

**OFFICE OF THE NATIONAL PUBLIC AUDITOR
FEDERATED STATES OF MICRONESIA**

**PERFORMANCE AUDIT ON THE IMPLEMENTATION OF RECOMMENDATIONS OF
AUDIT REPORT NO. 2017-01**

**The Division of Customs and Tax Administration
and
Secretary of Department of Finance and Administration
DID NOT TAKE CORRECTIVE ACTIONS TO ADDRESS ALL AUDIT FINDINGS AND
RECOMMENDATIONS**



AUDIT REPORT NO. 2020-06



**Haser H. Hainrick
National Public Auditor**



FEDERATED STATES OF MICRONESIA

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May 06, 2020

His Excellency David W. Panuelo, President
Honorable Members of the 21st FSM Congress
Federated States of Micronesia

RE: PERFORMANCE AUDIT ON IMPLEMENTATION OF RECOMMENDATIONS OF AUDIT REPORT NO. 2017-01

This report presents the results of the Performance Audit on the corrective actions taken to address Audit Findings and Recommendations that were issued in our prior Audit Report No. 2017-01 titled, 'Division of Customs & Tax Administration: Improvement is Needed in Assessing and Collecting the Taxes Due from Some Independent Contractors.

The main objective and scope of the Performance Audit were to determine whether the Management of CTA and the Secretary of the Department of Finance and Administration (in collaboration with the Office of Personnel and the Department of Justice) have taken corrective actions to address the prior audit findings and recommendations disclosed in Audit Report No. 2017-01.

Based on our audit, we concluded that Management has taken some corrective actions to address the findings and recommendations issued in our Audit Report no. 2007-01, however all the five recommendations were yet to be fully implemented. We also observed during our review that besides the two divisions, Customs and Administration of Tax (CTA) and Treasury being under the same department (Department of Finance and Administration), but there was lack of effective and appropriate coordination and communication especially in those areas where there is interdependence. Therefore, a new audit finding has also been included in this report as one of significant issues that affects the administration of tax for Independent Contractors.

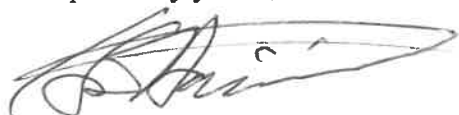
The current status of implementation as indicated in the table below is: three (3) recommendation were on preparation stages for implementation, while two (2) have been substantially implemented. The definition of the stages of implementation is provided in [Appendix A:](#)

Summary of Implementation Status:

Audit Recommendation	Stage of Implementation
On Finding No.1: Not all Independent contractors paid the taxes due on their revenues	
(i) Secretary of Finance and Administration (DOFA) to implement clear internal policies and guidelines to properly manage all government independent contractors for tax purposes.	Preparation for implementation
(ii) Secretary of Finance and Administration require that all employment contracts should be routed to the Division of Customs and Tax Administration (CTA) for proper tax considerations and to ensure that the correct amounts of tax payments are made accordingly	Substantial implementation
(iii) Secretary of Finance and Administration require the use of a uniform Independent Contract Agreement form by all departments/agencies for consistency and to ensure that the tax obligations are clearly included in the Independent Contract Agreements and paid for by the Independent Contractors as required by law.	Preparation for implementation
On Finding No.2: Payments to Independent Contractors with Employee Status Not Subjected to Salary Tax Withholding.	
(i) Secretary of Finance and Administration develop and implement guidelines on how to determine the existence of employer-employee relationships for independent contractors.	Preparation for implementation
(ii) Secretary of Finance and Administration assess and collect income withholding taxes from the independent contractors who have the status of employees.	Substantial implementation

Finally, it is worth acknowledging the assurance given by the Division of CTA to work with the new Tax Administration Advisor in addressing all recommendations.

Respectfully yours,



Haser H. Hainrick
National Public Auditor

Xc: Secretary, Department of Finance & Administration
Assistant Secretary, Division of CTA
Assistant Secretary, Division of Treasury
Secretary, Department of Justice
The Acting Director, Office of Personnel

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1. INTRODUCTION

1.1. Background

On December 28, 2016, the Office of the National Public Auditor issued an Audit Report No. 2017-01, as a result of the performance audit conducted on Independent Contracts due to concerns received regarding unpaid taxes. The report revealed the following audit findings:

- (i) *Finding No. 1* - Not all Independent contractors paid the taxes due on their revenues
- (ii) *Finding No. 2* - Payments to Independent Contractors with Employee Status Not Subjected to Salary Tax Withholding.

