OFFICE OF INSPECTOR GENERAL

For the Millennium Challenge Corporation

SURVEY OF THE MILLENNIUM CHALLENGE CORPORATION'S OVERSIGHT OF VALUE ADDED TAXES DUE FROM COMPACT COUNTRIES

AUDIT REPORT NO. M-000-10-003-S
September 28, 2010

WASHINGTON, DC

Office of Inspector General
for the Millennium Challenge Corporation

September 28, 2010

Victoria B. Wassmer
Vice President
Department of Administration and Finance
Millennium Challenge Corporation
875 Fifteenth Street, N.W.
Washington, DC 20005-2221

Dear Ms. Wassmer:

This letter transmits the Office of the Inspector General's final report on the Survey of the Millennium Challenge Corporation's Oversight of Value Added Taxes Due from Compact Countries. In finalizing the report, we considered your written comments to our draft report and included those comments in their entirety in Appendix I of this report.

The report contains four recommendations to strengthen MCC's oversight of value added taxes due from compact countries. We consider that management decisions have been reached for Recommendations No. 1, 3 and 4 but final action will not be reached until MCC provides further documentation to support its statements. Although MCC agrees with Recommendation No. 2, no management decision has been reached.

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

Sincerely,

Alvin A. Brown /s/
Assistant Inspector General/MCC

Attachment:

Millennium Challenge Corporation
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Suite 770
Washington, DC 20005
www.usaid.gov/oig

Survey of the Millennium Challenge Corporation's Oversight of Value-Added Taxes Due from Compact Countries

Background

According to the Compacts, all Millennium Challenge Corporation (MCC) funds are exempt from taxation by host governments. If the government of the host country collects the taxes for any reason, MCC must seek reimbursement of such taxes and require the government to refund the collected amounts within 30 days. MCC includes "no taxation" clauses in all bilateral assistance agreements with host countries.

All recipient countries that have signed bilateral assistance agreement with MCC have value-added tax (VAT) systems. In some countries, MCC has established supplemental tax agreements to cover country-specific taxes, including corporate and income taxes. Although bilateral framework agreements are an important tool for establishing the tax-exempt status of U.S. Government assistance, many Millennium Challenge Accounts (MCAs) are required to pay VAT and file for reimbursement with the host government. The practice of first paying VAT and then periodically requesting reimbursement raises the risk of unreimbursed VAT payments.

As of fiscal year (FY) 2009, MCC had obligated an estimated $6.5 billion and disbursed $1 billion in Compact and 609(g) funds to 20 countries. The VAT rates in Compact countries range from 12.5 percent to 25 percent. Depending on the country, the loss in unreimbursed VAT payments could be millions of dollars annually.

To deal with tax exemption of assistance funds, MCC issued a "Policy on Tax Exemption of MCC Assistance" in 2009. The policy states that all MCC assistance shall be exempt from taxation by the recipient governments. To implement the exemption of assistance funds and deal with VAT, a country may employ one or more of the following mechanisms outlined in the MCC policy document:

1. The host government issues an "exemption certificate" that allows the holder to be exempt from VAT.
2. The recipient country government will provide its national funds for payment of VAT.
3. The host government will collect VAT and reimburse it on request.

The survey focused on the prevailing practices of MCC and MCAs in relation to the objective below, and also examined MCC's ability to collect and centrally maintain VAT payment and collection data.

Survey Objective

The objective of this survey was to determine whether MCC has a process in place to follow up and collect VAT from foreign governments that receive MCC funds.

Survey Findings

MCC did not have (1) an adequate oversight process in place to follow up on VAT payments and reimbursements or (2) adequate standard procedures to account for VAT transactions.

More information on the results of the survey is described below.

MCC Did Not Have Adequate Oversight of VAT Process

According to Office of Management and Budget and Government Accountability Office guidance, an internal control is an integral component of an organization's management that provides reasonable assurance that the agency is achieving effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. MCC has a fiduciary responsibility to ensure that its funds are spent appropriately and that it has financial controls in place to improve its oversight of MCAs.[1]

However, the survey found that MCC (1) did not have a process in place to monitor VAT payments and collections; (2) could not determine the total amount of VAT reimbursements that were owed to MCAs; and (3) did not issue formal guidance to MCAs to record, track, and report VAT transactions in their Fiscal Accountability Statements.

