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**TECHNICAL ANNEX
FOR A PROPOSED GRANT
OF SDR 22.1 MILLION
(US\$ 33.4 MILLION EQUIVALENT)**

**TO
THE ISLAMIC REPUBLIC OF AFGHANISTAN
FOR A
PUBLIC FINANCIAL MANAGEMENT REFORM PROJECT**

April 30, 2007

**Financial Management Unit
South Asia Region**

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ABBREVIATIONS AND ACRONYMS

ACCA	Association of Chartered Certified Accountants
AFMIS	Afghanistan Financial Management Information System
ANDS	Afghanistan National Development Strategy
ARDS	Afghanistan Reconstruction and Development Services
ARTF	Afghanistan Reconstruction Trust Fund
APR	Annual Performance Review
CAO	Control and Audit Office
CQS	Consultants' Qualifications Selection
CSR	Civil Service Reform
DA	Designated Account
DAB	Da Afghanistan Bank
DFID	Department for International Development (UK)
EPAP	Emergency Public Administration Project
FBS	Fixed Budget Selection
FM	Financial Management
GDP	Gross Domestic Product
GOA	Government of Afghanistan
HRM	Human Resources Management
IARCSC	Independent Administrative Reform and Civil Service Commission
I-ANDS	Interim – Afghanistan National Development Strategy
ICB	International Competitive Bidding
IDA	International Development Association
ISA	International Standards of Auditing
LCS	Least Cost Selection
MIS	Management Information System
M&EU	Monitoring and Evaluation Unit
MOE	Ministry of Economy
MOF	Ministry of Finance
MTFF	Medium Term Financing Framework
NCB	National Competitive Bidding
NGO	Non Governmental Organization
PACB	Public Administration Capacity Building
PAR	Public Administration Reform
PEFA	Public Expenditure and Financial Accountability
PEFM	Public Expenditure and Financial Management
PFM	Public Financial Management
PFMR	Public Financial Management Reform
PPU	Procurement Policy Unit
PRGF	Poverty Reduction and Growth Facility
PRR	Priority Reform and Restructuring
PSIB	Programmatic Support for Institutional Building
QBS	Quality Based Selection
QCBS	Quality and Cost Based Selection
RIMU	Reform Implementation Management Unit
SAR	South Asia Region
SBD	Standard Bidding Documents
SDU	Special Disbursements Unit
SOE	Statement of Expenditures
SSS	Single Source Selection

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THE ISLAMIC REPUBLIC OF AFGHANISTAN
FOR A
PUBLIC FINANCIAL MANAGEMENT REFORM PROJECT

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I. COUNTRY AND SECTOR BACKGROUND

A. Issues in Public Financial Management

Recent Developments in the Afghan Economy

1. Afghanistan has achieved respectable economic growth during the past four years, with the real value of non-opium Gross Domestic Product (GDP) increasing by 29 percent in 2002/03, 16 percent in 2003/04, 8 percent in 2004/05, a drought year, and 14 percent in 2005/06. The Government of Afghanistan (GOA) has also maintained a stable macroeconomic framework as evidenced by the successful completion of all quarterly reviews under the IMF Staff-Monitored Program (SMP, from March 2004 to March 2006) and the first review of the Poverty Reduction and Growth Facility (PRGF) program. Monetary policy has been restrained, supported by the adherence to strong fiscal discipline and a “no overdraft” rule that prohibits Central Bank from financing a deficit. Inflation is decelerating and year-on-year inflation declined to 5.2 percent in September 2006 (compared to 16 percent in 2004/05).

2. During this period, public spending managed through the budget process has been the government’s main tool to implement its development strategy and coordinate donor assistance. In 2004, the government introduced the concept of a core budget (all funds flowing through government accounts subject to its Public Financial Management [PFM] regime) and an external budget (external assistance directly executed by donors; essentially ex-PFM) that accounts for almost two thirds of all spending. The core budget consists of an operating budget (“ordinary budget” covering current expenditure and some small capital expenditure) and a development budget (reconstruction projects and some recurrent costs). The total core budget expenditure increased between 2004/05 and 2005/06 by 30 percent to US\$1.1 billion. Within the core budget, operating expenditures amounted in 2005/06 to US\$651 million, 63 percent of which consisted of wages and salaries. Core development expenditures reached US\$424 million, increasing by 58 percent from 2004/05, reaching almost six percent of GDP, a commendable level by international standards. This development strategy has created a high demand for maintaining credible, transparent and effective PFM performance, principally through the Ministry of Finance (MOF).

3. While the external budget is financed exclusively from donor grants, the core budget is financed from four sources: (i) domestic revenues, which reached US\$415 million in 2005/06 (5.7 percent of GDP); (ii) donor grants, including the Afghanistan Reconstruction Trust Fund (ARTF) and proceeds of the International Development Association (IDA) budget support (US\$724 million or 9.9 percent of GDP); (iii) external loans, including the proceeds of the Programmatic Support for Institutional Building I (PSIB I) (US\$107 million or 1.5 percent of GDP); and (iv) changes in currency deposits at Da Afghanistan Bank (DAB), Afghanistan’s central bank. To date, the GOA has been able to maintain donor confidence and participation by operating within an agreed Medium Term Financing Framework (MTFF) that has accompanied its medium term development and poverty reduction agenda.

4. Continuing to use the budget process as the main instrument for promoting development and poverty reduction, the GOA and donors have agreed on a revised MTF (Table 1.1), based on the recently concluded Interim-Afghanistan National Development Strategy (I-ANDS) and “Compact” to end 2009-10. Meeting Compact objectives requires substantial increase in spending from US\$1.1 billion in 2005/06 to US\$1.6 billion in 2006/07 and US\$2.6 billion by 2009/10. In addition to making needed investments in development projects, key increases in operating expenditures are likely to be driven by: (i) the implementation of a new pay and grading policy; (ii) the recruitment of around 10,000 teachers per year; (iii) an increase in non-wage expenditures to cover levels for operating and maintaining new investments and to accommodate costs transferred from the external budget previously financed by donors outside the budget process; and (iv) significant increases in the security sector.

Table 1.1: Medium Term Fiscal Financing Requirements, 2002/03-2009/10
(US\$ million)

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
		Estimates			Rev.	Projections		
A. Domestic Revenues	131	208	268	416	540	715	880	1,080
B. Expenditures (B1+B2)	346	617	829	1,075	1,639	2,030	2,410	2,700
B.1. Ordinary Expenditures	346	452	560	651	884	1,030	1,210	1,300
Wages		299	396	411	546	650	750	825
Goods and Services		95	88	126	187	200	250	275
Capital Expenditures		41	41	37	24	25	30	40
Others		17	35	77	127	155	155	155
B.2. Development Expenditures	-	165	269	424	706	1,000	1,200	1,400
C. Budget Deficit (A-B) a/	(215)	(409)	(561)	(660)	(1,098)	(1,315)	(1,530)	(1,620)
D. Float and Adjustments	(15)	35	8	(40)				
E. Sale of Non-Financial Assets	-	-	-	40	40	100	200	200
F. Financing	230	375	553	700	1,098	1,315	1,530	1,620
ARTF	59	236	285	407	396	400	400	400
LOFTA and Army Trust Fund	17	36	54	82	96	75	75	75
PSIB b/	-	-	80	80	-	80	80	80
Other External Financing	134	99	377	302	486	680	925	1,015
Domestic Financing c/	20	4	(243)	(171)	120	80	50	50
Memo: External Budget	503	2,182	2,503	2,116	1,500	1,700	1,400	1,300
% GDP								
A. Domestic Revenues	3.2	4.5	4.5	5.7	6.4	7.2	7.6	8.2
B. Expenditures	8.5	13.5	13.9	14.7	19.5	20.5	20.9	20.5
of which operating budget	8.5	9.9	9.4	8.9	10.5	10.4	10.5	9.9
C. Budget Deficit	(5.3)	(8.9)	(9.4)	(9.0)	(13.1)	(13.3)	(13.3)	(12.3)
of which operating budget deficit	(5.3)	(5.3)	(4.9)	(3.2)	(4.1)	(3.2)	(2.9)	(1.7)

a/ Excluding grants; b/ Amount for successor program (e.g. for 2008/09 and 2009/10) to be decided; c/ Change in currency deposits. *Note:* the exchange rate for 2006/07 and beyond is AFA 50 per US\$. *Source:* Budget documents and Staff estimates.

5. GOA is expected to make a major improvement in generating domestic revenue over the Compact period, and has secured technical assistance to strengthen tax and customs performance. Nonetheless, there are significant risks and uncertainties about the outcome of this effort. As a result, donors’ assistance will remain crucial as a source of stable and predictable financing for Afghanistan’s budget in the coming years. Building on pledges made at the London Conference, external assistance to the budget is expected to increase from US\$1.0 billion in 2006/07 to US\$1.6 billion in 2009/10. The ARTF and the Law and Order Trust Fund for Afghanistan are expected to remain key vehicles for this assistance. In addition, Afghanistan has adopted a prudent external debt strategy and is expected to borrow only at concessional terms. It is also expected to become eligible under the Heavily Indebted Poor Countries initiative, combined with the Multilateral Debt Relief Initiative and bilateral commitment to debt cancellation, should lead to

significant debt relief in the coming years. All of these initiatives and options remain feasible, however, if the international community maintains confident that PFM functions are performed following acceptable international norms for transparency and accountability. It also would require that a larger percentage of the annual budget provisions (currently at about 37%) be used in the year for which they are allocated as an indication of growing efficiency in the use of public monies.

Achievements in PFM

6. Since 2002 the GOA has made progress in establishing a functioning public financial management system under the direction of the MOF. The World Bank assessment of Afghanistan's public financial management and procurement performance¹ conducted under the auspices of the Public Expenditure and Financial Accountability (PEFA) program (November 27, 2005), concluded that while there are weaknesses that threaten longer term sustainability of the MOF performance and "exacerbate the disconnect between public expectations and the actual delivery of services, the strong achievements in terms of fiscal discipline, cash control, and aggregate transparency have contributed to macroeconomic stability, as well as to sustained external assistance."

7. The MOF is producing annual budgets that meet basic requirements of the GOA-IMF-Donor approved MTFF, even though the timeliness of preparing these budgets and the system for monitoring budget execution and assuring their development effectiveness continues to require improvement. The system is also performing adequately against each of the six basic sets of criteria used to evaluate performance in the PEFA² partnership program. MOF's overall performance has also been recently reconfirmed in the Mid Term Review of the Public Administration Capacity Building (PACB) project that has provided financial support for the MOF treasury, procurement, and audit functions.

8. Importantly, the basic legal framework underlying the PFM and procurement systems has also been established including new procurement and financial management basic laws, establishment of basic systems and protocols for procurement and financial operations, and reporting and performance auditing. Recruitment and training of Afghan staff in procurement has begun. Additional analysis has been completed that provides the basis for upgrading the Afghanistan Financial Management Information System (AFMIS) and training of staff in basic accounting and auditing has occurred.

9. However, these achievements have been obtained with a high degree of direct donor assistance through the ARTF Administrator's Office and the Afghanistan National Development Agency and with the use of costly operations contracts with international firms, including the hiring of qualified Afghans as national contractors. In addition, the

¹ Afghanistan: Managing Public Finances for Development; November 27, 2005; conducted under the auspices of the PEFA Program.

² PFM "Turn outs;" addressing comprehensiveness and transparency; using policy-based budgeting; maintaining predictability and budget control; accounting, recording and reporting; maintaining external scrutiny and audits.

integrity of the system has depended on having PFM operations centralized in the MOF with little direct management role assigned to line ministries, provincial offices, or state owned enterprises. Moreover this control is being managed on a “transactions” basis, and with significant levels of *ex ante* clearances. Currently, as many as 70 long term international and 200 national contactors assure that MOF performs its basic budgeting, treasury, audit and procurement functions adequately. Not surprisingly, the areas of performance under the PEFA assessment with the highest ratings were those in which contractors played the most dominant role.

10. Donors have been willing to support such heavy direct management and supervision as part of addressing the emergency situation facing the country. However, this is not a sustainable situation and reforms should now be pursued to raise the level of responsibility and accountability for PFM within the “mainstream” MOF. The ANDS and Compact negotiated between the GOA and the donor community has identified both improving the performance of financial management services and capacity building to permit these services to be mainstreamed into the MOF and line ministries as part of their core operations. With this improved performance, the donor community would be able to meet several of its own wishes to improve the effectiveness of aid for Afghanistan: improving the timeliness and predictability in providing necessary resources, increased use of the core budget to receive and manage assistance (decreasing the reliance on the “external budget”) and improve transparency on using the external budget when used.

Continuing Challenges, Issues and Constraints

11. To achieve its developmental goals, GOA and the donor community have agreed on a MTFF to 2010 that is ambitious and sensitive to risks. Overall spending through the core budget is projected to rise by 63% compared to the plan for 2007 (Table 1.1). Of this, “ordinary spending” for personnel, operating costs and small investments would grow by 33%. This will increase the number of small, repetitive transactions, involving numerous agencies (the top 10 line ministries³ excluding defense and interior, account for only about 46% of this spending) and place increased demands on regular cash management, accounting, auditing, and the performance of these functions by line ministries. The MTFF also calls for an increase of about 100% in the development budget. Success in realizing this level of investment spending depends heavily on the GOA’s capability to execute tendering and contract management and to do so following improved procurement management practices. Currently, only about 52% of planned expenditures are being realized. This spending is concentrated in relatively few line ministries; five line ministries⁴ are expected to account for in excess of 60% of the total and the top 10 account for virtually the entire development budget. Lastly, while GOA expects to increase the level of financing through customs and nationally generated taxes, realistically the MTFF continues to require a 50% increase in external financing. The willingness of external sources to be forthcoming in a regular and predictable manner

³ In descending order; Education, Energy and Water, Foreign Affairs, Public Health, National Security, Higher Education, Finance, Justice, President’s Office, and Agriculture.

⁴ In descending order; Rural Development, Public Works, Water and Energy, Health, and Education.

will depend on maintaining transparency and good governance in public financial management.

12. In order to strengthen the capability and sustainability of the PFM system, MOF and the Control and Audit Office (CAO) have recognized that it will have to address several organizational and capacity constraints.

- Incomplete re-organization of MOF. While all main departments within MOF have undergone restructuring under the Priority Reform and Restructuring (PRR) program, the MOF would still require restructuring of its remaining functions to assure that all of its departments work as an integrated whole. It is also important that staffing plans in terms of numbers, job descriptions, grade levels, and qualifications be finalized. This is critical for making further staffing decisions, including revising grading and pay to adopt the GOA pay and grading policy, internalizing new rules governing the civil service; establishing the balance between the use of international and national contractors and civil servants to perform PFM functions.
- Concentration of Responsibility. A high degree of accountability in financial management decisions has been achieved by concentrating them in the hands of the ARTF, Afghanistan Reconstruction and Development Services (ARDS) and in MOF departments, in a closely monitored “transaction-based” system. However, this has also the effect of lowering accountability for procurement and financial management decisions on the part of line ministries and agencies and actually increases the governance risk of operations. There are limits to the expansion of the internal capacity of the MOF to further expand the transaction-based system and remain responsive, accountable and efficient. Line ministries and agencies should be involved in PFM to increase predictability and timeliness of their operations, albeit, in parallel with their capacity to meet accountability standards.
- Inadequate Human Resources Numbers, Capacity and Management. Engaging international firms and local consultants to perform basic treasury, budget, audit and procurement functions has been a default strategy, considering the inadequate technical capacity of the civil service and inadequate incentives to the few who are qualified to remain in government service. Government external auditing in Afghanistan, for example, is still dependent on external international advisors to perform financial statements audits and to conduct any other audits to acceptable standards. There is no accounting profession in the country and training in certification related programs is just becoming available and is given only in English which as such is not accessible for most CAO staff. Several remedies, including off-site training, adequate grading and pay, effective recruiting and management of careers of civil servants for the longer term

(including pension management), and establishing schemes of service for key professional classes are interlinked factors and require specialized management capacity that the MOF and most other ministries lack.

- Anti-corruption and Maintaining Accountability and Transparency while Reforming. The control environment on which Afghanistan's PFM formal controls rest is undermined by corruption in its various forms and manifestations. This is increasingly seen as one of the most important threats to Afghanistan's entire state-building and to delivering public services. The GOA recognizes the critical importance of addressing corruption and the MOF is seeking advice on how to fight it. While a strategy is being developed and implemented, however, the current PFM operational functionality cannot be reduced while the effects of PFM reforms are realized. Therefore, the MOF reform program would be compelled to maintain the high levels of transparency and accountability, which are constraints on corruption, already attained with the current technical assistance. Moreover, the demands for transparency and accountability for the use of public resources is growing in Afghanistan, first as anti-corruption sentiment is growing and second as the legislature is developing its role. Meeting these requirements would constrain the pace at which MOF could reduce its dependence on international supported staff and contracted services and de-concentrate of PFM operations. The transformation process would require careful study and management including close monitoring and evaluation, and adjustment of the reform program.
- Maintaining Good Coordination and Momentum in Reform. Most experts see "reform" as an evolutionary process which requires time and the involvement of all departments whose functions are interlinked. It is also a process that affects individuals who should be engaged. With several sources of assistance coming to the MOF, there is a risk of disconnects between the programs, agendas, timing and standards that may be adopted that would impair the smooth functioning the MOF as the GOA's apex public finance management organization. Moreover, staff may be subject to declining motivation and performance ("reform fatigue") as the process extends over time. Therefore a participatory and "change management" approach to improving performance would be preferred over a centralized "administered" change process. Both of these initiatives require a vehicle for coordinating and planning change that will be sustained for a considerable period of time.

B. Government's Public Financial Management Strategy

Overall Development Strategy

13. In January 2006, the government completed its I-ANDS and presented it together with the Afghanistan Compact to the international community. This strategy builds on earlier achievements, notably the National Development Framework (April 2002) and the report "Securing Afghanistan's Future" (March 2004). The I-ANDS is anchored in a vision for Afghanistan "to consolidate peace and stability through just, democratic processes and institutions, and to reduce poverty and achieve prosperity through broad based and equitable economic growth." These development objectives are consistent with the Millennium Development Goals' national targets adopted by the Cabinet in 2005. The strategy is structured around three pillars: (i) security; (ii) governance, rule of law and human rights; and (iii) economic and social development.

14. The Afghanistan Compact commits the Islamic Republic of Afghanistan and the international community to work toward a stable Afghanistan through good governance and bases the Compact on a number of principles that bear on PFM including: fiscal sustainability, lasting Afghan capacity and effective state and civil society institutions, combating corruption, and ensuring public transparency and accountability (Box 1.1).

