Millennium Challenge Corporation
Reducing Poverty Through Growth

MILLENNIUM CHALLENGE CORPORATION

Annual Report

2004

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THE SECRETARY OF STATE

WASHINGTON

I. A MESSAGE FROM SECRETARY OF STATE CONDOLEEZZA RICE, CHAIR OF THE BOARD, MILLENNIUM CHALLENGE CORPORATION

I have had the great privilege and opportunity to observe the evolution of the Millennium Challenge Account (MCA) from its inception. During my tenure as National Security Advisor, as we analyzed America's future security challenges, we noted that countries crippled by extreme poverty, ruled by corrupt, repressive regimes, and that fail to provide for the basic needs of their citizens, pose threats to their neighbors, to the United States and to the international community. The MCA – and the Millennium Challenge Corporation (MCC) that oversees it – are designed to contribute to fighting poverty in a way that will make the world more secure - by creating an incentive for good governance and by helping countries take effective control of their own development.

I am pleased with the progress made by MCC in its first eight months of operations, and equally importantly, by the countries the Board has selected as eligible for the MCA – this is as much a new process for them as it is for us. I also am encouraged to see that some countries that were not selected for MCA assistance are using the indicators as a guide for future policy improvements.

We appreciate the deep partnership between the Administration and Congress on development in general and the MCA in particular. We look forward to continuing that close collaboration as we proceed with implementation of this landmark initiative. This year MCC has set the stage for the creation of true partnerships for development. We have much to look forward to in 2005.

Condoleezza Rice

Condoleezza Rice
Chair, MCC Board of Directors

Millennium Challenge Corporation

Reducing Poverty Through Growth

Paul V. Applegarth
Chief Executive Officer

II. A MESSAGE FROM CEO PAUL APPLEGARTH October 2004

Looking back at all MCC has accomplished, it is hard to believe that we are still a "start-up" – as of this writing, we have not yet celebrated our first birthday. In February of 2004, a group of seven detailed employees turned on the lights for the first time at MCC's temporary headquarters.

As a startup, we faced the usual problems: getting phones and computers and then getting them to work. We recruited staff with three criteria: they had to be among the most talented in their field, they had to be team players, and they had to believe in our mission to reduce global poverty. While doing this we also had to implement a new way of delivering development assistance and do so in the glare of the international spotlight.

Our Board completed selection rounds for MCA eligible countries on May 6— the earliest date permitted under our legislation—and for Threshold Program eligible countries in September. MCC received the first eligible country proposals in late August, and we have maintained a constant dialogue with each country as they refine their programs for poverty reduction and growth. Our eligible countries are taking the time to get their proposals right. By September 30, we had 10 of 16 potential concept papers or proposals in hand.

Starting in May, MCC staff visited all sixteen 2004 eligible countries to explain our mission and our expectations. As many aspects of the MCA are radically different from traditional assistance programs, I have to confess that initially our message was met with enthusiasm, but also with some uncertainty. Some of this uncertainty centered around the "consultative process," which we emphasized was important to ensuring compact proposals reflected national priorities. Accordingly, while we had successful meetings with leaders and with government ministers in all of our eligible countries, we didn't stop there. We met with non-governmental organizations, local businesses, members of parliament, other donors, and the press. Our message to each was that they stay vigilant and stay involved. We told them that their participation was critical to identifying opportunities for meaningful poverty reduction and sustainable growth and to ensuring that proposals reflect the development priorities of all people, not just a minority of well-connected people.

The eligible countries have reacted with pride at being selected to apply for MCA funding. Just being selected ranks them favorably in comparison to their peers. Being an MCA country is an honor, as well as an opportunity and a responsibility.

For people who are unfamiliar with the MCC process, it is understandable that they expect immediate disbursement of aid dollars in light of the great need and the suffering of the more than one billion people worldwide living in extreme poverty. But MCC is not about to commit resources without confidence that these funds *will help to bring a poverty reduction and growth return* on this investment of US taxpayer funds. Our partner countries share the view that MCC funding must be used effectively. Both they and we are working quickly and carefully toward that end.

It is noteworthy that we also received a clean bill of health in our audited financial statements for 2004. This is important because we see ourselves as a fiduciary of the American taxpayer and set high standards for ourselves in terms of our financial operations and the way we conduct our overall business. We see ourselves as accountable to taxpayers as well as to the countries of MCC and their citizens.

As eligible countries move toward MCC compact negotiations, the act of refining and finalizing their proposals has had a dramatic impact. One government official commented that the intangibles his country gained—learning to incorporate diverse viewpoints, to prioritize a long list of development needs, and to focus on results, rather than inputs—were worth as much as any potential financial assistance from MCC. One country passed four pieces of anti-corruption legislation and began enforcement. The stated reason: a hope to qualify for MCA funding.

While we emphasize country ownership and the responsibility of the country to drive the timeline of the compact proposals, we don't leave them on their own. We let the countries take the lead but we do not passively sit by. We spend extensive time on the ground with the countries helping them to develop their proposals.

Our Board has scheduled the second round of MCA and Threshold eligible countries for November. We now have potential relationships with 23 of the poorest countries in the world, and look forward to expanding our reach in fiscal year 2005.

Finally, we could not have gotten where we are without the wholehearted assistance of many people. Our Board of Directors has been enthusiastic and invaluable. Our Chairman, Secretary of State Colin Powell, has gone above and beyond any call to promote and support MCC. Our friends on Capitol Hill have given us bipartisan support. Many organizations and individuals also have offered assistance of every kind to get us up and running and on our way to reducing poverty. And those seven detailees have grown to more than sixty full time employees. Their collective efforts are what moved us to where we are today.

Paul V Applegarth

Paul V. Applegarth

Chief Executive Officer

III. BOARD OF DIRECTORS

as of September 30, 2004

Colin L. Powell
Secretary of State
Chairman

John W. Snow
Secretary of the Treasury
Vice-Chairman

Paul V. Applegarth
Chief Executive Officer

Kenneth Hackett

Andrew S. Natsios
Administrator
U.S. Agency for International Development

Christine Todd Whitman

Robert B. Zoellick
U.S. Trade Representative

IV. MCC's MISSION

To provide United States assistance for global development through the Millennium Challenge Corporation in a manner that promotes economic growth and the elimination of extreme poverty and strengthens good governance, economic freedom, and investments in people.

On March 14, 2002 in Monterrey, Mexico, President Bush called for a "new Compact for global development," to link greater contributions from developed nations to greater responsibility from developing nations. Pledging the United States would lead by example, the President proposed the creation of the Millennium Challenge Account (MCA).

In January of 2004, Congress formally created the MCA and established the Millennium Challenge Corporation (MCC) — a U.S. government corporation — to oversee the Account. The program, envisioned by President Bush and established by Congress, would be substantial, providing significant new resources to the global fight against poverty. MCC country programs would be funded in multi-year Compacts of sufficient size to enable MCC to be among the largest donors in each country that receives funding.

The mission of MCC is to provide United States assistance for global development through the Millennium Challenge Corporation in a manner that promotes economic growth and the elimination of extreme poverty and strengthens good governance, economic freedom, and investments in people. To carry out this mission, MCC draws lessons from the past 50 years of development assistance:

- Aid is most effective when it reinforces sound political, economic, and social policies; therefore, reward countries that demonstrate performance in terms of putting in place policies to provide an environment for increased economic growth and poverty reduction.
- Development plans that engender country ownership are the most likely to succeed; therefore, allow countries to set their own priorities.
- Measure results from the beginning to boost effectiveness, accountability, and the transparency with which taxpayer resources are used; therefore, integrate monitoring and evaluation into the design and execution of activities.

