Office of Audit
for the Millennium Challenge Corporation

March 30, 2012

Mr. Patrick Fine
Vice President of Compact Operations
Millennium Challenge Corporation
875 15th Street, NW
Washington, DC 20005

Subject: Review of the Compact Closeout in Nicaragua
(Report No. M-000-12-003-S)

Dear Mr. Fine:

This letter transmits the Office of Inspector General's final report on "Review of the Compact Closeout in Nicaragua". In finalizing the report, we considered the Millennium Challenge Corporation (MCC)'s written comments on our draft report.

The report contains four recommendations to address the following three subjects: (1) the deobligation of unused compact funds, (2) bank account closure, and (3) taxes. MCC agreed with all four of our recommendations. We consider that management decisions have been reached on all four and final action taken on Recommendation 3. Final action will take place on Recommendations 1, 2, and 4 when all unused compact funding is fully de-obligated and MCC revises its *Guidelines for the Program Closure of Millennium Challenge Compacts*.

I appreciate the cooperation and courtesy extended to my staff during this review.

Sincerely,

/s/

Mark S. Norman
Acting Deputy Assistant Inspector General
for Audit
Millennium Challenge Corporation

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SUMMARY

The Millennium Challenge Corporation (MCC) signed a 5-year, $175 million compact with the Nicaraguan Government on July 14, 2005, to help residents of León and Chinandega, two areas in the northwest of Nicaragua.[1] To achieve that goal, MCC gave $92.8 million to improve roads, $33.7 million to rural business development, $26.5 million to address property rights problems, and the remainder to program administration and monitoring and evaluation. The compact entered into force on May 26, 2006.

Three years later, on July 3, MCC terminated funding for some projects in response to actions the Nicaraguan Government took during the 2008 municipal elections that MCC deemed inconsistent with a partner country's commitment to "just and democratic governance."[2] This action affected the property regularization project and some activities in the transportation project that were not already under contract. Overall, MCC reduced the amount of the compact to $113.5 million.

The compact's implementation phase ended on May 26, 2011. MCC gave Millennium Challenge Account (MCA)-Nicaragua 120 days to close compact activities, which made September 23, 2011, the final closeout date. According to MCA-Nicaragua's Program Closure Plan, the fiscal agent would close the books on August 24, 2011 (90 days after the implementation phase ended).

This limited-scope review looked at several aspects of the closeout process to identify where improvements may be made. The objective of this review was to answer the following questions:

- What is the status and plan for collection and return of any outstanding advances, receivables, retentions, and unused funding?

- Whether there are any issues or problems that could prevent adequate sustainability of the roads completed under the compact.

Regarding the first question, the review found the following:

- **MCA-Nicaragua Has Unused Compact Funding of $750,848** (page 5). At the time of our fieldwork, the estimated unused compact funding that would remain after completing all closeout activities was $602,398. However, subsequent to our fieldwork, MCC informed us that the actual amount was $750,848. Therefore, MCC needs to deobligate this amount in accordance with its *Compact Financial Management Policy and Procedure Manual*.

- **Closeout Procedures for Bank Accounts Were Not Clear** (page 5). MCA-Nicaragua and the independent fiscal agent were not sure how and when to proceed with closing MCA-Nicaragua's four permitted bank accounts. Therefore, adding more information on closing

[1] "Millennium Challenge Compact between the United States of America acting though the Millennium Challenge Corporation and the Government of the Republic of Nicaragua," Article 1, Section 1.1, <http://www.mcc.gov/documents/agreements/071405nicaraguacompact.pdf>.
[2] James Mazzarella, "Congressional Notification Transmittal Sheet, Millennium Challenge Corporation, June 17, 2009, <http://www.mcc.gov/documents/cn/cn-061709-nicaragua-partialtermination.pdf>.

bank accounts to the *Guidelines for the Program Closure of Millennium Challenge Compacts* would help make the process smoother for all accountable entities.

