



FEDERATED STATES OF MICRONESIA

Office of The National Public Auditor

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July 9, 2014

His Excellency Manny Mori, President
Honorable Member of the FSM Congress
Federated States of Micronesia
Palikir, Pohnpei FM 96941

RE: Audit of the Public Debt Management

We have completed the audit of the Public Debt Management for the National Government of the Federated States of Micronesia. This audit was conducted as part of a cooperative audit initiative undertaken by the Pacific Association of Supreme Audit Institutions (PASAI) with the support of Asian Development Bank (ADB) and INTOSAI Development Initiative (IDI). This audit was designed to enhance the transparency and accountability in FSM's management of public debt and assist the policy makers institute necessary legal and institutional reforms in order to strengthen the public debt management, enhance the sustainability of public debt, and reduce its vulnerability to international financial shocks.

As such, the objectives of the audit were to assess the adequacy of FSM National public debt management with respect to;

- The legal and institutional framework and the related processes and controls on compliance, monitoring and reporting; and,
- Government loan relending and guaranteeing activities

The audit was conducted pursuant to Title 55, Chapter 5 of the FSM Code, and in accordance with Generally Accepted Government Auditing Standards issued by the Controller General of the United States.

Based on the audit, we conclude that the FSM's legal and institutional framework lacked permanent and necessary provisions to implement adequately the system of debt management. It is only during the approval of each debt that the FSM Congress defines the requirements and some functions related to debt management. The basic requirements include borrowing purposes, debt management goals and objectives, reporting of debt obligations and others. We also found that the institutional framework needs further strengthening prior to deployment of debt management system. Similar to the legal framework, the institutional functions related to debt management were scattered and performed by different departments and offices without proper

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coordination to ensure an adequate debt management. Lastly, we found that State Governments and their public enterprises could generate risks to the National Government not only in consequence of guaranteed loans but also by the risks of undisciplined borrowings and unsustainable manner of borrowings. However, there has been no limit on such borrowings and analysis of the related risks. Our audit has disclosed the following weaknesses:

1. \$21 million of the FSM's external debt was spent for failed or partly successful projects;
2. \$13 million in Trust Account/Sinking Fund not regularly assessed whether sufficient for the repayment of the associated loans with outstanding balance of \$31 Million;
3. Legal framework was limited and lacked provisions to enable the implementation of a sound debt management system;
4. Limited organizational functions resulted in inadequate implementation of an effective debt management system;
5. Absence of loan limit and regular risk analysis on the states' and public enterprises' loans and on guaranteed and/or relent loans; and,
6. Lack of available information on public debt and borrowing activities.

Our recommendations include the following:

Improvement of Management Functions Related to Project Appraisal and Implementation

1. The President should:

- a. Require the development and implementation of a more comprehensive Project Appraisal and Approval Framework to ensure that the decision maker would consider all relevant elements necessary for the benefit of an informed judgment.
- b. Establish Debt Management Advisory Committee who will review and recommend the loaned finance (debt financing) project proposals.
- c. Initiate the study to strengthen the legal and institutional framework to mandate and be answerable to law; and establish clearly the responsibilities and accountabilities for the selection, approval and implementation of loan-financed projects. Some of the requirements that could be legislated and/or regulated include:
 - allowable project for loan financing e.g. investment project;
 - use project appraisal and approval framework;
 - formation of project governance structure;
 - development and implementation of project life cycle framework and risk management upon implementation of the project;
 - gathering of baseline metrics, statistics or parameters before, during and after the completion of the project.

Maintenance of Trust Account

2. We recommend that the Secretary, Department of Finance & Administration (DoF&A) should:

- Assign the responsibility for estimating on regular basis the sufficiency of the amount in the trust account and request an appropriation for the transfer of funds from the General Fund to the Trust Account, if necessary.
- Comply with the law to establish and/or maintain sufficient amount of funds in the Trust Account for debt servicing of the related loans.

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- For transparency and accountability purposes, disclose in the yearly audited financial statements whether the amount in the trust account/sinking fund is sufficient to cover the associated loans.

Improvement of Legal Framework for Debt Management

3. We recommend that the President should develop and propose the enactment of a Public Debt Act and/or the Secretary of Finance and Administration should develop and implement regulations, guidelines and procedures that should provide the strategic direction for debt management, define and clarify duties and responsibilities, and support the professional and operational focus of debt management. Lastly, the legal framework should specify requirements that would include, but not limited, to the following provisions and elements:

- Authority to borrow/Delegation of power;
- Borrowing purposes;
- Debt management goals and objectives;
- Debt management strategy;
- Borrowing limits, including borrowing limits for the states and public enterprises;
- Borrowing options - issuing bonds, instruments, multilateral or bilateral loan agreement, etc;
- Project appraisal and approval framework;
- Office responsible for handling/coordinating the debt management operation;
- Annual debt reporting to Congress including debt status, guaranteed loans, and debt sustainability analysis;
- Project progress and final report including report on outcome effectiveness;
- National Government oversight on loans contracted by public enterprises (Component Units);
- Gathering and developing project related baseline and operational data to allow comprehensive evaluation of the completed projects;
- Auditing/Assessment of debt management activities including an independent assessment of the economy, efficiency, and effectiveness of projects funded by debts

Improvement of Institutional Framework for Debt Management

4. We recommend that:

- The President should create a committee (e.g. Debt Management Committee) that would be responsible for the review of all government borrowings including guarantees.
- The Secretary of DoF&A should define the roles and responsibilities as well as the structure and functions for debt management that would include:
 - Consolidate the current debt management functions and build up the functions to allow for more efficient and effective management of debt;
 - Build up the staff capacity to perform efficiently the debt management functions.

Limits to States' and Public Enterprises' Loans

5. We Recommend that the Secretary, DoF&A should:

- Suggest provisions in the legal framework to include borrowing limits for the states and public enterprises loans;
- Develop and implement operating procedure manuals or guidelines on how to conduct risk analysis on debt;
- Improve the staff capacity to conduct a regular debt sustainability analysis including the risk analysis of debt; and,
- Assign to the staff the responsibility for conducting an analysis of risks associated with the states' and public enterprises loans.

Enhancement of the Transparency and Accountability in Debt Management

6. We recommend the Secretary of DoF&A should :

- Develop and implement policies, guidelines or procedures specifying the different levels, timing, and format of the various debt reporting requirements.
- Develop a policy specifying debt report users and frequency of circulation.
- Publish or issue periodic (e.g. monthly, quarterly, annual) reports on the status of FSM's total debt that include loans, guarantees, contingent liabilities, payment in arrears, debt levels and cost, debt sustainability and affordability, debt status over the year, details of any new borrowing and debt repayments, and key events in the management of debt.

We discussed the contents of the report with officials from the concerned departments/offices and provided them with copies of the draft report. At the exit conference, they indicated their agreement with the findings and recommendations. They were asked to provide written comments which were to be included as appendix in the final audit report. However, as of the date of this writing, we did not receive any management response and therefore, we are issuing this report without the management response.

Respectfully yours,



Haser Hainrick
National Public Auditor

Xc: Secretary, Department of Finance and Administration
Director, Office of SBOC
Assistant Secretary, Division of Investment and International Finance

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INTRODUCTION

Background

The FSM Office of the National Public Auditor conducted an audit on the Public Debt Management as part of a cooperative audit initiative taken by the Pacific Association of Supreme Audit Institutions (PASAI) with the support of the Asian Development Bank (ADB) and INTOSAI Development Initiative (IDI). The purpose of the audit was to enhance the transparency and accountability in management of public debt and to assist the policy makers to initiate the necessary reforms to strengthen the quality of management in maintaining a sustainable debt and, hence, reducing the country's vulnerability to international financial shocks.

FSM Government Structure and the Power to Borrow Money

The Federated States of Micronesia (FSM) consists of a national government and four state governments - National, Pohnpei, Chuuk, Kosrae, and Yap. Each government adopted a constitution that provides for three branches of government--executive, legislative and judiciary. The National Government's role in this structure is limited to certain constitutionally defined areas such as foreign affairs and those beyond the power of the states to control. The four states exercise a great deal of control over their own affairs, including the power to make external contracts.

Both the FSM Congress and the states concurrently exercise the power to borrow money on public credit¹. However, the FSM National Congress approval of all loans² has been a practice. It is thru the national government that external loan is arranged and transmitted. This arrangement ensures the development of a sense of partnership between the states and the national government in promoting the economic growth of the states. Based on experience though, the states may refuse loans most especially if the purpose of borrowing is against the state's related provision in the constitution.

The FSM Congress delegates its power to borrow money to the President. The President, in turn, delegates this responsibility to the Secretary of the Department of Finance and Administration (DoF&A) who raises loan with the concurrence of the President and approval of the loan terms and conditions by the FSM Congress.

Importance of Public Debt Management

Public debt (borrowing) remains an important tool for financing the development activities in a country. However, borrowings create public debt with an *intergenerational contract* that affects the future generations. This intergenerational character imposes significant fiduciary responsibilities on the part of the current public officials to decide and act with care and loyalty

¹ FSM Constitution Article IX, Section 3(b)

² loans and debts are used interchangeably in this report

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when it comes to incurring public debt. Thru public debt management, the policy makers must ensure the preservation of *equity (justice)* between today and tomorrow's generation. The debt issued today should not limit the policies of future governments because the future repayment of debt and interest, if unsustainable, could constraint the funds available for future public services and investments.

International Monetary Fund (IMF) and World Bank (WB) defined public debt management as *"the process of establishing and executing strategy for managing government's debt in order to raise the required amount of funding, pursue its cost and risk objectives, and to meet any other public debt management goals the government may have set."*³

FSM National Government Legal Framework for Management of Public Debt

At the FSM National Government, the legal framework for debt management is fragmented and scattered in several laws. These laws include:

1. Article 1X, Section 3(b) of the FSM Constitution grants power to the FSM Congress and to the states to borrow money;
2. Chapter 2 Section 204 of the Financial Management Act assigns responsibility to the FSM National Secretary of DoF&A to manage the country's public credit and enforce fiscal discipline in the management of the nation's resources.
3. Title 55 Subchapter V11 creates the ADB Loan Fund and prescribes the requirements for the establishment, purpose, deposits, disbursements and administration of the fund.
4. Title 55 Subchapter X creates the ADB Water Loan Fund and prescribes the requirements for the establishment, purpose, deposits, disbursements and administration of the fund.
5. In case of inability of the state to pay its loan to the national government, Title 55 Subchapters X Sections 1401.1(a) and 1401.2 grant authority to the National government the right to withhold and apply to the loan payments the states' share of tax receipts, and any funds received by the national on behalf of the states
6. Other related legislations (Acts) which the FSM Congress enacted to authorize the borrowings. Since the FSM Congress (national) approves all external loans, the congress enacts legislation for every approved loan or individual borrowing.
7. Legislations (Acts) enacted for the creation of state owned entities (SOE)⁴. These legislations include provisions that grant SOE the authority to borrow loan without the consent of the FSM Congress.

FSM National Government Institutional Framework for Management of Public Debt

Different departments in the government have been performing functions related to public debt management. The DoF&A, thru its two divisions-the Investment and International Finance Division and the Accounting Division, is performing debt management functions related to negotiating, loan signing, disbursing, recording, reporting, monitoring and debt servicing.

