

June 30, 2010

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, 2009 (on which we have issued our report dated June 30, 2010), 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 FSM National Government'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 FSM National Government'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 the FSM National Government's internal control over financial reporting and other matters as of September 30, 2009 that we wish to bring to your attention.

We have also issued a separate report to the President, His Excellency Emmanuel Mori, also dated June 30, 2010, on our consideration of the FSM National Government'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.

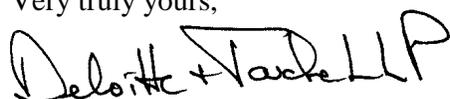
A description of the responsibility of management for establishing and maintaining internal control over financial reporting and of the objectives of and inherent limitations of internal control over financial reporting, is set forth in the attached Appendix II and should be read in conjunction with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

This report is intended solely for the information and use of the management of the FSM National Government 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 the FSM National Government 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 FSM National Government’s internal control over financial reporting as of September 30, 2009 that we wish to bring to your attention:

1. Deferred Revenue

Comment: The program description in the allotment advice does not agree with the nature of the non –U. S. federal grant award for program account number A1-23-70-71-36617-09. The National Government allotted the funding for a Suicide Program; however, the grant award stated that is for a Self Help Workshop for People with Disabilities in Chuuk. As such, the objectives of the grant may not have been met.

Recommendation: Program descriptions in the advice of allotment should be in line with project objectives.

2. ADB Cash

Comment: The ADB Loan fund has a negative cash account balance of \$8,360 that has been 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.

Recommendation: Reconciliation of this account should occur.

3. Pre-numbered Documents

Comment: It is normally best practice to use pre-numbered documents (i.e. checks, cash receipts) to minimize the duplication of documents and to account for their completeness. In Fundware, cash receipts and check numbers are assigned by the system. If documents are pre-numbered, the documents should be used in sequence (such as CTA cash receipts). Additionally, income tax assessments should be subject to review to ensure that appropriate rates are utilized and collections should be timely deposited to Treasury. There were also gaps noted in the CTA receipts and the Government was not able to provide the whereabouts of those receipts.

Recommendation: The National Government may consider using pre-numbered documents to deter and to minimize fraudulent reproduction of documents. If pre-numbered documents are used, they should be used in sequence. Additionally, income tax assessments should be subjected to a review to determine that appropriate rates were utilized and collections should be timely deposited to Treasury.

4. Accounts Receivable

Comment: Significant collections of receivables from NOAA do not appear to have occurred. Additionally, the same appears to be the case for vendors billed overtime charges of National Government employees and other miscellaneous receivables.

	AR	Allowance	Net
General	\$ 967,299	\$ 962,798	\$ 4,501
NOAA	1,023,132	832,357	190,775
	<u>\$ 1,990,431</u>	<u>\$ 1,795,155</u>	<u>\$ 195,276</u>

Recommendation: Aggressive efforts should occur to collect these receivable. As for NOAA, as it is a reimbursable federal program, the National Government may wish to revisit the cost of administering the program considering the amount of potential losses being incurred.

5. Local Procurement

Comment: For general fund and other non federal expenditures, local procurement regulations are not being followed.

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

6. Missing Documents

Comment: Underlying documentation requested for non-U. S. federal transactions could not be located in certain instances. We assessed the dollar value of the unlocated items to be immaterial to the financial statements

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

7. MLFC

Comment: Total loan payments related to the former MLFC debt approximated \$168,000. The Congress authorized up to \$150,000; hence a transfer for loan payments to the General fund was in that amount and the remaining \$18,000 was charged against a suspense account for ADB loan payments.

Recommendation: We recommend that adequate documentation be on file to demonstrate the disposition of the \$18,000.

8. Reprogramming Documents

Comment: Public Law 15-155 appropriated \$200,000 for the Disaster Assistance Emergency Fund (DAEF) Matching. In fiscal year 2009, this appropriation was used for expenditures on the Emergency Declaration for Tidal Surges in the FSM. No reprogramming documentation was provided to support the change.

