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Friday, December 9, 2011

His Excellency Manny Mori, President  
Honorable Members of the FSM Congress

**Executive Summary: Customs and Tax Administration (CTA) FY 2008- FY 2010**

The Office of the National Public Auditor (ONPA) announces the release of Audit Report No. 2011-07, Audit of the FSM Department Of Finance And Administration, Division Of Customs And Tax Administration. A digital copy of the report is available for public review online at [www.fsmopa.fm](http://www.fsmopa.fm) and printed copies are available at the ONPA's offices in Palikir, Pohnpei and Weno, Chuuk. The audit was conducted in accordance with Generally Accepted Government Auditing Standards (GAGAS) issued by the Comptroller General of the United States.

The Division of Customs and Tax Administration (CTA), within the Department of Finance & Administration (DFA), was established pursuant to Title 54 of the FSM Code. CTA maintains its main office in Palikir, Pohnpei and has a field office in each of the four states of Pohnpei, Chuuk, Yap and Kosrae. CTA is critically tasked with the responsibilities of maximizing collection of local revenues and to maintain border control through its customs services.

The audit scope covered fiscal years 2008, 2009 and 2010 and according to CTA records, during this period of time total local tax revenues were approximately \$74 million. Of this amount, approximately 90% came from collection of the Business Gross Revenue (BGR) Tax, Wage & Salary Tax (Income), and Import Tax, with the remainder (100%-90%) being collected for miscellaneous fees including the fuel tax. Of the 90%, each of the 3 categories were approximately equal.

The objective of our audit was to determine:

1. If management is adequately monitoring the controls to ensure payments collected by the Field Offices are properly receipted and remitted to the DNT.
2. If management is adequately monitoring controls that require business owners accurately and timely report BGR Tax and Wage & Salary Tax.
3. If management is adequately monitoring whether SADs on Import Taxes are properly assessed, verified and collected. And
4. If programs exist to promote ethical behavior in support of the FSM tax system.

Based on the audit testing, the auditors found that the CTA main office does not monitor adequately the field offices in carrying out their key activities of enhancing and enforcing tax collection throughout the FSM. Consequently, the following control weaknesses were found:

- Poor internal control over the system of manual cash receipts continues to put cash at risk of loss or theft. Instances of alleged theft by CTA employees have occurred.
- The tax rolls (list of active businesses) are incomplete and as a result, compliance and tax revenue collection is diminished. Unpaid or unreported taxes by businesses in Pohnpei are not followed-up and the auditors estimate that 40% or more, of businesses in Pohnpei are not

reporting the BGR Tax due. In Chuuk, delinquencies were followed up only when visited by a special task force in 2008 and 2009.

- The accuracy of payment of import taxes is not verified by CTA and the inspection of freight containers is hap-hazard, not formalized and seldom performed.
- CTA employees are not trained in the proper handling of potentially unethical situations including how to maintain independence with local businesses. In the absence of a CTA Code of Ethics and mandatory reporting of gifts, independence with local businesses is not assured nor specifically required.

Ultimately, the practices of CTA are lax especially in Pohnpei and Chuuk, and do not assure the citizens of the FSM that the tax and revenue laws are being uniformly enforced or complied with throughout the FSM.

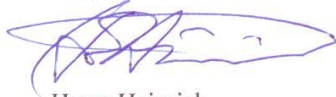
On October 12, 2011 we discussed the report during an exit conference with the Acting Secretary of Finance and Administration and the Assistant Secretary of CTA, both of whom expressed agreement with the findings and recommendation except one minor edit.

The audit report discusses the findings in detail and numerous recommendations were made.

*The CTA management response indicates a lack of ownership of the field office operations, which, until corrected, holds little hope for progress.*

We appreciate the assistance and cooperation of Customs and Tax Administration's staff during the course of our audit.

Respectfully yours,



Haser Hainrick  
National Public Auditor

XC: Vice President  
Secretary, Dept. of Finance & Administration  
Asst. Secretary, Division of Customs & Tax  
Deputy Asst. Secretaries at Field Offices in the States

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## **INTRODUCTION**

### **Background**

The Division of Customs and Tax Administration (CTA), within the Department of Finance & Administration (DFA), was established pursuant to Title 54 of the FSM Code. CTA maintains its main office in Palikir, Pohnpei and has a field office in each of the four states of Pohnpei, Chuuk, Yap and Kosrae. Its primary responsibilities are to maximize collection of local revenues and maintain border control through its customs services. Chapter 1 and 2, of the Title 54 FSM Code Annotated, provides the authority for imposing taxes on Wages & Salaries, Business Gross Revenue (BGR) and for all products imported to the FSM. Imported items will not be released by customs officials until all taxes have been paid. Title 54, as amended also set forth the tax rates and filing requirements for tax returns.

