

**AUDIT OF ADB GRANT ASSISTANCE  
WENO WATER SUPPLY WELL REMEDIATION PROJECT  
SEPTEMBER 30, 2010  
REPORT NO. 2011-03**



**Haser H. Hainrick  
National Public Auditor**



# FEDERATED STATES OF MICRONESIA

## Office of The National Public Auditor

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March 25, 2011

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

### **RE: Audit of the ADB Grant Assistance FSM: Weno Water Supply Well Remediation Project**

We have audited the accompanying statement of project account of the Federated States of Micronesia Weno Water Supply Well Remediation Project, Asian Development Bank (ADB) Grant Assistance financed by Japan Fund for Poverty Reduction (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

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)

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 Statement of Project Account  
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	<u>2010</u>	<u>Cumulative</u>
Cash Receipts		
Grant proceeds	\$ <u>60,500</u>	\$ <u>150,372</u>
Cash Disbursements		
Consultant services	63,820	120,424
Bank charges	271	292
Other operating cost	<u>9,724</u>	<u>9,724</u>
Total Cash Disbursements	73,815	130,440
Net Change in Cash	(13,315)	19,932
Cash at Beginning of Period	<u>33,247</u>	<u>0</u>
Cash at End of Period	<u>\$ 19,932</u>	<u>\$ 19,932</u>

See accompanying notes to this financial statement

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(1) Organization

Grant assistance to provide safe and secure water supply to the residents of Weno island in Chuuk state was provided to the Federated States of Micronesia (FSM) by the Japan Fund for Poverty Reduction (JFPR). Through an agreement with the government of Japan, the Asian Development Bank (ADB) is administering the grant, which was approved by ADB for funding of up to \$980,000 on July 17, 2008. The accumulated drawn amount for this grant is \$150,372 as of September 30, 2010.

The provisions of the grant require the establishment and maintenance of an imprest account. 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. The Chuuk Public Utilities Corporation (CPUC) is the Implementing Agency. 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.

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

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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, \$19,932 of cash is maintained in one financial institution subject to Federal Deposit Insurance Corporation (FDIC) insurance and which is fully FDIC insured.

(3) JFPR Project Imprest Fund Account

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

JFPR Imprest Account Balance	\$	89,875
Disallowed costs		295
Unreimbursed expenditures		69,648
Outstanding Checks		<u>-</u>
TOTAL	\$	19,932

(4) Compliance with the Grant Covenants

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

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March 25, 2010

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

### **RE: Audit of the ADB Grant Assistance FSM: Weno Water Supply Well Remediation 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 Weno Water Supply Well Remediation Project, Asian Development Bank (ADB) Grant Assistance financed by Japan Fund for Poverty Reduction (JFPR) (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 statements, 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 items 2010-1 and 2010-2 to be material weaknesses.

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 2010-3 through 2010-05 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 2010-6.

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, Communications & Infrastructure

Rose Nakanaga, Acting Secretary, Dept. of Finance & Administration



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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: We understand the checks are returned to the Project Accountant, usually to enable that individual to present the check to the bank and facilitate the wire 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

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more than remote likelihood that a material misstatement of the financial statement will not be prevented or detected.

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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Finding No. 2010-02 –Reconciliations Monitoring

Criteria: Provisions of the grant require the maintenance of an imprest account to facilitate day to day expenditures and to be managed, replenished, and liquidated in conformity with ADB policies and procedures. Periodic reconciliations of accounts ensure the completeness and accuracy of accumulated data.

Condition: Monitoring of reconciliations is not consistently performed. Our review of reconciliations of the imprest account revealed the following:

- A copy of the year end September 30, 2010 reconciliation was not available for our review at the start of our audit in February 2011, and we were advised that transactions were still being updated for the imprest account.
- Reconciliations are not timely performed, with reconciliations indicating preparation and review as much as 4 months or more after the bank statement date.
- Reconciling items are not cleared on a timely basis, with some items remaining outstanding for periods in excess of one year.

