OFFICE OF INSPECTOR GENERAL
for the Millennium Challenge Corporation

AUDIT OF THE MILLENNIUM CHALLENGE CORPORATION PROGRAMS IN HONDURAS

AUDIT REPORT NO. M-000-09-001-P
December 24, 2008

WASHINGTON, DC

Office of Inspector General
for the
Millennium Challenge Corporation

December 24, 2008

The Honorable John J. Danilovich
Chief Executive Officer
Millennium Challenge Corporation
875 Fifteenth Street, N.W.
Washington, DC 20005

Dear Mr. Ambassador:

This letter transmits the Office of Inspector General's final report on the *Audit of the Millennium Challenge Corporation's program in Honduras*. In finalizing the report, we considered your written comments to our draft report and included those comments in their entirety in Appendix II of this report.

The report contains five audit recommendations for corrective action. We consider that a Management Decision has been reached on Recommendations 1, 3, 4, and 5. Final action for recommendations 1, 3, 4, and 5 will require MCC to provide additional documentation. However, we consider that a Management Decision has not been reached on Recommendation No. 2 until MCC provides a detailed analysis of how the Rural Development Project caused the increase in farm and employment income. I appreciate the cooperation and courtesy extended to my staff during this audit.

Sincerely,

Richard J. Taylor /s/
Acting Assistant Inspector General
Millennium Challenge Corporation

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SUMMARY OF RESULTS

On June 13, 2005, Honduras became the second country to receive a compact[1] when the Millennium Challenge Corporation (MCC) and the Republic of Honduras signed a 5-year, $215 million agreement. The compact entered into force[2] on September 29, 2005, with a goal of alleviating two key impediments to economic growth: low agricultural productivity and high transportation costs. The Government of Honduras designated the Millennium Challenge Account-Honduras (MCA-H) as the accountable entity that would have the legal authority to oversee the implementation of the compact programs during the compact period (see page 3).

The objectives of this audit were to determine whether (1) MCC ensured that MCA-H established performance milestones and targets for its MCC-funded programs, (2) the MCC program in Honduras achieved its performance milestones and targets, and (3) MCC's reporting on the program in Honduras provided stakeholders with complete and accurate information on the progress of the program and the results achieved (see page 4).

The audit team found that, for the most part, MCC ensured that the MCA-H established performance milestones and targets; however, two indicators of MCA-H's Access to Credit component did not reflect revised project activities. Furthermore, MCA-H achieved three of ten performance milestones and targets reviewed, and the transportation project has encountered budget shortfalls due to an increase in cost and redesign of the CA-5 highway. In addition, MCC did not perform or document variance analyses of targets that it failed to meet. With the exception of the target variance analyses in Quarterly Progress Reports, MCC appears to have provided complete and accurate reporting of its program in Honduras to its stakeholders (see pages 5, 8, 11, 13, and 14).

This report includes five recommendations to MCC's vice president of compact implementation: (1) revise the two indicators—percentage of MCA-Honduras loan portfolio at risk and funds lent from MCA-Honduras to financial institutions—to reflect MCC's and MCA-H's revision of the Farmers Access to Credit activity; (2) analyze the Rural Development Project, Farmer Training and Development Activity to explain the increased income of beneficiaries and document the analysis; (3) develop a strategy to resolve budget shortfalls when they occur; (4) clarify MCC's expectations on roles and responsibilities of the MCA Monitoring and Evaluation function, specifically on the use of monitoring as a management tool; and (5) issue guidance by December 31, 2008 on reporting requirements for performance deviations from the targets established in its Monitoring and Evaluation Plans (see pages 7, 10, 12, and 14).

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[1] A compact is a multiyear agreement between MCC and an eligible country to fund specific programs targeted at reducing poverty and stimulating economic growth.

[2] According to MCC officials, entry into force is the point at which a binding commitment is recognized and compact funds are obligated.

Appendix II contains the management comments in their entirety. In its comments, MCC concurred with all of the recommendations as originally stated and included a second section in its response to provide additional clarification to the OIG's findings (see pages 15 -17)

BACKGROUND

Established in January 2004, the Millennium Challenge Corporation (MCC) is a U.S. Government corporation designed to work with some of the world's poorest countries. Based on its performance against MCC's 17 policy indicators, a country may become eligible to receive a compact, which is a multiyear agreement between MCC and the country to fund specific programs targeted at reducing poverty and stimulating economic growth. One of MCC's goals is to assist eligible countries that have developed well-designed programs with clear objectives, benchmarks to measure progress, and a plan for effective monitoring and evaluation of results.

On June 13, 2005, Honduras became the second country to receive a compact when MCC and the Republic of Honduras signed a 5-year, $215 million agreement. The compact, which entered into force on September 29, 2005, is intended to reduce poverty by alleviating the two key impediments to economic growth: low agricultural productivity and high transportation costs. The compact emphasizes increasing the productivity and business skills of farmers who operate small and medium-sized farms and their employees, and reducing transportation costs between targeted production centers and national, regional, and global markets. The Government of Honduras designated the Millennium Challenge Account-Honduras (MCA-H) as the accountable entity with the legal authority to oversee the implementation of compact programs.

Photograph of an MCA-H program farmer completing an onion harvest. Onions are a high-value horticultural product. Taken by OIG auditor, April 2008.

Honduras's compact has two major projects: the Rural Development Project and the Transportation Project. The $72 million Rural Development Project consists of four components: Farmer Training and Development to provide technical assistance in the production and marketing of high-value horticultural crops; Farmer Access to Credit to provide technical assistance and loans to financial institutions and expand the national lien registry system; Farm to Market Roads to construct and improve feeder roads that connect farms to markets; and Agriculture Public Goods Grant Facility to fund agricultural public goods projects that the private sector cannot provide on its own. The $126 million Transportation Project consists of three components: improving 109 kilometers of the CA-5 highway, which carries most of Honduras's import and export traffic between major production areas and the port; upgrading key secondary roads to improve access of rural communities to markets; and establishing a weight control system for vehicles using the roadways to help prevent premature deterioration of the roadways.[3]

[3] The compact budgeted $17 million for program administration.

Section 609(b)(1)(C) of the Millennium Challenge Act requires that each compact include benchmarks to measure progress toward achieving objectives, which are documented in the countries' Monitoring and Evaluation Plan (M&E Plan). MCC approved MCA-Honduras's M&E Plan on September 27, 2006.

To help compact countries develop their M&E Plans, MCC issued *Guidelines for Monitoring and Evaluation Plans* during fiscal year (FY) 2007. These guidelines provide MCC's expectations on the elements of the plan, including the program logic diagram, beneficiaries, assumptions and risks, performance monitoring, and reporting.

The M&E Plan discusses the program and its objectives, the program impact in terms of the economic rate of return, underlying assumptions and risks, and monitoring of the projects. The M&E Plan measures the results of the projects using four types of indicators. Compact Goal Indicators measure the impact of the program on the Hondurans who are affected by the program (program beneficiaries). Objective Indicators measure the final results of the projects to monitor their success in meeting the objectives. Outcome Indicators measure the immediate results of goods and services delivered under the project to provide an early measure of the likely impact of the projects on the objectives. Project Activity/Input Indicators measure the delivery of key goods and services to monitor the pace of project activity execution.