- **Some Goods and Services Could Be Subject to Value-added Tax (VAT) After Compact Completion** (page 6). MCA-Nicaragua requested, and the Government of Nicaragua granted, an extension of the VAT exemption for the 120-day compact closure period. However, the review team is concerned about VAT assessments on goods and services incurred or paid, such as the independent auditor's fee, after the end of the period. Therefore, it would be beneficial for MCC to revise its guidelines to require that all accountable entities ensure that expenses incurred or paid after compacts end are exempted from taxes.

Regarding the second question, this review found no significant issues or problems that could prevent sustainability of the 74 kilometers of roads constructed for $58 million under the compact. The team visited the roads a year and a half after they were built. By then, they had undergone a very intense rainy season, and the 1-year defect liability period had passed. Therefore, the observation was conducted under conditions that would alert the team to obvious problems in construction quality. Commercial activities and residential construction were observed along the constructed roads. Yet the team did not see any obvious disintegration or crumbling of asphalt and road shoulders that could result from poor-quality work.

FOMAV (Fondo de Mantenimiento), the Nicaraguan Road Maintenance Fund, is responsible for maintaining all roads. It was structured to remain autonomous and independent from the influence of politics. In 2005 the Government passed a gas tax and directed all the proceeds to FOMAV. The tax started at $0.06 per gallon and, per escalation clauses in the associated legislation, increased to the current $0.16 per gallon. FOMAV's road maintenance budget for 2010 was $24.8 million.

This report has four recommendations to MCC's vice president, Department of Compact Implementation:

1. Assure that the $750,848 of unused Nicaragua compact funding is deobligated (page 5).

2. Add information to *Guidelines for the Program Closure of Millennium Challenge Compacts* on closing bank accounts (page 6).

3. Provide consultation to MCA-Nicaragua on closing bank accounts (page 6).

4. Revise *Guidelines for the Program Closure of Millennium Challenge Compacts* to require that all accountable entities assure that expenses incurred or paid after compacts end are exempted from taxes (page 6).

Detailed results of this review appear in the following section. The scope and methodology are included in Appendix I. OIG's comments can be found on page 7, and the full text of management comments is in Appendix II.

REVIEW RESULTS

MCA-Nicaragua Has Unused Compact Funding of $750,848

MCA-Nicaragua submitted a detailed financial plan to MCC dated June 10, 2011, that showed $602,398 would remain out of the $113.5 million obligated under the compact. This amount was an estimate because the 120-day compact closeout period had not been completed at the time of our review. However, subsequent to our fieldwork, MCC notified us that the actual amount of unused funds was $750,848. MCA-Nicaragua's Program Closure Plan states the fiscal agent would close all of MCA-Nicaragua's books on August 24, 2011.

Obligated funds that are not used for compact activities should be appropriately deobligated as soon as possible, in accordance with MCC's *Compact Financial Management Policy and Procedure Manual* (August 2010), so that the U.S. Government may use the funds for other purposes. To address the deobligation of unused compact funding, the OIG makes the following recommendation.

> ***Recommendation 1.*** *We recommend that the Millennium Challenge Corporation, Vice President of Compact Operations assure that the $750,848 of unused Nicaragua compact funding be deobligated.*

Closeout Procedures for Bank Accounts Were Not Clear

MCA-Nicaragua was not sure how and when to close its four permitted bank accounts, consisting of two in U.S. dollars and two in local currency (cordobas). Properly closing all of these accounts when the compact ends, including the removal of account signatories, is one of the essential final elements of internal control.

The closeout procedures provided in MCC's *Guidelines for the Program Closure of Millennium Challenge Compacts* and the MCA-Nicaragua Program Closure Plan were not clear on closing bank accounts. MCA-Nicaragua made an effort to follow the guidelines in developing its closure plan. However, the MCA-Nicaragua director of administration and finance said he was waiting for additional guidance from MCC regarding how and when to proceed.