³ IMF and WB, Guidelines for Public Debt Management: Accompanying Document (2002), in www.imf.org

⁴ State-owned enterprises, public enterprises or government-owned enterprises were used interchangeably in this report to mean the same. They are corporations or enterprises run either by national government or by states.

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Furthermore, the DoF&A also maintains an up-to-date database of external debts including servicing requirements.

The Office of Statistics, Budget, and Economic Management, Overseas Development Assistance, and Compact Management (SBOC) is likewise performing debt management functions such as monitoring and managing of debt stock to satisfy the cash flow requirements in the Government's annual work plans.

The Department of Transportation, Communications, and Infrastructure (TC&I) or other designated agencies serve as the executing and/or implementing agencies for ensuring the successful implementation of the loan-financed projects. The TC&I also keep the books of accounts for the project. Furthermore, TC&I is responsible for reporting the project performance in terms of realizing the desired outputs and outcomes and in showing whether the new debt provided help in generating growth, prosperity, poverty reduction or in generating returns sufficient to sustain the repayment of debts.

FSM Loan Cycle Activities

In general, governments can borrow money by issuing marketable debt securities, taking bank loans, selling non-marketable securities to individuals, government-to-government (bilateral debt) and taking long-term concessional loan (multilateral debt) from multilateral international financial institutions like Asian Development Bank⁵ (ADB), World Bank (WB), and International Monetary Fund (IMF). One important consideration for multilateral debt is that the international financial institutions have the status of preferred creditors. This status means that payments to them have the highest priority over private and bilateral debts (government-to-government). These institutions also maintain that their bylaws prohibit them from granting debt relief or loan write-offs, as government and private creditors often do.

The FSM used mainly its long-term debts to fund developmental or capital projects. Thus, debt management in FSM covers the loan cycle activities, which include:

- 1) Plan and prioritize the government's capital projects;
- 2) Select project for funding from the priority projects;
- 3) Determine the planning, scope, appraisal and feasibility of the project;
- 4) Negotiate loan;
- 5) Authorize borrowing thru legislative Acts;
- 6) Obtain the approval of the loan contract terms from the loan lender's Executive Board;
- 7) Sign loan agreements;
- 8) Implement and monitor the project;
- 9) Manage loan disbursements;
- 10) Evaluate the performance of the project;
- 11) Close the project; and,
- 12) Payment/Service of loan.

⁵ ADB is a regional development bank established on August 22, 1966 to facilitate economic development of countries in Asia.

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Profile of FSM National Government Public Debt

As of September 30, 2012, the FSM National Government has outstanding public debt amounting to \$56,330,388 (Table 1). The FSM obtained all these external debts consisting of concessional-term⁶ loans from Asian Development Bank (ADB) to finance various development projects. The loans came from a basket of the world's major currencies (e.g. Canadian dollar, euro dollar, and Japanese yen) converted into special drawing rights (SDR), a currency created by Asian Development Bank. ADB, in turn, converts the SDR into US dollar upon drawdown. In this regard, SDRs can fluctuate either favorably or unfavorably with respect to US dollar. For example, if the SDR moved unfavorably against the US dollar during drawdown, the National government would be receiving less than it would have received.

Table 1 Outstanding Debts of the FSM National Government as of September 30, 2012							
Ref	Project	Total Drawdown/ Loan		9/30/12 Balance	Start	Maturity	Debt Service ⁷
1257	Fisheries Development Project	\$ 6,247,194	1A	\$ 5,216,110	01/15/04	07/15/33	\$ 127,166
1459	Water Supply and Sanitation	10,407,232	1B	9,200,668	02/01/07	08/01/36	208,971
1520	Public Sector Reform	20,289,421	1C	18,308,254	02/01/08	08/01/37	406,875
1816	Basic Social Services Project	4,233,829		3,478,521	02/01/09	08/01/32	173,927
1873	Private Sector Development	3,892,241		3,284,075	05/15/10	11/15/25	243,265
1874	Program	7,248,599		6,436,067	05/15/10	11/15/25	299,352
2100	Omnibus Infrastructure	4,800,000	2	3,119,233	01/15/10	01/15/29	76,766
2109	Development	9,686,000	2	7,287,460	05/15/10	11/15/25	299,352
Total		\$ 66,804,516		\$ 56,330,388			\$ 1,835,674

Source- Audited financial statement.

Remarks:

1. The total drawdown included the major additions on loan balances due currency adjustment by ADB amounting to \$6,129,847 (source-FY 2008 audited financial statement). Of this amount, \$4,207,662 (68%) was charged to the states and the remaining \$1,922,185 to the national government. The adjustments identifiable by ONPA consist of: (A) 1,095,967, (B) 1,292,213, (C) 2,607,404 or a total of \$4,995,584 while the \$1,134,263 cannot be identified as to project.
2. The amount is based on loan contract with ADB since the construction, and hence, the drawdown, is still ongoing.

It was the ADB's policy to lend only to FSM National Government and not directly to the FSM States. Since the FSM National obtained the loans to finance the implementation of FSM wide projects including those in the states, the significant portion of the loans was relent to the states and/or to public enterprises in the states. For the relent loans, the relending agreement between the national government and the state government specified the same terms and conditions as indicated in the ADB loan agreement signed between the National Government and ADB.

⁶ Non-interest bearing with a service charge that ranges from 1% to 1.5% per annum

⁷ Annual loan payments (principal + interest) based on FY 2012 audited financial statements of the FSM National Government by the external auditor.

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As of September 30, 2012, the national component units (government-owned enterprises) had total outstanding guaranteed loans amounting to \$36,615,244 as shown in Table 2:

Table 2- Outstanding External Debts – Component Units

Component Unit	Amount
FSM Telecommunications Corporation	\$ 30,497,706
National Fisheries Corporation	3,600,000
FSM Development Bank	710,755
FSM Petroleum Corporation	1,806,783
Total	\$ 36,615,244

Source: Audited Financial Statement

Objectives, Scope, and Methodology

Objectives: Our audit objective was to assess the adequacy of FSM National public debt management with respect to;

- The legal and institutional framework and the related processes and controls on compliance, monitoring and reporting; and,
- Government loan relending and guaranteeing activities.

Scope: We reviewed the related constitutions, laws, regulations, policies, processes and procedures including testing of debt transactions to verify the compliance with prudent debt management practices. Our audit covered the long-term debts as of the end of FY2012.

Our audit of public debt was limited to long term loan obligations contracted by the FSM National government and any other related contingencies. It did not include short-term obligations (due within a year) and other payables, which amounts to \$32,403,660 as of September 30, 2012 (Table 3) or 36% of the total recorded liabilities (\$88.7 million)⁸ of the FSM National government.

Table 3 - Other Liabilities as of September 30, 2012

Account	Amount
Accounts Payable	\$ 9,884,731
Compensated Absences Payable	1,238,725
Retention Payable	7,673,871
Due to FSM States Governments	6,914,884
Deferred Revenue	3,149,218
Due to Federal Agencies	1,126,478
Tax Refunds Payable	506,727
Due to Components	182,993
Other Liabilities and Accruals	1,726,033
Total	\$ 32,403,660

Source: Audited Financial Statement

⁸ Audited financial statement

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Furthermore, this audit did not include procedures to evaluate the controls on loan bookkeeping, payments and monitoring. Some indications came to our attention showing potential weaknesses in these areas. Hence, we sent a separate letter recommending that the Secretary of DoF&A should implement appropriate controls to improve the concerned areas.

Relative to the audit objective, ONPA confirmed the productivity of the debts in realizing the outcomes of the projects especially in growing the economy. In the process of this confirmation, ONPA relied on the ADB's performance and/or validation reports. The excerpts of the reports, shown in Appendix A, were used by ONPA in forming some of its observations in this report.

We conducted this audit pursuant to Title 55 of the 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."

Methodology – To accomplish our audit objectives, we perform the following:

To assess the adequacy of FSM National public debt management with respect to legal and institutional framework and the related processes and controls on compliance, monitoring and reporting,

- We reviewed the related provisions of the constitutions, laws, regulations, policies and procedures regarding debt activities and reviewed the existing organization/institutional structure supporting the debt activities. The focus of the review included the existence of the public debt legal framework particularly with regard to provisions on authorization to borrow, basic purposes of borrowing, debt strategies, borrowing limits, issuing guarantees on behalf of the national government, loan auditing and loan reporting requirements. We also reviewed the processes and functions for the handling of debt management operations.
- We also obtained and reviewed loan documentations and project completion reports to evaluate purposes and outcomes of the projects funded by loans.
- Finally, we interviewed key debt management officials to obtain their views on the existing public debt legal framework and institutional framework operating in the FSM environment.

To assess the adequacy of FSM National public debt management with respect government loan relending and guaranteeing activities,

- We obtained and reviewed loan documentations and project completion reports to evaluate the purposes and outcomes of the projects funded by loans.
- We also reviewed the monitoring and the reporting requirements with respect to loan relending and guarantees.

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- Finally, we interviewed key debt management officials to obtain their views on the existing public debt legal framework and institutional framework operating in the FSM environment.

We conducted this audit in accordance with the standards for performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States of America. 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. We believe that the evidence that we obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Prior Audit Coverage

This is the first audit conducted by ONPA about legal and institutional framework for public debt management

Conclusion

Based on the results of the audit, we found that FSM legal and institutional framework lacked permanent and necessary provisions to implement adequately the system of debt management. It has been only during the approval of each debt that the FSM Congress defines the requirements and some functions related to debt management. The basic requirements include borrowing purposes, debt management goals and objectives, reporting of debt obligations and others. We also found that the institutional framework needs strengthening prior to deployment of debt management system. Similar to the legal framework, the institutional functions related to debt management were scattered and performed by different departments without proper coordination to ensure an adequate debt management. Lastly, we found that State Governments and public enterprises could generate risks to the National Government not only in consequence of guaranteed loans but also by undisciplined or unsustainable manner of borrowings. However, there was no limit and analysis of the risks with respect to those loans.

Our audit revealed the following weaknesses:

- \$21 million of the FSM's external debt was spent for failed or partly successful projects;
- \$13 million in Trust Account/Sinking Fund not regularly assessed whether sufficient for the repayment of the associated loans with outstanding balance of \$31 million;
- Legal framework was limited and lacked provisions to enable the implementation of a sound debt management system;
- Limited organizational functions resulted in inadequate implementation of an effective debt management system;
- Absence of loan limit and regular risk analysis on the states' and public enterprises' loans and on guaranteed and/or relent loans.
- Lack of available information on public debt and borrowing activities; and,

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

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FINDINGS AND RECOMMENDATIONS

Finding 1: \$21 Million of FSM's External Debt was Spent for Failed or Partly Successful Projects

A loan-financed project should allow the FSM to develop economically and to sustain the subsequent payment of related debt. Thus, the project related debt management functions should not only ensure that a project is for a “fit purpose” based on sound selection but should also ensure successful project implementation. This is because the unsuccessful project makes debt more expensive by contributing to unsustainable level of debt⁹ and by affecting¹⁰ future generations when the time comes for debt repayment. These debt management functions related to the project include project selection, design and scoping, implementation, monitoring and evaluation.

