extorted Protection Payments From Subcontractors on the LGCD Project

The review revealed that Afghan subcontractors working on the LGCD project may have misused USAID funds to pay off Taliban insurgents in remote and insecure Taliban strongholds. By its very design and approach, the LGCD project may have contributed to the risk that USAID funds might fall into the hands of insurgents. DAI implements LGCD activities using subcontracts and subgrants, and the project relies on local communities that likely include Taliban insurgents or supporters to provide security during the implementation phase. As a result, insurgents might demand payments from DAI or its subcontractors who work in those dangerous areas.

In October 2006, USAID/Afghanistan awarded DAI a 3-year, \$95 million contract to implement the LGCD project. The contract was subsequently increased to \$349 million and extended to April 30, 2011. The project was meant to work in partnership with local communities to create a stable environment for medium- and long-term political, economic, and social development. The LGCD project looks for communities in insecure areas who are willing to work with local government authorities to implement small-scale infrastructure and community development activities. The contract states that one important responsibility of the communities is to guarantee security during the implementation phase of development activities. Yet some individuals told us that the local communities who were supposed to guarantee security very

likely included the Taliban or groups who support the Taliban. The original contract itself stated that dispute mediation and community security are “services” that the Taliban is providing.

Interviews with personnel from USAID, U.S. intelligence, and DAI indicated that, for LGCD subprojects, Afghan subcontractors would meet with local community leaders before the implementation phase and negotiate the terms of community support, including employment opportunities and security arrangements. The subcontractors would also negotiate security terms with insurgents either directly or indirectly through community leaders. Insurgents could demand from the subcontractor a “protection tax” of up to 20 percent of the total subcontract value in exchange for protection. “Protection” might include Taliban-provided security guards for the activity site and a promise not to attack the subcontractor’s personnel and equipment and not to halt the activity. Sometimes insurgents would try to renegotiate the terms of the security arrangement shortly after the subcontractor began implementation. Their intent was to extort more money from the subcontractor, and they would threaten violence if the subcontractor did not comply.

Various sources explained that Afghan subcontractors used several methods to recoup the money paid to insurgents. The most common method was to include the amount in the total cost of the subcontract up front, because subcontractors knew that the tax would have to be paid before implementation. Subcontractors allegedly considered such protection taxes as “mobilization costs” and billed them to DAI through normal invoicing procedures; the costs were then passed on to USAID for payment. Specific line items in the project budget might be inflated, or subcontractors might recoup costs by substituting low-quality, cheap materials for promised high-quality materials. Subcontractors might also stage a security incident at the project site and ask for more money from DAI to pay for security.

In 2009, DAI suspended or cancelled 27 LGCD subprojects totaling about \$1.4 million because of security incidents in the southern, southeastern, and eastern regions of Afghanistan. According to a DAI report, the security incidents mostly involved Taliban insurgent threats and violence around the subproject construction sites. For example, in June 2008, DAI awarded a 6-month, \$718,000 subcontract to an Afghan construction company to improve about 7.5 kilometers of gravel road in Kunar Province of eastern Afghanistan, just north of Nangarhar Province along the border with Pakistan. About 2 months after construction started, the subcontractor’s bulldozer was set on fire by unknown arsonists, according to DAI’s account of the security incident. DAI asked the subcontractor to suspend work in October 2008 and informed USAID of the situation. The subproject remained suspended until it was finally canceled in April 2009.

Further inquiry by USAID personnel in August 2009 revealed that Taliban insurgents from the local community had been involved with the arson. Apparently, insurgents had been requesting payment for security instead of providing it as part of their community contribution as originally agreed with the subcontractor. According to unclassified information obtained from U.S. intelligence officials, this incident fits the pattern of attempts by insurgents to renegotiate the terms of the security arrangement shortly after the subcontractor begins implementation. Their intent is to extort more money from the subcontractor, and they threaten or commit violence if the subcontractor does not comply. This type of activity is endemic in Taliban stronghold areas, and the LGCD incident in Kunar Province is representative of such occurrences in these areas, the officials said.

DAI ended up paying the full amount of the subcontract plus idle-equipment fees amounting to about \$740,000—costs that were passed along to USAID. The length of the subcontract was 6

months, yet the subcontractor worked for only about 2 months and, as calculated from the time actually spent at the job site, completed only 33 percent of the construction. We concluded that this subproject was not only a casualty of Taliban insurgent actions and violence but also was a waste of USAID money.

