

**AUDIT OF ADB LOANS 2099-FSM (SF) AND 2100-FSM
OMNIBUS INFRASTRUCTURE DEVELOPMENT PROJECT**

SEPTEMBER 30, 2010

REPORT NO. 2011-04



**Haser H. Hainrick
National Public Auditor**



FEDERATED STATES OF MICRONESIA

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March 25, 2011

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

RE: Audit of Asian Development Bank (ADB) Loans 2099-FSM (SF) and 2100-FSM: Omnibus Infrastructure Development Project

We have audited the accompanying statement of project account of the Federated States of Micronesia Omnibus Infrastructure Development Project, Asian Development Bank (ADB) Loans 2099-FSM (SF) and 2100 FSM (the Project) as of and for the year ended September 30, 2010. This financial statement is the responsibility of the Project's management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit 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. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes consideration of 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 express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in note 2, this financial statement was prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, this financial statement presents fairly, in all material respects, the cash receipts and disbursements of the Project as of and for the year ended September 30, 2010, on the basis of accounting described in note 2.

In accordance with *Government Auditing Standards*, we have also issued our report dated March 25, 2010, on our consideration of the Project's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of

internal control over financial reporting and compliance and the results of that testing, and not to provide opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.



Haser Hainrick
National Public Auditor

Cc: Mr. Francis Itimai, Secretary, Department of Transportation, Communication &
Infrastructure (TC&I)

Rose Nakanaga, Acting Secretary, Department of Finance & Accounting (DFA)

FEDERATED STATES OF MICRONESIA
ASIAN DEVELOPMENT BANK LOANS 2099-FSM(SF) AND 2100 FSM
(Omnibus Infrastructure Development Project)
Statement of Project Account
Year Ended September 30, 2010

	2010				Cumulative			
	ADB Share Loan 2099	Loan 2100	FSM Share	Total	ADB Share Loan 2099	Loan 2100	FSM Share	Total
Cash Receipts								
Loan proceeds – Direct	\$ 647,231	\$ -	\$ -	\$ 647,231	\$ 974,188	\$ -	\$ -	\$ 974,188
Loan proceeds – Imprest Account	85,550	-	-	85,550	556,308	50,000		606,308
Contributions from FSM	-	-	45,249	45,249	-	-	45,249	45,249
Total Cash Receipts	732,781	-	45,249	778,030	1,530,496	50,000	45,249	1,625,745
Cash Disbursements								
Consultant services	739,900	2,271	45,249	787,420	1,291,752	2,271	45,249	1,339,272
Other operating costs	12,341	33	-	12,374	32,807	345	-	33,152
Total Cash Disbursements	752,241	2,304	45,249	799,794	1,324,559	2,616	45,249	1,372,424
Net Change in Cash	(19,460)	(2,304)	-	(21,764)	205,937	47,384	-	253,321
Cash at Beginning of Period	225,397	49,688	-	275,085	-	-	-	-
Cash at End of Period	\$ 205,937	\$ 47,384	\$ -	\$ 253,321	\$ 205,937	\$ 47,384	\$ -	\$ 253,321

See accompanying notes to financial statement

FEDERATED STATES OF MICRONESIA
ASIAN DEVELOPMENT BANK LOANS 2099-FSM(SF) AND 2100 FSM
(Omnibus Infrastructure Development Project)
Notes to Financial Statement
September 30, 2010

(1) Organization

The Omnibus Infrastructure Development Project was undertaken to enhance public health and environmental quality through improved water supply wastewater infrastructure, and power generation in the Federated States of Micronesia (FSM). The project was funded by two loans from the Asian Development Bank (ADB). The FSM National Government entered into loan agreements 2099 FSM (SF) and 2100 FSM (the Project) with the Asian Development Bank (ADB) in the amounts equivalent to Special Drawing Rights (SDR) 9,686,000 and \$4,800,000, respectively. The equivalent value of SDR 9,686,000 was approximately \$14,200,000 at the time the loans were executed on June 28, 2005. The accumulated drawn amount for these loans is \$1,580,496 as of September 30, 2010.

The FSM Department of Transportation, Communications, and Infrastructure (TC&I) serves as the Executing Agency and is responsible for carrying out the Project, including authorization of payments to be made from the Imprest Fund. The Imprest Fund is required to be operated and liquidated in accordance with ADB Regulations. There are six implementing agencies consisting of the public utilities corporations from each of the states of Pohnpei, Chuuk, and Kosrae, and jointly the Department of Public Works and Transport (DPWT) and the Gagil-Tomil Water Authority (GTWA) in Yap. The accompanying statement of project account is prepared for the year ended September 30, 2010, and solely incorporates the activities of the Project.