We reviewed the assessment reports¹¹ on four out of the six loan-financed projects. The key criteria¹² used in the assessment include (1) relevance of design and formulation; (2) effectiveness in achieving program outputs and outcomes; (3) efficiency of the resource use in achieving outputs and outcomes; (4) preliminary assessment of sustainability; and (5) impact. Refer to **Appendix B** on pages 30-32 for the details of assessment.

Based on the results of our review, we found that at least \$21 million of loans had financed either failed or partly successful projects. For partly successful projects, the project evaluations raised further issues on sustainability, outcomes not achieved and inability to measure impact. For example,

- Fisheries Development Project – In 1998, FSM contracted a \$6 million loan to develop the fisheries industry, specifically the long lining industry, and the private investment sector. The loan has yearly debt servicing amount of \$127,166 payable up to 7/15/2033. The main component of the project involved Micronesia Longline Fishing Corporation (incorporated in 1998), which should demonstrate the viability of commercial tuna long lining¹³ and, thereby, attract private investment into the sector. The loan financed the acquisition of long liners for vessel productivity. Since its incorporation in 1998, the corporation did not become a profitable venture and thus, did not attract the expected private investors. In 2005, it went into bankruptcy. According to the project completion report, the project was not successful due to numerous project design and implementation problems.

⁹ The world is abounding with experiences of abandoned, incomplete or loan-financed projects not producing enough when the charges on the loans became due. The countries are unable to pay off borrowed loans resulting in accumulation of arrears and unmanageable growth of debt stock.

¹⁰ It is better to spend funds for providing essential services than spending them on servicing loans that financed unsuccessful projects.

¹¹ From ADB/s Project Completion Reports/Project Validation Report posted on internet site

¹² The same criteria used in ADB's project evaluation reports

¹³ Long line fishing is a commercial fishing technique that uses a long line, called the main line, with baited hooks attached at intervals by means of branch lines.

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- Basic Social Services Project – In 2003, FSM contracted \$4 million loan to prevent the decline in health and education services in FSM by implementing reforms to improve cost-effectiveness and protect access to education and public health services. The loan has yearly debt servicing amount of \$173,927 payable up to 8/1/2032. According to the project completion report, the project was partly successful. Moreover, the report raised concerns about the overall project sustainability and inability to measure the impact due to absence of baseline metrics and parameters against which to measure the effectiveness of the project. The performance monitoring system was not updated to align with the 2007-revised scope of the project.
- Private Sector Development Program – In 2003, FSM contracted \$11 million loan to support the economic and legal reforms in the private sector and to improve the public services to private sector. The loan has yearly debt servicing amount of \$542,617 payable up to 11/15/2025. Overall, the program was successful per ADB project completion report but the ADB Validation Report downgraded the rating for the criteria on relevance to less than relevant. Consequently, the overall rating became less than successful. To support the downgraded rating, the ADB Validation Report indicated that the program had a complex and ambitious design, which was beyond the government's implementation capacity.

As a result, the loan proceeds spent on failed projects resulted in an inefficient use of significant resources and a very high-priced learning experience for a country like FSM that relies significantly on a large percentage of its revenue from outside grants. Furthermore, the failure of loan-financed projects increased the risk that the future generations (intergenerational equity) will pay for loans used for funding unproductive and poorly conceived/planned and failed projects.

Cause and Recommendations

The project evaluation reports had identified several challenges that caused the unsuccessful implementation of projects. Some of these challenges include inadequate design; inadequate financial and risk analysis; inadequate/lack of attention to understanding the environment e.g. policy settings, capacity, physical, social and geopolitical issues; local worker constraints; differing national and state agendas; and inadequate consultation and participation of stakeholders. Furthermore, the project evaluation reports identified that there was inadequate review of project design, appraisal, and feasibility. Refer to Appendix A on pages 20 to 29 for more details regarding the Performance Evaluation of Loan-Financed Projects.

Although the loan-financed projects came from priority list identified during the strategic and country planning process and were implemented following a structured project life cycle framework,¹⁴ we noted that the project related debt management functions were inadequate. Some of the loan-financed project requirements could have been legislated and/or regulated to

¹⁴ Project Life Cycle refers to a series of activities to fulfill project goals or objectives.

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mandate the responsibility and accountability in ensuring the successful selection, design, appraisal and implementation of a project. For example,

- Investment Project – For purposes of approving the project, the laws or regulations could clearly require that the loan-financed project must be an investment¹⁵ and not a consumption¹⁶ spending. In addition, projects with high rates of return or the key infrastructure projects could be prioritized. Furthermore, the cash flows need to be clearly identified and be sufficient to repay the loans. For example, it was not clear whether the Basic Social Services Program, one of the loan-financed projects rated as partly successful, was an investment or a consumption spending. The proposal though indicated the unquantifiable and indirect economic benefits that *the improved capacities at education sector, which were aimed by the program, would lead to better opportunities and higher income potential in the medium and long term. On the other hand, the improved health sector would ultimately contribute to healthier population and, in turn, would reduce private and public health expenditures, more productive labor, and a high standard of living due to higher incomes.* As previously mentioned, the effectiveness or outcomes of these benefits were not verified during the project performance evaluation due to the absence of baseline metrics and parameters and continuous gathering of data after the project completion.

During our exit conference, the Secretary of DoF&A said that the Basic Social Services Program *was neither an investment nor consumable spending and the loan was made as preparation for the amended Compact.*

- Loan-Financed Project Approval Executive Information Summary – The responsibility and accountability of the decision maker could be legislated and/or regulated to oblige the decision maker to utilize coherent, consistent, sufficient and appropriate information that would ensure sound, quality, optimal and justifiable judgment or decision for project selection and approval. (Refer to Appendix C-Loaned-Finance Project Approval Executive Information Summary).
- Project Governance/Organizational Structure – The management of loan-financed project be given high-level attention to manage and dispose properly any implementation issues. Thus, the requirement for strong governance structure for the project could be legislated and/or regulated to assure its successful implementation. The governance structure can vary depending on the size of the project. For small projects, the organizational structure may delegate the responsibility and accountability to the Project Manager and a Senior Manager. For larger and/or more complex projects however, it might be necessary to establish a more formalized governance structure with roles and responsibilities be held

¹⁵ Investment spending generally relates to the creation and acquisition of capital goods with the intent of using them to try to stimulate economic production.

¹⁶ Consumption is a major concept in economics that constitutes a purchase of goods and services

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by senior executives and with provision for Project Sponsor and/or Project Steering Committee¹⁷.

- Project Life Cycle Framework and Risk Management – Depending on the size of the project, the responsibility and accountability for developing and implementing project life cycle framework and risk management activities could be legislated and/or regulated. These activities can either be the detailed functions integrated in debt management function or as a separate set of modular function for integration with debt management. The project lifecycle would provide guide in project management and ensure timely completion of the project deliverables. The risk management on the other hand, would ensure the implementation of a comprehensive approach to risk management with the end view that project problems such as design defect, inadequate funding, lack of commitment, delays, cost overruns and others are foreseeable and avoidable. Although a project life cycle methodology was followed in all of the projects, the members of the project team were not held accountable for their negligent duties.
- Baseline metrics, statistics or parameters and project performance evaluation – A project is worthless without the means to evaluate objectively its success and contribution to the nation's growth and development. Thus, the laws or regulations should define the responsibility and accountability for gathering the baseline metrics and parameters to evaluate the outcomes of the project. Although the existing projects were issued with performance evaluation reports (by ADB), some of the performance evaluations were lacking information on projects' outcomes due to absence of baseline and outstanding performance statistics and/or data. One of the key performances that should be monitored after the completion of the project is the cash inflow performance because of its direct relevance to the repayment of loans.

We recommend that the President should:

1. Require the development and implementation of a more comprehensive Project Appraisal and Approval Framework to ensure that the decision makers should consider all relevant elements necessary for the benefit of an informed judgment. (Refer to Appendix C Loan-Finance Project Approval Executive Information Summary as an example)
2. Establish a Debt Management Advisory Committee that will review and recommend the loaned finance (debt financing) project proposals.
3. Initiate a study to strengthen the legal and institutional framework to mandate and be answerable to law; and establish clearly the responsibilities and accountabilities for the selection, approval and implementation of loan-financed projects. Some of the requirements that could be legislated and/or regulated include:
 - allowable project for loan financing e.g. investment project;
 - use project appraisal and approval framework;
 - formation of project governance structure;

¹⁷ The Project Sponsor and/or Project Steering Committee must consider how the project objectives, project outcomes and long-term benefits are aligned with the strategic direction. They must be committed to providing effective governance until the project's outcomes have been wholly achieved or achieved to a significant extent

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- development and implementation of project life cycle framework and risk management upon implementation of the project;
- gathering of baseline metrics, statistics or parameters before, during and after the completion of the project

Finding 2 : \$13 Million in Trust Account/Sinking Fund Not Regularly Assessed Whether Sufficient for the Repayment of the Associated Loans with Outstanding Balance of \$31 Million

The public laws¹⁸ (Acts) authorizing certain loans require the creation of a Trust Account into which the states and the national governments should make gradual cash deposits until a total amount or a discounted value is sufficient to maintain for debt servicing of the covered loans. In addition, the laws require the National Government (thru DoF&A) to establish an External Debt Management Fund (Sinking Fund) to operate in conjunction with the Trust Account. Lastly, the related laws also require a regular estimation of the amount for transfer to Sinking Fund (from the Trust Account) to satisfy the debt payment or servicing.

Of the existing FSM loans, all except two¹⁹ have provisions for the maintenance of trust account. Of the loan contracts with the provisions for the maintenance of trust account, two kinds of trust accounts were defined. One of the trust accounts would hold the total amount or a discounted value sufficient to maintain the debt servicing of the covered loans. The other one would just hold the funds necessary for the yearly debt-servicing requirement.

The provisions for maintaining sufficient amount of investment in a trust account and sinking fund were part of public laws authorizing the loans for Public Sector Reform²⁰ (\$18M), Basic Social Services²¹ (\$3M), and Private Sector Development Program²² (\$10). These loans have an aggregate outstanding loan balance amounting to \$31 million as of September 30, 2012. Refer to Table 3.

Table 3 Loans with Sinking Fund						
Ref	Project	Original Loan	9/30/12 Balance	Start	Maturity	Debt Service ²³
1520	Public Sector Reform	\$ 20,289,421	\$ 18,308,254	02/01/08	08/01/37	\$ 406,875
1816	Basic Social Services Project	4,233,829	3,478,521	02/01/09	08/01/32	173,927
1873	Private Sector Development Program	3,892,241	3,284,075	05/15/10	11/15/25	243,265
1874		7,248,599	6,436,067	05/15/10	11/15/25	299,352
Total		\$ 35,664,090	\$ 31,506,917			\$ 1,123,419

Source- Audited Financial Statement

¹⁸ PL 9-154 (Public Sector Reform Program), PL 12-17 (Basic Social Services), PL 12-19 (Private Sector Development Program); and PL 14-16 (Omnibus Infrastructure Development Project)

¹⁹ The Fisheries Development Project and the Water Supply Sanitation Project

²⁰ Section 5.1.a of PL 9-154

²¹ Sections 5.1.b and 5.1.c of PL 12-17

²² Sections 5.1.b and 5.1.c of PL 12-19

²³ Annual loan payments (principal + interest) based on FY 2012 audited financial statements.

