



FEDERATED STATES OF MICRONESIA

Office of The National Public Auditor

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April 12, 2023

Honorable Eugene Amor
Secretary
Department of Finance & Administration
Federated States of Micronesia
Palikir, Pohnpei FM 96941

Greetings Secretary Amor:

In planning and performing our audit of the financial statements of the Renewable Energy Development Project (the Project), a Project funded by the Asian Development Bank and administered by the Department of Finance & Administration and implemented by the Department of Resources & Development of the FSM National Government, for the year ended September 30, 2022, which collectively comprise the Project's financial statements (on which we have issued our report dated April 12, 2023, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States, we considered the Project's internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Project's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Project's internal control over financial reporting.

Our consideration of internal control over financial reporting was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control over financial reporting. However, in connection with our audit, we identified, and included in the attached Appendix I, deficiencies related to the Project's internal control over financial reporting and other matters as of September 30, 2022, that we wish to bring to your attention.

We have also issued a separate report to the President of the FSM and the members of the 22nd Congress, also dated April 12, 2023 on our consideration of the Project's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreement and other matters that we consider to be a significant deficiency under standards established by the American Institute of Certified Public Accountants.

The definition of a deficiency is also set forth in the attached Appendix 1.

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

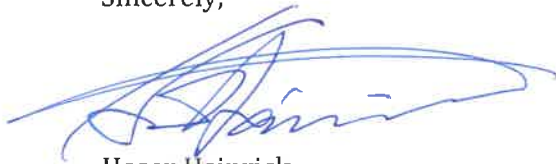
Although we have included management's written response to our comments in the attached Appendix 1, such responses have not been subjected to the auditing procedures applied in our audit of the financial statements and, accordingly, we do not express an opinion or provide any form of assurance on the appropriateness of the responses.

This report is intended solely for the information and use of the Project's management, the Office of the President, the Asian Development Bank and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. However, this report is also a matter of public record.

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

We wish to thank the staff and management of the Department of Finance & Administration and Department of Resources & Development of the FSM National Government for their cooperation and assistance during the course of the engagement.

Sincerely,



Haser Hainrick
National Public Auditor

cc: Secretary, Department of Resources & Development
Assistant Secretary, Division of Investment & International Finance
National Project Coordinator, REDP

We have identified a significant deficiency and other matters involving the Project’s internal control over financial reporting for the year ended September 30, 2022 that we wish to bring to your attention.

SIGNIFICANT DEFICIENCY**2022/01: Non-Maintenance of separate accounts and records for the Project**

Criteria: Section 4.02 of Article IV of the grant agreement dated 12/03/19 states that the recipient shall maintain separate accounts and records for the project.

Condition: Despite the efforts by DoRD and DoFA in recruiting a Project Finance and Administration Officer who is responsible for maintaining the project accounts, the following anomalies were noted:

- Separate accounts and records specifically for the project were not maintained such as reconciliations, trial balances, subsidiary ledgers and approved journal adjustments;
- Reliance on the Asian Development Bank Client Portal for Disbursements to prepare the financial statements for REDP.
- Fundware was not updated to reflect the transactions that have been processed and paid for the Project. As of 03/14/23, transactions posted in the Fundware amounted to \$16,610.67.

We acknowledge that the postings to Fundware is not performed by the Project; however the overall responsibility to ensure that Fundware is updated rests with the Project.

Effects: As a result of not maintaining separate accounts and records for the Projects:

- There were delays in the preparation and submission of draft financial statements for audit. The draft financial statements was submitted to ONPA on February 06, 2023 with an expected audit completion timeline of March 31, 2023.
- The draft financial statements were resubmitted on March 09, 2023, March 17, 2023 and March 27, 2023 to correct the errors and misstatements.
- Non-compliance to the requirements of the Project Administration Manual.

Root-Causes: Oversight function is not effective to ensure that:

- records are maintained and updated for the Project.
- adequate guidance (capacity building, awareness, procedural guidance drafted & approved) is provided to the Project Finance & Administration Officer.
- financial statements are thoroughly reviewed prior to submission for audit verification.