USAID's contracting officer's technical representative (COTR) for LGCD was neither familiar with the details of this incident nor aware of specific instances in which LGCD subcontractors had paid insurgents. However, mission employees who had worked on LGCD stated that such incidents might take place because LGCD works in unstable and dangerous areas worsened by military activity. With the large amount of money and numbers of people involved, providing sufficient oversight to prevent these payments was and continues to be difficult.

A USAID official who had previously managed LGCD activities in Nangarhar Province stated that security precautions prevented proper monitoring of subprojects and activities in the field. U.S. Government officials working under Chief of Mission authority were either prohibited from visiting project sites because of the high security risk or they had to travel in high-profile military convoys, which attracted too much attention in the local community, especially with insurgents. He said that DAI's international expatriate staff also could not go into these areas to monitor, and in many cases Afghan project staff could not enter these areas either. As a consequence, he explained, some LGCD subprojects were not monitored at all, and anything might have happened with them. Further, he said that DAI did not allow U.S. Government officials to visit its LGCD office in Jalalabad because DAI believed that LGCD's office would become a target for insurgent attacks. Although these restrictions might be valid precautions, they nevertheless prevented USAID's field program officers and activity managers from monitoring LGCD activities and establishing a working relationship with LGCD staff in the field.

Another USAID official who had previously managed LGCD stated that incidents such as the one in Kunar Province happen all the time because LGCD works in the most insecure areas. She explained that USAID is pushing contractors like DAI to work in kinetic areas with the military and asking the local community to protect U.S. interests. She suggested that USAID should let the military do its job first to secure the area before USAID goes in with development projects. In her opinion, USAID and DAI have tried to implement LGCD community development subprojects too soon in high-threat kinetic areas before the military could effectively clear and hold them, resulting in failed outcomes. U.S. intelligence officials echoed her words, saying: "Security first, governance, then construction."

According to the *White Paper of the Interagency Policy Group's Report on U.S. Policy Toward Afghanistan and Pakistan*, issued by the White House in March 2009, the U.S. Government's counterinsurgency strategy must integrate population security with building effective local governance and economic development and establish the security needed to provide space and time for stabilization and reconstruction activities. Further, the State Department's *Afghanistan and Pakistan Regional Stabilization Strategy* states that the pace and reach of civilian program implementation depends on a security environment permissive enough to allow civilian efforts to proceed.¹ Although USAID's intent was to follow the U.S. Government's counterinsurgency strategy with implementing LGCD subprojects, it might have overreached when selecting areas that were not yet secure enough for such activities. USAID's COTR for LGCD stated that DAI and USAID activity managers might not have performed appropriate risk assessments in selecting these areas because of pressure to implement subprojects quickly.

¹ U.S. Department of State, Office of the Special Representative for Afghanistan and Pakistan, January 2010 (updated February 2010).

Most USAID officials and DAI personnel we interviewed believed that neither USAID nor DAI could provide reasonable assurance of preventing USAID funds from going to the Taliban or others in exchange for protection while trying to implement community development projects in a war zone and in insurgency stronghold areas where little or no monitoring can be conducted. As a consequence, an estimated \$5.2 million of USAID funds were at risk of falling into the hands of insurgents if they demanded up to 20 percent of LGCD's award amounts for community development subprojects that were implemented in 2009.²

The Regional Inspector General/Manila referred its findings to OIG/Investigations for further investigation of illicit payments to Taliban insurgents. Therefore, we are not making any specific recommendation for USAID/Afghanistan to take such actions. However, we are making the following recommendation to mitigate the risk of such illicit payments on the LGCD project.

Recommendation 1. *We recommend that USAID/Afghanistan conduct appropriate risk and impact assessments of current and proposed locations that are targeted for Local Governance and Community Development subprojects to determine whether the security environment in those locations is permissive enough to allow civilian implementation and monitoring efforts to proceed without interference from insurgent groups.*

Indications of Pervasive Fraud in DAI's LGCD Jalalabad Office

We were alerted to indications of pervasive fraud concerning DAI's LGCD office in Jalalabad City in Nangarhar Province, where an Afghan employee was allegedly at the center of several fraud schemes with other employees. Specifically, sources informed us that this employee was leading a conspiracy with other Afghan employees to demand kickbacks from Afghan companies in exchange for subcontract awards from LGCD. This group of employees controlled the choice of which company was awarded the subcontract and could easily influence DAI's expatriate employees in Kabul to agree with the decision. Further, the employee at the center of the scheme was somehow connected with one of LGCD's subcontractors, through family relations or friendships, and influenced the subcontracting process to award projects to this favored subcontractor, who apparently had about 20 subcontracts with the LGCD project.