Box 1.1: Afghanistan Compact Benchmarks for Financial Management

By end-2007, the Government will ensure improved transparent financial management at the central and provincial levels through establishing and meeting benchmarks for financial management agreed with and monitored by the international community, including those in the anticipated PRGF. In turn and in line with improved government accountability, donors will make every effort to increase the share of total external assistance to Afghanistan that goes to the Core Budget.

Afghanistan will achieve, and then maintain, external debt sustainability by end-2007.

Public Financial Management Strategy

15. The government realizes that the reforms of the PFM system that have already begun will have to continue for it to meet the challenges of the next years. As the custodian of the PFM, the MOF has prepared a Strategic Plan for the years 1384-89 (2006-2010) that proposes reforms that could produce both greater efficiency in managing public resources (turnout) and maintaining the standards for oversight and governance that have been achieved.

16. These reforms set goals and a short term work agenda for: (i) mobilizing revenue and managing government finances; (ii) supporting economic management and growth; (iii) managing "public wealth;" (iv) promoting good governance; and (v) establishing itself as a "best practice leader" in public sector reform. The action plan for the immediate future covering 18 months seeks to correct some of the more immediate deficiencies in budget formulation and execution; procurement throughout the public sector; financial controls, accounting, reporting, audit and public accountability; and structural and administrative reform of the MOF, provincial administrations and the

financial management (FM) capabilities of line ministries. Annual progress reviews were expected to identify further actions for making incremental improvements.

17. The strategy cites, among others, the risk of development in various departments becoming misaligned and the need for good coordination between MOF and other ministries and agencies as a basis for extending sound PFM practices. It calls for a participatory process for strategic planning, regular support to MOF managers and decision-makers to assure alignment of actions, improved management of technical assistance, and regularized contact and communications with partner ministries and agencies.

18. In 2005 the World Bank conducted a review of the PFM in Afghanistan using a performance measurement framework developed by the PEFA partnership program⁵ which identifies a set of critical objectives of a PFM system and a standard set of high-level PFM indicators to assess performance against those objectives.

19. The assessment considered as part of the PFM arrangements the significant external support (both advisory and operational) provided to the government in procurement, treasury and audit as well as the work of the ARTF's Monitoring Agent.

20. This assessment generally portrays a public sector where financial resources are, by and large, being used for the intended purposes as authorized by a budget which is processed with transparency and has contributed to aggregate fiscal discipline. The expenditures and financial position are reported regularly in an understandable format. However, performance regarding the allocation of spending across programs and agencies and the efficiency of operations is not as good.

21. Since the assessment the government enacted the Public Finance and Expenditure Management Law with robust reporting requirements on public finances and a commitment to independent review by the Auditor General. This has been matched by the government's full and timely publishing of its monthly statement of budget execution on the MOF web site. Similarly, all large procurement opportunities are widely published and the outcomes are also widely shared.

22. The study led to an outline of a "Road Map for PFM reform" which coincides with the MOF agenda which also calls for maintaining the reform effort as a managed process through a special unit within the ministry.

⁵ The members of PEFA include the World Bank, International Monetary Fund, European Commission, UK Department for International Development, French Ministry of Foreign Affairs, Royal Norwegian Ministry of Foreign Affairs, Swiss State Secretariat for Economic Affairs, and Strategic Partnership with Africa (SPA). The analytical framework, indicator set, and detailed instructions for ratings are in PEFA (2005). Also see www.pefa.org.

II. IDA'S RESPONSE AND STRATEGY

A. IDA's Recent Support for PFM

23. IDA has supported the establishment and functioning of a sound PFM system since the launching of the Afghanistan Interim Administration in 2002. It has done this through two sets of complementary operations; through three operations providing PSIB (Box 2.1) which have focused on making progress in establishing an enabling legal framework for institutional development; and three investment operations; the Emergency Public Administration Project (EPAP, US\$10.0 million, GRTD-H 0060); the Second Emergency Public Administration Project (SEPAP, US\$8.4 million, GRTD-H 0550); and the Public Administration Capacity Building project (PACB, US\$27.0 million, GRTD-H 1440) (Table 2.1). Additionally, the Strengthening Financial Management Capacity Project (TF052735-AF) funded through the ARTF also provided support to the PFM reforms.

24. The basic objective of these grants has been to assist the GOA to make good and transparent use of public sector resources in the post conflict environment. This has been done by putting in place additional capacity to perform critical PFM operations, initiating the process of developing indigenous capacity to perform these functions and beginning the development of broader reforms in the public administration.

Box 2.1: Linkage with PSIB Series

Institution-building is at the core of the objectives of the PSIBs and significant achievements have been made under PSIB I and II, which are further advanced in the proposed PSIB III. The program supports improvements in the PFM legal framework; specifically civil service, procurement and financial management laws were enacted. The program also supports improvements in budget management processes and budget execution; all PSIB operations have supported the adoption of annual budgets, anchored in a macroeconomic framework; the program is also linked to a tightening of fiduciary standards. Beyond the change in the regulatory framework, the program supported reforms in payroll management, procurement, and internal and external audit. In particular, for the first time, the government submitted to Parliament its annual accounts with an external audit review, a prior action for PSIB III.

Another prior action for PSIB III is the commitment to a PFM action plan by the government. The plan follows the format of the roadmap which accompanied the Afghanistan PEFA review of 2005 and provides steps to be taken in the short and medium term. The steps in the following areas will be assisted directly by the Public Financial Management Reform (PFMR) project: budget execution with the AFMIS expansion, internal control with the implementation of the accounting manual and duty specific training for Treasury and line ministry financial management staff, internal audit and external with capacity building and work practices development, payroll with systems development, procurement and accounting and reporting with capacity building and direct operations support, accountability through the support for a public accounts committee in Parliament, and with monitoring of progress on reforms with the support to the Reform Management Unit.

25. With this support the government-wide procurement and financial management arrangements satisfied the fiduciary requirements for the Bank's general budget support and the ARTF contribution to the recurrent budget. Moreover, it enabled the Bank and

other donors to rely entirely on the government-wide treasury and audit systems for the financial management of investment operations.

26. The PACB project continues the operational support through consultant services to assure that basic public finance functions (procurement, treasury and audit) were performed so as to meet internationally accepted standards. The terms of reference for these consultants also contained references to providing training but this was not the principle mandate. However, the scope of its activities was broadened to include: (i) developing the regulatory and institutional framework in these core fiduciary management areas; (ii) further systems development that is based on a full understanding of medium-term requirements and the country's implementation capacity; and (iii) capacity building and training not only in the central agencies but also in line ministries and the provinces so that staff could maintain and operate systems independently and effectively. However, this set of activities was not well identified in the original design. Given the difficulties in filling positions in the Treasury Department with adequate national staff and the late mobilization of training consultants for prospective auditors, the project objectives were modified in late 2006 to align with the principle outcomes of the activities which were the maintenance of fiduciary performance.

27. During the period 2002 to the present, donors have provided continuous financing for the recovery program and are pledged to continue this support. While the government, with World Bank and other donor technical assistance on PFM, has been largely successful in maintaining a stable and transparent fiscal environment, there continues to be general concern that the demands for procurement, treasury operations, budget formulation and implementation, internal and external audit, and legislative oversight could exceed the PFM abilities of the MOF and agencies using public funds.

Table 2.1: IDA/ARTF Supported Investment Projects in PFM

<i>Operation</i>	<i>Amount</i>	<i>Date</i>	<i>Focus</i>	<i>Scope of Activities</i>
EPAP I	\$10 m	April 2002	Treasury, procurement, external audit	Primarily operational support through large TA contracts
EPAPII	\$8.4m	June 2003	Treasury, procurement, civil service management	Continued operational support. Early support for PRR and civil service management
PACBP	\$27 m	Dec. 2004	Treasury, Financial management systems, procurement, internal and external audit	Further operational support. Separate capacity building components
Counterpart Chief Financial Officer (funded through ARTF)	\$ 5.1m	Oct. 2003	Financial management in selected line ministries	Primarily operational support through a single large TA contract

Lessons Learned

28. There are a number of lessons from the Implementation Completion Report of EPAP 1, the mid-term review of EPAP II and the restructuring of the PACB project that the government and IDA have built into the proposed project.

- For an emergency operation to be effective in a severely damaged post-conflict environment, intensive Bank supervision is essential.
- Contracts for direct operations support need to be separated from capacity building activities to ensure that both are performed simultaneously. Under the EPAPs, initial capacity building suffered greatly due to the pressures to get the operations up and running quickly and keep them running in an environment of constant flux.
- The expectations for capacity building and institutional strengthening need to be closely aligned with the availability and skills levels of the government counterparts. All assumptions regarding the availability and capability of government counterpart staff need to be documented and validated with great care and revisited over time.
- The government needs to continue to engage the services of the advisors for as long as it takes to build sufficient, demonstrable capacity in core public administration areas even as the roles of the advisors become increasingly transitional. The legal framework for financial management and procurement in Afghanistan is now more demanding and poses significant new challenges to the government.
- Treasury, Procurement and Audit Departments are all still dependent on external advisors to perform the key tasks; where nationals are involved in critical matters, these are involved as local advisors and not civil servants. This is a consequence of incomplete restructuring and the failure to move to merit based recruitment.
- The systems to support budget execution are in place in the MOF but there is no functionality offered under the AFMIS to support operations by the line ministries (i.e., budget preparation, contract and grant management, purchasing and asset management, and personnel management) which are all critical to improved service delivery.
- Reform in the MOF is monitored by a unit in the Deputy of Administration but the cross cutting issues of the organization of the ministry, human resources and the monitoring and evaluation of the reform's progress do not get sufficient high level attention to achieve the implementation of the ministry's strategic plan.

B. Objectives, Rationale and Strategy for IDA's Continuing Support

IDA's Reform Strategy

29. In the context of the recently concluded agreement on the I-ANDS and the 2007-2010 Compact, donors and GOA have agreed that providing that the level of transparency, accountability and good governance that has been achieved to date under the preceding donor support operations for MOF is maintained, that there should be a progressive transfer of responsibility for managing the PFM systems to the MOF and away from reliance on the ARTF Monitoring Agent and the operations advisors for procurement, treasury and audit. This transition should proceed at a pace that is consistent with the MOF and line ministries' capacity to resolve regulatory, organizational and personnel management issues affecting sustainability. As the administrator for one major source of financing for the I-ANDS (ARTF) and a major provider of financing for both the operations and development budgets, IDA has a particular responsibility to lead in this effort.

30. The broad plan for making this transition would be: (i) continuing to provide operational support for basic operations through the services of internationally recruited firms, while (ii) making further steps to re-organize the MOF and line ministries in a more de-concentrated PFM system; (iii) deepening the regulatory framework and building human resource capacity to facilitate mainstreaming of operations; and (iv) managing these changes to assure their longer term sustainability. The strategy would encompass all of the major functions of the MOF and require the coordination of the contributions of several donors. Therefore, as part of the strategy, leadership for managing the transition would be placed in the MOF in a specialized Reform Implementation Management Unit (RIMU) that reports directly to the Minister of Finance. This would place the ownership and accountability for progress with the MOF. Lastly, the rate at which the transition can be made will depend on variables and circumstances that cannot be fully accounted for *ex ante*. Therefore, the implementation of the transition and the programming of resources to support it would be made through annual progress and program reviews, supported by third party "reviewers," reporting to the RIMU (see sub-component 3.1.6 of the Detail Project Description).

31. This broad plan is largely consistent with the vision which MOF has developed and the World Bank recommendations in "Managing Public Finance for Development." These aimed at guiding the MOF in identifying and implementing a wide range of actions required for strengthening its current functions and capacities and moving forward from meeting the emergency needs of the last four years toward a modern and effective public financial management organization.

Rationale for Continuing Bank Involvement with PFM Reform

32. Several donors are providing specific assistance to major departments in the MOF and other entities for PFM as appears in the Table 2.2.

Table 2.2: Donor Funding of Technical Assistance in Public Financial Management

<i>Function and Department</i>	<i>Donor</i>	<i>Objective</i>
<i>Ministry of Finance</i>		
Customs	EC	Construction of Customs Houses
	IDA	Customs Emergency Customs Modernization and Trade Facilitation Project
Revenue	ADB	Mustofiat Reform
	DFID	Tax Reform
	CIDA	Revenue Systems Development
Budget	DFID	Advisors for Budget Preparation and Control
	CIDA	Advisors for Budget Preparation and Control
	ADB	Capacity Building
Treasury	ADB	Mustofiat Reform
	IDA	Treasury Operations and Capacity Building
	US Treasury	Debt Reconciliation and Control
Internal Audit	IDA	Capacity Building and Institutional Strengthening
State Owned Enterprises	USAID	Policy Advisors
Minister's Office	ADB	Advisors
Procurement Policy Unit	IDA	Procurement Capacity Building
<i>Ministry of Economy</i>		
ARDS	IDA	Direct Operations Support to Procurement
<i>CAO</i>		
CAO	IDA	Capacity Building and Operations Support

33. In the next phase of its support for PFM, IDA's value added would be to build on the experience it has had through the series of projects cited above which donors have acknowledged as substantial. It would then provide additional leadership in coordinating donor assistance being provided in their respective areas of competence from its position as administrator of the ARTF.

Linkage with Public Administration Reform

34. The proposed project is one element of a wider public administration reform agenda that has been developed by the government, with IDA/ARTF support to contribute to a more effective state through better PFM performance and by building capacity to sustain this performance (Box 2.2). To date, in the same projects that have contributed to maintaining sound PFM, IDA has also provided major support for the restructuring of agencies and ministries and rationalizing the functions and job descriptions of public sector employees in order to pursue operational efficiencies of service delivery that lead to improved developmental outcomes from public expenditures. In restructuring agencies, attention is being placed on establishing reliable financial management units that would receive the training and capacity being decentralized from the MOF. Major re-structuring of the MOF itself has been part of this effort. The focus of the Public Administration Reform (PAR) is now being directed towards reform of civil service practices in a new Civil Service Reform (CSR) project, whose objective is to increase personnel performance through incentives, merit-based hiring, good management, and competency enhancement. Considering that personnel costs account for

about 30% of the MTFF (about 62% of the ordinary budget), gains in this area will be significant for controlling costs and increasing expenditure effectiveness.

35. Together with the CSR project, the Public Financial Management Reform (PFMR) project helps strengthen core business practices within government, namely human resource and financial management – through appropriate regulatory, organizational and technical reforms. Reforms in these areas should provide the supporting organizational environment within which more sector-specific reforms can be effective. Both projects support the achievement of specific triggers under PSIB as well as benchmarks under the Afghanistan Compact. Both projects also support the Government’s anti-corruption strategy through identifying and addressing areas that are vulnerable to corruption and through promoting a rules-based culture within government.

36. Therefore through these two operations, the CSR project and the proposed PFMR project, IDA will contribute to the government’s overall ability to execute two interlocked business practices – public financial management and personnel management.

Box 2.2: Linkages with IDA/ARTF’s Public Administration Reform Initiatives

A significant piece of analytical work is underway to assist the government to define priorities and programs in *Public Administration Reform*. This will include specific areas of work on: how to deepen line ministry reforms, the evolution of sub-national governance over time, and strengthening institutions of accountability. Work is progressing to define an integrated program of activities and mechanisms for managing resources in a coordinated way.

As part of defining work programs under this broader PAR framework, IDA has assisted the government in defining a realistic *implementation plan for achieving its civil service reform* goals in line with Compact benchmarks. This has been presented to donors for support at the April Afghanistan Development Forum.

A major work program is underway with IDA and other donor support to assist the government develop its *anticorruption strategy* and to identify areas where improvements could limit the vulnerability to corruption, including in the area of public administration reform.

The ARTF financed *Management Capacity Program* is supporting the interim buying-in of Afghan consultants into civil service positions to manage core common function departments while broader capacity building efforts take hold.

III. THE PROPOSED PROJECT

A. Project Objective

37. The objectives of the project are to: (i) develop an efficient and effective public financial management system; and (ii) develop the human resource capacity of the MOF and CAO to ensure better operation of public financial management.

38. Indicators for monitoring these performance objectives would correspond closely to those used in the recently completed PEFA analysis and would include: (i) the degree of coherence of budget, treasury and revenue estimates with ANDS priorities and MTFP; (ii) the timeliness of budget, treasury and revenue preparation and execution; (iii) the number of ministries/agencies successfully managing elements of the procurement and treasury functions with *ex post* control; (iv) measures of good governance such as the trend of the percentage of donor support transiting MOF core budget processes; and (v) the quality of governmental audit. The project's impact would also be observed in the proportion of the national budget that was being managed under improved line ministries and Mustofiats, and eventually, an improvement in the rates of implementation of budgets that are being made available.

B. Detailed Project Description

39. The PFMR project will be implemented over a period of three years and will contain the following components.

1. INSTITUTIONAL DEVELOPMENT (US\$ 11.4 million)

40. The project would assist each of the major departments within MOF and the CAO to develop and implement the structures, procedures and systems required to carry out their mandates under the new PFM legal framework. The legal framework is now ahead of the procedures and systems to support it. The project would also assist the Treasury Department with systems development, would assist MOF finish the procedures for procurement, and would develop work practices for government audit.

1.1 Procurement Institutional Development and Social Accountability

41. In order to cope with the urgent task of reconstruction in Afghanistan, arrangements were put in place under EPAP to provide 'centralized' technical assistance by means of operations support to advisors for procurement under the Procurement Unit of the ARDS. ARDS managed the Procurement Advisor and recruited and trained 10 local counterpart staff as Procurement Liaison Officers who serve as liaisons with the line ministries with an objective to ensure transfer of procurement capacity and responsibility to the line ministries. The Procurement Advisor also initiated a training program, conducted a review of procurement legislation, and prepared draft new legislation which was finally adopted in September 2005 as the new Procurement Law in Afghanistan.

42. The PACB project responded to the need to transfer procurement capacity as well as responsibility for procurement functions to the line ministries of the government. This required institutional development as the core component of the procurement reform initiative. While some of the capacity development assistance envisaged flowed from the Bank's previous intervention and implied further training of targeted individuals, the core objective of the overall plan was to develop institutional capacity. The capacity development program was predicated on a gradual transfer of procurement responsibility to the purchasing entities based on their demonstrated ability to house and make use of trained and experienced procurement officers.