The Assistant Secretary for CTA is responsible for directing the general operations of the CTA main office and its field offices in the four FSM States. A Deputy Assistant Secretary, under the supervision of the Assistant Secretary, manages each field office. During fiscal year 2009, CTA main office and the four field offices in each respective FSM States were authorized a total of 44 full-time positions. CTA Division structure is comprised of two main functions: *Customs* and *Tax Administration*:

1. Customs Administration includes inspection at ports of entry for sea and air, assessment of tax filing, and collection of taxes on goods and merchandise imported into the FSM by sea and air and prevention of prohibited goods of merchandise imported into the FSM. The section includes a Customs Specialist and Customs Analyst at the Main office, nine (9) Customs Officers and eleven (11) Customs Inspectors located at the various field offices.
2. Tax Administration is comprised of the Compliance, Document Processing, and Collection Branches. The Compliance and Document Processing Branches are located at the main office. Employees of the Collection Branch, except for the Manager, are located at the field offices in each of the states. The Manager of the Collection Branch is located at the CTA main office.
  - a. Compliance Branch is responsible for planning and conducting annual audits of taxpayers' records for compliance with the customs & tax code and determining the accuracy and completeness of taxpayers' BGR tax returns. The branch is operated by a branch manager and two revenue agents.
  - b. Document Processing Branch is currently operated by a branch manager and one tax technician. Duties and responsibilities of the manager are performed under the general administrative direction of the Assistant Secretary, CTA Central Office. The branch manager is charged with the responsibilities of controlling, safe-guarding and monitoring the central office files on tax returns and tax refunds and the compilation of statistical data provided through the tax returns as filed by tax payers throughout the Federated States of Micronesia.
  - c. Collection Branch is responsible for the collection of taxes on Wages and Salaries, BGR, Import Duties, License Fees, Penalty and Interest on a daily basis. Daily collections and reports are submitted to the National Treasury field offices in each State, except for Pohnpei which submits its collections and reports to the National Treasury in Palikir. The collection specialist at the CTA main office reconciles the daily collection reports with the National Treasury records, compiles monthly collection reports and maintains a general ledger of tax accounts. The Collection Specialist is at the main office. There are eight (8) revenue officers located in the field offices: three in Pohnpei, two in Chuuk, one in Yap and two in Kosrae.

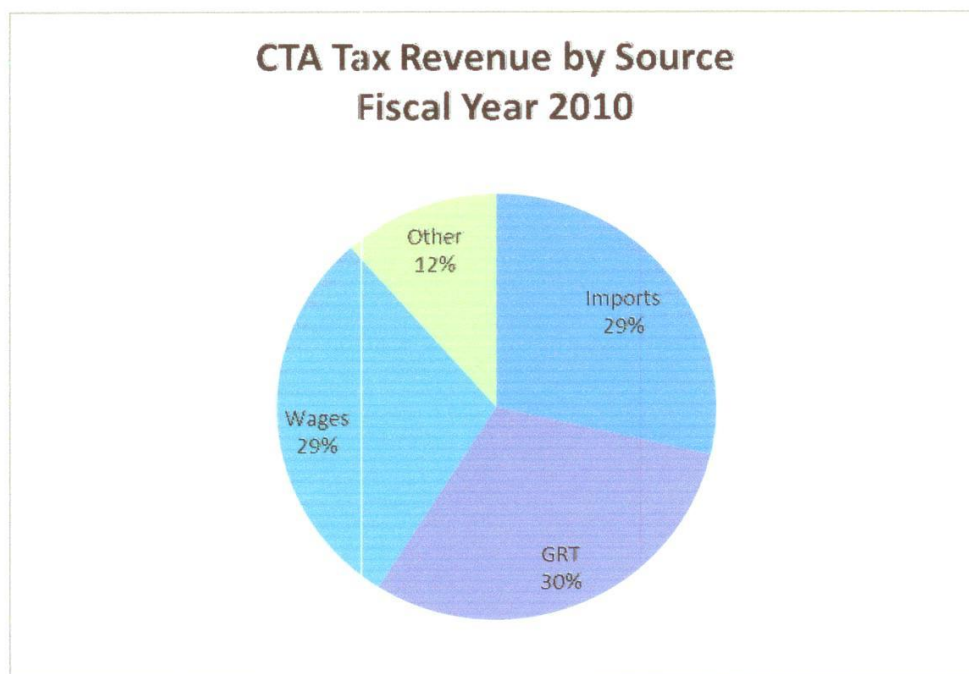
Customs and Tax Administration's record indicated that during fiscal years 2008, 2009 and 2010, total tax revenues were approximately \$74 million. As illustrated in Figure 1, the CTA collects taxes from many sources of revenue, including:

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- **Imports** - The amount of tax varies depending on the commodity.
- **BGR** - \$80 on the first \$10,000 of BGR and 3% on any excess for the calendar year. Businesses with less than \$2,000 in BGR during a year are exempt from tax.
- **Wage & Salary** – 6% of the first \$11,000 and 10% of any excess earned during each calendar year. Employees earning less than \$5,000 during a calendar year are entitled \$1,000 deduction before computing the tax.
- **Other fees** – Fuel, Cigarette, License fee, Penalty & Interest, Bank Charges etc.