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We found that regular assessment of the trust account/sinking fund for the above loans was not performed to determine whether the amount in the fund is sufficient for the repayment of covered loans. As of September 30, 2012, the book value of the trust account investment is \$13 million but in the absence of an analysis, it is unknown whether the amount is sufficient to repay the \$31 million covered loans.

On the other hand, the trust account that is required to hold the funds necessary for the yearly debt service payment was specified in the Tripartite Financing Agreement²⁴ for the two loans related to Omnibus Infrastructure Project. In addition to this trust account, the agreement also requires that the repayment of Omnibus Infrastructure Project loan should be accelerated so that the loan would be completely repaid during the remaining term of the Compact of Free Association, as amended.

However, we found that DoF&A did not create the Trust Account for the Omnibus Infrastructure Project as required by the tripartite agreement. The national government has been holding the states' revenue share of the annual grant under the amended Compact and/or the share of the FSM Tax Revenues to collect the states' share of debt servicing requirement.

As a result, the absence of regular assessment increased the risk that fund in the trust account may not be sufficient to repay the covered loans. If the fund is not sufficient, it would in turn result in transferring of debt burden to future generation, which is against the intent envisaged by the Congress when it enacted the public laws authorizing the loans and requiring the establishment of the fund for those loans.

Cause and Recommendations

Due to limited organization or institutional framework for debt management, the Secretary of DoF&A failed to assign the responsibility for regularly estimating the amount needed in the trust account/loan sinking fund. The absence of regular monitoring of the fund increased the risk that the DoF&A may not be complying with the law.

We also noted that there has been no disclosure in the audited financial statement as to the adequacy of the trust account thru a footnote appended in the accounts for 'investment' (in a trust account) and 'loan payables' in the Balance Sheet.

We recommend that the Secretary of the DoF&A should:

- Assign the responsibility for estimating on regular basis the sufficiency of the amount in the trust account and request an appropriation for the transfer of funds from the General Fund to the Trust Account, if necessary.
- Comply with the law to establish and/or maintain sufficient amount of funds in the Trust Account for debt servicing of the related loans.

²⁴ Agreement between the National, the State and the corporation for the relent loans.

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- For transparency and accountability purposes, disclose in the yearly audited financial statements whether the amount in the trust account/sinking fund is sufficient to cover the associated loans.

Finding 3: Legal Framework was Limited and Lacked Permanent Provisions to Enable an Implementation of a Sound Debt Management System

Prudent government practice requires a comprehensive and coherent legal framework²⁵ for implementing debt management activities. The legal framework provides for strategic direction, defines and clarifies powers, and supports the professional and operational focus of debt management. The legal framework also contributes to the achievement of lower borrowing costs, and prevention of fraud, waste and corruption in public debt. Without well-defined legal framework, officials could exploit gaps in the legal framework and could override weak internal controls in debt management to commit fraud, abuse, waste and misuse of loans proceeds.

We found that the FSM legal framework for debt management was limited and lacked some provisions that would enable sound debt management system. The approval of the FSM Congress is required for every borrowing. Thus, most of the existing provisions on loans were transaction-based, enacted only upon approval by Congress of the specific borrowing, and not generic but specific to debtor, e.g. Asian Development Bank. In addition, the current legal framework for debt management did not provide for explicit debt management policy. For example, the existing legal framework did not clearly define the following:

- Use of Borrowings
There are no safeguards against speculative investments and borrowings to finance expenditures. The best practices for borrowing include purposes such as to finance budget deficits, to fill short-term cash gaps, to refinance maturing debt, to finance investment projects, to finance guarantee payments in case of default, and others.
- Legal Definition of Debt Goals and Objectives
There is no high-level definition of the fundamental debt management goals and objectives, which would support the government's accountability for debt management and would help in formulating the debt management strategy.
- Debt Management Strategy
There is no mandate to develop a debt management strategy that would result in lower borrowing costs and reduce excessive levels of debt. The debt management strategy includes consideration of the optimal structure of public debt, interest rates – fixed or variable, and loan source allocation – commercial banks, bilateral, multilateral.

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²⁵ As an example, Republic of Cyprus law of 2102 providing for the management of public debt.

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➤ Debt ceiling

There is no defined debt ceiling. Prudent government practice has been to limit the debt as a percentage of the country's total economy or gross domestic product (GDP), the debt service to tax revenue receipts, and borrowings to capital expenditures.

➤ Annual Debt Reporting

There is no specific law or regulation mandating an annual debt reporting to the Congress. Normally, the debt report includes highlight on movements in debt portfolio and various debt management activities during the period. It also includes information on debts, maturity structure, on lent to the states and public enterprises, guaranteed loans, contingent liabilities, risk and debt sustainability analysis and others.

➤ Loan-Financed Project requirements that could be legislated and/or regulated as discussed under Finding1.

As a result, the inadequate legal framework for debt management increases the risk that the level and rate of growth in public debt may not be sustainable. In turn, the unsustainable debt would unduly expose the government to financial shocks and consequential difficulties to the detriment of economy and of satisfying the delivery of basic government services such as health and education.

Cause and Recommendation

The development and implementation of a coherent and comprehensive legal framework for incurring and management of debt have not been a priority.

We recommend that the President should require the development and proposal for the enactment of a Public Debt Act; and/or the FSM Secretary of Finance and Administration should develop and implement regulations, guidelines and procedures that should provide the strategic direction for debt management, define and clarify duties and responsibilities, and support the professional and operational focus of debt management. Lastly, the legal framework should specify requirements that would include, but not limited, to the following provisions and elements:

- Authority to borrow/Delegation of power;
- Borrowing purposes;
- Debt management goals and objectives;
- Debt management strategy;
- Borrowing limits, including borrowing limits for the states and public enterprises;
- Borrowing options - issuing bonds, instruments, multilateral or bilateral loan agreement, etc;
- Project appraisal and approval framework;
- Office responsible for handling/coordinating the debt management operation;
- Annual debt reporting to Congress including debt status, guaranteed loans, and debt sustainability analysis;
- Project progress and final report including report on outcome effectiveness;

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- National Government oversight on loans contracted by public enterprises (Component Units);
- Gathering and developing project related baseline and operational data to allow comprehensive evaluation of the completed projects;
- Auditing/Assessment of debt management activities including an independent assessment of the economy, efficiency, and effectiveness of projects funded by debts

Finding 4: Limited Organizational Functions Resulted in Inadequate Implementation of an Effective Debt Management System

Legal framework for debt management would be effective if there is a well functioning institutional arrangement equipped with high quality professional staff. Prudent practice requires clear specification of the organizational framework for debt management, including its mandates and roles. In addition, all the necessary functions should be defined, mandated and delegated. Lastly, a well functioning institutional or organizational arrangement should be able to perform efficiently the debt management functions covering the loan cycle activities.

We found that there was no structure with debt-management functions working in an organized fashion to provide a coherent debt management system. There was no law providing for the establishment of an institutional structure to carry out the day-to-day functions of a debt management office. The responsibilities and functions related to debt management were scattered in different departments in the government with no clear direction on the operation of a framework or a system supporting sound debt management practice. For example,

- The Department of DoF&A is responsible for negotiating, signing, recording, monitoring and reporting of public debt. The Secretary of DoF&A executes the loans with the review of the Attorney-General and approval of the President .
- The Office of Statistics, Budgets & Economic Management, Overseas Development Assistance & Compact Management (SBOC) is responsible for monitoring and evaluation of management of debt stock to satisfy the cash flow requirements of Government's annual work/operating budget.

We have assessed that the above existing organizational setup for debt management functions were limited because of the absence of a clear definition of functions as indicated in Appendix E, which lists down the debt management functions covering the appropriate stages of the loan cycle activities.

As a result, the limited organizational functions did not allow the implementation of an adequate and effective debt management system.

Cause and Recommendation

There is no office responsible for the functioning of an institutional arrangement equipped with professional capacity that would cover the entire loan cycle activities or debt management activities.

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We recommend that the President should create a committee (e.g. Debt Management Committee) that would be responsible for the review of all government borrowings including guarantees.

We also recommend that the Secretary of Finance and Administration should define the roles and responsibilities as well as the structure and functions for debt management that would include:

- Consolidate the current debt management functions and build up the functions to allow for more efficient and effective management of debt
- Build up the staff capacity to perform efficiently the debt management functions.

Finding 5 : Absence of Loan Limit and Regular Risk Analysis on States' and Public Enterprises' Loans and on Guaranteed and/or Relent Loans

Prudent practice requires that in order to limit the extent to which the National and the State governments can be held liable for the debts of the states and their public enterprises, it is necessary to explicitly define their borrowing authority and borrowing limits in the public debt legal framework. In addition, the legal framework should impose limits on how much the national government can guarantee. There should also be regular analysis and reporting of the financial risks associated with the states' and the public enterprises' loans in order to provide for contingent liabilities and to manage the related risks in a timely manner.

The State Governments exercise the authority to borrow with the approval of their respective legislature while the Acts creating the public enterprises grant the entities with independent borrowing authority. These authorities are in addition to the loans guaranteed by the national government for the states and/or public enterprises. Therefore, the State Governments and their public enterprises could generate risks²⁶ to the National Government not only in consequence of guaranteed loans but also from undisciplined or unguarded borrowings.

We found that there has been no analysis and hence, no reporting of the risks that could arise from the states and their public enterprises' loans (guaranteed and not guaranteed). Both the state governments and the independent public enterprises were not required to inform the National Government (Executive or Congress) of their loan risks, which could eventually create contingent liabilities realizable in the future.

As a result, the National Government may not be aware of the potential risks that the States and their public enterprises could generate, hence, may not be able to help in managing and implementing mitigation measures in a timely manner. For example, when Chuuk and Kosrae States²⁷ experienced fiscal difficulties, the National Government came into their rescue and

²⁶ Considering that the long history of governments is abounding with bailouts or intercessions to prevent ruin brought by debt crisis to an enterprise, sector and economy, the national government cannot totally adopt hands-off policy concerning debt problems or crisis that the autonomous state governments and public enterprises could experience.

²⁷ In 2007, the national government executed two MOUs with the states of Chuuk and Kosrae. They made the agreements in response to the state governments' financial crisis that resulted in the inability of the two states to

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provided cash assistance to the states. We noted however that providing this emergency assistance could create immediate problem to the National Government in a situation where it does not have sufficient means and ready resources. For loan related examples, we noted that the following loans have generated the financial risks to the National and/or state governments (Table 4):

Table 4 – Examples of Loan to Public Enterprises			
Entity	Outstanding Loan	Due Date	ONPA Comments
Micronesia Long-line Fishing Corporation (MLFC)	\$ 4,893,527	07/15/33	MLFC went bankrupt. The loan balance was absorbed by the National Government
Pohnpei Utility Corporation (PUC)	\$ 5,351,859	11/15/25	PUC was unable to pay the yearly loan servicing and pay the state government. Thus, the National Government has been holding the state's revenue share and/or Compact grant share to collect the loan-servicing requirement.