(2) Summary of Significant Accounting Policies

Basis of Accounting

Basis of accounting refers to when revenues and expenses are recognized in the accounts and reported in the financial statements. The Project uses the cash basis of accounting. Transactions are recognized as receipts or disbursements, and noncash transactions are not recognized. The cash basis differs from accounting principles generally accepted in the United States of America primarily because receipts (revenues) are recognized when received rather than when earned and disbursements (expenses) are recognized when paid rather than when the obligation is incurred.

As described above, this financial statement was prepared on the basis of cash receipts and disbursements, which is a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

FEDERATED STATES OF MICRONESIA
 ASIAN DEVELOPMENT BANK LOANS 2099-FSM(SF) AND 2100 FSM
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Cash

Custodial credit risk is the possibility that in the event of a bank failure the Project's deposits may not be returned to it. Such deposits are not covered by depository insurance and are either uncollateralized or collateralized with securities held by the pledging financial institution but not in the depositor's name. The Project does not have a deposit policy for custodial credit risk.

For the purpose of the statement of project account, cash is defined as cash in checking accounts. As of September 30, 2010, \$250,000 of cash maintained in one financial institution subject to Federal Deposit Insurance Corporation (FDIC) insurance is insured by FDIC. The remaining balance consists of uninsured cash on deposit.

(3) ADB Imprest Fund Account

A reconciliation of the ADB Imprest Account to cash as of September 30, 2010, is as follows:

ADB Loan 2099 FSM (FS) Imprest Account Balance	\$	264,800
ADB Loan 2100 FSM Imprest Account Balance		<u>50,000</u>
Total		314,800
LESS: Disallowed costs		5,256
Unreimbursed expenditures		79,282
ADD: Outstanding Checks		23,059
	\$	<u><u>253,321</u></u>

(4) FSM Contributions

Under the provisions of the loan agreement, FSM is required to provide counterpart funding for expenditures incurred under certain categories of the Project. During the year FSM made available \$45,249 in counterpart funding. The accumulated amount as of September 30, 2010 for the said counterpart funding is \$45,249. Additional in-kind assistance was provided in terms of an office for the Project Implementation Unit, staff assistance in both the National and State governments. A monetary value for this assistance has not been computed and is therefore not included in the accompanying statement of project account.

(5) Compliance with the Debt Covenants

Management is of the opinion that compliance with applicable debt covenants has occurred.



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March 25, 2010

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

RE: Audit of ADB Loans 2099-FSM (SF) and 2100-FSM: Omnibus Infrastructure Development Project

INDEPENDENT AUDITORS' REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

We have audited the financial statement of project account of Federated States of Micronesia Asian Development Bank Loans 2099-FSM (SF) and 2100 FSM (the Project) as of and for the year ended September 30, 2010, and have issued our report thereon dated March 25, 2010. We conducted our audit 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.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Project's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statement, 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 that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as described in the accompanying *Schedule of Findings and Responses*, we identified certain deficiencies in internal control over financial reporting that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A *deficiency in internal control* 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 material misstatements on a timely basis. A *material weakness* is a

deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the Project's financial statements will not be prevented, or detected and corrected on a timely basis. We consider the deficiencies described in the accompanying *Schedule of Findings and Responses* as item 2010-1 to be a material weakness.

A significant deficiency is a deficiency or 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. We consider the deficiencies described in the accompanying *Schedule of Findings and Responses* as items 2010-2 through 2010-4 to be significant deficiencies.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether the Project's financial statement is free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed one instance of noncompliance or other matters that are required to be reported under *Government Auditing Standards*, and which is described in the accompanying *Schedule of Findings and Responses* as item 2010-5.

This report is intended for the information and use of the management of The Project and of the Asian Development Bank and is not intended to be and should not be used by anyone other than these specified parties.



Haser Hainrick
National Public Auditor

Cc: Mr. Francis Itimai, Secretary, Department of Transportation, Communication & Infrastructure TC&I)
Rose Nakanaga, Acting Secretary, Department of Finance & Administration (DFA)

FEDERATED STATES OF MICRONESIA
ASIAN DEVELOPMENT BANK LOANS 2099-FSM(SF) AND 2100 FSM
(Omnibus Infrastructure Development Project)
Schedule of Findings and Responses
Year Ended September 30, 2010

MATERIAL DEFICIENCY

Finding No. 2010-01 – Segregation of Duties

Criteria: Proper separation of responsibilities ensures that the work of one individual acts as a check on the work of another in the performance of incompatible functions. Persons who handle cash or other forms of payment, such as signed checks, should have no incompatible duties with respect to the recording of payables or reconciliation of cash.