V. SUMMARY OF ACCOMPLISHMENTS

In the eight months since its founding, MCC is proud of its accomplishments and below is a summary of some of them. The largest accomplishment, however, is more difficult to quantify or enumerate -- the effect of the United States establishing an entirely unique development assistance program that incentivizes policy reforms, focuses programs exclusively on reducing poverty through economic growth, and emphasizes the importance of countries establishing their own priorities and ideas as opposed to a donor explaining what a country needs. At the same time, MCA is a program that requires a broad-based consultative process, highlights the importance of measuring results, and holds countries accountable for their ability to produce those results. Some specific accomplishments of MCC's first eight months include:

- **Selectivity:** Developed country selection criteria and methodology for FY2004; refined specific indicators based on public comment and announced processes to further refine for FY2005 and FY2006; selected 16 out of 63 candidate countries for FY2004; announced new set of 68 candidate countries for FY2005
- **Eligible Countries:** Engaged 16 countries for FY2004, including collaboration with government officials, local civic leaders, USAID and other donors; received and began review of 10 country proposals or concept papers
- **Threshold Countries:** Designed program from scratch; selected 7 eligible countries for FY2004; worked out the basis for an agreement with USAID to work with countries in program development and implementation
- **Congress:** Met all legislative deadlines, including country selection on first day it was legally possible; conducted numerous briefings and meetings to keep interested parties informed; cooperated with GAO to help them make three different presentations about MCC during the fiscal year
- **Public:** Held four public outreach sessions; conducted three Board meetings attended by the public
- **Staffing:** Built up staff from 7 to over 60 individuals with wide variety of backgrounds and experience in government, private sector development, multilateral institutions, NGOs and higher education
- **Administrative:** Held open, competitive process to select office space and began competitive process to develop an IT platform; competitively selected a public-sector financial manager; received clean bill of health in audited financial statements

VI. FY2004 OPERATIONS

A. SETTING UP THE ORGANIZATION

The initial MCC core staff consisted of only seven employees working in offices located in Rosslyn, Virginia. On February 2, the MCC Board of Directors held its first meeting. The first Board consisted of the Secretary of State (Chairman), the Secretary of the Treasury (Vice Chairman), the U.S. Trade Representative and the Administrator of the U.S. Agency for International Development. Two public members, Kenneth Hackett, President of Catholic Relief Services, and Christine Todd Whitman, who served as Governor of New Jersey and Administrator of the Environmental Protection Agency, were named and confirmed later. At its first meeting, the Board adopted the Corporation's by-laws, announced the initial 63 Candidate Countries, and named an interim CEO, Under Secretary of State Alan Larson. On February 20, the President announced his intention to nominate Paul V. Applegarth as CEO of MCC. A Senate hearing was held on March 31, 2004 and Mr. Applegarth was confirmed as MCC's first CEO on May 5, 2004.

B. COUNTRY SELECTION

In March, MCC submitted its criteria and methodology for selecting eligible countries for FY2004. The selection process involves a measurement of the candidate countries' overall performance in three broad policy categories: Ruling Justly, Encouraging Economic Freedom, and Investing in People. To assess policy performance within these three major policy categories, 16 publicly available indicators were used.

In assessing possible indicators, MCC explained that it favors those that: 1) are developed by an independent third party, 2) utilize objective and high-quality data, 3) are analytically rigorous and are publicly available, 4) have broad country coverage and are comparable across countries, 5) have a clear theoretical or empirical link to economic growth and poverty reduction, 6) are policy-linked, i.e. measure factors that governments can influence within a two to three year horizon, and 7) have broad consistency in results from year to year.

In fiscal year 2004, MCC used the following 16 indicators:

Ruling Justly
- Civil Liberties (Freedom House)
- Political Rights (Freedom House)
- Voice and Vote (World Bank Institute)
- Government Effectiveness (World Bank Institute)
- Rule of Law (World Bank Institute)
- Control of Corruption (World Bank Institute)

Investing in People
- Immunization rate (World Health Organization)
- Public Expenditure on Health (National Government Data)
- Primary Education Completion Rate (World Bank EdStats, <u>Education For All (EFA)</u>)
- Public Expenditure on Primary Education (National Government Data)

Economic Freedom
- Country Credit Rating (<u>Institutional Investor</u>)
- Inflation Rate [(International Monetary Fund's (IMF) International Financial Statistics (IFS), World Economic Reports (WEO) and other sources)]
- Days to Start a Business (World Bank)
- Trade Policy (The Heritage Foundation)
- Regulatory Quality Rating (World Bank Institute)
- Fiscal Policy (WEO and other sources)

In making its determination of eligibility for a particular candidate country, the MCC Board considered whether the country performs above the median in relation to its peers on at least half of the indicators in each of the three policy categories and above the median on the corruption indicator. One exception to this methodology was that the median was not used for the inflation indicator. Instead, to pass the indicator, a country's inflation rate needed to be under a fixed ceiling of 20%. The indicators methodology was used as the predominant basis for determining which countries will be eligible for MCA assistance. In addition, the Board used discretion in evaluating and translating the indicators into a final list of eligible countries. In this respect, the Board considered whether any adjustments should be made for data gaps, lags, trends, or other weaknesses in particular indicators. Likewise, the Board could deem a country ineligible if it performs substantially below average on any indicator and has not taken appropriate measures to address this shortcoming.

Through a variety of public outreach mechanisms, MCC made its selection criteria and methodology known and received constructive input on the indicators. In August, MCC submitted its selection criteria and methodology for FY2005 -- particularly highlighting two changes and a process to try to find a source of reliable, consistent data for assessing the quality of a country's policies regarding the management of natural resources.

MCC substituted the indicator "Girls' Primary Completion Rates" for the previous indicator, "Primary Completion Rates." Using primary school completion rate data disaggregated by gender continues MCC's focus on the importance of countries investing in the education of their people, and highlights the strong empirical linkage between investments in the education of women and girls and a country's economic growth and poverty reduction. Another indicator -- one-year consumer price inflation rate – was changed from a ceiling of 20% to 15% to be a more meaningful test of a government's economic policies.

MCC announced a process to try to identify an existing natural resources management indicator or to stimulate development of a new indicator. MCC explained that it would establish a working group, chaired by MCC Board Member Christine Todd Whitman, to work with outside groups and experts to establish criteria, and invite proposals, for such an indicator.

C. ELIGIBLE COUNTRIES

On May 6, 2004, MCC's Board of Directors selected 16 countries from among the 63 candidate countries to be eligible to submit proposals for MCC assistance. The selected countries, which have a combined population of more than 130 million people and an average per capita income of roughly $600 are: Armenia, Benin, Bolivia, Cape Verde, Georgia, Ghana, Honduras, Lesotho, Madagascar, Mali, Mongolia, Mozambique, Nicaragua, Senegal, Sri Lanka, and Vanuatu.

i) Inviting Proposals

In April 2004, MCC put proposal guidance on its website. Within 10 days of the May 6 announcement of the FY 2004 program, five MCC delegations departed for consultations in the 16 selected countries. The purposes of these preliminary visits, which occurred in May and June, 2004, were:

1) To advise the countries formally of their eligibility for the program and to describe the program. MCC delegations made it clear that eligibility was not a guarantee of MCC funding and that funding would depend ultimately on the quality of the proposals;

2) To invite the participation of both government and non-government entities in these countries in the development of the countries' proposals;

3) To discuss the issues that eligible countries would have to address in their proposals: How would the proposals lead to poverty reduction through growth? How would the proposal development process by an eligible country be made open to its public? What additional policy reforms would the countries adopt as a result of MCC funding?