43. The services required as part of the procurement component of PACB comprise: (i) a sustainable nationwide capacity building strategy to take into account the requirements not only of central government but also provincial and municipal government as well as the private sector; (ii) a program to assist and facilitate the achievement of PRR status for a number of key purchasers at central and sub-central level; (iii) a plan to transfer procurement capacity and responsibility to those central and sub-central purchasers according to a set of milestones; and (iv) a system of attestation whereby the performance of ministries can be assessed against identified benchmarks as part of the milestone mechanism. The objective was twofold: to build the capacity of procurement officers of the client, its key purchasing ministries, and provincial authorities; and to strengthen the organizational structure of the procurement function within procuring entities with a view to transferring responsibility for procurement from ARDS to the procuring entities themselves.

44. In 2005, as part of the broader review of Afghanistan's PFM system, an assessment of procurement procedures and performance focused on the legal framework applicable to the conduct of procurement in Afghanistan as well as on the performance of those responsible for applying the procurement procedures was carried out in 2005. The study confirmed the scope of procurement reform and capacity building activities under the PACB to: (i) create a Procurement Policy Unit (PPU); (ii) finalize and approve the Procurement Law and draft regulations to implement it; (iii) develop and implement a large scale capacity-building program for procurement officers in the government; and (iv) create a training program for the local private sector to enhance its capacity to participate in bids.

45. Under the PACB project, a PPU has been established under the MOF, a new Public Procurement Law has been adopted, the procurement regulations have been drafted, and a system has been established whereby all bidding opportunities as well as contract awards are published in the ARDS procurement website. However, due to various reasons, the government could not complete selection of a consultant for procurement reform support (Procurement Capacity Building and Legal & Institutional Framework Development) in due course. The process of selection has recently been completed and the contract with the procurement support consultant was signed in February 2007. Since only a few months of project duration are remaining for PACB, this component of procurement reform, which commences under PACB, would continue to be the central plank of the procurement reform initiative under the PFMR project.

46. In addition to assisting government purchasers in this way, the project will provide institutional support for the newly created regulatory body (PPU). The PPU requires direct assistance to carry out its functions (listed in the Procurement Law). They will have started down the path of creating an information website and a basic Management Information System (MIS) for procurement. This, however, requires significant further input to provide a useful tool. The PPU will also have many other tasks which will require funding, not least in respect of the adoption of secondary legislation (including guidelines and manuals) and the dissemination of information and analysis of data so that they can provide reports indicating the successes and failures of the system. The project will therefore include funds for the PPU to: (i) retain consultants to create more Standard Bidding Documents (SBDs), a procurement manual and guidance notes; (ii) develop the website and interactive MIS; and (iii) assist the PPU for publication, analysis and dissemination of review panel procedures, documentation and decisions. The MIS to be developed for procurement will provide a database of procurement requirements by contracting entity and track the procurement process of large procurements to the stage of contract award and supports the publication of procurement information. The AFMIS expansion will include a Purchases module which controls the payment of contracts once awarded (see sub-component 1.2).

Accountability and Disclosure

47. Given the significant changes in the legal and regulatory framework and the traditionally passive public response to expenditure on procurement, there is an initial need to encourage greater public awareness of the changes to the procurement rules and to promote change in behavior. The immediate need is to design an effective and strategic communication and procurement disclosure strategy, taking into account the specific circumstances that prevail in the country. To better support the transition and its related capacity building exercise, an effective communication component will be designed to raise awareness of the reform agenda and its implications within: (i) the government (politicians, parliamentarians, and public officials); (ii) the private sector (bidders, consultants suppliers, etc.); and (iii) civil society at large (academia, non-governmental organizations, civil society organizations, civilians). This component and the awareness it will raise should also mitigate risks of failure by ensuring a wider constituency is reached, ownership creation, and dealing with corruption through a sound, efficient and transparent procurement process. Putting procurement out in the open within civil society will also set the stage for possible future inclusion of civil society in the procurement function as an oversight element once the GOA has come up with its strategy on anti-corruption.

48. In the medium term, it is important not to lose sight of the opportunity to start work on social accountability initiatives. Efforts will be made to discover the most appropriate means of educating and including civil society in the monitoring of the procurement function. This should, however, be preceded by a situational analysis/assessment that would allow the development of such a longer term strategy.

49. In light of this gradual approach, the project will retain a consultant for a communications and awareness strategy (housed within PPU) and a consultant for situational analysis/assessment in respect of possibilities for social accountability measures.

1.2 Treasury Systems Development and Roll-out

50. Over the past four years, an integrated financial management system has been implemented in the Treasury of the MOF. The basic objective of this system was to ensure accountability over the Governments budget and expenditures including the use of donor funds. The system was not intended to be a complete integrated MIS that would be capable of serving the needs of all government managers. It was basically a Treasury system with FreeBalance software as the core application of the system known as the AFMIS.

51. As the government is moving forward with their reform program, the AFMIS needs to be enhanced to meet the increasing demands on the Treasury staff as well as line ministries and Mustofiats. The software platform for AFMIS is FreeBalance, the systems study carried out under the PACB project recommended keeping this platform given the knowledge acquired and the reasonably good performance of the core applications of expenditure module, general ledger, allotments, bank reconciliations and financial reporting. These core applications give Treasury all the means to effect payments, keep control by allotment, and report in compliance with the law and donor requirements.

52. The expansion should respond to the needs of line ministries where there is a need to automate control by contract and develop controls by grant. Given that the procurement capacity building contract will develop a procurement MIS to automate and control the process leading up to the selection and award of a contract, the PFMR should provide an application for the contract control. A Purchasing Module would provide this functionality. Similarly, the PFM law requires that each line ministry keeps a register of its fixed assets; given this and the integration provided between a Purchasing Module and a Fixed Asset Module, the AFMIS expansion should comprise Purchasing and the Fixed Assets Module. Similarly, the recording of revenue would be rendered more secure through the use of the Accounts Receivable Module.

53. A fully automated off-the-shelve Human Resources (HR) MIS for implementation in MOF is also considered necessary. At present, MOF uses the Microsoft Access based payroll system known as Verified Payroll Program which includes the Computerized Payroll System. Nevertheless, there is no HR functionality in the system and the support and documentation of in-house systems is not optimum. The ultimate goal for HR MIS is to direct deposit the net pay to each employee's bank account and provide the critical personnel data for eventual centralization and determination of pension liabilities.

54. A principle of systems implementation which the team and the government agreed is to have same vendor applications for all integrated operations (i.e., operations where individual transactions from the modules are required to be posted to other

applications). Following from this it was decided that FreeBalance Purchasing, Fixed Assets, and possibly HR Modules would be acquired to address the needs identified.

55. The systems study recommends the implementation of a budget support management system as a high priority. Whether the FreeBalance module meets the needs or whether another vendor's product should be used will be determined following the study tour by the MOF's budget and treasury officials to review the performance of HR and Budget Preparation Modules installed in other government settings. The same vendor principle is not critical in this case because the Budget Preparation Module and core accountability applications are not integrated but just interfaced with a periodic file submission for loading the budget and updates. The systems integrator consultant selected for the Treasury system will program the interface for the periodic uploading of the budget files to AFMIS and down loading of allotment and expenditure information.

56. Therefore, the project would engage a firm of consultants for up to 36 months to acquire, install, and train national staff in the use of the following modules from FreeBalance in order to complete the expanded financial management functions in AFMIS – Procurement, Fixed Assets, and Accounts Receivable. The Budget Preparation and HR Module vendor selection will be decided subsequently.

57. To conduct their designated business affairs and be partners with the MOF in distributing the growing administrative responsibilities, line ministries will require the ability to enter transactions into AFMIS and to approve such transactions through the Financial Controllers (Treasury staff) located within the line ministries. The project would support the roll-out of the AFMIS so that transaction processing and payment authorization may be decentralized but that payment processing would remain centralized within Treasury and the Mustofiats. This component will assist the government in rolling out AFMIS to five or six line ministries which currently account for the majority of public sector non-military and non-policing functions as well as six Mustofiats. The selection of line ministries will be made by Treasury and Budget Departments after considering the capacity and impact of the roll-out. The pre-conditions for the roll-out include the reform of the Administration Department of the line ministry to a point where staff are under the PRR, the organization and duties of all financial management staff are clear and documented and the line ministry enters into a written understanding with the MOF on its obligations for the roll-out and using AFMIS, and the line ministry provide the infrastructure to allow the installation of the terminals. In addition to the full roll-out to six line ministries, the consultant will assist the government in rolling out just the reporting module of the AFMIS to additional line ministries.

1.3 Internal Audit Work Practices

58. To date the internal audit activities in line ministries and agencies have been under the control of the CAO and have been oriented towards detecting frauds and irregularities by line ministries' staffs. The Public Expenditure and Financial Management (PEFM) Law and its financial regulations have transferred control of

internal audit from the CAO to the MOF by providing that the MOF appoint internal auditors to audit the financial and accounting affairs of all state administrations.

59. Initial steps have been taken under the PACB project to build a modern Internal Audit Department in the MOF, including the recruitment of more accounting specialists and initial training of recruits in internal auditing techniques, and the formation of a high level Audit Committee to oversee the department's work. Steps being undertaken by a consultant appointed under PACB include preparing an internal audit manual, various audit procedures for financial functions, and work programs for internal audits within the MOF.

60. The project would now support implementation of the expanded MOF responsibility through development of improved audit methodology and training. The project would also finance further development and roll-out of internal audit procedures and plans to the line ministries and provinces, and to improve the capacities of the internal audit staff through on the job training.

61. The consultant will be hired to provide work practice tools and on-the-job training to the cadre of internal auditors that are engaged in providing internal audit services in the MOF and the line ministries. Work practice tools will be developed in the form of a new internal audit manual that covers the requirements of Financial Regulations 11.5 to 11.10 including issues of internal audit organization, management, planning, conduct, reporting, and follow-up. The on-the-job training will involve leading the auditors in these ministries in carrying out and reporting some 80 major investment projects (selected on the basis of their value and implementation complexity that could disguise fraud) during the period of the engagement to build proficiencies to levels that accord with International Internal Audit standards.

62. The CAO has undertaken a significant number of audits that have identified possible malfeasance and the Auditor General has referred cases to the Attorney General for possible prosecution. There is a need for similar findings by internal auditors to be referred to a fraud investigation unit prior to consideration of prosecution or disciplinary action. The component will assist with establishing a fraud investigation unit in the MOF's Internal Audit Department, developing and launching its basic operational skills, and preparing a roadmap for developing specialist fraud investigation processes in Afghanistan.

1.4 Support for External Audit

1.4.1 Advisory Services

63. The CAO is reforming its organization, methods and operations. Major training efforts are in process to improve the skills of the audit staff. The CAO, with World Bank funding, has used a professional accounting firm to provide guidance to the CAO in these matters and there is a need for a senior advisor to the Auditor General on a full-time basis to continue improving the CAO's performance and to build capacity to fulfill its mandate

under the law. A new Audit Law is in preparation and the advisor will be needed to assist with implementation of new audit manuals and training the CAO in functions set out in the PEFM and draft Audit Laws.

64. The project would finance the services of a senior audit advisor for policy guidance which has been ongoing since 2006 and strengthening of the CAO which would allow the direct operations advisor firm to concentrate on delivering audit services. The advisor would be supported by three audit experts available on a full time basis to work as audit team leaders and provide on-the-job training to the CAO staff.

1.4.2 External Audit - Development of Physical Infrastructure

65. The CAO has moved to new accommodations and requires improved physical infrastructure for their operations. The project would finance improved physical infrastructure including the Information Technology Center, office furnishings and on-line access to AFMIS. The CAO has identified its requirements including computers and relevant software for the field and central audit staff, necessary terminals to connect with the AFMIS to support more efficient auditing, appropriate Computer Assisted Audit Techniques, office furniture, and work stations.

1.4.3 External Audit - Parliamentary Oversight

66. The project will support operationalizing the recent decision to establish the Parliamentary Oversight Committee function, and reinforce and reinvigorate the accountability of the Executive in the management of public finances to the legislature through a timely, comprehensive, and methodical review of audit reports and audited accounts of the government.

67. Exposure to a well tested system of legislative scrutiny of public spending in the context of a similar political system will help to create awareness of international best practice, and provide the Committee Chairman and Auditor General with much needed knowledge and understanding of: (i) a tested approach to the timely processing of audit reports and accounts; (ii) constitution and powers (including understanding of member nomination procedures, tabling of schedules, nominating a Chair); and (iii) means through which to promote accountability and transparency. This sub-component will be managed by the CAO and provide management assistance, training, and operating support to build the capacity of members of the parliamentary committee in their oversight function as well as supporting secretariat and technical assistance aimed at strengthening the administrative support to the committee.

2. HUMAN RESOURCES CAPACITY DEVELOPMENT (US\$ 5.0 million)

68. The transfer of skills to civil servants to operate PFM systems lies at the heart of sustainability of adequate PFM performance. Under this component, the project would provide consultants, training opportunities, and materials for the development of skills of MOF staff, line ministry staff, and CAO staff. In selecting staff for training, which in

turn leads to advancement, the MOF and the CAO will be sensitive to and follow gender-sensitive policies.

69. Given a three-year project life, it is not expected that the MOF and the CAO would acquire the full range and level of skills to assume complete responsibility to operate unaided all the PFM systems by the end of project date. However, while the exact end-state is not known at this time, advances along the continuum will be treated as solid progress in the right direction.

70. By project end, however, the MOF staff will have acquired the skills to interpret and apply the PFM laws and regulations for dealing with the routine and current state of budget execution, reporting and control. The nature of the technical assistance will transition away from direct operations support as capacity grows. While some direct operations support will be required for the maintenance and further development of the AFMIS, most technical assistance beyond the current project would be for policy formulation and implementing further reforms.

71. Similarly, the CAO will have progressed to a point where its staff can conduct routine review of compliance and simple project financial statement audits with the assistance of an external audit manager to ensure adherence to current auditing standards. Beyond the project life direct assistance would be required for conducting audit of State Owned Enterprises and complex projects, while the state budget audit could be done with the limited involvement of an audit advisor for quality control purposes. As in the case of MOF beyond the current project, technical assistance would be required for policy formulation and implementing further reforms.

72. The capacity of line ministry staff to carry out procurement should, on the other hand, advance to a point where at least in the targeted ministries this staff will assume responsibility for procurement with the mandated supervision of the PPU of MOF.

2.1 Human Resource Capacity Development in Procurement

73. In terms of individual training needs, the continuing need to provide purchasing entities with a competent cadre of procurement officers will be fulfilled through the continuation of the training programs developed initially by the procurement agents retained under EPAP I. The training activities of the procurement capacity building contract outlined in sub-component 1.1 will be delivered under this sub-component and will be rolled-out more widely, especially to local government entities as well as to specialist audiences such as decision makers and auditors. Further effort will be made to ensure that there is a private sector able to respond adequately to (and, where necessary, challenge) the public purchaser in the changed procurement environment. The training needs at sub-central level will be identified through the training needs assessment.

74. As a result and in addition to continuing with the existing training program under the PACB project, this project will provide more training at sub-central level, more

private sector workshops, specific training programs for the PPU staff, and a training program for dispute panels.

2.2 Human Resource Capacity Development in Financial Management

75. This sub-component will assist the MOF Treasury Department and the administration departments of selected line ministries in developing staff capacity in financial management functions. The program would be based on the training needs assessment that was conducted in 2006 for Treasury in the PACB project and additional training needs assessments may be conducted in the line ministries to be engaged in the decentralization process. Training in line ministries will be done in close coordination with the Budget Department to take any opportunity joint training with assistance provided by the Budget Department. Up to 200 staff could be affected. In addition to providing trainers and materials for duty specific training, for developing a pool of staff with higher accounting skills, the project will also provide funds to reimburse Treasury staff for attending classes conducted by private entities such as the ACCA.

2.3 Human Resource Capacity Development in Audit

76. The project would complete the classroom training in introductory accounting and auditing that began under the PACB project for the first batch of internal auditors of the MOF and staff of the CAO. Additionally, a stream of internal auditors and CAO auditors intended to provide leadership and more expert skills will be financed for advanced training. The Association of Chartered Certified Accountants (ACCA) professional accountant training now available in Kabul could be used for this purpose for staff who would become senior leaders in the Internal Audit Department and CAO. Selection of officers for this training should be based on career development plans and the likelihood that they can contribute over the mid-term to development of the Internal Audit Department and the CAO.

3. REFORM MANAGEMENT (US\$ 1.0 million)

77. The processes of coordinating support for improvements in MOF functions and for assuring the improvements are well aligned across departments and with other line ministries and Mustofiats would be managed through a newly-formed RIMU. The RIMU would be responsible for developing annual work plans which would assure the coordination of actions proposed in various departments, monitoring implementation of these actions so that the overall results of the project and the MOF strategic plan are achieved. This latter function has been initiated by the MOF. It would also be responsible for assuring that new personnel policies for the civil service being developed and supported by the Independent Administrative Reform and Civil Service Commission (IARCSC) are properly integrated into the MOF's own HR management department.

78. While it is important that there be continuity in applying actions to improve performance, the RIMU would be treated as a "task force" with a finite life and not as a permanent line agency of the MOF. Through this arrangement the MOF managerial team (minister, deputy ministers, and director generals) would be provided with options and

alternatives for making further improvements in overall ministerial functionality. The work of the RIMU would also allow the management of the MOF to conclude arrangements with other line ministries and Mustofiats covering their roles and responsibilities in implementing de-concentrated PFM functions. To meet its objectives, the RIMU would undertake the following tasks.

3.1.1 Targeted Restructuring of Internal MOF Business Arrangements

79. The RIMU would assure that the various functions and relationships between targeted MOF departments were organized to be mutually supporting in providing efficient PFM. It would draw on the support being offered through the IARCSC (being supported by an IDA grant supporting reforms in the civil service) to rapidly review and revise, as needed, decisions made under the PRR for the allocation of functional responsibilities, lines of authority and reporting, and the level and types of staffing required to exercise these functions. The IARCSC with financing of the CSR project would assist the MOF/RIMU to acquire the services of an internationally recognized expert in the operations of macro-level public finance institutions such as ministries of finance, treasury boards, central banking institutions to diagnose intra-institutional organizational issues in the MOF, propose solutions and support their implementation over a period of about 36 months.

80. The RIMU would then work with department heads and staff to implement any restructuring that is recommended. It would pursue a “change management” methodology that would involve the participation of the staff that would be affected in understanding the rationale for changes, receive feedback on proposals and build commitment and ownership of changes as they came into effect.