Condition: Segregation of duties is lacking over the control of cash disbursements. Presently, checks issued by the Department of Finance & Administration (DFA) in payment of project expenditures are returned to the Project Accountant. This individual also prepares payment requests, maintains vendor and invoice files, records all project transactions, and reconciles cash.

Cause: The checks are returned to the Project Accountant, usually to enable that individual to present the check to the bank and facilitate the wire transfer of funds to the payee.

Effect: Failure to maintain adequate segregation of duties over payments could result in misappropriation of assets or errors that go undetected or are not timely detected.

Recommendation: To reduce the risk of error and ensure adequate custody and control over disbursements, require DFA distribute checks in payment of project expenditures directly to payees. Ordinarily, the close supervision of management helps compensate for the lack of proper segregation of duties. However, at a minimum, require that checks not be returned to project personnel for handling. Additionally, where economical, the preference should be for DFA to facilitate payments via wire transfer.

We understand that, sometime during the beginning of the fiscal year, an individual in DFA began performing reconciliations of the Project's bank accounts. Project disbursements typically processed by DFA contain payment data that is available for reconciliation purposes. However, project transactions also include ADB direct payment of expenditures and deposits from ADB replenishment of imprest funds, information about which can be obtained by persons not directly involved in accounting for the project only from the bank statements. Bank statements and information concerning most reconciling items is obtained from the project accountant. Accordingly, these "after-the-fact" reconciliations performed by DFA may not provide the desired level of independent verification, and we believe there is a more than remote likelihood that a material misstatement of the financial statement will not be prevented or detected.

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Auditee response and corrective action plan: Our (DTC&I) opinion is that we should be responsible as Project Executing Agency/Project Manager in delivering payments/checks instead of DFA to ensure that contractors/consultants and suppliers are paid on time as there is interest charge for late payments after 30 days. In addition, we need to record exact payment amount from the check and the date the payment is deposited or wired to the payee's account.

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SIGNIFICANT DEFICIENCY

Finding No. 2010-02 – Manual Checks

Criteria: Manual checks are more prone to error and have a greater risk of check fraud.

Condition: Manual checks are used for project disbursements instead of the MICR encoded checks routinely used for most payments processed through DFA. The project checks are prepared using a typewriter. MICR encoding consists of blank stock containing no bank or account information. All data, including check number, amount, bank account and routing numbers, bank and company names and addresses, etc., are imprinted on the blank stock when checks are printed.

Cause: We understand DFA elected to utilize manual checks because it was easier and the project was not expected to last very long. However, using already existing and available MICR check stock would have been less expensive than ordering new checks and would only have required a minimum of effort to set up and configure in the accounting system.

Effect: The use of MICR checks increases the information and resources required to commit check fraud. MICR check stock also typically includes security features which make it difficult to reproduce. Accordingly, MICR check printing reduces the likelihood that funds may be misappropriated. Additionally, preparing typewriter produced manual checks interrupts normal business routines and as such may require more time and effort. Utilizing computer generated checks, whether or not MICR encoded, may result in greater scrutiny and control over transactions and thus a reduced risk of error.

Recommendation: To ensure proper control over disbursements and reduce the likelihood of fraud and misappropriation of assets, consider scrapping the manual checks and utilizing the same MICR encoded printing of checks that is the standard for check payments in DFA.

Auditee response and corrective action plan: DTC&I will work with DFA to eliminate manual checks as recommended to use MICR checks.

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Finding No. 2010-03 – Certificates of Insurance

Criteria: Section 7 (General Conditions of Contract) of the ADB Procurement of Works-Small Contracts user's guide, Standard Bidding Document requires the Contractor to maintain risk and liability insurance coverage in amounts established by each contract, and to provide policies and certificates for insurance to the Project Manager before the start date of the contract. The ADB Procurement of Works Contracts users' guide is one model used by the Project in developing contract terms.

Condition: Current certificates of insurance are not maintained on file by the Project for consulting and engineering contracts. As stipulated in each contract, specific levels of insurance coverage are required depending on the nature of the work to be performed. However, absent some form of evidence, as in the case of a certificate of insurance, there is no assurance adequate and continued insurance coverage is being maintained by contracting parties.

Cause: The current contracts only state the requirement for consultants and engineers to carry insurance at their own expense, and do not request submission of certificates of insurance.

