FROM THE AMERICAN PEOPLE

OFFICE OF INSPECTOR GENERAL
for the Millennium Challenge Corporation

RISK ASSESSMENT OF MILLENNIUM CHALLENGE CORPORATION'S MCA MADAGASCAR FINANCIAL OPERATIONS

AUDIT REPORT NO. M-000-06-003-F
March 28, 2006

WASHINGTON, DC

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Office of Inspector General
for the
Millennium Challenge Corporation

March 28, 2006

MEMORANDUM

TO: Acting Vice President for Finance and Administration, Michael Casella

FROM: Assistant Inspector General, John M. Phee /s/

SUBJECT: Risk Assessment of MCA Madagascar's Financial Operations (Report No. M-000-06-003-F)

This report presents the results of the subject assessment. This was not an audit and as such we did not apply procedures to identify all conditions that may adversely affect Millennium Challenge Account (MCA) Madagascar's financial operations. In finalizing this report, we considered your written comments on our draft report and included those comments in their entirety in Appendix II of this report.

This report contains two recommendations for corrective action. Based on your response to our draft report, we consider that a management decision has been reached for both recommendations. Final action for these recommendations must be determined by the Millennium Challenge Corporation (MCC) and we ask that we be notified of MCC's actions.

We thank you, your staff, and the staff of Millennium Challenge Account of Madagascar for the cooperation and the courtesy extended to the Office of Inspector General staff.

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Summary of Results

The Office of Inspector General (OIG) performed a risk assessment of MCA Madagascar to evaluate and identify vulnerabilities in high risk areas that may impact MCA Madagascar's financial operations. The risk assessment was performed during MCA Madagascar's implementation phase to detect early any vulnerabilities that may prevent MCA Madagascar from establishing effective financial operations.

MCA Madagascar, the accountable entity set up by the Government of Madagascar (GoM) to run the MCC-funded program, has high vulnerabilities in several critical areas that may adversely impact its financial operations. These critical areas include MCA Madagascar's: procurement; cash management; and disbursements. The MCC did not provide adequate guidance and oversight to MCA Madagascar during its implementation phase. The MCC must provide additional guidance and oversight to reduce the risk at MCA Madagascar and countries where compacts are signed in the future.

Background

On April 18, 2005, the United States of America, acting through the MCC signed a Compact Agreement with the GoM providing a grant of approximately $110 million. This was MCC's first Compact signed and "entered-into-force[1]." The goal of the Compact is to reduce poverty in Madagascar rural areas.

The GoM determined that the most effective way to reduce poverty is for the rural poor to invest in their land, employ proven technology to enhance productivity, improve farming methods, and sell to new markets. The Compact will address rural poverty through the following three projects:

- The Land Tenure Project (with funding of $37.8 million over four years) supports formalizing the titling and surveying systems, modernizing the national land registry, and decentralizing services to rural citizens.

- The Finance Project (with funding of $35.9 million over four years) includes measures to make financial services available to rural areas, improve credit skills training, and create a streamlined national payments system that is expected to reduce the time for check settlement from 45 to 3 days.

- The Agricultural Business Investment project (with funding of $17.7 million over four years) will help support farmers and entrepreneurs. It will also identify new markets and improve their production and marketing practices.

MCA Madagascar is responsible for overseeing, managing and implementing MCC's program in Madagascar. MCA Madagascar is still establishing its operational structure which will consist of: (a) a steering committee to oversee MCA Madagascar's responsibilities and obligations under the Compact; and (b) a management team that will be responsible for implementing the MCC program. The management team will consist of a Managing Director, Manager of Administrations and Finance, Manager of Monitoring and Evaluation, Manager of Procurement, and three Project Managers with responsibility for each of the three project areas.

MCA Madagascar entered into a contract with Gesellschaft fur Technische Zusammenarbeit (GTZ) to be the organization's Fiscal and Procurement Agent. In this role, GTZ will provide fiscal management and procurement services with the aim of ensuring a proper and transparent use of the funds provided by MCC under the MCC Compact.

