OFFICE OF INSPECTOR GENERAL
for the Millennium Challenge Corporation

RISK ASSESSMENT OF MILLENNIUM CHALLENGE ACCOUNT CAPE VERDE'S FINANCIAL OPERATIONS

REPORT NO. M-000-06-004-F
September 26, 2006

WASHINGTON, DC

Office of Inspector General
for the
Millennium Challenge Corporation

September 26, 2006

Mr. Michael Ryan
Vice President for Administration and Finance
Millennium Challenge Corporation
875 15TH Street, NW
Washington, DC 20005-2203

Dear Mr. Ryan:

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) Cape Verde'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 three recommendations for corrective action. Based on your response to our draft report, we consider that a management decision has been reached on Recommendation No. 2; however, no management decision was reached for the remaining two recommendations. Final action for these recommendations must be determined by the Millennium Challenge Corporation (MCC) and we ask that we be notified of the MCC's actions.

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

Sincerely,

/s/
John M. Phee
Assistant Inspector General/MCC

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SUMMARY OF RESULTS

The Office of Inspector General (OIG) performed a risk assessment of the Millennium Challenge Account (MCA) Cape Verde to evaluate and identify vulnerabilities in areas that may adversely impact MCA Cape Verde's financial operations. Based on our understanding of MCA Cape Verde and the Millennium Challenge Corporation (MCC), we decided to focus our effort on the cash management and procurement areas. The risk assessment was performed during MCA Cape Verde's implementation phase.

We assessed the risk associated with MCA Cape Verde's cash management process as medium to high. We determined that MCA Cape Verde needs to improve its process for estimating "immediate cash needs". "Immediate cash needs" refers to the minimum amounts of cash needed for carrying out the purpose of the approved MCA Cape Verde Compact programs. MCA Cape Verde maintained excess cash balances during the first four quarters after the Compact's "entry-into-force"[1] which increased the risk that funds could have been misappropriated.

We assessed the risk associated with MCA Cape Verde's procurement as medium to high. Based on our assessment, MCA Cape Verde implemented polices that complied with the procurement guidelines established by MCA Cape Verde and the MCC. However, we did have concerns with MCA Cape Verde's policy of making cash advances to contractors as interest-free loans for mobilization.

For its part, the MCC needs to (1) improve its process for reviewing and approving requests for disbursements, (2) modify its advance process to disburse funds for immediate cash needs only, and (3) provide additional guidance and oversight regarding cash management and procurement to MCA Cape Verde and countries where compacts are signed in the future.

[1] "Entry-into-force" is a term used to describe a signed compact once the country has met all conditions precedent to the first disbursement being made.

BACKGROUND

On July 4, 2005, the United States of America, acting through the MCC, signed a Compact Agreement with the Government of Cape Verde to provide a grant of approximately $110 million. The Compact "entered-into-force" on October 17, 2005. The goal of the Compact is to reduce poverty and unemployment in Cape Verde by encouraging private sector development and the implementation of agriculture and infrastructure projects. The Compact is designed to address rural poverty and unemployment through three projects to:

- Increase agricultural productivity on the islands of Santo Antao, Fogo, and Sao Nicolau by improving water management and soil conservation;

- Integrate internal markets and reduce transportation costs by improving roads and bridges on the islands of Santiago and Santo Antao, and by upgrading the Port of Praia; and

- Develop the private sector by reducing obstacles to private sector investment and reforming the financial sector.

Specifically, the three projects to be funded under the Compact are the (1) Watershed Management and Agriculture Support Project, (2) Infrastructure Project, and (3) Private Sector Development Project.

- The Watershed Project ($10.8 million over 5 years) supports activities to increase the capture, storage and distribution of rainfall water, thereby allowing poor farmers to irrigate their fields and increase agricultural productivity.

- The Infrastructure Project ($78.7 million over 5 years) supports road and bridge development, and improvements to the Port of Praia.

- The Private Sector Development Project ($7.2 million over 5 years) will focus on removing restraints to private sector development. The Government of Cape Verde, with the assistance of the International Finance Corporation (IFC), will focus on policy reforms and projects such as vocational training and education, human resource/entrepreneurship development, access to financial services, and small to medium-sized business linkages.

The Compact also includes approximately $13.3 million for program management, oversight, and monitoring and evaluation.

MCA Cape Verde is responsible for the oversight and management of the MCC Compact. At the time of our assessment, MCA Cape Verde was establishing its operational structure; the plans called for:

- A steering committee to oversee MCA Cape Verde's responsibilities and obligations under the Compact.

- A management team responsible for implementing the MCC Compact and related programs.