4) To invite into the proposal process representatives of the private sector, civil society, non-government organizations and opposition parties in each of the countries visited.

The results of these initial forays into the eligible countries were highly positive. The major finding: getting workable proposals was going to take time. Although the MCC program was welcomed enthusiastically by potential partners, it became obvious that to move the process from an initial concept to a full proposal to a formal negotiation would take a considerable amount of resources and a significant investment of time by country officials. The concept of the country developing its own priorities seemed new to many of the countries. Some looked for MCC direction in establishing program priorities; other countries seemed inclined to take earlier planned projects "off the shelf" for funding without particular reference to the strategic growth and poverty reduction policies which are required for MCC funding. In short, the process is likely to be iterative, extended in both time and scope, as proposals are developed and reviewed.

ii) Initial Proposals

Responding to the MCC delegation visits in May and June, country proposals and concept papers began reaching MCC in August and September. The proposal writing process itself spurred innovation by some of the eligible countries in expanding the participation of their populations.

MCC started conducting a preliminary type of due diligence on a few of the more detailed proposals shortly after their submission. The aim was to assess the economic plausibility and the logic of the proposals, ask questions about the consultative process, establish the groundwork on fiscal accountability mechanisms, procurement practices, and implementation capabilities, and a country's capability to set reasonable and useful benchmarks, and monitor program progress.

Early indications are that many of the initial proposals are quite responsive and in line with MCC's objectives. For instance, one proposal was prepared by the central government working with development councils which represent 144 local nongovernmental organizations, private sector entities and other groups within the country's regions. This process marks the first time in that country's history that the central government has employed these councils to develop the components of a foreign assistance program, giving these groups unprecedented ”ownership” of the process. The proposal itself is for a four year program that focuses on an area with both the most extreme rural poverty in the region and a high potential for economic growth. It includes measures to modernize land registration and to promote agribusiness through irrigation, extension services, financing, export promotion, and market development.

Some proposals, however, have not been prepared in a manner that involved broad input from civil society and other stakeholders in the countries' development process. Some proposals consisted more of a "laundry list" of projects rather than an attempt to identify a measurable result to accomplish. Further iterations of these types of proposals will be necessary.

The coordination of other international donor activities has been a major consideration by both MCC and eligible countries in the consultative process. There is widespread agreement that the proposals need to insure that MCC programs complement (rather than replace) other bilateral and international donor activities. MCC has indicated that there is no need to "reinvent the wheel" with regard to other donor documentation requirements -- such as the Poverty Reduction Strategy Papers prepared by the country in coordination with the World Bank and International Monetary Fund. The focus, rather, is on leverage -- on getting MCC proposals that tie into other donor programs and build on their efforts to reduce poverty through growth.

To date, programs identified in proposals that have been submitted to MCC vary greatly according to the needs of each eligible country. Some examples include:

- Integrated rural and regional development programs with a focus on improved infrastructure, targeted investment, and energy rehabilitation.
- A program to improve land titling procedures, expand access to credit, and identify domestic and international market opportunities.
- A program to develop agribusiness and increase agricultural productivity through irrigation system upgrades, improved access to financing, and strengthening regional technology research capabilities.

iii) Example of Due Diligence -- Fiscal Accountability

To provide an example on how MCC is conducting its due diligence, it is worth looking at a particular subject area. A key element of all Compact development and execution will be fiscal accountability—the mechanisms and processes that assure that funds are managed properly and procurements are undertaken in a fair, open, and transparent manner. The following is a summary of general guidance that MCC is providing to countries eligible to receive MCA assistance, though MCC notes that fiscal accountability -- like any aspect of due diligence -- will be reviewed on a country by country basis.

Principles

MCC is utilizing U.S. taxpayer funds and is accountable for those funds. The requirement to meet these accountability standards will guide the design, and be a key element, of MCC program implementation. In determining the appropriate financial accountability mechanism for each country, MCC will be guided by the following principles:

- The mechanisms should result in maximum transparency of financial transactions and activity.
- The mechanisms should have clear lines of authority and responsibility to assure accountability.
- The mechanisms should produce maximum integrity of financial information and assurance that the funds are used for the purpose intended.
- MCC will seek, wherever possible, to build upon existing systems, mechanisms, and previous assessment work.
- The mechanisms should, wherever possible, build capacity that will remain in place at the end of the MCC Program.

In developing a specific mechanism for a particular country, MCC and the country will seek an optimal balance among speed of program and project execution, efficiency of operation, minimization of overhead costs, sustainability of outcomes, and effectiveness of accountability.

Examples of mechanisms could be financial and accounting institutions, existing government financial systems, a project management firm, the establishment of separate financial management units and accounts within government, an overall project management firm, or the establishment of a trust managed by an independent party to oversee and account for MCC program funds. While the mechanisms will differ, some common elements will be part of fiscal accountability in every MCC program. The common elements include:

- Financial information will be provided on a periodic basis (e.g., monthly) and in a standard accounting framework that will allow information to be compared over time and across countries.

- Significant procurement actions must be available on a website (or some other method that would make the procurement process transparent) including notifications of procurements, solicitation documents, final contract awards, and change orders.

- Actual cash disbursements from MCC will be made periodically (e.g., quarterly) based on certified cash requirement needs and financial management and procurement standards.

- Ongoing disbursements will be subject to satisfactory performance on Compact goals and objectives.

- At a minimum, an independent auditor approved by the MCC Inspector General will conduct an annual audit. The financial accountability mechanism must address any audit recommendations promptly and transparently.

D. THRESHOLD PROGRAM

In May, the Board announced that MCC would launch a Threshold Program. Underlying all of MCC's efforts is the importance of incentivizing policy reform. The Threshold Program was set up to enhance this objective -- to provide assistance to countries that are close to qualifying for MCC and have demonstrated a commitment to meeting the eligibility requirements in the future. The program is directed toward improving the specific performance indicators on which a Threshold Program country has failed to score higher than the median.

At the end of the fiscal year, the Board selected Albania, East Timor, Kenya, Sao Tome and Principe, Tanzania, Uganda, and Yemen to be invited to submit their proposals for improving their MCA indicators. A deadline of January 31, 2005 was set for these countries to submit concept papers. MCC reached an agreement with the U.S. Agency for International Development to work in partnership on helping countries design and ultimately implement programs.

VII. ANNUAL REPORTING REQUIREMENTS

Pursuant to Section 613 of the Millennium Challenge Act of 2003

In accordance with the reporting requirements set forth in Section 613 of its authorizing legislation, MCC reports the following as of September 30, 2004:

> Section 613(b)(1). Amount of obligations and expenditures for assistance provided to each eligible country during the prior fiscal year:
>
> None

MCC has no information to report with respect to the remaining items in Section 613 because it had not obligated or expended any funds for assistance to any eligible country as of September 30, 2004. These items address the following reporting elements:

- Section 613(b)(2). Assessments of progress towards objectives and effectiveness of assistance in eligible countries with which MCC has established a Compact.

- Section 613(b)(3). Coordination of Compact assistance with other U.S. foreign assistance and related trade policies.

- Section 613(b)(4). Coordination of Compact assistance with other donor countries.

- Section 613(b)(5). Other relevant information related to Compact assistance.

In evaluating country proposals, MCC has consulted with other U.S. agencies and international donors regarding how the proposed uses of MCC assistance would complement current and planned development assistance projects.