3.1.2 Staff Re-grading under the GOA Pay/Grading Policy

81. The recently completed PRR process produced revised job descriptions and statements of qualifications for virtually all of the MOF 220 higher level staff (grades 2 and above) and about 70% of 5,700 lower level staff (grades 3 and below). The RIMU would arrange with the IARCSC for applying the new grade and pay policy of the government with support provided through the CSR project. The IARCSC Pay and Grade Unit would work with the RIMU and MOF HR Department to re-map the revised job descriptions into the new 8-grade system, and complete the task of defining new job descriptions to correspond to the new 8-grade system where this was required. Staff of the MOF HR Department would be trained in creating and grading job descriptions as part of the process. The IARCSC Pay and Grade Unit, supported by its own team of international experts, would then prepare confidential reports recommending the re-assignment of incumbents of former positions into the newly graded positions.

3.1.3 Support for the Human Resources Management (HRM) Department

82. The RIMU would facilitate the strengthening of the HRM Department to position it to perform new personnel management functions being developed under the GOA civil service reform strategy. It would arrange with the IARCSC to train and mentor

MOF/HRM staff to apply new operational procedures and manuals as they are developed under the CSR project covering: (i) hiring for positions graded 3 and below following merit-based practices; (ii) assessing individual job performance; (iii) managing personnel assignments, re-assignments, promotions and sanctions; and (iv) applying separation policies. In coordination with the CSR project, the RIMU would facilitate the placement of a human resources management expert for 36 months to assist the MOF HRM Department to re-organize so as to accommodate the management of new civil service regulations, and to mentor staff in applying the training and new operational norms.

3.1.4 Preparation of New Human Resources Management Initiatives

83. The MOF would be expected to make three major strategic decisions to sustain the effects of training, pay reform, and improved personnel management:

- Initiating “schemes of service” to permit the MOF to be competitive in recruiting and retaining professionals in selected professional streams considered critical for the long term performance of PFM functions within the framework of the new grading and pay system. While the new grade and pay system would be adequate for motivating and promoting staff and rewarding the performance of most general civil service functions in the MOF, select professions including accounting, procurement management, government auditing have special job descriptions, qualifications and certifications, and remuneration requirements that should be recognized if individuals in these fields are to become experienced and long term public servants. The RIMU and HRM Department would prepare a proposal for installing “schemes of service” for these three professional categories with the assistance of international experts in the matter, and when agreed, launch its application;
- Reducing the reliance on internationally recruited technical assistance in line functions of the MOF would be an important element in establishing the longer term sustainability of Afghanistan’s public financial management system. The current level of credibility of MOF’s financial management practices is being assured by the extensive use of international and national contractors which is not considered to be sustainable in the long run. In 2007 there are 76 full time expatriate consultants and 200 “local advisors” working primarily in line duties in the MOF. The RIMU would collaborate with the respective departments in MOF on a diagnosis of continuing needs, an inventory of positions that could be “nationalized” considering available human resource capacity, and a timetable for making the transfers; and
- Introducing gender-sensitive personnel practices. While there is not a national standard for recognizing and addressing the special requirements of women in the Afghan work force, the MOF would initiate: (i) a baseline survey to develop intelligence on the numbers and status of women currently employed and diagnose issues that impede their productive

contributions; and (ii) design actions that could be implemented within current legal constraints to remove obstacles and promote further participation of women in the MOF workforce.

3.1.5 PFMR Project Coordination and Administration

84. The RIMU would coordinate the implementation of the components of the project. It would also coordinate through the use of the annual work plan for MOF, the implementation of the PFMR project with the projects being financed in parallel, for example the DFID support to the Budget Department.

85. For the next three years, the RIMU would assume responsibilities for day-to-day project administration including the: (i) administration of contracts with international firms (including those not supported by the IDA Grant), as well as monitoring performance under these contracts; and for (ii) project related procurement, financial management, and accountability for safeguards. The Administration Department would participate in these tasks and assume control by the end of the third project year.

3.1.6 Monitoring and Evaluation of Results

86. The RIMU would temporarily incorporate the MOF Monitoring and Evaluation Unit (M&EU) to assure coherence between monitoring and evaluation of results and the development and re-development of reform work programs. The unit and RIMU would produce an Annual Performance Review (APR) with emphasis on the benchmarks contained in the Results Framework, as well as a review of actions that had been taken. It would cover all reform measures undertaken in the MOF, not just those supported by the PFMR project.

4. DIRECT OPERATIONAL SUPPORT FOR PFM FUNCTIONS (US\$ 16.0 million)

87. The goals of the government include maintaining appropriate fiduciary standards to provide reasonable assurance to the Afghan public and to international donors that government resources and donor funds are subject to appropriate budget and expenditure controls. This has been achieved during the reconstruction period with the assistance of direct operations support based on internationally recruited consultant firms for procurement, treasury and external audit. Moreover, the Mid-Term Review of the PACB project indicated that because of the limited progress in progress in capacity building of civil service skills in PFM, there is a need for continuing the direct operations support under a new PFM technical assistance operation on with the World Bank. It is also recognized that the outputs of these contracts provide the fiduciary framework that the government has agreed for the PSIB and for the ARTF contribution to the recurrent budget. The PFM action plan soon to be committed to by the government is also directly supported by the outputs of the direct operations support contracts. By the end of the project, however, the nature of support needed to procurement, treasury and audit will

have evolved to that of supervision, policy advice, and assistance for reform rather than for the execution of the day-to-day operations.

88. While the project's approach to direct operations support recognizes that this type of technical assistance is still necessary for the medium term, it looks for this round of contracts to contribute to building the skills for the Afghanistan public sector by two means: (i) on-the-job training for civil servants who will be acquiring basic knowledge under the HR Development component of this project with the direct operations consultant firms; and (ii) by including in the technical assistance teams under the direct operations support contracts a larger share of local advisors with concrete deliverables for the transfer of knowledge and skills for the operation of the PFM systems. This will contribute to a pool of local advisors highly trained in public financial management and provide sustainability as an alternative to international support in future in the form of in-country expertise which would complement the knowledge and skills of the civil service.

4.1 Direct Operations Support for Procurement

89. There are currently two forms of direct operational support for procurement funded by the PACB.

90. First, the services of a central procurement facilitation consultant directly support line ministries with the procurement process with both procurement of donor programs and domestically funded procurement. The consultant works under the Ministry of Economy (MOE) and an allowance is included to cover operating costs of the MOE Procurement Unit while the consultant services are required.

91. While these consultant services and support will be continued under the scope of the proposed project, the decentralization process envisaged through the transfer of procurement responsibilities which is integral to this project will mean that the need for such direct operational support will decrease significantly over time. Six line ministries are targeted for de-concentration of procurement following the training and certification under the capacity building of Component 1. Under the existing arrangement, the procurement facilitating consultants' team is located at the ARDS; however, a different approach is envisaged to be followed under the current proposed project whereby the team leader of the consultants' team will be located at the ARDS and all other key staff will be located at the line ministries. Through this modified approach, the procurement facilitating consultant will not only be able have better interaction with the line ministries but will also be able to mentor the line ministries' procurement staff.

92. Second, the PPU within the MOF is receiving direct support through the funding of its director (an international consultant) and core staff who are tasked with setting up the PPU and making it operational. This short term support will continue under this component to enable the PPU to begin its functions while a full complement of local staff is being recruited and trained in all the required functions.

4.2 Direct Operations Support to Treasury Operations

93. During the reconstruction MOF has maintained high levels of accountability in part through the assistance of a consultancy services to Treasury financed by earlier World Bank projects. The demand for transparency and accountability for the use of public resources is growing in Afghanistan and meeting the requirements for reform, accountability and transparency will constrain the pace at which MOF can reduce its dependence on international supported staff and contracted services. The project will continue to provide operational support for the Treasury functions through the services of internationally recruited firms.

94. Activities under this sub-component will include: operational support and on-the-job training in accounting and reporting, cash management, payroll processing, grant management, and payment processing as well as maintenance and operation of AFMIS. The contractor will put more emphasis than in the past on using local advisors and transferring a requisite minimum level of skills to them to operate the PFM systems by project end.

4.3 Direct Operations Support to External Audit

95. The scarcity of qualified accountants and the lack of understanding of financial statement audits within the CAO have required that the audit advisor firm play a significant role in the conduct of audits since 2002. During this period, the CAO has completed, with the assistance of the audit operations advisors, the audit of all of the World Bank and ARTF funded projects, and the capacity of the CAO staff has improved under the on-the-job training supplied by the firms during the audits. These steps have been successful in re-establishing the CAO as a working institution capable of absorbing institutional strengthening assistance, but it has not developed the institution and its staff sufficiently for them to conduct financial statement audits to international standards without continuing professional assistance.

96. This sub-component will first finance the consultant services to conduct with the CAO the external audit of donor projects. An important objective is achieving compliance with the International Standards of Auditing (ISAs). The audit operations advisors financed by the World Bank projects have not yet participated in audit of the government-wide financial statements. The passage of the PEFM Law necessitates that the CAO make greater use of the advisor in these audits which should be done in accordance with the ISAs. The firm will also assist with state budget audit during the period of the PFMR project.

97. Similarly, the selection criteria for the operations advisor will consider the share of local advisors in the team who are following some accreditation program in accounting. Team members are expected to acquire the core skills for audit field work by the end of the project life.

98. **Cost Estimates.** The cost estimated for each component in Table 3.1 is based on calculations performed by the Bank team using unit rates on contracts under the current PACB project.

Table 3.1: Costs by Component

<i>Component</i>	<i>US\$</i>
1. Institutional Development	11,400,000
2. Human Resource Capacity Development	5,000,000
3. Reform Management	1,000,000
4. Direct Operations Support for PFM Functions	16,000,000
Total	33,400,000

5. POTENTIAL RISKS AND MITIGATION

99. The PFMR project would be implemented in a high risk environment created by an uncertain security situation and general weakness in Afghanistan's institutional capacity for implementing operations. These risks are largely beyond the control of the MOF. Conversely, there is a high degree of consensus among donors and officials that reform in the MOF and the overall PFM system is critical and that there is strong ownership by current MOF leadership of a strategy for change. Safeguards issues (environmental, social) are not likely to arise as the project is designed to maintain fiduciary controls while gradually introducing reforms.

100. However, the project also faces significant implementation risks that derive from its being essentially an institution development and capacity building operation including those presented in Table 3.2.

Table 3.2: Risk Mitigation

<i>Risk</i>	<i>Mitigation</i>
Lagging training and capacity development that will limit pool of qualified personnel	Create new and additional civil society and university-led options for professional training and certification
Low recruitment and/or retention rates for trained personnel that will slow rate of transfer of responsibilities to civil service	Complete pay and grading reform in MOF; explore new grading options for certified PFM and procurement professionals
Resistance of staff to reforms	Adopt a participatory and change management approach to build in-house ownership of reform
Incomplete donor coordination creating reform program gaps and inconsistencies	Adopt pro-active donor coordination and mobilization action within RIMU
Non responsive reform programming, missing opportunities and repeating errors	Manage reform through annual performance evaluations and follow-on budget and work programs by RIMU with stakeholders
Objectives could be undermined by pervasive petty and procurement corruption	Emphasize the social accountability and greater disclosure on procurement
Reliance on country systems for project financial management and procurement implementation and not on project specific and project controlled arrangements	The country systems will be aided by the same project outputs and monitored by the project team and the PSIB supervision
No tradition of accountability or institutional framework to support de-concentration	Support to Parliament to encourage due process applied for malfeasance and support for building fraud investigation capacity

IV. INSTITUTIONAL ARRANGEMENTS AND PROJECT IMPLEMENTATION

101. The PFMR project will be implemented over a period of 36 months under the following arrangements.

1. Governance and Management Structure

102. The project would be implemented under the authority of the Minister of Finance. He would chair and be assisted by a PFM Reform Steering Committee, comprising senior MOF departmental managers (Treasury, Budget, Internal Audit, Administration, PPU), a representative of the MOE (responsible for procurement operations support) and a representative of the CAO to maintain focus on results, good communications, a consolidated view of the reform, and any necessary policy and regulatory improvements. This committee is a successor to the advisory committee overseeing the PACB.

103. Daily operations of the project would be organized and coordinated for a newly formed RIMU. The RIMU would report to the Minister and assist him as the “secretariat” for deliberations of the PFM Reform Steering Committee. This practice would follow, in effect, that already employed by the M&EU monitoring the implementation of the MOF Strategic Plan. The specific roles of the RIMU would be to: (i) prepare the overall plan of actions with the contributions of the various departments and donors making contributions; (ii) coordinate actions to assure mutual support and cross-functional efficiency; (iii) monitor progress; and (iv) evaluate the intended results. This would cover all project-supported activities including those implemented through the MOE and the CAO as well as activities financed by other donor partners (for example the Department for International Development-UK [DFID], supporting the development of the Budget Department).

104. Managers of the various MOF departments being supported through the project (and by other donors) would be responsible for achieving their own results within the MOF annual work plan once they are agreed.

2. Specific Implementation Arrangements for Project Components

105. Each component and sub-component would follow daily implementation arrangements specific to the needs of the department being assisted and tasks to be performed. These responsibilities are summarized in Table 4.1. The RIMU Director would convene periodic meetings of these working level authorities to identify and resolve implementation issues that were outside the scope of their individual authorities.

106. The Treasury Department, MOE, and CAO would also be ultimately responsible for the performance of line ministries in executing their specific areas of expertise following the decentralization of PFM functions. The implementation of the roll-out of AFMIS will be done in conjunction with the Budget Department given the coverage of

allotment and contract control now under their responsibility which will be affected by the roll-out. However, the RIMU would assist in coordinating the execution of decentralization process from an institutional development perspective. The RIMU would collaborate with the managers of the departments concerned to assure that critical agreements affecting the decentralization process have been or are being resolved including: selecting the line ministries to be assisted; setting preconditions to be met by line ministries prior to being supported in adopting PFM functions; defining procedures and processes for maintaining work flows between MOF and the line ministries and quality control; and assuring adequate training and materials for line ministry staff.

Table 4.1: Implementation Table

1	Component	Institutional Development				
1.1	Social Accountability	Treasury and Budget Departments		PPU		
1.2	AFMIS Development and Roll-out					
1.3	Internal Audit - Development of Work Practices		Internal Audit			
1.4	External Audit					CAO
2	Component	HR Capacity Building				
2.1	HR Development in Procurement			PPU		
2.2	HR Development in Financial Management	Treasury				
2.3	HR Development in Audit		Internal Audit			
3	Component	PFMR Management				
3.1	Public Financial Management Reform Project				RIMU	
4	Component	Direct Operations Support				
4.1	Direct Operations Support for Procurement					MOE
4.2	Direct Operations Support for Treasury	Treasury				
4.3	Direct Operations Support for External Audit					CAO

3. Coordination with Donors and with the PAR Strategy

107. The RIMU would conduct two closely related annual events that would include the participation of donors and other stakeholders. The APR would report on the achievement of results and evaluate progress considering the benchmarks set for the project and expectations set out in the previous years' annual work program. The APR would diagnose issues and lead to recommendations for modifying work programs, regulations or implementation arrangements. An annual work programming exercise, which would account for the results of the APR, would also include the participation of donors and account for changes in their support activities.

108. The government is committed to public administration reform and its strategy has recently evolved to encompass deep reforms within line ministries, improvements in institutions of oversight such as the judiciary and Parliament, and over the longer term, evolution in the role of sub-national institutions of governance and enhanced civil society engagement. Reform of the PFM in the MOF, MOE, CAO and other line ministries and sub-national bodies is a critical element of the overall GOA PAR strategy and program considering its role in determining civil service pay and responsibilities for determining the rate at which PFM functions can be transferred to line ministries and agencies. The Minister of Finance is a member of the PAR Steering Committee which oversees the civil service reform and general PAR program.

4. Procurement Arrangements

109. Afghanistan has made considerable efforts to establish the Legal and Regulatory Framework for procurement in the last five years with the donor support. A new Procurement Law reflecting the best international practices in public procurement has been enacted in November 2005 replacing the earlier Procurement Regulations. The Afghanistan Procurement Regulations and Procedures have been prepared and awaiting the clearance from the Ministry of Justice and the Cabinet of Ministers. A Special Procurement Commission which will be responsible to review the contract award recommendations for contracts exceeding US\$500,000 will be operational in April 2007. A Manual of Procedures for Procurement Appeal and Review has been prepared and the system will begin to be operational by April 2007. Afghanistan-specific bidding/proposal documents will be prepared by December 2007. Bidding opportunities for all major contracts and the contract awards are published in the ARDS website under the MOE. ARDS-PU is currently issuing the bidding documents to all the potential bidders electronically free of charge. The above actions will increase the transparency and the confidence of the business community. However, much needs to be done in dissemination of the new law/regulations/procedures/appeal mechanism to all the stakeholders of government and the business community. A technical assistance operation is in place to carry out an intensive and extensive capacity building program. Action will be simultaneously taken to develop procurement proficient personnel with an accreditation system. In addition GOA would seek opportunities to get the civil society involved to provide an oversight in the adherence to transparency in the process.

110. Most of the procurement under the project will be for the provision of technical assistance through firms/individuals which would provide assistance corresponding to each of the components and sub-components to MOF/MOE and CAO. ARDS-PU shall assist all the implementing agencies to carry out procurement of major consultancies including high value individual assignments and all goods following International Competitive Bidding (ICB) and National Competitive Bidding (NCB) procedures other than the assignment for selection of a firm to manage the Procurement Unit. The implementing agencies will provide technical inputs in preparation of terms of reference and specifications and take the lead in carrying out technical evaluations. The procurement departments of each implementing agency will be responsible for the procurement of small value goods contracts following Shopping and Direct Contracting

procedures. RIMU will take the lead in coordinating activities among all agencies. Actual tendering would be managed by the ARDS. A summary of procurement methods is given in Annex C.

111. The Financial Officer of the RIMU would be responsible for contract administration, and with the user department, shall monitor compliance with terms of reference/compliance to the agreed specifications.

5. Financial Management, Disbursement and Audit Arrangements

112. A PFM performance rating system has been recently developed for Afghanistan by the PEFA multi-agency partnership program which includes the World Bank, IMF, European Commission, and other agencies. Afghanistan's ratings against the PFM performance indicators portray a public sector where financial resources are, by and large, being used for their intended purposes as authorized by a budget that is processed with transparency and has contributed to aggregate fiscal discipline.

