OFFICE OF INSPECTOR GENERAL

AUDIT OF THE MILLENNIUM CHALLENGE CORPORATION'S FINANCIAL STATEMENTS, INTERNAL CONTROLS, AND COMPLIANCE FOR THE FISCAL YEARS ENDING SEPTEMBER 30, 2014 AND 2013

AUDIT REPORT NO. M-000-15-001-C
NOVEMBER 14, 2014

WASHINGTON, DC

Financial information contained in this report may be privileged. The restrictions of 18 USC 1905 should be considered before any information is released to the public.

Office of Inspector General

November 14, 2014

Ms. Dana J. Hyde
Chief Executive Officer
Millennium Challenge Corporation
875 15th Street, NW
Washington, DC 20005-2203

Subject: Audit of the Millennium Challenge Corporation's Financial Statements, Internal Controls, and Compliance for the Fiscal Years Ending September 30, 2014 and 2013 (Report No. M-000-15-001-C)

Dear Ms. Hyde:

Enclosed is CliftonLarsonAllen LLP's, final report on the subject audit. The Office of Inspector General (OIG) contracted with the independent certified public accounting firm of CliftonLarsonAllen LLP, to audit the financial statements of the Millennium Challenge Corporation (MCC) for the fiscal years ending September 30, 2014 and 2013. The contract required that the audit be performed in accordance with U.S. generally accepted government auditing standards, Office of Management and Budget (OMB) Bulletin 14-02, *Audit Requirements for Federal Financial Statements*, and the GAO/PCIE Financial Audit Manual.

The independent auditor expressed an unmodified opinion on MCC's fiscal year (FY) 2014 financial statements. The report states that the financial statements referred to above present fairly, in all material respects, the net position of MCC as of September 30, 2014 and 2013, and its net cost, changes in net position and budgetary resources for the fiscal years then ended, in conformity with accounting principles generally accepted in the United States.

In MCC's FY 2014 financial statements, the auditor identified one issue that was considered a material weakness and one other issue that was considered a significant deficiency. These matters are listed below and are detailed in the auditor's report.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of an entity's financial statements will not be prevented or detected and corrected on a timely basis.

U.S. Agency for International Development
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The material weakness was:

- Ineffective and Inefficient Integration of Data, Processes and Controls within the Financial Management Systems (Modified Repeat Finding)

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The significant deficiency was:

- Validation Control Over Grant Accrual Estimates Needs to be Strengthened (Modified Repeat Finding)

The auditor did not identify any instance of material non-compliance with laws and regulations.

In carrying out its oversight responsibilities, OIG reviewed the audit report and audit documentation provided by CliftonLarsonAllen LLP. This review, is different from an audit in accordance with U.S. generally accepted government auditing standards and was not intended to enable OIG to express, and we do not express, opinions on MCC's financial statements, internal control, or compliance with laws, regulations, contracts or grant agreements. CliftonLarsonAllen LLP is responsible for the attached auditor's report, dated November 12, 2014, and the conclusions expressed in it. However, our review disclosed no instances in which CliftonLarsonAllen LLP did not comply, in all material respects, with applicable standards.

To address the material weakness and the significance deficiency in internal controls reported by CliftonLarsonAllen LLP, we are listing below the findings with six recommendations to MCC's management:

Material Weakness

Ineffective and Inefficient Integration of Data, Processes, and Controls within the Financial Management Systems (Modified Repeat Finding)

Regarding the core financial system, we recommend that MCC:

1. Perform a comprehensive review and determine whether the Shared Service Provider's (SSP) financial management system is meeting its financial management and reporting needs. As part of this review, management should continue to evaluate whether:

    a. a separate grants management system that focuses on program and financial administrations that interfaces with the core financial system is needed, or

    b. to establish alternatives to recording numerous data lines in the Oracle AP and PO modules which is manual intensive and prone to errors.