Recommendations: Oversight function to be strengthened by:

- Increased monitoring by the National Project Coordinator to ensure that records are maintained and updated for the Project.
- Adequate guidance such as capacity building, and/or approved procedural guidance provided to the Project Finance & Administration Officer on the day-to-day activities to be completed for the Project.

- Ensuring that financial statements are thoroughly reviewed, checking that all balances are properly supported and free from errors and misstatements, prior to submission for audit verification.

Management Responses: Unfortunately, the FY22 AT finding in this regard has shown that a number of key weaknesses continue to be present, despite the hiring of a full-time FAO, including a lack of effective oversight on FAO activities by the NC, to ensure that reconciliations, trial balances, subsidiary ledgers and approved journal adjustments were being maintained, and to thoroughly review and submit the annual FS in an efficient manner. We agree with your recommendations and expect to address this finding immediately through implementation of appropriate actions in order to effectively improve the PMU staffing and management practices. These shall include:

- Emphasis on improving and maintaining separate accounts on the REDP financials at DoRD, working with DoFA. In addition, we will also develop a monthly internal financial reporting mechanism to be monitored by the NC and the Assistant Secretary for Energy to ensure that separate records are maintained and updated, including adhering to a process for quarterly and annual review.
- Recruitment and hiring of one or more additional, qualified Finance and Accounting staff into the PMU that will be primarily responsible for maintaining a separate project ledger and to collaborate with DOFA to ensure that Fundware and fixed asset registry is updated for REDP.
- Pursue capacity building opportunities with ADB and relevant partners to support and improved financial reporting.

OTHER MATTERS

2022/02: Non-Compliance with Financial Covenants

Criteria: Section 9 of Schedule 4 of the grant agreement for Additional Financing Grant Agreement dated December 17, 2021 states that *“the recipient shall ensure that, for the purposes of the Initial Project and this Project, each Project Beneficiary achieves and maintains, from December 2021 and annually thereafter, an operating ratio not exceeding 1.0.”*

Condition: From our review of the operating ratio of the project beneficiaries for the year ended 31 December 2021, we noted that none of the project beneficiaries achieved the required ratio. Refer to the table below for details:

Project Beneficiaries	Operating Ratio Achieved
Pohnpei Utilities Corporation	1.053
Kosrae Utilities Corporation	1.029
Yap State Public Service Corporation	1.007

Effects: The above resulted in non-compliance to the financial covenants of the grant agreements.

Root-Cause: The grant agreement does not specify how the Department of Finance & Administration and Department of Resources and Development of the FSM National Government can assist the project beneficiaries in complying with the financial covenants as both Departments do not have any controls on the operations of the project beneficiaries.

Recommendations: We recommend that the financial covenant requirements of the grant agreement be reviewed to specify how the Departments (DOFA and DORD) of the FSM National Government can assist the project beneficiaries comply with the financial covenant requirements.

Management Responses: To address the identified root cause of this finding, as well as to follow the ONPA recommendations, we shall undertake the following actions to support the project beneficiaries to comply with this financial covenant:

- Revisit with ADB and the Project Steering Committee (PSC) the financial covenant requirements.
- Other actions as needed, including effective implementation of the REDP so that it delivers the intended outcomes, including a substantial reduction of fossil fuel use for both KUA and YSPSC, and a subsequent reduction in expenditures for fuel, currently the largest expense.

SECTION II – DEFINITION

APPENDIX I

Deficiency: A deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis.

A deficiency in design exists when:

- a) a control necessary to meet the control objective is missing or*
- b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.*

A deficiency in operation exists when:

- a) a properly designed control does not operate as designed, or*
- b) the person performing the control does not possess the necessary authority or competence to perform the control effectively.*

Material Weakness: A deficiency, or a combination of deficiencies, in internal controls, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Significant Deficiency: A deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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

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

Management's Responsibility

The Project's management is responsible for the overall accuracy of the financial statements and their conformity with accounting principles generally accepted in the United States of America. In this regard, management is also responsible for establishing and maintaining effective internal control over financial reporting.

Objectives of Internal Control over Financial Reporting

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel and designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction, of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Inherent Limitations of Internal Control over Financial Reporting

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