113. At the project level, financial management will be coordinated by the RIMU of the MOF. The RIMU would report to the Minister of Finance as his project executive arm and will also serve as the "secretariat" for deliberations of the PFM Reform Steering Committee. A Financial Management Specialist will be recruited at RIMU with responsibility for financial management activities of the project which will include processing of consultants and suppliers invoices for payments (i.e., preparing M-16 forms payment orders); maintaining relevant accounting records; preparing required monthly, quarterly and annual reports; coordinating with other component implementing entities to ensure that adequate financial management requirements are met; liaising with the Special Disbursements Unit (SDU) to ensure that the Designated Account (DA) is replenished when due; and responding to project audits.

114. At the implementing entities responsible for the other components, a dedicated manager and an accounts officer will be assigned by these entities to ensure that they maintain adequate records and prepare technical and financial reports of their activities.

115. Quarterly un-audited financial statements will be prepared by the RIMU accounting unit. Consolidated project reports will be prepared, reviewed, and approved by the MOF, supported by the FM Advisor. A DA will be opened at Da Afghanistan Bank (DAB, Central Bank). The DA will be maintained by the MOF. Withdrawal applications for replenishment will be submitted monthly. Financial management arrangements for the project are detailed in Annex D.

116. **Funds Flow.** Funds management for the project will follow existing procedures. As with all public expenditure, all payments under the project will be routed through MOF. The FM Advisor will assist the MOF in executing and recording project payments. In keeping with current practices for other projects in Afghanistan, the DA will be operated by the SDU in the Treasury Department MOF. Requests for payments from DA funds will be made to the SDU by RIMU. In addition to payments from DA funds,

RIMU can also request the SDU to make direct payments to consultants or consulting firms and special commitments for contracts covered by letters of credit. Such requests will follow World Bank procedures. All withdrawal applications to IDA including replenishment, reimbursement, and direct payment applications will be prepared and submitted by MOF.

117. **Accounting and Reporting.** A Financial Management Manual will be prepared by RIMU documenting the financial management arrangements for the project. The manual will outline guidelines for project activities including specific requirements for each component implementing entity, and establish a project financial management system in accordance with standard Afghan government policies and procedures. This will include use of the Chart of Accounts developed by the Treasury to record project expenditure. Project accounts will be consolidated centrally in MOF, through the SDU and supported by the FM Advisor. Consolidated Project Financial Statements will be prepared for all sources and uses of project expenditures.

118. **Disbursement Method.** Disbursements from the IDA grant will make use of reimbursement, direct payment, and payments under Special Commitments including full documentation or against statements of expenditures, as appropriate.

119. **Retroactive Financing.** A provision has been made to reimburse the Government for payments from government resources up to a maximum of US\$2 million for eligible project expenditures incurred after April 15, 2007 and up to the signing of the Financing Agreement, in accordance with the Bank's procurement guidelines. In particular and given its urgency and priority, this provision is expected to be utilized to facilitate the early mobilization of the consultants on systems development and for the RIMU.

120. **Audit of Project Funds.** The Auditor General, supported by the Audit Agent, is responsible for auditing the accounts of all IDA-financed projects. Annual audited project financial statements will be submitted within six months of the close of GOA's fiscal year. The project audit of 1384 reported ineligible expenditures which are still pending resolution.

V. ACTION PLAN, MONITORING AND EVALUATION AND RESULTS

A. Action Plan

121. The MOF has agreed to establish the RIMU as the vehicle for advising MOF management on its action plan for improving overall PFM performance. Staffing of the RIMU has begun with the appointment of the Director. The remaining national staff of the RIMU were due to be appointed before project negotiations. The services of international advisors for the RIMU have begun in that terms of reference and qualifications for two key positions have been agreed. Securing these services will be arranged with the IARCSC under conditions governing the CSR project. The project will

be implemented through annual work plans; the plan for the first year will be prepared before the project begins.

B. Monitoring and Evaluation Arrangements

122. The RIMU would incorporate the current M&EU into its structure for the life of the PFMR project to assure coherent results-focused project management. The M&EU now reports to the Deputy Minister of Administration and this arrangement would be reinstated at the end of the project.

123. The M&EU which is staffed by a senior Afghan national consultant has conducted one full year monitoring the reform activities assigned to each of the MOF's operating departments contained in the MOF Strategic Plan. It has reported findings quarterly to the Deputy Minister of Administration and senior MOF officials. However, the Strategic Plan focused mainly on shorter term actions that would correct immediate operational deficiencies in the MOF's work. As a result, the M&EU has not had experience in monitoring "results" and evaluating longer term outcomes. It has not therefore been in a position to recommend re-programming reform activities contained in that Strategic Plan.

124. With the M&EU staff, the RIMU would introduce a new monitoring methodology including monitoring the achievement of annual benchmark results as presented in Annex A, in addition to the more conventional monitoring of the execution of activities that are agreed in annual work programs.

- Quarterly Activity Reports. RIMU/M&EU would continue current practices in compiling quarterly activity and input use reports that would also evaluate progress in meeting expected annual results. The audience for these reports would be the RIMU and the PFMR Steering Committee. They would be used essentially for short term management and coordination purposes. They would draw on observations by the M&EU and activity reports by those responsible for implementation of various components and sub-components (as is the current practice), as well as expenditure and personnel use data. They would estimate the likelihood of meeting annual results expectations based on these observations. The mid-year report would be compiled so as to coincide with a regular supervision mission of IDA and other donors.
- Annual Performance Report. During the last quarter of each project year, in time to influence the preparation of the following year's work program, the RIMU would contract with independent short term consultants to make a more thorough review of project performance. Their report would be "strategic" in nature and tone, compiling the updated information previously presented in quarterly activities reports, but focusing on evaluating progress in meeting results benchmarks (for individual components and sub-components) and the project's strategic objectives. It

would make recommendations concerning modification of activities, and in an extreme case, modification of expected results. The audience for this report would be the RIMU, the Minister, Deputy Ministers/Treasury, the Project Steering Committee, and donors.

- Annual Performance Review (APR). Based on the consultant's report, the Minister and the RIMU would convene an APR whose objectives would be to: (i) validate the factual findings and agree with or modify their interpretation; and (ii) discuss and agree on modifications to the reform program activities. This would assure that strategic results were going to be achieved and the follow-on annual work program (activities, costs, financing, implementation arrangements) would incorporate these actions. In the second APR, if exogenous events appeared to make original assumptions underlying the project unrealistic, the development objectives of the project may also be modified. The APR would be timed to meet the GOA budget cycle. Donors would be expected to time their project supervision activities to participate in the APR.

125. After approximately 24 months of project implementation, the RIMU would conduct a strategic review of progress in meeting overall PFMR results (Annex A). As a key part of this review, it would engage short term consultants to assist in updating the findings of the "PEFA Analysis" contained in the 2005 publication "Afghanistan: Managing Public Finances for Development." The purpose of this review would be to identify the framework for the preparation of a further 2-3 years of reform in the PFM system which might be supported by donors. The audience for this review would be the political level of the GOA, donors, and stakeholders. Donors would participate in this review treating it as an "identification" exercise for their further possible support for PFM reform.

C. Bank Supervision

126. Bank monitoring and evaluation will be based on a set of specific and monitorable performance monitoring indicators from the results framework presented in Annex A. Specific benchmarks have been outlined for agreement between the government and technical assistance providers early on in implementation so as to measure specific progress in meeting both the PFM performance and capacity building objectives. The project's task team leader will be located in Kabul and conduct continuous supervision. Additionally, a full supervision mission will be carried out twice a year comprising appropriate specialists from each of the component areas. This supervision will be conducted in coordination with the supervision of DFID's technical assistance on Budget Formulation and Execution. Before the end of the second year of project implementation, a mid-term review will be conducted in order to assess the advance toward the development objectives. The RIMU will have the primary responsibility to prepare and furnish to IDA quarterly project report highlighting progress in undertaking the actions required to achieve project development objectives.

ANNEX A. RESULTS FRAMEWORK AND MONITORING

Project Development Objectives	Project Outcome Indicators	Contribution to Global GOA/MOF Goals
(i) to develop an efficient and effective public financial management system	<ul style="list-style-type: none"> i) Coherence of budget, treasury and revenue estimates with ANDS priorities and MTFP ii) Timeliness of budget, treasury and revenue preparation and execution 	Maximizes PFM contribution to economic management and growth development impact and development impact of resource flows; lowers risk to donors of making longer term, predictable commitments
(ii) to develop the human resource capacity of the MOF and CAO to ensure better operation of public financial management	<ul style="list-style-type: none"> i) Level and perception of good governance in PFM operations ii) Number of ministries/agencies performing assigned treasury functions iii) Number of line ministries conducting stand alone procurement iv) Reliance on international technical assistance diminishing 	Builds “good use” justification for mobilizing national revenue (tax and customs reform) and good stewardship and improved development impact justification for increased donor support
Contributing Outcomes/Outputs	Contributing Outcome Indicators	Contribution to PDO Results
Authorities restructure institutions and de-concentrate operations: Mustofiat	<ul style="list-style-type: none"> i) Number of Mustofiat which have implemented restructuring and new processes of Mustofiat Reform program 	Provides structural framework for efficiency and efficacy in PFM contributes to a “culture of accountability” and good practice; broadens responsibility for good stewardship of national financial resources
MOF establishes, promotes and implements PFM systems that meet new accountability and transparency norms	<ul style="list-style-type: none"> i) Regular publication of opportunity and outcomes of public contracts. ii) Numbers of internal and external financial audits done to acceptable standards. iii) Timeliness, quality of annual financial statements submitted to the legislature and donors 	Provides basis for internal management and control of financial resources and assets, supporting good governance
MOF manages its human resources following improved recruitment, career management and incentives standards	<ul style="list-style-type: none"> i) Rate of re-grading staff at grades 2 and above and confirming assignments of qualified persons ii) Rate of re-grading staff at grades 3 and below in new structures with qualified persons iii) Improved work environment for women, including increase in numbers of women employed at different levels 	Provides the human resource capacity required for PFM systems to function

ANNEX A.1. ACTIONABLE INDICATORS AND PROGRESS BENCHMARKS

	Indicator	Baseline Dec. 2006	Benchmark Year 1	Benchmark Year 2	Benchmark Year 3	Collection and Reporting
1	Coherence of treasury and revenue estimates with ANDS priorities and MTFF	At Risk	[favorable reaction by donors]	[favorable reaction by donors]	Approval by donors at annual evaluation of treasury results (expenditure and revenue) vis-a-vis ANDS and MTFF framework	Minister, MOF; annual evaluation with donors; PEFA Review, 2009
2	Timeliness and predictability of treasury and revenue preparation and execution	Irregular and Moderate	<i>Quarterly cash forecast prepared and submitted to Minister</i>	Annual cash plan submitted to Minister, updated quarterly	Annual cash plan realized to within 80% of forecast	Minister, Treasury Reports, PEFA Review, 2009
3	Level and perception of good governance in PFM operations as measured by % of share of donor funds entrusted to the Core Budget	Moderate	5% increase of share of donor funds through Core Budget	5% increase of share of donor funds through Core Budget	5% increase of share of donor funds through Core Budget	Minister, MOF with donors; RIMU/M&E, APR; PEFA Review, 2009
4	Number of ministries performing assigned Treasury functions	None	2 Ministries recording payment request on line to AFMIS	4 Ministries with on-line access and making on line payment requests	6 Ministries with on line access for payment requests and recording allotments directly in AFMIS	RIMU/M&E, Annual Progress Review (APR); PEFA Review, 2009
5	Number of line ministries conducting stand-alone procurement	1	1	3	6	RIMU/PPU; APR
6	Reduced Reliance on International TA		Analysis of options and strategy determined	20% of strategic goal achieved	50% of strategic goal achieved	RIMU/Operations Departments
7	Number of Mustofiats which have implemented restructuring and new processes of Mustofiat Reform program	Nil	1	3	6	RIMU/Director General Treasury, APR
8	Regular publication of opportunity and outcomes of public contracts, in compliance with the Public Procurement Law and the Regulations		50% of the contracts meeting this requirement	80% of the contracts meeting this requirement	100% of the contracts meeting this requirement	Monthly procurement facilitating consultant reports and MOF procurement web site with information from procurement MIS
9	Number of internal audits completed in line ministries and Mustofiats to	Nil	4	12	24	RIMU/CAO; APR

	Indicator	Baseline Dec. 2006	Benchmark Year 1	Benchmark Year 2	Benchmark Year 3	Collection and Reporting
	acceptable standards					
10	Timeliness and quality of annual financial statements submitted to the legislature and donors	Only Qatia issued in line with law	Qatia and Annual Cash Based Financial Statements issued by Sept. 21	Qatia and Annual Cash Based Financial Statements and information on liabilities and assets issued by Sept. 21	Qatia and Annual Cash Based Financial Statements and information on liabilities and assets issued by Sept. 21 (as in year 2)	Bank supervision of submission by MOF to Parliament
11	Percentage of authorized positions filled by re-grading and mapping staff into 8-grade/52 pay-point system or hiring	0	50 of Level 2 and above	100 of Level 2 and above 50 of Level 3 and below	100 all levels	RIMU/HRM Unit/IARCSC (AB)
12	Improved work environment for women, including increase in numbers of women employed at different levels	Not available	Plan to be established as of 2007	Progress 5% a year	Progress 10% from base year	HR MOF personnel records

ANNEX B. PROJECT COST SUMMARY BY COMPONENT AND CATEGORY
(100% Financed by IDA)

000,000 of SUS		Consultant Services	Training	Goods	Incremental Operating Expenses	Total
Component 1 - Institutional Development						
1.1	Procurement Strengthening and Social Accountability	0.90				0.90
1.2	Treasury Systems Development and Roll-out	5.00				5.00
1.3	Internal Audit - Development of Work-practices	2.20				2.20
1.4	External Audit					
1.4.1	Advisory Services for External Audit	2.00				2.00
1.4.2	Office and IT Equipment for the CAO			1.00		1.00
1.4.3	Parliamentary Oversight - Public Accounts Committee	0.20			0.10	0.30
Component Sub-total		10.30		1.00	0.10	11.40
Component 2 - HR Capacity Building						
2.1	HR Development in Procurement		1.00			1.00
2.2	HR Development in Financial Management		2.00			2.00
2.3	HR Development in Audit		2.00			2.00
Component Sub-total			5.00			5.00
Component 3 - Reform Management						
3.1	Reform Management	0.70			0.30	1.00
Component Sub-total		0.70			0.30	1.00
Component 4 - Direct Operations Support						
4.1	Direct Operations Support for Procurement	3.10			0.90	4.00
4.2	Direct Operations Support for Treasury	8.00				8.00
4.3	Direct Operations Support for External Audit	4.00				4.00
Component Sub-total		15.10			0.90	16.00
Total		26.10	5.00	1.00	1.30	33.40

ANNEX C. PROCUREMENT ARRANGEMENTS

A. Country Context

1. The Bank has gained substantial experience and understanding of the procurement environment in Afghanistan through its involvement in the interim procurement arrangements put in place through EPAP as well as with the institutions such as ARDS that is holding the current responsibility for government's procurement administration. As part of the broader review of Afghanistan's PFM system, the Bank recently carried out an assessment of the procurement environment in the country based on the baseline and performance indicators developed by a group of institutions led by the World Bank and Organization for Economic Co-operation and Development/Development Assistance Committee.

2. The first key issue identified through the procurement assessment was the need for ownership and a champion in the government for reform, deepening of capacity, ensuring integrity in the operation of procurement systems, and promoting sound procurement among ministries.

3. A new Procurement Law was adopted in November 2005 which radically transforms the legal and regulatory framework for the procurement administration of Afghanistan. While it provides a very modern legal system for procurement, effective implementation of the law may encounter difficulties in the current weak institutional structure and capacity of the government. A PPU has now been established under MOF to ensure the implementation through the creation of secondary legislation, standard bidding documents, provision of advice and creation of the necessary information systems for advertising and data collection. "Afghanistan Procurement Regulations" has been prepared under two sections: (i) Regulations; and (ii) Procedures and under review by the Ministry of Justice prior to submission to the Cabinet of Ministers. Procedures for procurement appeal and review have been developed by PPU/MOF and the nominated members will be appointed for the system to be functional by April 2007.

4. In the absence of adequate capacity to manage procurement activities effectively, some interim arrangements have been put in place to improve the procurement management of the country. A central procurement facilitation service, ARDS-PU has been established under the supervision of MOE. The Bank and the government have agreed on a program for country-wide procurement reform and capacity building leading to the transition from centralized to decentralized procurement services. The Bank funded PACB project is the primary instrument for implementing the program to strengthen capacity of the line ministries to manage public procurement in an effective, transparent and accountable manner. However, the implementation of the procurement capacity building strategy has not made any significant progress yet due to lack of coordination and delays in decision making within the government. The envisaged radical changes to the procurement management environment expected from the new Law also require the urgent implementation of a comprehensive human resources and

capacity development program. The implementation of the procurement reform component of the PACB and the proposed PFMR project should be considered with due priority to ensure that fiduciary standards are further enhanced and that capacity is developed in the government to maintain these standards.

Part A - General

5. The procurement administration of the project would be carried out in accordance with the World Bank's "Guidelines: Procurement under IBRD Loans and IDA Credits" dated May 2004, "Guidelines: Selection and Employment of Consultants by World Bank Borrowers" dated May 2004, and the provisions stipulated in the Financing Agreement. The general description of various procurements under different expenditure categories are described below. For each contract to be financed by the Grant the different procurement methods or consultant selection methods, estimated costs, prior review requirements, and time frame agreed between the Grant Recipient and the Bank project team are described in the Procurement Plan. This Procurement Plan will be updated at least annually or more frequently as required to reflect the actual project implementation needs and improvements in the institutional capacity.

6. Procurement of Works. The proposed grant will not finance any works contracts.

7. Procurement of Goods. Goods procured under this project would include office furniture and equipment, IT equipment and software, multi media equipment, office equipment and computers for MOF/CAO. The procurement of goods will be done using Bank's SBDs for all ICB and Afghanistan-specific SBD agreed with the Bank for all NCB. Other procurement method will be shopping. All goods contracts estimated to cost more than US\$200,000 shall be procured following ICB procedures. The contracts estimated to cost more than US\$100,000 and less than US\$200,000 shall be procured following NCB procedures and contracts estimated to cost less than US\$100,000 shall be procured following shopping procedures. With the prior agreement with IDA, direct contracting method may be used to procure proprietary software including upgrades for existing software and other goods and services which meet the requirements as per the provision under paragraph 3.6 of Bank's Guidelines.

