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AUDIT OF
KENYA RURAL PRIVATE ENTERPRISE PROJECT
PROJECT NO. 615-0220

AUDIT REPORT NO. 3-615-89-11
February 24, 1989

UNITED STATES OF AMERICA

AGENCY FOR INTERNATIONAL DEVELOPMENT
REGIONAL INSPECTOR GENERAL/AUDIT

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February 24, 1989

MEMORANDUM FOR DIRECTOR, USAID/Kenya, Steven W. Sinding

FROM: RICHARD C. THABET, RIG/A/N

SUBJECT: Audit of Kenya Rural Private Enterprise
Project No. 615-0220
Audit Report No. 3-615-89-11

The Office of the Regional Inspector General for Audit, Nairobi has completed its audit of the Kenya Rural Private Enterprise Project No. 615-0220. Enclosed are five copies of the audit report.

A draft audit report was submitted to you, and your comments are attached to the report. The report contains three recommendations, all of which are resolved and may be closed upon receipt by this office of evidence that shows that the cited actions are complete. Please provide me these additional materials within 30 days.

I appreciate the cooperation and courtesy provided to my staff during the audit.

EXECUTIVE SUMMARY

The goal of the $50 million Kenya Rural Private Enterprise Project was to increase rural production, employment and income. The project's purpose was to establish and expand rural private enterprises in Kenya. The project was initiated on August 25, 1983 with signing of the project agreement between the Government of Kenya and USAID/Kenya, and was to be completed by March 31, 1989. As of October 19, 1988, A.I.D. had expended $1.9 million of loan funds and $5.3 million of grant funds.

The Office of the Regional Inspector General for Audit/Nairobi made a program results and financial audit of the project. The audit objectives were to determine (1) the extent to which the project's purpose was being attained, and (2) whether internal controls were sufficient to safeguard project resources. Concerning the first objective, we determined whether funds were being made available to rural private enterprises such that significant contributions toward the project's purpose of establishing and expanding rural private enterprise were being realized. We also evaluated the cause of impediments to accomplishing the project's purpose.

The project made little progress toward establishing and expanding rural private enterprise in Kenya. The $36 million loan program resulted in loans of only about $3.3 million, and additional approved loans by the project's planned termination date could not be expected to exceed an additional $6.8 million. In addition, the $7.1 million grant program was contributing little to the project purpose. Concerning the second audit objective, internal accounting controls over grant funds were inadequate to ensure their proper use.

Despite these problems, the project had many positive aspects. On the loan side, the project successfully introduced the concept that Kenyan commercial banks could make long-term loans, and the rate of loan approvals appeared to be increasing significantly. Further, commercial banks were contributing their promised one-third share of the loans, and the Central Bank of Kenya had opened a special account that may, in the future, provide a conduit for reloaning repayments from benefiting organizations. On the grant side of the project, the Kenya Rural Enterprise Programme, Limited had provided institutional and training support to Kenyan organizations. It had also done much to introduce satisfactory internal accounting controls over grant funds.

The audit identified three areas requiring improvement. USAID/Kenya needed to improve the rate at which loans were being made, and to require that Rural Enterprise Programme, Limited better focus its subgrants. Further, Rural Enterprise Programme, Limited needed to further improve its internal accounting controls of project funds by the Kenyan organizations.

The project agreement required establishment and expansion of rural private enterprises through provision of credit and technical assistance to commercial banks, which in turn were to make loans and provide business advice to entrepreneurs. However, the loan portion of the project had little impact on the establishment and expansion of rural private enterprises. This occurred because (1) the Government of Kenya and the Kenyan commercial banks were not prepared to implement the project agreement, and (2) various factors negatively impacted on the project's marketability to the targeted benefactors. As a result, the project will not provide the planned level of assistance to Kenyan rural private enterprise unless project constraints are removed. This report recommends that USAID/Kenya impose time limits for making loans under the project and deobligate project funds if the time limits are not met, and take specific actions to increase the marketability of the loan program. USAID/Kenya agreed with the recommendation and stated it was in the process of implementing it.

The project agreement stated that the project purpose was to be achieved at the small business level through a grant to a private voluntary organization, which would provide management advice and extend loans to small-scale entrepreneurs. However, the program contributed little toward the project purpose, and the progress made was neither cost effective nor sustainable. This occurred because (1) most of the project's funding was directed toward assistance to non-govermental organizations that did not appear to be sustainable, (2) problems with project implementation further limited the project's contribution. As a result, little of the $7.1 million of grant funds supported qualifying Kenyan rural private enterprise. This report recommends that USAID/Kenya direct that Rural Enterprise Programme, Limited require an increased emphasis on sustainability, termination of subgrants not contributing substantially to the project goal, and abandonment of this method of assisting small businesses if future project implementation does not improve the cost-effectiveness of this portion of the project. USAID/Kenya agreed with the recommendation and outlined plans to implement it.

A.I.D. Handbook 13 required that recipients of cooperative agreements exercise effective internal control and accountability over all funds, property and other assets, and ensure they were used solely for authorized purposes. The Rural Enterprise Programme, Limited agreements with its subgrantees required appropriate internal control measures, including periodic audit, so that project funds were controlled and used appropriately. However funds disbursed by Rural Enterprise Programme, Limited to its subgrantees were not always being adequately safeguarded in accordance with the above criteria. Lack of enforcement of the internal control procedures required by its grant agreements with subrecipients contributed significantly toward these problems. As a result, control over funds provided to Kenyan non-governmental organizations did not adequately safeguard against fund misuse, excessive cash advances or the risk of fraud or abuse. This report recommends that USAID/Kenya require that the Rural Enterprise Programme, Limited take specific actions to improve internal control by its subgrantees. USAID/Kenya agreed with the recommendation and stated it would implement it.

Office of the Inspector General

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KENYA RURAL PRIVATE ENTERPRISE PROJECT

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KENYA RURAL PRIVATE ENTERPRISE PROJECT

PART I - INTRODUCTION

A. Background

The goal of the Kenya Rural Private Enterprise Project was to increase rural production, employment and income. The project's purpose was to establish and expand rural private enterprises in Kenya. Two general approaches were used to accomplish this purpose. First, credit and technical assistance were provided to commercial banks, which in turn were to make loans and provide business advice to entrepreneurs. Second, the project was to provide subgrants through a private voluntary organization (PVO) to Kenyan non-governmental organizations (NGOs), which would then extend loans and provide advice to small businesses that could not qualify for bank loans.

The Government of Kenya (GOK) was responsible for making arrangements to ensure availability of funds needed to carry out the project. Kenyan commercial banks were to institute procedures to make term loans to qualified applicants on a cost-sharing basis with USAID/Kenya. A PVO intermediary organization (Rural Enterprise Programme, Limited) was to make subgrants to Kenya NGO's, which would then directly assist small-scale business organizations. A technical assistance contractor (Deloitte, Haskins and Sells) was to provide advice to Kenyan enterprises, and to monitor implementation of the project by commercial banks and the PVO intermediary. USAID/Kenya was to provide loan and grant funds for the loan and grant programs, and to pay other costs, including costs of REP and Deloitte, Haskins and Sells (DHS). USAID/Kenya also was to monitor project implementation to ensure compliance with the project agreement and effective and efficient use of A.I.D. funds.