Businesses file tax returns and make payments at the field offices.

Figure 1



Source: Data provided by CTA Main Office.



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**Table 1:**  
**CTA Tax Revenue Collected by State and Calendar Year (CY)**

State & Revenue Sources	FY 2008	FY 2009	FY 2010
<i><b>Pohnpei State</b></i>			
BGR Tax	\$2,579,071	\$3,553,975	\$3,881,229
Wage & Salary Tax	\$3,857,417	\$3,866,343	\$4,098,352
Import Duties	\$3,271,726	\$3,371,740	\$3,191,428
Other	\$1,644,978	\$1,524,521	\$2,094,754
<b>Total</b>	<b>\$11,353,191</b>	<b>\$12,316,580</b>	<b>\$13,265,763</b>
<i><b>Chuuk State</b></i>			
BGR Tax	\$1,404,781	\$1,621,732	\$1,936,394
Wage & Salary Tax	\$1,416,055	\$1,919,618	\$1,895,442
Import Duties	\$1,833,710	\$2,080,883	\$2,391,891
Other	\$226,094	\$305,512	\$233,821
<b>Total</b>	<b>\$4,880,641</b>	<b>\$5,927,745</b>	<b>\$6,457,547</b>
<i><b>Yap State</b></i>			
BGR Tax	\$1,186,717	\$1,614,144	\$1,571,445
Wage & Salary Tax	\$1,220,687	\$1,121,069	\$1,147,266
Import Duties	\$1,372,619	\$1,488,981	\$1,407,833
Other	\$641,342	\$676,397	\$660,774
<b>Total</b>	<b>\$4,421,365</b>	<b>\$4,900,592</b>	<b>\$4,787,318</b>
<i><b>Kosrae State</b></i>			
BGR Tax	\$509,568	\$687,968	\$708,837
Wage & Salary Tax	\$558,766	\$598,643	\$691,128
Import Duties	\$631,822	\$674,726	\$622,376
Other	\$74,423	\$78,389	\$81,084
<b>CTA Kosrae Total</b>	<b>\$1,774,580</b>	<b>\$2,039,727</b>	<b>\$2,103,425</b>
<b>Total for Fiscal Year</b>	<b>\$22,429,776</b>	<b>\$25,184,644</b>	<b>\$26,614,053</b>

Source: Data provided by CTA Main Office

**Objective, Scope and Methodology**

**Objectives:** The objectives of this audit were to determine:

1. If management is adequately monitoring the controls to ensure payments collected by the Field Offices are properly receipted and remitted to the DNT.
2. If management is adequately monitoring controls that require business owners accurately and timely report BGR Tax and Wage & Salary Tax.
3. If management is adequately monitoring whether SADs on Import Taxes are properly assessed, verified and collected. And
4. If programs exist to promote ethical behavior in support of the FSM tax system.

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Scope

The audit focused on the CTA's revenue-generating functions, specifically the adequacy of internal controls used in CTA central and field offices to safeguard cash receipts, the adequacy of monitoring controls by CTA management, the ability to monitor taxpayer compliance and its ability to collect delinquent tax revenue that occurred during fiscal year 2008, 2009 and 2010.

The audit was conducted pursuant to the authority vested in the National Public Auditor's as codified in the Title 55 FSM Code, Chapter 5 which states in part:

*"The Public Auditor shall inspect and audit transactions, accounts, books and other financial records of every branch, department, office agency, board, commission, bureau and statutory authority of the National Government and of other public legal entities, including, but not limited to States, subdivisions, thereof, and nonprofit organizations receiving public funds from the National Government."*

The audit was performed, as applicable, in accordance with the "Generally Accepted Government Auditing Standards" issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Accordingly, we included such test of records and other auditing procedures that were considered necessary under the circumstances.

Methodology

The audit fieldwork was conducted at CTA central office and the field offices in the States of Chuuk, Pohnpei, Yap and Kosrae.

1. To determine if management is adequately monitoring the controls to ensure payments collected by the Field Offices are properly receipted, reconciled, and remitted to the National Treasury, we observed office operations, interviewed key officials and reviewed CTA's records.
2. To determine whether management is adequately monitoring controls that require business owners to accurately and timely report BGR Tax and Wage & Salary Tax, we interviewed key officials, analyzed revenue collection reports and reviewed the current process by which CTA attempts to collect delinquent taxes.
3. To determine if management is adequately monitoring whether Self-Assessment Declarations (SAD) on Import Taxes are properly assessed the audit team observed the procedures used, performed inquiries of local office personnel including management, and reviewed CTA Records of inspections.
4. To determine whether programs exist to promote ethical behavior in support of the FSM tax system, we interviewed staff and management, and observed office operations.