[1] Once the conditions precedent are met the compact becomes a binding agreement.

Discussion

The OIG performed risk assessments of critical areas in MCA Madagascar's financial operations to identity potential vulnerabilities that could adversely impact MCA Madagascar's operations. Based on a preliminary assessment of MCA Madagascar's operations, we determined that the most critical financial areas were: procurement, cash management and disbursements. As such, our risk assessments were designed to identity and evaluate vulnerabilities in these areas.

At the time of our assessment, MCC had begun making disbursements to MCA Madagascar. However, MCA Madagascar did not have a comprehensive set of policies and procedures that included controls to ensure accurate accounting for and safeguarding of funds disbursed under the Compact. And up to the time of our assessment, MCC had not provided adequate oversight and guidance to MCA Madagascar to assist it with implementing the necessary controls.

According to MCC's management the Compact provided for operation of MCA Madagascar under an Interim Fiscal Accountability Plan during the Initial Operating Period as discussed in Annex 1, Section 3 (b) of the Compact and Section 4.1 of the Disbursement Agreement. A comprehensive Fiscal Accountability Plan was not required under these terms until January 27, 2006. MCA-Madagascar submitted a revised Fiscal Accountability Plan (FAP) on January 25, 2006 and MCC approved it on January 26, 2006. MCC management further acknowledged that better guidance on the content of an Interim Fiscal Accountability Plan could be produced and plans on issuing this guidance in the near future.

Section 4, (c) of the Compact states:

> MCA Madagascar shall adopt as part of the Implementation Plan a fiscal accountability plan that identifies the principles and mechanisms to ensure appropriate fiscal accountability for the use of MCC Funding provided under this Compact, including the process to ensure open, fair and competitive procedures will be used in a transparent manner in the administration of grants and cooperative agreements and the procurement of goods and services for the accomplishment of the Objectives (the "***Fiscal Accountability Plan***"). The Fiscal Accountability Plan shall set forth, among other things, requirements with respect to the following matters: (i) funds control and documentation; (ii) separation of duties and internal control; (iii) accounting standards and systems;(iv) content and timing of reports;(v) policies concerning public availability of all financial information; (vi) cash management practices; (vii) procurement and contracting practices, including timely payment of vendors; (viii) the role of independent auditors; and (ix) the role of fiscal agents and procurement agents."

At the time of our assessment MCA Madagascar had not implemented all of the key controls described in Section 4 (c) of the Compact which negatively impacted operations in all of the areas OIG reviewed: procurement; cash management; and disbursements. The absence of a comprehensive FAP resulted in key financial operations being performed inconsistently.

A detailed discussion of how these vulnerabilities affected each financial area reviewed is presented in the following sections of the report.

Procurement

The principles, rules and procedures set out in Madagascar's Law No. 2004-009, dated July 26, 2004 on Public Contracts (Madagascar Law on Public Contracts) govern the conduct and administration of the procurement of the goods, works and services that will be procured to implement the MCC-funded projects and programs. At the time of our assessment, MCA Madagascar had processed 118 procurement actions totaling $197,462. (394,924,330 Ariary, the local currency of Madagascar)

Based on our assessment, it appears that MCA Madagascar is complying with the principles, rules, and procedures set out in Madagascar's Law No. 2004-009. However, MCA Madagascar had not established operating procedures for implementing good management practices that would ensure that:

- Goods purchased by MCA Madagascar would be used for the purposes intended by the MCC. For example, MCA Madagascar was in the process of purchasing 21 cars of which 11 were going to be used by the MCA Madagascar managers and GTZ managers for both work and personal travel (seven were for the MCA Madagascar managers and the remaining four were for GTZ managers).

- Goods and services purchased by MCA Madagascar were properly approved by its management and by the Millennium Challenge Corporation. MCA Madagascar had not implemented a process for matching the procurement request, purchase order/contract, and a receiving report in order to validate that the goods and services had been received by the requester.