- A Procurement Review Committee to review the proposed procurements.

The management team will be composed of the following members: Managing Director, Senior Economist, Administrative and Finance Director, Procurement Manager, Monitoring and Evaluation Analyst, and four Project Managers (one manager with the responsibility for each of the three project areas and the remaining manager for overall coordination).

MCA Cape Verde contracted with the Ministry of Finance and Planning of the Republic of Cape Verde to be the organization's fiscal agent. In addition, MCA Cape Verde hired a Procurement Manager, who will perform the functions of a procurement agent.

ASSESSMENT OBJECTIVES

The OIG performed a risk assessment of critical areas in MCA Cape Verde's financial operations to identify vulnerabilities that could adversely impact MCA Cape Verde's operations. Based on a preliminary assessment of MCA Cape Verde's operations, we determined that the most critical financial areas were cash management and procurement. Therefore, our risk assessment was designed to identify and evaluate vulnerabilities in those areas.

DISCUSSION

We believe that the U.S. Department of the Treasury's Financial Management Service publications did not envision the inclusion of sovereign governments; however, the OIG used the Treasury Financial Manual (TFM) as a valuable source of sound business practices. The TFM is the Department of the Treasury's official publication for financial accounting and reporting of all receipts and disbursements of the Federal Government. The purpose of the TFM is to provide policies, procedures, and instructions for Federal departments and agencies to follow in carrying out their fiscal responsibilities. In the analysis of cash management and procurement, the OIG used the TFM as a source of sound business practice.

At the time of our assessment, the MCC had made one cash disbursement to MCA Cape Verde for $7.5 million. Contrary to Section 2025 of the TFM, this disbursement exceeded MCA Cape Verde's immediate cash needs. Immediate disbursement needs should be in accord with the actual immediate cash requirements of the recipient organization in carrying out the purpose of the approved program or project. Both MCA Cape Verde and the MCC recognized later that this disbursement was in excess of Cape Verde's immediate cash needs for the first quarter. Therefore, in lieu of requesting additional funds for the second quarter, MCA Cape Verde kept the funds initially provided and requested that no additional funds be disbursed. Subsequently, the MCC recognized that the funds provided in the initial disbursement were in excess of MCA Cape Verde's immediate cash needs for the second quarter as well. However, the MCC did not request that the excess funds be refunded, as described in Section 2075.30 of the TFM.

In the area of procurement, MCA Cape Verde implemented procurement polices that complied with the procurement guidelines established by MCA and MCC. However, we did have concerns with MCA Cape Verde's policy that could allow advance payments to be made to its contractors as interest-free loans for mobilization. As a practice, MCA Cape Verde would provide advance payments for 20 to 50 percent of the value of the contract.

With respect to contractors, the procurement guidelines did not address making advances to contractors, and the MCC had not provided instructions to MCA Cape Verde regarding advances to contractors or secondary recipients, as described in TFM, Section 2065.

The MCC has not adopted the following from The Treasury Financial Manual –Volume 1, Part 6-Chapter 2000:

- Section 2025 – Limitation and Timing of Cash Advances,
- Section 2065 – Cash Advances Under Federal Grant and Other Programs,
- Section 2075.30 – Responsibilities of Federal Program Agencies, and
- Section 2075.30a – Interest Earned on Federal Funds.

Section 2025 of The Treasury Financial Manual –Volume 1, Part 6-Chapter 2000, states:

> *Advances to a recipient organization will be limited to the minimum amounts necessary for immediate disbursement needs and will be timed to be in accord only with the actual immediate cash requirements of the recipient organization in carrying out the purpose of an approved program or project. The timing and amount of cash advances will be as close as is administratively feasible to actual disbursements by the recipient organization.*

Section 2065 of The Treasury Financial Manual –Volume 1, Part 6-Chapter 2000, states:

> *Advances made by primary recipient organizations to secondary recipients shall conform substantially to the same standards of timing and amounts as apply to advances by Federal program agencies to primary recipient organizations. Federal program agencies will require primary recipient's organizations to develop procedures whereby secondary recipient organizations can obtain funds from the primary recipient organization as needed for disbursement.*

Section 2075.30 of The Treasury Financial Manual –Volume 1, Part 6-Chapter 2000, states:

> *Federal funds should be promptly refunded to the Federal program agency and redrawn when needed if the funds are erroneously drawn in excess of immediate disbursement needs. The exceptions to the requirement for prompt refunding are when the funds involved will be disbursed by the recipient organization within seven calendar days or are less than $10,000 and will be disbursed within 30 calendar days. The exception is not intended to be construed as approval by Treasury for a recipient organization to maintain excessive funds.*

Section 2075.30a of The Treasury Financial Manual –Volume 1, Part 6-Chapter 2000, states:

> *Any interest income earned by a recipient organization on Federal funds will be promptly refunded to the Federal program agency unless specifically prohibited by law.*

A detailed discussion of how these vulnerabilities affect each financial area we reviewed is presented in the following section of the report.