Prior Audit Coverage

Common findings from prior Office of the National Public Auditor audit reports revealed the untimely remittance of revenue shares to the Governments and untimely deposit of CTA collections to the bank or the DNT in fiscal years 2005, 2006 & 2007. This audit did not include a determination of the non-compliance with timely deposit, as it was not noted as a finding in the Single Audit report for fiscal year 2009.

Also, the US GAO issued a report in 2006 titled *"Compacts of Free Association - Development Prospects Remain Limited for Micronesia and Marshall Islands"*. The CTA Officials were quoted to estimate that CTA collected between 40 to 60 percent only of taxes owed.



## **CONCLUSION**

Based on our audit, we conclude that CTA main office does not provide adequate oversight over field offices in carrying out their key activities of enhancing and enforcing tax collection throughout the FSM. Consequently, the following weaknesses existed.

- Poor internal control over the system of manual cash receipts continues to put cash at risk of loss or theft.
- The tax rolls (list of active businesses) are incomplete and as a result, compliance and tax revenue collection is diminished.
- Unpaid or unreported taxes by businesses in Pohnpei are not followed-up and in Chuuk, they were followed up only when visited by a special task force.
- The accuracy of payment of import taxes is not verified by CTA and the inspection of freight containers is hap-hazard, not formalized and seldom performed.
- CTA employees are not trained in the proper handling of potentially unethical situations including how to maintain independence with local businesses. In the absence of a CTA Code of Ethics, independence with local businesses is not specifically required.

Ultimately, the practices of CTA are lax especially in Pohnpei and Chuuk, and do not assure the citizens of the FSM that the tax and revenue laws are being uniformly enforced or complied with throughout the FSM.

The findings and recommendations are discussed in detail in the following pages.

## **AUDIT FINDINGS AND RECOMMENDATIONS**

### **A. Revenue & Tax Division (BGR and Wage & Salary Taxes)**

#### **Finding 1: Poor internal control over receipts puts cash at risk of loss or theft**

54 FSMC Chapter 1 establishes the duty of the Secretary of Finance to ensure all taxes are collected and remitted to the National Treasury:

*The taxes levied, assessed, and collected under and pursuant to this chapter shall be paid to the treasurer of the Federated States of Micronesia and become part of the General Fund of the Federated States of Micronesia as local revenue realization available for appropriation by the Congress of the Federated States of Micronesia.*

The receipting system must be designed and implemented with the view that receipts are the same as cash. Just as cash must be fully accounted, receipts must be fully accounted and physically secured from the point of ordering new stock, receiving and storage of new stock, transfer of new stock to field offices, daily inventory and daily usage. A receipt that becomes missing at any point in the physical cycle can be an indication of theft.

All receipts for payments received by the Revenue and Tax Division are manual, whereas the receipts issued for payment of import taxes are computer generated.



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Interview with a key official at one of the CTA field offices revealed that an employee had issued obsolete receipts without reporting the amount of cash collected. The alleged fraud was later discovered when, in subsequent quarters, taxpayers provided proof of prior payments. DFA reports that the allegation was submitted to the Department of Justice and consequently, the employee was requested to resign.

The current practices are lacking several key controls and the controls that do exist are not consistently applied.

The auditors found the following:

- Use of Unauthorized receipt books - The CTA main office in Palikir generally controls the ordering and printing of new official receipt books and then distributes the new stock to the field offices upon request. One field office ordered receipt books locally without authorization by the CTA main office. The receipts were later issued to customers.

As a result, unauthorized receipts could be used fraudulently to steal undocumented cash.

- Receipt Stock Is Not Secured - The field offices do not secure the boxes of unused receipt stock in a locked drawer or safe. The stocks of unused receipts are on shelves in the open employee work area. In one office we found the stock of unused receipts in the manager's office however, we also found that the manager's office remained open during extended periods when the manager was out of the building.

As a result, undocumented use of receipt books could have been used to steal undocumented cash. In other words, a "missing" receipt book in the hands of an employee could have been misused to steal cash.

- Receipt Stock Is Not Monitored
  - The field offices do not maintain records of: incoming new receipt stock, of receipt stock presently in the operations, or of receipt stock issued and used to completion. In other words, the field offices could not illustrate that the unused receipt stock included all items received and not yet used and that none were missing. This type of control (a log of all incoming new stock, minus the usage) can also be useful in the event of a break-in so that following the break-in the log can be reviewed to determine exactly which receipt stock is present and which are missing.

As a result, in the absence of such records the field offices could not account for what receipts should be in the unused receipt stock.

- The CTA main office does not routinely monitor or require physical inspection of the unused receipt stock on-hand at the local offices.

As a result, most importantly - missing stock may not be detected timely. Regular reporting of stock levels by the field offices is necessary not just for accountability but also to properly control reordering and avoid last minute local printing.