8. Selection of Consultants. There will be a several high value technical assistance (TA) contracts under the project. These TAs will include the hiring of consulting firms for: (i) Procurement Capacity Building and Legal and Institutional Reform; (ii) Treasury systems development and roll-out; (iii) Internal Audit Work Practices; (iv) HR development in Financial Management; (v) HR development in Audit practices; (vi) Management of Reform implementation of the MOF; (vii) Central Procurement facilitation; (viii) CAO support in audit operations; and (ix) Treasury Operations support. The consultant for Procurement Capacity Building and Legal and Institutional Reform has commenced the assignment. This assignment will be partly financed by the ongoing PACB II project.

9. In addition there will be high value assignments for individual consultants to provide: (i) advisory inputs to PPU; (ii) to support Internal Audit Reviews and Fraud Review; and (iii) external audit – Parliamentary oversight.

10. Some of the above assignments have already commenced under the on-going PACB project and extensions to the ongoing contracts as needed may be provided based on the performance of the consultants in the on-going assignment following Single Source Selection (SSS) procedures.

11. The selection of consultants under the project will include Quality and Cost Based Selection (QCBS), Quality Based Selection (QBS), Consultants' Qualifications Selection (CQS), Least Cost Selection (LCS), Fixed Budget Selection (FBS), SSS and individual consultants in accordance with Section V of the Bank's guidelines for the selection of consultants. Threshold for CQS procedure will be US\$200,000 per contract.

12. Short lists of consultants for services estimated to cost less than \$100,000 equivalent per contract may be composed entirely of national consultants in accordance with the provisions of paragraph 2.7 of the consultant guidelines.

13. **Incremental Operational Costs** which would be financed by the project would be procured using the implementing agency's administrative procedures which were reviewed and found acceptable to the Bank.

Part B - Assessment of the Agency's Capacity to Implement Procurement

14. The project will be implemented by MOF. An assessment of the capacity of the MOF to implement the procurement actions under the project was carried out in February 2007 by Deepal Fernando (Senior Procurement Specialist) and Rahimullah Wardak (Procurement Analyst) of the Afghanistan country office.

15. The assessment reviewed the organizational structure for the implementation of the project and the capacity of the implementing agencies to handle procurement.

Ministry of Finance

16. Director General (Administration) of the MOF is handling day-to-day small value procurement for the ministry. Therefore, that unit has the capacity to carry out small value contracts following shopping and direct contracting procedures with limited capacity building. This unit has not handled and does not have the capacity to handle large value contracts including selection of consultants.

Control and Audit Office

17. The Department of Services reporting to Director General (Finance and Administration) is responsible for all the procurement actions of the CAO. CAO's office does not carry out major procurement activities. In the recent past they have purchased a

few computers and furniture under the development and ordinary budget. They have one procurement officer. We can agree to allow the CAO office to procure goods following shopping and direct contracting procedures.

Ministry of Economy

18. The Procurement Unit of the MOE is handling day-to-day small value procurement for the ministry. Therefore that unit will have the capacity to carryout small value contracts following shopping procedures with limited capacity building. This unit has not handled and does not have the capacity to handle large value contracts including selection of consultants.

19. The ARDS-PU of the MOE already has sufficient capacity and experience in handling procurement. At present, PU provides procurement services to all the ministries under the GOA for all projects funded by the government and donors. There was a circular of MOF which indicates that ARDS-PU should carry out all the procurement actions for contracts estimated to cost more than US\$200,000. This requirement may be waived provided the implementing ministry/agency is sufficiently equipped with staff or procurement consultants capable of carrying out procurement actions. The staff of ARDS-PU is familiar with procurement procedures and guidelines of the GOA, World Bank and other donors. ARDS has a register of firms and consultants. All the bid invitations and Expressions of Interest are advertised in their website and the documents are issued electronically free of charge to the registered bidders and the others who wish to participate in the bidding process. All the awards as per the Law are published in the ARDS website on behalf of all the ministries who seek their services.

20. Based on the above assessment, it was agreed that all goods contracts following ICB/NCB procedures and all consulting assignments with firms and high value assignments of selection of individual consultants on behalf of the MOF will be carried out by the ARDS-PU under the MOE. The assignment for the selection of a consultant for central procurement facilitation will be handled by the administration unit of the MOF with guidance from MOE and PPU of MOF, as it will be a conflict to allow the current ARDS-PU to take a lead in the procurement process.

21. However in order to mitigate procurement risks, it is proposed to conduct several training programs as indicated below for the staff of the MOF, CAO, and MOE especially drawn from the administration unit and potential evaluation committee members. In addition, it is important that the consultant selected to carryout the capacity building activities carry out several programs to create awareness among all the stakeholders of the new Procurement Law and Afghanistan Procurement Regulations and Procedures. The proposed capacity building program is presented in section D1.

The procurement risk at the country level is considered as “Average.”

Part C - Procurement Plan

22. The Grant recipient, at appraisal, developed a procurement plan for project implementation which provides the basis for the procurement methods. This plan has been agreed between the Grant recipient and the project team and is available at MOF, Pashtunistan Wat, Kabul, Afghanistan. It will also be available in the project's database and on the Bank's external website. The procurement plan will be updated in agreement with the project team annually or as required to reflect the actual project implementation needs and improvements in institutional capacity.

Part D - Frequency of Procurement Supervision

23. In addition to the prior review supervision to be carried out from Bank offices, the capacity assessment of the Implementing Agency has recommended two procurement reviews per year.

Attachment 1

Details of the Procurement Arrangements involving International Competition:

A. Goods and Works and Non-Consulting Services

(a) List of contract packages which will be procured following ICB and direct contracting:

NIL

(b) Goods above US\$200,000 equivalent per contract and all Direct Contracting will be subject to prior review by the Bank.

B. Consulting Services

(a) List of Consulting Assignments with short-list of international firms.

<i>Ref. No.</i>	<i>Description of Assignment</i>	<i>Estimated Cost in US\$m</i>	<i>Selection Method</i>	<i>Review by Bank (Prior / Post)</i>	<i>Expected Proposal Submission Date</i>	<i>Comments</i>
PPU/03	Procurement Capacity Building and Legal and Institutional Reform	6.0	QCBS	Prior	2006	Contract Awarded; Procurement HR development is included. Partly financed under PACB.
MOF-1	Treasury systems development and roll out	5.0	QBS	Prior	Sept. 30, 2007	
MOF-2	Internal audit work practices	2.2	QBS	Prior	Sept. 30, 2007	
MOF-3	HR development in financial management	2.0	QBS	Prior	Sept. 30, 2007	
MOF-4	HR development in audit practices	2.0	QBS	Prior	Sept. 30, 2007	
MOF-5	Management of reform implementation of the MOF	1.0	QBS	Prior	Sept. 30, 2007	
MOF-6	Central procurement facilitation	3.1	QCBS	Prior	Sept. 30, 2007	
CAO-1	Support CAO in audit operations	4.0	QBS	Prior	Sept. 30, 2007	
MOF-7	Support Treasury operations	8.0	QBS	Prior	Sept. 30, 2007	
PPU/1-2	Advisory inputs to PPU (around four contracts)	0.8	Indv./ SSS	Prior		Already commenced under PACB. These will be considered based on the need and the performance of the consultants.
MOF-8	Parliamentary oversight	0.3	Indv.	Prior		
MOF-9	Procurement Strategic Communication and Dissemination Strategy	0.2	Indv./ CQS	Prior		

(b) Consultancy services estimated to cost above \$100,000 or equivalents per contract and all Single Source Selection of consultants (firms) and estimated to cost US\$50,000 for individual for assignments will be subject to prior review by the Bank.

(c) **Short lists composed entirely of national consultants.** Short lists of consultants for services estimated to cost less than UD\$100,000 equivalent per contract may be composed entirely of national consultants in accordance with the provisions of paragraph 2.7 of the consultant guidelines.

Procurement Plan

A. General

A1 Project information

Country: Afghanistan
 Recipient: Islamic Republic of Afghanistan
 Project Name: Public Financial Management Reform
 Grant No.:
 Project Implementing Agency: Ministry of Finance

A2 Bank's Approval Date of the Procurement Plan: March 31, 2007

A3 Date of General Procurement Notice: March 21, 2007

A4 Period covered by this procurement plan: Eighteen Months

B. Goods and Works and Non-Consulting Services

B1 Prior Review Threshold. Procurement Decisions subject to Prior Review by the Bank as stated in Appendix 1 to the Guidelines for Procurement:

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

B2 Any Other Special Procurement Arrangements. None

B3 Procurement Packages with Methods and Time Schedule

1	2	3	4	5	6	7	8	9
Ref. No.	Contract (Description)	Estimated Cost (US\$m)	Procurement Method	Pre-qualification (yes/no)	Domestic Preference (yes/no)	Review by Bank (Prior / Post)	Expected Bid-Opening Date	Comments
01	Computers and related IT equipment several packages	0.4	NCB/NS	No	No	Prior	Oct. 31, 2007	
02	Office equipment for CAO and other agencies	0.2	NCB	No	No	Prior	Oct. 31, 2007	
03	LAN for CAO	0.2	NCB	No	No	Prior	Oct. 31, 2007	
04	Furniture several lots	0.2	NS	No	No	Post	Oct. 31, 2007	

C. Selection of Consultants

C1 Prior Review Threshold: Selection decisions subject to Prior Review by Bank as stated in Appendix 1 to the Guidelines Selection and Employment of Consultants:

	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	

C2 Short list comprising entirely of national consultants. Short list of consultants for services, estimated to cost less than \$100,000 equivalent per contract, may comprise entirely of national consultants in accordance with the provisions of paragraph 2.7 of the Consultant Guidelines.

C3 Any Other Special Selection Arrangements. None

C4 Consultancy Assignments with Selection Methods and Time Schedule

1	2	3	4	5	6	7
Ref. No.	Description of Assignment	Estimated Cost (US\$m)	Selection Method	Review by Bank (Prior / Post)	Expected Proposals Submission Date	Comments
PPU/03	Procurement Capacity Building and Legal and Institutional Reform	6.0	QCBS	Prior	2006	Contract Awarded; Procurement HR development is included. Partly financed under PACB.
MOF-1	Treasury systems development and roll-out	5.0	QBS	Prior	Sept. 30, 2007	
MOF-2	Internal Audit Work Practices	2.2	QBS	Prior	Sept. 30, 2007	
MOF-3	HR development in Financial Management	2.0	QBS	Prior	Sept. 30, 2007	
MOF-4	HR development in Audit practices	2.0	QBS	Prior	Sept. 30, 2007	
MOF-5	Management of Reform implementation of the MOF	1.0	QBS	Prior	Sept. 30, 2007	
MOF-6	Central Procurement facilitation	3.1	QCBS	Prior	Sept. 30, 2007	
CAO-1	Support CAO in audit operations	4.0	QBS	Prior	Sept. 30, 2007	
MOF-7	Support Treasury Operations	8.0	QBS	Prior	Sept. 30, 2007	
PPU/1-2	Advisory inputs to PPU (around four contracts)	0.8	Indv./SSS	Prior		Already commenced under PACB. These will be considered based on the need and the performance of the consultants.
MOF-8	Parliamentary oversight	0.3	Indv.	Prior		
MOF-9	Procurement Strategic Communication and Dissemination Strategy	0.2	Indv./CQS	Prior		

D. Implementing Agency Capacity Building Activities with Time Schedule

D1. In this section is the agreed capacity building activities. In addition to the program conducted by IDA for MOF/MOE/CAO staff, it is proposed that staff involved in the procurement activities of the grant be nominated to participate at training programs for Procurement Law/Regulations/Procedures/goods/works and consulting services conducted by the consultant hired for capacity building assignment under the MOF/PPU.

Proposed Capacity Building Program

No.	Expected outcome / Activity Description	Estimated Duration	Estimated Start Date	Proposed Participants
1	Procurement Workshop: General Introduction	2 days	May 2007	CAO/MOF/MOE
2	Procurement Workshop: Procurement of Goods	1 day	June 2007	CAO/MOF/MOE
3	Procurement Workshop: Selection of Consultants	1 day	May 2007	CAO/MOF/MOE

D2 Agreed Procedures for National Competitive Bidding

In order to ensure economy, efficiency, transparency and broad consistency with the provisions of Section I of the Procurement guidelines, the following criteria shall be followed in procurement under National Competitive Bidding procedures:

- (i) Standard bidding documents approved by the World Bank shall be used.
- (ii) Invitations to bid shall be advertised in at least one (1) widely circulated national daily newspaper and bidding documents shall be made available to prospective bidders, at least twenty eight (28) days prior to the deadline for the submission of bids.
- (iii) Bids shall not be invited on the basis of percentage premium or discount over the estimated cost.
- (iv) Bidding documents shall be made available, by mail or in person, to all who are willing to pay the required fee.
- (v) Foreign bidders shall not be precluded from bidding.
- (vi) Qualification criteria (in case pre-qualifications were not carried out) shall be stated on the bidding documents, and if a registration process is required, a foreign firm determined to be the lowest evaluated bidder shall be given reasonable opportunity of registering, without any hindrance.
- (vii) Bidders may deliver bids, at their option, either in person or by courier service or by mail.

- (viii) All bidders shall provide bid security as indicated in the bidding documents. A bidder's bid security shall apply only to a specific bid.
- (ix) Bids shall be opened in public in one place preferably immediately, but no later than one hour, after the deadline for submission of bids.
- (x) Evaluation of bids shall be made in strict adherence to the criteria disclosed in the bidding documents, in a format, and within the specified period, agreed with the Association.
- (xi) Bids shall not be rejected merely on the basis of a comparison with an official estimate without the prior concurrence of the World Bank.
- (xii) Split award or lottery in award of contracts shall not be carried out. When two (2) or more bidders quote the same price, an investigation shall be made to determine any evidence of collusion, following which: (A) if collusion is determined, the parties involved shall be disqualified and the award shall then be made to the next lowest evaluated and qualified bidder; and (B) if no evidence of collusion can be confirmed, then fresh bids shall be invited after receiving the concurrence of the World Bank.
- (xiii) Contracts shall be awarded to the lowest evaluated bidders within the initial period of bid validity so that extensions are not necessary. Extension of bid validity may be sought only under exceptional circumstances.
- (xiv) Extension of bid validity shall not be allowed without the prior concurrence of the World Bank (A) for the first request for extension if it is longer than eight (8) weeks, and (B) for all subsequent requests for extensions irrespective of the period.
- (xv) Negotiations shall not be allowed with the lowest evaluated or any other bidders.
- (xvi) Re-bidding shall not be carried out without the World Bank's prior concurrence.
- (xvii) All contractors or suppliers shall provide performance security as indicated in the contract documents. A contractor's or a supplier's performance security shall apply to a specific contract under which it was furnished.

ANNEX D. FINANCIAL MANAGEMENT

I. Country Issues

1. The Bank has gained substantial experience and understanding of the financial management environment in Afghanistan through the large number of projects under implementation over the past four years. The PACB project is the primary instrument to continue and enhance the fiduciary measures put in place during the past years to help ensure transparency and accountability for the funding provided by the Bank and other donors.

2. A PFM performance rating system using 28 high-level indicators that was developed by the PEFA multi-agency partnership program was applied in Afghanistan in June 2005. PEFA is comprised of the World Bank, IMF, European Commission, and several other agencies. The system is structured around six core dimensions of PFM performance: (i) budget credibility; (ii) comprehensiveness and transparency; (iii) policy-based budgeting; (iv) predictability and control in budget execution; (v) accounting, recording, and reporting; and (vi) external scrutiny and audit. Afghanistan's ratings against the PFM performance indicators generally portray a public sector where financial resources are, by and large, being used for their intended purposes. This has been accomplished with very high levels of support from international firms; this assistance will continue to be needed over the medium term if these ratings are to be maintained. There is also much room for improvement.

3. In spite of undeniable gains made in reconstruction since the end of 2001, the challenges facing Afghanistan remain immense, not least because of the tenuous security situation in the region and continued prevalence of a large illegal and illicit economy. The policy framework benchmarks have not yet been fully costed so various priorities are funded through the annual budgeting process. The rising costs of the security sector constitute the major constraint on attainment of fiscal sustainability. With regard to executive oversight, the national assembly will play an increasingly active role. All in all, the new national strategy has created high expectations of the executive which could prove to be quite difficult to meet.

4. The public sector, in spite of considerable efforts to reform its core functions, remains extremely weak outside of Kabul. The lack of qualified staff in the civil service and the absence of qualified counterparts in the government after 30 years of war and conflicts is a binding constraint. Delays in reforming the pay structure and grading of civil servants have severely crippled the public administration of the country. Domestic revenues lag behind expenditures by a factor of ten to one. Large-scale corruption could emerge to undermine the government's efforts to enhance aid flows through national accounts. Capacities to track expenditures and monitor expenditure outcomes have improved but they need rapid and substantial strengthening if progress toward the attainment of national development targets is to be monitored. Currently 75% of external revenues bypass government appropriation systems.

5. The World Bank is financing a Financial Management Advisor to assist the MOF, an Audit Advisor to assist the CAO, and a Procurement Advisor to assist in procurement-related activities. Also an Internal Audit function is being developed within the MOF with World Bank financing. USAID, and earlier the Indian Aid Assistance Program, is financing a team of consultants and advisors to assist the DAB in local as well as foreign currency operations. The activities carried out under the existing public administration projects have helped the government to ensure that appropriate fiduciary standards are maintained for public expenditures, including those supported by the Bank and the donor community.

6. Progress has been slower than expected in shifting from operations support provided by the three advisors to capacity development and knowledge transfer to the civil servants. Given that, it is expected that the advisors will continue to be required for the medium term. Challenges still remain in attaining the agreed upon fiduciary standards and also to further enhance them. And to make matters more complex, the regulatory environment in Afghanistan has advanced significantly in the past three years. Unfortunately, even mastery of basic skills in the early environment does not fully qualify the civil servants to work effectively in the new emerging environment.