The project was initiated on August 25, 1983 with signing of the project agreement between the GOK and USAID/Kenya, and was to be completed by March 31, 1989. The project agreement, as amended, specified that project funding would be $62 million, with A.I.D. providing $24 million of loan funds and $12 million of grant funds, commercial banks providing $24 million of loan funds, and others providing the remaining $2 million. Implementation of the commercial lending program was very slow initially, and agreements with commercial banks were not reached until after an November 10, 1986 implementation letter reduced the commercial banks participation in the lending

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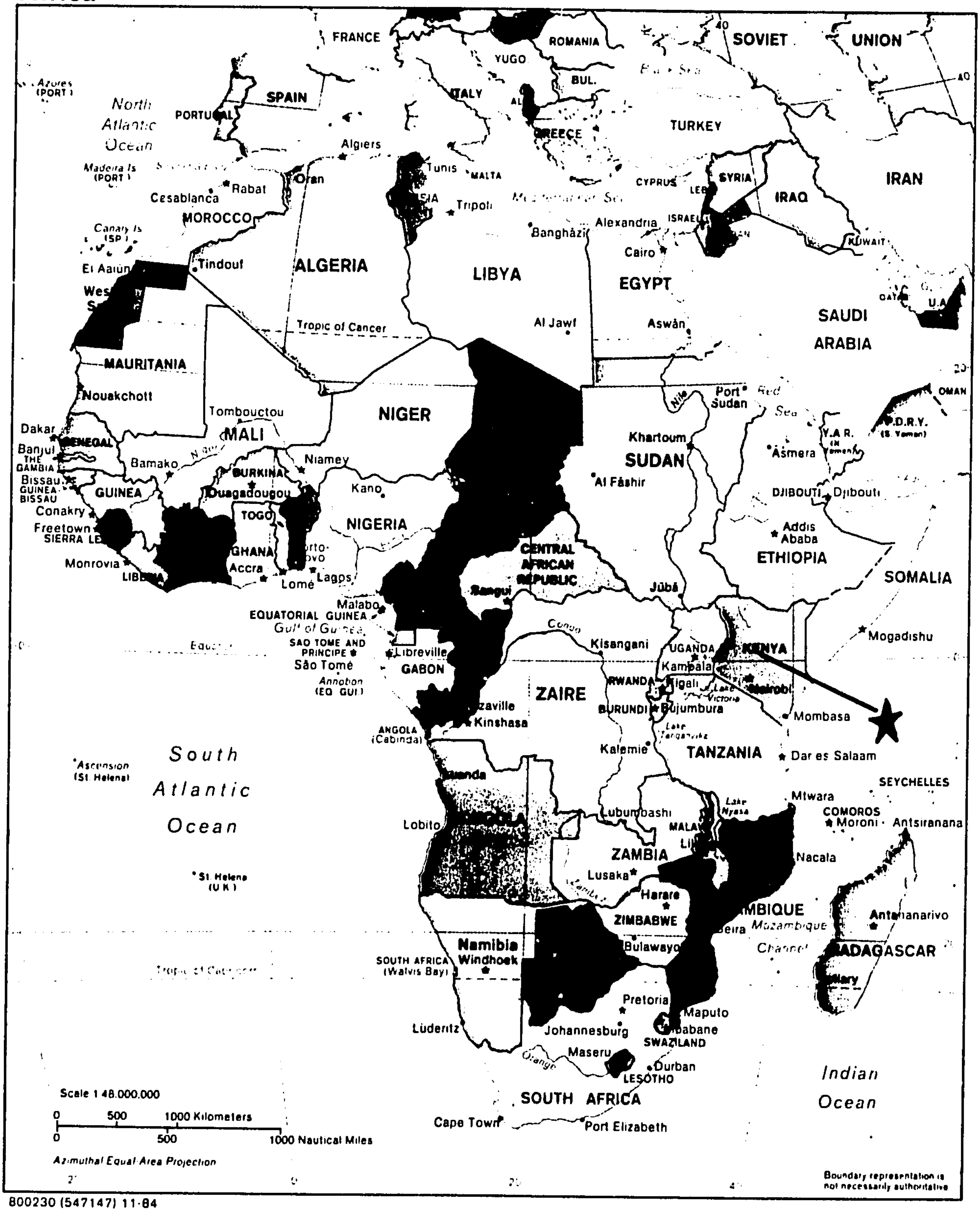

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program to $12 million. As of October 19, 1988, A.I.D. had expended $1.9 million of loan funds and $5.3 million of grant funds (Exhibit 1).

B. Audit Objectives and Scope

The Office of the Regional Inspector General for Audit/Nairobi made a program results and financial audit of the project. The audit objectives were to determine (1) the extent to which the project's purpose was being attained, and (2) whether internal controls were sufficient to safeguard project resources. Concerning the first objective, the audit determined whether funds were being made available to rural private enterprises such that significant contributions toward the project's purpose of establishing and expanding rural private enterprise were being realized. The audit also evaluated the cause of impediments to accomplishing the project's purpose.

The audit included a review of project and financial files maintained by USAID/Kenya, as well as administrative and financial records maintained by the PVO Intermediary, the Kenya Rural Enterprise Programme (REP) and 9 of its 23 subgrantees. Interviews were held with officials of USAID/Kenya, the Kenya Central Bank, all three Kenyan commercial banks involved with the project and eight of their branches, REP and nine of its subgrantees, and Deloitte, Haskins and Sells. The audit also considered the results of monitoring by Deloitte, Haskins and Sells of project implementation by the commercial banks and REP. Borrowers and subgrantees included in the audit were selected statistically.

The audit examined internal controls used by USAID/Kenya and REP to ensure that borrowers receiving funds under the project were properly qualified under the project's criteria, and that financial controls at REP were sufficient to ensure proper use of grant funds. However, the audit did not review cost incurred by Deloitte, Haskins and Sells, as records supporting these costs were kept in Washington, D.C. rather than in Kenya, where the audit was done.

The audit was made from July through October 1988 and a preliminary Report of Audit Findings was discussed with management officials in November 1988. The audit primarily covered the period January 1, 1985 through August 31, 1988, and covered obligations of $35.7 million and disbursements of 7.2 million, including $1.9 million to commercial banks, $3.9 million to REP, $1.3 million to Deloitte, Haskins and Sells, and $0.1 million for other purposes. All conversions from Kenyan shillings to U.S. dollars were made at the rate of $1.00 U.S. for 18 Kenyan shillings.

The audit included a review of the Government of Kenya's agreement to open a special account to provide a conduit for relending loan repayments from commercial banks. The audit also evaluated whether Kenyan commercial banks were providing their agreed-upon one third share of loans under the project. The audit was made in accordance with generally accepted government auditing standards.

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PART II - RESULTS OF AUDIT

The project made little progress toward establishing and expanding rural private enterprise in Kenya. The $36 million loan program resulted in loans of only about $3.3 million, and additional approved loans by the project's planned termination date could not be expected to exceed an additional $6.8 million. In addition, the $7.1 million grant program was contributing little to the project purpose. Concerning the second audit objective, internal accounting controls over grant funds were inadequate to ensure their proper use.

Despite these problems, the project had many positive aspects. On the loan side, the project successfully introduced the concept that Kenyan commercial banks could make long-term loans, and the rate of loan approvals appeared to be increasing. Further, commercial banks were contributing their promised one-third share of the loans, and the Central Bank of Kenya had opened a special account that may, in the future, provide a conduit for reloaning repayments from benefiting organizations. On the grant side of the project, the Kenya Rural Enterprise Programme, Limited (REP) had provided institutional and training support to Kenyan NGOs. It had also done much to introduce satisfactory internal accounting controls over grant funds.

The audit identified three areas requiring improvement. USAID/Kenya needed to improve the rate at which loans were being made, and to require that Rural Enterprise Programme, Limited better focus its subgrants. Further, Rural Enterprise Programme, Limited needed to further improve its internal accounting controls of project funds by the Kenyan organizations.

A. Findings and Recommendations

1. Most of the Project's Loan Funds Remained Unused

The project agreement required establishment and expansion of rural private enterprises through provision of credit and technical assistance to commercial banks, which in turn were to make loans and provide business advice to entrepreneurs. However, the loan portion of the project had little impact on the establishment and expansion of rural private enterprises. This occurred because (1) the GOK and the Kenyan commercial banks were not prepared to implement the project agreement, and (2) various factors negatively impacted on the project's marketability to the targeted benefactors. As a result, the project will not provide the planned level of assistance to Kenyan rural private enterprise unless project constraints are removed.