AUDIT OBJECTIVES

The Office of the Assistant Inspector General for the MCC conducted this audit as part of its FY 2008 audit plan. The objectives of this audit were to answer the following questions:

- Did the Millennium Challenge Corporation ensure that the Millennium Challenge Account-Honduras established proper performance milestones and targets for its MCC-funded programs?

- Is the Millennium Challenge Corporation program in Honduras achieving its performance milestones and targets in its MCC-funded programs?

- Did the Millennium Challenge Corporation's reporting on the program in Honduras provide stakeholders with complete and accurate information on the progress of the program and the results achieved?

Appendix I contains a discussion of the audit's scope and methodology.

AUDIT FINDINGS

Did the Millennium Challenge Corporation ensure that the Millennium Challenge Account-Honduras established proper performance milestones and targets for its MCC-funded programs?

The Millennium Challenge Corporation (MCC), for the most part, ensured that the Millennium Challenge Account-Honduras (MCA-H) established proper performance milestones and targets for its MCC-funded programs. MCC worked with MCA-H to develop its revised Monitoring and Evaluation (M&E) Plan and is currently working with the MCA to revise the M&E Plan to include new indicators for projects that, as of the end of the audit, they have begun to implement, such as the Public Goods Grant Facility component of the Rural Development project. During the audit, MCA-H was working from this revised M&E Plan which included some new indicators and replaced others with more relevant indicators. MCA-H had modified some of its projects, such as Farmer Access to Credit and Transportation, which changed the previously approved indicator. Also, MCA-H had begun to implement other projects, such as Farmer Access to Credit, Agricultural Public Goods Grants Facility, and Farmer Training and Development. Although some project changes are reflected in the revised draft M&E Plan, others are not. For example, MCA-H had not revised its indicators to reflect changes to the Access to Credit project, such as the input indicator that measures the amount of funds that MCA-H loaned to financial institutions.

The following sections include findings to improve the program's performance monitoring and evaluation plan as well as opportunities to improve the program's effectiveness.

Some Indicators Did Not Reflect Project Revision

Summary: According to MCC's *Guidelines for Monitoring and Evaluation Plans*, any changes in implementation should be reflected in the M&E Plan. The M&E Plan itself should be reviewed periodically and revised when necessary. However, two indicators for the Farmer Access to Credit activity did not correspond to the activity that was implemented under the program. This is because MCA-H has revised the Farmer Access to Credit activity during the compact implementation stage and overlooked revising these two indicators. As a result, MCA-H may be unable to accurately measure the effect of the changes made to the activity and may draw incorrect conclusions.

The Millennium Challenge Corporation issued *The Guidelines for Monitoring and Evaluation Plans*, November 2006, to the Millennium Challenge Accounts to assist eligible countries in preparing their M&E Plans.

The *Guidelines for Monitoring and Evaluation Plans* state that—

> Over the life of the Compact, the M&E Plan should help identify when problems are encountered or when there will need to be adjustments made in

implementation. At the same time, any changes in implementation should be reflected in the M&E Plan. The M&E Plan itself should be reviewed periodically and revised when necessary.

Although MCA-H is revising its M&E Plan and has eliminated one indicator and added several new indicators, two indicators for the Farmer Access to Credit activity did not reflect the scope of the activity. MCA-H had not revised the percentage of MCA-Honduras loan portfolio at risk (the outcome indicator for the Farmer Access to Credit activity) or the funds lent from MCA-Honduras to financial institutions (an input indicator for the Farmer Access to Credit activity). Further information on these indicators is given in Table 1.

Table 1. Indicator for the Farmer Access to Credit Activity

Indicators	Details	Source/ Responsible Entity	Frequency of Data Collection and Reporting
Outcome			
Access to Credit			
Percentage of MCA-Honduras loan portfolio at risk	(U.S. dollar value of loan outstanding on all loans 30 days past due)/(U.S. dollar value of total loans outstanding): averaged over the previous four quarters	Farmer Access to Credit Activity implementer and trust fund manager (source and responsible entity)	Quarterly from 12/2007 to 09/2010
Input			
Access to Credit			
Funds lent from MCA-Honduras to financial institutions	U.S. dollar value of funds disaggregated by direct lending institutions and second tier institutions	Implementing entity for Farmer Access to Credit Activity (source and responsible entity)	Quarterly

Source: Draft M&E Plan for MCA-H.

In the draft revision of the MCA-H M&E Plan, the outcome indicator explained that the Farmer Access to Credit implementer, who will also be the manager of the trust fund, will provide MCA-H with the data that it will use to measure these indicators. However, the actual indicators do not recognize that the funding ($6 million) obligated for this activity has been placed under the responsibility of a national bank (BAMER).

The current indicators did not reflect the Farmer Access to Credit activity because MCA-H has revised the Farmer Access to Credit activity during the compact implementation stage and overlooked revising these two indicators. MCA-H's compact with MCC stated that MCA-H will make loans to regulated financial institutions that will either give loans directly to program farmers or give loans to rural financial institutions that will in turn give loans to program farmers. However, MCA-H has changed this aspect of the activity by establishing a trust fund that the implementer, BAMER, will manage and that will provide the loans to both regulated and unregulated financial institutions.

As the result of not revising the indicators, MCA-H may inaccurately measure the effect of the activity. Furthermore, unrevised indicators may prevent stakeholders from identifying the full results of the activity's revision, which may lead MCA-H to draw incorrect conclusions about the activity. For this reason, the audit team makes the following recommendation.

> *Recommendation No. 1: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, revise the two indicators—percentage of MCA-Honduras loan portfolio at risk and funds lent from MCA-Honduras to financial institutions—to reflect MCC's and MCA-H's revision of the Farmers Access to Credit activity*.

Is the Millennium Challenge Corporation program in Honduras achieving its performance milestones and targets in its MCC-funded programs?

MCA-H did not achieve seven of the ten 2007 input and outcome targets for the Rural Development Projects—Farmer Access to Credit and Farmer Training and Development—as embodied in the M&E Plan. For the Farmer Access to Credit, none of the four input or outcome indicators that should have been met by September 30, 2007, had been achieved. During the audit, MCA-H was reassessing the Farmer Access to Credit activity, including reviewing the planned beneficiaries and the project indicators for the updated M&E Plan.

Of the Rural Development Project activities, the Farmer Training and Development activity was the furthest along, but it did not fully achieve its two June 30, 2007, input or outcome targets. However, for the 2008 targets, the implementing partner for the Farmer Training and Development activity reported achieving its March 31, 2008, targets. Additional detail on the projects and their specific indicators and targets can be found under "MCA-Honduras Achieved Certain, But Not All Targets" (see page 8).

Other indicators and targets pertaining to public goods grantees, another Rural Development Project activity, were not yet in place because these grants were not awarded until the latter part of 2007. During the audit, MCA-H was in the process of updating the M&E Plan to include indicators and targets for the grantees.