Sources explained that these DAI employees would provide details to the favored subcontractor on how much the project was worth, how much to bid on the project, what the project entailed, and where to inflate the prices in the bids. As part of the kickback scheme, the subcontractor would pay a percentage of the award amount back to the DAI employees in exchange for the inside information and for being awarded the subcontract. An examination of several approved subcontractor budgets showed inflated prices for some line items. For example, a subcontractor's budget listed costs for equipment so inflated that some items cost more than double the costs of another subcontractor working in the same area, doing the same type of work, as shown in Table 1. Another subcontractor doubled the normal delivery charges. When added up, inflated budgets on multiple subcontracts have a potential to be material when large quantities of equipment and materials are involved.

² In 2009, DAI implemented 560 community development subprojects costing about \$26 million under the LGCD project.

Table 1. Example of Subcontractor’s Inflated Costs

Description	Subcontractor #1 Inflated Costs (\$)	Subcontractor #2 Standard Costs (\$)	Quantity	Difference (\$)
Wheelbarrow	77.00	32.00	100	4,500.00
Shovel	6.00	3.20	100	280.00
Water bucket	10.00	2.00	100	800.00
Pickaxe	6.00	4.00	100	200.00

In addition to the evidence of possible fraudulent activity, sources revealed that DAI’s expatriate employees were not fully participating in DAI’s technical evaluation process of reviewing subcontractor bids to make certain that bids were within the fair market value. According to the Federal Acquisition Regulation (FAR), a contracting officer responsible for consenting to a contractor’s request to subcontract must consider, among other things, whether the contractor has performed adequate cost or price analysis or price comparisons and obtained accurate, complete, and current cost or pricing data, including any required certifications [FAR 44.202-2(8)].³ Further, FAR 44.304 states that the contracting officer shall maintain a sufficient level of surveillance to ensure that the contractor is effectively managing its purchasing program, and that surveillance shall be accomplished in accordance with a plan. The plan should cover pertinent phases of a contractor’s purchasing system (preaward, postaward, performance, and contract completion) and pertinent operations that affect the contractor’s purchasing and subcontracting.

Moreover, we found other indications that these same employees were working in collusion to fabricate monitoring reports that showed progress on existing LGCD subprojects when little or no progress had actually been made. They would take bogus photographs or use photographs from other projects and present them as evidence of progress on the current project. USAID personnel and others stated that such schemes are intentionally carried out in areas where expatriate or U.S. Government personnel could not visit because of security restrictions. Presumably, if little or no work were completed on a subproject, more money would be available for kickbacks to share among the colluders.

We were told that another USAID-funded project implemented by DAI had been experiencing similar instances of pervasive fraud in a regional office. In September 2009, the deputy chief of party for ASMED observed indications of fraud in reviewing voucher documentation from its regional office in Herat. ASMED’s chief of party informed USAID and OIG/Investigations and immediately closed the Herat office until evidence could be examined and the office could be restaffed. After collecting evidence in the office, DAI dismissed three staff members for cause, and several others voluntarily resigned. DAI hired a local auditing firm to conduct an internal audit of ASMED’s regional offices and to determine the extent of the costs that should not have been billed to USAID. The internal audit uncovered widespread fraud in ASMED’s Herat office, such as double billing, inflated costs, missing receipts, and suspicious invoices. DAI submitted to OIG a full accounting of ASMED’s internal audit in Herat. In addition, DAI implemented new procedures within the ASMED project to tighten financial controls and has continued to increase its monitoring efforts to detect fraud within the project by hiring additional monitoring staff. The results of the internal audit and the actions taken by ASMED were shared with officials of

³ FAR Part 44—Subcontracting Policies and Procedures.

USAID/Afghanistan and other DAI projects in Afghanistan. The LGCD project could benefit by conducting a similar internal audit.