> ***Recommendation No. 1: We recommend that the Millennium Challenge Corporation develop and implement a centralized system to monitor value-added tax and incorporate it into its policies and procedures.***
>
> ***Recommendation No. 2: We recommend that the Millennium Challenge Corporation establish a system for collecting value-added tax data on payments, reimbursements, and outstanding balances.***

MCC Did Not Have a Mechanism to Identify Balances Due From Host Governments

The statute establishing MCC requires that each Compact include a plan to ensure fiscal accountability for the use of Compact funds to accomplish Compact objectives.[2] The "Policy on Tax Exemption of MCC Assistance"[3] provided Compact countries with the following three options for VAT collection and reimbursements.

1. **Exemption Certificate:** The host government issues a certificate allowing the Accountable Entity to be exempt from VAT.

According to MCC:

- Fifteen compact countries use the exemption certificate mechanism.
- Of these 15 countries, VAT balances are due only from Morocco.

According to the information obtained from MCA auditors:

- MCA Cape Verde, MCA Ghana, MCA Lesotho, and MCA Mongolia had VAT balances due to them from their host governments

[1] GAO/AIMD-00-21.31, *Standards for Internal Control in the Federal Government* (November 1999); OMB Circular A-127, *Financial Management Systems* (revised January 9, 2009).
[2] Title VI—Millennium Challenge Act of 2003, as amended, Sec. 609 (b) (1) (G).
[3] Millennium Challenge Corporation, "Policy on Tax Exemption of MCC Assistance," OGC-2009-1.1 (March 13, 2009).

2. **Government Account (Dual Invoicing Mechanism):** MCA pays for the cost of purchased goods or services using MCC assistance funds and a portion of taxes from the national funds of the host government.

According to MCC:

- MCA El Salvador and MCA Georgia use this mechanism.
- The mechanism operates smoothly.

The Office of Inspector General (OIG) raised the following concerns:

- VAT transactions are not part of MCA financial management system.
- What internal controls are built into the duel invoicing mechanism?
- What monitoring process is in place?

3. Program Reimbursement Mechanism: The government of a country may collect VAT imposed on MCC assistance and reimburse VAT to the accountable entity from its national funds.

According to MCC:

- MCA Namibia and MCA Vanuatu are the only two countries using this reimbursement mechanism.
- Namibia is current on its reimbursement and Vanuatu has a small balance.

According to the information obtained from MCA auditors, as of December 31, 2009:

- Namibia had an outstanding balance of $117,705.
- Vanuatu had a balance of $1,565.

Recommendation No. 3: We recommend that the Millennium Challenge Corporation revise guidance to Millennium Challenge Accounts to establish comprehensive policies and procedures related to Millennium Challenge Accounts' value-added tax transactions and establish internal controls in accordance with best practices.

MCAs Are Not Reporting VAT Transactions In Their Fund Accountability Statements

The Compact Agreements require Accountable Entities to maintain records of all transactions related to MCC funds provided to the country.

- OIG reviewed 58 Fund Accountability Statements and found that MCAs are not reporting VAT transactions in their Fund Accountability Statements.
- OIG did not find any MCC guidance to MCAs regarding how to record, track, and report VAT in Fund Accountability Statements.

Recommendation No. 4: We recommend that the Millennium Challenge Corporation issue appropriate guidance to Millennium Challenge Accounts to develop standard policies and procedures to require value-added tax recording, transaction tracking, and reporting in their Fund Accountability Statements.