Recommendation No. 1

We recommend that the Director, USAID/Kenya:

a. extend the project's termination date, but impose time limits on reaching specified dollar targets for approving and disbursing project loans, including a requirement that failure to meet the targets will result in deobligations of unused project funds;

b. deobligate unused funds if targeted approval and disbursement rates are not achieved; and

c. prepare a revised brochure for issuance to the commercial banks that explains the program in a simplified manner.

Discussion

The Project Agreement between the GOK and USAID/Kenya, August 25, 1983, stated that the establishment and expansion of rural private enterprises in Kenya should contribute to the overall GOK goal of increasing rural production, employment and income. This goal was to be attained through the provision of credit funds to commercial banks, which would in turn make loans and provide business advice to qualifying entrepreneurs. The agreement established criteria concerning the nature of the loan program to ensure the project would specifically address the overall project goal.

Final implementing agreements among GOK, USAID/Kenya and the commercial banks were reached in early 1987. Under the agreements, $36 million was made available for the loan funds, of which A.I.D. was to contribute two thirds and the commercial banks a third. Lending under the project was to have a multiplicative effect, as loan repayments that exceeded the GOK's debt service to A.I.D. were to be made available for relending. Loan funds were to flow from USAID/Kenya through the Central Bank to three commercial banks and then on to the individual borrowers, who were to receive long-term loans.

USAID/Kenya also provided grant funds totalling about $3.3 million for implementation of the loan program. Of the grant funds, $2.8 million was for the technical assistance contractor, Deloitte, Haskins and Sells, who was to monitor project implementation by the commercial banks, assist them in providing business advice to businesses, and make feasibility studies. An additional $480,000 of grant funds was for incentives to commercial banks for making small loans.

The audit showed that little progress on the $36 million loan program has been made toward the project goal. Although the project termination date was only seven months away as of that date, the commercial banks had disbursed only about $1.3 million to 10 borrowers. An additional $2.0 million in loans had been approved by the banks and were awaiting final processing, such as registration of title deeds, before funds were disbursed. Thus, assuming all approved loans were eventually cleared, the project had resulted in 19 loans of about $3.3 million.

Based upon pending loan applications, the project would fall far short by the project termination date of the goal to lend $36 million. Of the $25.4 million of loan applications still being actively considered for approval by the commercial banks, only about $6.8 million was likely to be approved, given the following factors:

- Previous History The process of getting loans approved was difficult. Only a small percentage of applications received by the banks resulted in loan disbursements. Of 108 applications requesting loans of about $50.5 million, 36 loans for about $21.8 million were refused and an additional loan of almost $2 million was also likely to be turned down.

- Review of Pending Loan Applications Review showed that only $18.6 million of $25.4 million of pending loan applications, was likely be disapproved by the banks. The remaining $6.8 million of the pending loans were likely to be approved at some time in the future.

Thus the project could reasonably expect to result in loans totalling about $10.1 million based upon applications that had been received through August 31, 1988. Based upon previous history and the existence of credit constraints imposed on the commercial banks, the $10.1 million was unlikely to be disbursed until well after the project's termination date of March 31, 1989.

Several factors contributed to the project's past slow rate of progress since the project agreement was signed in August 1983. The GOK and the commercial banks were initially unwilling to implement the project as defined by the project agreement, and lending ceilings and problems in marketability of the loan program further limited the potential for making suitable loans to the extent planned.

Following signature of the project agreement, GOK officials were reluctant to establish the special account to which payments from the commercial banks would be made. In attempting to negotiate an agreement, USAID/Kenya in July 1985 submitted a detailed description of the special account to the GOK. However, negotiations concerning the account continued through April 1986 without success. In addition, officials of the Kenyan commercial banks objected to several conditions in the planned loan agreements between the GOK and the commercial banks, including the requirement that they share equally in funding subloans. Following continued negotiations, the conditions and terms for the project were finally satisfied in early 1987.

Various other problems then constrained progress. The commercial banks absorbed the risk of default; therefore, they required collateral, normally consisting of real property. Personal property was normally not acceptable as collateral, nor was lending based on projected performance after the loan had been received. Analysis showed that the $21.8 million of applications that had been disapproved were rejected primarily because the applicants could not raise the necessary collateral, not because they were not viable projects or did not meet project criteria. Further, analysis of pending applications also showed that most of the loans that would not be approved would be rejected because of lack of collateral.

USAID/Kenya officials, however, believed that the commercial banks should decide which loan applicants were creditworthy and that a loan guaranty program was inappropriate. The officials stressed that the increasing rate of loan approvals showed that the project goal could be reached in a reasonable period of time. Given the importance of the project's goal, we believe that the project termination date should be extended, but that specific targeted progress on a phased basis should be required.

An additional problem was that the brochure promoting the project was overly complex. The brochure was extremely long and legalistic and, and in our opinion, was overly complex.

As a result, the project has not provided credit funds to rural private enterprises at the level or speed expected. Therefore, eventual project success remained uncertain. The project can be extended beyond its planned termination date and thereby result in additional loans. However, the project bears a high administrative cost, as the cost of the technical assistance contractor was averaging $30,690 monthly. The project goal was worthwhile, and should continue to be pursued. However, USAID/Kenya should require expeditious progress toward making qualifying loans totalling $36 million, or deobligate remaining funds from A.I.D.'s contribution of $24 million.

Management Comments

USAID/Kenya stated that the loan program had made significant progress since the audit's cutoff date of August 31, 1988, due to removal of the constraints noted above. USAID/Kenya stated that, as of January 15, 1989, 40 loans for about $9.0 million had been approved and another 53 loans of about $19.0 million were pending approval. USAID/Kenya stated that it planned to issue a project implementation letter, rather than amending the project agreement as recommended, in order to extend the project's termination date until March 31, 1990. By then, it expected the entire $24 million of A.I.D.'s loan funds to be committed. However, disbursement of the $24 million was expected to take until December 31, 1990, after which any remaining unused funds would be reprogrammed, as recommended.

Concerning the recommended brochure, USAID/Kenya stated that producing a simplified brochure for issuance to loan applicants was unnecessary and counterproductive in that it could create demand in excess of available funding. As an alternative, USAID/Kenya proposed issuing a simplified brochure to participating bank officials, in order to assist toward achieving institutional development in marketing loans through participating banks. Accordingly, USAID/Kenya requested that we delete the recommendation to issue a revised brochure for issuance to prospective borrowers.

Office of the Inspector General Comments

The cited actions are generally responsive to the intent of the recommendation. The proposed extension of the termination date by a year until March 31, 1990 for committing the entire $24 million of A.I.D.'s funding, and until December 31, 1990 for disbursing this amount, represents a sufficiently stringent timeframe for completing the loan program. The instrument used to inform the parties of this decision is properly USAID/Kenya's decision, as long as the implementing parties understand that USAID/Kenya's committments and disbursements under the loan program will definitely terminate on March 31, 1990 and December 31, 1990, respectively. In addition, USAID/Kenya must be firmly committed to its decision to reprogram funds undisbursed as of December 31, 1990.

Concerning the brochure, the cited progress in making loan approvals indicates that USAID/Kenya's proposal to issue the brochure to bank officials instead of prospective borrowers, as recommended, is appropriate. We, therefore, have amended the recommendation accordingly.

Recommendation No. 1 may be closed upon receipt by this office of (1) the project implementation letter countersigned by implementing parties announcing USAID/Kenya's intention to discontinue making committments under the loan program on March 31, 1990 and disbursements after December 31, 1990, and stating further that USAID/Kenya will reobligate any funds remaining as of December 31, 1990 from its $24 million obligation, and (2) a copy of the revised brochure to be issued the the participating banks.