In the management response dated December 22, 2016, as incorporated in the Audit Report No. 2017-01, the Secretary, Department of Finance and Administration (DOFA) had noted and acknowledged the audit findings and provided assurance that the issues would be address as follows:

(i) *Response to Finding No.1 of the Audit Report No. 2017-01 was:*

- (a) 'All independent contracts were being enforced to have a business Identification (I.D) otherwise they were made to go through the Payroll II system (a payroll processing system that was established to process all contracts under contractual services which must have automatic tax deductions).'
- (b) 'Office of Personnel was to revise the contract agreement forms to accommodate all the information required'.

(ii) *Response to Finding No. 2 of the Audit Report No. 2017-01 was:*

- (a) 'Independent contractors were to be identified through business I.D numbers and for employment contracts to have personal Social Security Number'.
- (b) 'That the setup in place allowed the CTA to collect all taxes. That DOFA would continue to make sure that all employment contracts were allowing tax deductible on the employment contracts.'

Moreover, the Secretary of DOFA had also stated that they would work with the Department of Justice for better guidance and to ensure that the tax deductions were properly made.

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2. OBJECTIVE, SCOPE AND METHODOLOGY

2.1. Objective

The objective of this follow-up audit was to determine whether the Management of Customs and Tax Administration (CTA) and the Secretary of the DOFA in collaboration with the Office of Personnel and the Office of the Attorney General, have implemented corrective actions to address the prior Audit Findings and Recommendations disclosed in Audit Report No. 2017-01.

2.2. Scope

The scope of this performance audit focused on the status of implementation of our recommendations and as agreed by the Secretary, DOFA. This performance audit was conducted through interview meetings with appropriate personnel and verifications of various information provided by the Division of CTA relating to Independent Contracts.

We conducted this follow-up audit pursuant to the authority vested in the National Public Auditor as codified under Chapter 5, Title 55 of the FSM Code which states in part:

"The Public Auditor shall inspect and audit transactions, accounts, books and other financial records of very 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."

2.3. Methodology

We conducted this performance audit in accordance with generally accepted government auditing standards. 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

Under GAGAS, performance audit is inclusive of internal controls, compliance, prospective analysis, and assessments of program effectiveness, economy, and efficiency as delineated in paragraph 1.22, of the Government Audit Standards 2018.

The approach taken to determine whether the Management of CTA and the Secretary of the DOFA (in collaboration with the Office of Personnel and the Department of Justice) have taken appropriate corrective actions to address the audit findings and recommendations, included the following:

- (a) Interviewing senior and key members of the management to understand the current progress and clarify issues;

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- (b) Reviewing and analyzing support documents demonstrating progress in implementing the recommendations and assessing the degree to which the recommended corrective actions were implemented (See [Appendix B](#)); and
- (c) Debriefing auditee management personnel on the results of the performance audit.

3. PRIOR AUDIT COVERAGE

This is the fifth (5th) performance audit on the Division of Customs and Tax Administration (CTA).

4. CONCLUSION

Based on the results of our audit, we concluded that the Secretary, Department of Finance and Administration, in collaboration with the Office of Personnel and the Department of Justice, have not fully implemented all audit recommendations, however, have set plans and taken preparation steps to address all the findings and recommendations reported in Audit Report No. 2017-01.

The results of this performance audit are discussed in detail in the following pages.

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5. IMPLEMENTATION STATUS OF OUR RECOMMENDATIONS, AUDIT REPORT NO. 2017-01

**5.1. Implementation of Recommendations on Finding 1(Audit Report 2017-01):
Not all Independent contractors Paid the Taxes Due on Their Revenues**

We issued three (3) recommendations under Finding 1

5.1.1. Audit Report 2017-01: Recommendation No. 1

- (i) **We recommended that** the Secretary of Finance and Administration (DOFA) implement clear internal policies and guidelines to properly manage all government independent contractors for tax purposes.
- (ii) **Management Response to the prior audit was:** The department concurred with the finding and ‘was enforcing that all independent contracts must have a business identification (I.D) otherwise they should be processed through the payroll II system. This Payroll II system was established to process all contracts under contractual services. With that, all contracts through the process should have automatic tax deductions.’
- (iii) **Current Implementation Status:** The implementation was at *preparation for implementation* stage.