By all accounts, corruption and fraud are pervasive in Afghanistan—and growing. For example, unclassified documents obtained from U.S. intelligence officials stationed in a field office detailed pervasive corruption among senior provincial officials. According to a UN report issued in January 2010, it is almost impossible to obtain a public service in Afghanistan without paying a bribe.⁴ The report indicates that, during the past year, about 50 percent of the Afghan population had to pay at least one kickback to a public official. International organizations and nongovernmental organizations are not exempt from this negative picture; 54 percent of the population believed that such organizations are corrupt and are in the country just to get rich. The report also indicates that the rapid influx of aid monies has resulted in a new caste of rich and powerful individuals, providing yet another level of corruption. The country's ranking in the Transparency International's Corruption Perceptions Index continued to drop dramatically since 2005, and the latest report (2009) ranks the country at 179 of 180 countries—second worst in the world.⁵

The Regional Inspector General/Manila referred its findings to OIG/Investigations for further investigation. OIG/Investigations expanded its ongoing investigation of the LGCD fraud and worked with members of the International Contract Corruption Task Force, including the Special Inspector General for Afghanistan Reconstruction and the Federal Bureau of Investigation, as well as the local Afghanistan Prosecutor's Office and the Afghanistan Major Crimes Task Force. In June 2010, DAI terminated ten LGCD employees who were involved in the fraud scheme. We made the following recommendations to mitigate the risk of fraud within the LGCD project.

Recommendation 2. *We recommend that USAID/Afghanistan direct Development Alternatives, Inc., to conduct an internal audit of all offices under the Local Governance and Community Development Project to evaluate internal controls and take appropriate corrective actions on any material weaknesses identified and fraud uncovered. A copy of the report is to be provided to the USAID/Afghanistan Controller and the USAID Office of Inspector General.*

Recommendation 3. *We recommend that USAID/Afghanistan direct Development Alternatives, Inc., to implement policies and procedures to perform adequate cost analysis of fair market prices and to detect and prevent inflated costs and possible fraudulent activity as part of its subcontracting process for the Local Governance and Community Development Project.*

Recommendation 4. *We recommend that USAID/Afghanistan develop an action plan to maintain a sufficient level of oversight of subcontracting and purchasing systems by Development Alternatives, Inc., for the Local Governance and Community Development Project.*

⁴ "Corruption in Afghanistan, Bribery as Reported by the Victims," UN Office on Drugs and Crime, January 2010.

⁵ http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table

EVALUATION OF MANAGEMENT COMMENTS

The following sections provide our evaluation of the mission's comments to the draft report, which we received on September 15, 2010.

Recommendation 1. The draft report recommended that USAID/Afghanistan conduct appropriate risk and impact assessments of current and proposed locations that are targeted for LGCD subprojects to determine whether the security environment in those locations is permissive enough to allow civilian implementation and monitoring efforts to proceed without interference from insurgent groups.

The mission stated that the draft report provided the opinions of two USAID officials that had previously managed LGCD activities but did not support these opinions with written factual data, triangulation of sources, or additional evidence. The mission's response did not state clearly how it planned to implement Recommendation 1.

As our draft report indicated, the OIG team interviewed 43 key personnel from USAID, DAI, and Edinburgh International. The team also interviewed U.S. intelligence officials to obtain information on illicit payments made to the Taliban or others and collected various documents to provide a reasonable basis for our findings. A management decision for this recommendation can be recorded when we and the mission agree on a firm plan of action including target dates for implementing the recommendation.

Recommendation 2. The draft report recommended that USAID/Afghanistan direct DAI to conduct an internal audit of all offices under the LGCD project to evaluate internal controls and take appropriate corrective actions on any material weaknesses identified and fraud uncovered. A copy of the report is to be provided to the USAID/Afghanistan controller and USAID/OIG.

In its comments, the mission stated that we had reported indications of pervasive fraud in DAI's LGCD Jalalabad office, as provided by interviewed sources, but did not list supporting documentation for the alleged fraud. Nonetheless, the mission indicated that the contracting officer has directed DAI to conduct an internal audit of all offices under the LGCD Project.

It is OIG policy not to provide information in its published reports that would compromise investigations of suspected fraud. Instead, this information is provided to OIG/Investigations for further investigation. As indicated in the draft report, we referred the specific indications of pervasive fraud in LGCD's Jalalabad office to OIG/Investigations, which expanded an ongoing investigation of the LGCD fraud and worked with members of the International Contract Corruption Task Force, including the Special Inspector General for Afghanistan Reconstruction and the Federal Bureau of Investigation, as well as the local Afghanistan Prosecutor's Office and the Afghanistan Major Crimes Task Force. In June 2010, DAI terminated ten LGCD employees who allegedly had been involved in the fraud scheme. Because USAID/Afghanistan has directed DAI to conduct an internal audit of the offices implementing the LGCD project, final action has been taken on Recommendation 2.