Furthermore, MCA-H reported exceeding its 2007 M&E Plan compact goal target by 11 percent ($200,000). The 2007 goal was to increase beneficiary income by $1.9 million, and MCA-H reported increasing beneficiary income by $2.1 million. MCA-H's investment in the Farmer Training and Development activity, part of its Rural Development Project, yielded a reported increase of $1.3 million in farm income and $800 thousand in employment income. MCA-H's M&E Plan anticipated that the 2007 increase in beneficiary income would result from the Transportation Project, specifically from upgrading the CA-5 highway, not the Rural Development Project. Although MCA-H had completed many of the preparations for the highway's upgrade, such as road redesign and resettlement of many citizens in the highway's path, due to delays and budget shortfalls, construction of the road has not started.

MCA-Honduras Achieved Certain, But Not All Targets

Summary: In accordance with the compact, MCC's funding is contingent on successful achievement of targets established in the M&E Plan. MCA-H reported exceeding its 2007 compact goal target of $1.9 million by 11 percent ($200,000). MCC explained that MCA-H was able to reach its compact target while providing less farmer technical assistance than initially planned. Nevertheless, MCA-H did not meet the six 2007 input and outcome targets for its Rural Development Project. MCC explained that the project input targets were not met because project implementation was delayed by the lengthy setup of the MCA. Because not all the input and outcome targets originally established in the M&E Plan were achieved, projects may not be completed by the compact's end and MCC's contributions to the compact goal may be lessened.

According to annex I, section 2(e) of the compact between MCC and MCA-H, continued disbursement of MCC funding under the compact shall be contingent, among other things, on successful achievement of targets set forth in the M&E Plan.

MCA-H reported exceeding its compact goal target for the MCC-funded program in Honduras by increasing the income of beneficiaries for 2007 by $2.1 million, 11 percent more than its target of $1.9 million, even though it did not achieve any of its input and outcome targets. MCC explained that the goal target was the most important indicator of the program's success in Honduras. MCC officials explained that the impact of exceeding the compact goal target outweighed the impact of not meeting the lower-level indicators of project activities and results; it showed that fewer inputs were required than originally anticipated to achieve the project's results. However, MCC did not anticipate that it would achieve the target for the compact goal based on the results of the Farmer Training and Development activity. Furthermore, it has not provided any clear indication as to how the project attributed to the increase in beneficiary income. In fact, MCC's assumptions were based on upgrading the CA-5 highway on schedule, which would have contributed to the increase of beneficiaries' income; however, it was unable to achieve that target and as of this audit, has not begun construction of the highway. According to the MCA-H M&E plan, MCC assumed that it would increase the income level of its beneficiaries to $1.9 million by upgrading the CA-5 highway. (Refer to Table 2)

Furthermore, for the Rural Development Project, particularly the Farmer Training and Development activity MCA-H/MCC assumed that there would be no results in 2007 for the two high-level indicators[4]. Although MCA-H did not achieve the targets of the activity's low-level indicators, it exceeded targets of the high-level indicators by a total of $200,000. The indicators that MCA-H did not achieve for 2007 included the six Rural Development Project indicators discussed below.

For the Farmer Access to Credit activity, MCA-H reported no activity in its October 2007 Quarterly Progress Report toward meeting the following September 30, 2007, targets:

[4] Increase in farm income resulting from Rural Development Project, and Increase in employment income resulting from Rural Development Project.

1. Funds lent from MCA-Honduras to financial institutions (US$ millions)
2. Hours of T.A. [technical assistance] to financial institutions
3. Value of loans granted to program farmers (year end US$ millions)
4. Percentage of MCA-Honduras loan portfolio at risk

It should be noted that MCA-H and its implementing partner, ACDI/VOCA, reported the work activities that had taken place for the Farmer Access to Credit activity, such as an assessment of the financial services in the agriculture sector; however, because these activities were not captured by specific M&E Plan indicators, no activity was reported in the original M&E Plan.

Photograph of an MCA-H implementing partner extension agent (non-US Citizen) with a sample of a beneficiary's production of high-value horticulture. Photograph taken by OIG auditor, April 2008.

The original M&E Plan established two targets for the Farmer Training and Development activity:

- 16,600 technical assistance visits to program farmers (by May 1, 2007)
- 960 business plans prepared by the program farmers with the assistance of the technical assistance provider

MCA-H reported for the period ending June 30, 2007, that 9,798 technical visits had occurred (59 percent of the target), and that 289 business plans had been completed (30 percent of the target). However, the Farmer Training and Development implementing partner reported that the March 31, 2008, targets of 625 program farmers harvesting 950 hectares of high-value horticulture have been achieved ahead of the May 1, 2008, M&E Plan target. MCC explained that less technical assistance was required than anticipated to achieve the targets.

Table 2. Comparison of MCA-H M&E Plan Targets with Actual Performance

Indicator	M&E Plan Target	Actual Performance	Percentage of Target Achieved
Number of technical assistance visits to program farmers	16,600	9,798	59%
Number of business plans prepared by program farmers with assistance of technical assistance provider	960	289	30%
Funds lent from MCA-Honduras to financial institutions	$6,000,000	0	0%
Hours of technical assistance to financial institutions	4,800	0	0%
Value of loans to program farmers	$1,900,000	0	0%
Percentage of MCA-Honduras loan portfolio at risk	6%	0	0%
Benefits of CA-5 highway upgrade	$1,900,000	0	0%
Increase in farm income resulting from Rural Development Project	$0.0	$1,300,000 [5]	1,300%
Increase in employment income resulting from Rural Development Project	$0.0	$800,000	800%
Income increase of beneficiaries	$1,900,000	$2,100,000	111%

Source: MCA-H Quarterly Progress Reports and Monitoring and Evaluation Plan

MCA-H and MCC-H stated that the original M&E targets were not met because of the initial delay in setting up the accountable entity—MCA-H—and the resulting delay in the implementation of the projects in Honduras. Regarding exceeding the income indicators for the Rural Development Project, Farmer Training and Development Activity--where MCC initially anticipated no increase in income--MCC-H stated that less technical assistance to program farmers was required than anticipated to achieve the targets. MCC and MCA-H did not have any analyses to explain the reasons the income indicators exceeded their targets even though the low-level indicators did not meet its targets. The OIG believes that other factors such as incorrect underlying assumptions on the timing, amount of income earned by farmers, or exogenous factors could have contributed to exceeding the income indicators, while not achieving the low-level indicators.

Because the targets originally envisioned in the original M&E Plan were not achieved, the risk exists that projects will not be completed by compact end and their contributions to the compact goal will be lessened. For this reason, the OIG makes the following recommendation.

> *Recommendation No. 2: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, analyze the Rural Development Project, Farmer Training and Development Activity to explain what contributed to the increased income of beneficiaries and document the analysis.*

[5] As the data was provided after fieldwork, the OIG did not audit $1,300,000, $800,000, and $2,100,000.