There are still no documented internal policies and procedures adopted within the DOFA to guide the daily operations of the CTA division and other participating divisions to ensure effective management of tax revenue.

Draft “Guideline for Tax Clause to Insert in Contractors Contract” has been developed by the current Tax Administration Advisor (recruited in year 2019) to guide the Departments of the FSM national government in regards to tax clauses to be included in various types of contracts. According to the Division of CTA, the draft document has been with the Department of Justice for some time and more discussion on this between the CTA team and the DOJ will be carried out before the Guideline can be finalized and adopted for all national departments to use.

- (iv) **Effect of Non-implementation:** Tax assessments may not be carried out for all independent contracts therefore leading to non-payment of taxes due to the national government. The absence of tax assessment in contractors’ files was evident during the follow up audit.
- (v) **Cause of Non-implementation:** The recommended policies and guidelines were not developed and operationalized by the Management of CTA. Moreover, there was lack of effective oversight by the office of the Secretary of DOFA to ensure that the prior audit recommendations were implemented while the Assistant Secretary of the Division of CTA who has

direct supervision over the tax administration process failed to prioritize the implementation of the audit recommendations.

5.1.2. Audit Report 2017-01: Recommendation No. 2

- (i) **We recommended that** the Secretary of Finance and Administration require that all employment contracts should be routed to the Division of Customs and Tax Administration (CTA) for proper tax considerations and to ensure that the correct amounts of tax payments are made accordingly.
- (ii) **Management Response to the prior audit was:** The department concurred with the finding and stated that they were “enforcing that all independent contract must have a business identification (I.D) otherwise they would go through the Payroll II (which was established to process all contracts under contractual services and where tax deductions is effected automatically based on pre-determined rate)” and “for employment contract, should have a personal social security number”.
- (iii) **Current Implementation Status:** The recommendation was *substantially implemented though not consistently*. Based on the audit sample that was reviewed indicate that in some cases Tax Assessments was not carried out. Additionally, even though the Division of CTA has expressed its desires for the routing process to be consistent for all contracts, there was no documented Policy or Procedures that exist to support the process of routing contracts to their division to ensure tax verifications and assessments is carried out. The Division of CTA admitted that some contracts were still not routed to them as verified and confirmed from the audit sample reviewed.

Further detailed verification of the Division of CTA contractors’ files and Microsoft excel listing (intended to assist in collection and recovery of outstanding tax as it documents contractors’ details including tax assessed and paid amounts) revealed weak monitoring of the whole tax assessment process by the Division of CTA. The incomplete contractors listing proved an absence of periodic reconciliation of the tax payment records (maintained by the Division of National Treasury) against the listing of independent contracts that is maintained by the Division of CTA.

- (iv) **Effect of failure to full Implementation:** Independent contracts not routed to the Division of CTA will result in missed tax determination and assessments which may result in non-payment of taxes by the independent contractors. Furthermore, not having the documented

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policy and procedures to support this important routing process will still result in inconsistent implementation.

- (v) **Cause for failure to fully Implement:** The absence of documented Policies and Procedure Manual and weak monitoring of the whole tax revenue management process has led to the failure to fully implement this prior audit recommendation.

Moreover, the oversight role by the office of the Secretary of DOFA was not effective enough to ensure adequate controls exist to address the audit findings. The Secretary DOFA (who is part of the routing process and responsible for fund certification of all new contracts) failed to ensure that the process of routing the contracts to CTA is established as a compulsory procedure for all new employment and independent contracts made with the FSM national government.

5.1.3. Audit Report 2017-01: Recommendation No. 3

- (i) **We recommended that** the Secretary of Finance and Administration require the use of a uniform Independent Contract Agreement form by all departments/agencies for consistency and to ensure that the tax obligations are clearly included in the Independent Contract Agreements and paid for by the Independent Contractors as required by law.
- (ii) **Management Response to the prior audit was:** the department concurred with the finding and stated that the Office of Personnel Administration must revise the forms to accommodate all the information required.
- (iii) **Current Implementation Status:** The implementation was still at *preparation* stage.

The issue of lack of standard Independent Contract Agreement forms remains evident as various formats of Independent Contract Agreement forms were used by the national government departments/agencies. Some Independent Contract Agreements have tax clause which mandates the deduction of tax while others did not.