2. Investigate and correct the underlying causes for the system errors and limitations that prevent or delay the recording, processing, and summarizing of accounting transactions. Key issues that remain unresolved should be escalated immediately rather than back-log the problem. MCC should ensure that errors and open tickets are resolved appropriately and timely by the SSP and that routine MCA accounting activities recorded in Oracle

within the specified timeline. Moreover, manual adjusting journal entries should be used for limited transactions like unusual one-time entries or correcting entries.

3. In collaboration with the SSP, formalize in writing the system's issues and standardize the resolution processes and policy/procedures.

Regards supervisory reviews, we recommend that MCC:

4. Further review SSP data entries relating to MCA payment processing and related adjustments (i.e. obligation/disbursement adjustments). Perform reconciliation of AP and PO on a monthly basis and proactively resolve all differences in a timely manner.

<u>**Significant Deficiency**</u>

Validation Control over Grant Accrual Estimates Needs to be Strengthened (Modified Repeat Finding)

We recommend that MCC:

5. Update its *Expense Accruals Financial management Division Procedure Manual* to:

   A. Provide clear guidance regarding the accrual process as it relates to compacts that are in their final year as to how the accrual will be determined;

   B. Address how contract retentions will be accounted for and included in the grant accrual estimate; and

   C. Provide a logical and supportable look-back analysis and validation process to assess the reasonableness of the grant accrual on a quarterly basis. The look-back analysis should provide MCC with sufficient and appropriate information to explain unusual variances between actual and estimates, or support updating the current grant accrual methodology. Such periodic assessment of the adequacy of the grant accrual methodology should be documented and supported by data analysis. The accrued liability amount is subject to the risks that actual subsequent disbursement amount may be significantly different from management's estimate. When this occurs, management should further analyze the drivers/factors to ensure the validity and reasonableness of the estimation methodology.

6. Ensure that policies and procedures developed are current and are fully implemented by MCC staff during the grant accrual process to avoid potential calculation errors in the future.

OIG acknowledges MCC's management decisions for all 6 recommendations. Please inform us when final action has been achieved.

We appreciate the cooperation and courtesies extended to our staff and to the staff of CliftonLarsonAllen LLP, during the audit. Please contact Fred Jones at (202) 712-5817, if you have any questions concerning this report.

Sincerely,

/s/

Nathan Lokos
Assistant Inspector General for Audit
Millennium Challenge Corporation

cc: Parita Shah, Chief of Staff
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MILLENNIUM CHALLENGE CORPORATION

September 30, 2014

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CliftonLarsonAllen

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INDEPENDENT AUDITORS' REPORT

To the Inspector General
U.S. Agency for International Development

To the Board of Directors
Millennium Challenge Corporation

Report on the Financial Statements

We have audited the accompanying financial statements of Millennium Challenge Corporation (MCC), which comprise the balance sheets as of September 30, 2014 and 2013, the related statements of net cost and changes in net position, and the combined statements of budgetary resources for the years then ended, and the related notes to the financial statements (financial statements).

Management's Responsibility for the Financial Statements

MCC management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America (U.S.) and the design, implementation, and maintenance of internal control over financial reporting relevant to the preparation and fair presentation of these financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the U.S.; the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin No. 14-02, *Audit Requirements for Federal Financial Statements* (OMB Bulletin 14-02). Those standards and OMB Bulletin 14-02 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

We are also responsible for applying certain limited procedures with respect to the required supplementary information and other information included with the financial statements.

Opinion on the Financial Statements

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of MCC as of September 30, 2014 and 2013, and its net costs, changes in net position, and budgetary resources for the years then ended, in accordance with accounting principles generally accepted in the U.S.