MANAGEMENT'S DISCUSSION AND ANALYSIS

> *"We must tie greater aid to political and legal and economic reforms. And by insisting on reform, we do the work of compassion. The United States will lead by example."*
>
> ***President George W. Bush, Monterrey, Mexico March 22, 2002***

MISSION STATEMENT

With his announcement in Monterrey, President Bush launched a major new commitment by the United States to bring hope and opportunity to the world's poorest people. In proposing the Millennium Challenge Account (MCA) and the Millennium Challenge Corporation (MCC), the organization that would oversee and manage the Account, President Bush made clear that this program would be unlike any other in America's long history of foreign assistance. Along with significant new resources to fight world poverty, the President promised we would insist on the reforms necessary to make this a fight we could win.

With strong bipartisan support, Congress established the Millennium Challenge Corporation on the 23rd of January 2004, authorized MCC to administer the MCA and provided $1 billion in initial funding for FY 2004. President Bush has pledged to increase funding for the MCA to $5 billion a year, roughly a 50 percent increase over then current U.S. core development assistance.

The MCA draws on lessons learned about development over the past 50 years:

1. Aid is most effective when it reinforces sound political, economic and social policies - which are key to encouraging the inflows of private capital and increased trade - the real engines of economic growth;
2. Development plans supported by a broad range of stakeholders, and for which countries have primary responsibility, engender country ownership and are more likely to succeed;
3. Integrating monitoring and evaluation into the design of activities boosts effectiveness, accountability, and the transparency with which taxpayer resources are used.

<u>Mission, Key Principles and Organizational Structure</u>

<u>Mission:</u> MCC's mission is to provide United States assistance for global development through the Millennium Challenge Corporation in a manner that promotes economic growth and the elimination of extreme poverty and strengthens good governance, economic freedom, and investments in people. MCC will focus specifically on promoting sustainable economic growth that reduces poverty through investments in areas such as agriculture, education, private sector development, and capacity building.

Key Principles: The MCA is governed by the following key principles:

- **Reward Good Policy:** Using objective indicators, countries will be selected to receive assistance based on their performance in governing justly, investing in their citizens, and encouraging economic freedom.
- **Operate in Partnership:** Working closely with MCC, countries that receive MCA assistance will be responsible for identifying the greatest barriers to their own development, ensuring civil society participation, and developing an MCA program. MCA participation will require a high-level commitment from the host government. Each MCA country will enter into a public Compact with MCC that includes a multi-year plan for achieving shared development objectives and identifies the responsibilities of each partner in achieving those objectives.
- **Focus on Results:** MCA assistance will go to those countries that have developed well-designed programs with clear objectives, benchmarks to measure progress, procedures to ensure fiscal accountability for the use of MCA assistance, and a plan for effective monitoring and objective evaluation of results. Programs will be designed to enable progress to be sustained after the funding under the MCA Compact has ended.

Organization: MCC is managed by a Chief Executive Officer appointed by the President and confirmed by the Senate. MCC is overseen by a Board of Directors composed of the Secretary of State, the Secretary of Treasury, the U.S. Trade Representative, the Administrator of USAID, the CEO of MCC and four public members,[1] appointed by the President with the advice and consent of the Senate. The Secretary of State is the Chairman of the Board. MCC, which administers the MCA, is designed to support innovative strategies and to ensure accountability for measurable results. Accordingly, the Corporation was designed to make maximum use of flexible authorities to optimize efficiency in contracting, program implementation, and personnel.

MCC's internal organization is comprised of the Chief Executive Officer and eight vice-Presidencies:

(1) Office of the Chief Executive Officer: responsible for managing the operations in a manner that reflects policies of the Board of Directors and also achieves MCC's objectives in accordance with applicable laws and regulations and Congressional directives.
(2) General Counsel: Responsible for and directs all attorneys, agents and employees in the performance of all legal duties and services for and on behalf of MCC. This office is responsible for all legislative matters and maintains MCC's records.

[1] Two public members, Kenneth Hackett, president of Catholic Relief Services, and Governor Christine Todd Whitman, who served as Administrator of the Environment Protection Agency, were named and confirmed in July 2004.

(3) Administration and Finance: Responsible for all matters pertaining to the Corporation's financial, administrative, information technology, procurement, and human resource management policies and procedures.
(4) Country Relations: Responsible for managing assistance and the development of compacts. Manages the communications with eligible countries leading to the country's submission of a proposal. Provides advice to the countries about their proposals, plays a coordination role after the proposals are submitted and will coordinate the negotiation of compacts with individual countries.
(5) Markets and Sectoral Assessments: Responsible for evaluating country proposals to ensure that the projects that the countries propose are feasible and will lead to poverty reduction through economic growth. This office is also responsible for reviewing the financial and procurement systems in each country.
(6) Domestic Relations:Responsible for all Congressional and media communications concerning MCC. This office collects and disseminates information to all key stakeholders.
(7) Monitoring and Evaluation: Responsible for developing and administering the corporation's monitoring and evaluation program.
(8) Development Policy: Responsible for defining MCC's policies and procedures, gathering data on the countries, and developing briefing materials.
(9) International Relations: Responsible for developing and maintaining mutually beneficial relationships with international organizations.

PERFORMANCE GOALS, OBJECTIVES AND RESULTS FOR FY 2004

During the start up phase or the first nine months of its operations, or the period ending September 30, 2004, MCC's key goals were to:

<u>Objective 1:</u> Establish an enabling administrative and operational environment.

Performance Measures:

i. Office space rented, contracts executed for fundamental operational services such as accounting, information technology, contracting, and, travel services.
ii. Organizational structure and staffing plan developed, and 60 positions filled.

Results: MCC has successfully met all the performance measures identified above. MCC's temporary headquarters was established in Rosslyn, Virginia, with space rented from the Department of State. It is anticipated that MCC will relocate to Washington, DC in the summer of 2005. During its start up phase, MCC outsourced its financial management, human resources, contract and travel management functions to the Department of Interior's National Business Center.

On September 30, 2004, MCC had a total staff, including contractors of 61 people.[2]

[2] Includes 51 direct hire staff and 10 contractors.

MCC's ambitious staffing plan calls for a total staff of 150 to 200 employees by the end of FY 2005, and accordingly, MCC has hired a recruitment firm to assist it in meeting this important goal.

Objective 2: Meet the legal requirements specified in the Millennium Challenge Act and develop a process for providing program support.

Performance Measures:

i. Eligible candidate countries for FY 2004 and FY 2005 funding identified, Congress notified, and, list published in the Federal Register.
ii. Criteria and methodology for selecting eligible countries in FY 2004 and FY 2005 established, results published, and one or more public hearings held.
iii. Eligible countries for FY 2004 funding identified, report provided to Congress and published in the Federal Register.

Results: MCC developed the candidate country list, which included 63 and 71 countries respectively, for FY 2004 and FY 2005, notified Congress and published the report in the Federal Register, all within the specified time frames in the Act. Similarly, MCC developed the selection criteria and methodology and held four public hearings to solicit comment and facilitate understanding. On May 6, 2004, the Board selected 16 countries as eligible to apply for MCA financing in FY 2004; a report was submitted to Congress and published in the Federal Register. MCC also conducted public hearings to explain the results. Within weeks of this selection, MCC delegations visited the selected countries to explain MCA and invited these countries to submit proposals. MCC received 10 proposals and concept papers before the end of the fiscal year. MCC has clearly met this objective.

Objective 3: Coordinate with the United States Agency for International Development (USAID).

Performance Measures:

i. Threshold program developed.
ii. Memorandum of understanding signed with USAID.

Results: MCC, in close coordination with USAID, developed a Threshold program and executed a Memorandum of Understanding in September 2004, thereby meeting this objective.