The Management of the Office of Personnel however stated that all departments/agencies should be using the same template for contracts as circulated by their (Personnel) office.

It is anticipated that the draft "Tax Clause to Insert in Contractors Contract" [discussed in Section 5.1.1(iii)] that CTA is preparing would

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provide some insight to the Office of Personnel on how to review the currently existing three (3) types of contract agreement forms in order to ensure that standard tax clauses are captured in the contract agreement templates before the same are circulated and used by the national government departments.

(iv) Effect of Non-Implementation:

- (a) Lack of standardized contract agreement templates may result in the tax clauses not being captured in the contract agreements and therefore may provide an opportunity for the contractors to avoid their tax obligations to the FSM national government.
- (b) It also contributes to independent contractors not paying their taxes on time.

(v) Cause of Non-Implementation:

- (a) The general lack of communication and cooperation between the CTA Division (Department of Finance & Administration); the Personnel Office (for laxity in creating awareness on the standard contract agreement templates); and the Department of Justice (for not effectively assessing all contract agreements which are presented to their department for legal sufficiency) is the key factor that resulted in the lack of implementation of this audit recommendation on the need for standardization of Contract Agreement forms.
- (b) Lack of effective oversight by the Secretary of Finance and Administration to initiate the above-mentioned coordination between the three (3) offices is also a key contributing factor.

5.2. Implementation of Recommendations on Finding 2: Payments to Independent Contractors with Employee Status Not Subjected to Salary Tax Withholding.

We issued two (2) recommendations under Finding 2

5.2.1. Audit Report 2017-01: Recommendation No.4

- (i) **We recommended that** the Secretary of Finance and Administration develop and implement guidelines on how to determine the existence of employer-employee relationships for independent contractors.
- (ii) **Management Response to the prior audit was:** the department concurred with the finding and stated that they were “enforcing that all independent contract must have a business identification (I.D)

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otherwise they would go through the Payroll II (which was established to process all contracts under contractual services and where tax deductions is effected automatically based on pre-determined rate)" and "for employment contract, should have a personal social security number".

- (iii) **Current Implementation Status:** The implementation is at *preparation* stage. The draft "Guideline for Tax Clause to Insert in Contractors Contract" [discussed in Section 5.1.1 (iii)] has already been developed and awaits result of final discussion with the Office of the Attorney General before it can be adopted for use by all departments and agencies of the national government.
- (iv) **Effect of Non-implementation:** The lack of guidelines on contract agreement clauses to include for each contract type (those that are classified as businesses and those that are classified as employees) may lead to confusion on the type of taxes that each contract must be subject to. This may result into contractors paying high or low taxes; or inappropriate taxes.
- (v) **Cause of Non-implementation:** The Assistant Secretary of CTA Division and the Secretary of Finance and Administration failed to take the necessary actions to ensure implementation of the audit recommendations with the assistance of the Office of the Attorney General.

5.2.2. Audit Report 2017-01: Recommendation No.5

- (i) **We recommended that** the Secretary of Finance and Administration assess and collect income withholding taxes from the independent contractors who have the status of employees.
- (ii) **Management Response to the prior audit was:** The department concurred with the finding and asserted that "with the current set up, we are able to collect all taxes. We will continue to make sure that all employment contracts are allowing tax deductible on the employment contracts".
- (iii) **Current Implementation Status:** The recommendation was substantially *implemented*. There were a number of independent contract agreements from the CTA listing that currently pay tax through the Payroll II system which was set up for independent contracts (mainly those with employer-employee status).

However, detailed verification with CTA division and reconciliation against the National Treasury Division (Payables section and Payroll section) where the taxes are paid or deducted respectively, revealed

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outdated records of independent contractors maintained by the CTA division an indication that there was no consistent reconciliation of data maintained by the two divisions. Therefore, a need for an urgent thorough reconciliation of all independent contractors' tax payments against tax liabilities and a thorough verification and assessments of their contract status to ensure that they are paying the correct tax to the FSM national government (either the Gross Revenue Tax which is for businesses or the Wages and Salaries tax for employees).

According to CTA, it would be difficult to use the Payroll II system for all independent contractors due to some complexity of some of these contracts however they would work with the Contractors to get this implemented especially those who are currently filing their tax returns on salaries and wages.