Other Matters

Required Supplementary Information
Accounting principles generally accepted in the U.S. issued by the Federal Accounting Standards Advisory Board (FASAB) require that MCC's Management Discussion & Analysis (MD&A) in pages 7 through 33 be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by FASAB, who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the MD&A in accordance with auditing standards generally accepted in the U.S., which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the financial statements. We do not express an opinion or provide any assurance on the MD&A because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

Other Information
The other information such as the Message from the Chief Executive Officer in pages 3 and 4, Message from the Vice President, Department of Administration and Finance and Chief Financial Officer in page 37, and other information in pages 85 to 115 contains a wide range of information, some of which is not directly related to the financial statements. This information is presented for purposes of additional analysis and is not a required part of the financial statements or RSI. The other information has not been subjected to the auditing procedures applied in the audit of the financial statements, and accordingly, we do not express an opinion or provide any assurance on it.

Report on Internal Control over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with *Government Auditing Standards*

Report on Internal Control over Financial Reporting

In planning and performing our audit of the financial statements, we considered MCC's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of MCC's internal control or on management's assertion on internal control included in the MD&A. Accordingly, we do not express an opinion on the effectiveness of MCC's internal control or on management's assertion on internal control included in the MD&A.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that were not identified. However, we identified certain deficiencies in internal control described below and in Exhibits 1 and 2 that we consider to be a material weakness and a significant deficiency, respectively.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A *material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of MCC's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiency summarized below and described in Exhibit 1 to be a material weakness.

Ineffective and Inefficient Integration of Data, Processes and Controls within the Financial Management Systems (Modified Repeat Finding)

A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the deficiency summarized below and described in Exhibit 2 to be a significant deficiency.

Validation Control over Grant Accrual Estimates Needs to be Strengthened (Modified Repeat Finding)

Report on Compliance and Other Matters

As part of obtaining reasonable assurance about whether MCC's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements consistent with our professional responsibilities discussed below.

The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported in accordance with the *Government Auditing Standards* or OMB Bulletin 14-02.

Management's Responsibility for Internal Control and Compliance

MCC management is responsible for (1) evaluating the effectiveness of internal control over financial reporting based on criteria established under the Federal Managers' Financial Integrity Act (FMFIA), (2) providing a statement of assurance on the overall effectiveness on internal control over financial reporting, and (3) complying with other applicable laws, regulations, contracts, and grant agreements.

Auditors' Responsibilities

We are responsible for: (1) obtaining a sufficient understanding of internal control over financial reporting to plan the audit, and (2) testing compliance with certain provisions of laws, regulations, contracts and grant agreements that have a direct and material effect on the determination of the financial statement amounts and applicable laws and regulations for which OMB Bulletin 14-02 requires testing.

We did not evaluate all internal controls relevant to operating objectives as broadly established by the FMFIA, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to testing controls over financial reporting. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our audit results to future periods is subject to risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate. In addition, we caution that our internal control testing may not be sufficient for other purposes.

We did not test compliance with all laws, regulations, contracts and grant agreements applicable to MCC. We limited our tests of compliance to certain provisions of laws, regulations, contracts and grant agreements that have a direct and material effect on the determination of the financial statement amounts and applicable laws and regulations for which OMB Bulletin 14-02 requires testing. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

Management's Response to Findings

Management's response to the findings identified in our report is presented in Exhibit 3. We did not audit MCC's response and, accordingly, we express no opinion on it.

Status of Prior Year's Control Deficiencies

We have reviewed the status of MCC's corrective actions with respect to the findings included in the prior year's Independent Auditors' Report, dated December 11, 2013. The status of prior year findings is presented in Exhibit 4.

Purpose of the Report on Internal Control over Financial Reporting and the Report on Compliance and Other Matters

The purpose of the Report on Internal Control over Financial Reporting and the Report on Compliance and Other Matters sections of this report is solely to describe the scope of our testing of internal control and compliance and the result of that testing, and not to provide an opinion on the effectiveness of MCC's internal control or on compliance. These reports are an integral part of an audit performed in accordance with *Government Auditing Standards* in considering MCC's internal control and compliance. Accordingly, these reports are not suitable for any other purpose.