Although the MCC guidelines do not specifically discuss the closure of accountable entity bank accounts, they do state that the fiscal agent must close the books 90 days after the compact ends, which in the case of MCA-Nicaragua was August 24, 2011. This appears to conflict with MCA-Nicaragua's Program Closure Plan, which states in Section 4.13.4 on cash assets that, "As of September 23, 2011, the balances of the authorized accounts and petty cash should be close to zero and the Bank Agreement shall also be concluded."

The MCC guidelines should provide specific information on closing permitted bank accounts for all accountable entities to consistently follow. Nicaragua is among the first of the compacts to be completed. As a result, MCC has the opportunity to refine and update its guidelines to help ensure a smoother closeout process for all accountable entities. To help improve the compact closeout process, OIG makes the following recommendations.

> ***Recommendation 2.*** *We recommend that the Millennium Challenge Corporation, Vice President of Compact Operations add information to* Guidelines for the Program Closure of Millennium Challenge Compacts *on closing bank accounts.*

> ***Recommendation 3.*** *We recommend that the Millennium Challenge Corporation, Vice President of Compact Operations provide consultation to MCA-Nicaragua on closing bank accounts.*

Some Goods and Services Could Be Subject to VAT After Compact Completion

MCC compacts require that all funding be exempt from taxes. However, MCA-Nicaragua's original VAT exemption certificate expired on the compact completion date of May 26, 2011. When the VAT exoneration certificate was obtained, it was not foreseen or anticipated that VAT-subject expenses would be incurred after the compact ended. As a result, MCA-Nicaragua requested, and the Nicaraguan Government granted, an extension of the VAT exemption for the 120-day compact closure period; the extension exempted goods and services until September 23, 2011.

However, we are concerned about VAT assessments paid after that date. For example, Grant Thornton's draft independent audit report was not due to OIG until September 23, 2011, and as a result, the payment for the associated audit services was made after that date. Other expenses, such as utilities, that were invoiced to MCA-Nicaragua after the bank accounts were closed could be subject to VAT.

Other MCC accountable entities may encounter similar problems exempting goods and services from taxes after compact expiration, but MCC's guidelines do not address the issue. Consequently, OIG makes the following recommendation.

> ***Recommendation 4.*** *We recommend that the Millennium Challenge Corporation, Vice President of Compact Operations revise* Guidelines for the Program Closure of Millennium Challenge Compacts *to require that all accountable entities assure that expenses incurred or paid after compacts end are exempted from taxes.*

EVALUATION OF MANAGEMENT COMMENTS

On March 9, 2012, MCC provided a formal response to our draft report (included in Appendix II). As a result of MCC's comments, we removed Recommendation 4 from the draft report and renumbered the recommendations in the final report. In its comments, MCC agreed with all four of our final recommendations.

MCC agreed with **Recommendation 1**, to ensure that the $750,848 of unused Nicaragua compact funding is deobligated. MCC plans to deobligate unused Nicaragua compact funding by December 31, 2012, in accordance with its *Compact Financial Management Policy and Procedure Manual* (August 2010), which describes the compact deobligation process. OIG considers that a management decision has been reached. However, final action cannot take place until the unused compact funding is fully deobligated.

MCC agreed with **Recommendation 2**, to add information to *Guidelines for the Program Closure of Millennium Challenge Compacts* on closing bank accounts. MCC stated it would consider OIG's recommendation during the next revision of the guidelines, which is scheduled to be evaluated by September 30, 2012. OIG considers that a management decision has been reached. However, final action cannot take place until MCC revises its *Guidelines*.

MCC agreed with **Recommendation 3**, to provide consultation to MCA-Nicaragua on closing out bank accounts. In August and September 2011, MCC provided written notification and procedures to MCA-Nicaragua and its fiscal agent on closing out bank accounts. For Recommendation 3, OIG considers that a management decision has been reached and final action taken.