Cash Management

The MCC and MCA Cape Verde need to improve their cash management practices. Contrary to the TFM, the MCC provided a cash advance to MCA Cape Verde that exceeded MCA Cape Verde's immediate cash needs. MCA Cape Verde's immediate cash needs are the minimum amounts of cash needed for carrying out the approved MCA Cape Verde Compact programs. The MCC also allowed MCA Cape Verde to maintain this excess cash balance during the first four quarters after MCA Cape Verde's entry-into-force. Because the MCC had not implemented the TFM cash management requirements, it put its funds at greater risk for misappropriation.

Excess Cash Balances

At the time of our assessment (March 2006), MCA Cape Verde had received one cash disbursement. During October 2005, MCA Cape Verde requested and received $7.5 million[2] from the MCC to cover its expenses for the first quarter (from October 2005 to December 2005). MCA Cape Verde established a special bank account and deposited the funds as required by the Compact. As of December 31, 2005, MCA Cape Verde had approximately $7.4 million in its account from this initial disbursement. Because MCA Cape Verde had excess funds, MCA Cape Verde did not request a disbursement for the second quarter (from January 1, 2006, to March 31, 2006). As of March 29, 2006, MCA Cape Verde still had over $7.2 million remaining in its accounts from the initial disbursement[3]. According to MCA Cape Verde officials, this represented $2 million in excess of their immediate cash needs for the third quarter. When MCA Cape Verde submitted its fourth Disbursement Request/Financial Report, it did not request funds for its fourth quarter.

The MCC and MCA Cape Verde officials explained that $6.2 million of the $7.5 million disbursement was requested to provide a 20 percent[4] cash advance for the infrastructure contracts, which were budgeted to cost approximately $25 million. These contracts were scheduled to be awarded during calendar year 2005. However, at the time of our fieldwork, these contracts had not yet been awarded, and the projected cash needs had not materialized. Both the MCC and MCA Cape Verde acknowledged that these funds exceeded MCA Cape Verde's immediate cash needs. This situation occurred largely because:

- The MCC disbursed a cash advance to cover a 90-day period instead of the 30-day period typically used by other Federal Government agencies.

- Both the MCC's process for reviewing and approving requests for disbursements and MCA Cape Verde's process for cash forecasting were based solely on the fact that funds were included in the approved budget and not on an assessment of MCA Cape Verde's immediate cash needs.

- Neither the MCC nor MCA Cape Verde considered the status of the procurements and the additional requirements and, accordingly, did not have a clear idea of when the contracts would be awarded and when MCA Cape

[2] Of the $7.5 million, $.5 million was provided as "Working Capital Balance."

[3] MCA Cape Verde documentation that we reviewed indicated that interest being earned on the MCC accounts containing the excess cash was being submitted to the MCC. As of July 20, 2006, MCA Cape Verde had submitted approximately $179,000 of interest earned to the MCC.

[4] According to the MCC officials, the MCC actually provided advances equivalent to 25 percent of the estimated contract price instead of the 20 percent requested by MCA Cape Verde.

Verde would have to fund the contracts. For example, in order to complete these procurements, (1) the procurements must be reviewed by the Procurement Review Committee (PRC); (2) a technical evaluation panel must review the proposals submitted; and (3) the MCC must provide a no-objection response to the proposed procurements once the procurements were reviewed and recommended by the PRC and the technical evaluation panel.

- These were the first major procurements made by MCA Cape Verde; hence, no historical data existed to assist with establishing a timeline for completing the procurement process and, therefore, determining when MCA Cape Verde would need funds for the contract.

The MCC needs to:

- Strengthen its process for reviewing and approving requests for cash disbursements.

- Modify its advance process to disburse funds for immediate cash needs only.

- Issue guidance that is consistent with the practices described in the TFM.

The OIG is not making a recommendation to address the MCC's policy related to disbursements for 90-day periods instead of the 30-day periods because this issue was addressed in an audit of the MCC financial statements.[5]

For its part, MCA Cape Verde needs to strengthen its process for forecasting its cash needs.

Financial Reporting

MCA Cape Verde does not perform accounting on an accrual basis, by recording commitments or obligations. Because MCA Cape Verde maintains its accounts on a cash basis instead of an accrual basis, unpaid expenses (liabilities) are not recorded in the general ledger. The absence of these liabilities in the general ledger may result in MCA Cape Verde not reporting all liabilities on its periodic financial statements used by the MCC and others to determine their financial position.