2. The Grant Program Had Not Made Significant Contributions Toward the Project Purpose

The project agreement stated that the project purpose was to be achieved at the small business level through a grant to a PVO, which would provide management advice and extend loans to small-scale entrepreneurs. However, the program contributed little toward the project's purpose, and the progress made was neither cost effective nor sustainable. This occurred because (1) most of the project's funding was directed toward assistance to NGOs that did not appear to be sustainable, and (2) project implementation further limited the project's contribution. As a result, little of the $7.1 million of grant funds supported qualifying Kenyan rural private enterprise.

Recommendation No. 2

We recommend that the Director USAID/Kenya:

a. take appropriate action with Rural Enterprise Programme, Limited to require that (1) subgrants specifically address the issue of sustainability by planning for a level of operations and future donor contributions that will provide a basis for future operations without continued indefinite A.I.D. assistance; and (2) all subgrantees receiving loan funds submit specific plans to Rural Enterprise Programme, Limited showing a time-phased schedule of how reflows of principal and interest will be relent;

b. require that the Rural Enterprise Programme, Limited, terminate subgrants that are not effectively supporting Kenyan enterprises as specified by the cooperative agreement, as amended; and

c. terminate its approach of assisting Kenyan business establishments through Kenyan non-governmental organizations if future internal monitoring and evaluations through March 31, 1991 show that the Kenyan organizations have not significantly improved the degree of direct assistance to the small businesses.

Discussion

The project agreement between the GOK and A.I.D., August 25, 1983, for the Kenya Rural Private Enterprise Project stated that the project purpose of expanding rural private enterprise would be partially achieved through the provision of grants to PVO's, which will in turn provide management advice and small-scale loans to entrepreneurs. The agreement further stated that a PVO intermediary was to be used to provide access to small businesses. A July 1986 letter from USAID/Kenya to the PVO intermediary, the Kenya Rural Enterprise Programme, Limited (REP) stated that the PVO program was used because it was the only evident access at the time of project development to rural small businesses, which lacked access to formal credit institutions and were therefore ineligible for the project's formal loan program.

Cooperative Agreement No. 615-0220-A-00-4005-00, May 11, 1984 between REP and USAID/Kenya 1/, as amended on April 11, 1985 and June 29, 1987, provided about $7.1 million for REP to undertake an intermediary role in assisting Kenyan non-governmental organizations (NGOs) provide financial and non-financial services to small businesses. Among other functions, REP was to make subgrants to NGO's for support of income-generating assistance projects at local levels. According to the agreement, NGO's were to be administratively sound, or have demonstrated the capacity to readily improve their management. Supported programs were required to be cost-effective in reaching the poor, and be for off-farm activities. Exhibit 2 contains a breakdown by expense category of the approximately $7.1 million to be provided to REP under the cooperative agreement which was scheduled to terminate on March 31, 1989.

As of June 30, 1988, REP had awarded 30 subgrants for about $4.0 million to Kenyan NGO's to implement project activities at the grassroots level. Seventeen subgrants totalling about $3.6 million were concerned with assistance projects. The remaining 13 subgrants for $0.4 million were for administrative services and other general purposes. A list of the subgrants is at Exhibit 3.

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1) The actual party to the Cooperative Agreement is World Education, Incorporated, a U.S. PVO headquartered in Boston, Massachusetts. However, the entity implementing the program in Kenya is officially registered as the Kenya Rural Enterprise Programme, Limited, which transacts all of its business in Kenya under this latter designation.

The audit found that the PVO program was not contributing much toward the goal of assisting rural private enterprise. About $5.6 million of the project's grant funding of $7.1 million will have been spent by March 31, 1989. The $5.6 million will provide a maximum in financial assistance to small businesses of about $1.15 million, to be used primarily for making loans to businesses and for setting up facilities to teach productive trades to young Kenyans. About $4.44 million will have been spent for institution-building and administrative costs of both REP and the NGOs. Although the project agreement stated that most assistance would be non-financial, the ratio of non-direct to direct financial assistance will be about four to one which, we believe, is not a cost-effective approach for assisting rural private enterprise, as was required (Exhibit 4).

Further, as described below, much of the 20 percent of direct financial assistance benefited retail businesses or on-farm activities. While retail businesses were not specifically precluded from assistance, they were considered to be of lower priority for assistance than firms that were clearly productive in nature.

REP's program report for the year ending June 30, 1988 provided a statement of cumulative project accomplishments through that date. The report highlighted beneficiary statistics for 17 of its subgrantees, who were to receive $3.6 million. According to the report, the 17 subgrantees through June 30, 1988 had approved loans totalling about $460,000 to 1,246 businesses. The report stated further that about 84 percent of the assisted enterprises were engaged in productive activities, and the remainder in retail operations.

This audit, however, showed that most of the approved loans actually supported on-farm activity or retail businesses. We examined loan portfolios of five subgrantees that had made 1,049 of the 1,246 cited loans, and found that about 976 of the 1,049 loans were to farmers or to owners of retail, service or rental property businesses. (Exhibit 5).

Excluding the 902 loans for about $116,500 made by one organization to farmers, REP had approved only 344 loans totalling about $344,000. Based upon results of this audit, about half of the 344 had questionable connections to the project's criteria requiring that assisted organizations be productive. The following shows results of audit at the five recipients examined.

- The National Christian Council of Kenya (NCCK), which had a $732,670 grant, approved 103 loans totalling about $117,000 and disbursed 46 loans for about $55,000. Of the loans approved, over half supported small retail establishments, service industries, or construction of rental property. The other half of the loans were to businesses involved with poultry-raising, tailoring or knitting, carpentry, cattle fattening, and other purposes.

- Partnership for Productivity Kenya (PfP), with a $323,285 grant, had made 902 loans totalling about $116,500, all of which were made to farmers for the purchase of seeds and fertilizer. These loans directly supported on-farm activities, an activity specifically prohibited by the cooperative agreement. Of the $116,500 in approved loans, about a third represented reflows from repaid loans.

- Chogoria Hospital, with a $370,822 grant, had made 10 loans for about $47,000, against which it had disbursed about $7,500 to five small businesses. Of the ten loans approved, three were to businesses engaged in retail operations.

- Tototo Industries, with a $195,524 grant had awarded nine loans totalling about $12,500 through June 30, 1988. Four of the assisted enterprises were retail establishments and the remaining five were distributed among poultry-raising activities and other enterprises.

- The Anglican Diocese of Eldoret, with a $200,033 grant, had disbursed about $51,500 to 25 enterprises. Six of the loans were for retail businesses, one was used to pay off another bank loan, one was for construction of rental property, two were for on-farm activities, and three were diverted for purposes other than for which the loan was approved.

Based upon these results, the project had contributed little toward the project's purpose. Almost 80 percent of the funding was for institution-building activities, training or administration. The remaining 20 percent was divided among loan funds for small businesses and training centers, the latter of questionable validity considering the project purpose. Further, even the limited amount of funding available for loans under the program had been used largely for retail and on-farm activities.

This occurred because most of the project's funding was directed toward non-financial assistance to the NGOs which did not appear to be sustainable in the long term. In addition, project implementation by REP and Kenyan NGOs has further reduced the project's contribution to the project's purpose.

Assistance to the Kenyan NGOs did not appear sustainable. Using most the program's funds for non-financial assistance was justifiable only if such expenditures made the recipients self-sustainable in providing future assistance to the target population. This, however, was not the case, for several reasons. First, the amount of assistance to any single NGO was insufficient to provide a future financial return large enough to support the assisted program. Second, REP cannot continue its operations beyond March 31, 1989 without continued financial assistance from A.I.D. Third, this audit demonstrated that after about four years of project implementation, few if any of the NGOs have attained the management skills to provide assistance to Kenya businesses as planned by the project agreement. USAID/Kenya should terminate the approach of directing assistance to Kenyan businesses through NGOs if improvements in delivery of direct financial assistance are not realized within a two-year period.