(iv) Effects of failure to fully implement the recommendation:

- (a) Failure by the contractor to file or pay tax and failure by the CTA Division to enforce the collection of the right taxes due to the national government is a breach of the tax laws FSM Code Title 54 on Taxation and Customs.
- (b) There is a potential loss of \$673,675.93 (an average of \$2,339.15 per independent contract) which is a result of uncollected tax from independent contractors and delinquent tax liabilities as at December 2019. (Source: updated CTA listing on independent contracts provided on April 8, 2020)

(v) Causes of failure to fully implement the recommendation:

- (a) The absence of effective internal controls including documented policies, procedures, guidelines and reconciliations which are the key contributing factors for effective administration of tax revenue payable to the FSM national government.
- (b) Failure to implement the prior audit recommendation, which is an oversight role of the Secretary of DOFA and the management role of the Assistant Secretary of CTA.

6. RECOMMENDATION

- (i) We reiterate our five (5) recommendations issued as per our Audit Report No. 2017-01 issued on December 28, 2016 to the Department of Finance and Administration (DOFA), and that they should be implemented as agreed to, by the management of the Department.

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- (ii) We recommend that the Division of Customs and Tax Administration should use all means possible to collect the outstanding tax and delinquent tax liabilities amounting to \$673,675.93 as at December 2019 while current tax dues should be closely monitored.
- (iii) We recommend that the Division of Customs and Tax Administration should develop and operationalize appropriate and sufficient policies and procedures to guide its tax force in identifying, collecting and monitoring customs duties and tax payables to the FSM government.

7. NEW FINDING 01: LACK OF COORDINATION AND EFFECTIVE COMMUNICATION BETWEEN THE DIVISION OF CUSTOMS & TAX ADMINISTRATION AND DIVISION OF TREASURY

The roles and functions of the two-divisions, Division of Customs and Tax Administration (CTA) and Division of Treasury differs, however they all fall under one parent department (Department of Finance and Administration) and the functions of one division are somehow linked to the function of the other division. For example, the CTA division collects custom duties and tax while the Treasury Division maintains the record of each tax payer accounts, outstanding tax and those who are taxed through payroll. It was expected therefore that there would be periodic reconciliation of records of tax-payers accounts in CTA and those at Treasury Division, however, this was not the case which led to incorrect and outdated CTA records and lack of effective and timely actions by CTA in collecting taxes from independent contractors.

It was also expected that the Secretary, Department of Finance and Administration would require quarterly reports on revenue collections and outstanding debts on tax and custom duties from the two division. Based on these reports, the disparity could have been easily identified and therefore a need to reconcile.

7.1 Causes

- (i) Lack of effective internal policies within the divisions under the Department of Finance and Administration; and
- (ii) Lack of effective governance processes within the CTA and the overall Department of Finance and Administration.

7.2 Potential Effects

- (i) Loss of revenue due to lack of correct data on current and outstanding tax receivable; and
- (ii) Complaints from tax payers who may find themselves receiving tax notice on settled obligations.

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7.3 Recommendations

We recommend that:

- (i) The Secretary, Department of Finance and Administration should ensure that there are appropriate and sufficient internal controls (policies and procedures) within all divisions and units under his/her department in order to foster coordination and effective communication;
- (ii) The Assistant Secretary, Customs and Tax Administration and Assistant Secretary, Treasury should improve coordination and communication in all those areas where information is dependent on each other in order to have harmonized data/information.

8. APPENDICES

APPENDIX A

STAGES OF IMPLEMENTATION OF AUDIT RECOMMENDATIONS

Summary

There are five stages used to assess the status of implementation of the recommendations. The stages are as listed below:

- (i) **Not yet implemented - No progress or insignificant progress**
Actions such as having meetings and generating informal plans.
- (ii) **Planning stage**
When formal plans for organizational changes have been created and approved by the appropriate level of management with appropriate resources and a reasonable timetable.
- (iii) **Preparation for implementation**
If the entity made preparations for implementing a recommendation by hiring or training staff, or developing or acquiring the necessary resources to implement the recommendation.
- (iv) **Substantial implementation**
If the structures or processes are in place and integrated within at least some parts of the organization, and some achieved results have been identified.
- (v) **Full implementation**
If the structure and processes are operating as intended and are fully implemented.

Obsolete

The recommendation is obsolete if it is no longer applicable because the issue has become outdated as a result of having been superseded by something newer.