II. Risk Assessment and Mitigation

7. The table below identifies the key risks that the project may face and indicates how these risks are to be addressed.

Risk	Risk Rating	Risk Mitigation Measures	Residual Risk	Condition of Negotiations, Board or Effectiveness (Y/N)
Inherent Risk				
Country Inherent Risk	M	Source - PFM study	M	N
Project Financial Management Risk	H	Minimize use of Designated Account, maximize direct payments to consultants; all procurement through Procurement Advisor.	S	N
Perceived Corruption	H	Government commitment, internal controls and new internal audit will help to reduce the high level of perceived corruption.	S	N
<i>Overall Inherent Risk</i>	H		S	
Control Risk				
1. Weak Implementing Entity	H	Newly formed Reform Implementation Management Unit (RIMU) of MOF will undertake the day-to-day management and a PFM Reform Steering Committee (PFMRSC) will be created to perform oversight function. Both RIMU and PFMRSC will have defined TOR. A Financial Management Specialist will be recruited specifically for the RIMU to	S	Y

Risk	Risk Rating	Risk Mitigation Measures	Residual Risk	Condition of Negotiations, Board or Effectiveness (Y/N)
		take responsibility of the project FM activities.		
2. Funds Flow	S	Payments will be made to consultants, Suppliers, etc. from the Designated Account by SDU-MOF. In addition to payments out of DA funds, the implementing entities can also request the SDU to make i) direct payments from the Credit Account to consultants or consulting firms, and ii) special commitments for contracts covered by letters of credit. These payments would only be made by SDU after due processes and proper authorization from the respective component implementing entities.	M	N
3. Budgeting	S	RIMU will coordinate with each component implementing entity for preparation of annual work plans and budgets; these would then be presented to the PFMRSB for approval.	M	N
4. Accounting Policies and Procedures	S	Will follow international standards. Project accounting procedures and details of the FM arrangements will be documented in an FM Manual to be approved by the Bank.	M	Y
5. Internal Audit	H	Newly-created internal audit department will review project internal control systems.	S	N
6. External Audit	H	Will be audited by CAO with support from Audit Advisor.	S	N
7. Reporting and Monitoring	H	Strengthening the SDU is a priority under the new FM Advisor contract, to provide information that will comply with agreed format of financial reports.	S	Y
Overall Control Risk	H		S	
Detection Risk	S	Adequate accounting, recording, and oversight will be provided in project procedures. Accounting/Recording/oversight by SDU – MOF of all advances/M-16 supported by Financial Management Advisor.	M	N
Risk rating: H=high risk; S=substantial risk; M=modest risk; L=low risk				

III. Strengths and Weaknesses

Strengths

8. The government provides assurance to the Bank and other donors that the measures in place to ensure appropriate utilization of funds will not be circumvented. The government support for PACB is strength in itself to enhance financial management in Treasury operations, public procurement, internal audit in the public sector, and external audit by the Auditor General. A specific strength is that this is a follow-up project, and thus, the agencies involved in the implementation of each component have experience in implementing Bank projects and following Bank procedures.

Weaknesses and Action Plan

9. The main weakness in this project, as in many others in Afghanistan, is the ability to attract suitably qualified and experienced counterpart staff especially for financial management. The additional staff to be funded by the project, together with intensive training programs included in this project, is expected to strengthen the fiduciary arrangements.

IV. Action Plan

Significant Weaknesses	Action	Responsible Agent	Completion Date
Shortage of qualified and experienced FM staff	Appointment of a Financial Management Specialist in RIMU	MOF	June 30, 2007
Project internal controls and procedures need to be defined	Financial Management Manual developed	MOF (RIMU)	August 31, 2007

V. Implementing Entity

10. The project would be implemented under the authority of the Minister of Finance. The Minister would be assisted by the PFM Reform Steering Committee (PFMRSC) comprising senior MOF departmental managers, a representative of the MOE responsible for procurement administration, and a representative of the CAO to maintain focus on results, good communications and a consolidated view of the reform and to discuss and recommend any necessary policy and regulatory improvements.

11. The PFMRSC will serve as the oversight body for the project. The committee will convene at least every quarter to review progress with implementation and review and approve work plans and budget.

12. Daily operations of the project would be managed by a newly formed RIMU. The RIMU would report to the Minister of Finance on project implementation and will also

serve as the “secretariat” for deliberations of the PFMRS. The specific role of the RIMU would be to plan, coordinate, monitor and evaluate the implementation of the overall PFM reform strategy work program and the achievement of its intended results. This would cover all project-supported activities including those implemented through the MOE and the CAO as well as activities financed by other donor partners (for example, DFID, supporting the development of the Budget Department). The RIMU would also undertake analyses and recommendations of key policy issues affecting the efficient performance and sustainability of PFM reforms. It would be responsible for planning for and facilitating and obtaining the contributions of the IARCSC to developing the MOF human resources management capabilities so that they are consistent with overall civil service management regulations and best practices. Lastly, the RIMU would facilitate establishing and maintaining linkages with line ministries and Mustofiats that would be the “clients” in strengthening PFM institutions.

13. Managers of the PPU, Treasury, Internal Audit, MOE, and CAO being supported through the project (and by other donors) would be responsible for achieving their own specifically assigned results, once they had agreed with annual work plans and established implicit performance agreements through the PFMRS. The RIMU would monitor these performance agreements.

14. The Financial Management Specialist to be recruited at RIMU will take responsibility for financial management activities of the project, which will include processing of consultants and suppliers invoices for payments (i.e., preparing M-16 forms payment orders); maintaining relevant accounting records; preparing required monthly, quarterly and annual reports; coordinating with other component implementing entities to ensure that adequate financial management requirements are met; liaising with the SDU to ensure that the Designated Account is replenished when due; and responding to project audits.

15. To ensure that the implementing entities responsible for the other components maintain adequate records and prepare technical and financial reports of their activities, a dedicated manager and an accounts officer will be assigned by the MOE and CAO.

VI. Budgeting

16. RIMU will coordinate with each component implementing entity for the preparation of annual work plan and the derivation of annual budget. This would then be submitted to the PFMRS for approval. RIMU shall also coordinate quarterly budget reviews to ensure adequate budget discipline and control. It will be responsible for ensuring that project expenditures for each fiscal year are captured in the governmental development budget of that fiscal year. The RIMU must get approvals from the presidential office and the Parliament and attach them to B27 and Project Coding Sheet forms at the time of requesting yearly allotments for contracts under the project to avoid delays in payment processing.

VII. Funds Flow

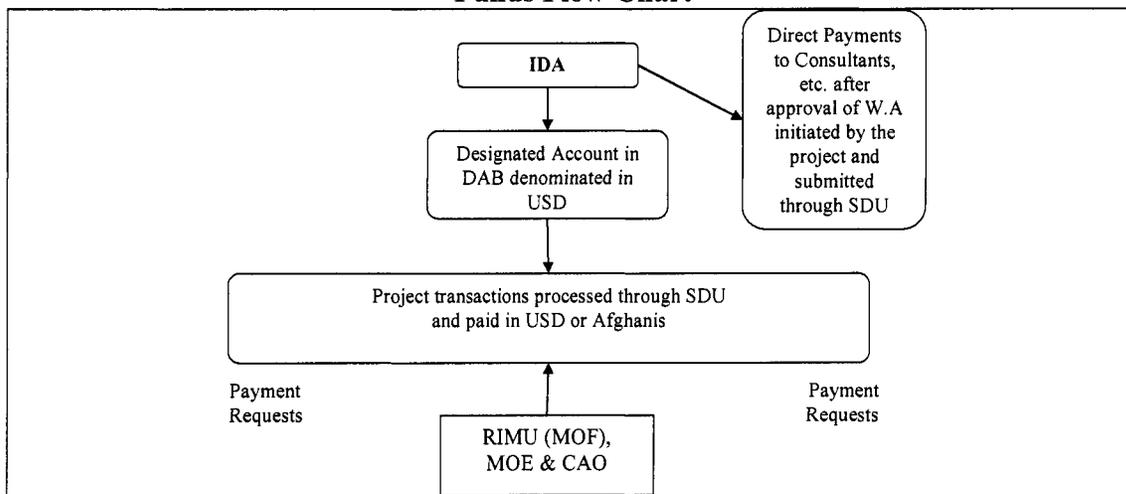
17. The standard funds flow mechanism in Afghanistan will be followed in this project. Project funds will be deposited in the Designated Account to be opened and maintained at the DAB. The Designated Account, in keeping with current practices for other projects in Afghanistan, will be operated by the SDU in the Treasury Department of the MOF. Requests for payments from the Designated Account will be made to the SDU by the implementing entity when needed.

18. In addition to payments out of DA funds, the implementing entities can also request the SDU to make: (i) direct payments from the Grant account to consultants or consulting firms; and (ii) special commitments for contracts covered by letters of credit. These payments will follow World Bank procedures. All project payments will be made to either international firms or local firms that have bank accounts in DAB, a local commercial bank, or an overseas bank. All payments will be made either through bank transfers into the account of such firms or by check. Expenditures for each component will be paid centrally from RIMU in accordance with the approval mechanisms documented in the project FM Manual.

VII. Retroactive Financing

19. A provision has been made to reimburse the government for payments it makes from government resources up to a maximum of SDR 1.3 million (US\$2 million) for eligible project expenditures incurred after April 15, 2007 and up to the signing of the Financing Agreement in accordance with the Bank's procurement guidelines. In particular, and given its urgency and priority, this provision is expected to be utilized to facilitate the early mobilization of the consultants on systems development and for the RIMU.

Funds Flow Chart



VIII. Legal Requirements for Authorized Signature

20. The MOF has authorization to disburse funds from the Grant. Specimen signatures of authorized signatories in MOF have previously been submitted to the Bank.

IX. Accounting

21. The SDU will maintain a proper accounting system of all expenditures incurred along with supporting documents to enable IDA to verify these expenditures. The FM staff of RIMU will: (i) supervise preparation of supporting documents for expenditures; (ii) prepare payment orders (Form M16); (iii) obtain approval for M-16s by the Minister or Deputy Minister depending on the payment amount; and (iv) submit them to the Treasury Department in MOF for verification and payment. While original copies of required supporting documents are attached to the Form M16, the project is required to make and keep photocopies of these documents for records retention purposes. The FM Advisor in the MOF/SDU will use the government's computerized accounting system, AFMIS, for reporting, generating relevant financial statements, and exercising controls.

22. RIMU FM staff will maintain essential project transaction records using Excel spreadsheets and generate required monthly, quarterly, and annual reports. At the MOE and CAO, the assigned accounting officer will maintain essential project records and prepare basic financial reports (Receipts and Payments Account) on their activities.

23. The FM Manual, to be prepared by RIMU and approved by the Bank, will include: (i) roles and responsibilities for all FM staff; (ii) documentation and approval procedures for payments and release of funds to each implementing entity involved in the project; (iii) project reporting requirements; and (iv) quality assurance measures to help ensure that adequate internal controls and procedures are in place and are being followed.

24. The FM Manual will also establish project financial management in accordance with standard Afghan government policies and procedures including use of the government Chart of Accounts to record project expenditures. The use of these procedures will enable adequate recording and reporting of project expenditures. Overall project accounts will be maintained centrally in SDU, which will be ultimately responsible for recording of all project expenditures and receipts in the Government's accounting system. Reconciliation of project expenditure records with MOF records will be carried out monthly by the assigned FM staff in RIMU.

X. Internal Control and Internal Auditing

25. Project-specific internal control procedures for requests and approval of funds will be described in the FM Manual to be developed before disbursements begin including segregation of duties, documentation reviews, physical asset control, and cash handling and management. Adequate procedures, guidelines, and controls on payments to implementing entities involved in the project will also be included in the FM Manual.

26. The Financial Management Specialist in RIMA will be responsible for coordinating FM activities of the project with the SDU.

27. Annual project financial statements will be prepared by SDU/MOF detailing activities pertaining to the project as separate line items with adequate details to reflect the details of expenditures within each component.

28. The project financial management systems will be subject to review by the newly-established internal audit directorate of the MOF, according to programs to be determined by the Director of Internal Audit using a risk-based approach.

XI. External Audit

29. The project accounts will be audited by the Auditor General, with the support of the Audit Advisor, with terms of reference satisfactory to the Association. The audit of the project accounts will include an assessment of the: (i) adequacy of the accounting and internal control systems; (ii) ability to maintain adequate documentation for transactions; and (iii) eligibility of incurred expenditures for Association financing. The audited annual project financial statements will be submitted within six months of the close of fiscal year. All agencies involved in implementation and maintaining records of expenditures would need to retain these as per the IDA records retention policy.

30. The following audit reports will be monitored each year in the Audit Reports Compliance System:

Responsible Agency	Audit	Auditors	Date
MOF, supported by Special Disbursement Unit	SOE, Project Accounts and Designated Account	Auditor General	Sept. 22

XII. Financial Reporting

31. Financial statements and project reports will be used for project monitoring and supervision. Based upon the FM arrangements of this project financial statements and project reports will be prepared monthly, quarterly, and annually by the RIMU. These reports will be produced based on records kept on Excel spreadsheets after due reconciliation to expenditure statements from SDU (as recorded in AFMIS) and bank statements from DAB.

32. The project reports will include: (i) sources and uses of funds by project component; and (ii) expenditures consolidated and compared to governmental budget heads of accounts. RIMU will forward the relevant details to SDU/DBER with a copy to IDA within 45 days of the end of each quarter month. The government and IDA have agreed on a pro forma report format for all Bank projects; a final customized format for project reports will be agreed prior to project negotiations. The annual project accounts to be prepared by SDU from AFMIS after due reconciliation to records maintained at the RIMU will form part of the consolidated Afghanistan government accounts for all

development projects. This is done centrally in the MOF Treasury Department, supported by the Financial Management Advisor.

XIII. Disbursement Arrangements

33. Table D-1 shows the allocation of IDA proceeds in a single, simplified expenditure category and Table D-2 presents the expected co-financing. The single category for “goods, consultancy services, training, and operating costs” is defined in the Financing Agreement to facilitate preparation of withdrawal applications and record-keeping. Project funds will be disbursed over approximately 40 months. The closing date of the project will be December 31, 2010 with a final disbursement deadline four months after the closing date.

34. During this additional 4-month grace period, project-related expenditures incurred prior to the closing date are eligible for disbursement. Disbursement procedures set out in the Bank’s “Disbursement Handbook for World Bank Clients” (May 2006) are applicable to this project.

Table D-1: IDA Financing by Category of Expenditure (SDRs million)

Expenditure Category	Amount of the Grant Allocations	Financing Percentage
(1) Goods, consultants’ services, training and Incremental Operating Costs ⁶	22.1	100 %
Total	22.1	-

Table D-2: Estimated Co-financing (SDRs million)

IDA	ARTF	JSDF	Beneficiaries	Total
22.1				22.1

35. **Summary Reports.** Summary reports in the form of Statements of Expenditure will be used for expenditures on contracts above US\$25,000.

36. **Designated Account.** A single designated account will be opened at DAB in US dollars for a maximum amount of US\$1.2 million, representing three months of estimated expenditures. The SDU in MOF will manage both payments from and new advances/replenishments to this account.

37. Cash advances may be issued from the Designated Account to be held and managed by RIMU (MOF). This agency’s internal controls, cash handling accounting, and preparation of Statements of Expenditures (SOEs) have been assessed as satisfactory.

⁶ Incremental Operating Costs refers to project-related incremental expenses incurred on account of project implementation support and management including the rental of office space; the operation, maintenance, rental and insurance of vehicles; fuel; communications, supplies and charges; advertisements; books and periodicals; office administration and maintenance costs; bank transaction charges; utility charges; domestic travel and per diem but excluding salaries of officials and staff of the Recipient's civil service.

38. New cash advances will only be made when all other prior cash advances have been justified through submission of SOEs to the SDU. The Designated Account will be replenished on a monthly basis.

39. **Direct Payments.** Third-party direct payments will be permitted for amounts exceeding 25 percent of the advance in the Designated Account or approximately \$250,000. All such payments require prescribed supporting documentation.

40. **Preparation of Withdrawal Applications.** The SDU will review withdrawal applications for quality and conformity to Treasury procedures, and then obtain the authorized signatures. Selected RIMU (MOF) finance staff will be registered as users of the World Bank web-based Client Connection system, and play an active role in managing the flow of disbursements.

XIV. Financial Management Covenants

- MOF shall submit audited financial statements for the project within six months of the end of each fiscal year. The project's audit report will cover the financial statements, the Designated Account, and SOEs in accordance with terms of reference agreed with the Association.
- Un-audited project interim financial reports will be submitted by RIMU (MOF) on a quarterly basis to the World Bank and a copy to SDU-MOF within 45 days after the end of each quarter month.

XV. Supervision Plan

41. During project implementation, the Bank will supervise the project's financial management arrangements. The team will:

- Review the project's quarterly un-audited interim financial reports as well as the project's annual audited financial statements and auditor's management letter.
- Review the project's financial management and disbursement arrangements (including a review of a sample of SOEs and movements on the Designated Account and bank reconciliations) to ensure compliance with the Bank's minimum requirements.
- Review agency performance in managing project funds to ensure that it is timely, accurate, and accountable. Particular supervision emphasis will be placed on asset management and supplies.
- Review of financial management risk rating and compliance with all covenants.

XVI. Conclusion

42. The FM arrangements, including the systems, processes, procedures, and staffing are adequate to support this project -- subject to implementation of the items listed in the action plan.

ANNEX E. TERMS OF REFERENCE FOR MAJOR TECHNICAL ASSISTANCE PACKAGES

Component 1.2 - Treasury Systems Development and Roll-out

Background

1. The Islamic Republic of Afghanistan has begun a program of government financial management improvements which is expected to have far-reaching consequences for the manner and processes of financial transactions, recording, accounting, and reporting over the next several years. The extent of these reforms is evolving but includes budget and expenditure reforms and improved accounting, financial reporting, and internal controls.
2. Over the past four years, an integrated financial management system has been implemented in the Treasury of the MOF. The basic objective of this system was to ensure accountability over the government's budget and expenditures including donor funds. It was not intended to be a complete integrated management information system that would be capable of serving the needs of all government managers. It was basically a Treasury system. FreeBalance software is the core application of the system known as the AFMIS.
3. As the government has moved forward with their reform program, it became apparent that AFMIS needed to be enhanced to meet the increased needs of the Treasury staff as well as line ministries and Mustofiats. Therefore, in this component, the consultant will need to acquire the following modules from FreeBalance in order to complete the expanded financial management functions in AFMIS – Procurement, Fixed Assets, and Accounts Receivable. The vendor for the Budget Preparation module will be decided subsequently.
4. A fully automated off-the-shelf HRMIS for implementation in MOF is also considered necessary. At present, MOF uses the Microsoft Access-based payroll system known as Verified Payroll Program which includes the Computerized Payroll System. Nevertheless, there is no HR functionality in the system and the support and documentation of in-house systems is not optimal. The ultimate goal for HRMIS is to direct deposit the net pay of each employee into his or her bank account and provide the critical personnel data for eventual centralization and determination of pension liabilities.
5. AFMIS will be the core financial management information system of the GOA. The information contained in AFMIS will provide MOF a foundation for a comprehensive management information view related to the country's financial resources. In addition, AFMIS will provide useful financial information to line ministries to enable them to better manage their programs. It will give these ministries the facilities to download relevant and authorized data and perform required analyses.