Project implementation by REP and the NGOs has further reduced the amount of qualifying assistance to small private enterprise. REP was to have implemented the project such that its subgrants would be completed by March 31, 1989 when the cooperative agreement ended, in which case $4.2 million of financial assistance would have been made available to the NGOs as of that date. However, only about $2.8 million is expected to have been disbursed to the NGOs by March 31, 1989. Therefore, REP will require continued funding to complete administering the $4.2 million subgrant program.

The NGOs also often were slow in implementing their subgrants, which delayed assistance to small businesses. NGOs were slow in making loans, and most did not plan for relending principal and interest repayments. For example, of the five subgrantees whose loan programs and portfolios were reviewed during this audit:

- NCCK took over 14 months to make its first loan under the program and over half way through its grant period had disbursed only about a fifth of the principal available for lending. Although the rate of lending appeared recently to be increasing, it still had not re-programmed reflows for relending, thereby potentially reducing by over 100 percent the total amount that could be lent under its grant.

- PfP was aggressively lending and relending funds, but had experienced an arrearage rate of about 35 percent on its first-year loans.

- Chogoria Hospital was very slow in disbursing loans. As of September 7, 1988, after over three-fourths of its grant term had been completed, Chogoria had disbursed only about five percent of the principal available to it under the program. Chogoria also had not reprogrammed repayments for relending.

- Tototo Industries was proceeding well in making loans, but had not reprogrammed repayments for relending.

- The Diocese of Eldoret was suffering arrearage problems in repayment.

As a result, the grant portion of the project has provided little assistance to qualifying Kenyan small businesses, which was its specific purpose as defined by the project agreement and subsequent implementing documentation. The project had other beneficial results, and will continue to provide technical and non-financial assistance in the future. However, these benefits do not sufficiently address the project purpose and are not sustainable. Specific changes as recommended are needed to provide more assistance to productive enterprises.

Management Comments

USAID/Kenya stated that its long-term goal was to provide more direct financial assistance to rural small businesses, and that this project was its only mechanism for providing such assistance. USAID/Kenya said it was convinced that the project's approach of developing indigenous NGO capacity to extend this assistance was the best way to achieve this goal. It stated that sustainability of the NGOs cannot be based on loan reflows, as project resources are inadequate to both build the capacity of NGOs to manage loan programs and to finance loan portfolios large enough to provide them with a steady source of income. Therefore, the project was concentrating on building the institutional capacity of the NGOs as a preliminary step toward more effectively assisting rural enterprises. USAID/Kenya stated further that if subgrantees could demonstrate their effectiveness under this project, it was confident that they could attract sufficient resources to become sustainable.

Concerning Recommendation No. 2, management stated that it would issue a project implementation letter to address the issues of sustainability, reprogramming of loan reflows, and termination of ineffective subgrants. USAID/Kenya also agreed to terminate the NGO approach of assisting rural small enterprises if a supportive and positive final evaluation of the project was not received in two years. USAID/Kenya stated further that it would share the results of an upcoming April 1989 interim program evaluation with us.

Office of the Inspector General Comments

This project represents a costly approach toward assisting Kenyan small rural businesses. About $7.1 million will have been committed through March 31, 1989, and as stated above, very little actual direct financial assistance will have actually been provided the small businesses. Moreover, based upon audit results, we do not believe that the NGOs will be able to continue the programs that have been originated under this project after A.I.D.'s assistance is terminated. If not, funding under this project will have accomplished little.

Nevertheless, this audit does not recommend that the grant program be terminated. In effect we are willing to agree with USAID/Kenya that it should have an additional two-year period to demonstrate that the the instituition-building assistance to the NGOs can in fact make them self-sustaining entities in assisting small businesses in rural areas in the future. However, steps can be taken, as recommended, to improve the project's payoff in assisting small businesses.

USAID/Kenya has expressed a willingness to instruct REP to take these specific actions, and has agreed to discontinue assisting small rural businesses through Kenyan NGOs if future evaluation shows this is not an effective approach. Accordingly, this recommendation is considered resolved and can be closed upon receipt by this office of the cited implementation letter, documentation from REP that appropriate actions were taken and policies implemented, and a copy of the report of the upcoming, interim evaluation.

3. Improvements Were Needed In Financial Controls Over Funds Provided to Kenyan Organizations

A.I.D. Handbook 13 required that recipients of cooperative agreements exercise effective internal control and accountability over all funds, property and other assets, and ensure they were used solely for authorized purposes. REP's agreements with its subgrantees required internal control measures, including periodic audit, so that project funds were controlled and used appropriately. However, funds disbursed by REP to its subgrantees were not always being adequately safeguarded in accordance with the above criteria. Lack of enforcement of the internal control procedures required by its grant agreements with subrecipients contributed significantly toward these problems. As a result, control over funds provided to NGOs did not adequately safeguard against fund misuse, excessive cash advances or the risk of fraud or abuse.

Recommendation No. 3

We recommend that the Director, USAID/Kenya require that Rural Enterprise Programme, Limited:

a. annually make financial audits of all large subgrants and a quarter of small subgrants, beginning with all subgrants not specifically covered by this audit;

b. require correction of financial problems detected by its financial monitoring effort or through results of audit, or terminate the grant in question;

c. require that subgrantees provide evidence that they are ready to disburse loans before providing cash advances for the loans, and immediately liquidate any excessive advances still retained by subgrantees;

d. require that Daraja Trust repay amounts, as shown by detailed audit, that (1) it disbursed from the first grant funds after the grant had terminated, and (2) represented inappropriate reimbursement for personal expenses; and

e. require that the National Christian Council of Kenya (1) reimburse amounts billed against its current grant that was not supported by its accounting records, as determined by independent review of the records, and (2) ensure that all cash receipts be deposited on a timely basis.

Discussion

A.I.D. Handbook 13 required that recipients and subrecipients of cooperative agreements exercise effective control and accountability for all funds, property and other assets. Recipients were to adequately safeguard all such assets and ensure that they were used only for authorized purposes. Procedures were to be used to minimize the time elapsing between the transfer of funds from the U.S. Treasury and disbursement by the recipient. Funds were not to be deposited in interest-bearing accounts. The handbook also required that if A.I.D. determines that funds provided under cooperative agreements have been expended for purposes not in accordance with terms of the agreement, the recipient should refund such amounts to A.I.D.

REP required that its subgrantees agree to keep proper books of accounts, document all expenditures and institute appropriate internal control measures. Grant funds were to be restricted for use to the activities specified, and grantees were to make quarterly statements of fund use. Funds were to be used according to an approved budget. Funds granted but not expended for the project were to revert to REP when the grant expired or was terminated. Finally, there were to be audits of the grant commencing one full calendar year after the initial grant was made to determine the propriety and necessity of expenditures according to the terms and purposes of the grant.

Some of the funds disbursed by REP to its subgrantees were not being adequately safeguarded in accordance with the above criteria. Based upon review of eleven areas related to fund control, accountability and use by nine Kenyan NGO's[2/], overall management of project funds provided to the NGOs was mixed and could be improved. Seven of the nine NGOs had problems in at least one of the eleven performance areas, and one NGO had deficiencies in six different areas. Exhibit 6 provides a breakdown of the problems noted.

2/ The eleven areas were accountability; appropriate use of funds; documentation of loan agreement, disbursements and repayments; use of funds outside of grant period; potential insolvency; control over cash receipts; use of funds in accordance with budget; procurement procedures; handling of cash advances; handling of cash disbursements; and deposit of grant funds into an interest-bearing account.

Insufficient enforcement by REP of its internal control procedures contributed toward these problems. WEI established policies to help safeguard against inappropriate use of grant funds by subrecipients, including (1) reviewing their accounting systems before disbursing funds, (2) providing financial monitoring of the grant during its implementation, and (3) requiring independent financial audits of the grants. These policies, however, did not adequately safeguard project funds because REP did not utilize some of the controls or did not take always action to correct known problems.