While the cash basis of accounting may be acceptable for MCA Cape Verde, the MCC needs to receive financial data prepared on an accrual basis or in a form that could be readily translated into accrual-based data. The preparation of the MCC's annual consolidated financial statements (including data relating to MCAs) on an accrual basis is required by 31 U.S.C. 3512(e), which states, "To assist in preparing a cost-based budget under section 1108 (b) of this title and consistent with principles and standards

[5] Audit Report No. M-000-06-001-C, *Audit of the Millennium Challenge Corporation's Financial Statements, Internal Controls, and Compliance for the Period Ending September 30, 2005 and the Nine Month Period Ending September 30, 2004*, dated December 6, 2005, Recommendation No. 3.

the Comptroller General prescribes, the head of each executive agency shall maintain the accounts of the agency on an accrual basis to show the resources, liabilities, and costs of operations of the agency." The MCC is currently working with the Certified Public Accounting firm that is auditing the MCC annual financial statements to prepare a policy and form for the MCAs to report the necessary accrual financial information.

Procurement

The MCC has not issued guidance to MCA Cape Verde regarding advances made to secondary recipients/contractors. The principles, rules and procedures that govern the conduct and administration of the procurement of the goods, works and services that need to be acquired to implement the projects and programs under this Compact are set out in:

- *The World Bank Guidelines: Selection and Employment of Consultants by World Bank Borrowers*, May 2004.

- *The World Bank Guidelines: Procurement Under IBRD Loans and IDA Credits*, May 2004 (World Bank Procurement Guidelines).

- The Procurement Agreement between the MCC and MCA Cape Verde.

- The Interim Fiscal Accountability Plan. According to the MCC's management, the Compact provided for the operation of MCA Cape Verde under an Interim Fiscal Accountability Plan, and a comprehensive Fiscal Accountability Plan (FAP) was being developed.

However, none of the guidance mentioned above specifically addresses advances to recipients/contractors. Furthermore, the MCC had not provided guidance as described in the TFM Section 2065, which states that advances made by primary recipient organizations to secondary recipients shall conform substantially to the same standards of timing and amounts as apply to advances by Federal program agencies to primary recipient organizations. As a result, the practices of the MCC and MCA Cape Verde are not consistent with the practices set forth in TFM Section 2065. Additionally, MCA Cape Verde is increasing the risk that its funds may be misappropriated and interest lost on the funds advanced to the contractors.

Contrary to practices described in TFM Section 2065, MCA Cape Verde's policy allows for making advances to contractors ranging from 20 to 50 percent of the total contract value. According to the contracts we reviewed, these advances were provided 30 days after a guarantee was provided by the contractor. No justification statement regarding immediate cash needs or liquidation period was required. The contract stated that the funds advanced were an "interest free loan."

At the time of our assessment, the largest contract signed by MCA Cape Verde was valued at $11 million (999,419,857 Escudos, the local currency of Cape Verde) and included a clause for total advance payment of "20% of the Accepted Contract Amount payable in the currencies and proportions in which the Accepted Contract Amount is payable," approximately $2.2 million. We examined this area of advances and found the following examples:

- MCA Cape Verde's contract for road construction dated April 3, 2006, provided for an advance payment of 20 percent of the contract value or approximately $2.2 million.
- MCA Cape Verde's contract for supervision of the construction on the roads dated March 30, 2006, provided for an advance payment of 30 percent of the contract value or approximately $258,000.
- MCA Cape Verde's contract for constructing walls and setting up the office dated January 5, 2006, provided for an advance payment of 50 percent of the contract value or approximately $7,000.

The MCC Compact with the Government of the Republic of Cape Verde has provisions for $78.8 million for Infrastructure Projects. If MCA Cape Verde makes advances of 25 percent on all contracts awarded, the outstanding advances would be $19.7 million. The potential interest income lost is calculated by multiplying 4 percent by $19.7 million, which is $788,000.

Conclusion

Based on our preliminary assessment of MCA Cape Verde's operations, the OIG determined that the most critical financial areas were cash management and procurement. We found that at the time of our fieldwork, MCA Cape Verde and the MCC had not adopted the sound cash management guidance consistent with the TFM issued by the Department of the Treasury, which the OIG used as a source of sound business practice. We assessed the risk associated with cash management and procurement as medium to high.