- Goods and services purchased by MCA Madagascar were properly accounted for – i.e. acquired goods were recorded in an inventory system and labor-related data (time and attendance) were recorded in a tracking system. For example, as of September 30, 2005 MCA Madagascar had 17 contractors employed to perform its day-to-day operations but had not implemented a system to record their time and attendance to support the salary payments. Furthermore, MCA Madagascar purchased all employees cell phones for business communications but did not establish an inventory system for tracking the receipts for those phones.

MCC had not provided adequate oversight and/or guidance regarding the use of and accounting for MCC-funded property. As a result, at the time of the assessment, MCC funds provided to MCA Madagascar were highly vulnerable to fraud, waste, and abuse.

MCC's management was very receptive and responsive to the results of our risk assessment at MCA Madagascar. For example, MCC's management immediately cancelled the procurement of the seven cars being purchased for the MCA Madagascar managers for both their business and personal use.

Cash Management

The Compact requires MCA Madagascar to implement a FAP to establish financial policies, procedures, controls, and processes for performing financial operations.

At the time of our assessment, MCA Madagascar had not implemented a comprehensive FAP in order to establish adequate internal controls to effectively manage the funds provided by MCC but had implemented an interim FAP. However, MCC had not provided adequate detailed guidance to the MCA Madagascar for completing the interim FAP. OIG's assessment found no evidence that formal accounting procedures were performed prior to October 2005. Specifically, MCA Madagascar did not maintain its accounts on an accrual basis, and its procedures for performing bank and petty cash reconciliations were inadequate. Additional details are provided below:

- No evidence existed to support that MCA Madagascar performed any formal accounting procedures prior to October 2005. According to the Fiscal Agent, he tracked MCA Madagascar's transactions on an excel spreadsheet but it was not available for our review because the spreadsheet had been destroyed.

- At the time of our review, the MCA Madagascar did not perform its accounting on an accrual basis. Its accounting system did not record commitments or obligations and disbursements were posted in the general ledger after the bank made the disbursement. For example, we reviewed an invoice that was approved for payment and sent to the central bank for payment on November 15, 2005. The bank executed the payment on December 5, 2005 and MCA Madagascar received the payment receipt from the bank on December 7, 2005. MCA Madagascar recorded the payment on December 5, 2005 (20 days after the payment was sent) for this disbursement. These expenses should have been recorded once the invoice was approved for payment on November 15, 2005. MCA Madagascar's failure to record transactions on an accrual basis (or when MCA submits an invoice for payment) may result in MCA spending or committing more funds than they have available.

- MCA Madagascar did not have adequate procedures to perform bank reconciliations. Bank reconciliations were not consistently performed or subsequently reviewed by a supervisor. We also found that there was insufficient separation of duties, as all of the bank reconciliations were performed by the accountant who also processed disbursements. Our review of the bank reconciliations found that MCA Madagascar's Fiscal Agent reviewed bank statements periodically throughout the month as transactions were executed by the central bank. However, complete reconciliations were not performed on a monthly basis. For example, the October 31, 2005 bank reconciliation was prepared using the October 19, 2005 bank statement and the October 31, 2005 general ledger balance. In this case, MCA Madagascar should have prepared the monthly reconciliation using a bank statement(s) covering the entire period ending October 31, 2005. Our review of the general ledger revealed that there were no transactions after October 19, 2005. Although the bank statement agreed with the general ledger, the general ledger balance did not agree with MCA Madagascar's lst quarterly report submitted to MCC.

At the time of our assessment the risk that fraud, waste, and abuse could occur and not be detected in this area was high.

MCC Management noted that the revised Fiscal Accountability Plan adopted by MCA-Madagascar in January 2006 (subsequent to our assessment fieldwork) had detailed procedures on accounting, recording of transactions, and bank reconciliations. Management also indicated that a fully automated accounting software package is due to become operational in April 2006.