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APPENDIX B:

IMPLEMENTATION STATUS MATRIX OF RECOMMENDATIONS GIVEN UNDER AUDIT REPORT NO. 2017-01

Serial No.	Finding	Recommendations	Action Taken (as per the detailed action plan/report submitted)	Status/progress (Implemented, Not Implemented, On-going)	Reasons for noncompletion of action on any recommendations	Timeframe to Implement Audit Recommendation (Impacts)
1.	Not all Independent Contractors Paid the Taxes Due on Their Revenues	<p>The Secretary, Department of Finance and Administration in coordination with the Attorney General Should:</p> <p>(i) Implement clear internal policies and guidelines to properly manage all government independent contractors for tax purposes.</p> <p>(ii) Require that all employment contracts should be routed to the Division of Customs and Tax Administration for proper tax considerations and to ensure that the correct amounts of tax payments are made accordingly.</p> <p>(iii) Require the use of a uniform Independent Contract Agreement form by all departments/agencies for consistency and to ensure that the tax obligations are clearly included in the independent Contract Agreements and paid for by the independent contractors as required by law.</p>	<p>Procedures Developed. No specific written policy</p> <p>Completed for National Departments. Yet to roll out State wide.</p> <p>Discussed with AG's Office stating text to be included and in what circumstances.</p>	<p>In progress (Deadline given by DOFA was 9/30/2019)</p> <p>Implemented. All contracts should route to CTA for tax assessment and payment.</p> <p>Not fully implemented. All Contracts should have a section for tax.</p>	<p>Policy not completed by previous advisor.</p> <p>Road blocks at State level, e.g. Chuuk AG's Office.</p> <p>CTA recently become aware of recommendation.</p>	<p><100% tax being collected. Deadline given by DOFA was 9/30/2019</p> <p>Inconsistencies with contracts. (No implementation timeframe was given by DOFA)</p> <p>Some contracts entered into may not have addressed tax requirements. (No implementation timeframe was given by DOFA)</p>

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Serial No.	Finding	Recommendations	Action Taken (as per the detailed action plan/report submitted)	Status/progress (Implemented, Not Implemented, On-going)	Reasons for noncompletion of action on any recommendations	Timeframe to Implement Audit Recommendation (Impacts)
2.	Payments to Independent Contractors with Employee Status Not Subjected to Salary Tax Withholding.	<p>(i) Develop and implement guidelines on how to determine the existence of employer-employee relationships for independent contractors.</p> <p>(ii) Assess and collect income withholding taxes from the independent contractors who have the status of employees.</p>	<p>No guideline but employment status determined by CTA with general position that individual contractors are employees.</p> <p>This currently happening for National Contractors. Gaps with roll out to State.</p>	<p>In progress</p> <p>(Deadline given by DOFA was 9/30/2019)</p> <p>Implemented. All Independent Contracts are being routed to CTA for tax assessment and collection.</p>	<p>Report not disseminated to CTA.</p> <p>Some compliance issues forced with the states.</p>	<p>Time being sued providing advice.</p> <p>(Deadline given by DOFA was 9/30/2019)</p> <p><100% of tax being collected.</p> <p>(No implementation timeframe was given by DOFA)</p>

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9. MANAGEMENT RESPONSE




GOVERNMENT OF THE
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April 29, 2020

MEMORANDUM

TO: Office of the National Public Auditor

FROM: Secretary, Department of Finance and Administration 

SUBJECT: Audit Report No. 2017-01 (Customs and Tax Administration)

I wish to thank you and your staff for a thorough audit and follow-up of our Customs and Tax Administration's management of the assessment and collection of taxes for independent contractors. Your findings have led to substantial improvements in the tax revenue collected from the independent contractors. The Department of Finance and Administration will continue to improve on the substantive progress we have made to date in this area.

I generally agree with your recommendations, but wish to reiterate a couple of comments made in our exit meeting.

1. Finding No.1(iii): This recommendation should be made to the Department of Justice and the Personnel Office, as these two offices are responsible for developing templates for all FSM Government employee and non-employee contracts.
2. Finding No.2(i): This Department has recently developed and issued a guideline on how to determine whether a contractor is an employee or not. A requirement that all independent contractor's contracts have a tax clause will be inserted in the amendments to the Financial Management Regulations (FMRs), currently being prepared. The amended FMRs will also contain a link to the new guideline. I therefore consider that this recommendation has been substantially implemented.
3. Finding No.2(ii): It is generally the responsibility of the employers who employ independent contractors that are employees to deduct the tax from the contractor's payments, and then pay the tax withheld to this Department (section 131 of Title 54 FSMC). This recommendation should be amended.