Source: Audited Financial Statements

Cause and Recommendation

There was no mechanism for systematic analysis and oversight of the risks on the States' and public enterprises' loans. Furthermore, there were neither operating procedure manuals nor guidelines on how to conduct an analysis of the risks. Lastly, no staff was assigned to perform debt risk analysis.

We recommend that the Secretary, Department of Finance & Administration should:

- Include in the public debt legal framework the National Government's debt exposure, liability limits, and how much it can guarantee on loans made by the states and their public enterprises as indicated in Finding # 3.
- Develop and implement operating procedure manuals or guidelines on how to conduct debt risk analysis
- Improve the staff capacity to conduct a regular debt sustainability analysis including the risk analysis of debt
- Assign to the staff the responsibility for conducting an analysis of risks associated with the states' and the SOEs' loans.

advance their own money as required by the U.S. Government grants. The states' financial crisis threatened the continued viability of the federal programs funded by grants.

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Finding 6 : Lack of Available Information on Public Debt and Borrowing Activities

Prudent practice requires that periodic reports on debt and borrowing activities should be available to the public and should show the true condition of public debt and its most relevant details. The periodic reporting would hold the public debt managers accountable to Senior Debt Officials, the Boards charged with governance, the President and to the Congress.

We noted that the only report submitted yearly that contain information on debt stock and servicing has been the report on audited financial statement. However, this report normally did not contain sufficient information on debt management activities including an assessment as regards to the effectiveness of the government's debt management strategy.

Furthermore, though the DoF&A produces reports on debt management activities for internal purposes but such reports were not submitted as regular reports to the President or to the Congress. In addition, DoF&A provides reports (on as needed basis) about the FSM outstanding debt to different offices on demand.

As a result, the President and Congress were not receiving timely full information regarding the financial and operational activities relating to debt management. Moreover, the public may not be aware of the level of risk and problems in public debt management.

Cause and Recommendation

There was no required periodic (e.g. monthly, quarterly, and annual) reporting of information on debt like total debt loans, guarantees, contingent liabilities and payment arrears, debt sustainability and affordability, debt status, key events in the management of debt and others.

We recommend that the Secretary of the Department of Finance and Administration should:

1. Develop and implement policies, guidelines or procedures specifying the different levels, timing, and format of the various debt reporting requirements.
2. Develop a policy specifying debt report users and frequency of circulation.
3. Publish or issue periodic (e.g. monthly, quarterly, annual) reports on the status of FSM's total debt that include loans, guarantees, contingent liabilities, payment in arrears, debt levels and cost, debt sustainability and affordability, debt status over the year, details of any new borrowing and debt repayments, and key events in the management of debt.

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APPENDICES

Appendix A -Performance Evaluation of Loan-Financed Projects

Project Profile and Evaluation ²⁸							
Lender	Original Amount	Balance as of 9/30/12	Start	End	Annual Debt Service		
					Principal	Interest	Total
ADB #1257 Fisheries Development Project	\$ 6,247,194	\$ 5,216,110	1/15/04	7/15/33			\$ 127,166
<p>The amortization of the loan started in 2004. In 2008, ADB adjusted the loan balance to reflect foreign currency adjustment amounting to \$1,095,967. Thus, this in effect increased the dollar equivalent of the original loan by 21% from \$5,151,227 to \$6,247,194.</p> <p>The FSM National relent 70% of the loan proceeds (\$3.6 thousand) to Micronesia Long-line Fishing Corporation (MLFC). In 1991, the FSM National incorporated MLFC with National Fisheries Corporation (government owned enterprise) as the majority owner.</p> <p><u>Purpose:</u> MLFC would demonstrate the feasibility of commercial tuna long-lining industry and, thereby, attract private investment into the sector. The company purchased long-liners vessels for productivity.</p> <p><u>Evaluation:</u> According to the <u>project completion report</u>, the project was not successful due to numerous project design and implementation problems. Thus, it did not achieve its overall aim of assisting the government in accelerating economic growth through the development of the country's domestic commercial fishing industry, particularly the harvest of sashimi-grade tuna privately owned long line fishing vessels. Since the MLFC started operation in 1997 however, it did not become a profitable venture and hence did not attract the expected private investors. In 2005, it went bankruptcy.</p> <p><u>Lessons Learned</u></p> <ul style="list-style-type: none"> ➤ <u>Understand the FSM Environment.</u> In designing the project for fisheries, the FSM realities-financial, physical, and geographical issues, must be clearly understood. The project be appropriately designed in the context of clear understanding of the situation confronted by a particular fishery (such as reliability of airfreight). ➤ <u>Consider Public Policy Setting and Environment.</u> Design of projects with commercial component must take account of the analysis of the public policy setting and enabling environment since it will provide importance in the likelihood of success. An important weakness in the design and appraisal of the project was the lack of attention to analyzing whether or not an appropriate enabling environment was in place. A thorough analysis of the public policy setting needed to precede the design and implementation of the project. ➤ <u>Design Change</u> - Project should have been suspended and a full review undertaken so as the likely outcomes of the design change could be fully understood. Example, review of the design change involving replacement of new vessels with the purchase of secondary vessels. ➤ <u>Selection of Consultants</u> – Consultants without Pacific Experience and/or consultants who did not have appropriate technical skills led to poor outcomes – unsatisfactory and/or incomplete. 							

²⁸ Project purpose and evaluation indicated on this Table were extracted from ADB Program Performance Audit Report/Validation Report

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Project Profile and Evaluation ²⁸							
Lender	Original Amount	Balance as of 9/30/12	Start	End	Annual Debt Service		
					Principal	Interest	Total
ADB #1459	\$ 10,407,232	\$ 9,200,668	2/1/07	8/1/36			\$ 208,971
Water Supply and Sanitation Project	The FSM National relent the portion of the loan proceeds, under the same terms and conditions of the ADB loan agreement, to Chuuk State Public Utility (\$4,144,208), Pohnpei State Utilities Corporation (\$2,543,997) and Yap State Public Service Corporation (\$2,721,435).						
	<p><u>Purpose:</u> The purpose of the loan was to improve the efficiency of water supply services and enhance the commercial viability of utility companies by addressing their facilities and management.</p> <p>The substantive proceeds of the loan, during the project appraisal, were planned to be used for the following:</p> <ol style="list-style-type: none"> 1. Chuuk – Construction of 30 water wells, refurbishment of a water treatment plant and three water tanks, construction of a new water transmission pipe line, and installation of chlorinating facilities. 2. Pohnpei- Construction of four (water) distribution pipelines extending the coverage of the service areas. 3. Yap – Construction of seven water wells and deepening of another well, construction of transmission and distribution pipe lines and a pumping station, refurbishment of a water treatment plant and installation of chlorinating facilities and a water tank. 						
	<p><u>Evaluation:</u> According to the <u>project completion report</u>, the project, including the planned physical infrastructure, was successfully implemented in both Pohnpei and Yap and generated significant improvements in living conditions and socio economic conditions.</p> <p>However, the project was not implemented successfully in Chuuk State during the loan project implementation. Various problems resulted in a very expensive project implementation. From the original 30 water wells appraised during the loan approval, only 16 water wells were actually drilled in year 2002 and out of this, only five water wells were left due to lack of budget for maintenance brought about by financial difficulty being experienced then by Chuuk Public Utilities Corporation.</p> <p>Additional costs related to this project was incurred from 2009 to 2012, though using grant this time, when the Japan government thru the Japan Fund for Poverty Reduction (JFPR) provided grant assistance amounting to \$980,000 (administered by Asian Development Bank) to rehabilitate water wells. The project was completed on July 9, 2012 and restored the 28 water wells back into operation delivering safe and secure water supply to the residents of Weno Island.</p>						
	<p><u>Lessons Learned</u></p> <ul style="list-style-type: none"> ➤ <u>Project Performance</u> - At the inception stage, baseline data, measures, and the meaningful and measurable performance indicators be developed to monitor and evaluate the project outputs and outcomes. The design should identify specific physical infrastructure and improved living conditions. ➤ <u>Project Readiness</u> – The project readiness should be addressed to avoid unnecessary delays in loan effective date and project implementation. ➤ <u>Design Change and/or Construction Variation Order</u> – Necessary design change and construction variations with major cost implications should be discussed and agreed to avoid implementation delays. 						

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Project Profile and Evaluation ²⁸							
Lender	Original Amount	Balance as of 9/30/12	Start	End	Annual Debt Service		
					Principal	Interest	Total
	<div>➤ <u>Land Use</u> – The design should consider land use if necessary because land acquisition is a difficult challenge in FSM.</div> <div>➤ <u>Legislative Support</u>- The readiness of essential legislative support should be confirmed at the project appraisal or loan negotiation stage to avoid implementation delays.</div> <div>➤ <u>Counterpart Funding</u>- The readiness of essential counterpart funding should be confirmed at the project appraisal or loan negotiation stage to avoid implementation delays.</div> <div>➤ <u>Cost Recovery (for commercial project)</u> – Maintain separate records for operations to assist in cost recovery.</div>						
ADB #1520	\$ 20,289,421	\$ 18,308,254	2/1/08	8/1/37			\$ 406,875
Public Sector Reform Program	<p>ADB disbursed the funds on two tranches of \$10 million and \$8 million. The FSM National relent the portion of the loan proceeds, under the same terms and conditions of the ADB loan agreement, to the States of Chuuk (\$5,128,335), Yap (\$3,500,000), Kosrae (\$2,000,000), Pohnpei (\$4,053,685). (Note: the remaining amount with the National Government was \$3,000,000).</p> <p><u>Purpose</u>: The goal of the project was to transform and develop a more efficient FSM economy. Its purpose had two dimensions: (1) reforming and reducing the size of the public sector to adjust to declining external resource transfers, and (2) shifting the balance of economic activity away from the public to the private sector. Five outputs were specified: (1) reduced size and operating cost of the civil service; (2) increased domestic revenue generation; (3) restructured government operations and public enterprises, with the divestiture of some of the latter; (4) successful mitigation of negative social and economic impacts of the adjustment in public expenditure; and (5) improved conditions for private sector development.</p> <p><u>Evaluation</u>: According to the ‘project performance audit report,’ the program completion report rated the program as generally successful particularly in reducing the cost (payroll) and size (workforce) of the public sector. The performance of the program based on specified outputs were as follows:</p> <div>(1) Reduced Size and Operating Cost of the Civil Service – The program provided a total costs savings amounted to \$18 million²⁹, which was committed for the repayment of the original loan including the repayments to the subsequent loans obtained by the National Government such as Private Sector Development and Basic Social Services. Thus, the costs of the program were fully recovered.</div> <p><i>As of FY2013, the reduction in public servants compared with the original program targets still stands at 16%, and remained a considerable achievement. However, the payroll costs have grown steadily and reverted back to the levels prevailing before the program was initiated, thus completely eroding the progress achieved.³⁰</i></p> <div>(2) Increased Domestic Revenue Generation- According to the ‘project performance audit report’, all the State Governments met the tax revenue targets by the end of the program period in 2001. The consolidated tax revenue was 27% higher on average in the 4-year period FY1998-FY2001.</div>						

²⁹ As of September 30, 2012, the amount remaining in the trust account is \$13 million in investment book value.

