

STATE OF KOSRAE
FEDERATED STATES OF MICRONESIA

AUDITORS' REPORT ON
INTERNAL ACCOUNTING CONTROL

SEPTEMBER 30, 1987

AUDITORS' REPORT ON INTERNAL
ACCOUNTING CONTROL

Honorable Yosiwo George
Governor, State of Kosrae
Federated States of Micronesia:

We have completed our examination of the financial statements of the Kosrae State Government as of September 30, 1987, and for the year then ended, and have issued our report thereon dated July 12, 1988. As part of our examination, we made a study and evaluation of the State's system of internal accounting control to the extent we considered necessary to evaluate the systems as required by generally accepted auditing standards and the standards for financial and compliance audits contained in the U. S. General Accounting Office's Standards for Audit of Governmental Organizations, Programs, Activities and Functions and as in the provisions of OMB Circular A-102 issued pursuant to the Single Audit Act of 1984, P.L. 98-502. For the purpose of this report, we have classified the significant internal accounting controls in the categories of: budgetary and appropriation cycles, revenues and receipt cycles, purchases and disbursement cycles, payroll and personnel cycles, treasury cycles, and external financial reporting. Our study included all of the listed control categories. The purpose of our study and evaluation was to determine the nature, timing and extent of the auditing procedures necessary for expressing an opinion on the financial statements administered by the Kosrae State Government. Our study and evaluation was more limited than would be necessary to express an opinion on the system of internal accounting control taken as a whole.

The management of the State is responsible for establishing and maintaining a system of internal accounting control. In fulfilling that responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of control procedures. The objectives of a system are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with statutory authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles.

Because of inherent limitations in any system of internal accounting control, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the system to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the degree of compliance with the procedures may deteriorate.

Our study and evaluation made for the limited purpose described in the first paragraph should not necessarily disclose all material weaknesses in the system. Accordingly, we do not express an opinion on the system of internal

accounting control of the State of Kosrae taken as a whole or on any of the categories of controls identified in the first paragraph. However, our study and evaluation disclosed the conditions stated in the following pages that we believe result in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the financial statements of the State of Kosrae, may occur and not be detected within a timely period.

These conditions were considered in determining the nature, timing, and extent of the audit tests to be applied in our examination of the 1987 financial statements, and this report does not affect our report on the financial statements dated July 12, 1988.

This report is intended solely for the use of the Kosrae State Government, and the cognizant audit and other federal agencies and should not be used for any other purposes.

July 12, 1988



Certified Public Accountants

General Matters

General Ledger Reconciliations

1. As a basis for control over State assets, periodic and consistent general ledger reconciliation is essential. We believe that Kosrae State Finance personnel have a basic understanding of general ledger control and required reconciliations; however, we found numerous instances where it was obvious that the general ledger was neither reviewed nor reconciled. A brief outline of some of the unreconciled accounts follows:

Accounts Payable - The subledger detail of vendor invoice payables could not be agreed to the general ledger control account. Additionally, we found one fund with a debit balance in the accounts payable account.

Accounts Receivable - The receivables balances in the reimburseable grant funds remained at the same balance as prior year. All collection activity was posted as current year revenues.

Stock Inventory - No adjusting entries were made to update the inventory account to the September 30, 1987 balance.

Fixed Assets - Apparently, Kosrae State has abandoned their efforts to maintain general ledger accountability over fixed assets. The balances were not updated nor adjusted for fiscal year 1987 activity.

Revenues - We found that all Compact funds had been recorded as general fund revenues. Had even a cursory review of the special revenue funds been performed, the error would have been found.

Reserve for Encumbrances - We found incomplete reconciliations of encumbering documents to the encumbrance subledger. Our encumbrance testing revealed missing documents, incomplete liquidation information on partially liquidated encumbrances, and pre-fiscal year 1986 encumbrances which remain on the encumbrance subledger.

Recommendation

We suggest that the State Finance Office develop a checklist for required reviews and reconciliations and designate the employee responsible for the review and target dates. Further, it will be absolutely necessary for the director of finance to personally review the checklist, the balance sheet, and the revenue and expense reports and ensure that reconciliations are prepared as required.

Filing

2. As noted in our prior year report, Kosrae State Finance continues to experience problems with organizing and maintaining its document filing system. We were unable to locate numerous cash receipts, payroll allotment forms, contracts, and other encumbering documents. While filing is a mundane task, it is essential to an organized office and the ability to reconcile general ledger accounts.

Recommendation

We recommend that management review current policies for document retention and emphasize to accounting personnel the need for accurate and timely filing of accounting documents.

Budget and Appropriation Cycle

3. Based on our analysis of the State's estimated revenues and appropriated expenditure budgets, we found that the expenditure budgets exceeded estimated revenues. While this practice is not prohibited, State Law 2-131, Section 3, paragraph 3(c) requires that "recommendations as to how the deficiency is to be met" should be included in the annual appropriation bill. We were not able to find any evidence of the required recommendation in the appropriation laws.

Recommendation:

We suggest that the Governor and the Legislature seriously review the revenue estimates provided by the Budget office prior to appropriating in excess of the revenue estimates. During fiscal year 1987, local State revenue collections fell short of local revenue estimates by \$1,289,512 or 63% of the original estimate, causing even greater deficiencies than planned. Secondly, we recommend that if appropriations are made in excess of the revenue estimates, recommendations be included in the appropriation law specifying how the deficiency is to be met as required by State law. Finally, we recommend that Finance include revenue estimates as "revenue budgets" in the Dilog automated accounting system so that actual revenue collections can be tracked against estimates.