MCA-H Lacked Adequate Funding for the Transportation Project

The compact between MCC and the Government of Honduras (GOH) budgeted $125.7 million for components in the Transportation Project, $97.9 of which was for the enhancement of the CA-5 highway. However, MCA-H has experienced a budget shortfall and determined that it needs an additional $130 million to complete upgrades to the CA-5 highway, particularly the construction of the South Segment of the highway. According to MCC officials, the budget shortfall occurred because of increased petroleum and construction material costs, devaluation of the U.S. dollar, and changes to the design of the CA-5 highway. As the result of the budget shortfall, the GOH, among other things, acquired a loan from the Central American Bank of Economic Integration, which will cause the GOH to incur expenses not originally budgeted with the compact. Furthermore, the budget shortfall has caused the MCC to decrease the economic rate of return of the Transportation Project from 25 percent to 11.9 percent.

The compact between MCC and the Government of Honduras budgeted $125.7 million for components within the Transportation Project—construction of the CA-5 highway, rehabilitation of secondary roads, and a weight control system. However, during project implementation in 2007, MCA-H and MCC determined that this level of funding might prove insufficient to complete the Transportation Project and that it needed another $130 million.

According to MCC officials there were several reasons for funding shortfall on the Transportation Project. First, construction costs increased because of the increase in the costs of petroleum, steel, and other construction materials. Management stated that it recognized a possible funding shortfall in October 2007, as it prepared the bidding documents for the highway construction. This potential for the shortfall became more evident in February 2008 when MCA began to receive bids for the construction of the north segment of the CA-5 highway. According to MCC, the bid costs were 50 percent higher than the amount estimated in the compact. Second, MCA-H proposed several changes to the design of the CA-5 highway, which also increased costs by $32.1 million (32 percent more than the original $97.9 million) and delayed the project. Some of those changes included the addition of the fourth lane, inclusion of a traffic interchange, and realignment to reduce resettlement impacts on individuals and communities. Third, the value of the U.S. dollar declined, contributing to the increased cost of construction materials. A report submitted by the MCC mission office in Honduras to MCC noted the cost of materials and the expansion of the CA-5 highway as factors that may result in budget shortfalls.

As the result of the funding challenges, MCC and MCA-H have made several changes to the project. First, because the money allocated in the compact could not fund the additional fourth lane, the Honduran government secured a loan from the Central American Bank of Economic Integration (CABEI) to cofinance the construction of section 2 in the south segment, where MCA-H will include a fourth lane. The Government of Honduras received an additional $130 million in loans from CABEI, beyond the $97.9 million provided in the compact for the CA-5 highway, to fund the increased costs of building the highway. Second, according to an MCC official, the additional funding from CABEI has enabled MCA-H to continue building the planned number of secondary roads, which would have otherwise been reduced. Before the loan, MCC and MCA-H had planned to reduce construction of the secondary roads from seven to three roads. Nevertheless, because the Honduran government has acquired a loan from CABEI, it has incurred a debt of $130 million to construct a part of the CA-5 highway that was not initially budgeted as an MCC grant. Furthermore, because part of the funding would come from CABEI, the upgrade of the CA-5 highway could not be attributed to MCC alone and reduces its attribution to this portion of the project.

> *Recommendation No. 3*: *We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, develop a strategy to resolve budget shortfalls when they occur.*

MCA-Honduras Needs to Perform and Document Variance Analyses

Summary: MCC's *Guidelines for Monitoring and Evaluation Plans* provide that significant deviations from targets be explained in Quarterly Progress Reports as a means of disseminating results to stakeholders. However, MCA-H did not complete or document variance analyses of targets in its Quarterly Progress Reports to stakeholders. For example, a Quarterly Progress Report stated that for the indicator "number of business plans prepared by Program Farmers with assistance of T.A. provider," 289 business plans had been prepared as of May 2007. However, the M&E Plan reflected a target of 960 business plans to be completed. Stakeholders could not assess the deviation between the target (960 business plans) and actual performance (289 business plans), because the Quarterly Progress Report did not report the cause of the deviations or any actions taken or planned to address them. MCC stated that the guidelines are not applicable to the existing M&E Plan. It is necessary to understand the reasons targets are missed to help ensure that ongoing projects are progressing as planned and are contributing to the compact's goals. Without the variance analyses, stakeholders lack explanations for the deviations and their impact on the projects in Honduras.

The Millennium Challenge Corporation issued *Guidelines for Monitoring and Evaluation Plans*, November 2006, to the Millennium Challenge Accounts to help eligible countries prepare their M&E Plans. The guidelines explain each part of the plan, including specific reporting requirements for the Quarterly Progress Report (QPR), a public report on program and project progress by the MCA.

The *Guidelines for Monitoring and Evaluation Plans* state that—

> Performance monitoring helps track progress toward Compact goals and objectives, and to serve as a management tool....Over the life of the Compact, the M&E Plan should help identify when problems are encountered or when there will need to be adjustments made in implementation.

Regarding reporting, the guidelines state that—

> The Progress Report includes information on both M&E management issues and program results, including implementation issues such as setting up necessary databases, hiring of M&E staff, as well as key program results and milestones. The Indicator Tracking Table reports results against projected targets, explaining significant deviations from the targets.

Furthermore, the guidelines state that the MCA M&E staff will play an important role regarding outreach related to the compact and that information should be disseminated explaining indicators, targets, and results.

MCC maintains that because the MCA-H September 2006 M&E Plan preceded the guidelines, they are not applicable, but that MCA-H will be required to follow the guidelines when revising its M&E Plan. While it would be unreasonable to require compliance with the guidelines for preparing the 2006 MCA-H M&E Plan after the fact; MCA-H should have complied with the guidelines' quarterly reporting requirements from November 2006 onward.

Nevertheless, MCA-H did not conduct analyses comparing M&E Plan targets with actual activity or report the results of the analyses in the QPR, which summarizes the progress in project implementation and main monitoring and evaluation activities. MCC and MCA-H explained that projects are monitored continuously by the task managers through work plans, implementation partner reports, regular meetings between MCC-H and MCA-H, and internal MCC reports.

The QPR reported project activity information from its implementing partners, but MCA-H did not compare the activity to specific targets for the period stated in the M&E Plan in Annex A: Indicator Follow-up Chart. The information presented in the Indicator Follow-up Chart typically consisted of the indicators from the M&E Plan, along with the activity for that period. For example, for the indicator "*# of business plans prepared by Program Farmers with assistance of T.A. provider*," the chart showed 289 business plans as of May 2007. However, in the M&E Plan, 960 business plans were to be completed. Stakeholders could not assess the deviation between the target (960 business plans) and actual performance (289 business plans). Further, the QPR did not report the cause of the deviations or any actions taken or planned to address them.

MCC-H cited a number of reasons why variance analyses of the indicators were not conducted. MCC-H stated that MCA-H was not required to follow the *MCC Guidelines for Monitoring and Evaluation Plans*, as the guidelines were not issued under an Implementation Letter.[6] Also, MCC-H stated that it does not use M&E Plan indicators as a management tool to monitor project activity. The task managers, who were responsible for the projects' progress and completion, used the established workplan to manage the projects. With regard to the MCA-H monitoring and evaluation function, MCC-H stated that more emphasis is placed on evaluation than monitoring.[7] Finally,

[6] MCC counsel explained that although an Implementation Letter is one method of ensuring that MCC guidance is followed, it is not always necessary to issue one for all guidance. Further, MCC has approval authority over key documents such as the Monitoring and Evaluation Plan and may reject changes to the plan that do not conform to the guidelines.