Scope and Methodology

This survey took place in Washington, DC, from March 1 through April 15, 2010, and focused on MCC's ability to follow up on or collect VAT from foreign governments that received MCC funds. The audit team performed the following tasks to respond to the survey objective:

- Met with the Department of Compact Implementation and Administration & Finance officials,
- Reviewed MCC bilateral framework agreements with countries receiving Compact funds,
- Gained an understanding of overall MCC programs and operation in the context of the survey objective,
- Identified MCC's progress or lack of progress in dealing with VAT issues,
- Reviewed MCC's ongoing activities in relation to VAT issues in future compacts,
- Conducted telephone interviews with MCA auditors to gain an understanding of VAT-related processes in place at MCAs, and
- Attempted to identify the amount of taxes levied and reimbursed during FY 2009, but could not accomplish this task. The auditors of 10 countries provided partial information on VAT activity.

EVALUATION OF MANAGEMENT COMMENTS

MCC provided written comments to our draft survey report and the comments are included in their entirety in Appendix 1 of this report. In its response, MCC agreed with all four recommendations. However, in its concurrence MCC provided two comments on our findings and considered part of those findings as misleading.

MCC disagreed with the OIG's assertion that MCC could not determine the total amount of VAT reimbursement that was owed to MCAs. MCC contends that they were able to produce stated balances upon request at the time of the OIG's survey. In support of their contention they provided Exhibit 2 with their response indicating VAT balances by country as of April 30, 2010 which is different than what the survey team was provided at the time of survey. Additionally, information obtained by OIG from independent auditors reported different balances of outstanding VAT and reimbursements. During its survey OIG did not find any structured mechanism available to MCC to capture VAT data for payments, reimbursements, and balances.

MCC also stated that OIG's assertion that "MCAs are not reporting VAT transactions in their fund accountability statements" is misleading. MCC provided Exhibit 1 that included a list of fund accountability statements on which, it claimed, VAT was reported. However, our review of the same reports did not find, with the exception of Madagascar, VAT payments or reimbursements identified as a distinct and identifiable line item on the fund accountability statements. Independent auditors of these audit reports however, had identified VAT as questioned costs resulting in overstatement of expenses. Including questionable VAT payments in a report is not equivalent to showing VAT as a distinct and identifiable line item on the fund accountability statement.

MCC provided the following comments to the recommendations:

In response to Recommendation No. 1, MCC concurred with the recommendation but believed that its exposure to uncollected VAT was minimal as evidenced by their Exhibit 2, which listed outstanding VAT balances by country as of April 30, 2010. We have serious concern with the completeness and validity of this data. We consider that management decision has been reached, but final action will not be reached until MCC provides us with its enhanced policies and procedures for monitoring VAT effectively.

MCC agreed with Recommendation No. 2 and stated that information exists within the MCAs accounting system for monitoring VAT. Our survey did not reveal any such accounting system and we would like MCC to provide us further details of such accounting systems. Until further information is received from MCC we consider that management decision has not been reached. We however, would look forward to collaborating with MCC to revise audit guidelines for MCAs to record VAT payments, reimbursements, and balances.

In response to Recommendations Nos. 3 and 4 MCC concurred with the recommendations. MCC will inform MCAs of proposed changes in policies and procedures, revision of guidelines and fund accountability statement. We consider that management decision has been reached but final action will not be reached until MCC provides OIG with the final documentations of proposed actions.

MILLENNIUM
CHALLENGE CORPORATION
UNITED STATES OF AMERICA

DATE: September 8, 2010

TO: Alvin Brown, Assistant Inspector General
Millennium Challenge Corporation

FROM: Victoria B. Wassmer, Vice President
Millennium Challenge Corporation
Department of Administration and Finance

SUBJECT: Management Response on the Survey of the Millennium Challenge Corporation's Oversight of Value Added Taxes Due from Compact Countries, Report No. M-000-10-003-S.

This memo serves as MCC's Management Response to the four recommendations contained in the Survey of the Millennium Challenge Corporation's Oversight of Value Added Taxes Due from Compact Countries, Report No. M-000-10-003-S In addition, MCC hereby provides comments on Findings A and B.