REP's review of recipients' accounting system should have ensured that they were able to properly account for and disburse grant funds. This audit, however, showed that two of nine recipients could not properly account for grant funds, and four handled cash disbursements inappropriately (Exhibit 6).

Independent audit and internal financial monitoring should have disclosed the problems reported above. However, audit was not effectively used. REP had established an informal policy that all grants exceeding about $55,000, and a quarter of smaller grants would be audited annually. However, only two final audit reports covering use of grant funds had been issued through August 31, 1988 (one in July 1988 and the other in August 1988), although some grants had been initiated over three years ago. Three additional audits were in progress. One of the two final audit reports disclosed fairly significant problems, including financial reports to REP not in agreement with the recipients' books, unauthorized borrowing of REP funds, and large unexplained differences between expected and actual loan repayments.

REP also had mixed results in its attempts to correct known problems with its recipients' financial management. On the positive side it had, for example, refused some requests for excessive cash advances by NCCK and Chogoria, required outside monitoring of loan disbursements by PFP, required that NCCK pay from other funds for equipment that it had purchased without approval, and made only minimal disbursements to Kitui pending needed improvement to its accounting system. However, REP knew of many of the other problems disclosed at Exhibit 6, but was unable to get the NGO's to take the required corrective action.

As a result, some funds were misused, the NGO's retained advances excessive to their needs, and the risk of fraud or abuse was significantly increased. The results shown at Exhibit 6, indicate that the poor controls could have a significant impact on the project if improvements were not made.

In conclusion, REP was aware of the need to closely monitor project funds, and had done much to enhance such financial management and correct problems. However, as summarized above, problems still existed. REP, therefore, needed to take the specific actions as recommended.

Management Comments

USAID/Kenya stated that this report does not give REP adequate credit for having identified the problems referred to in the audit. USAID/Kenya stated, however that it would instruct REP to implement all portions of Recommendation No. 3.

Office of the Inspector General Comments

The cited action is responsive to the recommendation. The recommendation will be closed upon receipt by this office of the letter to REP directing the indicated actions, and the response by REP which provides evidence that the cited actions have been taken or policies implemented.

B. Compliance and Internal Control

Compliance

Finding 2 discussed that some loans made under the grant portion of this project did not fully comply with criteria established by the Project Agreement. Finding 3 reported that some Kenyan NGO's did not fully comply with their grant agreements with REP, and REP did not fully implement internal control procedures designed to ensure that the NGO's fully complied with the agreements.

Internal Control

Finding 3 disclosed that REP and the NGO's controls were inadequate to fully safeguard project resources.

AUDIT OF
KENYA RURAL PRIVATE ENTERPRISE PROJECT

PART III - EXHIBITS AND APPENDICES

Exhibit 1

Funding Status As of October 19, 1988
A.I.D. Funds
(Millions of U.S. Dollars)

Category 1/	Obligations	Disbursements
Loans to Sub-borrowers	$24.0	$1.9
Technical Assistance	2.8	1.3
Small Enterprise Promotion	0.5	-
PVO Management and Loan Funds	7.1	3.9
Evaluation	0.2	-
Contingencies	0.5	-
Business Advisory Services	0.6	0.1
Total	$35.7	$7.2

Note

1/ Of the categories below, Loans to Sub-borrowers were funded by U.S. loan funds, and the remaining categories by grant funds.

M'

Exhibit 2

Cooperative Agreement Financial Plan
(In thousands of U.S. Dollars)

Category	Obligations	Disbursements 1/ Amount	Disbursements 1/ Percent of Obligations
Administrative Salaries	$1,150.7	$869.9	75.6%
Consultants	131.3	102.6	78.1%
Travel and Transport	201.8	221.8	109.9%
Allowances	112.8	88.9	78.8%
Other Direct Costs	172.1	193.1	112.2%
Equipment and Supplies	136.8	88.2	64.5%
Overhead	638.7	544.6	85.3%
Subcontracts	315.0	315.0	100.0%
Subgrants(2)	4,200.0	1,445.8	34.4%
Total	$7,059.2	$3,869.9	54.8%

1/ Disbursements to subrecipients by Kenya Rural Enterprise Programme (REP) through June 30, 1988.

2/ As of June 30, 1988, REP had awarded $4,019,860 of the $4,200,000 obligated for subgrants, of which $1,445,741 had been disbursed.

Subgrants Awarded Through June 30, 1988

Grantee Name	Amount of Grant	Amount Disbursed to Grantee
National Christian Council of Kenya (NCCK)	$49,652	$46,775
Appropriate Technology Advisory Committee 2/	39,637	54,880
Kenya Women's Finance Trust	174,288	125,486
Catholic Diocese of Kitui 2/	292,246	-
Maendeleo Ya Wanawake Organization 2/	25,581	25,326
Presbyterian Church of East Africa	22,091	21,334
Upweoni Community Development Center	416,541	211,592
Diocese of Eldoret Grant No. 1 2/	194,793	162,747
NCCK Grant No. 2 2/	732,700	189,865
Partnership for Productivity - Kenya 2/	323,285	139,183
Maryknoll Fathers - Bura	54,675	39,647
Chogoria Hospital 2/	370,822	85,410
Tototo Home Industries 2/	195,524	107,174
Consolata Society and Ruka Catholic Mission	96,100	-
Isiolo Diocese	250,993	77,184
Saleseans of Don Bosco, Limited.	331,810	24,917
Ilbukui Women's Group	48,468	-
Daraja Trust Limited. 2/	93,692	-
Wongonyi Home Economics Group	6,907	6,852
Grantee Pool Services	196,250	29,419
Eight Other Grants	103,805	97,950
	$4,019,860	$ 1,445,741

1/ Amount shown reflects the U.S. dollar equivalent of the amount granted in Kenyan shillings, converted using the exchange rate as of the date of the award. The rate ranged from 15.17 to 17.11 shillings to the dollar.

2/ Grantees visited during the audit.

Exhibit 4

Comparison of Indirect and Direct Assistance to Small Business
(In Millions of Dollars)

	Indirect Cost	Direct Financial Assistance	Total
REP Cost	$2.811	$ -	$2.811
NGO Costs	1.629 1/	1.146	2.775
Total	$4.440	$1.146	5.586

1/ According to Rural Enterprises Programme, Limited most of these costs will support training of personnel; acquisition of fixed assets, including automobiles, computers and office furniture and other administrative and operating costs.

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Exhibit 5

Analysis of Approved Loans

Type of business	Number of Approve Loans/Organization NCCK	DOE	Tototo	Chogoria	PFP	Total
Farm	1	1	-	-	902	904
Retail	48	6	4	3	-	61
Poultry	9	-	2	1	-	12
Service	2	3	-	-	-	5
Corn Milling	3	3	-	1	-	7
Tailoring	9	2	1	3	-	15
Carpentry	5	2	-	2	-	9
Leather	3	-	-	-	-	3
Rental Property	4	2	-	-	-	6
Bakery	1	-	1	-	-	2
Welding	-	1	-	-	-	1
Zero Grazing	4	1	-	-	-	5
Transportation	1	2	-	-	-	3
Other	13	2	1	-	-	16
Total Loans	103	25	9	10	902	1049

1/ NCCK - National Christian Council of Kenya. This audit examined 81 of the NCCK's 103 loans, and projected the breakout by type of the 103 loans based upon actual results for the 81 loans examined.

