

June 30, 2009

Honorable Finley S. Perman  
Secretary of Finance and Administration  
Federated States of Micronesia:

Dear Secretary Perman:

In planning and performing our audit of the financial statements of the governmental activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Federated States of Micronesia (FSM) National Government as of and for the year ended September 30, 2008 (on which we have issued our report dated June 30, 2009), in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, we considered the State's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the State's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of FSM's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting. However, in connection with our audit, we identified, and included in the attached Appendix I, deficiencies related to FSM's internal control over financial reporting and other matters as of September 30, 2008 that we wish to bring to your attention.

We have also issued a separate report to the Honorable Emmanuel Mori, also dated June 30, 2009, on our consideration of FSM's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters.

The definition of a deficiency is also set forth in the attached Appendix I.

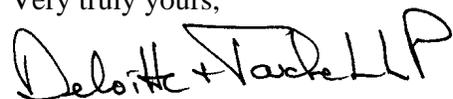
A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with this report.

This report is intended solely for the information and use of the management of the FSM and the Office of the National Public Auditor and is not intended to be and should not be used by anyone other than these specified parties. However, this report is also a matter of public record.

We will be pleased to discuss the attached comments with you and, if desired, to assist you in implementing any of the suggestions.

We wish to thank the staff and management of FSM for their cooperation and assistance during the course of this engagement.

Very truly yours,



**SECTION I – OTHER MATTERS**

We identified, and have included below, other matters involving the State’s internal control over financial reporting as of September 30, 2008 that we wish to bring to your attention:

1. Investments

Comment: The movement in the investment in the BoFSM does not agree to the revenue recognized from the sale of stock. The National Government could not provide the rationale for the difference.

Movement in the investment	\$5,910
Revenue from sale of stock	<u>2,354</u>
Difference	\$3,556

Recommendation: Changes in the investment account should be reconciled with revenue to account for stock movements.

2. Cash

Comment: We noted several instances of duplicate check numbers. It is our understanding that this condition existed because the system assigns check number.

There was improper cut-off of checks. Check number 81383 was dated in FY08 and cleared in FY09; however, it was not included in the outstanding check listing. Check number 40041 was dated 10/2/08; however, this check was included as outstanding.

The following copy of outstanding checks could not be located.

<u>Check No.</u>	<u>Date</u>	<u>Debit</u>
78166	3252008	\$ 15,000
78186	3252008	60,000
5012822	1112008	8,458
1164 - ADB		2,700

Recommendation: The National Government may consider using pre-numbered checks to avoid duplication of check numbers. Moreover, the duplicate check numbers may create improper check cut-off. Documents should be readily available for verification.

3. ADB Cash

Comment: The ADB fund has a negative cash account balance of \$8,360, carried over from prior year. This account is used as a clearing account. However, the National Government cannot identify the nature of the negative balance as there does not appear to be timely reconciliations of the account.

Recommendation: Timely reconciliation of accounts should occur.

4. Pre-numbered Documents

Comment: It is normally best practice to use pre-numbered documents (i.e. checks, cash receipt) to ensure no duplication of documents and account for its completeness. In Fundware, cash receipts and check numbers are assigned by the system.

Recommendation: The National Government may consider using pre-numbered documents to deter instances of fraudulent reproduction of documents and to strengthen controls.

5. NOAA

Comment: NOAA is presented in the financial statements as part of the Grants Fund. Currently NOAA transactions are incorporated in the Reimbursable funds and are comingled with MiCare payroll transactions. In the current year, as there were only two months of transactions recorded in Fundware, NOAA transactions were readily identifiable. However in subsequent years, there exists a possibility that NOAA transactions may not be accurately presented in the financial statements.

Recommendation: The National Government may consider segregating the accounting of NOAA in Fundware to allow accurate financial presentation and to minimize reconciliations involved in segregating NOAA transactions.

6. Accounts Receivable

Comment: There does not appear to be significant collections of receivables from NOAA and other vendors billed for overtime charges incurred by National government employees. The receivables are recorded in account 01-1810. In the current year account 01-1810 recorded an allowance of \$1.2 million.

Recommendation: Aggressive effort should be made to collect these receivables to augment liquidity of the Government. As for NOAA, as it is a reimbursable federal program, the National Government may want to revisit the cost of administering the program considering the collection constraint in the reimbursement request.

7. Timely Collection of Travel Advances

Comment: There appears to be lack of aggressive effort to collect travel advances. However, the National Government has provided a sufficient allowance to cover these uncollectible advances and therefore, this matter does not have a material impact on the financial statements.

Travel advances	\$ 1,434,098
Allowance	<u>1,237,459</u>
Remaining	\$ <u>196,639</u>

Recommendation: The FSM National Government should adhere to travel advance policies to assist in collections. This matter has been cited in prior year.

8. Annual Leave

Comment: For 3 of 3 (100%) tested, approved annual leave forms supporting annual leave utilized were not available.

<u>Employee Number</u>
913130
69604
28799

Recommendation: We recommend that periodic reviews of annual leave occur to determine compliance with personnel policies and regulations. In addition, annual leave taken should be documented and be readily available for verification.

9. Local Procurement

Comment: For general fund and other non-federal expenditures, local procurement regulations are not always followed. In addition, included in the General fund is a purchase of a \$500 mobile phone charged as office supplies. There was no rationale provided as to the relation of the expenditure to the program.

Recommendation: The National Government should adhere to local regulations and nature of expenditure charged should be related to program and account.

10. Missing Documents

Comment: Underlying documentation of the sampled items in the following accounts were not provided.

<u>Account</u>	<u>Fund</u>	<u>Aggregate Amount</u>
Revenue	GF	\$ 20,285
Accounts payable	GF	16,892
Expenditures	GF	129,940
Expenditures	NM	<u>39,733</u>
		<u>\$206,850</u>

Recommendation: The National Government should maintain sufficient documentation on file to substantiate program costs.

**SECTION II – DEFINITIONS**

The definition of a deficiency that is established in AU 325, *Communicating Internal Control Related Matters Identified in an Audit*, is as follows:

A *deficiency* 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 deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when (a) a properly designed control does not operate as designed, or (b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.

## **MANAGEMENT'S RESPONSIBILITY FOR, AND THE OBJECTIVES AND LIMITATIONS OF, INTERNAL CONTROL OVER FINANCIAL REPORTING**

The following comments concerning management's responsibility for internal control over financial reporting and the objectives and inherent limitations of internal control over financial reporting are adapted from auditing standards generally accepted in the United States of America.

### **Management's Responsibility**

FSM National Government management is responsible for the overall accuracy of the financial statements and their conformity with generally accepted accounting principles. In this regard, management is also responsible for establishing and maintaining effective internal control over financial reporting.

### **Objectives of Internal Control over Financial Reporting**

Internal control over financial reporting is a process affected by those charged with governance, management, and other personnel and designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting (i.e., the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles).

### **Inherent Limitations of Internal Control over Financial Reporting**

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.