Disbursements

Contrary to the requirements of section 3.6 (b) of the Compact, which requires that MCA Madagascar adopt a FAP which among other things describes required (i) funds control and documentation and (vii) procurement and contracting practices, MCA Madagascar did not have a consistent process for making disbursements. Specifically, MCA Madagascar had not identified the documents required for making a disbursement, such as an original invoice, purchase order, receiving report, etc. as required by the Compact. Furthermore, invoices were not systematically signed or approved by the Fiscal Agent. The absence of these key policies, processes, and controls could result in duplicate payments, unauthorized disbursements or spending in excess of the approved budget. Specifically,

- Our review of invoices revealed that support for payments was not always adequate or consistent. None of the invoices we reviewed had obligations, commitments or receiving reports.

- Our review of a sample of invoices found that the personnel at the Ministry of Finance, which is not a part of MCC, certified the receipt of goods and services. These certifications included advances for employees working temporarily as consultants and telecommunication expenses for MCA's Fiscal Agent, GTZ. The interim FAP requires Ministry of Finance personnel to certify payments, however, the lack of support in the payment packages reviewed and the Ministry of Finance's limited involvement in MCA operations makes the Ministry of Finance vulnerable to certifying improper payments.

At the time of our assessment, the risk that fraud, waste, and abuse could occur and not be detected in this area was high.

MCC Management noted that the Interim Fiscal Accountability Plan required that all payments, regardless of value, be approved by two different divisions at the Washington headquarters. They also noted that a revised Fiscal Accountability Plan was adopted by MCA-Madagascar in January 2006 (subsequent to our assessment fieldwork) which substantially expanded disbursement procedures and controls.

Conclusion

Based on a preliminary assessment of MCA Madagascar's operations, we determined that the most critical financial areas were: procurement, cash management, and disbursements. We found, at the time of our assessment field work, that MCA Madagascar had not implemented effective and comprehensive financial policies and procedures. Based on our review, we assessed the risk in the three critical financial areas that we reviewed as being high and concluded that these risks could adversely impact MCA Madagascar's financial operations. We attributed these vulnerabilities to the fact that Millennium Challenge Corporation did not provide effective oversight and guidance for completing the interim FAP during MCA Madagascar's implementation phase. Our risk assessment found that additional oversight by the Millennium Challenge Corporation would have improved MCA Madagascar's efforts to implement effective financial policies and procedures. The vulnerabilities identified in this report may hamper MCA Madagascar's ability to accurately account for and safeguard funds provided by MCC in accordance with the Compact.

These concerns were discussed with MCA Madagascar and MCC management. They generally agreed with the results of our risk assessment and have begun to implement corrective actions.

Recommendations

To address the identified vulnerabilities discussed in this report we are making the following recommendations to MCC for corrective action.

> **Recommendation 1:** **We recommend that the Millennium Challenge Corporation establish and provide a set of detailed accounting policies and procedures to Millennium Challenge Account (MCA) countries prior to the initial cash disbursement, which can be used during their implementation phase.**

> **Recommendation 2:** **We recommend that the Millennium Challenge Corporation establish and distribute a set of policies and procedures for managing assets purchased with Millennium Challenge funds.**

EVALUATION OF MANAGEMENT COMMENTS

MCC provided written comments to our draft report that are include in their entirety in Appendix II. In its response, MCC agreed with the two recommendations in the draft report.

For Recommendation No. 1, MCC agreed that improved guidance in all areas of financial management, including the areas of accounting policies and procedures, can be provided. MCC stated that it had provided significant guidance to MCA Madagascar and other MCA countries using the lessons learned from MCA Madagascar.

For Recommendation No. 2, MCC agreed with the recommendation and immediately stopped the purchase of the seven cars for the MCA Madagascar managers. Additionally, MCA Madagascar immediately changed its policy to recognize that cars cannot be considered as part of an employee compensation package.