MCC agreed with **Recommendation 4**, to revise *Guidelines for the Program Closure of Millennium Challenge Compacts* to require that all accountable entities take necessary action to ensure that expenses incurred or paid after compacts end are exempted from taxes. MCC will advise compact countries nearing completion to review their VAT exemption status in order to ensure that payments made from the end of the compact through the end of the 120-day closeout period are exempt. Further, MCC will consider OIG's recommendation during the next revision of the guidelines. For Recommendation 4, OIG considers that a management decision has been reached. However, final action cannot take place until MCC revises its *Guidelines*.

SCOPE AND METHODOLOGY

Scope

OIG conducted this review of MCA-Nicaragua to determine whether the entity adhered to MCA-Nicaragua's Program Closure Plan that MCC approved on January 10, 2011. We selected policies and procedures that related to our review objectives, which included "Monitoring Component," "Budget for the Closure Process," and "Reporting & Auditing."

Although this review was not an audit, we conducted the review in accordance with Government Auditing Standards, specifically Chapters 3 and 7, Sections 7.55 and 7.72 to 7.79. We planned and performed the review to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our review objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions.

We conducted fieldwork for this review from June 13 to 29, 2011, in Managua and at MCC headquarters in Washington, D.C. OIG selected Nicaragua because its compact ended on May 26, 2011, and it was going through MCC's closeout process.

Methodology

The review team met with MCC staff in Washington, D.C., and Managua. While in Nicaragua, the team held discussions and reviewed supporting documentation on the closeout process conducted by MCA-Nicaragua. We also conducted a site visit to observe the rehabilitation of all three segments of the road project constructed under the compact, totaling 74 kilometers.

To answer the review objectives, the team:

- Interviewed pertinent MCA-Nicaragua personnel responsible for overseeing the infrastructure projects and other compact activities.

- Interviewed Nicaraguan Government officials with responsibilities for the construction and ongoing maintenance of the road infrastructure project.

- Reviewed the process and status of the monitoring and evaluation component, including the final impact evaluation.

- Analyzed pertinent financial and progress reports and related documents.

MANAGEMENT COMMENTS

MILLENNIUM CHALLENGE CORPORATION
UNITED STATES OF AMERICA

Memorandum

DATE: March 9, 2012

TO: Mark S. Norman, Acting Deputy Assistant Inspector General for Audit
USAID Office of the Inspector General for MCC

FROM: Tom Hurley, Division Vice President
Department of Compact Operations
Millennium Challenge Corporation

SUBJECT: MCC Management Comments to the OIG's draft report on the Review of the Compact Closeout Process in Nicaragua, Report No. M-000-12-XXX-S.

Thank you for the opportunity to provide MCC's management comments to OIG's draft report on the Review of the Compact Closeout Process in Nicaragua dated January 31, 2012. We understand that these comments will be included in their entirety in Appendix II of your final report.

In the context of the recommendations outlined in the draft report, the following are MCC's management comments:

- **OIG Recommendation 1:**

  We recommend that the Millennium Challenge Corporation Vice President of Compact Operations ensure that the $750,848 in unused Nicaragua Compact funding is de-obligated (page 6).

  MCC Management Comments:

  MCC agrees with this recommendation and plans to de-obligate unused Nicaragua Compact funding as soon as practicable, in accordance with MCC's *Compact Financial Management Policy and Procedure Manual (August 2010)*, which describes the Compact de-obligation process:

  > "The Division of Finance coordinates compact financial close-out processes due to expiration, suspension or termination of a Compact or unused amount of previously obligated funds. The Division of Finance de-obligates any unliquidated obligations on expired Compacts and re-programs and re-apportions the funds.
  >
  > In accordance with MCC's *Policy on Suspension or Termination of Assistance and/or Eligibility for Assistance* (November 2005), MCC complies with the following:

Step 1: Upon expiration, suspension or termination of the Compact, the Fiscal Accountability notifies the ACFO, who in turn, notifies the FSP to suspend or terminate all requested payments.

Step 2: The Fiscal Agent transfers any remaining compact balances in the permitted account, and accrued interest, to MCC via CPS no later than 30 days after the recipient country government receives MCC's request for such transfer. The Accountable Entity / Fiscal Agent prepare and submit a QFR to the Transaction Team Leadership outlining the transfer amount.