- Missing receipts are not followed-up by CTA main office - The Revenue Collection Officer at the main office compiles a daily revenue collection record that includes receipt numbers issued by each field office. The audit team found in FY 2010, 39 receipts were not accounted for; in FY 2009, 37 receipts were not accounted for; and in FY 2008, 19 receipts were not accounted for. Most concerning though, is that the audit found that CTA Management had not followed-up on the unaccounted for receipts.

As a result, fraud similar to past instances could be repeated and not be detected on a timely basis.

The poor internal controls described above clearly make revenue vulnerable to loss and theft.

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**Cause**

A complete system of internal control over the manual receipt life cycle may never have been established.

CTA management indicates that a break down in controls occurred when they failed to ensure that new employees were properly trained in properly controlling the complete, receipt-life-cycle.

**Recommendation**

We recommend that the Assistant Secretary should personally ensure that adequate policies and procedures are developed and that internal controls are implemented and functioning adequately, including:

1. The CTA main office should:
  - a. Control all receipt activity including never allowing field offices to order receipt stock directly. If local printing becomes necessary it must be fully controlled by the central office so that vendor relationships are not undertaken by the local staff in an official capacity.
  - b. Ensure field offices implement logging of all receipt activities described below, and forward copies of field office logs to central office weekly or at least monthly to ensure field offices are complying.
  - c. Require field offices to secure receipt stock in a locked drawer or safe, and provide complete accountability of the receipt life cycle.
  - d. Investigate to conclusion immediately, all missing receipts.
2. The local field offices should log in detail, all receipt activities including:
  - a. Receipt stock received from the Central Office
  - b. Receipt stock currently in use (including specific location and who has custody),
  - c. Receipt sequence used (consumed) - this is currently done
  - d. Receipt sequence remaining / available in stock.

**Finding 2: Incomplete tax rolls diminishes tax collection**

The responsibility of CTA to actively identify new taxpayers is clearly specified in the revenue officer job description as a major duty and responsibility as follows:

*[The Revenue Officer] Canvasses the entire state where he/she is assigned to spot new taxpayers as well as those who have closed for the purpose of purifying the tax rolls.*

To properly fulfill their mandate CTA should maintain a complete list of businesses for the purpose of identifying, detecting and correcting the non-payment of taxes due.

The auditors found CTA does not actively identify new taxpayers but instead uses a listing of taxpayers who made payments in the prior year.

- At the start of each calendar year, the businesses that filed returns and paid taxes in the prior year were listed in a spreadsheet, referred to as the "Tax Roll."



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- CTA Revenue Officers did not canvass their respective states to spot new taxpayers or those who have closed, and
- Other procedures were not performed to identify new taxpayers who are not filing returns. As a result, new businesses not paying their taxes were not identified and revenue to the National and State Governments was not maximized.

**Cause**

The Local Offices reported:

- They do not have the time to obtain listings of active businesses from other government entities for the purpose of identifying new businesses. Additionally,
- A vehicle many times is not available for conducting observation to identify new businesses.

The Central Office was not monitoring to determine if the Local Offices were identifying new businesses.

**Recommendation**

We recommend that the Assistant Secretary monitor the Local Offices performance of the following:

- Obtain business listings from the following authorities and compare the listings to the CTA tax rolls to identify new taxpayers who did not file:
  - local municipal government,
  - state government - tax division, and the
  - FSM Social Security Administration.
- Observe businesses operating in the State and add any that are not included in the tax rolls.

**Finding 3: Lack of follow-up for tax delinquency increases noncompliance and diminishes tax revenue**

54 FSMC Chapter 1 Subchapter V § 151-153 states (emphases added):

*All persons, employees, and businesses required to make and file returns under this chapter shall keep and maintain accurate records, and the records may be inspected and audited at any reasonable time by the Secretary for the purpose of administering the provisions of this chapter.*

*Upon the failure of any person, business, or employer to make and file a return ..., or upon failure to pay any amount due, the Secretary may notify such person, business, or employer of such failure and demand that a return be made and filed and the tax paid as required...*



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*If such person, business, or employer upon notice and demand by the Secretary fails or refuses within 30 days after receipt of said notice ..., the secretary may make a return for such person, business, or employer from any information and records obtainable, and may levy and assess the appropriate amount of tax...*

*All taxes imposed or authorized under this chapter shall be a lien upon any property of the person or business obligated to pay said taxes and may be collected by levy upon such property in the same manner as the levy of an execution.*

The audit team found:

- Demand notices were not issued to businesses located in Pohnpei State at any time during the period of our audit regarding unpaid taxes due in fiscal year 2008 to 2010. Since demand notices were not issued, liens against properties for payment were also not processed.