Furthermore, according to MCC management, MCC has established and published a policy covering the personal use of assets purchased with MCC funds. This policy is included in its *Cost Principles for Cost Reimbursement Contracts under MCC-Financed Grants* and *Cost Principles for Government Affiliated Accountable Entities*. The first document is complete and posted on the MCC website. The second document is in the final stages of clearance by MCC and will be posted on the MCC website and provided to counterpart entities responsible for managing MCC programs.

Based on MCC's comments we consider that management decisions have been reached on these recommendations.

SCOPE AND METHODOLOGY

Scope

The Office of the Inspector General performed a risk assessment of MCA Madagascar financial operations. The purpose of the assessment was to evaluate and identity vulnerabilities in areas that may adversely impact MCA Madagascar's financial operations. This was not an audit and as such we did not apply procedures to identify all conditions that may adversely affect MCA Madagascar's financial operations. The risk assessment was conducted at MCA Madagascar's headquarters in Antananarivo, Madagascar from December 9, 2005 to December 16, 2005.

Methodology

We interviewed MCA Madagascar personnel, GTZ personnel, Central Bank of Madagascar officials and MCC personnel to gain an understanding of MCA Madagascar operation and controls. The risk assessment focused on MCA Madagascar's financial operations from August 2005 to December 9, 2005. We assessed transactions, policies, controls and procedures in effect during this period. We judged risk exposure (i.e. the likelihood of significant abuse, illegal acts and/or misuse of resources; failure to achieve program objectives; and noncompliance with laws, regulations, and management policies) in the areas of cash management, disbursements and procurement. Using this information, we assessed the level of risk (low, moderate, or high) for each of these key financial operation.

The general methodology for the risk assessment included the following:

- Interviews of key personnel in each of the areas assessed;
- Reviews of the Compact agreement, sub-agreements and applicable laws, regulations;
- Reviews of current policies, procedures and processes;
- Evaluations of transactions processed during the review period; and
- Consideration and analysis of the Millennium Challenge Corporation's role in the establishment of and the implementing processes of MCA Madagascar.

The risk assessment has the following limitations:

- Higher risk exposure assessments are not a definitive indicator that objectives are not being achieved or that irregularities are occurring. Rather, a higher risk exposure implies that the particular function is more vulnerable to adverse events.

- Because the assessments consider both internal and external factors, some of which are outside the span of control of management, risk exposure assessments, in isolation, are not an indicator of management capability.

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Millennium Challenge Corporation

Reducing Poverty Through Growth

MEMORANDUM **March 24, 2006**

TO: **Alvin Brown, Office of the Inspector General**
United States Agency for International Development

FROM: **Michael Casella, Acting Vice-President for Administration and Finance,**
Millennium Challenge Corporation /s/

SUBJECT: **Management Response to Recommendations from the**
Risk Assessment of MCA Madagascar's Financial Operations

Recommendation 1: We recommend that the Millennium Challenge Corporation establish and provide a set of detailed accounting policies and procedures to MCA countries prior to initial cash disbursement, which can be used during their implementation phase.

Management Response:

The MCC welcomes and agrees with Recommendation 1 of the risk assessment and agrees that improved guidance in all areas of financial management, including the area of accounting policies and procedures, can be provided. The MCC has attempted to establish a corporate culture of continual improvement in all areas of its operations and its communications with counterpart countries. MCC provided significant guidance to Madagascar and other MCA countries, and is using the lessons learned from our experience with Madagascar to improve the guidance we issue.

The MCC issued *MCC Fiscal Accountability Guidelines* in December 2004 and those *Guidelines* were posted on the MCC website in English, French, and Portuguese and provided to all eligible countries in early 2005. Included in the *Guidelines* are sections on commitment control, internal controls, cash management, accounting methodologies, transparency, prompt payment, procurement, and auditing.

The MCC recognizes that guidance on the MCC process can be continually improved and frequently issues updated or new guidance in a broad range of areas. In the area of accounting policies and procedures, the MCC is issuing detailed guidance on elements of a Fiscal Accountability Plan, a document required in all MCC Compacts to cover internal financial management and procurement procedures and policies of an MCA entity.