Recommendations

Based on a preliminary assessment of Millennium Challenge Account (MCA) Cape Verde's operations, the OIG determined that MCA Cape Verde's risk in the area of cash management and procurement is medium to high. Therefore, we are making the following recommendations:

> *<u>Recommendation No. 1:</u> We recommend that the Millennium Challenge Corporation's Vice President of Administration and Finance establish policies and procedures for evaluating disbursement requests submitted by Millennium Challenge Accounts (recipient countries) to ensure that the amounts disbursed are only for immediate cash needs. The policies and procedures should include a provision that funds identified as being in excess of immediate needs be promptly refunded by Millennium Challenge Accounts to the Millennium Challenge Corporation.*

Recommendation No. 2: *We recommend that the Millennium Challenge Corporation's Vice President of Administration and Finance require that the Millennium Challenge Accounts provide financial statements prepared on an accrual basis or provide supplemental data to inform the Millennium Challenge Corporation of accrued expenditures as of the end of the period.*

Recommendation No. 3: *We recommend that the Millennium Challenge Corporation's Vice President of Administration and Finance provide policies and procedures to Millennium Challenge Accounts on advances to secondary recipients. The policies and procedures should include provisions that advances provided by the Millennium Challenge Accounts:*

- *Conform to the same standards of timing and amounts that are applied by Millennium Challenge Corporation to the Millennium Challenge Accounts.*
- *Only be provided for immediate cash needs.*
- *Be deposited by the secondary recipient in an interest-bearing account, with interest earned submitted to the Millennium Challenge Accounts.*
- *Be promptly refunded to the appropriate Millennium Challenge Account office if identified as being in excess of immediate disbursement needs.*

EVALUATION OF MANAGEMENT COMMENTS

The MCC provided written comments to our draft report that are included in their entirety in Appendix II. The MCC agreed with one of the three recommendations in the draft report.

For Recommendation No. 1, the MCC has not made a management decision on this recommendation.

The MCC did not address the recommendation regarding the establishment of policies and procedures for evaluating disbursements requests by MCAs to ensure the amounts are disbursed for immediate cash needs. The MCC stated it is studying the portion of the recommendation that states that amounts disbursed should only be for "immediate cash needs."

Furthermore, the MCC did not address the portion of the recommendation that the policies and procedures should include a provision that funds identified as being in excess of immediate cash needs be refunded.

The MCC Management concurred that "more explicit policies on the Review of Disbursement Requests are appropriate". The MCC established a working group several months ago to generate "Standards of Review" that explicitly states what various reviewing parties are responsible for. While the "MCC does not believe that any that any of the Disbursement Request reviews have problems", the MCC does believe "that the Standards of Review policy will ensure that there are no gaps in the overall process and that there are no misunderstandings by any of the reviewing departments as to their responsibilities. The revised clearance framework and Standards of Review will be finalized in September of 2006."

For Recommendation No. 2, the MCC has made a management decision on this recommendation.

The MCC concurred "with this recommendation, specifically the portion of the recommendation that the Vice President for Administration require MCAs to provide supplemental data to inform MCC of accrued expenditures as of the end of the period." The MCC had "already agreed with the Inspector General that for Fiscal Year 2006, MCC will generate accruals for our end-of-year financial statements based on supplemental information received from our sovereign grant recipients, and we are currently in the process of obtaining this supplemental information."

The MCC did not specifically identify the method by which the MCC would instruct MCAs to prepare and provide supplemental data to inform MCC of accrued expenditures as of the end of the period for subsequent years (after September 30, 2006), but has informed the OIG that it is in the process of developing such a methodology .

For Recommendation No. 3, the MCC has not made a management decision on this recommendation.

The MCC concurred “that MCC should provide clear guidance on all issues related to the implementation of MCA Compacts, including…the use of grant disbursements, and the re-disbursement” of these funds.” However, the MCC did not address the recommendation’s components related to the MCAs re-disbursing funds in the form of advances to secondary recipients. The MCC cited the Principles of Federal Appropriations Volume II Chapter 10 as the basis for its position.

Chapter 10 of Volume II of the Principles of Federal Appropriations includes a section titled “Funds in the Hands of Grantee: Status and Application of Appropriation Restrictions.” This section states “grant funds in the hands of a grantee are no longer viewed as federal funds for certain purposes does not mean that they lose their character as federal funds for all purposes . It has been held that the government retains a “property interest” in grant funds until they are actually spent by the grantee for authorized purposes. Further “It makes no difference whether the funds are paid to the grantee in advance or by reimbursement…The holdings are based on the continuing responsibility of the federal government to oversee the use of the funds.” The section titled “Cash Management Concerns and Requirements” states that “One problem with the advance funding of assistance awards is that the recipient may draw down funds before they are actually needed…But there is another reason. When money is drawn from the Treasury before it is needed, or is in excess of current needs, the government loses the use of the money…premature drawdown not only profits the recipient, but does so at the expense of …the taxpayer.”