[7] The *MCC Guidelines for Monitoring and Evaluation Plans* define monitoring as "A continuing function that uses systematic collection of data on specified indicators to provide the main stakeholders of an ongoing development intervention with information on the progress and

MCC-H stated that an analysis of the variances in the QPR would require additional M&E staff time that was not available.

However, by not determining and reporting why the original M&E Plan targets are not being met, the M&E function is not discharging its responsibility of monitoring the projects and project implementation to help ensure that ongoing projects are progressing as planned and are contributing to the compact's goals. Nor is, M&E providing stakeholders with adequate information in the QPR on project targets and any variances.

Recommendation No. 4: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, clarify MCC's expectations on roles and responsibilities of the MCA Monitoring and Evaluation function, specifically on the use of monitoring as a management tool.

Recommendation No. 5: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, issue guidance by December 31, 2008 on reporting requirements for performance deviations from the targets established in its Monitoring and Evaluation Plans.

Did the Millennium Challenge Corporation's reporting on the program in Honduras provide stakeholders with complete and accurate information on the progress of the program and the results achieved?

For the items tested, MCC provided complete and accurate reporting of its program in Honduras to its stakeholders (Congress, Office of Management and Budget, nongovernmental organizations, and the public), with the exception of the target variance analysis in the Quarterly Progress Reports discussed previously. The Office of Inspector General (OIG) reviewed several reports that MCC provided to Congress and the public that discussed MCC's budget, spending, and compact implementation. Although there were some discrepancies of data reported in two quarters of the *Federal Registrar*, MCC has since taken steps to correct the errors and implemented a different method to prevent future inaccuracies. For example, MCC began to perform its financial reporting internally in the second half of FY 2007; previously, financial reporting had been outsourced to the National Business Center. MCC has now automated its financial reporting process by using Oracle.

In a judgmentally selected sample of the data that MCA-H used to report its implementation status, the OIG did not find any discrepancies in MCA-H's supplemental documents. In addition, further testing of the data submitted by one of its contractors, FINTRAC, showed very few errors. The OIG tested 5 percent of the reported 1,021 program farmers and found discrepancies in 6 percent of the tested population, which was within the materiality threshold of 10 percent.

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achievement of objectives as well as the use of allocated funds." The guidelines define evaluation as "the use of social research methods to study, appraise, and help improve social programs in all their important aspects, including diagnosis of problems, conceptualization and design of programs, implementation, administration, and effectiveness and efficiency outcomes."

EVALUATION OF MANAGEMENT COMMENTS

The MCC provided written comments to our draft report that are included in their entirety in Appendix II. In its response, MCC agreed with the recommendations in the draft report. In addition, MCC included a second section to its comments where it provided additional comments, clarifications and corrections to the draft report.

For Section 1, MCC provided the following comments:

In response to recommendation No. 1, MCC agreed with the recommendation and mentioned that MCC and MCA-Honduras have already addressed the issue in the revised M&E Plan, which they expect to approve by the end of calendar year 2008. In the revised M&E Plan, MCC revised the program description and program logic section to clearly communicate the flow of funds from MCA-Honduras to the trust fund that BAMER manages; MCC has revised the relevant indicators and definitions for the Access to Credit activity; and has removed the previous references to MCA-Honduras in the indicator table.

In Recommendation No. 2, MCC agreed with the recommendation and explained that it has already begun analysis of the Rural Development Project. It explained that it will continue to analyze all of the data for the Farmer Training and Development Activity (FTDA) in 2009. In addition, MCC has finalized key questions for the mid-term review, which will cover several topics related to FTDA program to date. However, MCC did not provide the information requested in the recommendation—explain what contributed to the increased income of beneficiaries and document the analysis. As the result, the OIG considers that a management decision has not been reached on this recommendation.

For Recommendation No. 3, MCC agreed with the recommendation and stated that it already maintains a strategy to periodically review and update project cost estimates, initiating project restructuring or funding reallocations when necessary, based on those reviews, and agreeing with the host government on a revised plan to implement decisions. MCC explained that it established the CA-5 restructuring plan in January 2008 because the bids it received from construction firms were higher than initially forecasted, and cited that the reasons behind the budget shortfall were due to US dollar devaluation, higher than expected bid costs, increase in initial estimated costs after further project development from pre-feasibility to design, and increase in oil prices.

For Recommendation No. 4, MCC agreed with the recommendation and is already in the process of implementing the recommendation by revising the Monitoring and Evaluation Plan Guidelines. The revised guidelines will provide further clarification about the M&E function and MCC's expectations. In addition, MCC launched an initiative to ensure that compact countries include the appropriate Output/Activity and Process Milestone indicators were included in every M&E Plan as a way to stress the importance of monitoring as a management tool. MCC issued the guidance to all country teams to implement the process, which should be completed by summer 2008. MCC stated that it has included various output and process measures in the revised M&E Plan for MCA-Honduras.

For Recommendation No. 5, MCC agreed with the recommendation, stating that it has already issued this guidance independently in March 2008 by updating its Quarterly Disbursement Request Package guidance, which also includes the Indicator Tracking Table (ITT). The guidance explains requirements and expectations for all of the reporting mechanisms provided to MCC, including the ITT. Specifically, the guidance provides instructions for reporting on M&E Plan indicators and requires that the percent deviation between the actual reported and the target for each indicator be calculated. Furthermore, guidance for the accompanying Narrative report requires a section which "should include a 2-3 sentence written explanation for any significant variations (10%) from the agreed targets contained in that Indicator Tracking Table." MCC stated that it expects to update the ITT guidance further in early 2009.

Based upon MCC's written comments, the OIG considers that a Management Decision has been reached on Recommendations 1, 3, 4 and 5. At the time that MCC provides a response to recommendation number 2—explaining what contributed to the increased income of beneficiaries as a result of the Rural Development project--a final management decision can then be made.

For Section 2, MCC provided the following comments:

For number 1 of this section, MCC stated that the following statement is not correct in several aspects.

"… Furthermore, the economic rate of return[8] for the Transportation project has decreased from 25 percent to 11.9 percent, according to the recent draft of MCA-H's M&E Plan. Since ERRs measure the impact on poverty reduction when the targeted beneficiaries of the project are poor, a reduction in the percentage reduces the number of beneficiaries which will be impacted by the project." (Draft Report, Page 11)

MCC stated that the ERR in Honduras decreased because the costs to construct the CA-5 Highway increased, but the estimated benefit to the beneficiaries did not. The OIG agrees with this statement and will restate the paragraph. However, the OIG believes that because additional funding was required from CABEI, the impact of the highway upgrade cannot be attributed to MCC alone.