Recommendation: Changes in the nature of budget allocations should be appropriately supported by reprogramming authorizations.

9. Scholarship Checks

Comment: In certain instances, scholarship checks were made out solely to the student instead of to the student and the institution.

Recommendation: We recommend that this policy continue to be reexamined to determine if the checks should be made out to both parties.

10. Program Related Purchases

Comment: Certain expenditures of the Caroline Voyager taken in June, July and December included payments for vessel provisioning that included perfume, cigarettes, candy, wine and a copier.

Recommendation: Expenditures charged should relate to the program and account.

11. Monitoring of Budget

Comment: For General Fund program number 09850, Public Law 15-55 appropriated \$65,000 of which \$46,000 was specifically reserved for travel. However, per the expenditure report submitted, \$54,000 was expended on travel and no reprogramming documents were made available.

Recommendation: Changes in the nature of budget allocations should be appropriately supported by a reprogramming authorization.

12. Segregation of Duties

Condition: For certain investment related transactions, including fishing fees, initiation of the transfer of funds between accounts and the reconciliation of transactions are performed by the same person. Initiation of entries in recording the transaction is approved by the same person who reviews and approves the investment activity. Although actual posting of the journal vouchers (JV) to Fundware is performed and approved by the National Treasury Division, the reconciliation and JV preparation is performed by the same person.

Recommendation: Segregation of incompatible duties is important to provide assurance that assets are safeguarded against irregularities. Fundamentally, persons who have the ability to cause investments to be recorded or written down without a higher level of approval should not also have access to assets. In addition, persons reconciling investments and related amounts and approving/initiating ledger postings should not have unrestricted access to assets.

13. Budgetary Statement

Condition: Certain appropriations and reprogramming requests may not have been presented in the correct program account budget and this may result in an immaterial over or under program expenditure. Certain program accounts' budget were corrected during the audit process. Additionally, in some instances, the fund status report was not updated to reflect correct program appropriations. Instead, a manually prepared schedule was provided to support preparation of the RSI budgetary statement.

Recommendation: The National Government should maximize the functionality of Fundware. Budget amounts should be completely and correctly entered in the system to allow for accurate, relevant and timely reporting.

14. Annual Leave

Comment: Annual leave is overstated by approximately \$90,000 and the effect of this determination is reflected in the list of uncorrected adjustments. The amount recorded was as of 12/31/2009, which was utilized due to discrepancies noted during the audit process.

Recommendation: Appropriate review should be performed as to the accuracy of amounts recorded.

15. Encumbrances

Comment: Travel encumbrances are not periodically reconciled with travel advances.

Recommendation: Periodic reconciliation should occur to reaffirm the validity of outstanding encumbrances.

16. Formalize Loan Agreement

Comment: A formal loan agreement has not been prepared relative to a loan extended to a component unit. An immaterial difference in the outstanding loan amount exists between the two parties.

Recommendation: The Government should formalize the loan agreement and resolve the current difference.

17. Deferred Revenue

Comment: For 3 of 7 non-US Grants tested, no movement in the recorded deferred revenue occurred during fiscal year 2009 and the grant was silent as to the return of funds upon project completion. There was insufficient documentation (cash receipt or grant award) to fully determine the validity of the recorded balances. Additionally, several deferred revenue accounts have not yet been transferred to Fundware.

Recommendation: The continuing validity of the deferred revenue accounts should be assessed.

18. Payroll

Comment: For the non-US federal payroll transactions, certain system pay rates differ from Personnel Action Forms. Additionally, certain related timesheets could not be located.

Recommendation: Sufficient documentation should be on file to support recorded transactions.

19. General Fund

Comment: For 49 of 177 non payroll general fund expenditures tested aggregating \$179,846, there was either insufficient or no underlying documents provided.

Recommendation: We recommend that supporting documents be maintained on file and be readily available.

20. Authorization

Comment: An allottee authorization supporting a related transfer of expenditures to the allottee's account was not provided.

Recommendation: We recommend that allottee authorizations approving transfers of expenditures be maintained on file and be readily available.

**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.