More than 40% of businesses<sup>1</sup> listed in the official tax roll for Pohnpei State are not filing BGR tax returns and not making payments and again, demand notices were not issued. While it is possible that some businesses on the list have closed, new businesses were not included (Reference to finding 2 above).

- Demand notices to businesses located in Chuuk State were only issued when a special task force visited the local force. Liens against properties for non-payment were not processed.

As a result, significant amounts of revenue for the Nation were not collected.

#### **Cause**

CTA Management is not performing its duty to assess and collect revenue proactively.

#### **Recommendation**

We recommend that the Assistant Secretary should monitor the Local Offices and /or CTA Palikir to *ensure*:

- Demand notices are regularly issued and distributed to non-filers and non-payers; and,
- Levies are duly processed when non-compliant businesses continue to not pay taxes owed.

### **B. Import Tax Administration**

#### **Finding 4: Inspection practices and SAD processing do not ensure proper assessment, verification and collection of taxes due**

FSM Code Title 54, Chapter 2 Section 238 Paragraph 3 states, regarding imported goods (emphases added):

*(a) Entry shall be verified by the presentation to Customs by the consignee, or authorized agent of the consignee, of a completed and signed entry form together with a non-negotiable bill of lading or an air waybill and vendor's invoices for the imported goods.*

*(b) The consignee shall answer any questions relating to the goods and, upon request of a Customs officer, furnish any other documentation deemed necessary...*

<sup>1</sup> This is based on 4<sup>th</sup> quarter: CY 2008-2010.

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The audit team found that CTA personnel:

- Did not routinely verify that the goods and amounts declared on the SAD agreed to the supplier invoices attached to the SAD. CTA personnel referred to this procedure as "post-audit."
- Container inspections claimed to be conducted by CTA Pohnpei were not documented. For example: CTA Pohnpei records indicated that 17 containers were inspected from January 2010 to June 2010. However, only 4 of the 17 inspections or 24% of inspections were documented.

As a result, in the absence of SAD verification and lack of container inspections, or hap-hazard performance of container inspection, significant amounts of import taxes may not be realized.

**Cause**

- Central Office Management has not formalized the procedures for SAD verification and freight container inspections.
- Central Office Management did not monitor Field Office SAD verification and container inspections.

**Recommendation**

We recommend that the Assistant Secretary should develop policies and procedures regarding:

1. Verification of SAD: Develop a policy and procedure that requires Field Office personnel to verify the SAD to the supporting documentation. The policy should be risk-based, practical and the procedure should specify which items should be verified at the time that the importer initially submits the SAD, and which should be subsequently verified during "post-audit." For example: Prior to accepting the SAD, the CTA employee could scan ("eye-ball") the supplier invoices for high-tax items such as tobacco, alcoholic beverages, and other drinks to ensure inclusion on the SAD. A system could be used to signify verification performance, for example: tick marks, verifier initials, or other codes.
2. Inspection of Freight Containers:
  - a. Develop a policy for container inspection that references the correct procedures, performance frequency and specifies a standard format for reporting the results.
  - b. Prepare, document and implement a formalized procedure to be used by the Local Offices for use when inspecting containers.

**C. All CTA Personnel**

**Finding 5: CTA employees are not trained in the proper handling of potentially unethical situations**

The FSM Code contains a Code of Conduct for all FSM Officials; one excerpt is quoted below.

11 FSMC Chapter 5, Sub-chapter 2: Subsection 510:

*"Inherent in the success of any democracy is the trust of its citizens in the honesty and integrity of its public officials. To encourage such trust and insure the integrity of public office, a standardized code of conduct is needed. A public official must conduct himself or herself in such a way, in both public and private life, so as not to:*



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- (1) place himself or herself in a position in which there exists a conflict of interest or in which the fair exercise of his or her public or official duties might be compromised;*
- (2) demean his or her office or position;*
- (3) call into question his or her integrity;*
- (4) endanger or diminish respect for or confidence in the integrity of the Federated States of Micronesia, National Government; or*
- (5) actually use or give the appearance of using his or her public office for personal gain."*

CTA employees, as the tax and revenue collection agents for the Nation, are constantly faced with situations that are vulnerable to bribery or other unethical conduct. Every CTA employee is involved in some aspect of collecting taxes or other duties from businesses, businesses which naturally and rationally desire to minimize, or not pay taxes. It is likely that no other government activity is as directly vulnerable to unethical conduct as the agency that collects and maintains the records over businesses paying taxes.

The audit team found no documentation of employee training regarding the above code of conduct, for example training as to:

- How to handle potentially unethical offers made by unscrupulous business owners.
- Expected behavior including how to avoid the appearance of vendor favoritism.
- How to maintain independence from the local business owners and avoid undue influence.

As a result, CTA agents may not be properly skilled to handle unethical situations, or how to avoid the appearance of unethical situations.

**Cause**

Management has limited time and resources and ethics training was not developed or implemented.