Regarding MCC's comments on number 2 of this section,
"…MCC-H cited a number of reasons why variance analyses of the indicators were not conducted. MCC-H stated that MCA-H is not required to follow the MCC Guidelines for Monitoring and Evaluation Plans, as the guidelines were not issued under an Implementation Letter.[9] Also, MCC-H stated that it does not use M&E

[8] The economic rate of return (ERR) is a cost benefit analysis of a project-- in this case—the CA-5 highway, that MCC uses to justify funding. The ERR measures increase in incomes and the impact on poverty reduction. ***(IG – Draft Report on Honduras performance audit.)***

[9] MCC counsel explained that although an Implementation Letter is one method of ensuring that MCC guidance is followed, it is not always necessary to issue one for all guidance. Further, MCC

Plan indicators as a management tool to monitor project activity, as the task managers are responsible for the projects' progress and completion. With regard to the MCA-H monitoring and evaluation function, MCC-H stated that more emphasis is placed on evaluation than monitoring.[10] Finally, MCC-H stated that an analysis of the variances in the QPR would require additional M&E staff time that was not available…. However, by not determining and reporting why the M&E Plan targets are not being met, the M&E function is not discharging its responsibility of monitoring the projects and project implementation to help ensure that ongoing projects are progressing as planned and are contributing to the compact's goals. Nor is, M&E providing stakeholders with adequate information in the QPR on project targets and any variances."

MCC stated that the statement did not accurately portray MCC's response on the issue. MCC stated that it made a legal determination that it did not need an implementation letter in order to ensure compliance with the new guidelines. In addition, MCC stated that the M&E Plan predated the M&E Guidelines and thus the Guidelines should not have been used during the audit. It is for this reason that MCC and MCA-H are updating the MCA-H M&E Plan. Furthermore, MCC stated that monitoring occurred initially by using the workplans of individual activities, which also explains why the original MCA-H M&E Plan may have focused more on evaluation. Finally, MCC also stressed that it did not mention a lack of staffing as the reason variance analysis did not take place.

OIG will not rephrase the above mentioned section because the statements are based from meetings with MCC officials.

For number 3 of this section, regarding MCC's comments that it provided several corrections and clarifications to the finding "MCA-H Lacked Adequate Funding for the Transportation Project," the OIG will make the applicable changes.

Regarding MCC's comments on number 4 of this section, which explained that the Agricultural Public Goods Grant activity and the Access to Credit activity were under implementation for months; the OIG will rephrase that statement in the report.

For number 5 of this section, where MCC mentioned that construction of the road began in September 2008, the OIG will not rephrase its statement because construction of the road did not begin during time of the audit.

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has approval authority over key documents such as the Monitoring and Evaluation Plan and may reject changes to the plan that do not conform to the guidelines. ***(IG – Draft Report on Honduras performance audit)***

[10] The *MCC Guidelines for Monitoring and Evaluation Plans* define monitoring as "A continuing function that uses systematic collection of data on specified indicators to provide the main stakeholders of an ongoing development intervention with information on the progress and achievement of objectives as well as the use of allocated funds." The guidelines define evaluation as "the use of social research methods to study, appraise, and help improve social programs in all their important aspects, including diagnosis of problems, conceptualization and design of programs, implementation, administration, and effectiveness and efficiency outcomes." ***(IG – Draft Report on Honduras performance audit)***

SCOPE AND METHODOLOGY

Scope

The Office of Inspector General conducted this performance audit of the Millennium Challenge Corporation's (MCC) program in Honduras in accordance with generally accepted Government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective(s). We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective(s). The audit reviewed the milestones and targets from entry into force to the end of calendar year 2007. The $215 million compact entered into force on September 29, 2005. Through December 31, 2007, MCA-H had disbursed $13.7 million of the compact funds to Millennium Challenge Account-Honduras (MCA-H).

We conducted the audit at MCC headquarters in Washington, DC, and at MCA-H in Tegucigalpa, Honduras, during a site visit in April 2008. In addition, we visited farmer beneficiaries in a number of Honduran departments. We also met with implementing partners tasked with farmer training and with resettlement for the transportation project, grant recipients for the Agriculture Public Good Grants activity, and credit providers.

To reach our conclusions regarding MCA-H's two projects, we relied on interviews with MCC staff, MCA-H staff, and implementing partners. We used these interviews to help assess the program's work plans, financial reports, Quarterly Progress Reports, Monitoring and Evaluation Plan (M&E Plan), and information shared with Congress and the public. We also examined supporting documentation for an implementing partner's reports and MCA-H Quarterly Progress Reports.

We examined the internal control environment by identifying and assessing the relevant controls. We tested for various controls, including supporting documentation, verification procedures, and guidance. In addition, we reviewed prior audit reports regarding MCC's program in Honduras and considered relevant findings.

Methodology

To answer the three audit objectives, audit steps were established to determine the following:

- Whether MCA-Honduras had established plans and milestones to monitor and implement the compact's projects;
- Whether the program was on schedule according to the established plan and milestones; and
- Whether data reported by MCC, MCA-Honduras, and the implementing partners to Congress and the public reflected the program's progress.

Specifically, we performed the following activities:

- Interviewed MCC personnel, MCA-H staff, and implementing partners to gain an understanding of the overall objectives of the program and its challenges.

- Conducted a detailed examination of supporting documentation for the two projects to verify that intended results were being achieved. The examination consisted of reviewing relevant documentation, conducting interviews, and making site visits.

- Interviewed beneficiaries to determine how MCC-funded programs had affected their lives.

- Determined the potential impact of achieving or not achieving selected milestones and targets.

MANAGEMENT COMMENTS

MILLENNIUM
CHALLENGE CORPORATION
UNITED STATES OF AMERICA

DATE: November 10, 2008

TO: **Alvin Brown, Assistant Inspector General**

FROM: **Dennis Nolan, Acting Deputy Vice President /s/**
Department of Administration & Finance

SUBJECT: Response to the Draft Report on the Audit of the Millennium Challenge Corporation Programs in Honduras

This memorandum serves as MCC's management response to the *Draft Report on the Audit of the Millennium Challenge Corporation Programs in Honduras.* We also consider this response to be the management decision for the recommendations in the draft audit.

MCC appreciates the opportunity to comment on this draft audit of our Honduras programs. Section 1 provides MCC's responses to the five recommendations contained in the report. Section 2 provides additional comments, clarifications, and corrections on the report as a whole. Please note that the source of each footnote is documented in parentheses at the end of each footnote.

Section 1 – MCC's Responses to the Recommendations

Recommendation No. 1: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, revise the two indicators—percentage of MCA-Honduras loan portfolio at risk and funds lent from MCA-Honduras to financial institutions—to reflect MCC's and MCA-H's revision of the Farmers Access to Credit activity.

MCC agrees, and MCC and MCA-Honduras have already addressed this issue in the revised M&E Plan, which is expected to be approved by the MCA-Honduras Supervisory Board and MCC by the end of calendar year 2008. Specifically, in the revised M&E Plan, the following changes were made: i) the program description and program logic sections were revised to more clearly communicate the flow of funds from MCA-Honduras to the trust fund managed by BAMER and then to the financial intermediaries; ii) the relevant indicators and definitions for the Access to Credit activity, including those named by the OIG, have been revised so that it is clear that the funds are administered by the financial intermediaries, which received them from BAMER; and iii) the previous references to MCA-Honduras in the indicator table have been removed.

Recommendation No. 2: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, analyze the Rural Development Project, Farmer Training and Development Activity to explain what contributed to the increased income of beneficiaries and document the analysis.