Effect: A certificate of insurance is a document that evidences for one party the insurance coverage held by another party. It evidences the coverage in place at the time of issuance of the certificate. Without evidence of insurance coverage, there is no assurance that contracting parties have maintained the level of coverage they indicated they had when the contract was executed. If insurance coverage lapses, or is not maintained at adequate levels third parties may seek to recover losses from the Project in the event of damage and destruction to property or injury or loss of life. In any event, should third parties not prevail, legal costs may still be incurred and considerable time and effort expended in defending possible claims or litigation.

Recommendation:

To reduce the likelihood of losses from third party claimants, ensure that current certificates of insurance are maintained for contracts. Certificates should reflect that insurance is written on a per occurrence basis and include special instructions which stipulate that:

- The Project is named as an additional insured.

FEDERATED STATES OF MICRONESIA
ASIAN DEVELOPMENT BANK LOANS 2099-FSM(SF) AND 2100 FSM
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Schedule of Findings and Responses
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- Provide a minimum of 30 days written notice of cancellation or non-renewal of policies.

Auditee response and corrective action plan: This is an oversight on our part to secure insurance certificates from our contractors and consultants although they are required to carry insurance coverage under their contracts. We will inform them to submit the certificates.

FEDERATED STATES OF MICRONESIA
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Finding No. 2010-04 – Interest income not earned

Criteria: Idle cash represents an unused resource. While it is important to ensure sufficient cash is available to meet obligations, effective cash management and planning ensures that idle cash is appropriately invested to maximize the return to the organization. Funds that do not earn a return represent a loss of potential income.

Condition: Idle cash is not properly managed. Since its inception, the project has maintained its funds in a non-interest bearing checking account with the Bank of Guam. It also has incurred bank service charges in connection therewith. At the time the bank account was established by DFA the bank offered, and still does offer, an interest bearing checking account.

Cause: DFA initially established the checking account at the beginning of the project. The Project Accountant represents that a request was made to utilize an interest bearing checking account. The account was opened as non-interest bearing by DFA.

Effect: During the past few years, the project has not only failed to take advantage of interest that could be earned on idle funds, but has also incurred bank charges in connection with the non-interest bearing checking accounts they presently maintain. The loan agreements permit the earning of interest on imprest funds held on deposit and further permit the project to use any interest earned for project expenditures. Notwithstanding interest rates have been very low, considering imprest fund balances have typically been in the \$250,000 to \$300,000 range, the Project could likely have earned \$10,000 or more in interest over the past three years.

Recommendation: Consider opening and transferring balances into an interest bearing account. The Bank of Guam currently offers a business premium checking account which earns interest. In addition, the bank offers statement savings accounts that, while limiting the number of monthly withdrawals, earn a higher rate of interest and may be a suitable investment for project funds given the level of project activity.

Auditee response and corrective action plan: DTC&I will work with DFA to transfer remaining funds balance into an interest bearing bank account.

FEDERATED STATES OF MICRONESIA
OMNIBUS INFRASTRUCTURE DEVELOPMENT PROJECT
ADB LOANS 2099-FSM (SF) AND 2100-FSM
Schedule of Findings and Responses
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COMPLIANCE

Finding No. 2010-05 – Progress Reports

Criteria: Section 11 of the ADB Project Administration Manual (PAM) provides for detailed progress reports to be prepared on a quarterly basis. The PAM further requires the progress reports to be submitted to ADB within 30 days after the end of the period covered by each report.

Condition: A review of compliance with the loan covenants revealed that only two progress reports had been prepared during the year. The two reports covered a period of two quarters each. However, these reports, dated March 31 and December 30, 2010, were not timely prepared.

Cause: The number of project personnel is limited and they have other responsibilities within the office and functions of the Executing Agency. These other responsibilities compete for time and effort with project requirements.

Effect: Failure to conform to the requirements established by ADB could result in violation of the loan covenants and cancellation of the loan agreement.

Recommendation: Reemphasize to project personnel the significance of progress reports and the importance of complying with the loan covenants and other ADB requirements.

Auditee response and corrective action plan: We will put more efforts and improve on the reporting requirements to comply with the loan covenants although we are understaffed as reported above.

FEDERATED STATES OF MICRONESIA
OMNIBUS INFRASTRUCTURE DEVELOPMENT PROJECT
ADB LOANS 2099-FSM (SF) AND 2100-FSM
Schedule of Findings and Responses
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Report No. 2011-04

ONPA CONTACT AND STAFF ACKNOWLEDGEMENTS

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Keller Phillip, Auditor-In-Charge
Lover Haimin, Staff Auditor

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