**Recommendation**

We recommend that the Assistant Secretary should develop and implement an ethics reinforcement program that includes:

- Group discussions of various scenarios that employees have to deal with or potentially may have to deal with and how best to handle such situations,
- Multi-faceted programs and training for values reinforcement,
- Mandatory reporting with annual declaration of:
  - Gifts received (if -0-, then -0- is declared),
  - Credit accounts with local businesses over a specific amount (to be decided by the Secretary of Finance & Administration).
  - Employee owned, or partially owned, businesses.



Office of the National Public Auditor  
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**MANAGEMENT RESPONSE (page1 of 3)**



Secretary of Finance  
&  
Administration

GOVERNMENT OF THE  
FEDERATED STATES OF MICRONESIA  
Department of Finance and Administration

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October 28, 2011

Mr. Håser Hainrick  
National Public Auditor  
Office of the National Public Auditor  
Federated States of Micronesia  
Palikir, Pohnpei FM 96941

Re: Management Response on the Audit of Customs and Tax Administration FY  
2008 to FY 2010

Dear Mr. Hainrick:

We wish to thank you for your letter of October 18, 2011 in which you had given CTA the opportunity to submit formal response to the draft findings and recommendations of the Audit of the FSM Department of Finance and Administration, Division of Customs and Tax Administration covering Fiscal Years 2008 to 2010. Herein is our response to the audit report.

**Finding 1: Poor internal control over receipts puts cash at risk of loss or theft.**

The Document Processing Branch at the CTA central office maintains log on receipts printed for each field office and transmittal to field offices.

With regard to "missing receipts are not followed-up by CTA main office", it is difficult for us to comment on this as the report indicated only the number of receipts not accounted for, i.e. FY 2009, 39 receipts; FY 2009, 37 receipts; and FY 2008, 19 receipts and did not indicate the receipt numbers. The Collection Specialist at the central office who reviews and accounts for daily collection reports and data from field offices stated that all receipts that were requested by the auditors during the audit at the central office were given to them.

We noted the finding and management of CTA and the Department of Finance and Administration will institute procedures and guidelines at central office and all field office on monitoring, control and security of receipts, including printing of stocks and monitoring of issued serialized cash receipt numbers.

10/31/11 JH

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**Finding 2: Incomplete tax rolls diminishes tax collection**

Tax rolls are maintained at each field offices with copies of the respective tax roll at the Document Processing Branch at the central office. Updating of the tax roll is the responsibility of the field offices in posting tax return information into the tax roll for purpose of identifying non-filers, those that file but have not paid, issuance of notice and demands, issuance of make-up returns, and other activities associated with use of the tax rolls.

All field offices have a vehicle for their use to perform Customs functions, and Revenue functions on BGRT and Wages and Salaries including field visits to businesses. It is the responsibility of the Deputy Assistant Secretary for each field office to make appropriate arrangements for efficient use of their vehicle in ensuring appropriate coverage of field activities.

The filing and payment of quarterly tax returns falls during the month of April, July, October and January. There are three months in between filing periods and we consider that to be enough time for field offices to carry out the various responsibilities that are needed to be done on the Revenue side of CTA operation before the next filing and payment due date, if field offices concentrate and stay focus on what they are supposed to do.

We acknowledge and noted this finding. CTA management and the Department of Finance and Administration will institute measures to address this finding. Such measures will include getting information from local municipal government, state government (tax division) and the FSM Social Security Administration. We will work to update the tax rolls by February 2012 and share it with the Office of the National Public Auditor. We will reinforce procedures and monitor progress on a quarterly basis through reports from field offices.

**Finding 3: Lack of follow-up for tax delinquency increases noncompliance and diminishes tax revenues.**

As with our comment on finding 2, issuance of demand notice to file tax return, demand notice for payment and update of tax rolls to indicate closed businesses and to add-on of new businesses in the tax rolls is the responsibility of field offices. The three months in between quarters should provide the time needed for field offices to update tax rolls, issue demand to file and demand to pay and to visit delinquent tax payers for collection of delinquent taxes, and perform other field activities.

Management acknowledges the finding and recommendations. We will put in place monitoring mechanism of field offices in the issuance of demand notices to non-filers and non-payers.

**Finding 4: Inspection Practices and SAD processing do not ensure proper assessment, verification and collection of taxes due.**

*John A. Smith*  
Director

**Office of the National Public Auditor  
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The Customs Unit at the central office developed a container inspection report template for field offices to use in reporting result of container inspection. However, not all container inspected are reported on this form. The central office will reinforce use of this form with field offices.