CliftonLarsonAllen LLP

CliftonLarsonAllen LLP
Arlington, Virginia
November 12, 2014

EXHIBIT 1

Material Weakness

1. Ineffective and Inefficient Integration of Data, Processes, and Controls within the Financial Management Systems (Modified Repeat Finding)

GAO *Standards for Internal Control in the Federal Government* states that internal control is not one event, but a series of actions and activities that occur throughout an entity's operations and on an ongoing basis. Control activity, which is one of the five components of internal control, are the actions management establishes through policies and procedures to achieve the objectives and respond to risks in the internal control system, which includes the entity's information system.

Control activities can be implemented in either an automated or a manual manner. Information system control should be installed at an application's interfaces with other systems to ensure that all inputs are received and are valid, and outputs are correct and properly distributed. Other control activities include: proper execution of transactions and events, accurate and timely recording of transactions and events, and appropriate documentation of transactions. Monitoring, which is another component of internal control, assesses the quality of performance over time and promptly resolves the findings of audits or other reviews. Corrective actions are a necessary complement to control activities in order to achieve agency objectives. Ongoing monitoring includes regular management and supervisory activities, comparisons, reconciliations, and other routine actions.

Accounting is a systematic process of identifying, recording, measuring, classifying, verifying, summarizing, interpreting and communicating financial events. These financial events are ultimately presented in financial statements through the financial reporting process. Each step in the accounting process is an integral part of the financial reporting process.

MCC continued to make progress in maintaining internal control to improve its accounting and financial reporting processes. For example, in FY 2014, MCC made improvements in resolving legacy open system tickets on a timelier basis. MCC stated that during the last six months of Fiscal Year (FY) 2014, it closed 52% of all tickets open longer than 6 months and 80% of all open tickets. Also, supervisory reviews have been more effective in identifying balance errors at the financial management system's sub-modules (i.e. AP, PO) level and making necessary correcting entries at the system's general ledger (GL) module in order to report correct financial account balances and accommodate financial reporting processes throughout the fiscal year. However, MCC continues to face a huge challenge in its accounting and reporting processes primarily due to its financial management systems' limitations, and the sheer volume of financial activities that are complex and require manual attentions and reviews to compensate for the systems' limitations. As a result, the accounting and financial reporting processes, as a whole, is inefficient, duplicative, and the risks that internal controls are not effective to prevent, detect, and correct errors timely is high, increasing the reasonable possibility of a material misstatement in the financial statements.

We have summarized and grouped those findings into systemic issues below:

a. *Standards for Internal Control in the Federal Government* states that "Management retains responsibility for monitoring the effectiveness of internal control over the assigned processes performed by service organizations." Service organizations are external parties that management engages to perform certain operational processes for the entity, such as accounting and payroll processing.

EXHIBIT 1

Material Weakness

MCC uses a Shared Service Provider (SSP) to process its accounting transactions. The SSP's core financial system and its current configurations prevent MCC from recording certain significant transactions in a systematic and correct manner. Issues with the system posting model and related version upgrades continue to exist. Our review of the September 30, 2014 SSP's open system ticket report, which tracks financial system issues, identified issues that remain unresolved for an unreasonable period of time. Due to the volume and variety of transactional financial events that MCC must record within the financial system's sub-modules relating to its grantees; MCC frequently has to prepare manual journal vouchers (JVs) and system's adjustments at the back end of the transactions to correct errors at the GL module level to resolve differences between the:

a) Purchase Order (PO) and GL module;
b) Accounts Payable (AP) and GL module;
c) incorrect postings;
d) system module interface errors;
e) system version upgrade issues; and
f) obligation/funding and/or disbursement corrections.