³⁰ Source –IMF FSM Economic Report as of August 2013.

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Project Profile and Evaluation ²⁸							
Lender	Original Amount	Balance as of 9/30/12	Start	End	Annual Debt Service		
					Principal	Interest	Total
					<p>(3) Restructured Government Operations and Public Enterprises, with the divestiture of some of the latter- The program performance was not consistent. In Yap and Chuuk, there was <u>no significant</u> restructuring associated with downsizing. On the other hand, there was <u>significant</u> restructuring of government departments in National and Kosrae. The effort to reform and divest public enterprises was not successful as hoped. One reason was that with a weak private sector, there are few people with capital and/or business experience to bid for or successfully manage the public enterprises.</p> <p>(4) Successful Mitigation of Negative Social and Economic Impacts of the Adjustment in Public Expenditure – According to the ‘project performance audit report’, the project was relatively successful. The early retirement pay helped ensure that downsizing was politically acceptable. However, the expectation that many would use the retirement pay to start business did not happen to any significant extent. Instead, people used the money to retire debt, fund the consumption and migrate.</p> <p>(5) Improved Conditions for Private Sector – The main achievement was the passage of new foreign investment legislation. However, there was limited response from the private sector.</p> <p><u>Lessons Learned</u></p> <ul style="list-style-type: none"> ➤ <u>Voluntary redundancies</u>- It is not desirable to design major public sector downsizing based on voluntary redundancies. The government should retain the key staff needed to maintain core competencies to provide acceptable standard and quality of service delivery. ➤ <u>Process of Reform and Structural Adjustment</u> - The process of reform and structural adjustment in FSM will necessarily take a long time and will require a core of champions capable of understanding the rationale for reforms and who can maintain strategic direction. ➤ <u>Social Analysis of Historical, Structural, Socioeconomic and Cultural Conditions</u>- There must be sufficient analysis of social, historical, structural, socioeconomic and cultural conditions during project preparation. ➤ <u>Reform and Divestiture of Public Enterprises</u>- In a small and low-income country with weak private sector, there are few people with capital and/or business experience to bid or successfully manage such enterprises. 		
ADB#1816 Basic Social Service Project	\$ 4,233,829	\$ 3,478,521	2/1/09	8/1/32			\$173,927
<p>The portion of the loan proceeds were relent to States of Chuuk (\$2,983,000), Yap (\$993,000) and Kosrae (\$614,000).</p> <p>According to the ADB Project Completion Report, the rationale of the project was to forestall the decline in health and education services in the FSM by implementing reforms to improve cost-effectiveness and protect access to basic education and basic health services. The FSM receives most of its development assistance funding through the Compact of Free Association with the United States, commonly called the Compact. When the project was being designed, it was not certain that the Compact would be renewed. The second Compact was, however, successfully negotiated and in place by the time the project was signed. There were two major changes made regarding the design of the program – in 2001 and in 2007. The need for two major changes in scope reflected the difficulties experienced in getting project activities under way or output achieved. This reflected some of the early design issues, particularly the ambitious nature and complexity of the project, its weak assumptions about relations between the national and state governments, and the difficulty of achieving policy changes.</p>							

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Lender	Original Amount	Balance as of 9/30/12	Start	End	Annual Debt Service		
					Principal	Interest	Total
	<p><u>Purpose:</u> The program has four components as follows:</p> <ol style="list-style-type: none">1. Strengthen system accountability and community participation2. Improve the quality of the education and health systems3. Develop sustainable funding options for education and health4. Improve education and health facilities						
	<p><u>Evaluation:</u> According to the project completion report, overall the project was rated partly successful, based on the assessment of its relevance, effectiveness, efficiency and sustainability. Despite the changes due to the second Compact, the scoped project achieved about 71% of the outputs. Although the project did not succeed in fully implementing reforms, it made valuable headway in initiating them. Follow up actions by the DOH and DOE at the national and state level are crucial to sustain the project outputs and achieve overall objectives to improve health and education capacity and outcomes.</p>						
	<p>Component 1: Strengthen System Accountability and Community Participation. The objective of this component was to address the need to (i) gather reliable and comprehensive data on which decision making can be made, and (ii) increase community participation to make the education sector accountable and improve outcomes.</p> <ol style="list-style-type: none">a. Establish education performance monitoring units (EMUs) and data based decision making system at state and national level. The EMUs were intended to measure the performance of schools, teachers, and principals. Chuuk progressed most in establishing a functional state EMU although it was not formally integrated in the system. The EMU establishment was therefore evaluated as 20% complete at the close of the project. Chuuk and Kosrae are moving toward adoption. A computerized national education management information system (EMIS) was developed. This created the capacity to routinely calculate 20 core education indicators, which have provided the basis for Joint Economic Management Committee (JEMCO) reports since 2007. An issue unsolved was to combine the EMIS with a second performance monitoring system, the Pacific Education Data Management System (PEDMS), which supports more at the state level. The intended integration of the EMIS system with the similarly functioning PEDMS was not achieved because of its technical complexity.b. Projects to support community participation in schools in collaboration with nongovernment organizations. A structured process of community participation was demonstrated through workshops and adopted by the national Department of Education (DOE) as a national process. Guidelines were produced. Pilot school improvement plans were implemented in Kosrae and Yap and demonstrated good outcomes through improved test outcomes. In Chuuk, the project helped establish a women’s nongovernment organization (NGO) that works to improve conditions in state schools. The system was developed but not fully implemented in the states.c. Set of health indicators established and routinely reported. A national computerized health information system (HIS) was established, with hardware and software installed, training conducted, and protocols developed. The HIS has improved national and state reporting of morbidity and mortality trends and was introduced using the World Health Organization (WHO) international classification of disease codes. It provides the basis for JEMCO reports on 14 core health indicators. While all states use the HIS to report these indicators, they continue to use other database systems for their own administration, as the HIS does not meet all their data needs. The health departments still have reservations about the usefulness of the HIS at the						

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							state level.
							<p>Component 2: Improve the Quality of the Education and Health Systems. This component addressed the requirement for better trained and motivated professionals and strengthened institutional capacity to improve the quality of basic social services.</p> <ul style="list-style-type: none"> a. Strengthen teacher, school, and principal monitoring and support. The aim was to introduce legislation on performance-based conditions, but, after the 2007 change in scope, this changed to developing a teacher observation and performance management system. The main output was the teacher observation and performance management system. It was piloted and approved in Chuuk, Kosrae and Yap. The National DOE promoted the implementation. The monitoring system was not fully established in the states. b. Establish and maintain certification system for qualified teachers. The policy and process were developed for the certification scheme, but the deadline has repeatedly been pushed back and was not implemented by project completion. c. Design and distribute teaching guides on the core curriculum. The project helped the DOE develop national standards and benchmarks and coordinate the alignment of state curricula with them. This took longer than expected because it involved developing curricula for subjects at all levels throughout all the state school systems. The output was evaluated as 50% complete at the close of the project. d. Develop and publish early education learning materials in local languages. The originally planned textbook loan scheme was modified in the 2007 change in scope to avoid duplicating Compact provisions and accommodate requests from states for funding support to develop, edit, print, and distribute appropriate early entry and elementary reading books in local languages. Several materials were designed, printed, and distributed and were in use in classrooms in Chuuk and Yap, while materials for Kosrae were still in production at the close of the project. This output was evaluated as 90% complete at the close of the project. e. Strengthen and rationalize drug and medical supply management including procurement and distribution. The project secured funding from the Australian Agency for International Development (AusAID) to establish an accreditation program for health dispensary assistants in Chuuk and prepared a dispensary improvement plan. <ul style="list-style-type: none"> ➤ Chuuk - An accreditation program for health dispensary assistants and dispensary improvement plan ➤ Yap - Inventory System f. Implement a uniform quality assurance program in participating states and in the national Department of Health (DOH). Each of the states now has some type of quality assurance system in place. These systems are not yet functioning with uniform indicators in all states, but the national DOH continues to promote this policy. This output was 80% complete at the close of the project. g. Develop and implement a program to improve the training and skills of health personnel. The project was to develop a national health workforce plan, approved by all states. The accreditation program was established only for health dispensary assistants in Chuuk and no effective national plan is in effect. This output was 30% complete at the close of the project. <p>Component 3: Develop sustainable funding options for education and health. This component was to develop a framework for a realistic and sustainable approach to health</p>

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	financing reform in the FSM. Two outputs were completed:						
	a. Health insurance options paper prepared and debated at National forum. An options paper was prepared at the request of the DOH and discussed at a national meeting. (100% completed)						
	b. Standard program budget implemented at National and State levels. Standard accounting systems were established throughout the FSM. The national DOH system was operating at both the state and the national level, with further assistance from World Health Organization. (90% completed)						
	➤ Component 4: Improve education and health facilities. This component aimed to improve education and health facilities in participating states and establish a process to use the loan funds as government matching funds to effectively access Compact infrastructure maintenance funds. However, at the time of project completion, the process remained uncertain. This work involved renovating <u>eight schools and two health dispensaries</u> in Yap and Chuuk. The renovation of <u>eight schools and two health dispensaries</u> in Yap and Chuuk <u>was completed</u> though with delays for the two schools in Yap because of the delay in the delivery of roofing materials and communication difficulties between the contractors and state officials required the project to be extended into 2009 to see the work completed.						
	<u>Effectiveness in Achieving Outcome</u>						
	The objective of wide ranged system changes was difficult to achieve, given weak commitment to this type of reform in the FSM and limited technical capacity in the country. The project did not achieve all of its outcomes as described in the original design, the modified design of 2001, or the modified design of 2007.						
	Some project outputs became less effective due to change in the development assistance situation after the signing of the second Compact. For example, the health and education data networks under objective 1 were well established to operate, but both needed to be well integrated with routine information systems. Additional support to connect the two data systems would have been useful for effective data management. Most activities relating to objectives 2 and 3 were aimed principally at capacity building either by developing and implementing new systems or policies or by improving technical facilities and managerial skills. These took longer than anticipated because of technical capacity constraints, in particular, the frequent turnover of government officials and absence of decision-makers on travel; delays in appointments due to changing administrations and the lead time required for recruiting advisors; and logistical difficulties caused by infrequent shipping. The project effectiveness was rated less effective.						
	The design and monitoring framework was produced in January 2004 and included monitoring and evaluation indicators. In May 2005, an information and procedures manual was produced by DHESA, including a project target monitoring system. However, as these systems were all based on the original design from before 2006, the targets were outdated. Over the decade since 1999, health and education indicators in the FSM have improved, but the lack of baseline data or appropriate indicators precludes measuring the actual impact of this project.						
	<u>Lessons Learned</u>						
	➤ <u>Consultation and Participation</u> – Adequate consultation and participation at the state and community level during project design and scope change are essential for understanding the institutional capacity and for identifying appropriate implementation arrangements and required technical assistance.						
	➤ <u>Operations and Maintenance</u> – It is essential to include maintenance components for new						