The OIG believes that the advances provided by MCA to a contractor or a secondary recipient must contain the same cash management criteria to which the MCC must comply.

SCOPE AND METHODOLOGY

Scope

The Office of Inspector General (OIG) performed a risk assessment of MCA Cape Verde financial operations. The purpose of the assessment was to evaluate and identify vulnerabilities in areas that may adversely impact MCA Cape Verde's financial operations. This was not an audit and as such we did not apply all Government Accounting Standards procedures to identify all conditions that may adversely affect MCA Cape Verde's financial operations. The risk assessment was conducted at MCA Cape Verde's headquarters in Praia, Cape Verde from March 28, 2006, to March 31, 2006. Following the assessment fieldwork performed in Cape Verde, the assessment team consulted with MCA Cape Verde and the MCC in Washington from April, to July 2006.

Methodology

To gain an understanding of MCA Cape Verde operation and controls, the OIG interviewed MCA Cape Verde, General Directorate of the Treasury, and MCC personnel. The risk assessment focused on MCA Cape Verde's financial operations from October 14, 2005, to March 28, 2006. 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 and procurement. Using this information, we assessed the level of risk (low, moderate, or high) for each of these key financial operations.

The general methodology for the risk assessment included the following:

- Interviews of key MCC and MCA Cape Verde personnel in each of the areas assessed;
- Reviews of the Compact agreement, sub-agreements and applicable laws and regulations;
- Reviews of current MCC and MCA Cape Verde policies, procedures and processes;
- Evaluations of transactions processed during the review period; and
- Considerations of the MCC's role in establishing and implementing MCA Cape Verde.

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.

MANAGEMENT COMMENTS

MILLENNIUM
'CHALLENGE
CORPORATION

MEMORANDUM August 29, 2006

TO: John Phee
Assistance Inspector General for the Millennium Challenge Corporation

FROM: Mike Casella
Deputy Vice President for Administration and Finance

SUBJECT: MCC Management Response to Recommendation from the Risk Assessment of MCA Cape Verde's Financial Operations

The MCC appreciates the opportunity to respond to the text and recommendations of the report.

> ***Recommendation No. 1: We recommend that the Vice President of Administration and Finance establish policies and procedures for evaluating disbursement requests submitted by MCAs (recipient countries) to ensure that the amounts disbursed are only for immediate cash needs~. The policies and procedures should include a provision that funds identified as being in excess of immediate needs be promptly refunded by MCA to MCC.***

Management response:

The MCC partially concurs with this recommendation.

MCC concurs that more explicit internal policies on the review of Disbursement Requests ("Requests") are appropriate. To that end, an internal working group was established several months ago to generate "Standards of Review" that explicitly state what various reviewing parties are responsible for. In 2005, the MCC documented a clearance framework requiring multiple levels of review of Disbursement Requests prior to any MCC disbursements for any MCC Compact. That clearance matrix was updated in 2006 and the list of authorized clearers is updated on a regular basis. Initially, MCC did not fully document procedures covering which portions of the Disbursement Request needed to be reviewed by the various departments. While MCC does not believe that any of the Disbursement Requests reviews have problems, we do believe that the Standards of Review policy will ensure that there are no gaps in the overall review process and that there are no misunderstandings by any of the reviewing departments as to their responsibilities. The revised clearance framework and Standards of Review will be finalized in September of 2006.

MCC is studying the portion of the recommendation that states that amounts disbursed should be only for "immediate cash needs". The report references Chapter 2000 the Treasury Financial Manual (TFM) and recommends that MCC implement various sections of this chapter, including 2025, 2065 and *2075.30.* However, MCC has researched the origins of Chapter 2000 and questions its applicability to our grant activities. Moreover, the Comptroller General has issued a clear body of decisions regarding this issue in Chapter 10 of Volume II of the Principles of Federal Appropriations, which clearly distinguish between the treatment of contracts and grants with respect to the general limitation on advances. These decisions have focused on whether a particular disbursement is for appropriate grant purposes, rather than whether they only cover immediate cash needs, and have approved grants in instances where the general rules limiting advances to immediate cash needs would not have allowed the disbursement. Chapter 10 does require that interest earned on grant funds pending their use for program purposes belongs to the federal government, and the report correctly notes that any unused cash balance on hand with MCA-Cape Verde is held in an interest bearing account and all interest earned is returned to the U.S. Treasury. We have attached relevant portions of Chapter 10 to this response.