This system deficiency, combined with MCC and/or SSP's inadequate and untimely reviews and corrective actions, negatively impact MCC's ability to record transactions timely, properly, and accurately. Although MCC applied compensating controls to detect and correct these errors, with the sheer volume, amount, and complexity of these transactions (automated and manual), there is a high risk that errors will not be detected, reported, and corrected timely or not detected at all. Our audit identified instances where errors were not timely detected and resolved. These errors, if left undetected and/or uncorrected at either the financial system level or via frequent manual adjustments at the GL module level; increase the risks of material misstatements in MCC's financial statements. Moreover, this system deficiency results in inefficiencies and negatively impacts MCC's limited staff resources.

The government-wide policies and standards issued pursuant to FMFIA, states that agencies are responsible for managing their financial management system even when they utilize a service provider to implement, operate and maintain the systems. Agencies must ensure that their financial management systems meet applicable Federal requirements and are adequately supported throughout the systems' life cycle. Furthermore, agencies must monitor the service provider's performance and ensure that service failures are promptly resolved.

b. Although MCC has made strides in improving its financial reporting by further enhancing certain quality control review processes in response to prior year's findings, much still needs to be done. MCC's accounting and transactions recording process continue to be susceptible to errors even with MCC's progress in improving and resolving outstanding data errors/issues. MCC uses the Oracle federal financial management system (Oracle) to generate its financial statements. Manual journal voucher (JV) entries are posted directly into Oracle GL module to correct data errors that reside primarily within the system's sub-modules and/or post adjustments. Oracle then automatically generates the financial statements from these data inputs. Our audit identified instances where MCC posted correcting journal entries that resulted in further errors of which subsequent journal entries were required to resolve the errors in Oracle at June 30, 2014 and September 30, 2014. Some of these erroneous correcting journal entries are described in c below.

c. In reviewing the financial statements and performing our internal control testing, we identified errors and control deficiencies that led us to question the effectiveness and timeliness of supervisory reviews and errors resolution. For example,
   - Reconciliation differences between AP/PO modules and GL due to SSP recording errors within Oracle.
   - Incorrect liability classification of "other liabilities" between "intragovernmental" and "with the public" of approximately $440 thousand was presented in the June 30, 2014 balance sheet due to untimely correction by MCC.
   - Certain JVs tested have inaccurate or inadequate explanation and/or supporting documentation and were posted with errors.
   - For open system tickets that remained unresolved as of quarterly reporting to OMB, MCC will post temporary JVs to its GL in order to carry out its financial reporting function. MCC will then reverse various JVs in the beginning of the new fiscal quarter in order to allow SSP time to investigate the data/recording issue. For issues that remain unresolved by the next financial reporting quarter, duplicative JVs will be posted yet again to temporarily resolve the data/recording issue.
   - For long standing issues that MCC and IBC can't resolve either individually or collectively, MCC will post JVs that do not reverse within the GL on a permanent basis in order to reflect the correct accounting transactions and/or balances. However, unresolved data issue remained within the accounting system or sub-module level. Inherently, the accounting system is unable to carry out financial reporting function without continual and persistent manual intervention by MCC financial personnel and/or financial contractors.

Recommendations

With regards to the core financial system, we repeat our prior year recommendations that MCC:

1. Perform a comprehensive review and determine whether the SSP's financial management system is meeting its financial management and reporting needs. As part of this review, management should continue to evaluate whether:
   a. a separate grants management system that focuses on program and financial administrations that interfaces with the core financial system is needed, or
   b. to establish alternatives to recording numerous data lines in the Oracle AP and PO modules which is manual intensive and prone to errors.

2. Investigate and correct the underlying causes for the system errors and limitations that prevent or delay the recording, processing, and summarizing of accounting transactions. Key issues that remain unresolved should be escalated immediately rather than back-log the problem. MCC should ensure that errors and open tickets are resolved appropriately and timely by the SSP and that routine MCA accounting activities recorded in Oracle within the specified timeline. Moreover, manual adjusting journal entries should be used for limited transactions like unusual one-time entries or correcting entries.

EXHIBIT 1

Material Weakness

3. In collaboration with the SSP, formalize in writing the system's issues and standardize the resolution processes and policy/procedures.