Having already begun this analysis, MCC agrees with the recommendation. MCC will continue our analysis. Furthermore, all of the data for the Farmer Training and Development Activity (FTDA) will continue to be analyzed in more detail in 2009 through the following: i) a data quality audit to fully examine the actuals at all indicator levels reported against the M&E Plan so far; and ii) a mid-term review of the activity, conducted by the impact evaluator already under contract with MCA-H. Data quality audits are required for all countries, per the M&E Plan Guidelines. MCC will ensure that one takes place in Honduras, with appropriate breadth and depth, in Calendar Year 2009. The mid-term review's key questions have been finalized and agreed in a scope document for the impact evaluator, and will cover many topics related to the performance of the FTDA program to date, including: i) analysis of the progress to date against the M&E indicators, particularly those related to income, production, and number of hectares; ii) comparative analysis of the results achieved so far against the baseline data collected for the activity, as well as any exogenous factors that may be influencing results that should be accounted for; and iii) whether the project is on track to meet the end-of-Compact targets, and the reasons why the project is or is not on track. MCC would also like to note that at this time, MCC's and MCA-H's program monitoring, both against the M&E Plan, and against work plans and other management tools, does not indicate that the end-of-Compact targets are in jeopardy.

Recommendation No. 3: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, develop a strategy to resolve budget shortfalls when they occur.

MCC agrees and already maintains a strategy for periodically reviewing and updating project cost estimates, initiating project restructuring or funding reallocations as may be necessary based on those reviews, and agreeing with the host government on a revised plan to implement decisions. The CA-5 restructuring plan was established in January 2008 based on bids received for construction of the North Segment of CA-5 that were higher than initially forecasted. Budget shortfalls occur for a variety of reasons. Among the most prominent reasons for budget shortfalls in FY08 were: 1) USD devaluation; 2) worldwide construction boom and higher than expected bid costs; 3) increases in initial estimated costs after further project development from pre-feasibility to feasibility to design; and 4) higher oil prices. Based on the reality of such macroeconomic impacts, MCC conducts reviews on a country-by-country basis as described above.

Recommendation No. 4: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, clarify MCC's expectations on roles and responsibilities of the MCA Monitoring and Evaluation function, specifically on the use of monitoring as a management tool.

MCC agrees and is already in the process of implementing this recommendation through the following efforts: i) a revision of the Monitoring and Evaluation Plan Guidelines is underway, to provide further clarity about the M&E function and the expectations associated with it; and ii) in March 2008, MCC launched an initiative to ensure that appropriate Output/Activity and Process Milestone indicators were part of every M&E Plan, as a way to emphasize the importance of monitoring as a management tool. MCC issued guidance to all country teams to undertake this process and to complete it by summer 2008. The guidance provided to MCC staff states:

"…M&E leads on each IST will *facilitate* a process to identify and select, in consultation with the MCA M&E and project directors and MCC sector leads, key process milestones that will be part of the M&E Plans[11]. Examples of such milestones include key studies completed, construction designs finalized, tender for works issued, policy actions taken, all of which are important drivers of future, higher level results. For countries that do not yet have an M&E Plan in place the M&E Plan development process will emphasize not only outcome and output indicators but process milestones as well."

Furthermore, follow-up on reporting through M&E mechanisms against output and process milestone measurements will continue in 2009. Regarding Honduras, specifically, various output and process measures have been added to the revised M&E Plan, to ensure that the M&E framework is used as a management tool.

Recommendation No. 5: We recommend that the Millennium Challenge Corporation's vice president, Department of Compact Implementation, issue guidance by December 31, 2008 on reporting requirements for performance deviations from the targets established in its Monitoring and Evaluation Plans.

Having already issued such guidance independently, MCC agrees with the recommendation. In March 2008, MCC updated its Quarterly Disbursement Request Package guidance, which covers the requirements and expectations for all of the reporting mechanisms provided to MCC as part of the quarterly Disbursement Requests, including the Indicator Tracking Table (ITT, Annex 5 of the package), which is the venue for reporting against the M&E Plan. The ITT template document (http://www.mcc.gov/documents/mcc-guidance-template-dr-annex05-itt.xls) in the package, which provides the instructions for reporting on M&E Plan indicators, requires that the percent deviation between the actual reported and the target for each indicator be calculated. Then, the guidance for the accompanying Narrative Report (Annex 1 of the package, http://www.mcc.gov/documents/mcc-guidance-narrativereport.pdf) requires a section which "should include a 2-3 sentence written explanation for any

[11] If necessary additional output measures will also be added. This will be determined on a case by case basis depending on the composition of indicators contained in each M&E Plan. ***(MCC, Activity Monitoring guidance document.)***

significant variations (10%) from agreed targets contained in that table [the ITT]." MCC expects to update the ITT guidance further in early 2009, and this updated version will again reiterate, even more clearly, that deviations of more than 10% require an accompanying explanation. Furthermore, the management information system that MCC is developing for deployment in 2009 is expected to contain a function that flags all deviations of more than 10% and prompts MCAs for a narrative explanation of the deviation when they are inputting their data.

Section 2 – Additional Comments, Clarifications, and Corrections

The following are comments relate to specific statements or excerpts of the report which require clarification.

1. "… Furthermore, the economic rate of return[12] for the Transportation project has decreased from 25 percent to 11.9 percent, according to the recent draft of MCA-H's M&E Plan. Since ERRs measure the impact on poverty reduction when the targeted beneficiaries of the project are poor, a reduction in the percentage reduces the number of beneficiaries which will be impacted by the project." (Draft Report, Page 11)

This statement is not correct in several aspects. ERRs are the product of benefit-cost analyses that estimate how much a project will increase incomes in relation to costs. By itself, an ERR does not provide any information about the number of beneficiaries for a given project or about the total impact on poverty. According to MCC's Guidelines for Economic and Beneficiary Analysis of a Compact Proposal (http://www.mcc.gov/countrytools/compact/fy07guidance/english/28-guidelinesforeconandbeneanalysis.pdf), "The essence of such an analysis is a straightforward comparison of costs and benefits, where the costs are the MCA grants and the benefits are increases in incomes in recipient countries." In the case of Honduras, the ERR went down because the costs increased; the estimated benefits did not decrease. Consequently, it is incorrect to say that "a reduction in the percentage reduces the number of beneficiaries which will be impacted by the project." It is also incorrect to imply that the impact of this project on poverty has declined. In this case, the estimated number of beneficiaries remains the same, as does the impact on poverty; what has changed is the cost of achieving those benefits. In addition, while the new ERR is lower, it still surpasses the relevant minimum threshold of 3% established by MCC for Honduras at the time the Compact was developed and is above the hurdle rate relevant for new countries in 2008 of 11.5%. Thus, the new ERR indicates that, even at the higher prices, the road investment remains a cost-effective way to increase local incomes and reduce poverty.