Recommendation 3. The draft report recommended that USAID/Afghanistan direct DAI to implement policies and procedures to perform adequate cost analysis of fair market prices and to detect and prevent inflated costs and possible fraudulent activity as part of its subcontracting process for the LGCD project.

In its response, the mission stated that the contracting officer has directed DAI to conduct a self-assessment of its existing procurement policies and procedures and modify them accordingly.

No management decision has been reached on Recommendation 3 because it is not clear what, if anything, DAI will do differently as a result of the review.

Recommendation 4. The draft report recommended that USAID/Afghanistan develop an action plan to maintain a sufficient level of oversight of subcontracting and purchasing systems by DAI for the LGCD project.

The mission provided an action plan in its response, which stated that the mission will conduct periodic surveys of DAI's purchasing system. The mission intends to hire new staff to conduct these surveys by April 2011.

A management decision has been reached on this recommendation.

USAID/Afghanistan's written comments on the draft report are included in their entirety (without attachments) as Appendix I to this report.

SCOPE AND METHODOLOGY

The Regional Inspector General/Manila conducted this review in accordance with the general standards in Chapter 3 of *Government Auditing Standards* and the *Office of Inspector General Audit Procedures Handbook*.⁶ Those standards require that we plan and perform the review to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions, based on our review objective. We believe that the evidence obtained provides that reasonable basis for our findings and conclusions based on the review objective. The objective of this review was to determine whether there was an indication that Edinburgh International had misused USAID funds to pay the Taliban or others in exchange for protection.

The scope of this review was Edinburgh International's security costs charged to the following three USAID-funded projects implemented by Development Alternatives, Inc. (DAI):

- Afghanistan Small and Medium Enterprises Development (ASMED)
- Incentives Driving Economic Alternatives for the North, East, and West (IDEA-NEW)
- Local Governance and Community Development (LGCD)

We judgmentally selected Edinburgh International from a universe of 22 private security contractors (PSCs) that provided security to 39 implementing partners with USAID-funded acquisition and/or assistance awards in Afghanistan. In making our selection, we considered several factors, such as the number of USAID projects charged per PSC, location of USAID activities and security services provided in Afghanistan (i.e., outside of Kabul), and amount of costs charged to USAID. In terms of cost, Edinburgh International was one of USAID's top five highest-paid PSCs. We also considered input from USAID/Afghanistan and our own experience from previous audits and investigations. The review covered the period from January 1 to December 31, 2009.

The review was performed in the Islamic Republic of Afghanistan from March 29 through May 13, 2010. In Kabul, fieldwork was conducted at USAID/Afghanistan and at offices of

⁶ *Government Auditing Standards*, July 2007 Revision (GAO-07-731G).

Edinburgh International and its prime contractor, DAI. The review team also visited Nangarhar PRT in eastern Afghanistan. To answer the review objective, we collected evidence to facilitate a reasonable conclusion as to whether there was any evidence that Edinburgh International had misused USAID funds to pay bribes to the Taliban or others in exchange for protection.

USAID's contracts with DAI for the three selected projects included a standard clause that stated: "The Contractor/Recipient is reminded that U.S. Executive Orders and U.S. law prohibits transactions with, and the provision of resources and support to, individuals and organizations associated with terrorism. It is the legal responsibility of the contractor/recipient to ensure compliance with these Executive Orders and laws. This provision must be included in all subcontracts/subawards issued under this contract/agreement."

Although our primary focus was on Edinburgh International, the review also considered indications of illicit payments made by other USAID-funded contractors and subcontractors if specific information came to our attention. Upon a closer look at the three USAID-funded projects selected under this review, the LGCD project emerged as the project with the highest inherent risk that USAID funds might be misused to pay insurgents or others in exchange for protection. By its very design and approach, DAI implements LGCD activities using subcontracts and subgrants in unstable, remote areas, and it relies on local communities that likely include the Taliban to provide security during the implementation phase.

As for the risk profile of the other two selected USAID-funded projects, the inherent risk of illicit payments was considered lower than LGCD's. ASMED is an economic-growth project intended to support private sector development and business associations. Activities were primarily implemented in major city centers across Afghanistan, not in remote, insecure areas. IDEA-NEW operates only in relatively secure areas of the eastern region and uses a low-profile security approach.