Once again, I thank your Office for its comprehensive audit, and your staff for their professionalism.

Thank you

10. ONPA EVALUATION OF MANAGEMENT RESPONSE

We requested for a management response from the management of the Department of Finance and Administration (DOFA) and we commend the Secretary, for his positive response to the recommendations and most importantly by indicating that the follow-up audit led to substantial improvements in the collection of tax revenue from independent contractors.

The Secretary, DOFA generally agreed with all the audit recommendations except for recommendations under the following audit findings.

10.1. Finding 1: Recommendation No. 3

10.1.1. We had recommended that the Secretary of Finance and Administration **require** the use of a uniform Independent Contract Agreement form by all departments/agencies for consistency and to ensure that the tax obligations are clearly included in the Independent Contract Agreements and paid for by the Independent Contractors as required by law.

10.1.2. Management Response

"The recommendation should be made to the Department of Justice and the Personnel Office, as these two offices are responsible for developing templates for all FSM Government employee and non-employee contracts."

10.1.3. ONPA Evaluation

We evaluated the management response above and concluded that the recommendation should be maintained as it is. The management of DOFA agreed to implement the recommendation which was first made in our prior Audit Report No. 2017-01, however they failed to.

It is our view that the Secretary DOFA and the CTA team should collaborate with the Department of Justice and the Office of Personnel in order to develop and operationalize a standardized independent contract agreement forms that will capture appropriately tax obligations to be paid by all contractors as required by law.

10.2. Finding 2: Recommendation No. 4

10.2.1. We recommended that the Secretary of Finance and Administration develop and implement guidelines on how to determine the existence of employer-employee relationships for independent contractors.

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10.2.2. Management Response

"The Department has recently developed and issued a guideline on how to determine whether a contractor is an employee or not. A requirement that all independent contractor's contracts have a tax clause will be inserted in the amendments to the Financial Management Regulations (FMR), currently being prepared. The amended FMR will also contain a link to the new guideline. I therefore consider that the recommendation has been substantially implemented".

10.2.3. ONPA Evaluation

We evaluated the management response above and agree to maintain the audit finding and implementation status as "preparation for implementation".

We note that the new guideline while it has been recently developed, is yet to be included as part of the amended Financial Management Regulations (FMR) which DOFA is currently preparing and has already circulated to various stakeholders for comments and inputs. We anticipate that implementation of the guideline would be evident later on.

10.3. Finding 2: Recommendation No. 5

10.3.1. We had recommended in our prior Audit Report No. 2017-01 that the Secretary of Finance and Administration assess and collect income withholding taxes from the independent contractors who have the status of employees.

10.3.2. Management Response

"It is generally the responsibility of the employers who employ independent contractors that are employees to deduct the tax from the contractor's payments and pay the tax withheld to DOFA (section 131 of Title 54 FSMC). This recommendation should be amended."

10.3.3. ONPA Evaluation

We evaluated the management response above and concluded that our recommendation should be maintained as it is.

We concur with the response of Secretary of DOFA, but while the Sub-Chapter III of Chapter 01 of Title 54 of FSM Code requires employer to collect tax on any wages and salaries by deducting and withholding and pay the

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same to Government, however it is the duty of Secretary of DOFA to supervise the collection of all revenue whether declared and paid by employers or not, as stated in Chapter 02 of Title 55 of FSM Code

It is our view that the Division of CTA assessments and thorough verification of current contracts should detect the correct tax payable by each contractor.

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11. NATIONAL PUBLIC AUDITOR'S COMMENTS

We would like to thank the Management of the Department of Finance and Administration, staff of the Division of Customs and Tax Administration and National Treasury for their facilitation and cooperation during the course of the audit. We anticipate positive implementation results when we carry out another follow-up audit, six (6) months from the date of issuing this report.

We have provided copies of the final performance audit report to the President and Members of the 21st FSM Congress. Furthermore, the report is made available to the public via our official website and copies will be made upon request.

If there any questions or concerns regarding this report, please do not hesitate to contact our office. Contact information for the office can be found on the last page of this report along with the National Public Auditor and staff that made major contributions to this report.



Haser H. Hainrick

National Public Auditor

May 06, 2020

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12. ONPA CONTACT AND STAFF ACKNOWLEDGEMENT

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