MCC's FINANCIAL STATEMENTS

The financial statements, presented herein, have been prepared to report the financial position and results of operation of MCC, pursuant to the requirements of 31 U.S.C. 3515 (b). While these statements have been prepared from the books and records of MCC in accordance with generally accepted accounting principles (GAAP) for Federal entities and the formats prescribed by the Federal Accounting Standards Advisory Board (FASAB), the statements are in addition to the financial reports used to monitor and control budgetary resources which are prepared from the same books and records. As such, these statements should be read with the realization that they are for a component of the U.S. Government, a sovereign entity. MCC's financial statements for the nine months ended September 30, 2004 reflect a classic start up organization, where the program or business purpose has not been implemented from a financial perspective. MCC has three costs centers: Program, Administration and Audit.

The financial statements however provide a glimpse of MCC's evolving character, a lean corporation that manages a substantial development investment fund, with limited human resources. MCC's objective is to maximize the use of its human resource capital to further its business objectives and accordingly, the bulk of its back office operations, such as financial, information technology and human resource management have been outsourced. MCC's key administrative costs are staff salaries and benefits, travel, rent and operational services. It is anticipated that salaries and benefits will account for about 55 percent and travel, particularly those related to program due diligence and monitoring, will account for about 20 percent of all administrative costs. Audit services, provided by USAID's Inspector General's office, amounted to 7 percent of administrative costs in FY 2004 and is expected to consume a lower percentage of administrative costs in the future as MCC operations expand and the full contingent of staff is hired. No direct program funds were obligated or disbursed in FY 2004.

MCC'S SYSTEMS, CONTROLS AND LEGAL COMPLIANCE

MCC's strategy, given that: (i) it did not have a full complement of staff; (ii) had outsourced all its key administrative operational functions; and (iii) was developing its compact process, was to use outside resources to assess and validate its key internal control structures, instead of conducting an internal review of its internal control structures. The USAID Inspector General has issued a report based on a review it performed addressing the following:

- What progress has the Millennium Challenge Corporation made in achieving its planned organizational structure?

- What is the status of the Millennium Challenge Corporation's compact development process?

- What progress has the Millennium Challenge Corporation made in complying with the Millennium Challenge Act of 2003 and other applicable federal laws and regulations?

and, conducted reviews of:

- MCC's compliance with the Federal Information Security Management Act, and

- The external auditors, as a part and parcel of the present financial statement audit, have reviewed the Department of Interior's National Business Center and MCC internal control structures related solely to MCC's financial statements.

These reviews and audits provide MCC with reasonable assurance as to the validity of the internal control systems and its ability to rely on them. MCC will be implementing the recommendations emanating from the above: (i) MCC recently developed its own information technology network and accordingly, will develop a security program as called for by the report; and, (ii) MCC has obtained assurance from the Department of Interior's National Business Center that they will be conducting a FISMA audit of the Oracle system in FY 2005.

MANAGEMENT CHALLENGES FACING MCC

There are many management challenges that face MCC. They include:

(i) Staffing: MCC's ability to effectively perform its business function, which includes due diligence, compact negotiation, management and program monitoring, is dependent on the ability to rapidly hire staff. MCC has outsourced recruitment support and anticipates that this requirement will be met.

(ii) Integrated financial and management information system: As a lean organization, MCC needs to make sure that its management information systems are responsive to the needs of its managers and that this information is readily accessible by its staff and partners. The financial management, human resources, and procurement systems used by MCC are not integrated, resulting in duplicative data entry, duplication of effort and loss of management information. MCC plans to standardize its operations on one integrated platform that would also provide a framework for managing its program resources. MCC has already begun discussions with NBC to determine if they are willing and able to support these key functions on the platform chosen by MCC. If not, MCC will have to look for other means of meeting this requirement.

(iii) Overseas risk: MCC's business takes place in countries where risks are perceived to be higher. MCC's assistance modality and method of implementation, where the foreign governments will generally manage the resources, is new and has not been tested, increasing potential risk. The developmental benefits of this approach, however, by far outweigh the risks, and MCC believes that this risk can be greatly reduced or mitigated with adequate due diligence and management controls.

INDEPENDENT AUDITOR'S REPORT

Financial Statements from the Inspector General's Audit Report September 30, 2004

WILLIAMS, ADLEY & COMPANY, LLP
Management Consultants
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT

Inspector General
United States Agency for International Development

Board of Directors
Millennium Challenge Corporation

We have audited the accompanying Statement of Financial Position of the Millennium Challenge Corporation (Corporation) as of September 30, 2004, and the related Statements of Operations and Changes in Net Position, Cash Flows, and Budgetary Resources for the nine months ended September 30, 2004. These financial statements are the responsibility of Corporation management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial statement audits contained in *Government Auditing Standards,* issued by the Comptroller General of the United States, and the Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Corporation at September 30, 2004, and cash flow for the nine months ended September 30, 2004, in conformity with accounting principles generally accepted in the United States of America.

Our audit was made for the purpose of forming an opinion on the basic financial statements of the Corporation taken as a whole. The information contained in the Management's Discussion and Analysis is not a required part of the financial statements but is supplementary information required by the Federal Accounting Standards Advisory Board guidance. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the information. However, we did not audit the information and do not express an opinion thereon.

The accompanying Statement of Functional Expenses for the nine months ended September 30, 2004 is presented for purposes of additional analysis and is not a required part of the basic financial statements. This statement is the responsibility of the management of Corporation. The information in this statement has been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, is fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

In accordance with *Government Auditing Standards*, we have also issued our reports dated January 6, 2005, on our consideration of the Corporation's internal control over financial reporting and on our tests of its compliance with provisions of laws and regulations. Our reports on internal control and compliance are an integral part of an audit conducted in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

This audit was performed pursuant to the Government Corporation Control Act, and is intended solely for the information and use of the United States Congress, the President, the Director of the Office of Management and Budget, the Comptroller General of the United States, the Corporation and its Inspector General. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Williams, Adley & Company, LLP

January 6, 2005
Washington, DC

Millennium Challenge Corporation
Statement of Financial Position
As of September 30, 2004

	Total	Program	Administrative	Audit
Assets				
Fund Balance with Treasury *(Note 2)*	$ 989,816,579	$ 986,171,577	$ 3,288,818	$ 356,184
Prepayments *(Note 3)*	168,599	-	168,599	-
Total Assets	$ 989,985,178	$ 986,171,577	$ 3,457,417	$ 356,184
Liabilities				
Accounts Payable	$ 23,884	$ -	$ 23,884	$ -
Other Liabilities *(Note 4)*	854,625	-	498,441	356,184
Accrued Unfunded Annual Leave	169,901	-	169,901	-
Total Liabilities	$ 1,048,410	$ -	$ 692,226	$ 356,184
Net Position				
Unexpended Appropriations				
Obligated	$ 2,765,191	$ -	$ 2,765,191	$ -
Unobligated	986,171,577	986,171,577	-	-
Cumulative Results of Operations	-	-	-	-
Total Net Position *(Note 5)*	$ 988,936,768	$ 986,171,577	$ 2,765,191	$ -
Total Liabilities and Net Position	$ 989,985,178	$ 986,171,577	$ 3,457,417	$ 356,184

The footnotes are an integral part of these financial statements

Millennium Challenge Corporation
Statement of Operations and Changes in Net Position
For the nine month ended September 30, 2004