Cause: Presently, completed reconciliations are hand carried by the preparer, the project accountant, to an official in DFA who signs and dates the reconciliation to evidence their review and approval. However, this only occurs when the reconciliation is delivered to the reviewer. If no monthly reconciliation is prepared there is no review. If reconciliations are prepared late, then the review is performed late. Moreover, there is no evidence to suggest that inquiries had been made about why the reconciliations were not received or were received late, or that questions had ever been raised about any of the items appearing in the reconciliations.

Effect: Failure to reconcile accounts on a timely and consistent basis could result in errors leading to the misstatement of financial information, misappropriation of assets, and non-compliance with grant covenants. Misstatement of financial information and failure to comply with grant covenants could lead to cancellation of grant assistance. Since the imprest fund reconciliation also serves to reconcile cash on deposit at the bank, errors that go undetected or are not detected for a considerable period of time may result in losses. Banks require notification of errors within a reasonable time, without which the bank may not be held liable.

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Accordingly, if monitoring procedures are not adequately performed, there is no mechanism to ensure reconciliations are properly and timely prepared. Since ADB only receives copies of reconciliations when requests for replenishment of imprest funds are made, which are infrequent, the failure to properly reconcile imprest balances may go undetected for some time.

Recommendation: Reemphasize to employees the importance of timely preparing reconciliations and the significance of monitoring that performance. To ensure appropriate monitoring and supervisory review require:

- The project accountant initial and date the reconciliation upon completion. Notwithstanding that presently only one person prepares reconciliations, providing evidence of the performance of control procedures fixes responsibility for their performance and is the basis for review of those procedures. Dating the reconciliation would be useful in documenting its timely preparation.
- The Project Manager review and approve all imprest reconciliations. Project Management is best suited to perform this function due to its familiarity with project transactions and their day to day supervision in all other matters of project activity. This review should likewise be documented by signing or initialing and dating the reconciliation or other document(s) associated with this control activity. This should not preclude DFA from continuing to perform, if they so wish, their current, albeit inconsistent, monitoring procedures.
- Establishment of target dates or timetables for the completion and availability for review of reconciliations.

Auditee response and corrective action plan: We will reconcile the imprest account more frequently as recommended and the Project Manager to review and approve all reconciliations.

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SIGNIFICANT DEFICIENCY

Finding No. 2010-03 – Manual Checks

Criteria: Checks that are more secure should be used to disburse project funds.

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.

During our review we noted checks were issued out of sequence. Additionally, from the listing we obtained from DFA of the sequence of twenty 2010 check numbers, checks for four of the numbers were missing. These do not appear to have been issued, but have not been voided, either in the accounting system or otherwise. The missing checks could not be located.

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

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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. 2010-04 – 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 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.

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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.



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Finding No. 2010-05 – 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, but no action was taken. 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 account they presently maintain. The grant agreement permits the earning of interest on imprest funds held on deposit and further permits the project to use any interest earned for project expenditures. Notwithstanding interest rates have been very low, at a minimum, this would either enable the project to avoid bank charges or earn enough interest to offset any bank fees it might incur.

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, which 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.

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COMPLIANCE

Finding No. 2010-06 – Progress Reports

Criteria: Paragraph 14 (b) of the Grant Agreement Letter requires that quarterly progress reports and annual reports on the carrying out of the project be furnished to ADB.

Condition: The Project failed to submit required quarterly and annual progress reports in compliance with provisions of the grant.

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 grant covenants and other ADB requirements.

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

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<u>Finding</u>	<u>Finding Status</u>
2009-1	Resolved

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**ONPA CONTACT AND STAFF ACKNOWLEDGEMENTS**

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**ONPA CONTACT:** Haser H. Hainrick, National Public Auditor  
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Patrick J. Zacchini, CPA, Audit Supervisor  
Keller Phillip, Auditor-In-Charge  
Lover Haimin, Staff Auditor

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