2/ DOE - Anglican Diocese of Eldoret

3/ Tototo - Tototo Industries

4/ Chogoria - Chogoria Hospital

5/ PFP - Partnership For Productivity - Kenya

Specific Internal Control Deficiencies

Specific Deficiency[2/]	Organizations Involved[1/]
1. Insufficient Ability to Account for Fund Use	A,G
2. Inappropriate Use of Funds	C,D,E
3. Loans Inadequately Documented or Justified	B
4. Funds Used Before or After Grant Period	C,D
5. Potential Significant Financial Problems	C
6. Inappropriate Handling of Cash Receipts	D,E
7. Funds Not Used in Accordance with Budget	D,E
8. Funds used Inappropriately for Procurement	D
9. Organization Maintained Excessive Cash Advance	B,C,D,F
10. Inappropriate Handling of Cash Disbursements	A,B,E,G
11. Funds Deposited Into Interest-bearing Account	G

1/ Key to Organizations:

		No. of Problems Noted
A	- Catholic Diocese of Kitui	2
B	- Anglican Diocese of Eldoret	3
C	- Daraja Trust	4
D	- National Christian Council of Kenya	6
E	- Partnership for Productivity - Kenya	4
F	- Chogoria Hospital	1
G	- Appropriate Technology Advisory Committee	3

2/ Specific Deficiencies are as described below, by organization.

A. Catholic Diocese of Kitui (CDK). The grant to CDK was approved on March 29, 1988 for $292,246 to install the Mutomo Community Technical Centre. REP was aware that CDK did not have a satisfactory accounting and reporting system and required such a system before initially disbursing funds to the project. REP also hired a consultant to install an accounting system.

The audit showed that CDK had not installed a satisfactory accounting system at the project site by September 7, 1988. The consultant had delivered a report detailing a possible system, but REP considered it overly complex for CDK's purposes. The system that had been informally set up was inadequate, and personnel at the project site were unfamiliar with financial management procedures.

B. Anglican Diocese of Eldoret (DOE). DOE's grant was approved April 17, 1986 for $194,793. The grant purpose was to establish a Small Scale Business Scheme, which would make loans to micro-enterprises in the general area of Eldoret, Kenya.

The audit disclosed various problems with DOE's financial management of project funds. First, DOE did not adequately document or justify loans to its clients. A consultant hired by WEI to examine credit administration reported that prior to his arrival in May 1988, a loan collection system didn't exist. Since then DOE has gone back to most borrowers to remake basic loan documents including guarantee documents, loan agreements and loan application documents. The consultant's report also stated proper accounting records were not maintained for the revolving loan fund.

Second, DOE's control over cash disbursements was inadequate. Our review of DOE's disbursements during 1987 showed that about 40 percent of all vouchers examined had not been authorized before the funds were disbursed.

Third, DOE was maintaining excessive cash advances. The draft report by the Certified Public Accountant who had audited DOE's project accounts stated that $21,800 of its cash advances of about $46,200 as of March 31, 1988 was not supported by corresponding cash balances, in effect representing a temporary net borrowing of project funds.

C. Daraja Trust. REP agreed on October 19, 1987 that it would provide Daraja Trust with $93,692 toward establishment of a Family-based Small Enterprise Development Project. The Project was to make loans to needy small entrepreneurs. This audit showed various problems with Daraja's financial affairs, as follows:

- Daraja had used REP funds for an earlier grant made for the purpose of evaluating Daraja's management to pay expenses of a personal nature, such as club memberships, guards services and utility expenses at a personal residence, credit card bills and personal vehicle operating expenses. The amount of such expenses was at least 33,447 Kenya Shillings, or $1,858. REP officials stated that payment of non-salary benefits was common in Kenya. However, the amounts paid had not been supported by a statement of the services rendered or amounts due for the services rendered.

- Daraja had used at least Kshs 170,714 (about $9,500) remaining from its earlier grant after the current grant period had ended. The funds were used to pay operating expenses and personal expenses of the executive director.

- Daraja has experienced significant financial problems. Its financial position as of December 31, 1986 showed net current assets of about $10,400, of which about $9,500 should have been repaid to REP after the earlier grant had expired.

- Daraja maintained advances from its earlier grant well in excess of its needs.

D. National Christian Council of Kenya (NCCK). REP's November 1986 grant to NCCK of $732,700, representing about a sixth of REP's total grant funds, was made to establish a small business scheme to lend funds to small-scale enterprise. NCCK's implementation of the project had the following problems:

- NCCK improperly used at least $1,100 after completion of a previous REP grant, and had billed the current grant for $10,000 not supported by its accounting records. (that is, billings for 1987 were about $10,000 higher than the amount that NCCK's accounting records showed should have been billed). REP stated that NCCK had adjusted its charges under the current grant to correct the the $1,100 overcharge.

- One of NCCK's branch offices deposited some cash receipts two weeks after received, and the office involved had no safe in which to store funds after their receipt.

- NCCK was not spending funds in accordance with its grant agreements with REP. On an earlier grant, it had significantly overspent personnel costs without approval. During the first year of implementation of its current grant, it had overspent three budgetary line items by amounts far exceeding the authorized 15 percent.

- NCCK had purchased equipment costing about $15,100, including duty charges. REP's agreement with NCCK specifically required that REP's approval before purchasing equipment, and prohibited payment of duty charges. NCCK had not obtained the required approvals. It should be noted that REP had discovered the problem and required restitution.

- NCCK had obtained an advance of about $66,700 for subloans about six months before the first disbursement against the funds.

E. Partnership for Productivity - Kenya (PfP). The $323,285 grant with PfP was to implement the Lugari Enterprise Development Project. The project was designed to provide agricultural inputs to farmers, primarily by loan. The audit disclosed the following problems with financial management.

- PfP charged the project for about $14,500 of the general manager's salary, a cost not included in the approved budget. REP, however, had required reimbursement.

- PfP's had poor internal control over cash receipts. Receipts for cash were not prenumbered. The financial records showed only 57 percent of principal due had been paid as of March 31, 1988, and ledger cards supporting loans outstanding had not been updated from March 31, 1988 until our visit to the project site on August 16, 1988.

- Internal Control over disbursements was inadequate in that most of the expenses at the project site were from petty cash, which was kept informally by personnel at remote sites.

F. Chogoria Hospital. REP approved Chogoria Hospital grant of $370,822 to establish the Chogoria Community-based Small Scale project, to make loans to income-generating enterprises run by small groups in the area.

Chogoria's financial management was generally good. The only problem noted of a financial nature was that Chogoria requested advances well before they were needed. For example, Chogoria had requested about $22,200 in advance for their loans at least nine months before the first disbursement was made. Other advance requests were also made before needed.

G. Appropriate Technology Advisory Committee (ATAC). ATAC received two grants in February and May 1985 totalling $53,574, toward the costs of hosting an exhibition of Indian machinery and purchasing some of the equipment for display in a Small Industries Development Center.

Financial management of the grant funds was poor. There was no accounting as such of expenditures. Repeated inquiries by REP were needed before ATAC provided a list of machinery acquired with grant funds. Proper records were not maintained to show disbursement of funds. Funds were intermingled with general operating funds in an interest-bearing account.

UNITED STATES GOVERNMENT

memorandum

DATE: February 8, 1989

REPLY TO ATTN OF: Steven W. Sinding, Director

SUBJECT: Draft Report of Audit of Kenya Rural Private Enterprise Project (615-0220)

TO: Richard C. Thabet, RIG/A

We are extremely disappointed that after so many months of dialogue with RIG/A, our disagreements with the Audit continue to be based on fundamental differences of opinion over project design strategy - i.e., what is a viable mechanism for assisting rural micro-enterprise. We consider it quite appropriate for the Audit to be concerned with the project's progress to date and to question the cost effectiveness and sustainability of the PVO approach. However, we are surprised that RIG/A took it upon itself then to reach such categorical conclusions as "USAID/Kenya placed little emphasis on the project's purpose in designing and implementing (the PVO grant) portion of the project", or "these (technical and non-financial) benefits do not sufficiently address the project goal and are not sustainable." These conclusions are not supported by the Audit's analysis and we disagree with them.