	Total	Program	Administrative	Audit
Revenues				
Appropriations Used	$ 5,163,232	$ -	$ 4,807,048	$ 356,184
Expenses	$ 5,163,232	$ -	$ 4,807,048	$ 356,184
Excess of Revenues over Expenses	$ -	$ -	$ -	$ -
Net Position				
Excess of Revenues over Expenses	$ -	$ -	$ -	$ -
Increase in Unexpended Appropriations				
Obligated	2,765,191	-	2,765,191	-
Appropriated	992,071,577	992,071,577	-	-
Permanent Recission	(5,900,000)	(5,900,000)	-	-
Unobligated	986,171,577	986,171,577	-	-
Total Increase in Unexpended Appropriations	988,936,768	986,171,577	2,765,191	-
Beginning Net Position - January 23, 2004	$ -	$ -	$ -	$ -
Ending Net Position - September 30, 2004	$ 988,936,768	$ 986,171,577	$ 2,765,191	$ -

The footnotes are an integral part of these financial statements

Millennium Challenge Corporation
Statement of Functional Expenses
For the nine month period ended September 30, 2004

	Total	Program	Administrative	Audit
Salary and Benefits	$ 2,185,333	$ -	$ 2,013,058	$ 172,275
Travel	460,463		443,508	16,955
Rent/Lease	322,833		322,833	
Utilities	170,241		170,241	
Information Technology Services	502,286		502,286	
Accounting Services	316,496		316,496	
Other Services	893,483		726,529	166,954
Supplies and Equipment	102,368		102,368	
Miscellaneous	209,729		209,729	
	$ 5,163,232	$ -	$ 4,807,048	$ 356,184

The footnotes are an integral part of these financial statements

Millennium Challenge Corporation
Statement of Cash Flows
For the nine month period ended September 30, 2004

	Total	Program	Administrative	Audit
Cash Flows from Operating Activities				
Excess of Revenues over Expenses	$ -	$ -	$ -	$ -
Adjustments Affecting Cash Flow:				
Appropriated Capital Used	$ (5,163,232)	$ -	$ (4,807,048)	$ (356,184)
Increase in Prepayments	(168,599)	-	(168,599)	-
Increase in Accounts Payable	23,884	-	23,884	-
Increase in Other Liabilities	854,625	-	498,441	356,184
Increase in Unfunded Annual Leave Liabilities	169,901	-	169,901	-
Total Adjustments	$ (4,283,421)	$ -	$ (4,283,421)	$ -
Net Cash Generated by Operating Activities	$ (4,283,421)	$ -	$ (4,283,421)	$ -
Cash Flows from Financing Activities				
Appropriations Received Net of Recissions	$ 994,100,000	$ 986,171,577	$ 7,572,239	$ 356,184
Fund Balance with Treasury, Beginning	$ -	$ -	$ -	$ -
Fund Balance with Treasury, Ending	$ 989,816,579	$ 986,171,577	$ 3,288,818	$ 356,184

The footnotes are an integral part of these financial statements

Millennium Challenge Corporation
Statement of Budgetary Resources
For the nine month ended September 30, 2004

	Total	Program	Administrative	Audit
Budgetary Resources:				
Budget Authority:				
Appropriations	$ 1,000,000,000	$ 992,071,577	$ 7,572,239	$ 356,184
Net Transfer, Current Year Authority	-			
Unobligated Balance - Beginning of Period	-			
Unobligated Balance - Transferred				
Spending Authority from Offsetting Collections	-			
Advances Received	-			
Adjustments:				
Recoveries of Prior Years Obligations	-			
Permanently Not Available (Note 6)	(5,900,000)	(5,900,000)		
Total Budgetary Resources	$ 994,100,000	$ 986,171,577	$ 7,572,239	$ 356,184
Status of Budgetary Resources:				
Obligations Incurred	$ 7,928,423	$ -	$ 7,572,239	$ 356,184
Unobligated Balance Available:				
Apportioned	986,171,577	986,171,577		
Unobligated Balance Not Available:	-			
Total Status of Budgetary Resources	$ 994,100,000	$ 986,171,577	$ 7,572,239	$ 356,184
Relationship of Obligations to Outlays:				
Obligated Balance, Net - Beginning of Period	$ -	$ -	$ -	$ -
Obligations Incurred	7,928,423	-	7,572,239	356,184
Recoveries of Prior Years Obligations	-			
Adjustments				
Obligated Balance, Net - End of Period				
Accounts Payable	(1,048,410)		(692,226)	(356,184)
Undelivered Orders	(2,596,592)		(2,596,592)	
Total Outlays	$ 4,283,421	$ -	$ 4,283,421	$ -
Outlays:				
Disbursements	4,283,421	-	4,283,421	-
Collections / Refunds	-			
Net Outlays	$ 4,283,421	$ -	$ 4,283,421	$ -

The footnotes are an integral part of these financial statements

Millennium Challenge Corporation
Footnotes
(As of September 30, 2004)

Note 1 – Summary of Significant Accounting Policies

A. Basis of Presentation

These financial statements have been prepared to report the financial position, results of operations, cash flows, and budgetary resources for the Millennium Challenge Corporation (the Corporation), as required by Section 613 of the Millennium Challenge Act of 2003. The Corporation was formed on January 23, 2004. These financial statements have been prepared from the books and records of the Corporation in accordance with generally accepted accounting principles (according to the Federal Accounting Standards Advisory Board, or FASAB) for the period January 23, through September 30, 2004. The Corporation is not subject to income tax.

The principal financial statements of the Corporation are the:

- Statement of Financial Position;
- Statement of Operations and Changes in Net Position;
- Statement of Cash Flows; and
- Statement of Budgetary Resources.

The notes to the financial statements are considered an integral part of the financial statements.

B. Reporting Entity

The Corporation was created by the Millennium Challenge Act of 2003 (Public Law 108-199). The Corporation provides United States assistance for global development. This assistance is provided in such a manner as to provide economic growth and the elimination of extreme poverty and strengthens good governance, economic freedom, and investments in people.

C. Budgets and Budgetary Accounting

The activities of the Corporation are funded through an appropriation with indefinite expiration (no-year funds). For FY 2004, $1 billion was initially appropriated. This appropriation funds both the cost of administrative operations, and any grants, compacts or contracts with eligible entities.

D. Basis of Accounting

Transactions are recorded in the accounting system on an accrual basis and a budgetary basis. Under the accrual method of accounting, revenues are recognized when earned and expenses are recognized when a liability is incurred, without regard to receipt or payment of cash.

The recognition of budgetary accounting transactions is essential for compliance with legal constraints and controls over the use of Federal funds. Budgetary accounting principles are designed to recognize the obligation of funds according to legal requirements, which in many cases is prior to the occurrence of an accrual-based transaction. Thus, the financial statements differ from other financial reports submitted pursuant to Office of Management and Budget directives for the purpose of monitoring and controlling the use of the Corporation’s budgetary resources.

E. Fund Balance with Treasury

The Corporation does not maintain cash in commercial bank accounts. The U.S. Treasury processes all cash receipts and disbursements for the Corporation. The Fund Balance with Treasury represents no-year funds, which are maintained in appropriated funds that are available to pay current and future commitments.

F. Advances to Others

The Corporation advances funds, primarily in response to grantee drawdown requests, to facilitate completion of any approved grant or contract.

G. Property and Equipment

The Corporation capitalizes property and equipment at historical cost for acquisitions of $25 thousand or more, with an estimated useful life of two or more years. These assets can include telephone equipment, computer systems equipment, copiers, computer software, furniture, and assets under capital leases. These assets are depreciated (or amortized) over estimated useful lives ranging from two to ten years, using the half-year convention. Normal maintenance and repair costs on capitalized property and equipment are expensed when incurred.