2. *"…MCC-H cited a number of reasons why variance analyses of the indicators were not conducted. MCC-H stated that MCA-H is not required to follow the MCC Guidelines for Monitoring and Evaluation Plans, as the guidelines were not issued under an Implementation Letter.[13] Also, MCC-H stated that it does not use M&E*

[12] The economic rate of return (ERR) is a cost benefit analysis of a project-- in this case—the CA-5 highway, that MCC uses to justify funding. The ERR measures increase in incomes and the impact on poverty reduction. ***(IG – Draft Report on Honduras performance audit.)***

Plan indicators as a management tool to monitor project activity, as the task managers are responsible for the projects' progress and completion. With regard to the MCA-H monitoring and evaluation function, MCC-H stated that more emphasis is placed on evaluation than monitoring.[14] ***Finally, MCC-H stated that an analysis of the variances in the QPR would require additional M&E staff time that was not available…. However, by not determining and reporting why the M&E Plan targets are not being met, the M&E function is not discharging its responsibility of monitoring the projects and project implementation to help ensure that ongoing projects are progressing as planned and are contributing to the compact's goals. Nor is, M&E providing stakeholders with adequate information in the QPR on project targets and any variances."***

The above statements do not accurately portray MCC's response on those issues.

First, MCC must reiterate the clarification it provided to the OIG during the audit process regarding whether it was necessary to provide an Implementation Letter for the Guidelines for Monitoring and Evaluation Plans to take effect. As stated in the footnote on this issue in the draft report, an Implementation Letter is only one method of ensuring that MCC guidance is followed. Upon the issuance of the MCC Guidelines for Monitoring and Evaluation Plans, each M&E sector lead worked with the MCAs to determine a specific timeline for updating M&E Plans, both to comply with the new guidelines and to address any other changes as may have been necessary. As such, and because MCC retains broad approval rights over any revisions to the M&E Plans, a legal determination was made that an implementation letter was unnecessary in order to ensure compliance with the new guidelines.

Second, at the time the statement was made, MCA-H was not in breach of the guidelines for Monitoring and Evaluation Plans. The Guidelines were not a reasonable standard against which to audit MCA-Honduras as their original M&E Plan predated the issuance of the guidelines. As was discussed extensively during the audit process with the OIG, MCA-H and MCC both thought it important to update the MCA-H M&E Plan to bring it into compliance with the guidelines and have actively worked toward that end.

Third, while the M&E Plan, prior to revision, did not contain many output and process indicators to monitor early progress of activities, it was not the case that such monitoring did not occur. It did occur, and continues to occur, but initially MCA-Honduras used the workplans of individual activities as the primary tool for monitoring progress in early

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[13] MCC counsel explained that although an Implementation Letter is one method of ensuring that MCC guidance is followed, it is not always necessary to issue one for all guidance. Further, MCC has approval authority over key documents such as the Monitoring and Evaluation Plan and may reject changes to the plan that do not conform to the guidelines. ***(IG – Draft Report on Honduras performance audit)***

[14] The *MCC Guidelines for Monitoring and Evaluation Plans* define monitoring as "A continuing function that uses systematic collection of data on specified indicators to provide the main stakeholders of an ongoing development intervention with information on the progress and achievement of objectives as well as the use of allocated funds." The guidelines define evaluation as "the use of social research methods to study, appraise, and help improve social programs in all their important aspects, including diagnosis of problems, conceptualization and design of programs, implementation, administration, and effectiveness and efficiency outcomes." ***(IG – Draft Report on Honduras performance audit)***

stages. The use of workplans as a tool for project monitoring also explains why the original MCA-Honduras M&E Plan may have contained more of a focus on evaluation. But it should also be noted that even the original M&E Plan contained an extensive monitoring framework, which MCA-H has followed.

Finally, MCC maintains that it did not make any mention of a lack of staff time as the reason variance analysis did not take place.

3. There are several corrections and clarifications MCC would like to provide to the section, "MCA-H Lacked Adequate Funding for the Transportation Project," both to the box text and the main body of that section. Please see corrections to the text below, which have been inserted directly into the OIG's text, highlighted in gray.

The compact between MCC and the Government of Honduras (GOH) budgeted $125.7 million for components in the Transportation Project, $97.9 of which was for the enhancement of the CA-5 highway. However, MCA-H has experienced a budget shortfall and determined that it needs an additional $130 million to complete the upgrades to the CA-5 highway, particularly on the South Segment. According to MCC officials, the budget shortfall occurred because of increased petroleum and construction material costs, changes to the CA-5 highway design, and increased resettlement costs. The GOH is in the process of securing a loan from the Central American Bank of Economic Integration in order to cover the shortfall and the additional enhancements it is seeking for the highway. Furthermore, the increased costs have caused the MCC to decrease the economic rate of return of the Transportation Project from 25 percent to 11.9 percent.

The compact between MCC and the Government of Honduras budgeted $125.7 million for components within the Transportation Project—construction of the CA-5 highway, rehabilitation of secondary roads, and a weight control system. However, during project implementation in 2007, MCA-H and MCC determined that this level of funding might prove insufficient to complete the Transportation Project.

According to MCC officials there were several reasons for the funding shortfall on the Transportation Project. First, construction costs increased because of the increase in the costs of petroleum, steel, and other construction materials. Management stated that it recognized a possible funding shortfall in October 2007, as it prepared the bidding documents for the highway construction. This potential for the shortfall became more evident in February 2008 when MCA began to receive bids for the construction of the North Segment of the CA-5 highway. According to MCC, these bid costs were 50 percent higher than the amount estimated in the compact. Second, MCA-H proposed several changes to the design of the CA-5 highway, which also increased costs by $32.1 million (32 percent more than the original $97.9 million) and delayed the project. Some of the changes included the design of a fourth lane to one of the sections, the inclusion of a traffic interchange, and realignments to reduce resettlement impacts on individuals and communities along the highway (some of which had changed since the project had been designed). Third, the value of the U.S. dollar declined, contributing to the increased cost of construction materials. A report submitted by the MCC mission office in Honduras to MCC noted the cost of materials and the

expansion of the CA-5 highway as factors that may result in budget shortfalls.

As a result of the funding challenges, the Government of Honduras acted to leverage the MCC grant funding and requested a $130 million loan from the Central American Bank for Economic Integration (CABEI). The leveraging of the MCC grant funding allowed the Government of Honduras to apply for the loan on a concessional basis, thus keeping its commitment to other international financial institutions, namely the International Monetary Fund. The loan would make available $130 million in addition to the $97.9 million provided in the compact for the improvement of the highway. Second, according to an MCC official, the additional funding from CABEI would enable MCA-H to build the three secondary roads and numerous rural roads that have been planned. Without the CABEI loan, the number of these secondary and rural roads would possibly have been reduced to cover the costs on the CA-5 highway.

4. "MCC worked with MCA-H to develop its revised Monitoring and Evaluation (M&E) Plan and is currently working with the MCA to revise the M&E Plan to include new indicators for projects that they will begin to implement, such as the Public Goods Grant Activity of the Rural Development Project."

MCC notes that the Agricultural Public Goods Grant activity and the Access to Credit activity have both been under implementation for months; it is not correct to say that implementation is about to begin.

5. "Although MCA-H has completed many of the preparations for the highway's upgrade, such as road redesign and resettlement of many citizens in the highway's path, due to delays and budget shortfalls, construction of the road has not started."

MCC notes that construction on the road began in September 2008.

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