6. To conduct their designated business affairs, line ministries will require the ability to enter transactions into AFMIS and to approve such transactions through the Financial Controllers (a Treasury staff) located within the line ministries. One objective of the AFMIS roll out is to have transaction processing and payment authorization decentralized but payment processing to remain centrally within Treasury and the Mustofiats. This will streamline transaction processing and enable Treasury staff to be reassigned from data entry to other key Treasury functions. For the purpose of this Component, the consultant will assist the government in rolling out AFMIS to six line ministries and six Mustofiats. In addition to rolling out AFMIS to six line ministries, the consultant will assist the government in rolling out just the report module of AFMIS to six additional line ministries.

Objectives

7. The objective of this contract is for the contractor to assist the government in rolling out AFMIS to the six line ministries and six Mustofiats. This roll-out will occur after the contractor installs additional modules (Procurement, Fixed Assets and Account Receivable, Budget Preparation, and HR) purchased from FreeBalance or from other vendors especially for HR and Budget Preparation. In addition, the contractor will roll-out just the Reporting Module to six additional line ministries in order to facilitate management reporting capabilities and develop the program interfaces for HR and Budget modules if sourced from a vendor other than FreeBalance.

Scope of Services

8. This consultancy has several distinct but related components:

- Roll out the enhanced AFMIS to Treasury.
- Roll out the enhanced AFMIS to the six line ministries and six Mustofiats in a phased approach. Roll out to line ministries is dependent on having qualified Financial Controllers in place at the line ministries.
- Enhance the management reporting capability in AFMIS to meet management needs from the system.
- The consultant will need to develop a roll-out plan and schedule for the system for all designated sites. In addition, a plan also needs to be developed for rolling out the Reporting Module to the six additional line ministries.
- A checklist needs to be developed detailing tasks that need to be undertaken for roll out of the system to a typical line ministry and Mustofiat.
- Assist the Treasury in determining HR functionality to be activated from the new module, train payroll units in the use and develop the interface with AFMIS.
- The consultant will take the lead in addressing change management issues within Treasury and the respective ministries and Mustofiats.
- The consultant shall, in conjunction with MOF personnel, develop and negotiate with line ministries and Mustofiats, appropriate Service Level Agreements for the effective and efficient operation of AFMIS. These draft agreements shall be developed and signed by the MOF and individual line ministries and Mustofiats

prior to implementation of the systems at the respective line ministries and Mustofiats.

Component 1.4.1 - External Audit Advisory Services

Background

9. The CAO is in the process of reforming its organization, methods, and operations. Major training efforts are in process to improve the skills of the audit staff. EPAP and PACB assistance has used a professional accounting firm to provide guidance to the CAO in these matters and there is a need for a senior advisor to the Auditor General on a full-time basis to manage the processes of continuing improvement that are needed for the CAO to reach a level of performance that no longer needs the routine direct support operations of the contracted firm. A new Audit Law is in preparation and the advisor will be needed to assist with its implementation.

10. An advisor has been in place for one year under PACB and has been a valuable source of assistance, supported by the program of technical assistance included in the terms of reference for the supporting audit firm providing direct audit support. The PFMR project will concentrate the work of the audit firm on delivering audit services and support the strengthening of the CAO by continuing the provision of an advisor supported by three audit experts available on a full-time basis to work as audit team leaders and provide on-the-job training to the CAO and its staff. This will greatly improve the quality of the audit work, embed the new audit manuals provided, and build a competent audit workforce conducting audits that are relevant to the role of the CAO as set out in the PEFM Law and the draft Audit Law.

11. Some particular Articles of the PEFM Law will be directly addressed by the advisory services. The advisory services will support Articles 5 and 6 which impose obligations on relevant persons for the conduct of financial affairs by training the auditors to assess internal controls and the implementation of these obligations, and thereby support the system of accountability established by the Law. Article 55 requires a final budget reconciliations report and a set of financial statements prepared in accordance with International Public Sector Accounting Standards. Revenues, expenditures, assets, and liabilities will be reported and audited by the CAO as per Article 59 which requires audit certification and public report to the National Assembly within six months of the end of the year. The auditing services will enable these certifications and reports to be in accordance with International Auditing Standards.

Contractor Terms of Reference

12. The specific function of these advisor services are to coordinate the training and capacity building in the CAO, and ensure that quality control arrangements are instituted in the CAO so that audits are conducted to international standards.

Objectives

13. The goals of the GOA include maintaining appropriate fiduciary standards to provide reasonable assurance to the Afghan public and to international donors that government resources and donor funds are subject to appropriate allocation and expenditure controls. An important objective is achieving compliance with international standards of financial management including the use of internationally recognized accounting, auditing, and reporting standards enabled by modern technology and software applications.

14. This contract seeks to consolidate and enhance the capacity of the CAO to increasingly provide comprehensive auditing services in accordance with International Auditing Standards and to provide the financial statement certifications and audit reports required by the PEFM Law. Specific milestones will be set over the period of the contract to achieve this objective.

Scope of the Assignment

15. This consultancy will provide support to the Auditor General with advice on policy and operations matters as they arise and provide specific orientation for the development of accounting and auditing professional standards and the development of the support and liaison for the public accounts committee. As the CAO is now facing the need to implement the PEFM Law and the proposed Audit Law, there will be a need to consider re-structuring of CAO organization and operations and a strategy for handling the career development and training requirements of the staff to service those re-structuring. The consultancy will guide and support the CAO in the necessary processes which will involve identification of appropriate grading, staff appointment, and allocation processes, and training arrangements. The outcome should be a CAO with appropriately competent, skilled and trained officers to carry out the audit direction, management, and technical audit activities of the CAO.

Specific Components of the Assignment

16. *Advising the CAO.* The consultant will advise the president of the CAO on policy and operational matters as they arise. The consultant will provide specific written inputs on the annual audit plan, staff development and annual training plan, progress of the plan, and approaches to special investigations. The consultant will provide guidance on the implementation of the Audit Law, the audit manual, the Code of Conduct, the Strategic Development Plan, and an HR and Career Development Program for the audit

staff of the CAO. A new Training Needs Assessment will be needed to update training requirements.

17. ***Monitoring the Grant and ARTF Audits.*** The consultant will support and oversee the work of the contractor engaged to provide Direct Support Operations to the CAO in its conduct of the Grant and ARTF audits, as well as the audits required by the PEFM Law.

18. ***Assisting the CAO with Other Types of Audit.*** The consultant will advise and assist with the introduction of audits relating to value-for-money, IT, controls evaluation, customs, revenue, and State Owned Enterprises. The consultant will assist the CAO in implementing audit manuals and work practices for other types of audit as appropriate. The consultant will manage the work of the audit experts assisting with the introduction of these types of audit as well as their leadership and improvement of current audit types.

19. ***Accounting and Auditing Professional Standards.*** The consultant will assist the CAO and MOF in beginning to establish the accounting profession and the supporting regulatory and academic frameworks. The consultant will assist in defining a framework for establishing the profession including the governance arrangements and the roles of the public and private sectors. The consultant will assist as necessary to provide drafts for the requisite laws and regulations. The consultant will establish curricula for the main academic bodies delivering accounting and auditing training at the various levels required by CAO audit staff.

20. ***Accounting and Auditing Training.*** The consultant will participate in and manage the work of the Audit Experts in providing on-the-job training to CAO auditors. English language and IT training will continue using available sources of training and increasingly use training that is available in the local market. Costs for these trainings will be funded from the sub component. The consultant will manage the training to be provided under the Duty Specific Training sub component.

21. ***Public Accounts Committee.*** The consultant will propose steps to establish a system of response and scrutiny for external and internal audit reports for management and parliament. Only 2% of government bodies respond to audit reports on their activities. There has been no involvement of the MOF in dealing with audit reports. The consultant will assist with and manage the support that is to be given to the committee under the Supporting Parliamentary Oversight sub-component of this PFMR project.

Outputs

22. By the end of the assignment the consultant and the Audit Experts will have assisted the CAO to have undertaken the activities described under the scope of work. The CAO and key staff in the CAO and the MOF will have a clear role in the establishment of the accounting profession and processes for adopting and applying international accounting and auditing standards in Afghanistan.

Specific Products

- Reports on the products delivered by PACB - Audit Law, the audit manual, the Code of Conduct, the Strategic Development Plan.
- Report on steps taken in developing an HR and Career Development Program
- Report on Training Needs Assessment.
- Periodic reports on performance of the audit agent working on financial statement audits and on-the-job training.
- Periodic reports on performance of the audit experts working on audits and on-the-job training.
- Report on progress with establishing the accounting profession.
- Documenting and assessing formal accounting and audit training available in Afghanistan.
- Curricula for the main academic bodies delivering accounting training leading to an accounting accreditation designation suitable for the CAO staff.
- A plan for the accreditation of all CAO staff to appropriate levels for their position on the hierarchic structure of the CAO.
- Mechanism and regulation for responses to internal and external audit reports by management and parliament.
- Annual report and recommendations to the president of the CAO on audit plan for the state budget audit.
- Periodic reports on progress of annual audit plan.
- Report on support to the Public Accounts Committee.

Deliverables

23. The deliverables and timing of the assignment include:
- (a) Inception Report** will be based on initial consultations with relevant counterparts within the government (including TA advisors), the Auditor General's office and the World Bank. It will provide a detailed work program for the period of the assignment including milestones to be achieved in implementing the capacity building component of the project, and indicate steps that need to be taken by the government and the World Bank to facilitate the timely execution of the assignment.
 - (b) First Quarterly Report** within four months of the start of the assignment and quarterly thereafter to the Auditor General, reporting on progress being made against objectives and milestones set out in the agreed work plan, identifying any problems or constraints to achieving progress, and setting out the planned achievements for the following quarter. Quarterly reports shall include an updated work program.
 - (c) Final Report** within two weeks of completion of the assignment. The final report will report on all key activities undertaken during the assignment and progress against the original objectives and milestones set out in the agreed work plan. It

will also report on any problems or constraints encountered, actions taken to overcome these and recommendations for future activities by the government.

24. These reports will be submitted by the consultant at the specified times to the Auditor General, the World Bank, and any other designated counterparts. Reports should be in digital as well as hard copy format and written in English.

Liaison and Reporting Arrangements

25. The consultant will report directly to and work with, the Auditor General and the designated Project Manager, as well as any other designated counterparts from the government.

26. The consultant will closely coordinate with the World Bank task team leader for the project and technical assistance team to the Parliament.

Consultant Qualifications

27. This assignment requires consultants with an adequate mix of relevant qualifications:

- Advanced degrees or professional qualifications in auditing or accounting, or similarly relevant disciplines and experience.
- Operating experience in public sector auditing at the management level.
- Experience in managing the transition of audit to complying with international accounting and auditing standards.
- Experience working with parliamentarians and with parliamentary committees on audit issues.

Component 4.2 - Direct Operations Support to Treasury

Background

28. The GOA has begun a program of financial management improvements which are expected to have far-reaching consequences for the processes of financial transactions, recording, accounting, and reporting over the next several years. The extent of these reforms is evolving but includes budget and expenditure reforms and improved accounting, financial reporting, and internal controls.

29. Over the past four years, an integrated financial management system has been implemented in the Treasury of the MOF. FreeBalance software is the core application of the AFMIS. As a result of the implementation of the new system, significant improvements have been made in cash management, grant management, bank reconciliations, revenue recording, and recording of budget appropriations and allotments.

30. The contract for the current financial management consultant is due to end. The consultancy for this project is for a financial management consultant to provide services as set forth in the sections below.

Objectives

31. An objective of the government is maintaining appropriate fiduciary standards to provide reasonable assurance to the Afghan public and to international donors that government resources and donor funds are subject to appropriate budget and expenditure controls. Another objective is achieving compliance with international standards of financial management, including the use of internationally recognized accounting, auditing, and reporting standards enabled by modern technology and software applications. The government seeks to maximize the use of existing technical capability and the FreeBalance software to the extent possible.

32. Additionally, the government is looking to building the skills for the Afghanistan public sector by two means: (i) on-the-job training for civil servants who will be acquiring basic knowledge under the HR development component of this project with the direct operations consultant firms, and (ii) including in the technical assistance teams under the direct operations support contracts a larger share of local advisors with concrete deliverables for the transfer of knowledge and skills for the operation of the PFM systems. The contractor will put more emphasis than in the past on using local advisors and transferring a requisite minimum level of skills to these to operate the PFM systems by project end.

Scope of Service

33. The financial management component will assist MOF to build capacity and attain higher levels of efficiency in budget execution and financial reporting. This consultancy, which will continue and expand upon the work of the previous FM consultancy, has a number of distinct but related components:

- Operation and maintenance of AFMIS
- Transaction processing for the national budget, including World Bank funded projects and projects of other donors incorporated in the government budget
- Accounting and periodic financial reporting to the government and donors
- Further development of the chart of accounts to meet management requirements
- Maintaining the Verified Payroll Program in Treasury
- Reviewing financial control framework, develop and implement financial regulations consistent with the PEFM Law
- Continue developing the cash management function in the Treasury
- Assist in implementing the Treasury Development Strategy
- Provide on-the-job training for civil servant counterparts and duty specific training for local advisors to operate the specific components of the Treasury systems independently by project end

Reporting Arrangements

34. The FM consultant will report directly to and work with the MOF and the designated Project Manager as well as any other designated counterparts from the government.

35. The FM consultant will closely coordinate with the World Bank task team leader for the project, with World Bank and IMF task team members focusing on public expenditure management and Treasury modernization issues, World Bank missions, and other defined donors organizations.

Consultant Qualifications

36. This assignment requires a team of consultants with an adequate mix of relevant qualifications:

- Advance degrees in business, accounting, information systems, payroll processes, public administration or similarly relevant disciplines and experience
- At least 10–15 years of working experience in public sector financial management, accounting, procurement, information technologies and other relevant areas
- All key consultants must have recent operational experience with or exposure to modern integrated financial management systems
- Operating experience in conducting such assignments in developing countries
- A clearly identified capacity, supported by previous client references, to impart real knowledge and understanding of modern system solutions to reflect the clear need to provide a significant awareness raising and education process at all levels of government
- Local expertise and local language skills
- Excellent report-writing, verbal communications, and human relations skills

Contract Arrangements

37. The contract is for three years. A consultancy staffing of experienced international specialists over the three year period is envisaged, supported by a team of about 20 local consultants. The local staff of the existing FM consultant may be available to the successful FM consultant. The assignment is expected to start in January 2008.

Component 4.3 - Direct Operations Support External Audit

Background

38. Since August 2002, an audit consultancy firm, funded out of EPAP (PKF International) and then PACB (Deloitte), has been providing operational support and capacity building assistance to the CAO. The scarcity of qualified accountants and the

lack of understanding of financial statement audits within the CAO have required that the firm play a significant role in the conduct of audits. During this period, the CAO has completed, with the assistance of the firm, the audit of a substantial number of World Bank and ARTF funded projects, and the capacity of the CAO staff has improved under the on-the-job training supplied by the firm during the audits. These steps have been successful in re-establishing the CAO as a working institution capable of absorbing institutional strengthening assistance, but it has not developed the institution and its staff sufficiently for them to conduct financial statement audits to international standards without continuing professional assistance.

39. The firm also prepared draft human resources assessment covering training needs, training strategy, HR management, and a staff qualifications inventory. A range of formal training activities including training in English, computer literacy, and basic accounting, and informal on-the-job training through the conduct of audits have been conducted with more than 100 CAO staff taking part. In addition, an audit law has been drafted as well as a draft strategic plan prepared for the CAO with an audit manual yet to be completed. Mid-term reviews of progress on these issues indicated a need for more direct, full-time concentration on implementation and further progression of these activities in this project is to be undertaken by an audit advisor and some audit experts recruited full-time to support the CAO under the Advisory Services sub-component of this project. This will enable the audit firm to concentrate on the audit and on-the-job training work.

40. The goals of the government include maintaining appropriate fiduciary standards to provide reasonable assurance to the Afghan public and to international donors that government resources and donor funds are subject to appropriate allocation and expenditure controls. An important objective is achieving compliance with international standards of financial management including the use of the International Standards of Auditing. The firm has largely been excluded in practice from assisting the CAO with auditing the government's financial statements. The passage of the PEFM Law necessitates that the CAO make greater use of the firm in these audits during the period of the PFMR project as well as for the ARTF and the Grant audits to conduct them in accordance with international standards.

Contractor Terms of Reference

41. The specific purpose of this consultancy is providing the direct operations support to the CAO in conducting all of its certification audits.

Support to Audit Operations

42. Assistance to be provided under this consultancy for audit operations will focus on direct, technical audit support and informal on-the-job training to the CAO teams undertaking audits of the SY1386, 1387, and 1388 financial statements for the ARTF, the government's annual accounts, and selected World Bank projects. Additionally, the project will provide assistance for the audit of the UNDP Nationally Executed Expenditure (NEX) projects. As a guideline, approximately 30 World Bank project audits

are expected to be undertaken for each solar year. It is estimated that about 20 person months of experienced and qualified consultancy services will be required to provide support and on-the-job training during the annual audit season to about 240 person months of CAO audit staff.

43. The on-the-job training provided during actual audit of accounts is regarded as a key part of the capacity building being provided to CAO staff through knowledge transfer. The training during the period is to become more formalized with the intention of accrediting CAO staff with competencies in the various elements of audit work as laid out in the International Federation of Accountants Competency Standards for Auditors.

44. Additionally, the government is looking in this round of contracts to contribute to build the skills for the Afghanistan public sector by two means: (i) on-the-job training for civil servants who will be acquiring basic knowledge under the HR development component of this project with the direct operations consultant firms, and (ii) including in the technical assistance teams under the direct operations support contracts a larger share of local advisors with concrete deliverables for the transfer of knowledge and skills for the operation of the PFM systems. The contractor will put more emphasis than in the past on using local advisors and transferring a requisite minimum level of skills to these to conduct independently audit field work.

Outputs

45. The principal project-assisted outputs deriving from the direct audit technical assistance are:

- Audited SY1386, 87, and 88 financial statements for the ARTF and the State Budget Reconciliation, and State Financial Statements;
- Audited SY1386, 87, and 88 financial statements for World Bank projects; and
- Audited 2007, 2008, and 2009 financial statements for UNDP NEX projects.

46. Capacity building outputs will be accredited work experience statements for all CAO staff participating in the on-the-job work experience program afforded by the above audits in eight competency skills.

47. Capacity building will enable CAO to perform the majority of audits of government loans and grants to international standards within the period of the contract with agreed milestones.

ANNEX F. MAP