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	<p>systems and facility renovations to ensure sustainability of project outputs.</p> <ul style="list-style-type: none">➤ <u>Technical Assistance</u> – Providing long-term technical assistance at the state level would be more appropriate to support long-term development, including human resource development and monitoring and quality control system➤ <u>Ownership</u> – State governments should be closely involved in project monitoring and evaluation.➤ <u>National and State Responsibilities</u> – The interlinked responsibilities of the national and state governments need to be fully taken into account in the design of any future project.➤ <u>Human Capacity Building</u> - Capacity issues need to be addressed comprehensively from the outset of the project.➤ <u>Stakeholders' Engagement</u> - The preparation and implementation of any future projects need to include consultation of all levels of government and with civil societies and communities. This is especially essential for the sustainability of investment in new processes and facilities.						
ADB #1873&1874 Private Sector Development Program	1873	\$ 3,892,241	\$ 3,284,075	5/15/10	11/15/25		\$ 243,265
	1874	\$ 7,248,599	\$ 6,436,067	5/15/10	11/15/25		\$ 299,352
	Total	\$ 11,140,840	\$ 9,720,142				\$ 542,617
	<p>ADB provided two loans for this project. FSM initially obtained the first loan (#1873) from the ADB's Special Funds and then obtained another loan (#1874) in furtherance of the program. The portion of the proceeds for loan 1873 were relented to States of Chuuk (\$650,000), Yap (\$400,000), Kosrae (\$832,126) and Pohnpei (\$550,000) while the portion of proceeds for loan 1874 were relented to States of Chuuk (\$1,410,436), Yap (\$1,137,537), Kosrae (\$1,242,014) and Pohnpei (\$592,636).</p> <p><u>Purpose:</u> The project had two components. The <u>Component A</u> of the Private Sector Development aimed to support the economic and legal reforms in private sector. The loan outputs included (1) maintenance of balanced budgets; (2) reduction of wage differential between public and private sectors; (3) contribution of additional compact funds to the FSM Trust Fund; (4) achievement of external debt below 24% of the GDP; (4) implementation of public sector enterprise reforms; (5) enactment of long-term-lease, mortgage, and new foreign investment laws. The <u>Component B</u> aimed to develop private sector by improving the public services to private sector.</p> <p>The loan outputs and components included (1) establishment of new secured transaction system; (2) strengthening of the capacity of FSM Development Bank; (3) improve development services of the small business development centers, and (4) improve coordination and monitoring of program.</p> <p><u>Evaluation</u> – Overall, the program was successful per ADB project completion report but the ADB Validation Report downgraded the rating for the criteria on relevance to less than relevant. Thus, the Validation Report downgraded the overall rating to less than successful. To support the downgraded rating, the Validation Report indicated that the program had a complex and ambitious design, which was beyond the government's implementation capacity.</p> <p>The project design addressed a wide range of enabling environment issues that seen as a necessary but not sufficient condition to stimulate private sector growth. The assumption that the private sector could absorb redundant civil servants, although compensated, was unrealistic, given the small size and even temporarily contracting economies and</p>						

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					Principal	Interest	Total
					significantly different skill and attitude sets needed by the private sector.		
					<u>Lessons Learned</u> <p>The designer of the program should strengthen preparatory work for better design and monitoring frameworks. There were two major lessons identified: (1) the need for stronger program preparation and (2) the need for the design to be more appropriate for the local circumstances.</p> <p>Regarding the need for stronger program preparation, the ADB validation report pointed out four areas where loan preparation could have been stronger, which would have enhanced program implementation and possibly reduced the delays in achieving loan effectiveness. These were the need for:</p> <ul style="list-style-type: none"> ➤ <u>Stakeholders' Engagement</u> - <ul style="list-style-type: none"> • Broad consultation, awareness raising, and development of skills of key state stakeholders; • Early stakeholder and beneficiary involvement in the program preparatory process to ensure program quality and ownership that could have minimized delays (e.g., designing and approval procedures for civil works and PIU staffing) ; ➤ <u>Human Resource Capacity</u> - Assessment of individual capacities, particularly in the executive and legislative branches of government, before an accurate judgment is made of the time needed to prepare for loan effectiveness and then implement reforms; ➤ <u>Legislator's Awareness</u> - Formal discussions with legislators to improve their understanding of the constraints facing the sector, thereby facilitating earlier passing of key legislation for maintaining the impetus for change in the enabling environment for PSD; 		

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					Principal	Interest	Total
	Loan #	Original Amount	Balance	Start	End		Yearly Payment
ADB #2100/2099 Omnibus Infrastructure Project	2100	\$ 3,148,589	\$ 3,119,233	1/15/10	1/15/29		\$ \$23,526
	2099	7,289,517	7,287,460	1/15/10	7/15/36		\$2,057
	Total	\$ 10,438,106	\$10,406,693				\$ 25,583
	<p>The portion of the loan proceeds were relent, under the same terms and conditions under the ADB loan, to States of Pohnpei/Pohnpei Utility Corporation (\$xx), Chuuk/Chuuk Utility Corporation \$xx, Yap/GTWA (\$xx) and Kosrae/Kosrae Utility Administration (\$xx)</p> <p><u>Purpose</u> : The overall objective of the Project is to enhance public health and the environment through assistance to improve water supply infrastructure in Kosrae and Yap, and wastewater infrastructure in Pohnpei; and to support economic growth and poverty reduction in Chuuk through improvements to the electrical power sector. The project objectives include:</p> <ol style="list-style-type: none"> 1. Improved public health through enhanced quality of and access to potable water in Kosrae and Yap; 2. Enhanced public health, environmental quality, and surface and groundwater quality through provision of wastewater management and infrastructure in Pohnpei; and 3. Poverty reduction, support for economic growth and environmental improvements through power generation and distribution improvements, and power station environmental remediation in Chuuk. <p>The Project also advances private sector development by providing improved infrastructure and an enhanced business environment.</p> <p><u>Evaluation</u>: No evaluation yet was conducted since the project is ongoing.</p>						

Source: Completion/Validation reports

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Appendix B-Summary of Assessment Made on Loan-Financed Projects

Criteria	ADB #1257 \$ 6,247,194 Fisheries Development Project	ADB#1520 \$20,289,421 Public Sector Reform Program	ADB#1816 \$4,233,829 Basic Social Services Project	ADB#1873&1874 \$11,140,840 Private Sector Development Program	
	Per ADB Program Completion Report	Per ADB Program Completion Report	Per ADB Program Completion Report	Per ADB Program Completion Report	Per ADB Validation Report
Relevance of design and formulation	Relevant	Highly relevant	Relevant	Relevant	Less than Relevant
Efficiency in achieving outputs and outcomes	Less than efficient	Efficient	Not rated due to lack of baseline data or appropriate indicators	Less efficient	Less than efficient
Effectiveness in achieving Outcome	Not achieved	Effective	Less Effective	Effective	Effective
Preliminary Assessment of Sustainability	Less likely sustainable	Likely	Less likely sustainable	Likely to be sustainable	Likely to be sustainable
Impact	Little impact	High significant impact	Impact cannot be directly measured	Not rated but indicated a positive impact	Moderate
Overall	Unsuccessful	Successful	Partly Successful	Successful	Less than successful

Source- ADB Performance Report/Evaluation Report

Criteria

- **Relevance** is the consistency of a project's impact and outcome with the government's development strategy, the Asian Development Bank's lending strategy for the country, and the Asian Development Bank's strategic objectives at the time of approval and evaluation and the adequacy of the design.
- **Efficiency** describes, ex post, how economically resources have been converted to results, using the economic internal rate of return, or cost-effectiveness, of the investment or other indicators as a measure and the resilience to risk of the net benefit flows over time.
- **Effectiveness** describes the extent to which the outcome, as specified in the design and monitoring framework, either as agreed at approval or as subsequently modified, has been achieved.
- **Sustainability** considers the likelihood that human, institutional, financial, and other resources are sufficient to maintain the outcome over its economic life

Rating

- **Highly Successful.** The overall weighted average is greater than 2.7. This rating is given to projects whose achievements exceed expectations and that have a high probability that the outcome and impact will be achieved sustainably and efficiently over the project's

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life; that the project remains relevant; and that no significant, unintended, negative effects will occur.

- **Successful.** The overall weighted average falls between 1.6 and less than 2.7. Even though the outcome may not have been completely achieved or some negative results may have occurred that prevent a rating of highly successful, no major shortfall has taken place and the expected outcome and impact will, overall, be achieved sustainably over the project's life. The project remains relevant and its implementation and operations are efficient. Any negative effects are small in relation to the gains under the project.
- **Partly Successful.** The overall weighted average falls between 0.8 and less than 1.6. Even though the evaluation anticipates a significant shortfall in achieving the design outcome and impact and may consider full sustainability unlikely, it expects that some project components will achieve major benefits, for example, equivalent to at least half the level originally expected.
- **Unsuccessful.** The overall weighted average is less than 0.8. In this case, the evaluation considers that the project is a technical (minimal achievement of outcome) and/or economic failure. Any facilities are expected to operate at a low level of installed capacity or at high cost, necessitating a large subsidy. Negative effects may be apparent.

ADB's Program Completion Report/ Validation Report³¹

Project performance evaluation is part of an ADB accountability framework aimed at improving project performance and uses the same methodology and terminology for **self-evaluations**, **independent evaluations**, and **validations**.

After the project facilities and technical assistance activities are completed, ADB prepares a project completion report or technical assistance completion report to document the implementation experience. These reports are prepared within 12-24 months of the completion of the project.

“Self-evaluation” refers to the evaluation of ADB operations by the departments responsible for the concerned public sector operations. It includes final reviews of country and regional partnership strategies and may include self-evaluations (reviews) of policies, and procedures that govern ADB operations. ADB publicly disclose the **project completion reports** on ADB's Internet site. Client governments are required to prepare their own project completion reports.

“Independent evaluation” refers to an evaluation of ADB operations by Independent Evaluation Department (IED) through the preparation, among others, of performance evaluation reports (PPERs), and TA performance evaluation reports. The IED independently and systematically evaluates ADB policies, strategies, operations, and special concerns that relate to organizational and operational effectiveness. By doing so, it contributes to achieving development effectiveness of ADB operations by providing evaluation feedback on performance, and generating and disseminating evaluation lessons. IED's mandate is to undertake evaluation activities to help ADB Management and developing member country stakeholders who are

³¹ ADB Website/Wikipedia

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responsible for planning, designing, and implementing projects and programs to understand whether resources have been well spent, and whether the planned outcomes have been achieved.

“Validation” refers to IED’s independent check of self-evaluation reports issued by Management in terms of their evidence and plausibility. This includes a review of ratings provided by these reports. It also includes an assessment of the quality of the self-evaluation report.

To be credible and to provide an objective performance assessment, the evaluation function must be independent from project or program design and implementation. To fulfill its mission effectively, IED develops and sustains a reputation for excellence by following the principles of independence, impartiality, and integrity. Drawing on the good practice standards of evaluation agencies, IED has recognized and adopted **four** dimensions of evaluation independence: behavioral autonomy, organizational independence, insulation from external influence and avoidance of conflicts of interest.