H. Grants Payable

Grants are made to eligible countries with an approved Compact. Grants become budgetary obligations, but not liabilities, when they are awarded. At the end of each fiscal year, the Corporation reports the total amount of unreimbursed authorized grantee expenses, earned under the terms of the Compact, as grants payable.

I. Accounts Payable

The Corporation records as liabilities all amounts that are likely to be paid as a direct result of transactions or events that have already occurred. Accounts payable represents amounts due to both Federal and non-Federal entities for goods and services received by the Corporation, but not paid for at the end of the fiscal year.

J. Actuarial FECA Liability

The Federal Employees' Compensation Act (FECA) provides income and medical cost protection to covered Federal civilian employees injured on the job, employees who have incurred a work-related occupational disease, and beneficiaries of employees whose death is attributable to a job-related injury or occupational disease.

Claims incurred for benefits for Corporation employees under FECA are administered by the Department of Labor (DOL) and later billed to the Corporation. The Corporation's actuarial liability for worker's compensation includes any costs incurred but unbilled as of year-end, as calculated by DOL, and is not funded by current appropriations.

Because 2004 is the first year of limited operation for the MCC, there are no FECA liabilities incurred or reflected on the statements.

K. Other Liabilities

Other liabilities included amounts owed but not paid at the end of the fiscal year for payroll and benefits.

L. Accrued Annual Leave

Annual leave is accrued as a liability based on amounts earned but not used as of the fiscal year-end. Each year, the balance in the accrued annual leave account is adjusted to reflect current year pay rates and leave balances. Annual leave is funded from current appropriations when used. As unused annual leave is used in the future, financing will be obtained from appropriations current at that time. Sick leave and other types of non-vested leave are expensed when used.

M. Net Position

Net position is composed of unexpended appropriations and cumulative results of operations. Unexpended appropriations are funds appropriated and warranted to the Corporation that are still available for expenditure at the end of the fiscal year. Cumulative results of operations represent the net differences between revenues and expenses from the inception of the Corporation.

N. Revenues

The Corporation obtains funding for its program and operating expenses through no-year appropriations. Appropriations are recognized as an accrual-based financing source at the time they are used to pay program or administrative expenses, except for expenses to be funded by future appropriations such as earned but unused annual leave. Appropriations expended for property and equipment are recognized as a financing source when the property is purchased.

O. Retirement Benefits

The Corporation's employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). FERS was established by the enactment of Public Law 99-335. Pursuant to this law, FERS and Social Security automatically cover most employees hired after December 31, 1983. Employees hired prior to January 1, 1984, elected to join FERS and Social Security or remained in CSRS.

For employees covered by CSRS, the Corporation contributes 8.51 percent of their gross pay towards retirement. For those employees covered by FERS, the Corporation contributes 11.50 percent of their gross pay towards retirement. Employees are allowed to participate in the Federal Thrift Savings Plan (TSP). For employees under FERS, the Corporation contributes an automatic one percent of basic pay to TSP and matches employee contributions up to an additional four percent of pay, for a maximum Corporation contribution amounting to five percent of pay. Employees under CSRS may participate in the TSP, but will not receive either the Corporation's automatic or matching contributions.

The Corporation made retirement contributions of $5 thousand to the CSRS Plan and $117 thousand and $20 thousand to the FERS and TSP Plans in fiscal year 2004.

P. Use of Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

Q. Contingencies

The Corporation can be a party to various routine administrative proceedings, legal actions, and claims brought by or against it, including threatened or pending litigation involving labor relations claims, some of which may ultimately result in settlements or decisions against the Corporation. In the opinion of the Corporation's management and legal counsel, there are no proceedings, actions or claims outstanding or threatened, which would materially impact the financial statements of the Corporation.

R. Judgment Fund

Certain legal matters to which the Corporation can be named as a party may be administered and, in some instances, litigated and paid by other Federal agencies. Generally, amounts paid in excess of $2.5 thousand for Federal Tort Claims Act settlements or awards pertaining to these litigations are funded from a special appropriation called the Judgment Fund. Although the ultimate disposition of any potential Judgment Fund proceedings cannot be determined, management does not expect any liability or expense that might ensue would be material to the Corporation's financial statements.

S. Donated Services

The Corporation utilized donated services from other Federal agencies during the period of establishment for the Corporation. The dollar amount of these donated services is immaterial to these statements.

Note 2 – Fund Balance with Treasury

The U.S. Treasury accounts for all US Government cash on an overall consolidated basis. The Fund Balance with Treasury line on the Statement of Financial Position consists of the following:

Fund Balance with Treasury as of September 30
(In Dollars)

	2004
Appropriated Funds	
Unobligated	$ 986,171,577
Obligated	$ 3,645,002
Total	$ 989,816,579

Note 3 – Prepayments

The prepayment reflects a prepaid lease on office space with the U.S. Department of State.

Note 4 – Other Liabilities

Other Liabilities as of September 30
(In Dollars)

2004	
Type	**Amount**
Accrual	
Office of the Inspector General	$ 356,184
Payroll	$ 330,216
Travel	$ 81,001
Miscellaneous	$ 87,224
Total	$ 854,625

Note 5 – Net Position

The reported net position consists of unexpended appropriations and cumulative results of operations (cumulative results of operations represents the differences between revenues and expenses since the Corporation's inception).

Net Position as of September 30
(In Dollars)

2004	
	Appropriated Fund
Unexpended Appropriations	$ 988,936,768
Cumulative Results of Operations	$ 0
Total Net Position	$ 988,936,768

Note 6 – Permanent Rescission

In fiscal year 2004, $5.9 million of amounts previously appropriated under the 2004 Foreign Operations, Export Financing, and Related Programs Appropriations Act (Public Law 108-199) were rescinded. This rescission was part of the Across-the-Board Rescission, 2004.

WILLIAMS, ADLEY & COMPANY, LLP
Management Consultants
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Inspector General
United States Agency for International Development

Board of Directors
Millennium Challenge Corporation

We have audited the Statement of Financial Position of the Millennium Challenge Corporation (Corporation) as of September 30, 2004, and the related Statements of Operations and Changes in Net Position, Cash Flows, and Budgetary Resources for the nine months ended September 30, 2004, and have issued our report thereon dated January 6, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*.

In planning and performing the September 30, 2004 audit, we considered the Corporation's internal control over financial reporting by obtaining an understanding of the Corporation's internal control, determining if internal control had been placed in operation, assessing control risk, and performing tests of internal controls to determine our auditing procedures for the purpose of expressing an opinion on the financial statements. We limited internal control testing to those controls necessary to achieve the objectives described in *Government Auditing Standards* and OMB Bulletin 01-02. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982, such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on the Corporation's internal control over financial reporting. Consequently, we do not provide an opinion thereon.

Our consideration of internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal controls over financial reporting that, in our judgment, could adversely affect the Corporation's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, in amounts that would be material in relation to the financial statements being audited, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected.

We noted one matter involving internal control over financial reporting and its operation that we consider to be a reportable condition. We do not consider this reportable condition to be a material weakness.

Review of Oracle Federal Financials System

The Millennium Challenge Corporation (Corporation) does not have its own financial system. The Corporation contracted with the Department of Interior, National Business Center (NBC) to provide accounting and IT services including usage of its Oracle Federal Financials System application. The NBC has not conducted an internal control review, such as a Statement of Auditing Standards (SAS) 70 review, of the Oracle Federal Financials System nor has MCC directed NBC as its third-party servicer to have a review conducted in accordance with the federal system requirements.