MCC believes that our current practice of disbursing funds to MCA-Cape Verde and our other sovereign grant recipients based on review of quarterly disbursement requests, and disbursed in monthly tranches based on the budgets and procurement plans of our grant recipients, meets the tests laid out in Chapter 10 and is consistent with the purposes of our grants that are specified in the Millennium Challenge Act of 2003. We are currently discussing our views on this issue with counsel at the Financial Management Service and other relevant authorities and will develop a final position on this question in the near future.

We also have comments on specific points made or conclusions reached in the report on MCA-Cape Verde's procurement practices:

- The report implies that there was a fault in the review of the initial MCA-Cape Verde Disbursement Request due to the fact that the projected cash requirement at the time of the Request was at variance from the actual experience of MCA-Cape Verde's cash outlay over the period in question. This implication is in spite of recognition in the report that the original cash requirement projection of MCA-Cape Verde was built on the assumption that key construction and construction supervision contracts would be signed during the disbursement period. This was a reasonable assumption both at the time MCA-Cape Verde submitted its Request and when MCC approved the Request.

- Subsequent to the transfer of grant funds under the request, MCC, in conducting its monitoring and oversight responsibilities of key procurements, concluded that the final stages of the procurements should be temporarily put on hold in order for MCA-Cape Verde to address issues in the documentation of the process as well as for MCA-Cape Verde's own internal review process to take place, due to the newness of both the processes and the organization carrying out the processes. Thus, the variance between projected and actual cash outflow of MCA-Cape Verde was a matter of timing differences, not arising from changes in underlying contractual obligations, and was due to decisions taken after the Request had been approved, not due to a fault in the review process itself.

<u>Recommendation</u> <u>No. 2</u>: We recommend that the Vice President of Administration and Finance require that the MCAs provide financial statements prepared on an accrual basis or provide supplemental data to inform MCC of accrued expenditures as of the end of the period.

Management response:

MCC concurs with this recommendation, specifically the portion of the recommendation that the Vice President for Administration and Finance require MCAs to provide supplemental data to inform MCC of accrued expenditures as of the end of the period. We have already agreed with the Inspector General that for Fiscal Year 2006, MCC will generate accruals for our end-of-year financial statements based on supplemental information received from our sovereign grant recipients, and we are currently in the process of obtaining this supplemental information. This approach is similar to that followed by the Environmental Protection Agency in order to generate accruals on grants provided to state governments.

We do not believe that MCAs should be required to provide financial statements prepared on an accrual basis. All MCC Compacts require that recipient countries follow internationally acceptable accounting standards. The International Public Sector Accounting Standards Board (IPSASB), an international body (that includes US membership) and generally recognized as an authoritative source for public sector accounting, issues International Public Sector Accounting Standards (IPSAS) which explicitly provide that cash based accounting is an acceptable method of accounting in the public sector. Thus, if a recipient government follows IPSAS, it is in compliance with Compact requirements.

More importantly, MCC approaches issues, such as accounting standards, with the view that the implementation of a Compact should reinforce the policies and practices of a recipient country when those policies are consistent with sound public administration. In the instant case, when a country has adopted a generally accepted international accounting standard, if MCC were to then reject that practice, this rejection would undermine the policy framework of the recipient government.

In addition to the requirement that a recipient country follow internationally acceptable accounting standards, the MCC does explicitly require that all MCA entities record and control on a commitment basis. A commitment is not the equivalent of a legal obligation to make a payment based on the receipt of goods and services, the general basis of recording an accrued expenditure. Rather, it is more analogous to a reserve of budget resources and, as applied by the MCC, is generally recorded at the expected value of a contract upon execution of the contract.

This requirement recognizes that whatever accounting standards are used, there must be a system in place to assure that total MCC spending does not exceed funding. The report incorrectly states that MCA-Cape Verde does not record commitments. All financial reports required by MCC explicitly incorporate reporting on commitments and MCA-Cape Verde has been in compliance with these reporting requirements since entry into force.

***Recommendation No. 3*: We recommend that the Vice President of Administration and Finance provide policies and procedures to MCAs on advances. The policies and procedures should include provisions that advances provided by the MCAs:**

- ***Conform to the same standards of timing and amounts that are applied by MCC to the MCAs.***
- ***Only be provided for immediate cash needs.***
- ***Be deposited by the recipient in an interest-bearing account, with interest earned submitted to the MCAs.***
- ***Be promptly refunded to the appropriate MCA office if identified as being in excess of immediate disbursement needs.***

Management Response:

We partially concur with this recommendation.