The review's methodology included examining Edinburgh International's financial records and invoices submitted to DAI for the three selected USAID projects to identify unusual transactions, such as payments to third parties, extraordinary expenses, miscellaneous expenses, petty cash expenses, and overbilling schemes. We examined \$3.85 million (34 percent) of the \$11.3 million that Edinburgh International invoiced to DAI in 2009. We interviewed 43 key personnel from USAID, DAI, and Edinburgh International. The team also interviewed U.S. intelligence officials to obtain information on illicit payments made to the Taliban or others.

MANAGEMENT COMMENTS**MEMORANDUM**

TO: Bruce N. Boyer, Regional Inspector General/Manila

From: Earl W. Gast, Mission Director, USAID/Afghanistan /s/

DATE: August 24, 2010

SUBJECT: Review of Security Costs Charged to Three USAID Projects in Afghanistan by Edinburgh International for the Period January 1 to December 31, 2009 (Review Report No. 5-306-10-00X-S)

REFERENCE: BBoyer/EGast memo dated July 22, 2010

Thank you for providing the Mission the opportunity to review the Regional Inspector General (RIG) Memorandum on its review of our implementing partner, DAI, and its draft report of its security provider, Edinburgh International with the objective being “to determine whether there has been any indication that Edinburgh International misused USAID funds to pay the Taliban or others in exchange for protection.”

USAID/Afghanistan is pleased that “the review found no indication that Edinburgh International had misused USAID funds to pay the Taliban or others in exchange for protection.”

USAID/Afghanistan would like to express its gratitude for the professionalism, flexibility, resourcefulness, and hard work exhibited by the review team and is pleased to provide as response to the reviews recommendations and related actions to address statements made in the draft report.

INTRODUCTION**Stabilization and the Afghanistan Context**

USAID stabilization activities in Afghanistan remain integral to the U.S. Government’s counterinsurgency efforts and its stabilization programs regularly adapt to the fluid operational environments created by armed conflict. Adaptation against a fast-moving insurgency and changing security levels require that USAID/Afghanistan’s operational

program implementation culture adapt rapidly in its reporting requirements, risk assessments, and means to measure progress.

Four major drivers of instability in Afghanistan often describe the cyclic nature of USAID's operational environment in Afghanistan: 1) Corruption in government that enables - 2) bad behavior by officials that creates - 3) popular rage and disillusionment that - 4) empowers the insurgency. Though oversimplified here, the description helps define the reasoning of USAID's stabilization interventions (the need to break the conflict driver cycle) and demonstrates the inherent risks of intervening in any of the four parts of the cycle to achieve success.

USAID takes seriously the risks presented by the conflict drivers realized in Afghanistan today and measures critically all policy, strategy, and program activities when determining program design in high-risk areas. Although the time and resources needed to comply with the paperwork requirements of reporting, assessing, monitoring, evaluating, and responding to requests for information regarding risk and impact require considerable attention, USAID strives to balance the need for the regular monitoring with the need for rapid programming. It is difficult at times, particularly under the sustained pressure of unstable and complex environments, but these conditions in no way diminishes the value of proper oversight, particularly in stabilization programming, and again, helps present the need for proper balance between assessing and delivery.

A critical action to provide such balance in Afghanistan was the creation of the USAID Stabilization Unit in Kabul. Through formal Mission Notice #2010-54, the USAID Stabilization Unit became the Mission's management body for stabilization efforts in Afghanistan. This management effort, unique to USAID experiences in other conflict-prone countries, will strive to serve as a crosscutting team to ensure that USAID/Afghanistan's stabilization activities and associated future planning, program budgeting, and performance monitoring are coordinated and complementary across all USAID/Afghanistan technical offices. The Unit also envisions efforts to capture and help determine best practices in risk mitigation in Afghanistan and eventually minimize duplicative activities when insurgent violence dissipates, the operational environment stabilizes, and a more classic development environment can take hold.

USAID strives to strike a balance between implementation and control and as stated above, is pleased that the RIG review found no indication that Edinburgh International had misused USAID funds to pay the Taliban or others in exchange for protection. USAID also appreciates the additional information presented in the review regarding risk and impact, internal reviews, cost analyses, and sub-contracting oversight. In response to concerns expressed related to this information external to the objective of the review, USAID presents the following Mission responses to the recommendations.