The Federal Financial Management Improvement Act financial system requirements state that a system should comply with OMB Circular A-127, *Federal Financial System Requirements*. The Circular requires an agency to conduct an internal control review of all federal financial systems in accordance with FMFIA. By not completing an internal control review of the financial system, management does not have a comprehensive understanding of the system's internal controls and the risk involved in conducting system transactions. Per the Corporation, they are the first organization to use the system. It is a new system for NBC.

Recommendation

We recommend that MCC direct the National Business Center to conduct an internal control review, such as a SAS 70 review, to assess the control environment of the Oracle Federal Financials System.

We also noted other matters involving internal control and its operation that we will report to Corporation management in our management letter.

This audit was performed pursuant to the Government Corporation Control Act, and is intended solely for the information and use of the United States Congress, the President, the Director of the Office of Management and Budget, the Comptroller General of the

United States, the Corporation and its Inspector General. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Williams, Adley & Company, LLP

January 6, 2005
Washington, DC

WILLIAMS, ADLEY & COMPANY, LLP
Management Consultants
Certified Public Accountants

INDEPENDENT AUDITORS' REPORT ON COMPLIANCE WITH LAWS AND REGULATIONS

Inspector General
United States Agency for International Development

Board of Directors
Millennium Challenge Corporation

We have audited the Statement of Financial Position of the Millennium Challenge Corporation (Corporation) as of September 30, 2004, and the related Statements of Operations and Changes in Net Position, Cash Flows, and Budgetary Resources for the nine months ended September 30, 2004, and have issued our report thereon dated January 6, 2005. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and the Office of Management and Budget (OMB) Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements.*

The Corporation's management is responsible for complying with laws and regulations applicable to the Corporation. As part of obtaining reasonable assurance that the Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin 01-02, including the requirements referred to in the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and we did not test compliance with all laws and regulations applicable to the Corporation.

Under FFMIA, we are required to report whether the Corporation's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. To meet this requirement, we performed tests of compliance with FFMIA section 803(a) requirements.

The results of our tests disclosed one instance, see the Auditors' Report on Internal Control over Financial Reporting, where the agency's financial management systems did not substantially comply with the Federal financial management systems requirements. This instance of non-compliance is required to be reported under *Government Auditing Standards* or OMB Bulletin No. 01-02

Providing an opinion on compliance with those provisions was not, however, an objective of our audit and, accordingly, we do not express such an opinion.

This audit was performed pursuant to the Government Corporation Control Act, and is intended solely for the information and use of the United States Congress, the President, the Director of the Office of Management and Budget, the Comptroller General of the United States, the Corporation and its Inspector General. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Williams, Adley & Company, LLP

January 6, 2005
Washington, DC

MANAGEMENT COMMENTS AND OUR EVALUATION

We consider the management comments to be responsive to the recommendations made in this report. We have included these comments in their entirety in Appendix I.

MCC's management noted the non-compliance and internal control weakness identified the auditors' reports and concurred with the report finding and recommendation that MCC require the National Business Center (NBC) to conduct an internal control review to assess the control environment of the Oracle Federal Financials System used to process MCC's transactions. MCC stated that it has discussed the issue with the NBC and NBC has scheduled a SAS 70 audit of the Oracle Federal Financials System which is expected to be completed in fiscal year 2005.

Based on MCC's comments, we consider that a management decision has been reached on the report's recommendation. MCC should report to the OIG when final action has been taken.

VIII. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS AND ANNUAL INTEGRITY ACT REPORT

MCC began to fully implement internal accounting and administrative control systems for the corporation during this, its first year of operations. MCC was able to meet the intent of the Federal Managers' Financial Integrity Act of 1982 (FMFIA) for FY 2004 by using the work of the Office of the Inspector General / USAID, external audits and reviews, observations and analyses of its daily operations and audits performed by its service partners. Because not all of these controls were formalized and documented and MCC did not perform a formal assessment of these controls, MCC's internal control procedures did not fully comply with the requirements of the FMFIA. MCC did not identify any material reportable internal control weaknesses; items identified are reflected in the Management Discussion and Analysis section of the audit report attached hereto.

MCC's service provider, the Department of Interior's National Business Center (NBC), did not conduct a formal review of the Oracle Financial System used to record MCC's financial transactions. The Office of Inspector General / USAID auditors identified this as a weakness during the audit of MCC's financial statements. As a result, MCC did not technically comply with the requirements of the Federal Financial Management Improvement Act and the related Office of Management and Budget (OMB) Circular A-127, which requires that agencies conduct a review of all Federal financial systems as part of FMFIA compliance. NBC has accordingly contracted for a Statement of Auditing Standards (SAS) 70 review of the Oracle Financial System used by MCC; the auditor's report is expected to be issued by April 30, 2005.

A report from the Office of Inspector General / USAID issued in FY 2004 determined that MCC had not developed an information security program or implemented such a program under the Federal Information Security Management Act of 2002 (FISMA) while using a State Department hosted network. MCC accepted the Inspector General's recommendation and agreed to begin to address it in the course of migrating to a proprietary network in December 2004. The Inspector General is currently auditing the work performed to date and to delineate what further steps are needed.

Certification:

MCC did not perform a formal internal control assessment for the year ended September 30, 2004. Based on reports from the Office of Inspector General / USAID and the Government Accountability Office, including audits, inspections, reviews and audits of financial systems, as well as knowledge gained from daily operations of MCC programs and systems, I conclude that the systems of internal controls used by MCC provide reasonable assurance that the intent of the Federal Managers' Financial Integrity Act was achieved.

Paul V Applegarth

Paul V. Applegarth
Chief Executive Officer

Appendix I

Millennium Challenge Corporation
Reducing Poverty Through Growth

January 11, 2005

Henry L. Barrett
Assistant Inspector General
AIG/MCC-Room 8.09.63, RRB
1300 Pennsylvania Avenue, NW
Washington, DC 20523

Re: Audit Report of the 2004 Financial Statement

Dear Mr. Barrett:

We have received the audit report submitted by Williams, Adley & Company, LLP, including the opinion on the Millennium Challenge Corporation's (MCC) financial statements, internal controls, and compliance with laws and regulations. We are pleased to note that all five financial statements (Financial Position, Operations and Changes in Net Position, Cash Flows, Functional Expenses and Budgetary Resources) have received unqualified opinions in our first year of operations. We thank you and your team, as well as Williams, Adley & Company, for working closely with us during the audit process.

During the course of the audit, you identified and reported an instance of weakness in the internal controls over financial reporting and a related instance of non-compliance with selected provisions of applicable laws and regulations. We concur with your finding and recommendation that the National Business Center conduct an internal control review of the Oracle Financial System as called for by SAS 70. As noted in your report, we have discussed this issue with NBC who has scheduled a SAS 70 audit of this system, which is expected to be completed in fiscal year 2005.

MCC recognizes the importance of accountability, transparency and public disclosure, and our goal is to achieve excellence in our financial management systems. We look forward to working with you and your staff on the FY 2005 audit. Any questions may be addressed to Nimalka Wijesooriya, Comptroller at MCC or to me.

Sincerely,

/s/
Paul V. Applegarth, Chief Executive Office

(202) 521-3600 | (202) 521-3700 [Fax]
P.O. Box 12825
Arlington, VA 22209
www.mcc.gov

Appendix II.

Key Staff
as of September 30, 2004

Paul V. Applegarth
Chief Executive Officer

Jon Dyck
Vice President and General Counsel

John Hewko
Vice President
Country Relations

Gary Keel
Vice President
Administration and Finance

Clay Lowery
Vice President
Markets and Sectoral Assessments

Frances McNaught
Vice President
Domestic Relations

Charles Sethness
Vice President
Monitoring and Evaluation