The Government of Madagascar proposed, and MCC agreed, to establish MCA-Madagascar as a completely new unit of government with the sole purpose of managing implementation of the

MCC Compact. One of the underlying requirements of MCA-Madagascar was that it was to be staffed with the best qualified individuals selected through an open and transparent competition, a process that took time to be conducted properly. It was understood at the point of Compact signature that MCA-Madagascar needed to become formalized and would start with a minimal number of people and this was recognized in section Annex 1, Section 3 (b) of the Compact and Section 4.1 of the Disbursement Agreement which discuss an Initial Operating Period which did not end until January 27, 2006.

It should be noted that a comprehensive Fiscal Accountability Plan was not required until January 27, 2006 at the earliest, as documented in the Disbursement Agreement, a date after the period of the risk assessment which took place from December 9-16, 2005. A revised Fiscal Accountability Plan was adopted by the MCA Steering Committee on January 16, 2006, submitted by MCA-Madagascar to MCC on January 25, 2006, and approved by MCC on January 26, 2006. During the Initial Operating Period, an Interim Fiscal Accountability Plan was adopted and in effect from the date of Entry Into Force and no funds were disbursed under the Madagascar Compact until a professional third-party fiscal agent had been contracted.

The Interim Fiscal Accountability Plan covered basic operations and procedures in recognition that activities would consist primarily of acquiring and equipping an office and building a staff. As noted in the risk assessment, procurement actions at the date of the assessment were less than $1700 on average, indicative of activity consistent with equipping an office and acquiring basic services. Also as indicated in the assessment, staff were initially engaged through temporary contracts prior to adoption of a formal Employment Agreement.

In recognition that detailed procedures would be developing, the MCC required that the Interim Fiscal Accountability Plan include a pre-approval by MCC of every single re-disbursement of MCC funding. This element was included in the Interim Fiscal Accountability Plan and adhered to. Accordingly, every payment of MCC funds as of the date of the risk assessment field work had been reviewed and approved by individuals from two different divisions of the MCC.

With respect to accounting issues, the risk assessment notes that a general ledger system was in place during the Initial Operating Period but not a fully automated accounting software package. It was envisioned and agreed by the MCC that a fully automated accounting software package would not be installed until the management of MCA-Madagascar was in place to determine appropriate accounting classifications necessary to provide management information they determined would be required for efficient management of the MCA-Madagascar program.

Recommendation 2: We recommend that the Millennium Challenge Corporation establishes and distributes a set of policies and procedures for managing assets purchased with Millennium Challenge funds.

Management Response:

The MCC welcomes and agrees with Recommendation 2 of the risk assessment.

Much as employee compensation in the United States frequently takes the form of health insurance, life insurance, and public transport subsidies, it is a normal and accepted practice in many parts of the world to provide employee compensation in forms other than cash, including in the form of provision of an automobile for business and personal use. The MCC recognizes that the provision of an automobile for personal use is an unfamiliar practice in the US and has adopted a policy, that reinforces the requirement in Section 2.3(i) of the Compact, that assets purchased with MCC funds should be used primarily to support the objectives of an MCC program and not for personal use.

This policy covering the personal use of assets is included in *Cost Principles for Cost Reimbursement Contracts under MCC-Financed Grants* and *Cost Principles for Government Affiliated Accountable Entities.* The first document is complete and posted on the MCC website. The second is in the final stages of clearance and will be posted on the MCC website and provided to counterpart entities responsible for managing MCC programs.

In addition, guidance on overall asset management is included in the detailed guidance for Fiscal Accountability Plans discussed above.

Neither the policy on personal use of assets nor the detailed guidance for Fiscal Accountability Plans was in effect during the period of the risk assessment. When MCC communicated to MCA-Madagascar its policies and guidance on assets, MCA-Madagascar immediately took steps to reflect the MCC position. As an example, MCA-Madagascar immediately altered its intended compensation policy and halted the process it had initiated to acquire automobiles that would support a form of compensation that included the provision of vehicles for business and personal use.

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