Specifically, we concur that MCC should provide clear guidance on all issues related to the implementation of MCA Compacts, including on the use of grant disbursements and the "redisbursement" of these funds. MCC is in the final stages of issuing a guidance document that consolidates policies concerning allowable costs of an Accountable Entity that can be funded with MCC Grants. These Cost Principles address many of the questions that have been raised by our MCA counterparts during the early stages of implementation.

However, we question both the applicability and the impact of the specific recommendations on the timing and the amounts of disbursements made by MCAs to contractors or sub-grantees. As discussed in our response to Recommendation No. 1 above, Chapter 10 of Volume II of the Principles of Federal Appropriations focuses on whether a particular disbursement is for appropriate grant purposes, rather than whether it only covers immediate cash needs. Chapter 10 applies this same test to instances where a grant recipient further "re-disburses" grants funds to sub-recipients.

In the specific procurements by MCA-Cape Verde cited in the report, MCC believes that the re--disbursements made for these procurements were consistent with this standard. MCC assistance is unlike most other forms of U.S. foreign assistance in its requirement for Compact recipients to be the implementers of MCC programs. The primary entities responsible for implementation—referred to as MCAs in the report—are untested in the market place and there will naturally be a period before potential bidders for Compact funded procurements of goods, services, and works understand the structure of the MCA, its reliability as a customer, its history as a prompt payer of valid invoices, its exact relationship with the US Government and its practice of not entering into obligations for which it does not have adequate resources. The risk to the MCAs associated with being new entrants to the marketplace is that bidders will either choose not to bid because of unfamiliarity and uncertainty or will factor in a higher perceived level of risk in their financial proposals.

To minimize the uncertainty, the guidance provided by MCC to our MCA counterparts has been to structure procurements in a manner that is consistent with industry standard practices, and to address the lack of familiarity on the part of potential bidders. In the construction industry (the subject of the procurements noted in the report), it is a standard practice to provide an upfront mobilization payment to contactors in recognition of the need for contractors to mobilize equipment and labor (often long distances) and to prepare to perform under the contract. In fact, the contract language that the report cited in reference to this mobilization payment was modeled directly on standard contract language used for World Bank funded works contracts, deliberately used to reinforce to the marketplace that this contract followed standard donor funded project practices.

Section 609(b)(l)(I) of the Millennium Challenge Act requires that an MCC Compact contain "a requirement that open, fair, and competitive procedures are used in a transparent manner in the administration of grants or cooperative agreements or the procurement of goods and services for the accomplishment of objectives under the Compact." In order to carry out the intent of these legislative provisions, the overriding principle MCC uses in its guidance on procurements conducted with MCC grant funds is to maximize competition to the greatest extent possible. The principle of competition reinforces other key aspects of sound public sector procurement including transparency and fairness.

Based on the above points, MCC believes that the procurement practices that MCA Cape Verde followed, based on our procurement agreement with Cape Verde, are consistent with the specific authorities provided by and grant purposes defined in the Millennium Challenge Act, and therefore are consistent with the decisions of the Comptroller General discussed above. As noted in our response to Recommendation No. 1, we will continue to discuss our views on this matter with relevant authorities in order to arrive at a final position on this issue.

We also have comments on specific recommendations made or conclusions reached in the report on MCA-Cape Verde's procurement practices:

- The report does not discuss the fact that MCA-Cape Verde required a bank guarantee to secure the mobilization payments in the event of non-performance, which mitigates the risk of providing a payment early in the construction process.

- The report does not make a distinction between cost-based contracts and fixed- price lump-sum contracts. In the former, the contract provides for reimbursement of allowable costs and payments are directly tied to the incurrence of costs by the contractor. In the latter, the contract is a fixed price for the delivery of specific goods, works, or services and the costs faced by the contractor are irrelevant to the contract. Accordingly, references in the report to matching payments to costs of the contractor are not applicable in a fixed-price lump-sum contract.

- The report concludes that providing a payment not directly tied to a cost represents a cost of money based on a market interest rate, characterized as a loss of interest. However, if a payment schedule is known at the time of a request for proposals, potential bidders, who also understand the time value of money, will be able to factor into their financial proposals their own perceived cash flow and, if the payment schedule provides for a payment in excess of their incursion of cash outflow, will be compelled to reduce their overall financial bid by an appropriate discount rate in order to try to have the most competitive overall bid. Thus, one can conclude that any cost of funds incurred by MCA-Cape Verde due to a payment prior to incursion of costs by the contractor is offset by a more advantageous overall financial proposal as a result of the contractor seeking to best its competition in the bidding process. This phenomenon is dependent on strong forces of competition, again reinforcing MCC's desire to assure that competition is at the core of all MCA procurement processes.

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