MISSION RESPONSES TO AUDIT RECOMMENDATIONS

Recommendation No 1: We recommend that USAID/Afghanistan conduct appropriate risk and impact assessments of current and proposed locations that are targeted for Local Governance and Community Development subprojects to determine whether the security environment in those locations is permissive enough to allow civilian implementation and monitoring efforts to proceed without interference from insurgent groups.

The Mission agrees with the recommendation with necessary context defined.

The Local Governance and Community Development Program (LGCD), as a field driven stabilization program designed to turn communities away from the insurgency and towards the Government of the Islamic Republic of Afghanistan (GIROA), will continue to implement in unstable areas where GIROA authority is contested and the populace has yet to decide 'en masse' whether or not to support the GIROA. The core operational aspects of the program include working in unstable areas that pose risk. USAID is accountable for deploying its stabilization programs and field staff as far forward as possible in partnership with our U.S civil-military partners on the ground, to contribute to ultimate victory over the insurgency. In the context of Afghanistan, the innate intention of the program is to operate in communities deemed permissive, but still contain elements of risk that are unknown or have not materialized before. USAID/Afghanistan recognizes the critical importance of implementing this program in areas that are secure with International Military Forces (IMF) controlling the battlespace. This is a requirement for all stabilization programs.

DAI does conduct risk and impact assessments of the security situation of current and proposed locations that are targeted for LGCD subprojects. When DAI conducts these risk assessments, they share results with the COTR for approval; however, there have been occurrences where the security situation changed so rapidly that active projects were not able to modify or disengage in a timely manner. The COTR for the LGCD program has contacted DAI and all USAID Activity Managers for this program, especially in the volatile South and East, to ensure they do not implement in high-risk areas – especially those deemed under control by suspected Taliban or other threatening groups. In order to implement its other contractual commitments, due diligence on the part of DAI will continue in the event that high-risk areas become environmentally permissive and activities can begin. This difficult task is resource dependent, costly, and time consuming. However, as security conditions change and increased Civil-Military coordination by both DAI, the USAID Activity Managers at the Provincial and District levels and with assistance from the new Stabilization Unit, USAID/Afghanistan will continue to ensure improved risk assessment. Methods such as geographically defined “targeting boards,” are practices implemented by DAI down to the sub-district level to allow for proper civilian implementation, monitoring, and evaluations regarding program activities.

The COTR has also directed provincial and district level implementer staff to meet weekly with Field Program Officer Activity Managers to review relevant operational information in DAI's areas of implementation, including current and anticipated security conditions on the ground. With security conditions changing daily in some districts – holding weekly meetings between USAID field staff and DAI ensures that current and planned activities are reviewed against the security dynamic. The COTR is notified of every security incident affecting DAI projects, which then triggers a review of whether or not implementation should continue or not and whether or not wider USAID programming is even possible for that district.

Based on the information above, the Mission believes that its implementers do conduct risk and impact assessments as appropriate to the complex environment and in accordance with contractual obligations. In the discussion section of the review findings, the RIG describes various means in which payments may be made to insurgents, and describes methods on how to recoup money, but does not provide additional evidence that these methods are endemic or problematic to USAID programs. The review also provides the opinions of two USAID officials that previously managed LGCD activities, but does not support these opinions with written factual data, triangulation of sources, or additional support evidence in the review. USAID does concur that certain USAID-funded activities can become at-risk activities and will assure that implementers continue to conduct appropriate and cost-effective risk and impact assessments and continue to be vigilant in proposing additional and cost-effective assessment means.

USAID deems that a management decision has been reached on this recommendation and requests your concurrence and closure of this recommendation.

Recommendation No 2: We recommend that USAID/Afghanistan direct Development Alternatives, Inc., to conduct an internal audit of all offices under the Local Governance and Community Development Project to evaluate internal controls and take appropriate corrective actions on any material weaknesses identified and fraud uncovered. A copy of the report is to be provided to the USAID/Afghanistan Controller and the USAID Office of Inspector General.

The review details indications of pervasive fraud in DAI's LGCD Jalalabad office as provided by interviewed sources, but does not list supporting documentation for the alleged fraud. Certainly, USAID will take appropriate action and explore the allegations of possible fraudulent activity presented in the review and asks the RIG to provide any additional factual documentation, secondary sources, and/or cross references that help support the allegations made by sources to aid in that action. The Mission agrees with the recommendation and suggests a modified approach.