With regards to supervisory reviews, we recommend that MCC:

4. Further review SSP data entries relating to MCA payment processing and related adjustments (i.e. obligation/disbursement adjustments). Perform reconciliation of AP and PO on a monthly basis and proactively resolve all differences in a timely manner.

EXHIBIT 2

Significant Deficiency

1. Validation Control over Grant Accrual Estimates Needs to be Strengthened (Modified Repeat Finding)

MCC reported approximately $906 million in compact grant related expenses and an accrued grant liability of $143 million for expenditures incurred by the MCC Compact Accountable Entities [(also known as Millennium Challenge Accounts (MCAs)] but not yet paid by MCC at September 30, 2014.

A. In FY 2014, MCC continues to refine its accrual methodology and started to accumulate data store to validate its methodology. However, MCC's basis for validating the reasonableness of the grant accrual, as indicated within its *Grant Accrual Validation Whitepaper* provided on July 31, 2014, was inadequate and could not be supported. MCC is relying on an assumption that in-house invoices[1] and accrued expenses are being paid within the next 90 days. MCC had performed validation by comparing subsequent disbursements in the next 90 days against the amounts accrued. However, MCC could not provide evidence to show that this assumption was consistently reliable. Our analysis indicated that the assumption needs to be expanded and we requested MCC to expand the validation to at least 120 days in evaluating whether the accrual approximates actual.

   We also identified that the third quarter accrual estimates was substantially understated by approximately $42 million or a difference of 35 percent due to the following errors:

   - MCC did not use the current spending authority for one MCA in the accrual calculation, and
   - MCC did not confirm the calculated accrual amounts with the MCAs that were closing in FY 2014. Without confirmations, MCC should have included the unused spending authority as the grant accrual amount and not the calculated amount.

   FASAB Federal Financial Accounting Technical Release (TR) 12, *Accrual Estimates for Grant Programs,* states that "As part of agencies' internal control procedures to ensure that grant accrual estimates for the basic financial statements were reasonable, agencies should validate grant accrual estimates by comparing the estimates with subsequent grantee reporting." "Agencies should document and maintain support for the data and assumptions used to develop grant accrual estimates. The documentation will facilitate the agency's review of the assumptions, a key internal control, and will facilitate the auditor's testing of the estimates."

B. MCC MCAs retain a percentage of the invoice amount from vendors performing large works contracts until the last payment is made based on final acceptance of the contract work completed. Given that the MCAs are on a cash basis of accounting, these contract retention costs were not being reported until the final payment was made. Consequently, MCA contract retentions were not being incorporated into the grant accrual calculation until such time as the MCA requests the funds needed to pay for them in the quarterly spending authority that is approved by MCC. As of September 30,

[1] In-house invoices are invoices received and approved by the MCAs for payment but the payment requests have not yet been submitted to the SSP for processing.

2014, the contract retentions were $23.5 million. MCC did not include these outstanding contract retentions as part of its grant accrual until year-end.

SFFAS No. 5, paragraph 19, defines a liability for federal accounting purposes as a probable future outflow or other sacrifice of resources as a result of past transactions or events. General purpose federal financial reports should recognize probable and measurable future outflows or other sacrifices of resources arising from (1) past exchange transactions, (2) government-related events, (3) government-acknowledged events, or (4) non-exchange transactions that, according to current law and applicable policy, are unpaid amounts due as of the reporting date.

C. MCC's *Expense Accruals Financial Management Division Procedure Manual*, dated February 2014, does not reflect the current grant accrual validation process.

TR 12 also states that: "Documented procedures are important to communicate relevant information on the grant accrual estimation to employees and management as well as other interested parties, such as auditors. As an agency experiences employee turnover, these documented procedures can provide vital information for new employees on how to complete reliable, well supported grant accrual estimates. Such documentation may be used to establish consistent procedures for developing grant accrual estimates across grant programs with similar characteristics."