<u>Inspector General Finding A</u>
<u>MCC Did Not Have Adequate Oversight of VAT Process</u>

I. Management Comments on Audit Findings

1. The audit survey found that MCC (1) did not have a process in place to monitor VAT payments and collections; (2) could not determine the total amount of VAT reimbursements that were owed to MCAs; and (3) did not issue formal guidance to MCAs to record, track, and report VAT transactions in their Fiscal Accountability Statements.

MCC believes the statement in the finding that MCC… "(2) could not determine the total amount of VAT reimbursements that were owed to MCAs" is misleading. MCC was able to produce stated balances upon request at the time of the Survey. Refer to the attached Exhibit 2 for the outstanding VAT as of April 30, 2010.

Inspector General Finding B
MCAs Are Not Reporting VAT Transactions in Their Fund Accountability Statements

2. The Compact Agreements require Accountable Entities to maintain records of all transactions related to MCC funds provided to the country.

- OIG reviewed 58 Fund Accountability Statements and found that MCAs are not reporting VAT transactions in their Fund Accountability Statements.
- OIG did not find any MCC guidance to MCAs regarding how to record, track, and report VAT in Fund Accountability Statements.

MCC believes the bullet point "OIG reviewed 58 Fund Accountability Statements and found that MCAs are not reporting VAT transactions in their Fund Accountability Statements" is misleading. This statement implies that VAT was not addressed in the Fund Accountability Statement audit reports. On the contrary, it was frequently addressed as shown in attached Exhibit 1.

II. Management Response to the Audit Recommendations

Recommendation No. 1: We recommend that the Millennium Challenge Corporation develop and implement a centralized system to monitor value-added tax and incorporate it into its policies and procedures.

MCC Management Response:
MCC concurs with the recommendation. Based on the outstanding balance on Exhibit 2 MCC believes that its exposure to uncollected VAT is minimal and that the corrective action plan detailed in our response to Recommendation No. 2 provides an appropriate vehicle to centrally monitor VAT. Although MCC's policies and procedures comply with best practices for monitoring VAT in the international donor community, MCC proposes a further enhancement to its policies and procedures for VAT monitoring by establishing an acceptable threshold ceiling amount for outstanding VAT as reflected on the MCA's audited Fund Accountability Statement (FAS). Should the VAT ceiling amount be exceeded, MCC will require that the MCA provide a corrective action plan to reduce the VAT to an acceptable level within a 60 day period. This revision to our monitoring system will be included in MCC's Fiscal Accountability Plan as adopted by the MCAs by October 29, 2010.

Recommendation No. 2: We recommend that the Millennium Challenge Corporation establish a system for collecting value-added tax data on payments, reimbursements, and outstanding balances.

MCC Management Response: MCC concurs with the recommendation. MCC believes that this information exists within the MCAs' accounting system for monitoring VAT. However in order to ensure consistency in format, MCC proposes, in conjunction with the OIG, the development of a revised format for the Fund Accountability Statement (and Audit Guidelines) that includes a standard note and schedule identifying all VAT activities (payments, reimbursements, and outstanding balances) for the reporting period on a cumulative basis.

This revision to the Fund Accountability Statement reporting will align MCC with donor best practices and enhance MCC's ability to provide oversight and monitoring of the various VAT processes in each country. The revision will also serve as a key internal control to ensure that MCC assistance is exempt from VAT required by the terms of the compacts. The target date for completion of the revisions to the FAS is November 30, 2010.

Recommendation No. 3: We recommend that the Millennium Challenge Corporation revise guidance to Millennium Challenge Accounts to establish comprehensive policies and procedures related to Millennium Challenge Accounts' value-added tax transactions and establish internal controls in accordance with best practices.

MCC Management Response: MCC concurs with the recommendation. MCC has in place the Fiscal Accountability Plan, as well as relevant tax agreements procedures and regulations promulgated by the government where appropriate relating to VAT transactions and establishing internal controls. To further inform MCAs of changes to these policies and procedures, MCC will send a guidance letter to the MCAs informing them of the upcoming revisions to the FAS, as detailed in our response to Recommendations No. 1, 2 and 4 as well as instructions for revising its policies and procedures regarding VAT transactions. The target date for completion is October 29, 2010.