Treasury Cycle

4. It appears that a significant amount of time lapses between the authorization of bank transfers from the general fund checking account to the payroll account and the time when the transfer is actually recorded in the State's general ledger. The payroll account frequently is overdrawn and late or non-existent reconciliation of the payroll account contributes to this problem.

We also noted, as in prior years, infrequent (weekly) deposits. Prior to the State of Kosrae having an actual banking institution, the Finance office held large sums of cash and acted in some ways as a bank. Perhaps because of this previous situation, Finance personnel are unconcerned

with undeposited money. However, the State now collects more cash for various local taxes and services and should not allow these funds to remain idle, undeposited, and non-interest earning.

Recommendation

We recommend that tight cash control procedures be established by Finance. Daily cash deposits should be made and all receipts, disbursements, and transfers should be recorded in a timely manner.

Purchases and Disbursement Cycles

5. We would like to commend the Director of Finance for his policy designed to control unauthorized purchases by requiring fund certification of obligating documents prior to departmental purchases. However, we believe that tighter controls should be placed on the Kosrae State Government purchasing cycle. As noted in our prior year's report, Kosrae State lacks comprehensive procurement procedures. There is no policy concerning related party transactions where program managers or department heads purchase from close relatives, and in the absence of any local open bidding requirements, the potential for misuse of public funds is great. Further, in the case of federal grant funds, we found that bidding procedures were not consistently applied, as required by Circular A-102 resulting in numerous questioned costs.

Recommendation

We recommend that Kosrae State consider implementing State procurement regulations, which include related party transactions and bidding requirements. We also recommend that all department heads become fully cognizant of the purchasing and bidding regulations outlined in Attachment O of OMB Circular A-102.

6. In addition to a lack of procurement procedures, we found instances of lack of adherence to established procedures as follows:
 - . No evidence of Finance's approval of payment vouchers. Our tests of certain key items (disbursements over \$12,000) revealed several payment vouchers for which there was no indication of approval by Finance personnel. Lack of an independent review of payment vouchers is a clear violation of good internal control procedures.
 - . No evidence of reconciliation of prepaid purchase orders to the goods received. Hospital purchases of pharmaceutical supplies were prepaid and we were not able to find any evidence that the goods received were reconciled to the payments made.
 - . Lack of proper documentation supporting travel vouchers. All the travel vouchers tested had inadequate supporting documentation.

Recommendation

Finance has established procedures for payment voucher processing including required documentation, approval process, and reconciliation to receiving reports. While the procedures are followed in most cases, exceptions should not be made, and accounting supervisors should ensure that the established procedures are consistently followed. We recommend that the Director of Finance also periodically review selected transactions to ensure adherence to established policy.

Revenue and Receivables Cycle

7. As mentioned previously, total Compact revenues were recorded in the general fund and not divided among the operations, CIP, and special revenue funds as required under the provisions of the Compact. It appears that this error was due not to a misunderstanding of fund restrictions, but to a lack of general ledger review and reconciliation. Certain funds are restricted and Kosrae Finance must properly classify the revenues and associated expenditures each year in order to comply with the agreed upon terms and conditions of the Compact. Additionally, we found that none of the investment income related to the Compact investment had been recorded, thus misstating revenues and investment assets.

Recommendation

The Director of Finance should assign reconciliation responsibility to a Finance employee. Quarterly reconciliations should be performed reconciling the general ledger balance to Compact apportionment schedules and the FSM Investment Division investment income reports.

8. Several of the State's special revenue and CIP funds operate on an earned reimbursement basis. Specifically, CFMS State projects and federal grants funds are reimbursed only as local State funds are advanced to fund expenditures. For the last several years, audit adjustments have been posted to accrue revenues and record receivables for these funds. Kosrae Finance apparently does not understand the composition of these receivable balances, as all receipts are recorded during the year as revenues and the balances are never adjusted. Of even greater concern, receivables at September 30, 1987, for these funds approximated \$1,214,416. As these are reimburseable funds, State cash assets are being held by other governments without earning interest.

Recommendation

Kosrae State Finance should concentrate on establishing a receivable recognition and billing cycle. Reimbursements for federal assistance grants and CFMS capital projects should be billed monthly in order to make best use of State monies.

Prior Year Unresolved Findings and Recommendations

The following findings and recommendations from prior year reports on internal controls have yet to be successfully resolved. These findings and recommendations are summarized below:

Report on Internal Controls, September 30, 1986, report dated March 13, 1987:

<u>Finding No.</u>	<u>Heading</u>	<u>Page No.</u>
II-1-3	Cash	3
II-1-C	Capital Assets	4
II-3-C	Procurement and Payables	8
II-3-E	Revenues and Receivables	9
III-2	CFSM Project Receivables	11
III-3	General Administrative Environment	12

Report on Internal Controls, September 30, 1985, report dated January 4, 1986:

6	Procurement Policies	5
---	----------------------	---

Report on Internal Controls, September 30, 1984, report dated April 5, 1985:

2	Procurement Policies	5
6	General Fixed Assets	8