Recommendations

We recommend that MCC:

1. Update its *Expense Accruals Financial Management Division Procedure Manual* to:

    a. Provide clear guidance regarding the accrual process as it relates to compacts that are in their final year as to how the accrual will be determined;
    b. Address how contract retentions will be accounted for and included in the grant accrual estimate; and
    c. Provide a logical and supportable look-back analysis and validation process to assess the reasonableness of the grant accrual on a quarterly basis. The look-back analysis should provide MCC with sufficient and appropriate information to explain unusual variances between actual and estimates, or support updating the current grant accrual methodology. Such periodic assessment of the adequacy of the grant accrual methodology should be documented and supported by data analysis. The accrued liability amount is subject to the risks that actual subsequent disbursement amount may be significantly different from management's estimate. When this occurs, management should further analyze the drivers/factors to ensure the validity and reasonableness of the estimation methodology.

2. Ensure that policies and procedures developed are current and are fully implemented by MCC staff during the grant accrual process to avoid potential calculation errors in the future.

EXHIBIT 3

Management's Response to Audit Findings

MILLENNIUM
CHALLENGE CORPORATION
UNITED STATES OF AMERICA

November 12, 2014

Ms. Mia Leswing
Principal
CliftonLarsonAllen LLP
4250 N. Fairfax Drive, Suite 1020
Arlington, VA 22203

Mr. Christopher Johnson
Director, External Financial Audit Division
1300 Pennsylvania Avenue, NW
Washington, DC 20005

Dear Ms. Leswing and Mr. Johnson:

In response to the audit findings and recommendations provided in your financial statement audit report, MCC has the following comments:

Material Weakness: Ineffective and Inefficient Integration of Data, Processes, and Controls within the Financial Management Systems (Modified Repeat Finding)

<u>Recommendations from the auditors regarding the core financial system:</u>

1. Perform a comprehensive review and determine whether the SSP's financial management system is meeting its financial management and reporting needs. As part of this review, management should continue to evaluate whether:

   a. a separate grants management system that focuses on program and financial administrations that interfaces with the core financial system is needed, or

   b. to establish alternatives to recording numerous data lines in the Oracle AP and PO modules which is manual intensive and prone to errors.

2. Investigate and correct the underlying causes for the system errors and limitations that prevent or delay the recording, processing, and summarizing of accounting transactions. Key issues that remain unresolved should be escalated immediately rather than back-log the problem. MCC should ensure that errors and open tickets are resolved appropriately and timely by the SSP and that routine MCA accounting activities recorded in Oracle within the specified timeline. Moreover, manual adjusting journal entries should be used for limited transactions like unusual one-time entries or correcting entries.

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3. In collaboration with the SSP, formalize in writing the system's issues and standardize the resolution processes and policy/procedures.

Recommendations from the auditors regarding supervisory reviews:

4. Further review SSP data entries relating to MCA payment processing and related adjustments (i.e. obligation/disbursement adjustments). Perform reconciliation of AP and PO on a monthly basis and proactively resolve all differences in a timely manner.

Response from MCC:

MCC concurs with recommendations 1 - 4.

Significant Deficiency: Validation Control over Grant Accrual Estimates Needs to be Strengthened (Modified Repeat Finding)

Recommendations from the auditors:

1. Update MCC's *Expense Accruals Financial Management Division Procedure Manual* to:

   a. Provide clear guidance regarding the accrual process as it relates to compacts that are in their final year as to how the accrual will be determined;
   b. Address how contract retentions will be accounted for and included in the grant accrual estimate; and
   c. Provide a logical and supportable look-back analysis and validation process to assess the reasonableness of the grant accrual on a quarterly basis. The look-back analysis should provide MCC with sufficient and appropriate information to explain unusual variances between actual and estimates, or support updating the current grant accrual methodology. Such periodic assessment of the adequacy of the grant accrual methodology should be documented and supported by data analysis. The accrued liability amount is subject to the risks that actual subsequent disbursement amount may be significantly different from management's estimate. When this occurs, management should further analyze the drivers/factors to ensure the validity and reasonableness of the estimation methodology.