Recommendation No. 4: We recommend that the Millennium Challenge Corporation issue appropriate guidance to Millennium Challenge Accounts to develop standard policies and procedures to require value-added tax recording, transaction tracking, and reporting in their Fund Accountability Statements.

MCC Management Response: MCC concurs with the recommendation. As stated in our response to Audit Recommendation 2, MCC's corrective action plan is to develop, in coordination with the OIG, a revised format for the Fund Accountability Statement (and Audit Guidelines) that includes a standard note and schedule identifying all value-added taxes (payments, reimbursements, and outstanding balances) for the reporting period and on a cumulative basis. As a result of this new format, MCAs will more accurately report VAT transactions within its FAS, and thus be required to modify their accounting systems (including its chart of accounts) to ensure the proper accumulation and reporting of VAT activities in its books and records. Per Recommendation 3, MCC will issue a guidance letter to the MCAs informing them of the upcoming revisions to the value-added tax recording, transaction tracking, and reporting in the Fund Accountability Statements. The target date for completion is October 29, 2010.

Exhibit 1
Sampling of Fund Accountability Statements on which VAT was reported

MCA Country	VAT Amount	Audit Period	Report Number	Report Date
Cape Verde	$1,687	10/17/05-6/30/06	M-000-07-002-N	1/11/07
Cape Verde	$3,000	7/1/06-12/31/06	M-000-08-008-N	4/25/08
Cape Verde	$1,300	1/1/07-6/30/07	M-000-08-015-N	7/28/08
Cape Verde	$1,310	7/1/07-12/31/07	M-000-09-009-N	12/23/08
Cape Verde	$3,549	1/1/08-6/30/08	M-000-09-016-N	5/12/09
Cape Verde	$980	7/1/08-12/31/08	M-000-10-003-N	11/23/09
Ghana	$3,581	1/1/08-6/30/08	M-000-09-002-N	10/29/08
Ghana	$3,829	7/1/08-12/31/08	M-000-09-023-N	9/10/09
Ghana	$6,328	1/1/09-6/30/09	M-000-10-010-N	3/31/10
Lesotho	$10,212	7/23/07-6/30/08	M-000-09-012-N	3/17/09
Lesotho	$22,310	7/1/08-12/31/08	M-000-09-017-N	6/23/09
Lesotho	$8,873	1/1/09-6/30/09	M-000-10-012-N	4/29/10
Madagascar	$355,840	7/21/05-6/30/06	M-000-07-001-N	12/21/06
Morocco	Internal Control	1/1/08-12/31/08	M-000-10-011-N	4/23/10
Vanuatu	Non-Compliance	1/1/09-6/30/09	M-000-10-006-N	3/1/10

Exhibit 2
Outstanding VAT Balances by Country as of April 30, 2010

Country	Balance
Armenia	$0
Benin	$0
Burkina	$0
Cape Verde	$4,010
El Salvador	$0
Georgia	$0
Ghana	$51,397
Honduras	$0
Lesotho	$765
Mali	$523
Mongolia	$0
Morocco	$25,028
Mozambique	$0
Namibia	$284,609
Nicaragua	$0
Tanzania	$11,259
Vanuatu	$2,527
TOTAL	**$ 380,118**
Average	**$ 22,360**

Note:

1. This chart also indicates that the average outstanding VAT balance was slightly over $22,000 for all countries. If Namibia (where a relatively high balance is expected) were excluded from the analysis, the average of the remaining countries reduces to approximately $6,000. MCC feels that this level, while important to note and monitor, is not a high risk.

2. Most MCAs have established robust systems utilizing tax-exemption certificates such that neither MCA nor its contractors pay VAT -the VAT balances are thus assessed at zero. In countries where analogous arrangements are not supported by host government legislative frameworks, MCA accounting systems are set up to monitor outstanding VAT balances and Fiscal Agents have established standard procedures for requesting and tracking reimbursements.

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