Appendix C-Loaned-Finance Project Approval Executive Information Summary

- Note: The project implementation should not start without clear confirmation of the counterpart funding since this would only delay implementation, add costs and could be a factor for the project failure.

- | Current Policy/Settings | Proposed Reforms | Intended Outcome |
|-------------------------|------------------|------------------|
|-------------------------|------------------|------------------|

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Note: The implementation of the project should not start without clear confirmation and adaption of the required policy changes.

11. Social Compatibility

- Perform diligence study and evaluation to ensure that each element is given due consideration during the design of the project.

Note: The classic flaw in the development project is the ignorance of certain relevant elements such as historical, political, social, cultural, economic and environmental context in which the project would operate. Inadequate understanding of these elements results in project design flaws.

12. **High level** Input/Process, Desired Output, Desired Outcome, Baseline Statistics, Performance Measures

Input	Process	Output	Outcome	Performance Measure
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- **Provide a table with a clear mapping** or relationships of input/process, output, outcome and performance measures to establish project expectations in terms of specific deliverables and to evaluate the performance of the project after the completion.
- Outputs to be achieved thru inputs and processes

Note: The achievement of project output for use in realizing the outcome

- Expected outcomes of the project with corresponding performance measures

Note: Conceptually, the outcomes are the realization or attainment of project goals and objectives. These could be the high-level macroeconomic goals and objectives such as economic growth, poverty alleviation, decrease in unemployment ratio, increase in literacy rate, private sector growth and others.

13. Cash Flows From the Project for Repayment of the Loan

- Source of revenue must be identified for the repayment of debt

14. Baseline and outstanding data to evaluate the project

- Identify and evaluate whether data are existing to be able to evaluate the project after its completion

Note: Project Management should be made accountable (by law or regulation) for the continuous gathering of baseline and outstanding data to be able to evaluate the performance of the project.

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15. Major Assumptions Made

16. Required Collaborations across Disciplines and Sectors

- Discuss the required collaborations, coordination or interface to ensure the success of the project

Note: Lack of the determination of the required collaborations across disciplines and sectors contributes to insufficient due diligence or a lack of knowledge of the broad and complex contexts in which development projects exists

17. Initial Assessment of Project Risks and Mitigation Measures

- Identify and evaluate the major risks and the corresponding mitigation measures
- Identify and evaluate the major environmental risks as well as the risks to the human safety
- Determine whether the risks without mitigation measures are within the risk appetite of the country

18. Project life Cycle Approach

- Since the success of the project is very important to the nation, there must be very brief discussion of the project life cycle approach to gain confidence that the project would be successfully implemented. Some of the key elements in the project cycle include planning and scoping, governance structure, outcome realization, stakeholders engagement, risk management, issues management, documentation and formal approval for the change of scope³² and/or project delivery, status reporting, project review and evaluation and project closure.
- **Project Delivery** - The project delivery program covers cost estimation, financial planning, and project management.

19. Project Governance Structure³³

- Evaluate the need for a Project Steering Committee or a Project Sponsor for big projects.
- Discuss how the proposed governance structure would ensure the success of the project

³² The documentation of change in scope must include the corresponding analysis in the change of project outputs and outcomes.

³³ Project governance refers to the process by which the project is directed, controlled and held to account. The aim of the project governance is to plan and manage the project throughout its life in order to achieve success.

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20. Major Lessons Learned from Past Project Implementation

- Include discussion of the relevant key lessons learned from past project implementations that are to be considered and incorporated in the current project implementation.
- Provide also information whether exactly the same nature of project was implemented before and the result of implementation.

21. Major Critical Success Factors

- Provide information for clear understanding of the critical issues or factors that would ensure the success of the project.

22. Project Sustainability Requirement

- Availability of local manpower skills and education including the strategy to acquire them in the long run if not available
- Required strengthening of institutional organization to handle future operation
- Required provision for maintenance
- Relevant data and metrics that should be continuously collected to measure the benefits of the project
- Determine whether the project sustainability could be achieved in the short and long-term after the implementation to continuously achieve the outputs and use them to sustain the realization of outcomes.

Notes:

- The World Bank defines sustainability, "as to be the ability of a project to maintain an acceptable level of benefit flows through its economic life".
- Poor sustainability is depriving the government from the returns expected of these investment
- The dimension of sustainability includes: *Continued operation and maintenance of project facilities, continued flow of net benefits, continued community participation, Equitable sharing and distribution of project benefits, institutional stability and maintenance of environmental stability.*

23. Readiness to Implement the Project

- Establish the criteria and determine whether the project team is ready to implement the project

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Appendix D–FSM under the Compact of Free Association and Intergovernmental Fiscal Arrangement

FSM – A former Trust Territory of the Pacific Islands - entered into the Compact with the U.S. in 1986. The Compact between the FSM and the U.S. provides FSM with benefits including U.S. economic assistance (including eligibility for certain U.S. federal programs), defense, and special migration provisions. In exchange, the U.S. receives defense and certain other operating rights in the FSM, as well as the right to deny access to FSM territory by other nations. Renegotiations of certain terms of the Compact occurred in 2003, notably the economic provisions of the Compact were amended. The renewed Compact (commonly called the "amended Compact") for FSM took effect on May 1, 2004.

The amended Compact provides U.S. support for a 20-year period that began in FY2004. Under the amended Compact, FSM receives two streams of funds – Compact sector grants, and Compact Trust Fund (CTF) contributions, totaling approximately \$2.1 billion during that period. Contributions to the CTF will increase on an annual basis, offset by declines to Compact grants. The CTF is designed to provide an annual source of revenue when the annual U.S. assistance terminates at the end of FY2023. Around 70 percent of Compact grants will provide funding for operational purposes in the sectors of education, health care, private sector development, the environment, public sector capacity building, and enhancing reporting and accountability. Of this amount, around 85 percent is earmarked for the health and education sectors alone. The remaining 30 percent of Compact grants will provide funding for public infrastructure, with around $\frac{3}{4}$ earmarked for the education and health care sectors.

Almost all service delivery functions (e.g. health and education) have been assigned to the four state governments, and they are financed through a combination of fiscal transfers on-granted by the national government, and the States' share in domestically generated revenue (equal share in most revenue categories, 80 percent of fuel tax, and none of the fishing license fees). The key fiscal transfers to the state governments are the Compact grants. In addition to this, the state governments receive the Compact Supplemental Education Grant, and other grants also made available by the U.S. At the aggregate level, these grants make up around 60 percent of total revenues while domestic revenues (including non-tax revenues) make up the rest.

Appendix E-Example of Debt Management Functions Considering the Activities at Stages of the Loan Cycle

1. Project Identification
 - a. Identify projects to be funded by debt
2. Project Appraisal and Approval
 - a. Prepare and update a Project Appraisal and Approval Framework that would consider all factors for a successful projects and enable a comprehensive basis for approving the project
 - b. Appraise the project to determine feasibility
3. Loan Negotiation and Contracting
 - a. Prepare, review and update the debt strategy
 - b. Prepare an annual borrowing plan

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- c. Assess all types of risks in incurring new loans or in issuing guarantees including the mitigations measures to address the identified risks.
- d. Oversee the loan contracting and issuance process and be responsible for determining the loan structure and for negotiating reasonable terms and conditions for all new borrowing
- e. Develop and implement operational guidelines, document procedures and approval processes for domestic and external borrowing;
- f. Process applications for government guarantees, issue guarantees and conclude agreements with borrowers;
- g. Function as clearing house for requests for information from donors, international financial institutions, commercial banks and other creditors.
- h. Process applications for on-lending borrowed funds and conclude agreements with the borrowers; and
- 4. Loan Disbursement
 - a. Disburse the loan in accordance with the action plan and when meeting all the conditionalities for loan effectiveness.
 - b. Determine the method of disbursement including the development and implementation of appropriate disbursement procedures
- 5. Project Implementation and Monitoring
 - a. Supervise project implementation
 - b. Develop/calibrate the metrics that would enable measurement of the success of the project based on pre-defined goals, objectives, outputs and results.
 - c. Monitor project implementation
 - d. Submit periodic implementation reports as basis for monitoring
 - e. Elevate issues causing the project delay for 100% resolution of issues and concerns.
- 6. Project Evaluation
 - a. Evaluate the impact of the project as against the goals, objectives and targets as well as against long-term effects – i.e. economic growth, employment, literacy, environmental protection and others.
 - b. Ensure the implementation of corrective measures to ensure timely and effective achievement of goals and objectives or to mitigate and address the negative effects of the project.
- 7. Debt and Risk Analysis
 - a. Undertake frequent portfolio analyses to assess future debt service prospects and problems and propose action that should be taken to overcome them;
 - b. Prepare debt sustainability analyses to assess the long-term sustainability of projected borrowing levels;
 - c. Assess external vulnerability using debt and reserve adequacy indicators;
 - d. Formulate policies for the issue of government guarantees and on-lending borrowed funds;
 - e. Assess and manage market, rollover, liquidity, credit, settlement and operational risks in the loan portfolio;
 - f. Formulate a borrowing policy and an annual borrowing plan for the government/public sector. It could involve the adoption of ceilings for total debt outstanding broken down into foreign and domestic debt and targets for various stock and flow debt indicators;
 - g. Prepare a borrowing strategy for implementing the annual borrowing plan.

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- h. Formulate guidelines for unguaranteed borrowings of state owned enterprises.
Prepare or provide inputs on public debt to periodic economic and financial reports and data for presentation to Congress.
- 8. Loan Repayment or Servicing
 - a. Keep timely, comprehensive and accurate records of outstanding government debt, contracts, guarantees, contingent liabilities and new borrowing in a single debt database and in a secure place.
 - b. Maintain loan database
 - c. Monitor and advise on all debt servicing obligations of the government and loan agreements
 - d. Process debt service payments
 - e. Monitor the performance of on-lending agreements and report defaults to the government
 - f. Monitor all contingent liabilities and ensure that adequate loan loss provisions are made in the budget to meet likely default.
 - g. Prepare forecasts on government debt servicing and disbursements as part of cash management and the yearly budget preparation.
 - h. Prepare periodic statistical and other reports on the status of public debt that are required by the government and lender
 - i. Publish, in a timely manner, monthly (and quarterly) reports showing the status of outstanding debt, debt payments, and projected debt payment obligations.

Source- Unitar

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MANAGEMENT'S RESPONSE

We discussed the contents of this report with the management during the exit conference and they agreed with all the findings and recommendations. We also sent a request for formal management response. However, we did not receive the response therefore; we are issuing this report without the management response.

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NATIONAL PUBLIC AUDITOR'S COMMENTS

We would like to thank management and staff at the Department of Finance and Administration for their assistance and cooperation during the course of the review.

In conformity with general practice, we presented our draft findings and recommendations to the Division of Investment and International Finance for comment. However, we did not receive the response therefore; we are issuing this report without the management response.

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 listed on the last page of this report, along with the ONPA and staff who made major contributions to this report.



Haser H. Hainrick
National Public Auditor
July 9, 2014

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ONPA CONTACT AND STAFF ACKNOWLEDGEMENT

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