2. Ensure that policies and procedures developed are current and are fully implemented by MCC staff during the grant accrual process to avoid potential calculation errors in the future.

Response from MCC:
MCC concurs with recommendations 1 and 2.

Sincerely,

/ s /

Matthew L. Bohn
Vice President, Department of Administration and Finance
and Chief Financial Officer

EXHIBIT 4

Status of Prior Year Findings and Recommendations

As required by *Government Auditing Standards* and OMB Bulletin 14-02, we have reviewed the status of MCC corrective actions with respect to the findings and recommendations included in MCC's Report on Internal Control for FY 2013. The following analysis provides our assessment of the progress MCC has made through September 30, 2014 in correcting the noted deficiencies.

FY 2013 Findings	FY 2013 Summary of Recommendations	FY 2014 Status
Material Weakness: Ineffective and Inefficient Interrelationship among Software, Personnel, Procedures, Controls and Data within MCC's Financial Management Systems (Modified Repeat Finding)	1. Perform a comprehensive review and determine whether the service provider's financial management system is substantially in compliance with the federal financial management system's requirements and meeting MCC financial management and reporting needs. As part of this review, management should determine whether (a) a separate grants management system that focuses on program and financial administrations that interfaces with the core financial system is needed, or (b) to establish alternatives to recording numerous data lines in the Oracle AP module which is manually intensive and prone to errors.	Open – reported as MW, modified repeat finding
	2. Investigate and correct the underlying causes for the system errors and limitations that prevent or delay the recording, processing, and summarizing of accounting transactions.	Open – reported as MW, modified repeat finding
	3. In collaboration with the SSP, formalize in writing the system's issues and resolution process.	Open – reported as MW, modified repeat finding, recommendation modified
	4. Continue to streamline the MCDR recording and adjustment process.	Closed
	5. Implement an effective management review of its accounting and financial reporting processes using the comprehensive review process.	Closed
	6. Further review SSP data entries relating to the MCA payments processing and related adjustments. Perform reconciliation of AP on a monthly basis and proactively resolve all differences.	Open – reported as MW, modified repeat finding, recommendation modified

EXHIBIT 4

Status of Prior Year Findings and Recommendations

Significant Deficiency: 1. Validation Control over Grant Accrual Estimates Needs to be Strengthened (Modified Repeat Finding)	7. Develop and implement a logical and supportable look-back validation process to assess reasonableness of the grant accrual estimate, and then perform a grant accrual look back analysis on a quarterly basis for a sufficient period of time to develop a pattern or trend.	Open – reported as SD, modified repeat finding
	8. Update the Expense Accruals Policy and Procedures to reflect the change in the methodology.	Open – reported as SD, modified repeat finding
	9. Develop audit procedures for the MCA audit to compare spending authority amount granted against actual MCA expenses, and investigate and document significant variances. MCC should maintain a library of historical MCA financial data.	Closed
	10. Continue to enhance the accrual methodology.	Closed
2. Monitoring of MCA Audits Needs to be Strengthened (Modified Repeat Finding)	11. Continue the collaboration between the USAID OIG and the MCC management to improve timelines of the MCA audits; adequacy of the MCA audit procedures; monitoring and reviewing the quality and performance of the MCA audits; and tracking and conducting follow-up of corrective action plans with the MCAs timely.	Open but will be reported as a management letter comment in FY 2014.
3. Information Systems Controls Need Improvement	12. We did not include recommendations in our audit report. Our recommendations were included in a separate USAID OIG Report titled "Audit of Millennium Challenge Corporation's Fiscal Year 2013 Compliance with Federal Information Security Management Act of 2012," Audit Report M-000-13-001-P.	Closed