RPE is one of A.I.D.'s earliest large-scale tests of approaches to reaching a normally unreachable segment of the economy with credit and other business assistance. AID/W Micro-enterprise Development Program Guidelines explicitly target programs that develop intermediate financial institutions (IFIs) for this group of entrepreneurs that cannot access formal sources of credit. The Guidelines give strong preference to developing IFIs by strengthening and working through local privately owned and controlled institutions such as PVOs and NGOs. If the Audit's conclusions about RPE's design are ever substantiated by time and expert opinion, AID/W guidelines will most likely be reviewed and modified. We, however, are confident that the basic approach of RPE is correct, and suspect that its start-up delays and implementation problems will instead serve as valuable lessons to be applied to similar projects with similar approaches in Kenya and other parts of the world.

Putting aside our differences of opinion, the Audit can be seen to have confirmed our concerns about the institutional capacity of indigenous NGOs, and to have made many recommendations for corrective actions that, assuming we have interpreted them correctly, will improve project implementation. Our specific comments on the major Audit Findings and our proposals for addressing the Recommendations follow.

Finding No. 1 "Most of the Project's Loan Funds Remained Unused"

This correctly states the status of the loan program when the Audit began in August, 1988, but progress in recent months is much more encouraging. As of January 15, 1989, 40 loans totalling $9.041 million (A.I.D. share) had been approved by the three participating commercial banks. Following a careful review in which questionable loan applications were removed from the list, an additional 53 loans totalling $18.995 million (A.I.D. share) were pending approval as of mid-January. This then totals over $28 million in approved and pending loans. As RPE has only $24 million available for lending, we are reasonably confident of disbursing the loan program during the period of a project extension.

This improvement is largely due to removal of the constraints identified in the Audit Finding. The Commercial Banks are beginning to see the medium-term loan as a useful addition to their portfolios of services. This change in attitude and the shortage of foreign exchange in the country has improved the marketability of the program. Finally, the IMF credit ceiling has been raised and is no longer perceived by the banks as a constraint to lending.

Consistent with Audit Recommendation No. 1.a., we are in the process of extending the RPE PACD by one year, to March 31, 1990. We expect to be able to commit the entire $24 million by that date, for actual disbursements that, according to the terms of the Loan Agreement, may continue over an additional nine month period. Our target date for deobligating (Recommendation Nos. 1.a. and 1.b.) and reprogramming unused loan funds is therefore December 31, 1990. We consider a PIL to be the appropriate mechanism for advising the GOK of this target date.

Institutionalizing medium-term lending practices in Kenya is as important a project objective as actually disbursing the loan funds. Development experience elsewhere in the world has shown that this type of behavioral modification is most successful when other standard procedures, such as loan approval criteria, are not changed. This is the approach taken in the project. Standard loan approval criteria in Kenya include requirements for collateral, so for now, we accept the fact that some loan applications for financially viable purposes may be turned down because of lack of collateral. We share the Audit's concerns in this regard, but have chosen to proceed one step at a time.

We can develop and issue a simplified brochure for loan applicants (Recommendation No. 1.c.), but this may be unnecessary and counterproductive given the recent rate of loan approvals and the project's institutional development objectives. The generation of demand for credit in excess of available resources may create disappointment and ill will toward the program. The project's approach to achieving the institutional development objective is to market the loan program through the committed and supportive staff of the participating banks. Plans are already underway to produce a brochure targeted at bank managers and their loan officer staff. The brochure will clarify the eligibility criteria for the RPE program, the procedures of application and approval, and highlight the advantages of this supplemental term lending window for the banks. This will assist the commercial bank officers in marketing a better understood loan program with potential borrowers and provide a checklist reference on loan compliance. Given the danger of raising client expectations and the existing plans for developing a brochure for bank officers, we urge RIG/A to consider deleting Recommendation No. 1.c.

Finding No. 2 "The PVO Program has not made significant contributions toward project goals"

As we understand it, the Audit bases this finding not on any contention that the project is being implemented contrary to its design, but rather on an opinion that the basic design is incorrect. RIG/A is entitled to its opinions, but we do not consider the Audit or this Mission response to be an appropriate forum for debating the validity of a design strategy which was developed, reviewed and approved by the Agency's most competent development specialists, and is fully supported by AID/W Micro-enterprise Development Program Guidelines. We and the Rural Enterprise Program would like nothing better than to provide more direct financial assistance to rural micro-enterprises. That is our mutual long-term goal. However, the fact remains that there is no viable commercial banking or other existing mechanism for providing such assistance. We strongly disagree with the basis for this Audit Finding and remain convinced that the project's approach of developing indigenous NGO capacity to extend this assistance remains the best solution to the problem of reaching Kenyan rural micro-enterprises.

We are pleased that your February 1, 1989 memo acknowledges that retail establishments can be productive in nature, and trust that the Audit discussion will be modified accordingly. You are correct in your understanding that retail businesses are accorded lesser priority in our program and in this project. Criteria for the loan program of RPE reflect this priority. Regardless of priorities, however, retail enterprises are too large a part of the rural micro-enterprises sector to be ignored as developing the institutional capacity of indigenous PVOs is the major objective. To the extent that the PVOs have choices of investments to support, we expect our priorities to be followed. However, we also expect assistance to continue to be provided to retail enterprises under the PVO program.

In the design and our implementation of this activity, we share your concern for the sustainability of the PVO approach. However, sustainability in this case cannot be based primarily on the size of loan reflows as suggested by the Audit. Project resources are simply inadequate to first build up the capacity of PVOs to manage loan programs and then finance loan portfolios large enough to provide them with a steady source of income. The project design recognized this fact and instead determined to concentrate on building institutional capacity in order for the PVOs to become more effective delivery mechanisms for donor and GOK assistance to rural enterprises. If the subgrantees can demonstrate their effectiveness under the RPE project, we are confident that they can attract sufficient resources to become sustainable.

Given our basic disagreements with this Audit Finding, we also disagree with intent of part (1) of Recommendation 2.a. As we have discussed above, we already consider all assistance provided to subgrants to be specifically oriented to the project purpose. Furthermore, as the capabilities and clientele of each PVO are different, it is not desirable or possible to meaningfully preset specified levels of credit or training or any other type of assistance.

We do agree with the importance of sustainability and loan reflow management addressed by part (2) and (3) of Recommendation No. 2.a., but do not feel that an amendment of the Cooperative Agreement is necessary or appropriate for responding to these concerns. The standard provisions of REP subgrants already require the establishment of financial controls to manage loan reflows. If REP has not paid much attention to reflows, it is because they have not yet been generated in sufficient amounts to make them a management issue. We consider a PIL to REP as the most appropriate means of raising the issues of sustainability and loan reflow management and for requesting that ineffective subgrants be terminated (Recommendation 2.b.).

Recommendation 2.c. - to terminate the NGO approach if it is not working, is acceptable within the two year time frame suggested by the Audit discussion. We request that the recommendation be modified to reflect this two year period. We propose to share the pertinent results of our March/April program evaluation with RIG/A and to advise REP by letter that continuation of the program under the PED project beyond March 31, 1991, will be contingent on a positive and supportive final evaluation of RPE.

Finding No. 3 "REP needed to improve financial controls over funds provided to Kenyan NGOs"

We agree that indigenous NGOs are weak financially and accordingly consider the project's approach of focussing resources on institution building, rather than more direct transfers of credit, to be supported by this Audit Finding. We do not, however, believe the Audit gives current REP financial controls adequate credit for having identified the problems referred to in the Audit. Nevertheless, we propose to instruct REP by letter to implement all portions of Recommendation No. 3, as you have agreed to modify them per your memo of February 1, 1989. We request that the amount of reimbursement required from the NCCK (Recommendation 3.e.) be based on a thorough review of their accounting records, not the "about $10,000" as currently stated in the draft.

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SAA/S&T	1
PPC/CDIE	3
REDSO/ESA	1
RFMC/Nairobi	1
IG	1
DIG	1
IG/PPO	2
IG/LC	1
IG/ADM/C&R	12
AIG/I	1
RIG/I/N	1
IG/PSA	1
RIG/A/C	1
RIG/A/D	1
RIG/A/M	1
RIG/A/S	1
RIG/A/T	1
RIG/A/W	1