Step 3: In case of expiration and termination, the ACFO reviews the QFR, approves the de-obligation of un-liquidated obligations and transmits the QFR to the FSP.

Step 4: The FSP records the de-obligation in the core financial system.

Step 5: The Senior Budget Officer reprograms funds to the future account."

- **OIG Recommendation 2:**

We recommend that the Millennium Challenge Corporation Vice President of Compact Operations add information to the Guidelines for the Program Closure of Millennium Challenge Compacts on closing out bank accounts (page 7).

MCC Management Comments:

MCC agrees with the recommendation to include text referring to the closure of bank accounts in the *Compact Closure Guidelines*. MCC will consider OIG's recommendation during the next revision of its *Program Closure Guidelines*.

- **OIG Recommendation 3:**

We recommend that the Millennium Challenge Corporation Vice President of Compact Operations provide consultation to MCA-Nicaragua on closing out bank accounts (page 7).

MCC Management Comments:

MCC agrees with this recommendation but prior to receiving OIG's draft report, MCC already provided guidance to MCA-Nicaragua on closing out bank accounts. During the closeout period (May 27, 2011 through September 23, 2011), MCC provided detailed instructions to MCA-Nicaragua in order to supplement the guidance and procedures outlined in MCA-Nicaragua's approved Program Closure Plan.

MCC provided written notification and procedures on August 15, 2011, and September 1, 2011, respectively, to MCA-Nicaragua and its Fiscal Agent that all accrued interest and remaining Compact funds should be remitted to the United States Treasury by 11:59 AM on September 2, 2011; and indeed, all accrued interest and remaining Compact funds were remitted by the Fiscal Agent to the United States Treasury on September 2, 2011, as instructed by MCC. In addition, MCC provided written notification to MCA-Nicaragua and its Fiscal Agent on September 1, 2011, that the Permitted Accounts be closed no later than September 23, 2011 by a procedure to be confirmed by Bank de la Producción S.A. (BANPRO), MCA-Nicaragua's local custodian bank; and indeed, all four Permitted Accounts were closed by the Fiscal Agent on September 13, 2011.

- **OIG Recommendation 4:**

  We recommend that the Millennium Challenge Corporation Vice President of Compact Operations revise the Guidelines for the Program Closure of Millennium Challenge Compacts to include general guidelines for paying expenses after the final closeout (page 7).

  MCC Management Comments:

  MCC disagrees with this recommendation. The *Program Closure Guidelines* already include references for the need to make arrangements agreeable to MCC for payments after the end of the closure period for allowable expenditures.

  In its last revision of the *Program Closure Guidelines* (May 9, 2011), MCC anticipated that two types of expenses would require payment after the closeout period (i.e., payments for final audit deliverables and continuing expenses for post-Compact monitoring and evaluation activities). Since the drafting of this version of the Guidelines and in the interest of limiting the use of Compact funds after the closeout period, MCC has determined that payments for such expenses would not come from Compact funds. MCC does not believe it necessary to divulge to Accountable Entities through the *Program Closure Guidelines* what non-compact sources of funding it may use to make final payments.

- **OIG Recommendation 5:**

  We recommend that the Millennium Challenge Corporation Vice President of Compact Operations revise the Guidelines for the Program Closure of Millennium Challenge Compacts to require that all accountable entities take necessary action to ensure that expenses incurred or paid after compacts end are exempted from taxes (page 8).

  MCC Management Comments:

  MCC agrees with this recommendation. MCC will advise partner compact countries nearing completion to review their Value Added Tax exemption status in order to ensure that payments made from the end of the Compact through the end of the 120-day closeout period are tax exempt. In addition, MCC will consider OIG's recommendation during the next revision of its *Program Closure Guidelines*.

If you have any questions, please contact Pat McDonald, MCC Compliance Officer, at 202-521-7260.