We have advised DAI to 'ramp up' its internal expatriate Compliance Officers from two to three, who have senior level experience in compliance, auditing, financial controls, and investigative competencies. In two weeks, DAI will have its third Senior Compliance Officer in place and it will continue to task them to review all of its Contracts, Procurements and Grants (CPG) offices. The role of the Compliance Officers is to

prevent and mitigate fraud by conducting spot checks to ensure correct procedures and identify gaps in systems. The Compliance Officers also investigate allegations of fraud. In addition, internal audits are periodically conducted by a team from DAI's home office, and the present schedule for audits includes RC-W, RC-S and RC-SW to be audited first and RC-E and RC-SE after Eid. The Contracting Officer has formally directed DAI to conduct an internal audit of all offices under the LGCD Project to evaluate internal controls and take appropriate corrective actions on any material weaknesses identified and fraud uncovered.

DAI is in daily contact with the RIG Office at the USAID Mission in Kabul on alleged improprieties and information is passed rapidly – currently between 24-72 hours of notification between both USAID Activity Managers and DAI directly to the RIG. USAID expatriate and national staff have reinforced their efforts to report alleged cases of improprieties reported either by local communities, or from GI RoA directly to the COTR for immediate investigation. The COTR has sent guidance to all Activity Managers to meet with their local DAI implementers at least on a weekly basis. The COTR and Alternate COTR in these respects are playing a crucial role in immediately moving information received either from USAID/LGCD Activity Managers, or from DAI to the RIG for review and preliminary guidance.

Based on the information above, the Mission deems that a management decision has been reached on this recommendation and requests your concurrence and closure of this recommendation.

Recommendation No 3: We recommend that USAID/Afghanistan direct Development Alternatives, Inc., to implement policies and procedures to perform adequate cost analysis of fair market prices and to detect and prevent inflated costs and possible fraudulent activity as part of its subcontracting process for the Local Governance and Community Development Project.

The Mission agrees with the recommendation and suggests a modified approach.

DAI adheres to federal regulations in awarding and managing procurements, including sub-contracts, under the LGCD project; and DAI already has procurement policies and procedures in place that it uses for the LGCD project. However, the Contracting Officer has directed DAI to review its existing procurement policies and procedures, modify them accordingly, and implement them to ensure it performs adequate cost analysis of fair market prices and to detect and prevent inflated costs and possible fraudulent activity as part of its subcontracting process for the LGCD Project.

Based on the information above, the Mission deems that a management decision has been reached on this recommendation and requests your concurrence and closure of this recommendation.

Recommendation No 4: We recommend that USAID/Afghanistan develop an action plan to maintain a sufficient level of oversight of subcontracting and purchasing systems by Development Alternatives, Inc., for the Local Governance and Community Development Project.

The Mission agrees with the recommendation.

DAI does not have an approved purchasing system pursuant to FAR 44.3, as it has not had a Contractor Purchasing System Review (CPSR). Since it does not have an approved purchasing system, the USAID Contracting Officer reviews requests for consent to subcontract in accordance with FAR 44.201. In reviewing these requests, the Contracting Officer considers the factors set forth in FAR 44.202-2 and determines whether adequate price competition was obtained. He/she considers the cost and pricing analysis and justifications provided by the contractor. Contracting Office staff also performs an analysis of proposed costs comparing them to those incurred under other USAID projects. The Contracting Officer may also rely on knowledge of national contracting staff who know market conditions in determining the reasonableness of proposed costs. However, due to the fluid nature of the local markets in which LGCD operates, and a wide variety of product quality among necessary equipment and supply products, in which LGCD operates, market conditions, including price fluctuations on the quantity and quality of supplies, can change regularly and rapidly.

USAID/Afghanistan will take the following actions to address this recommendation:

1. USAID requested that DAI conduct a Contractor Purchasing System Review (CPSR) no later than October 31, 2010 to establish a baseline for DAI's proficiency in performing their responsibilities in subcontracting in accordance with FAR 44.3. The assessment will provide a baseline of DAI's capability and document weaknesses for further action by the Contracting Officer and/or his/her field support team.
2. When the review is complete, the Contracting Officer will request a corrective action plan for remedying any identified shortcomings in subcontract consent procedures from DAI.
3. USAID plans to conduct periodic surveys of DAI's purchasing system. USAID has approved new Cost & Pricing Analyst positions, which would include these surveys. The estimated timeframe for these positions to be filled is April 2011.

Based on the information above, the Mission deems that a management decision has been reached on this recommendation and requests your concurrence and closure of this recommendation.