We noted the finding and recommendation and we will include in existing policies and procedures the requirement for staff to initial or sign on office copy of the SAD to signify that support documents (invoice, airway bill, bill of lading, etc.), calculation of duties and verification of goods with high duty rates have been reviewed and verified the

**Finding 5: CTA employees are not trained in the proper handling of potentially unethical situations.**

The report stated that it is likely that no other government activity is as directly vulnerable to unethical conduct as the agency that collects and maintains the records over business paying taxes. We agree with this statement as to the level of vulnerability, however, we feel that the issue of integrity and ethics is one that should be addressed across all offices and agencies of Government as there are other agencies that also collect other revenues for the Government and other agencies that if their responsibilities are compromised, it will be detrimental to the operation and well being of the Government. We are addressing the ethical issue when we do job interviews where we discuss scenarios that will likely put employees in vulnerable situations where there may exist a conflict of interest.

As with other findings we noted and acknowledge this finding as well and we will look for training, like APDPA, etc. that will address the issue of potentially unethical situations and to increase staff awareness of integrity and ethics in Government.

Once again, thank you for the opportunity to comment on the report.

Sincerely,

  
Rose Nakanaga  
Acting Secretary

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**ONPA EVALUATION OF MANAGEMENT RESPONSES (page 1 of 2)**

FINDING 1

In the response to Finding 1 "Poor internal control over receipts puts cash at risk of loss or theft," management indicates a log on receipts that were printed and sent to the field offices is maintained by Palikir. Per our audit findings, we believe management may be misinformed. The CTA Document Processing Branch at the CTA main office indicated no log was maintained during the period of the audit, scope of new receipt stock that were received from printers and then sent to the field offices.

Regarding the finding of "missing receipts are not followed up by CTA main office" CTA management indicates that since the report does not reference which receipts were missing that it is difficult for management to respond. There may be a misunderstanding here as there was no request made for receipts by the audit team. The missing receipt numbers indicated in the report were captured by the Collection Specialist from the Daily Revenue Collection Report for all the four States in FY '08, FY '09 and FY '10 as provided by the Collection Specialist to the auditors on April 20, 2011 via e-mail. The Collection Specialist had no comment on the unaccounted receipts and there had been no record of management action taken despite the fact that many of the unaccounted receipts were more than 6 months old. The audit recommendation is that all missing receipts should receive immediate management attention, and all cash should be immediately verified. In the event of a void receipt, documentation should be on file.

FINDINGS 2 and 3

CTA management stated that the field offices are responsible for key operating activities and ensuring appropriate activities are carried out in the States. However, CTA Main Office is the oversight office for the field offices. The CTA Main Office - upper management must accept responsibility for the poor performance of the field offices in Pohnpei and Chuuk, as described in the audit findings and generally agreed by management. The task for revenue collection may be delegated to the field offices *but the overall revenue collection for the FSM is still the responsibility of CTA Upper Management.*

FINDING 4

The management response is adequate if performed in the manner described and monitored by the CTA Main Office.

FINDING 5

In its response, CTA management feels that the issue of integrity and ethics training and reinforcement should be addressed across all offices and agencies of Government as there are other agencies that also collect other revenues for the Government. CTA management further stated that ethical issues were addressed during the initial job interview when employees are interviewed.

It is true that the issue of integrity and ethics should be addressed to all offices and agencies of the Government; however, the scope of our audit is on CTA's revenue generating functions which provide services for the public interest. The fact that other departments should also perform ethics training does not excuse CTA Management from their responsibility to implement practical ethics training especially considering their responsibility and duty to properly handle the Nation's "cash register" for local revenues.

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**IN SUMMARY**

It is essential that the public regard CTA as competent, unbiased and effective in collecting taxes and assessing duties. Public confidence in the quality of services provided by CTA is enhanced when CTA encourages high ethical standards of conduct and performance. If the public does not have such confidence, taxpayers may become discouraged to comply with tax requirements.

CTA Management must accept responsibility for the field offices to ensure proper performance of these key revenue functions.

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**NATIONAL PUBLIC AUDITOR'S COMMENTS**

**We would like to thank management and staff at the Division of customs & Tax for their assistance and cooperation during the course of the review.**

**The ONPA may perform a follow-up review within the next 9-12 months to ensure that the Division of Customs & Tax have taken corrective measures to address all the findings and recommendations provided in this report.**

**In conformity with general practice, we presented our draft findings and recommendations to the Secretary of the Department of Finance & Administration and the Assistant Secretary of the Division of Customs & Tax for comment.**

**We have provided copies of the final report to the President and Members of the Congress for their use and information. We will make copies available to other interested parties upon request.**

**If there are any questions or concerns regarding this report, please do not hesitate in contacting our Office. Contact information for the Office are listed on the last page of this report, along with the ONPA and staff who made major contribution to this report.**



**Haser Hainrick**

**National Public Auditor**

**December 9, 2011**



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**ONPA CONTACT AND STAFF ACKNOWLEDGEMENTS**

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**ACKNOWLEDGEMENTS:** In addition to the contact named above, the following staff made key contributions to this report:

Ron Sufficool, CPA, CISA, CIA, CFE, CMA, CGAP, Audit Manager

Julinida Weital, Auditor-In-Charge

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